

# Hedge accounting in currency management under IFRS 9

## New opportunities or is it merely old wine in new wineskins?

Corporate Treasury

Currently, one of the hot topics in Treasury and Accounting is the accounting standard IFRS 9, generally applicable since the beginning of 2018. For industrial entities, the primary IFRS 9 focus is on Phase 1 “Classification and measurement” and Phase 2 “Impairment”. Because the standard does not yet contain any prescriptions on the accounting of macro hedges, Phase 3 “Hedge accounting” in accordance with IFRS 9.7.2.21 has not yet become mandatory.

Instead, the standard foresees a transitional rule, which says that entities may continue to apply IAS 39 to account for hedges upon using IFRS 9 for the first time for hedge accounting. Despite this, many entities have decided to implement the full standard during IFRS 9 projects, i.e. including hedge accounting. In practice, the new hedge accounting for FX gives rise to the question whether the new IFRS offers any new opportunities or whether everything remains as is.

For entities deciding to keep their hedge accounting in accordance with IAS 39, everything remains the same. Having said this, it should be noted that it is currently not yet foreseeable when the transitional rule on hedge accounting will end and changes will become necessary. However, as a rule, if you are applying IFRS 9 to your hedge accounting, you have to apply the entire standard. It is not possible to undertake a part of hedge accounting in accordance with IFRS 9 and another part in accordance IAS 39. This means that an entity has to decide to apply either the new standard or the transitional rule, i.e. IAS 39.

Once hedge accounting is performed under the new standard, several changes will occur. Among other things, these include the following:

- A better integration of the hedge accounting into the company’s risk management strategy,
- Elimination of the fixed effectiveness thresholds,
- Elimination of voluntary de-designation,
- New requirements applicable to the measurement of the prospective hedge effectiveness,
- New requirements applicable to the calculation of the ineffective amount.

Special attention is also paid to the new accounting treatment of forward points and currency basis spreads, as well as the designation of aggregated net positions as underlying transaction.

Due to the mandatory consideration of currency basis spreads and the specific rules for the forward component, the effectiveness of the hedge is measured more accurately (cost-by-cause principle) and presented in a more differentiated way Pursuant to IFRS 9, an entity has the possibility to separate the forward and spot components of a forward transaction, and to designate as hedging instrument only the changes in the value of the spot component. As an alternative, it is also possible to separate the currency basis spreads of a financial instrument and to exclude this financial instrument from the designation as hedging instrument. The separation is expected to increase the effectiveness of the hedging relationship. In case of a separation, two OCI's would be posted for the cash-flow hedges. OCI 1 "hedge reserve" is based on the designated part of the hedge transaction, while OCI 2 "cost of hedging" represents the change of the non-designated part. When the underlying transaction takes place, both OCI's are reclassified. For this, the moment in time depends on whether the underlying transaction refers to a period or a moment in time. The challenge for this new possibility to represent the different components lies in the correct separation and recognition of the components, as well as the correct allocation of the credit risk adjustments to these components.

The designation of the aggregated net positions for forex risks, such as the netting of foreign-currency cash flows of planned receivables and liabilities was not possible under the IAS 39 regime. With IFRS 9, you now have the possibility to designate this risk directly. The advantage of designating a net position is that the representation of hedges in the balance sheet is truer to the entity's actual risk management, which is often managed using net positions. In practice, it seems however that this possibility is hardly ever used as the procedure is very time-consuming. Under IFRS 9, the designation of a net position pursuant to IFRS 9 requires increased documentation efforts and complex booking logic, which is why entities often refrain from using that option. Such entities therefore stick to a pure designation of the gross position, just as has been the case up to now.

On the whole, the changes in IFRS 9 show that the possibilities for representing FX hedges in the balance sheet have been expanded and that, indeed, not everything remains the same. In practice, however, it becomes evident that, with the exception of the mandatory changes, such as the separation of hedging reserve from cost of hedging, entities stick with the procedure they know and that few make use of the new opportunities offered by IFRS 9. As a rule, however, we recommend doing a cost/benefit analysis just like for IAS 39 to determine whether it makes sense to use the options offered by IFRS 9 in regard to recognizing hedges in the balance sheet, because while some rules are challenging to implement they could also have a positive effect. Furthermore, it is important to create the technical prerequisites to keep efforts required for the application to a minimum in order to get the most out of it. For this, it is indispensable to equip the treasury management system with suitable access to market data, creating an even closer (automated) integration between treasury, accounting and the overall risk management strategy.

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# Are FinTechs really as important as they are made out to be?

Corporate Treasury

Everything is being digitalized. Everything is becoming faster, better, cheaper. FinTechs are conquering the (financial) world. Right now. In this very moment. But what is the hype all about?

You are bound to get this impression if you follow the news put out by the trade press, associations, Twitter or any other form of analog or digital media. Not infrequently, treasurers express their unease that they are not yet working with the hottest FinTechs, like apparently numerous colleagues are already doing. That's a bit like "everyone in my class has an iPad, except me".

But let's face it, first of all: not every software company offering treasury solutions is a FinTech. Without going too deeply into the definition of financial technology (FinTech for short), this is a [collective term for technologically advanced financial innovations that create new financial instruments, financial services or financial intermediaries](#). Let's parse this definition a bit further and look at the industry FinTechs are being used for (e.g. banks, insurance companies), the scope of application (e.g. payments, investments, hedging) and the customer segment (e.g. retail banks, corporate banks) and you will find the kind of interaction the FinTechs strive for (B2B, B2C, C2C) and their positioning (e.g. as a bank or a non-bank).

The FinTechs' behavior differs from that of established financial service providers, in particular regarding:

- Speed & efficiency: FinTechs use a whole battery of technologies (e.g. real-time updates, mobile connectivity) to improve and speed up the access to financial services (and products)
- New business models: FinTechs are quick in taking up market conditions and developing new business models based on them. For instance, since the publication of the Payment Services Directive II (PSD II), a couple of FinTechs have developed innovative services in the payment environment.
- Agility: FinTechs are not encumbered with legacy IT and/or high administrative costs and can therefore offer services cheaper than traditional financial service providers.
- Transparency: Contrary to many financial service providers, FinTechs put their bets on transparency when it comes to services (e.g. the pricing of options).

## FinTech Monopoly ...

FinTechs are also subject to the winner-takes-it-all mentality, just like other participants in the internet economy. How else would you explain that just about USD 100bn have been invested in FinTechs since 2010, with about USD 72bn alone in the USA since 2015?

In Germany alone, there are about 300 active FinTechs. If you [list](#) them all according to area of activity, it becomes clear that not all will be able to survive. And this is not even counting the global player

competition from the USA and China, where the maxim of elbowing your way to the top is much more widespread. Want to hear an example? How many currencies is your company currently dealing with? Are you really ready to add another 100 crypto currencies to this list?

Trust in the financial sector is a valuable commodity that develops slowly until it reaches a level acceptable to customers. This is why it is so difficult for FinTechs to enter into areas where trust is of the essence in particular for companies. This is especially true if the area where the FinTechs are active is not yet subject to financial market regulations. In addition, direct access to end customers translates into high margins because no other party chips away at them. Both, private and corporate customers are usually very loyal to their financial service providers. Even if the introduction of the PSD II has shaken up the industry a bit, most FinTechs should heed the advice of Mike Sigal who said, "Incumbents that don't seek to partner will die." This also has ramifications for corporations who should carefully consider with which financial service providers and FinTechs they should team up.

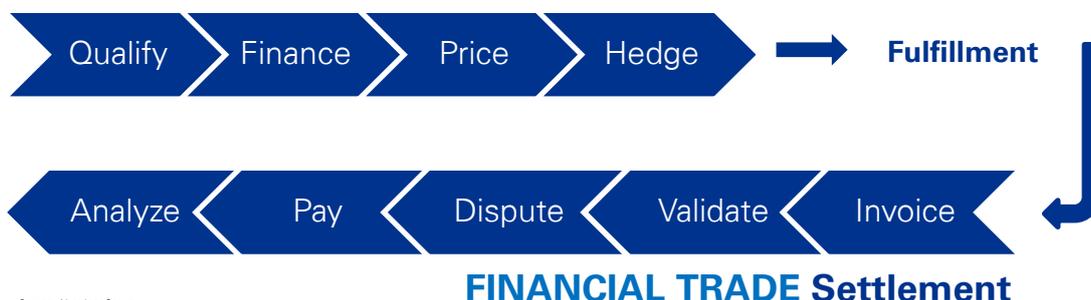
### So where is the music playing?

Let's try to bring some light into the dark!

For all of the hype around digitalization or FinTechs, the basic rule still applies: the income generated by an investment should be higher than the investment itself after having taken into consideration all of the risk factors.

Having said this, it becomes interesting to look at the financial supply chain a bit closer in order to answer the question of where I can generate added value at which process step from the trade enablement (i.e. with whom would I like to deal under what circumstances) to the financing to payment operations by using the services of a FinTech? Where can we accelerate the throughput speed, lower process costs, eliminate the middle men with their fees or boosting transparency, thus improving competition, through process automation?

## FINANCIAL TRADE ENABLEMENT



Source: AberdeenGroup

Each of the steps in the financial supply chain or sub-area of the technical backbone can then be assigned to corresponding FinTechs, whose use will generate a positive return.

In consideration of the statement made above, i.e. that many FinTechs will disappear as fast as they appeared in the market, their integration into systems and processes is of special significance. The cost and the future impacts on other processes and systems are especially relevant if one has to expect that whatever was implemented may have to be removed again or developed further – either because the FinTech has disappeared, the expected income/savings did not materialize or a better competitor has entered from the wings. In other words, failure not only has an impact on the FinTech itself but also on its clients. Whether treasurers are up to this to-ing and fro-ing?

For treasury departments, FinTechs are not necessarily sensible by definition but only if they provide a solution which just happens to be offered through a FinTech – plus they also have to be integrated into the already existing treasury system. Depending on the corporate structure, the degree of homogeneity of the business model and corporate management, the treasury system used may be extremely complex and contain many parameters and restrictions. One of the important restrictions are finite human and financial resources. Whilst financial restrictions may still be thrown to the wind if

the use of FinTechs will improve the company's economic efficiency, expanding human resources is not easily possible, not even by using external resources, such as consultants.

It is therefore not surprising that the areas where FinTechs are currently being used also are those that the treasury department was going to address in the context of a digital transformation anyway, i.e. payment operations, currency management and financing. While the discussion around payment operations is dominated by process and transaction costs as well as security issues, in currency management it is mostly market transparency and competition, and in financing, it is the elimination of the middle man (in this case, the bank).

To round off this article, a quick anecdote to illustrate that it is not only a question of which FinTechs develop how and in what direction but rather that also well-established service providers can jump into the fray and compete with FinTechs, see Ripple vs SWIFT. Initially, the outlook for Ripple as a service provider for real-time payment operations and especially for tracing cross-border transactions through correspondent banks was excellent but once SWIFT GPI entered the market, this changed again. The catch-up distance between the two has become smaller, although the technical advantage of Ripple due to its using blockchain technology remains. So how will the race end? It could well be that after an initial phase of mistrust that these two will love each other and merge.

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# Continuous intraday trading in the energy industry

## What is the status quo and where are we headed?

Corporate Treasury

It was already possible to trade electricity at intervals of a quarter of an hour since 2011. Now, after nearly 7 years, IT systems and business processes are mature enough that trading is fully automated. Creativity hardly knows any boundaries when it comes to developing own algorithms.

The benefits and impacts of the introduction of intraday trading became evident very quickly. For instance, the changing market reaction for intraday trading patterns resulting from the input of renewable energy become obvious and day-ahead trading can be anticipated, thus allowing a strategic positioning – naturally whilst maintaining the requirements of the balancing group contract. In addition, intra-day compensation for fluctuations in volatile solar and wind power becomes possible, thus reducing deviations in delivery, which has significantly reduced the amount of activated control energy and thus the balancing power costs over the years.

On the other side, we have companies that have made profits by generating control energy. These must now find new business lines as the outlook is quite clear: Especially the market for balancing energy is no longer very significant because the time to gate closure (i.e. the time by when the next 15-minute increment may be traded) has been reduced and the number of market participants has increased. However, the loss of this business line does not pose that much of a problem for most companies as they benefit more from the use of the intraday market and the related algorithmic trading systems than they hurt from the loss, as the following listing shows.

- **Market arbitrage:** Trading price differences between two different price zones, for example buying in Germany and immediately selling in Austria.
- **Flexibility marketing:** Continuous trading by matching market prices with marginal costs. Should a market price be (temporarily) above the current marginal costs, more output is sold. If the market fluctuates at a price level below marginal costs, sold amounts may be re-bought and used to fulfill other delivery commitments. This strategy is popular among power plants.
- **Storage:** Allows an optimization of storage facilities by selling more expensive time slots stored (e.g. EUR 55 for 13:00-13:15h) and the immediate sale of the same amount in a more advantageous time slot (e.g. EUR 45 for 20:30-20:45h) in order to balance the amount of energy. The strategy is used especially by power plants with storage facilities, such as biogas or pump storage plants.

Of course different types of assets may be combined in order to be even more agile on the market. With this, the following applies: the more flexible you are, the more profits can be reaped. For

instance, pump storage facilities may be used to balance the ramp-up/ramp-down periods of a coal-fired power plant in order to avoid exceedances or deficits within the individual 15-minute time slots.

In order to automate this as much as possible, IT system providers in the energy industry are working intensively to further develop their high-frequency trading systems. They, too, have recognized already many years ago the benefits of algorithmic trading and strive to offer as many out-of-the-box functionalities and trading strategies as possible. Despite the fact that the pioneers of intraday trading (usually large electricity traders) decided several years ago to develop such software in-house, it actually makes more sense these days to implement a well-established off-the-rack solution into one's own system landscape due to the large number of functionalities and the simple integration. Like this, the interface updates to trading venues no longer have to be implemented individually, etc. and companies can concentrate better on their core competence, i.e. the development of further trading strategies. Even if different IT systems have different functionalities, they nevertheless have one thing in common: Apart from their pre-defined strategies, they also offer the possibility to develop and test own ideas by using different programming languages, such as Java, Python or R.

## Outlook

In order to anticipate how energy trading will develop over the next few years, it is worth taking a quick look at the financial industry. There, trading algorithms, technical chart analyses and high-frequency trading have been part of the equation for many years already. Even if the energy industry also has to master the additional components in the form of physical power delivery, which means having to deal with more complex situations, there are many overlaps nonetheless.

For one, the popularity of tools that provide technical chart analyses is on the rise. These make it possible to present price developments using graphs and to enrich and test these against any pre-defined or self-programmed indicators and trading strategies. Like this, companies can test simple analyses or complete trading strategies, either for speculative trading or as further decision-making criteria for a best-buy or best-sell strategies.

Moreover, the development of digitalization and thus other technologies, provide an interesting perspective for intraday trading. Connecting or integrating artificial intelligence and machine learning algorithms into trading systems is already being researched by some in cooperation with energy traders and software providers. This potentially produces a completely new type of algorithms. Furthermore, a combination of increasing computing power and cheaper super-computers will offer the possibility to implement real-time optimizations of the intraday market. Currently, this is not yet possible due to the excessive time required to calculate individual optimizations, since the information in the fast-moving intraday market is usually obsolete after a few seconds and trading is therefore no longer profitable.

Finally, it is also highly likely that other commodities (such as gas) will also be traded on a continuous intraday market using high-frequency trading systems and that the trading volume as well as the number of orders will increase. Even if the high-frequency trading is currently restricted by contractual penalties if exceeding the rather conservative order-to-trade ratio, it should nonetheless be expected that the IT and exchange infrastructure will be enhanced drastically, thus allowing for a new type of high-frequency algorithms.

## Conclusion

Even if the energy industry still has some catching up to do as far as trading volume, IT systems and business processes are concerned, it is nevertheless just a matter of time. The proof is not only the continuously increasing number of market participants but also the continuous development of IT systems and trading infrastructure. For example, the [Cross-Border Intraday \(XBID\) project](#) will create a platform which should allow trading power intraday across borders between 15 European countries. Projects such as this one and the outlook described above prove that there will be more exciting changes to come and that companies in the energy sector will have plenty of possibilities to benefit from these developments.

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