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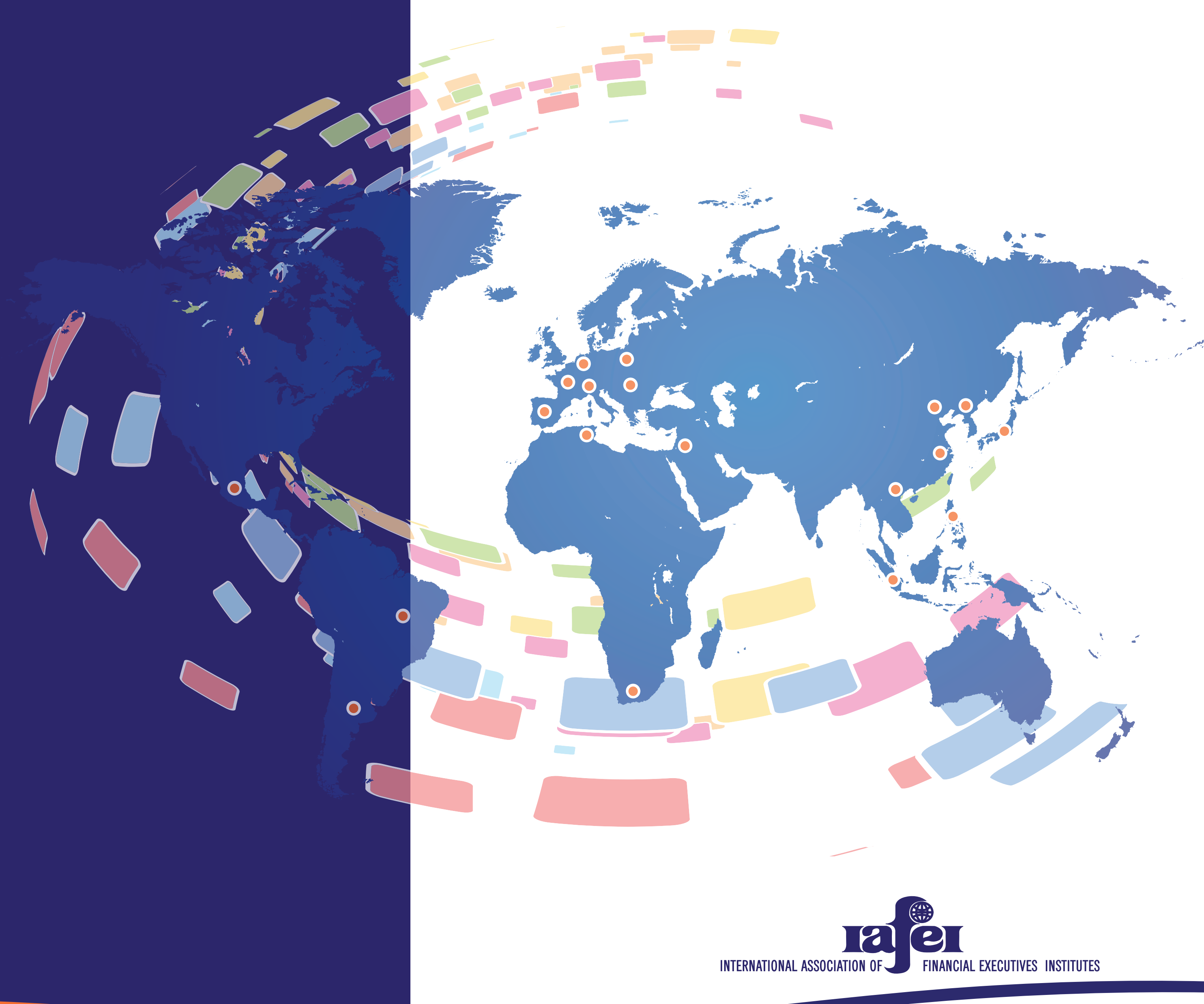

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IAFEI
INTERNATIONAL ASSOCIATION OF FINANCIAL EXECUTIVES INSTITUTES

LETTER OF THE CHAIRMAN

Dear Colleagues,

I am delighted to introduce to you the new issue of IAFEI QUARTERLY, which you will find vastly improved in terms of content and graphical layout.

All thanks go to our Chief Editor Helmut Schnabel for the great work he is doing on behalf of almost 20 thousand CFOs around the world, members of the national institutes affiliated with IAFEI, to deliver to them complete and targeted information on themes regarding their professional activity.

The increased involvement of the Technical Committees gives us the opportunity to analyse in depth numerous technical issues, and the variety of international inputs create fascinating and useful benchmarks.

While IAFEI continues to initiate structural reform proposals for renewing and strengthening our organization, about which we will keep you informed in the coming months, I must immediately thank our Russian associates for the enormous efforts currently being put into the preparation of our upcoming Annual Congress, scheduled for 14-15-16 September in Moscow.

It is the first time ever for this event in Russia, but the enthusiasm and commitment of our colleagues there will certainly ensure a very successful and high-profile congress.

Best wishes for your work, and for enjoyable reading of the IAFEI QUARTERLY.

Fausto Cosi
IAFEI Chairman

LETTER OF THE CHIEF EDITOR

Dear Financial Executive,

You receive the IAFEI Quarterly XXXIInd Issue.

This is another issue of the IAFEI Quarterly, the electronic professional journal of IAFEI, the International Association of Financial Executives Institutes.

This journal, other than the IAFEI website, is the internal ongoing information tool of our association:

> *destined to reach the desk of each financial executive,*
> *or reach him, her otherwise,*
> *at the discretion of the national IAFEI member institutes.*

This issue is the second one under the regime of the New Start far the IAFEI Quarterly. This new start has been backed up by the IAFEI Board of Directors decision of October 13, 2015, to establish an Editorial Board consisting of 10 IAFEI representatives from all continents.

This issue has more articles from inside IAFEI than before, and once more the layout and the visual design have been further improved by the Italian IAFEI Member Institute ANDAF.

And this issue again has the more user friendly format, introduced last summer.

From the table of contents you can now directly click into every article, without scrolling through the entire issue.

Once again:

I repeat our ongoing invitation, to IAFEI member institutes, and to each of their members, to send us articles for inclusion in future IAFEI Quarterlies, and to also send to us your suggestions for improvements.

With best personal regards

Helmut Schnabel
Chief Editor

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THE ROLE OF SELF-CONTROL IN FINANCIAL DECISION MAKING

"I CAN RESIST EVERYTHING EXCEPT TEMPTATION." (OSCAR WILDE'S QUOTE ON HIS LADY WINDERMERE'S FAN, A PLAY ABOUT A GOOD WOMAN, 1892)

by LUIZ ROBERTO CALADO, Vice-President of the Brazilian IAFEI Member Institute IBEF,
and BERNARDO FONSECA NUNES, Stirling Behavioural Science Center, Scotland, UK

Self-control is an important capacity that prevents people from acting on impulses which has been identified as a critical human skill in both economics and psychology. Economists often defined self-control as the ability to stick to prior plans and thus have consistent intertemporal choices. In psychology, self-control is defined as the ability to regulate one's behaviours, emotions, and thoughts.

This article addresses recent developments that are overcoming disciplinary boundaries in order to generate a more coherent description for the role of self-control on everyday financial behaviour, including the behaviour of the Chief Financial Officers. As they have to most important financial role in the firms. We focus on applications closely related to policymaking and financial regulation, such as: saving for retirement, indebtedness and investment attitudes. The present discussion suggests that the trait of self-control might prevent failures by avoiding rather than resisting to temptations.

First of all, the reader must be familiar with some key concepts often discussed in the self-control literature.

Currently, the favourite explanation of self-control problems given by open-minded economists is the occurrence of present bias (Delaney and Lades, 2015; O'Donoghue and Rabin, 2015), which suggests that the conventional assumption of time-consistent decisions and exponential discounting of future values is wrong. When considering trade-offs on two future moments, present biased preferences denote stronger weight to the earlier moment as it gets closer (see O'Donoghue and Rabin, 1999, 2001), describing, in this sense, a conflict between an individual's short-run and long run "selves".

This was initially formalized in the classic quasi-hyperbolic discounting model of Laibson (1997):

$$\mathcal{U}(x_t, \ \dots, x_T) = u(x_t) + \beta \sum_{\tau=1}^{T} \delta^{\tau} u(x_{t+\tau}) \qquad (1)$$

where β and δ represent discount factors (usually with β,δ<1), being the former a measure of present bias and the later a measure of impatience. In other words, outcomes delayed by an additional time period have their values multiplied by δ, obtaining then its time-discounted value, and all non-immediate outcomes are multiplied by β, generating a short-term desire – the so-called present bias – and potentially a self-control failure. Those familiarised with behavioural economics would promptly recognize that this model follows the ideas of dual process theories, which assume that human decision making consists of two distinct systems, well-described by Daniel Kahneman (2003) in his Nobel Prize lecture.

Despite its rich descriptive power, the quasi-hyperbolic discounting model does not fully explain why time-inconsistent decisions and self-control failures arise, requiring then further extensions. In order to better describe the nature of present bias, Delaney and Lades (2015) built on psychological insights that understand self-control problems as intrapersonal conflicts between temptations and the ability of self-control. Basically, a failure occur when the temptation dominates an individual's capacity to resist (self-control). Formally, they proposed the following microfoundation for the present bias parameter:

$$\beta = \frac{1}{1+T(1-SC)} \qquad (2)$$

where $T > 0$ represents temptations' level and $0 < SC < 1$ represents self-control ability. This formalisation suggests that present bias is positively related to temptations and negatively related to self-control, so an individual needs self-control only when tempted.
This development allows the differentiation between heterogeneous decision makers in terms of their sophistication (O'Donoghue and Rabin, 1999). For instance, sophisticated individuals are conscious that temptations and self-control weaknesses are likely events in everyday life, and so is present bias, so they might engage in proactive commitments to avoid or mitigate the effect of future temptations. On the opposite level, completely naïve individuals are unaware of their present bias and believe they will not encounter any temptations in the future. This is in line with empirical studies on personality and individual differences showing that individuals high in trait self-control are more likely to avoid temptation and distraction, rather than simply resisting goal-inhibiting impulses (Ent et al., 2015).

The concepts of present bias and sophistication within the context of self-control have become decisive for policymaking and regulation. For example, present biased sophisticated savers may demand financial products which prescribe penalties and liquidity constraints, such as mutual funds and pension plans, to help them to overcome self-control problems. Also, these individuals may avoid credit card use in order to mitigate the occurrence of consumption temptations and abuse of credit use. Sophisticated investors may follow investment strategies that are tied to specific asset allocation rules or non-discretionary trading systems to avoid overconfidence and the desire of maintaining losing trades for longer periods than the profitable ones – the so-called disposition effect. At the same time, a benevolent financial regulator would wish to protect naïve participants that lack financial literacy or are simply unaware of the constant visceral influences on financial decisions. The remainder of this article covers some applications of the current knowledge about self-control problems, their effects on financial decision making and the suggestions of recent empirical studies.

1. Retirement savings, self-awareness and commitment mechanisms

Present bias leads people to save insufficiently for retirement: even when they wish to save more, they fail to do so by procrastinating the decision to opt-in a pension plan. It has also been suggested that self-awareness regarding one's biases might be a stronger determinant of financial behaviour than their direct effect itself. Theoretical predictions between behavioural parameters and the role of sophistication on retirement savings were exposed by Goda et al (2015, p. 9). For instance, a sophisticated saver, aware of

the existence of potential self-control problems through the lifecycle, may be able to implement commitment devices to counteract personal biases and prevent a premature spending of personal savings, while a naïve individual would not (Laibson, 1997, Angeletos et al, 2001). Examples of such commitment mechanisms in financial products are the classic use of illiquid housing equity as a vehicle for saving, and the partial illiquidity of retirement savings accounts which imposes tax penalties to early withdrawals. Lastly, it has been empirically documented that self-awareness of potential biases has a positive effect on retirement savings even after controlling for measures of IQ, financial literacy and socio-demographic characteristics (Goda et al, 2015).

The relationship between present bias and retirement savings, driven by the documented existence of heterogeneous sophisticated and naïve agents, makes financial regulators and service providers interested in understanding the benefits of such commitment technologies in financial products. It became critical to understand how salient they should be in order to correctly inform policy and effectively generate behavioural changes. This question was experimentally addressed recently by Beshears et al (2015) using a representative sample of the U.S. adult population. The authors pointed out that: (i) conventional economic theory predicts that nothing should be contributed to a commitment account when it offers the same expected return as a fully-liquid account. (ii) higher penalties may reduce premature withdrawals, but they may also discourage deposits, defeating the goal of raising net savings; on the other hand, (iii) if savers recognize that penalties help them overcome self-control problems, they may welcome higher penalties and make more deposits in response. In sum, they test whether the demand for commitment savings accounts is affected by how illiquid the offered savings accounts are.

Commitment devices have been shown as strongly appealing. When participants were asked to allocate money between a liquid account and a commitment account that randomly varies across participants in terms of interest rates, prohibitions and penalties for withdraws prior to a commitment date, they presented a consistent demand for commitment technologies. Participants allocated around half of their endowments to the commitment account when there was no difference in interest rates between the two vehicles, and one-quarter of their money even when the interest rate paid by the commitment account was lower than the liquid account. These results build on previous evidence from field experiments on the role of commitment savings accounts performed in different countries (see Beshears et al, 2015, p.3). Ultimately, this suggests the presence of sophisticated present-biased individuals in the U.S. adult population.

An anxious reader might think that policymakers should set high withdraw tax penalties on pension plans because this act would benefit all agents and the aggregate national level of savings. Although, we need to consider that sophisticated players are only part of the market, if not the minority, hence generating an ambiguous effect of higher withdraw penalties on total contributions to these accounts that is not irrespective of how heterogeneous the population in question is. First of all, financial products like private and workplace pension plans, given their risk profile and asset allocations, have expected returns that are higher than vehicles with immediate liquidity, such as current account deposits. Beshears et al (2015) show that when the commitment account presented in their framework paid an interest rate higher than the liquid account, as is the real case of pension schemes, the empirical relationship between illiquidity levels and deposits in the commitment account was insignificant, suggesting that the U.S. adult population contains also naïve present biased individuals and/or individual who have consistent time-preferences, i.e., without present bias. The interaction of these two other groups is described in Table 1. Both make positive commitment deposits that diminish as the commitment account's illiquidity rises. This ends up offsetting the increase in commitment deposits by the group of sophisticated present-biased individuals.

Table 1. Relationship between illiquidity levels and deposits in commitment accounts

Group characteristic	*Without present bias*	*With present bias*
Sophisticated	Deposits decrease as illiquidity rises because this group has time-consistent preferences. No need for commitment devices.	Deposits increase as illiquidity rises because this group is aware of their bias and potential self-control problems.
Naïve	Deposits decrease as illiquidity rises because naïve agents are unaware of whether biases and potential self-control problems.	

Note: based on Beshears et al (2015).

For further references of the lessons learned and to be learned about the interaction between present bias, self-control and commitment devices, we suggest the recent review of O'Donoghue and Rabin (2015). The study proposes a set of research questions, being among them: how to assess the impact of present bias against other phenomena?; and how to assess whether the demand for commitments are due to present bias?

In sum, the recent studies of Delaney and Lades (2015). Goda et al (2015) and Beshears et al (2015) provide good initial evaluations to address these questions to better inform policymaking in the context of retirement savings.

2. Conclusions

Increasing the illiquidity pension schemes may not increase aggregate contributions because only one segment of the population has the desire for strict commitment in order to stick with a previous decided plan. This highlights the need for further developments to deal with innocent unsophistication of the naïve group. Enhancing financial literacy and the access to professional advice can be potential complementary mechanisms.

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THE ANTI-TAX AVOIDANCE PROPOSED EU DIRECTIVE

ACKNOWLEDGING THE LIMITS NATIONAL TAX LAWS HAVE IN AN INCREASINGLY INTERCONNECTED WORLD, WHICH PREVENT THEM TO KEEP PACE WITH GLOBAL CORPORATIONS, FLUID MOVEMENT OF CAPITAL, AND THE RISE OF THE DIGITAL ECONOMY, SOME YEARS AGO OECD STARTED A PROJECT AIMED AT FOCUSING ON GAPS AND MISMATCHES THAT CAN BE EXPLOITED TO GENERATE DOUBLE NON-TAXATION, AND ULTIMATELY UNDERMINING FAIRNESS AND INTEGRITY OF TAX SYSTEMS.

by **ANDREA CIRCI**, International Tax Partner Studio Tributario e Societario Deloitte, Italy
and **MASSIMILIANO MATTIOLI**, Tax partner LMBA – Tax & legal firm in Bologna, Italy

INTRODUCTION

Base Erosion and Profit Shifting (BEPS) project is the OECD response to tax planning strategies that exploit these gaps and mismatches in tax rules to artificially shift profits to low or no-tax jurisdictions: OECD conservative figures indicate annual losses in a range from 4 to 10% of the global corporate income tax (CIT) revenues due to such policies, equal to annual amount of 100 to 240 USD billion.

As a result of a project formally launched in 2013 with the release of the Action Plan, on 5 October 2015 OECD presented the final BEPS reports: a 15-actions package of measures for closing the gaps in existing international rules which allow corporate profits to be artificially shifted from a jurisdiction to another where little or no economic activity takes place, thus ensuring that profits are taxed where economic activities generating the profits are performed and where value is actually created. G20 Finance Ministers committed for “swift, global and efficient implementation” of BEPS conclusions.

Previously the need for a “comprehensive anti-BEPS Directive” was stressed by Finance Ministers Schäuble (Germany), Sapin (France) and Padoan (Italy) in a November 2014 letter to Commissioner Moscovici, advocating in the context of the OECD/G20’s final adoption of the BEPS conclusions for “a set of common, binding rules on corporate taxation to curb tax competition and fight aggressive tax planning”.

At the ECOFIN meeting held on 8 December 2015 the European Union (EU) Council recalling that several legislative proposals linked to the BEPS agenda are under discussion – including the proposal for a Common Consolidated Corporate Tax Base (CCCTB) – emphasized the need for a coordinated implementation by Member States of the anti-BEPS measures to be adopted at EU level on the assumption that a common approach at EU level towards the implementation of certain options among the several proposed by OECD BEPS conclusions would bring value with a view to ensure the proper functioning of the Single Market. A draft text of the so-called "Anti-BEPS Directive" was discussed.

On 28 January 2016 the European Commission released the Anti-Tax Avoidance Package made up of proposed measures on the basis of the three "core pillars" Commission's agenda for fairer taxation (i.e., ensuring effective taxation within the EU, increasing tax transparency and securing a level playing field). The package includes:

- a revision of the Administrative Cooperation Directive, whereby national authorities will exchange tax-related information on multinational companies' activities, on a country-by-country (CbC) basis ("CbC Reporting");
- a proposed Anti-Tax Avoidance Directive, with legally-binding measures to tackle some of the most prevalent tax avoidance schemes ("Anti-BEPS Directive");
- a "Communication on an External Strategy for Effective Taxation", aimed at reinforcing cooperation with international partners in fighting tax avoidance and promoting fair taxation globally through international standards and a common approach;
- a recommendation to Member States on how to prevent tax treaty abuse ("Tax Treaties Recommendation").

RATIONALE OF THE PROPOSED DIRECTIVE

The proposed Anti-Tax Avoidance Directive ("Draft") responds to the need for a stronger and more co-ordinated EU approach against corporate tax abuse. Considering that most EU Member States (22 out of 28), as members of OECD, have committed to implement the measures contained in the 15-Actions BEPS Final Reports, the EU Commission acknowledges that an unilateral, not coordinated implementation of BEPS by each Member State, far from attaining the intended purpose, could create new loopholes and mismatches that can be exploited by companies seeking to avoid taxation, thereby actually hampering EU and OECD efforts to prevent such practices.

Indeed, the Commission considers that actions undertaken by each single Member State moving on its own cannot sufficiently achieve those aims. On the contrary, such an approach would only replicate and possibly worsen the existing fragmentation in the internal market and "perpetuate the present inefficiencies and distortions in the interaction of a patchwork of distinct measures".

It is therefore seen as more effective for the purpose of tackling cross-border tax avoidance practices to provide a common framework for the implementation of BEPS Actions into Member States' national systems in a coherent and coordinated fashion by creating a "minimum level of protection for national corporate tax systems" across the EU and the proposed Directive aims at an "essential minimum degree of coordination within the Union for the purpose of materialising its objectives".
Direct taxation is the preserve of EU Member States, however, and EU law requires unanimous agreement among all Member States for passing measures relating to areas where their sovereign legislative power is granted. The text therefore set principle-based rules and leaves the details of their implementation to Member States, "on the understanding that they are better placed to shape the precise elements of the rules in a way that best fits their corporate tax systems".

DETAIL OF THE MEASURES

The Draft is broadly inclusive and aims to all taxpayers subject to corporate tax in a Member State, including permanent establishments, located within the EU, of corporate taxpayers which are not themselves subject to the Directive.
The proposed Directive targets situations where taxpayers act against the actual purpose of the law, exploiting disparities between national tax systems in order to reduce their final tax burden, be it low tax rates, double deductions or mismatches – when cross-border transaction are structured so that income remain untaxed by making it deductible in one jurisdiction whilst it is not included in the tax base across the border either.

The outcome of such tax avoidance practices distorts business decisions in the internal market and ultimately affect the fair functioning of the internal market. The proposed Directive lays, therefore, down anti- tax avoidance rules in six specific fields: deductibility of interest; exit taxation; a switch-over clause; a general anti-abuse rule (GAAR); controlled foreign company (CFC) rules; and a framework to tackle hybrid mismatches.

Interest limitation rule (Article 4)
Interest payments are generally tax deductible in the EU Member States. It is a rather common tax planning strategy for multinational groups to debt-finance group companies in a high-tax jurisdiction where interest payment are deductible and paid to the group's lender company which is based in a low-tax country. In this way, the group reduces its overall tax burden.

In order to make it less attractive for companies to artificially shift debt in order to minimise their tax bill, the proposed Directive intends to limit the amount of net interest that a company can deduct from its taxable income, based on a fixed ratio of its EBITBA – with a cap. More in detail, in view of the "minimum level of protection" set out in Article 3, the Directive set the rate for deductibility at 30% of EBITDA, which is the top of the scale (10 to 30%) recommended by the OECD, capping the deductible amount at 1 mEUR. Member States are allowed to introduce stricter rules.

It is a Commission's intention not to penalize taxpayers which run reduced risks as regards BEPS. Net interest are therefore considered deductible up to a fixed maximum amount set a 1 mEUR, which is triggered where it leads to a higher deduction than the EBITDA-based ratio.
The interest limitation rule applies in relation to a taxpayer's net financial costs without distinction of whether the costs originate in domestic, cross-border within the EU or with a third country borrowing.
As for what specifically regards financial and insurance entities, the Commission states it is generally accepted that they should also be subject to limitations to the deductibility of net interest; nevertheless, acknowledging that these sectors have special features, a more customised approach is necessary and at the present stage of discussion it is not yet possible to provide specific rules.

Exit taxation (Article 5)
Quite often no provision exits for taxing assets (e.g., intangibles) when they are moved from an EU Member State to a third country. This facilitates to shift usually high-value assets out of Member States to no or low tax countries, thus avoid paying tax in the EU on the underlying profit.
The rationale behind exit taxes is to ensure States the right to tax any capital gain created in their territory even if a taxpayer moves assets or its tax residence out of the tax jurisdiction of that State and even if this gain has not yet been realised at the time of the exit.
The Directive allows the EU Member State of origin to levy tax on the fair market value of the transferred assets minus their tax book value under given circumstances such as: the transfer of its head office or permanent establishment ("PE") out of the State – regardless of whether the destination is another Member State or a third Country; the transfer of assets from PE to head office and vice-versa, where they are located in different countries; the transfer of residence out of the Member State of origin, unless the assets remain effectively connected to a PE located in that State.
The exit tax payment can optionally be deferred under certain conditions and to the extent they are maintained. For transfers between member States a corresponding rule is set whereby the Member State of destination shall accept the market value determined by the Member State of exit as starting value for its tax purposes.
Asset transfers of a temporary nature are exempted from taxation provided they are intended to revert to the Member State of origin.

Switch-over clause (Article 6)
Considering the complexities in giving credit relief for taxes paid abroad, States tend to increasingly exempt dividend income and capital gains from taxation. The unintended negative effect of this approach is that it may encourage untaxed or low-taxed income to enter the EU and circulate within it thus often enjoying a double non-taxation status.
Switch-over clauses are targeted against such practices. The Draft provides for a "taxation and related credit relief" system for taxes paid abroad when the statutory CIT rate in the third country of source is lower than 40% of the statutory CIT rate of the Member State receiving the income, thus ensuring equal treatment between EU and third-country origin payments.

General anti-abuse rule – GAAR (Article 7)
Tax systems worldwide have gaps which can be exploited by those in search of reducing their overall tax bill.
The purpose of general anti-abuse rules (GAARs) in a tax systems is to fill in those gaps, by tackling abusive tax practices that have not yet been dealt with through specifically targeted anti-abuse provisions.
It is widely accepted that taxpayers should have granted the right to choose the most efficient tax structure. What the Draft targets are "non-genuine arrangements or a series thereof", i.e. those wholly artificial arrangements carried out for the essential purpose of obtaining a tax advantage contrary to the object or purpose of the otherwise applicable tax provisions.
The Draft provides that such (series of) non-genuine arrangements shall be ignored for the purposes of calculating the corporate taxpayer's CIT liability, which shall therefore be determined with reference to the economic substance according to the applicable national law.

The Commission stresses that the importance of ensuring that the GAARs apply in a uniform manner to all situations (either domestic, within the Union and vis-à-vis third countries), so that their scope and results of application do not differ.

Controlled foreign company (CFC) legislation (Articles 8 & 9)
With the purpose of reducing their overall tax bill, multinational groups sometimes shift profits from their parent company in a high tax country to controlled subsidiaries in low or no tax countries, where profits are kept indefinitely without being repatriated.

The proposed (CFC) rule is aimed at discouraging such practices by allowing Member States where the parent company is located to tax those profits regardless of their actual repatriation and the amounts of income attributed to the parent company should be limited to the portion exceeding the arm's length principle.
The CFC rule will be triggered only in case certain conditions are met, namely:

- an effective tax rate in the third country lower than 40% of that in the Member State
- a control relationship between parent and subsidiary whereby the former holds directly or indirectly more than 50% of capital, voting rights or entitlement to profits of the latter
- the subsidiary is not listed on one or more recognised stock exchanges, and
- more than 50% of the subsidiary's income is made of passive or captive items of income.
-

Exceptions apply, notably with reference to financial undertakings tax resident within the EU or their PEs, on the grounds that financial and insurance sectors are heavily regulated and therefore unlikely to be captured by artificial situations without economic substance as those targeted by CFC rules.
In order to avoid double taxation a tax credit for any taxes paid abroad is granted to the parent company as well as a recapture mechanism in case the CFC profits are repatriated.

Hybrid mismatches (Article 10)
When two tax systems give a different legal characterisation of the very same item the interaction of their two legal systems may "mismatch", leading to a double deduction (i.e. deduction in both states) or a deduction of the income in one state without inclusion in the tax base in the other state.

Hybrid mismatches can arise as a difference in the legal characterisation of payments (financial hybrid instruments) or entities (hybrid entities).
To prevent that outcome, the Draft lays down rules whereby in a mismatch situation the Member State of the source (of income, payment or expense) should give a legal characterisation to the hybrid instrument or entity and the other Member State jurisdiction should accept it. The rule applies between Member States only, since the tax treatment of hybrid mismatches between Member States and third countries "need to be further examined".

EVALUATION TIMEFRAME

Article 11 provides that the Commission shall evaluate the implementation of the Directive three years after its entry into force and report to the Council.

WHAT'S NEXT IN FOREX MARKETS AFTER A CONVULSIVE QUARTER 1, 2016

IN THE FIRST QUARTER OF 2016, FINANCIAL MARKETS WERE HIT BY THE HIGHEST VOLATILITY SINCE THE FINANCIAL CRISIS OF 2008–09. IN FACT, VOLATILITY IN JANUARY WAS THE HIGHEST IT HAD BEEN SINCE THE GREAT DEPRESSION! FORTUNATELY, AS THE QUARTER ENDS, THINGS ARE CALMER. AT THE TIME OF WRITING, THE U.S. DOLLAR (USD) IS AT ITS WEAKEST LEVEL IN NINE MONTHS. THIS DOESN'T NECESSARILY MEAN, HOWEVER, THAT THE WORST IS OVER. WE FIRST REVIEW QUARTER ONE FOREIGN EXCHANGE MARKET (FOREX) EVENTS, THEN POINT OUT CURRENCY RISKS MOVING FORWARD.

by EDUARDO GARZA CASTILLON SEGOVIA, Engineer, National President of the Treasury Technical Committee of **IMEF**

In the first quarter of 2016, financial markets were hit by the highest volatility since the financial crisis of 2008–09. In fact, volatility in January was the highest it had been since the Great Depression! Fortunately, as the quarter ends, things are calmer. At the time of writing, the U.S. dollar (USD) is at its weakest level in nine months. This doesn't necessarily mean, however, that the worst is over. We first review quarter one foreign exchange market (forex) events, then point out currency risks moving forward.

What happened in quarter one?

On the first working day of the year, upon release of a worse-than-expected China PMI Manufacturing Index showing contraction for the tenth month in a row, the Chinese stock market fell 7% and MSCI All Country Global Index dropped more than 3%.

Volatility continued over the first six weeks of 2016 in large part over bad news from China and clumsy measures taken by Chinese central bank (PBOC) to cope with what seems an inevitable economic slowdown. On 6 January, the PBOC lowered its reference daily rate, provoking a dive in the yuan to a five-year low rate

against the U.S. dollar to nearly 6.56 yuan per dollar.
Fear seized global financial markets. Speculation that China was in trouble and could need to devalue further sent capital outflows from China to record levels and in turn debilitating the yuan to even further lows of 6.61 yuan's per dollar before the end of January. Fears of global economic contagion drove asset prices down farther. China's stock market lost almost 25% of its value, and safe haven currencies such as the dollar and yen soared to new peaks. So high were fear levels that the yen kept strengthening even after the Bank of Japan (BoJ) passed new stimulus measures, adopting for the first time a negative interest rate.

Currency movements in January and early February exacerbated prior downward trends in global commodity prices expressed in U.S. dollar terms. Brent crude fell to just over $28 dollars per barrel; non-oil commodity prices also plunged in dollar terms. Global equity markets entered a bear market.

Things looked so gloomy that even the Federal Reserve (the Fed), led by Janet Yellen, seemed threatened and overwhelmed by it. At their 27 January meeting, the Federal Reserve's monetary policy committee voted to keep rates unchanged and seemed to hint that the Fed would sit tight while assessing how global conditions could affect U.S. growth.

In early February, many economic specialists started warning that the US would enter a recession within the next 12 to 18 months. As such, many started to criticize the Fed's decision to hike rates the previous December 2015 with the US economy showing signs of losing steam. With several European central banks and even the BoJ having introduced negative policy rates to stimulate growth and inflation, several specialists started voicing that the Fed should follow suit.

In first half of February, just as these voices began to echo in financial forums, financial markets started to stabilize. An important stabilizing trigger was a pickup in oil prices on talks between Russia and the Organization of Petroleum Exporting Countries on a possible output freeze. In less than a week, oil prices gained more than 10%. The U.S. dollar moved down against most currencies around the World, with the USD/CNY stabilizing at around 6.57. Risk aversion subsided.

On February 12, positive news came out in the US: January's retail sales had advanced more than expected. A few days later, more positive news came out, this time from China: the PBOC said it viewed the yuan as undervalued. Its currency promptly advanced against those of its trading partners.
Investors who had gone to cash in safe-haven currencies started returning to risk assets, causing oil prices in dollar terms to keep advancing. By early March, they had risen another 10–15%, which fed back into optimism.
It was in this environment that, on March 4, the USA's jobs report showed more job creation than expected. Oil prices recovered to end-2015 levels.
On March 10, the European Central Bank (ECB) lowered its reference rate to zero and expanded its quantitative easing program. While these measures were not unexpected, they, too, contributed to calm that was returning to the world markets.

All eyes then turned to the Fed. Speculation that the Fed would not hike rates in March had weakened the U.S. dollar further against world currencies. The Fed surprised financial markets on March 16 with FOMC member median views that just two rate hikes would be appropriate this year, not the four projected at last December's meeting.
At first, the U.S. dollar weakened further—to levels not seen in nearly nine months. But then came reports showing improvement in the U.S. manufacturing sector, and statements from four Fed presidents that analysts were underestimating US economic strength and inflationary pressures. These events sent the dollar back up some.

On Friday 25 March, with the first quarter about to end, the USA revised up fourth-quarter GDP growth figures by four tenths of a percentage point. (Data movements like this one boost the dollar because they point toward earlier Fed hikes.) But since then, a dovish speech made on March 29 by Fed Chair Janet Yellen drove the dollar back down.

Forex market risks for the remainder of the year
So where do the world economy and the U.S. dollar go from here? Of course, the only sure forecast is to expect the unexpected. Nonetheless, a few educated guesses suggest that the USA will escape recession this year and possibly next year too.

What makes me say so? Something I call global resilience. While it's true that economies and asset prices can turn south abruptly, at the same time and to my ceaseless amazement, more often than not, the world economy comes through adversity intact or even ahead.

Now, this isn't to say that no risks lie ahead. Several well-known ones do lies ahead; and some less well knowns lurk too. The obvious ones are ISIS terrorist attacks, "Brexit", China's slowdown, and, most of all,

a Fed rate hike. A less obvious one is something that would normally be a non-event for global markets: U.S. presidential elections. I'll begin with the less obvious one.
Donald Trump is currently the front runner to become the Republican Party's nominee.
This scenario worries not only many Americans but also various world leaders. It's true that (at the time of writing) polls show that Trump would probably lose against either Clinton or Bernie Sanders. But we can't rule out a Trump victory. Markets could have a strong negative reaction.

Great Britain will hold an election to see whether they remain or exit the European Union. This process will almost certainly create market volatility as voting day, June 23, approaches. So far, the chances of a Brexit are low. Nonetheless, I project that the U.S. dollar will approach historic peaks against most world currencies late in June.

Finally, we have the risk of further terrorist attacks like the ones suffered by Brussels this month and Paris last November. Even though ISIS is apparently being beaten by the international coalition currently fighting it in Syria and Iraq, it can still react violently in financial hubs such as New York, London, or even Hong Kong, triggering a bout of severe market volatility.

A China-triggered crisis remains a risk, of course, but a low-probability one, in my view. While the Chinese national debt has ballooned in recent years and its asset bubbles there persist, the most recent economic news out of China give hope that the worst is over for China for 2016.

I know this is sounding pessimistic. But remember what I said about resilience. Also, note that the USA has everything it needs to keep its expansion going a bit further, though the way to get there will certainly be rocky.
My base-case scenario is in fact benign. In it, although volatility again erupts in financial markets, the "Brexit" threat comes and goes, Trump does not become president of the USA, and China grows at least as fast as its target pace of 6.5%.

This has been a piece in which I warn readers that, although the quarter one is ending on a calm note after all, we can't let our guard down: complicated and volatile times lie ahead. At the same time, I remind you that we have global resilience on our side.

IMPONDERABLES ARE INCREASING

THE CFO OF VILLEROY & BOCH ABOUT THE CONSEQUENCES OF THE WEAKNESS OF THE RUSSIAN ROUBLE, PLAGIARISMS AND THE LACKING OF YOUNG FITTERS

Interview with Dr. Markus Warncke, CFO of Villeroy & Boch, Börsen-Zeitung, March 12, 2016, article provided by GEFIU, Association of Chief Financial Officers Germany

Dr. Warncke, are you of the opinion that Villeroy & Boch is a world-wide corporation group with a world-famous trade mark or a traditional respectively family business?

All in one. We are a world-wide corporation group considering that we are represented in 125 countries. Nobody would deny the fact that Villeroy & Boch is a world-famous trademark. We are surely in a position to call ourselves a traditional business founded in 1748. As the common stock is owned by the founder's descendants and further, a family member is part of the board of management – Nicolas Luc Villeroy is responsible for the division tableware – it is no question that we are a family company.

In your opinion, what does the brand Villeroy & Boch stand for concerning the consumer? Sanitary ware, products relating to eating or – as described by your company – lifestyle?

Personally, I regard the notion of lifestyle as too wide. With this, we also wanted to express our designer-competence. But the average customer is certainly thinking of our wash basins, water-toilets, bath- and shower-trays, bathroom fittings and tiles respectively dishes, cutlery ware and glasses at first.

Villeroy had reached an operating profit of 42 million Euro. This is the highest amount since more than 10 years and an increase, regarding the annual comparison, of nearly 10%. What are the reasons?

There have essentially been two reasons: on the one hand the increase of revenues of 4.9% to 803.8 million Euro – the highest value since six years – and on the other hand the efficiency increasing concerning our plants which led to a decreasing of the manufacturing costs, this caused a margin improvement. Further, the revenue quality increased, which means that the part of higher margin products increased while the part of low-margin articles decreased.

For this year, you are targeting an improvement of 5 to 10 %. What is the optimism based on?

It is based on the aspects which have already led to the upward trend in 2015 as for the current year, we are assuming an increase in turnover as well as an improvement in process efficiency. Further, there will be

a special effect: The International Sanitary and Heating Fair, ISH, is taking place every two years, recently in March 2015. When the innovations, which had been represented on the ISH, are going into production, then this is leading to start-up costs which are not arising in the following year, meaning 2016. For that reason, the profitability is rising concerning the bath- and wellness-segment.

A target range for the expected turnover is normally announced by Villeroy. For 2015 it was 3 to 5%, the result was 4.9%. For this year, the spectrum was broadened by one percentage point to 3 to 6%. Why?

Despite all optimism the imponderables of our business have even increased, especially in the emerging countries.

Please a little more precisely.

Russia will remain a challenge in 2016. If the Rouble depreciates even further – actually one Euro costs around 80 Roubles – the business development will become critical there. We don't have an own production in Russia, that means, costs in Euro will arise while revenues will be earned in Rouble. For that, we have already increased the prices there, but you cannot continue that continuously. Further, the hedging-costs are so high, that it does not add up. But let us be clear: We are in a position to come through to lean periods in Russia of several years. In 2015, we have made revenues of 25 million Euro, of which 85% were for bath- and wellness-products. In the long term we are regarding this as a very promising market.

And China?

Last year, we have generated 27.7 million Euro in the People's Republic – without Hongkong. This is a rise of 22% in comparison to 2014. More of 90% of the revenue is accounted for by bath- and wellness-articles. In relation to the group turnover, this represents a part of 3.4%. China is a huge market which is still developing very dynamically. But there, our sales volume is vanishingly small regarding the market size. Therefore, our target is to grow out of the niche existence.

But the Chinese economy situation shows first signs of a slowdown. Is it also possible for Villeroy to live with a significant lower rate of GDP growth of e. g. 6% in comparison to former years?

It has to be noted that a growth of 6% is much more than most countries can expect for 2016. And you have to look at this relatively: When the GDP has grown by 14% in 2007, this is a lower increase than 6% today regarding the GDP at that time. Although we are cautiously optimistic concerning our China business in 2016, it is difficult to assess our development there caused by the growth slowdown and the turbulences on the stock markets of Shanghai and Shenzhen.

How the revenue increase of 30 to 50 million Euro is to be reached this year, then?

On the one hand, our optimism is based on the extremely positive development around the turn of the year, especially in the last two months of the previous year business across the group - except Russia - ran outstandingly. This could be continued. Further, our range has been expanded by many new products which are guided by current trends, e. g. “Barbecue”, “Pasta” and “Pizza” in the segment of fine dining which will record increasing revenues.

***Where have been the Ebit-margins of the group and the two business divisions ? Do you have long-term objectives*?**

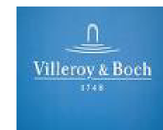
The rate of return before interest and tax in comparison to the revenue should reach 7% in the long-term. In 2015, it was at 5.2% group-wide. The margin of bath and wellness should be at 10 % in the long-term, the margin of fine-dining at 5%. In the previous year the corresponding values ranged at 6.6 and 3.0%.

How severely Villeroy & Boch is affected by product copies of China and other countries?

In my perception it decreased a bit. Probably due to the fact, that in China the mentality concerning this has changed. There, the instinct and the respect for trade- and product-rights have increased. But in case of copying products of the worldwide protected trade mark Villeroy & Boch – partially these are very brazy 1:1-copies – we will not hesitate to take decisive action with the support of attorneys at law, police and customs duty. As an example, we let remove the corresponding articles from the exhibition stand of the faker – we cannot take a joke of that. In case of denying the copying of our product, we would go to court.

Besides plagiates, the cheap-goods from Asia are bothering European manufacturers. Also for that reason, competitors had to file for insolvency. How Villeroy is dealing with that?

I should open a little more the scope of my answer.



Villeroy & Boch Group

Key Figures

Sales in million Euro

Year	Value
2014	766
2015	804

Gross Margin in million Euro

Year	Value
2014	341
2015	361

Operating Profit* in million Euro

Year	Value
2014	38
2015	42

Net Profit after Taxes in million Euro

Year	Value
2014	24
2015	27

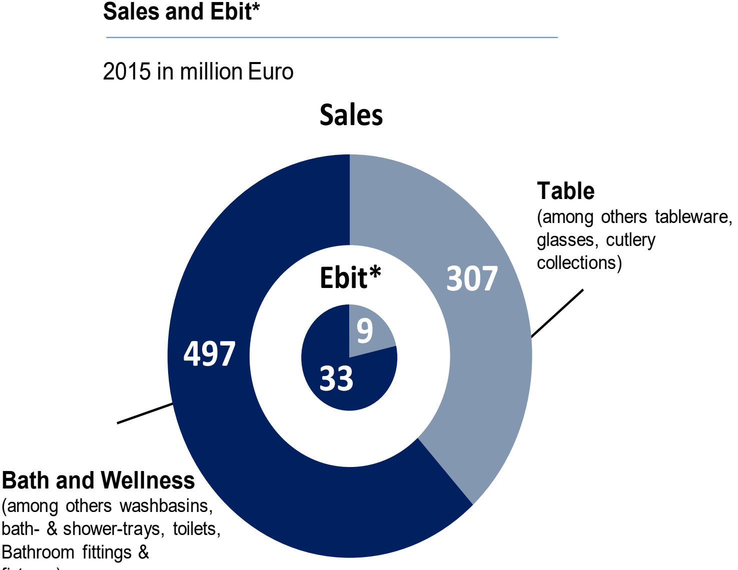
Operating Cash-Flow in million Euro

Year	Value
2014	51
2015	34

*Operating Profit before interest and taxes, adjusted for special effects

Villeroy & Boch Group

Sales and Ebit*



Market Capitalization (preferred shares only)
Status March 11, 2016
189 million Euro

Source: Company, Thomson Reuters

It is a part of the social change that for many – especially younger – consumers the significance of dishes, cutlery-ware and glasses decreased compared with 40 years ago. If you have the possibility to buy a coffee cup for 1 Euro at IKEA, you in an early age will not buy it from us for 25 Euro. The worth assigned to this product some decades ago, is now switched to maybe smartphones or long-distance travels. There is no longer a separation between everyday-life tableware and dishes for special occasions, wedding-lists at the porcelain shop have been outdated as well as the hope chest. In times of change concerning this social transformation, China entered the World Trade Organization WTO at the end of 2001.
In the sequel, the European market was floated by cheap-products of China. We are taking this development into account in making single products more attractive. Exaggerated, we are not concentrated on selling a set of tableware for 12 persons on the one hand, but we have smaller sets for e. g. 4 persons on special offer or single articles which are suited for supplements to existing dishes respectively cutlery or as a gift. On the other hand with such offers, we are in line with food trends.

To which market segment do you assign the Villeroy-products?

We see ourselves as a premium supplier, but are affordable to the quality-conscious household.

And where is the position of the brands Vivo and Gallo Design?

These are our secondary brands concerning fine-dining. Vivo and Gallo Design are significantly more price-aggressive than Villeroy & Boch, nevertheless, I would locate them in the medium price-segment. To illustrate this with an example: If a plate of Villeroy & Boch costed 25 Euro, you would find a price of 10 Euro on the price tag of Vivo or Gallo. But this is not the level of IKEA-products.

Don't you fear cannibalization?

I do not see the danger of displacement for products of Villeroy & Boch by Vivo or Gallo. In fact, the buying habits are changing with increasing income – young people, who are purchasing something of Vivo or Gallo with a low budget, will access to our core brand later on. And you should take into consideration the conditions: The revenue of our segment fine-dining was nearly 307 million in 2015, of which 12 million Euro accounted for the secondary brands.

Obviously, the Villeroy-board is not satisfied with the process-efficiency in the plants. How do you want to improve this?

The ratio of "good parts" of the overall output quantity can be surely improved in the sanitary-segment; actually it is at 80 – 90%. In our plants in Mexico and Thailand it is even lower. The relatively high part of rejects – the ratio of "good parts" is at least nearly 100% in the segment of plates – is caused by many parameters which are to be regarded especially by the burning of product innovations in the segment sanitary-ceramic, e. g. toilets or washbasins. The fine adjustment is not easy. At the beginning of a product ramp-up, there is a real learning curve. In the first weeks, the success rate may be beyond 80%. To reduce the subsequent costs incurred, we will build two prototype factories; one at our company's headquarter at Mettlach, Germany, and one in Hungary. As these factories which will cost 1.5 to 2 million Euro each, the production of new articles will be simulated; this will help us to reduce costs.

Villeroy & Boch, Preferred Shares, 13,95 € Share Price as of 23/03/2016

Index Price Chart, Index-base as of 25. 03. 2011 = 101,4199

-Black line Villeroy & Boch Preferred Share
-Yellow line DAX30 German Large Cap Index

https://www.comdirect.de/inf/aktien/detail/chart.htm 23.03.2016

The Villeroy-&-Boch-board is many a time concerned about the problem finding new installation technicians. Why?

This will affect us much more than the often-quoted dying of the specialized retail sector – in meaning of the distribution points - in the longer term, because the customers will just purchase elsewhere, e.g. via internet where we can record enormous turnovers. But if you can hardly find craftsmen who are installing our products, our growth will be limited.

Do you still have a local bank?

We do not have a local bank in its original sense, but a financing group to which more than 10 banks are belonging. Actually, we are using the services of these institutes for several tasks, e. g. for processing the payment in certain regions.

How Villeroy is financed?

With 26 % equity and 74% outside capital, hereby the biggest position are our pension liabilities. Two classical bank credits of 25 million Euro each and 5-year maturity are included to the outside capital. The one redemption is due in 2019, the second one year later. After the latest refinancing the effective interest rate is - on average - below 2 % per year.

Have you ever thought about other types of financing than bank credits?

Sure, e.g. bonded loans, bonds and US Private Placement. We will be prepared for such types of financing if there is shown their advantageousness, but this is not the case so far. For example, for our classical bank credits we need not to give guarantees. Also for our peak cash-demand of about 30 million Euro in the second quarter of a year which is caused by the
payment of dividends and employee bonuses, we get along with the current credit lines. Furthermore, we don’t have the complicated structures of other financing models with our credits.

How high is the net debt per December 31, 2015?

Zero. Actually, we had 65.6 million Euro cash on year end and so a net liquidity of 15 million Euro.

Do you pay negative interest rates on your deposits or have you paid them?
No one has dared to request that till now.

And if any bank did so?

Then it would have the choice: either renounce the negative interest rate or to loose us as customer.

Villeroy is the same as the 1. FC Nürnberg to the first federal soccer league of Germany: Constantly one is ascend and relegated. Actually, your shares are not listed in the SDAX, the German Small Cap Index. How important is the membership in the Small-Cap-Index for you?

We are pleased to join the membership to the SDAX. But it is not a catastrophe, when we are not taking part. For us, it is obvious that institutional investors have investment principles which make it difficult to invest in shares of companies with relatively low stock market-liquidity. Through this, the market turnover of our shares – that is the criterion to that our SDAX-membership fails – remains rather low.

Personal information
Hamburg boy’
Dr. Markus Warncke is a family man. The 46 year old man spends his little leisure time which is concentrated on parts of the weekend and holidays, with his female partner and his two kids (5 and 7 years old), e. g. with sailing. His close relationship to this sport is probably caused by his origin, the native of Hamburg is joking during the interview with Börsen-Zeitung who is therefore, respecting soccer, sympathizing with the HSV, the Hamburg Soccer Team.
Warncke studied at Essen and Düsseldorf (final grade: MBA diploma) and acquired a doctorate in business administration at the university of Erlangen. His professional career started with Daimler Benz at Stuttgart in 1996. Since 2001, Warncke is working for Villeroy & Boch. To 2005, he led the segments corporate audit and M&A, then he was responsible for the financing – among others - of the segment Wellness & Fittings until 2007. After further stages as Head of Group-Treasury (until 2011) as well as Group Financial Controller, Warncke has been appointed to Head of Finance in spring 2014. The appointment to the Management Board was made in January 2015. Besides Financing he is responsible for controlling, taxes, IT, purchase, real estate and audit.
Before being promoted to CFO, Dr. Warncke was a member of the IAFEI International Working Committee Treasury.

from Börsen-Zeitung, Frankfurt am Main, Germany, March 12, 2016.
Responsible for translation: GEFIU, the Association of Chief Financial Officers Germany, translator: Helmut Schnabel

OVERVIEW ON THE BEPS FINAL PACKAGE

By PIERGIORGIO VALENTE, Chairman IAFEI International Tax Working Committee

Some are of the view that we are witnessing a paradigm shift, others maintain that we are merely on the threshold of much more complex times embedded with an increased compliance burden.

With the release, on October 5, of the long-awaited final Reports on the OECD BEPS (Base Erosion and Profit Shifting) project, we are now about to enter the "implementation phase".

The BEPS final Package includes:

a. Minimum standards
b. Revision of existing OECD Standards
c. Common approaches and best practices guidance
d. Detailed report on measuring BEPS.

Minimum standards were agreed in areas in which no action by some countries would have created negative spill-overs (including negative impacts on competitiveness) on other countries, respectively on Actions 5 (Harmful Tax Practices), Action 6 (Treaty Abuse), Action 13 (Transfer Pricing Documentation and Country by Country Reporting) and Action 14 (Dispute Resolution Mechanisms).

On Action 5, there was consensus on an agreed methodology to assess whether there is substantial activity in a given preferential regime. The nexus approach for preferential intellectual property (IP) regimes demands an alignment of the benefits of such regimes along with substantive research and development activity; in addition, countries committed to transparency through the mandatory spontaneous exchange of relevant information on specific rulings.

As far as Treaty Abuse is concerned (Action 6), the minimum standards include model provisions developed to prevent treaty abuse to be included in the multilateral instrument available to countries for implementation of the agreed provisions on tax treaty issues into bilateral tax treaties. Taking into account that some of these provisions call for additional technical work, further developments are expected in years to come.

Minimum standards were also agreed on Action 13 (Transfer Pricing Documentation and Country by Country Reporting). MNEs with an annual consolidated group revenue equal or above EUR 750 million will need to report: revenues, pre-tax profits, income tax paid and accrued, number of employees, stated capital, retained earnings, and tangible assets in each jurisdiction where they operate.

CbCR should be filed in the ultimate parent company's jurisdiction and exchanged automatically through government-to-government information exchange procedures. In addition, it was acknowledged that the CbCR should be disclosed only to Tax Administrations and under specific conditions (ensuring confidentiality, and the proper use of information).

Finally, in the dispute resolution area (Action 14), agreement on a minimum standard to ensure progress on dispute resolution was reached. A large group of countries expressed their commitment to move quickly towards mandatory and binding arbitration.

The Minimum Standards were supplemented with OECD Standards and Recommendations: by revisiting existing standards (e.g., transfer pricing); by suggesting a common approach that will facilitate the convergence of national practices in other areas (e.g., hybrid mismatch arrangements, interest deductibility) and also best practice guidance (e.g., CFC, mandatory disclosure).

Please find here below a brief overview (based on OECD Reports) of the main developments in each action:

As the OECD BEPS Explanatory Statement released in October 2015 outlines, "Countries are sovereign. It is therefore up to them to implement these changes, and measures may be implemented in different manners,

Action 1	• A ring-fenced solution to the tax challenges it poses is not appropriate. • PE definition has been revisited (no agreement on a new nexus in the form of a significant economic presence) • In the area of indirect taxes, guidelines have been developed and implementation mechanisms identified to facilitate VAT collection based on the country where the consumer is located, which is particularly relevant for online ordering and delivery of goods and services.
Action 2	• A common approach: on domestic legislation and related treaty provisions where necessary to neutralize hybrid mismatches which undermine their tax base or the tax base of their partners. • Recommendations for the design of domestic rules and model treaty provisions have been agreed together with detailed commentary for their implementation.
Action 3	• The Report sets out recommendations in the form of building blocks of effective Controlled Foreign Company (CFC) rules, while recognizing that the policy objectives of these rules vary among jurisdictions. • It identifies the challenges to existing CFC rules posed by mobile income such as that from intellectual property, services and digital transactions and allows jurisdictions to reflect on appropriate policies in this regard.
Action 4	• A common approach which will facilitate the convergence of national practices by interested countries to limit base erosion through interest expenses, for example via intra-group and third party loans that generate excessive deductible interest payments. The common approach aims at ensuring that an entity's net interest deductions are directly linked to the taxable income generated by its economic activities and fostering increased coordination of national rules in this space.
Action 7	• Changes to the PE definition have been agreed to address techniques used to inappropriately avoid the tax nexus, including via commissionaire arrangements and the artificial fragmentation of business activities. • Follow-up work: additional guidance on profit attribution to the PE to be released. Follow-up work will also be needed in 2016 to incorporate the changes resulting from the report on Action 7 into the Model Tax Convention through an update of the Model
Action 8 - 10	• Existing standards have been clarified and strengthened, including guidance on the arm's length principle. • Changes to the TP Guidelines will ensure that the transfer pricing of MNEs better aligns the taxation of profits with economic activity. • The TP Guidelines are also being modernised in relation to intangibles (e.g., hard-to-value intangibles).

as long as they do not conflict with their international legal commitments. (…) … the emergence of competing sets of international standards, and the replacement of the current consensus based framework by unilateral measures, could lead to global tax chaos marked by the massive re-emergence of double taxation."

As such, it is crucial to ensure consistent implementation and effective monitoring. We need implementation to be consistent at national level to ensure legal certainty and avoid a rise on adjustments by Tax Authorities, spill-overs, and an increase on double or multiple taxation. The BEPS implementation form that will be developed by the OECD is expected to enable/facilitate such effective implementation.

As far as monitoring, OECD needs to carry out effective and tight monitoring to survey national and internationally implemented measures.

The success will depend on countries' receptivity and single/consistent implementation; nonetheless, expected changes of behavior towards tax should be creating a friendlier, fairer and more transparent tax systems within the short-term.

WHICH ARE CFOS PERCEPTIONS ON GOODWILL WRITE-OFF UNDER IFRS/US-GAAP?

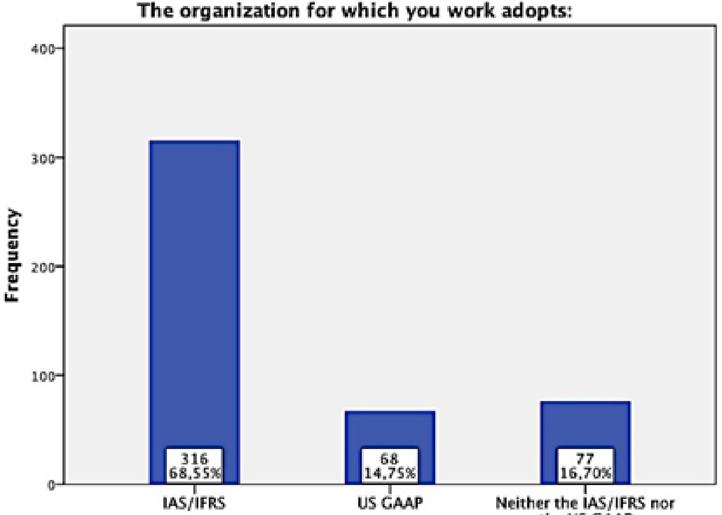
By Marco Allegrini, Chairman IAFEI IFRS Committee
and Silvia Ferramosca, Phd in Business Economics, Post Doctoral Research Fellow, University of Pisa

Introduction

The present work is the result of a project started at the University of Pisa in the Spring 2015 aimed at analysing whether the CFOs or people working in similar positions perceive that goodwill write-offs (GWO) may be used discretionally. This research has been embraced by the IAFEI IFRS Committee.
Indeed, both under IAS/IFRS and US GAAP managers may exploit the flexibility of the accounting standards because they have incentives to do so or, conversely, because they signal to investors the company future perspectives.

Research design and survey delivery

We designed the initial questionnaire grounding on prior academic literature on goodwill write-offs and on a recent questionnaire on the subsequent measurement of goodwill available on the website of the European Financial Reporting Advisory Group and of the OIC (Organismo Italiano di Contabilità) (EFRAG and OIC, 2014). We then piloted five tests[1] asking feedbacks on the following aspects: structure, length, wording, possible omissions and/or undervalued properties. The pilot tests to completely respond to the questionnaire lasted between 4 to 18 minutes. After the tests we were recommended to insert a question on the demographics and few other minor revision to the wording and format.
We sent the survey link to the LinkedIn connections of one of the group researcher with CFOs previously added to the connection network. From mid July 2015 we began sending the survey to CFOs from all over the world and by mid of March 2016 (eight months) we totally surveyed 1,712 CFOs. By the end of March 2016 a number of 461 CFOs responded to our survey invitation. Considering the successful rate of responses (26.9%) we did not proceed to send the invitation to require the involvement of non-respondents.
In the full sample of 461 participants, 316 work for an organization adopting the IAS/IFRS, 68 the US-GAAP and the remaining 77 in organizations adopting national accounting standards (but not IAS/IFRS nor US-GAAP).



Survey respondents

The final sample of 384 participants includes mainly the responses of CFOs (303, almost the 80% of the sample), of Controller or Financial manager (29), Chief Audit Executive or people working in top audit position (3) and other comparable position (15)[2] , the remaining 34 answers are missing.
About the 52.9% work in a privately held (non-listed) company, while the 44.6% in publicly-traded (listed) companies, only 1.3% in public sector companies and another 1.3% in other type of organizations.
In terms of total revenues, about the 51.9% of the participants works in companies with revenues lower than 500 million dollars, the 29.2% in companies with revenues ranging between 501 million and 5 billion dollars while the remaining 18.8% in companies with total revenues higher 6 billion dollars.

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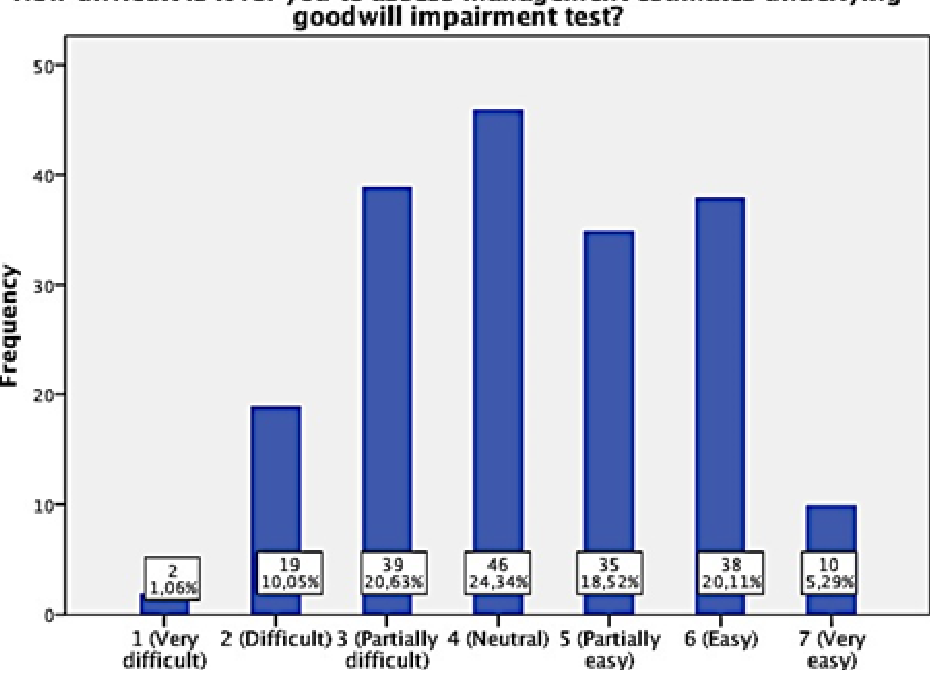
1 The pilot test were conducted on five persons: a Full Professor in Accounting, a Researcher whose main interests are on Accounting and Corporate Governance, a Ph.D. Student in Statistics, a Ph.D. Student in Accounting and Finance and a Chief Professional Accountant.

2 Specifically, the 15 other position are: managing director, assistant CFO, CFO of a subsidiary, corporate finance, finance director, IFRS and ICF manager, administrative manager, Vice-president corporate development, head of finance and accounting, head of reporting department, Regional CFO, head of consolidation and controlling, divisional CFO, head of economy and budgeting and independent board member/audit committee.



Main results

How difficult is it for CFOs to assess management estimates underlying goodwill impairment test?

While the accounting and auditing academic literatures argue that the estimates underlying the impairment of goodwill are hardly verifiable and auditable ex-post, the surveyed CFOs believe that for them these estimates are not so hard to assess (about 44% of the CFOs indicate that these estimates are from partially easy to very easy to assess). However, the CFOs' confidence over the estimates underlying the goodwill is not so decisive as almost a quarter of the participants is neutral and the remaining 31.7% finds these estimates from partially to very difficult to assess.

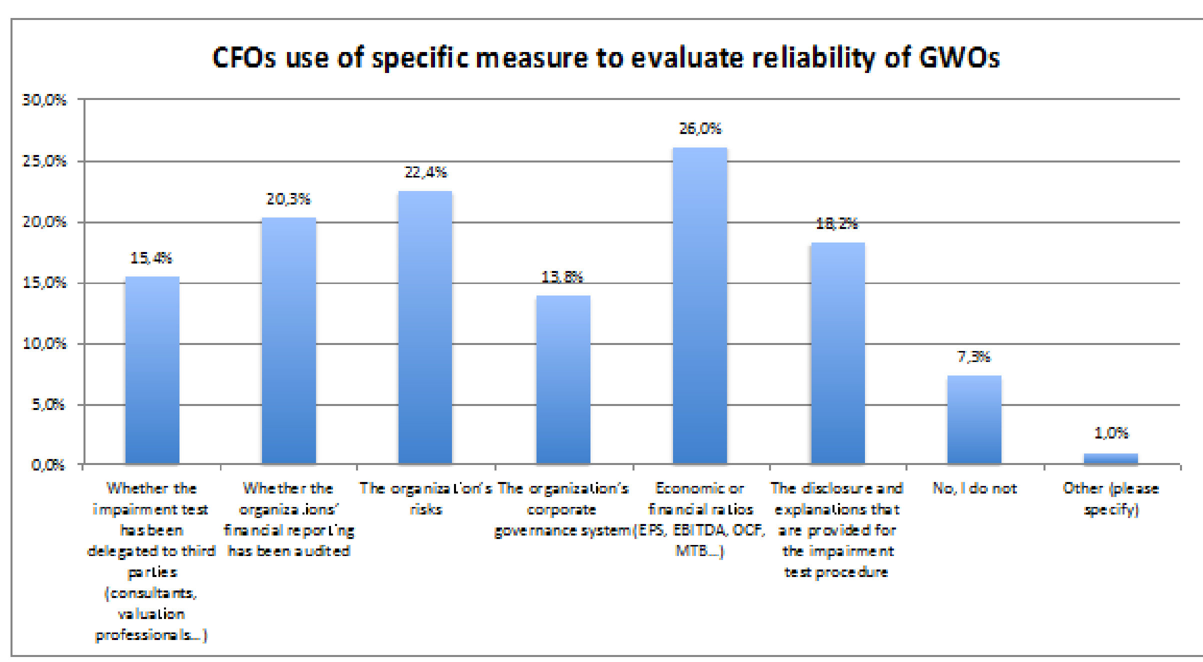
Does the impairment test provide a more faithful representation than the amortization process?

Starting from the first group of propositions, we can see that overall about the 71% of the respondents agree that the impairment test provides a more faithful representation than the amortization process.

About 58% of respondents believe that the elimination of the goodwill amortization increased the subjectivity. About 66% of the participants believe that the valuation based on estimated future cash flows is useful in financial reporting and more than half of the respondents disagree or is neutral on the question related to the management that exploits the room for discretion allowed by the accounting standards. Consistently with this last result, almost half (49.3%) of the respondents disagree also that management will not recognize goodwill write-offs when the goodwill is impaired and as a consequence about 60.7% (65.2%) of the respondents are convinced that the impairment losses on goodwill reflect the underlying macro (micro) conditions in which the company operates. These responses and percentages are confirmed by the results on the question posed in an inverse manner. Indeed, only 29.4% of the CFOs believe that management discretionally uses the goodwill write-offs to achieve its own incentives or to send credible signals to the outside (about 35.3%).

What do CFOs think about management discretionary use of goodwill write-offs?

The second group of responses indicates that more than 52.7% of the respondents believes that prohibiting goodwill write-offs reversals leads to untimely and/or underestimated write-offs. More than 40% of the CFOs agree that the management uses discretionary goodwill write-offs to meet analysts' earnings forecasts. Optimistic analysts earnings forecasts according to CFOs seems to be a preeminent incentive for management compared to personal incentives and signalling to the outside. Also the leverage and the compensation schemes are seen as strong incentives to manipulate the impairment losses (40.3% of agreement for both of them). As predicted and tested by academic literature, CEO changes are thought to be relevant incentives (about 41.3% of respondents agree). Concerning big bath and income smoothing incentives we can see that



CFOs are concerned about both of them (about 49.3% and 40.3% agree).

Do CFOs use specific measures/procedures to evaluate the overall reliability of goodwill impairment test?

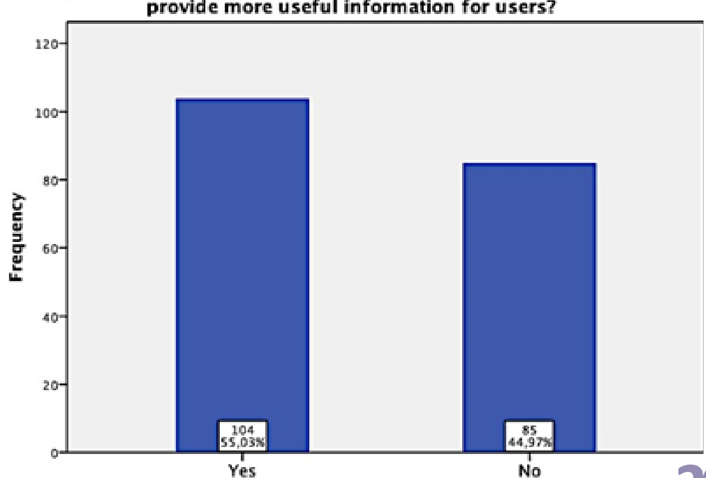
About 26% of CFOs use economic or financial ratios, 22% evaluate the organization risks and about the 20% takes into account whether the financial report has been audited. Significantly important is considered by about 18% of the respondents also the disclosure and explanations provided for the impairment, while the 15% take into account whether the impairment test has been delegated to third parties and the 14% the company corporate governance system. We did not expect that the 7% do not use any specific measures or procedures to check the reliability of the process. A CFO than specified that he (or she) uses the historic performance of the cash generating unit while another revealed to use the sensitivity analysis disclosed.

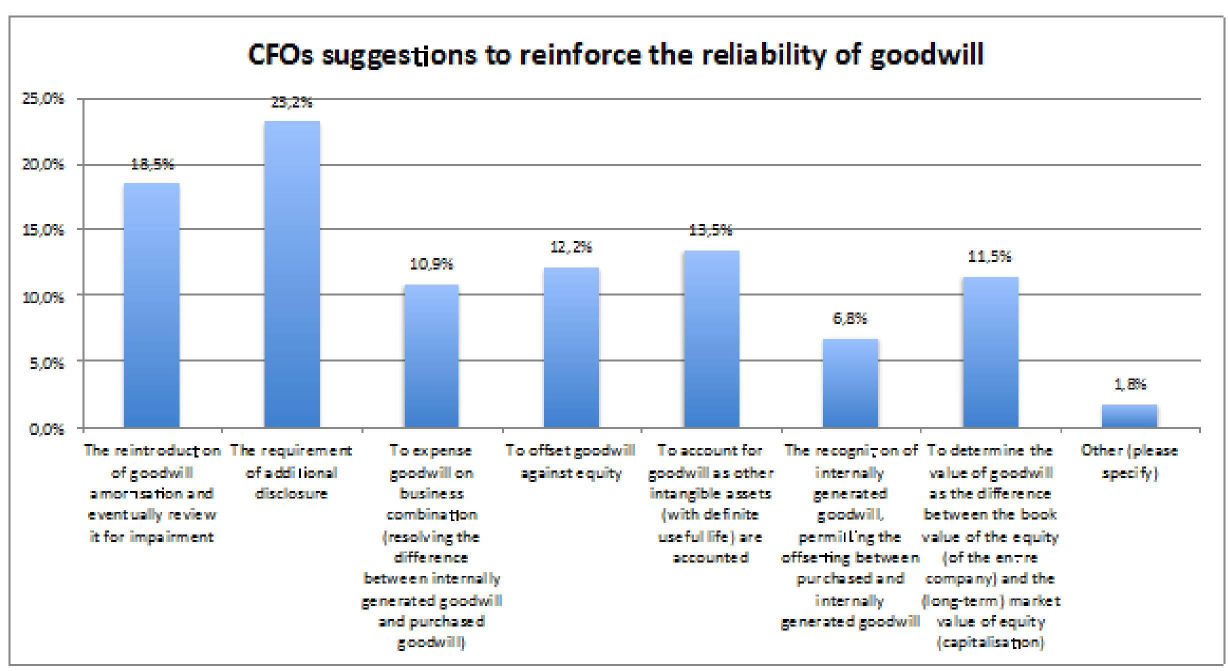
Do CFOs compare their evaluation with other evaluation(s) of subjects in other positions?

Again, we did not expect that so many respondents do not compare their evaluation with the evaluation(s) of other subjects (20.6%), this result may contribute to the behavioural studies on the top-executives overconfidence. Although, 15.6% of the participants admit to compare their evaluation with those of the controller, 9.9% with those of the internal auditor, 8.3% with those of the process owner and with those of the risk managers and 6.0% with those of the compliance officer.

Which is, at the end, CFOs opinion on the current accounting method for goodwill?

It is relevant that more than half of the respondent CFOs (55%) is convinced that there are other accounting treatments for goodwill, which might better fulfil the information usefulness objective of financial reporting. More than 23% of CFOs suggest the requirement of additional disclosure. A wide percentage (18.5%) believes also that the reintroduction of goodwill amortization and its eventual review for impairment might solve the reliability issues. We can see that also accounting for goodwill as other intangibles (with definite useful life) is perceived as a good solution (13.5%) as well as to offset goodwill against equity (12.2%) or to expense it on business combination (10.9%) or to determine the value of goodwill as the difference between the book value of the equity and the long-term market value of equity (11.5%). A part of the participants (6.8%) believes also that it could be satisfactory to account for goodwill as other intangible assets with definite useful life are accounted.

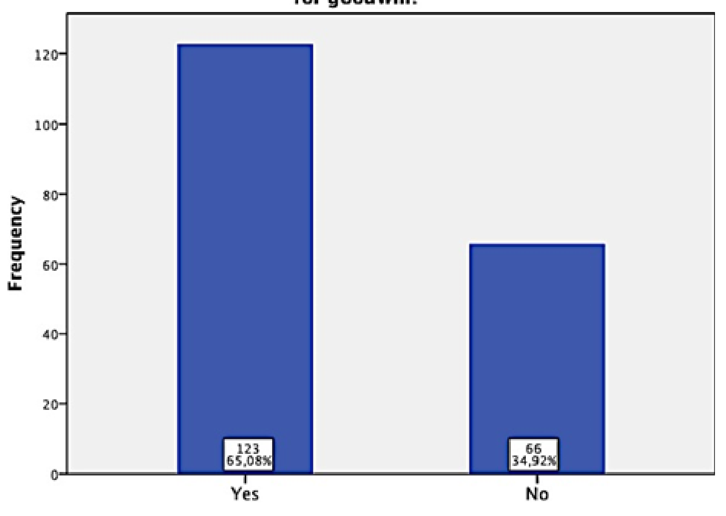




This question raised the interest of some CFOs who for instance recommend as follows: «If no amortisation reintroduction will be possible, then are absolutely important: a) standardisation of mechanism on WACC, g rate and other parameters; b) possibility to reaccount an impaired goodwill in front to different economics conditions; 3) impose very mandatorily all the sensitivities to be done and to be reported in the disclosures», or suggest that the relevance of benchmarks and specialized firms, or the need of standardised test methods considering also the capital market valuation practice or another that firmly states as follows: «I believe the current approach is the best even though it introduces subjectivity».

Purposely, the questionnaire concludes by asking CFOs their overall preference between the impairment test and the amortization process and more than 65% of the respondent CFOs prefer the impairment test.

Overall, do you prefer the impairment test than prior amortization process for goodwill?



Discussion

The conclusive question on the CFOs preference between the impairment test and the amortization of goodwill directly answers to the EFRAG recent debate on a possible reintroduction of the goodwill amortization. Although the difficulties underlined to implement the test, the 65% of the respondents prefer the impairment of goodwill. However, the remaining 35% still prefer the amortization process.

We conclude this report with some of the CFOs suggestions and recommendations, which might constitute the case for future investigation. Interestingly a CFO suggests to «review/propose impairment test methods/tools», hence future accounting studies might create a tool to assess the effectiveness of the impairment test.

On the other hand, another CFO points out how actually in liquid and transparent markets the market operators are sufficiently prepared to estimate fair value estimates and that they can adjust their expected cash flows, the fall in the share price as a consequence advances the recognition of the impairment losses. This CFO expresses as follows: «My sense is share price falls after impairment write downs are more sentiment driven and a reflection on the ability of the relevant management to communicate future direction. After all, an impairment is a correction of a past action (an acquisition) and if the market assesses the acquisition won't justify the price paid (i.e. the company has overpaid), it will adjust the share price immediately and not wait for a subsequent impairment». However, we then could ask (as a future research question): does the market anticipate or react to goodwill write-offs?

The debate on the goodwill amortization vs. the impairment of goodwill is quite vigorous also amongst CFOs. Moving from the CFOs sustaining the amortization we can read the following observations against the impairment test:

a. «*Impairment test is worth to assess at a given period the value of the assets compared to a straight amortisation method. However given high incidence of semi objectives variables in the future cash flows calculations (interest, beta, assumptions) the value can differ significantly and results are often forced to obtain a given value. A straight depreciation method reflects the original paid value amortisation that should be strengthened by the impairments test*»;
b. «*Previous amortization process, while not perfect, was a better solution. Impairment test has a tendency to be misused and will hit mostly during downturn economical cycles*»;
c. «*The old process of amortization was easier to deal with from a forecasting and cost stand point. Impairment has caused hard to forecast changes*»;
d. «*In my point of view, the impairment test has been using just as a formal process. Without any implications on the company management*».

On the other hand, another stream of thought within these professionals asserts that: «Impairment tests are useful in that any projections made one year can be reviewed the following and are more difficult to manipulate. Market values based on DCFs are somewhat subjective but will always be better than accounting/ book measures unrelated to market valuations».

A CFO stresses how often the trouble is not the decision to impair or not impair the goodwill but with the measurement of the impairment loss. He/she adds: «The first problem is the uncomplete standardization of schemes, choice of comparables, interest rates, “premium” on cost of capital, WACC, g-rate, perpetuity, etc. which creates a general situation of discretionality. But on top of this the bigger problem in my opinion is volatility. When I take the data of my comparables, they are at a precise closing date (and with different schemes I can’t be sure of a perfect comparability), the interest rates and the “premium” for small-medium caps had fluctuated a lot in the past month to month. So we take punctual data of comparables, under a non-complete standardization of methods and schemes, moreover under a very volatile capital market, while we pretend to book in a very definitive way a GWO (in fact non recourse for a subsequent revaluation of it)». He/she continues suggesting the introduction of the possibility of reversals of goodwill write-offs: «If we have to accept the “principle based” approach (so no mandatory schemes and no real standardisation), and moreover if we have to accept volatility of many data contributing at impairment calculation (especially since 2008 onward), that’s OK... but in such a situation, we have then to accept even up and down volatility of Goodwill value as a consequence (so at least revaluation admitted)». A further point raised for goodwill amortization is stated by another CFO: «…I repute as workable the goodwill amortization. It has been quite clearly demonstrated that a healthy industrial cycle has a duration of maximum 30 years (and recently... even shorter and shorter). By creating databases of “healthy economic cycles” sector by sector, in the future could be available standardised methods to amortise Goodwill in a comparable way among comparables». A CFO proposes also an alternative accounting method for goodwill: «An alternative to Goodwill amortization could be a “clever cap” at the goodwill, so that people will obliged to a GWO when exceeding it. For example (free cash flow x 20) = max cap allowed for Goodwill. Something simple and possibly based on data of the applicant itself, so that it can’t be so much arguable. I propose the free cash flow because the cash flow scheme in IAS-IFRS is most standardised one and therefore discretionality will be limited “by definition”».

Two competing perspectives from CFOs may condense the conclusion of this paragraph. While a CFO stressed the independence of the directors and senior management stating that: «As a professional Chartered Accountant my integrity is to do the calculation of GWO to the best of my ability. The Directors and senior managers I have worked with would always try and do the right thing. People and companies in general try to do this...there is always one bad apple however that makes your questions fair!»; another CFO argues that companies cannot avoid to use “accounting cosmetics” in a financial world which is not transparent, doing earnings management is a “self-defence action” employed by the companies.

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PRICE POINT
February 2016

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Economies and Markets

CHINA AFTERSHOCKS RATTLE GLOBAL MARKETS

Nick Beecroft
Portfolio Specialist, Asia ex-Japan Equities

EXECUTIVE SUMMARY

Once again, developments in China have reverberated across global equity, currency, and commodity markets and revived fears that surfaced after China's surprise currency devaluation and stock market crash last summer.

Markets likely will remain volatile, China's economy will continue slowing, and the country's currency may weaken further. However, T. Rowe Price does not anticipate an economic hard landing or a financial crisis in China.

Moreover, the recent turmoil in China's market does not change our constructive longer-term view of prospects for investing in China and Asia more broadly.

THE CURRENCY

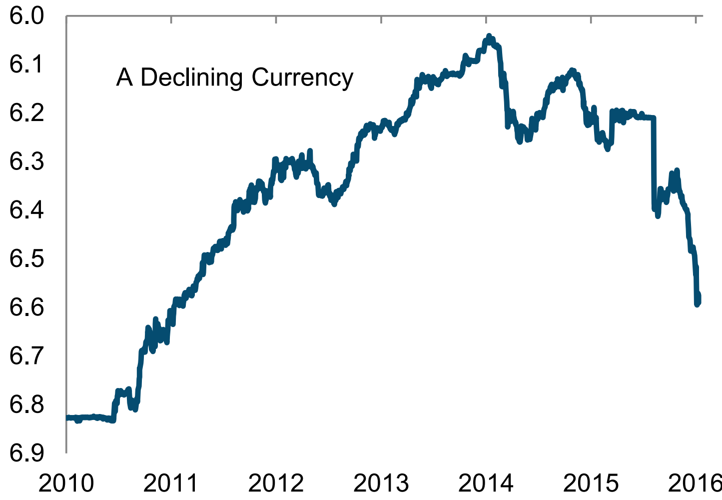
The Chinese currency, called the renminbi, has been under pressure, especially since a devaluation by China authorities in August of last year took investors by surprise. At the end of last year, its value also began to be pegged to a basket of currencies instead of solely to the U.S. dollar, which implies a further devaluation. The dollar has been appreciating against most major global currencies, and the renminbi recently hit its lowest level versus the dollar in five years.

The potential for a further unexpected and sharp decline in the renminbi is the key current risk in China, as this could hasten continuing capital outflows from China and put more pressure on its economy. Once global markets believe that China's intent is to weaken the currency, it is very difficult to control the forces that seek to take advantage of that move.

Our expectation is that China will let the renminbi float within limits against the new basket of currencies, and that would suggest downward pressure this year, but in a fairly controlled fashion. However, managing that devaluation process is difficult to achieve. The government may need to continue drawing on its significant foreign exchange reserves to defend the currency over the coming quarters. China can afford to do this for a while, but not forever.

Our base case, therefore, is for a managed, gradual devaluation of the renminbi this year and for authorities to re-build confidence in the currency. But it's certainly possible to envisage more disruptive outcomes.

Figure 1: **Chinese Yuan in One U.S. Dollar**
Inverted scale to show decline in yuan



Source: Bloomberg. As of January 2016

THE ECONOMY

It was inevitable that China's economy—the world's second largest—would slow from the double–digit growth attained over previous decades, particularly with the government attempting to transition the economy from one led by manufacturing, investment, and exports to one more driven by domestic consumption and services.

Nevertheless, the slower pace of growth along with mounting concerns whether China's leaders can effectively manage this transition have sent tremors through global emerging markets several times over the past three years—with fears now impacting developed markets as well.

The government's recent heavy-handed intervention aimed at supporting its equity markets and currency, and its inconsistent communications, have undermined investors' confidence in China's leadership and spurred more capital outflows from the country.

The Chinese government recently reaffirmed its expectation for economic growth to average 6.5% per year between now and 2020. We consider that to be difficult to achieve without also seeing some undesirable consequences.

While the risk of policy mistakes remains high and should be closely monitored, we don't believe that a hard landing for China is the most likely outcome. Policymakers have every incentive to ensure that doesn't happen; their very existence probably depends on it.

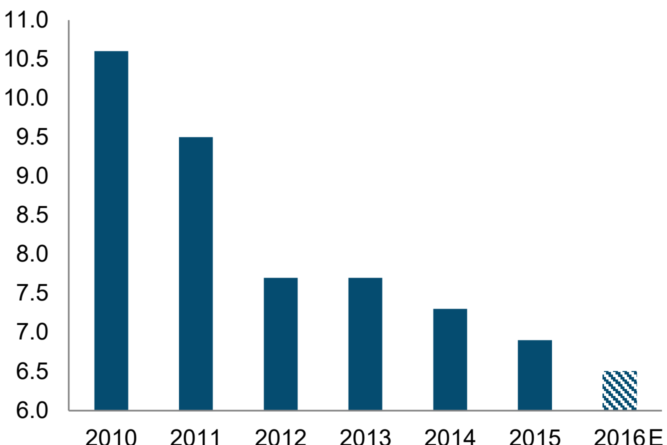
Several options, including the use of monetary and fiscal policy, are likely to be used to support growth and smooth the transition. Even if China grows at 6.3% this year as the International Monetary Fund forecasts, that is still a very impressive rate in the context of global growth.

THE DEBT BUBBLE AND FINANCIAL CRISIS

China has experienced a massive buildup of debt since the 2008 financial crisis and a significant rise in nonperforming assets in its banking system.

We believe that the level of nonperforming loans in China is substantially higher than the 1.5% rate reported by the central bank. China's banking stocks have been trading at valuations that would indicate a nonperforming loan rate of about 6%. If China were to suddenly recognize all of those nonperforming assets, it could prove highly disruptive to the economy and could trigger a financial crisis at some point. But we think that outcome is extremely unlikely given China's government control of the banking system and the financial system more broadly.

Figure 2: **China Real GDP Y/Y%**
A Sharp Slowing in Economic Growth



Sources: Bloomberg and China National Bureau of Statistics. As of January 2016

A much more likely outcome is that we see an "ever-greening" or a rolling over of bad debt over the next few years, given China's unwillingness to let financial firms fail, its emphasis on stability, and its huge current account surpluses and foreign exchange reserves.

There is the risk that avoiding the pain of deleveraging swiftly and kicking the can down the road will exact a heavy toll on the economy longer term.

That is one reason why we expect growth to continue to slow unless China enacts more transformational reforms that will improve efficiency and productivity in the economy.

THE STOCK MARKET AND CHINA LEADERSHIP

Despite a decline of 45% in China's Shanghai Composite Index last summer, China was one of the better-performing regional stock markets last year, with a gain of 9.4% in U.S. dollars, based on FactSet data. However, the steep decline at the start of this year reflected renewed fears about China's economy, currency, and management.

So far this year, the government has had to reverse policy and suspend newly installed circuit breakers that shut down the market twice in one week. There is no doubt that Chinese policymakers are struggling to balance state control with more market-driven pricing mechanisms.

It is important to remember that China alone is not to blame for the turmoil in global equity markets early this year. Investors are also concerned about U.S. and global growth, the declining oil price, the outlook for corporate earnings, and the Federal Reserve's move to finally begin raising interest rates.

OPPORTUNITY AND OUTLOOK

Despite the turmoil in China's stock market, we continue to find attractive companies where the long-term benefits should outweigh the near-term risks. One key area of focus is disruptive technology. Investing in some of China's high-growth Internet stocks has been very profitable.

We also find opportunity in the consumer and service sectors, with Chinese consumers moving up the value-added curve, buying more expensive, higher-quality items. In the services area, health care and logistics offer promising opportunities. We also see potential in reform beneficiaries—state-owned enterprises that should benefit from change in government policy over the next few years.

Recent events do not change our longer-term view on China or the rest of Asia. We expect the China market to offer attractive growth opportunities for many years to come. Also, the structural growth story in Asia remains robust. Economies are growing at healthy levels in a global context, supported by large, often young populations that are moving up the income curve.

As we get more clarity on China's currency framework, we expect volatility to subside, allowing investors to focus on the more positive features of the China and Asia story once again.

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SELL FIRST, THEN UTILISE
SO SIMPLE THIS IS NOT ANY MORE

NEW ACCOUNTING REGULATIONS HAVE SERIOUS CONSEQUENCES FOR LESSEES AND FOR READERS OF FINANCIAL STATEMENTS

by GEORG GIERSBERG, Frankfurter Allgemeine Zeitung, Frankfurt am Main, Germany, February 1, 2016

It is a favorite model: one is selling one´s corporate headquarter, and one is leasing it back from the purchaser. The corporate headquarter disappears from the balance sheet, and it shows up anymore only in the profit and loss statement as rental expense.
The seller at once gets a lot of money, with which for instance he can pay back loans. This lowers the interest expense and it shortens the balance sheet, with the consequence, that the equity share in percent of the balance sheet total goes up. This situation is going to be finished starting January 1, 2019.

After many years long deliberations the International Accounting Standards Committee, IASB, has published new regulations for leasing contracts. Who is setting up international financial statements as per IFRS regulations, must, as lessee, take up leasing objects into his balance sheet. The sold corporate headquarter is thus showing up again in the balance sheet. On the asset side as right of utilization, against which a liability of the same size is booked on the liability side. The right of utilisation is written off over the time frame of the contract, the liabilities are decreased step by step with the concomitant leasing payments.

This first sounds like pure accounting technique and little exciting. But first of all many corporations are impacted by this, as today ever more buildings, equipments, aircrafts, vehicles and other objects from the copier to the telephone tower are being leased. It also makes no difference as to whether one defines the relationship as leasing or as rent. Whenever there is an utilization

right of an object with a maturity of more than one year it is from an accountancy technical term view a phenomenon of leasing. With this also retail shops are impacted, which usually are renting shopping facilities for the longer term.

But there are also serious consequences for the readers of balance sheets. As by taking up all leasing objects on to the balance sheet - exceptions are only objects, which are rented for a shorter term than twelve months and which have a value of less than 5000 € - the balance sheets are lengthened, the equity ratio is then lowered and the leverage is increased.

In addition, through this change of accounting regulation, the profit before interest, taxes and depreciation, the Ebitda, is improving. This ratio is very much liked by many CFOs as an expression of earnings power.

So far the leasing contracts and their leasing expenses have shown up in the profit and loss statement, and there as expenses they lowered the profit. In future they show up in depreciation and in interest expense - and thus only after computing the profit before interest, taxes and depreciation. The Ebitda is improving. With this, also so called multiples to the Ebitda have to be adjusted, which per example play a great role when it comes to takeovers.

For the lessor nothing changes. He, also in future, has the leasing object on the asset side, meaning the corporate headquarter. This is liaised with the non logic, that the lessee , though, has liabilities in his balance sheet against which there are no receivables at the lessor.

As every regulation, also this one can be circumvented in future. For one, one can decompose the leasing or rental object in such a way, that the single parts fall below the amount of negligence. For two, one can rent instead of the equipment the capacity. Then it is formally not a leasing contract. Certain outsourcing contracts could also be redefined as service contracts, and then they would not any longer be leasing contracts. Overall, however, the observers are of the opinion, that the new regulations are an improvement. First and foremost it is said that the comparability of financial statements is being improved.

In spite of intensive negotiations, it was not achieved, to attain uniform regulations as per IFRS and as per the US American GAAP.

FROM FRANKFURT ALLGEMEINE ZEITUNG, FRANKFURT AM MAIN, GERMANY, FEBRUARY 1, 2016.

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CORPORATE FINANCE LEANING MORE TOWARDS CAPITAL MARKETS

A EUROPEAN RATING AGENCY SHOULD NOT BE ABSENT FROM THIS

By Torsten Hinrichs, Chief Executive Officer , Scope Ratings AG,
from Börsen-Zeitung, Supplemental Issue, Frankfurt am Main, Germany, February 4, 2016

For a long time now, investors and issuers have been demanding a european rating alternative to the three us agencies. why? because more and more projects, infrastructure measures, as well as companies and banks in europe are financed through the capital markets. just recently, eu commissioner jonathan hill presented his plans for a capital markets union, thereby reinforcing the political will to further expand and support corporate financing through the capital markets. Against this backdrop, ratings will present a key competency in the financing markets – even more so in the future than in the past. A European voice must not be absent from this concert.

Additionally, investors are still exposed to an American-shaped monopoly of opinions, due to the oligopolistic structure of the ratings market. The assessment method applied by the US agencies, and ratings based on these, barely differ, reflecting a US-centric view of economic affairs and the default risk of issuers. At the same time, issuers' regional and cultural peculiarities barely rate a mention.

Therefore the central question is: by how much can a European rating alternative distinguish itself from the US agencies in terms of analyses and ratings? One hope, often expressed in the wish for a European rating agency, cannot be maintained, however: the credit ratings assigned to issuers will not be more forgiving or friendly than those from the American agencies; agencies that assign courtesy ratings will not be tolerated by the market. Instead, a European rating agency has to establish an alternative perspective and methodical approach which better reflects the realities of the European capital markets, and do a better job at considering peculiarities of European issuers.

A European rating agency can also crucially differ from the Americans in its fundamental approach. For example, the analytics of the American agencies are quite systematic and became even more formalistic in the past. This tendency was caused by the (valid) efforts to make ratings more comprehensible to outsiders.

Placing investor needs at centre stage.

Scope Ratings, too, places great value on transparency, publishing detailed methodologies. But we give our analysts the freedom to rate superficially identical matters differently, whenever this is felt necessary. That is precisely what constitutes the added value of our work. And thus, when evaluating credit risks, we place more trust on our analysts' deep understanding. This takes time not only during the analytical process, but in the explanation of our results. However, through this tailored approach, we differ from the schematic, industrial method of the American agencies.

Investors frequently criticise that rating analyses and methods are becoming more and more extensive and complex. Therefore, a rating alternative has to aspire towards less complexity, while remaining more significant and substantial than the US agencies. For example, Scope does not focus on an unmanageable amount of different types of bank ratings. Instead, it concentrates on the ratings for banks, short- and long-term liabilities, and for the corresponding capital instruments.

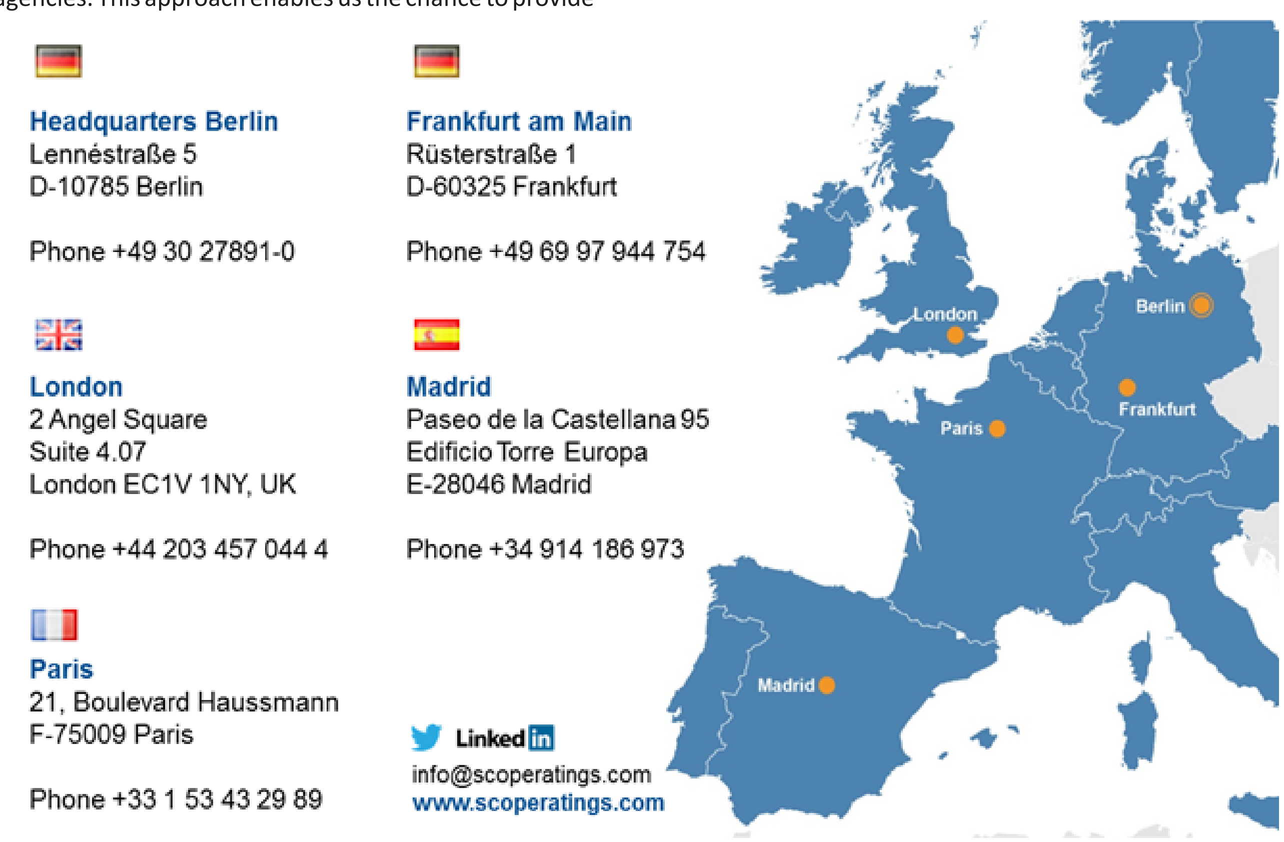
Investors have also vehemently demanded forward-looking analyses and appropriate projections. To serve these needs more thoroughly than larger agencies, we use forecasting techniques from equity research, in addition to classic fixed-income analysis. Our analytical teams are thus made up of experienced representatives from the investor side, equity research and rating agencies. This approach enables us the chance to provide a real outlook that does not simply and mechanistically perpetuate past trends into the future.

In contrast to the methodical approaches of the large agencies, our big advantage is that we develop fresh methods as well as process experiences from the financial crisis. Therefore, we are the first rating agency to have reflected in our methodologies the new regulations on bank recovery and resolution (BRRD) in its entirety.

Forgoing a mechanistic link of country and issuer ratings is also analytically relevant. A sovereign cap, i.e. limiting a rating through that of the issuer's domicile state, does not exist at Scope. Even if close ties and interplay exist between states and resident companies, the majority of European banks and businesses are active in large parts of Europe and beyond. In our view, there is no reason for mechanistically chaining issuers with widely diversified business models to the rating of the home country.

Effectively considering European-specific Characteristics

When assessing businesses and their bonds, there are also numerous aspects that a European rating agency can do differently and better. We rely on a regional rating approach, which can more effectively consider European-specific characteristics in corporate finance and accounting. For example, European businesses maintain more liquidity than US companies. We view this positively, as it can be a sign of prudent management and a buffer against unforeseeable crises.



A further aspect are pension provisions. We only classify parts of the pension obligation as liabilities, depending on the level of invested pension assets versus annual pension payments, as well as the transparency of businesses when it comes to disclosing pension capital. This is justified by the fact that part of the pension obligation is only payable long after the rated bonds and loans mature.

Europe and the USA also differ substantially with regards to their corporate cultures. Yet these are not considered in Anglo-Saxon assessments. However, these play a large role in differentiating between company- and manager-led businesses, for example. Family-run companies in Europe are defined by great stability: Owners forgo dividends, and prefer to maintain assets for future generations. This needs to be reflected in the rating.

The choice of comparative data has a great impact on the rating. This especially plays an important role when evaluating structured finance activities. In the past, for example, the performance of European loan securitisations was significantly more positive than for US-based transactions. The use of American benchmarks to rate European transactions is thus incomprehensible, not just for issuers but for investors as well. Scope Ratings consistently uses European benchmarks.

A European rating alternative can also distinguish itself from US agencies through analytical features. These stem from a tradition when ratings were required, which continues to negatively impact service quality and customer orientation today. Here, a European rating agency can set different standards – for example, through more transparency and comprehensibility, and explanations in rating reports. Being more accessible and communicating proactively can also gain an agency points, and offer added value against the US agencies.

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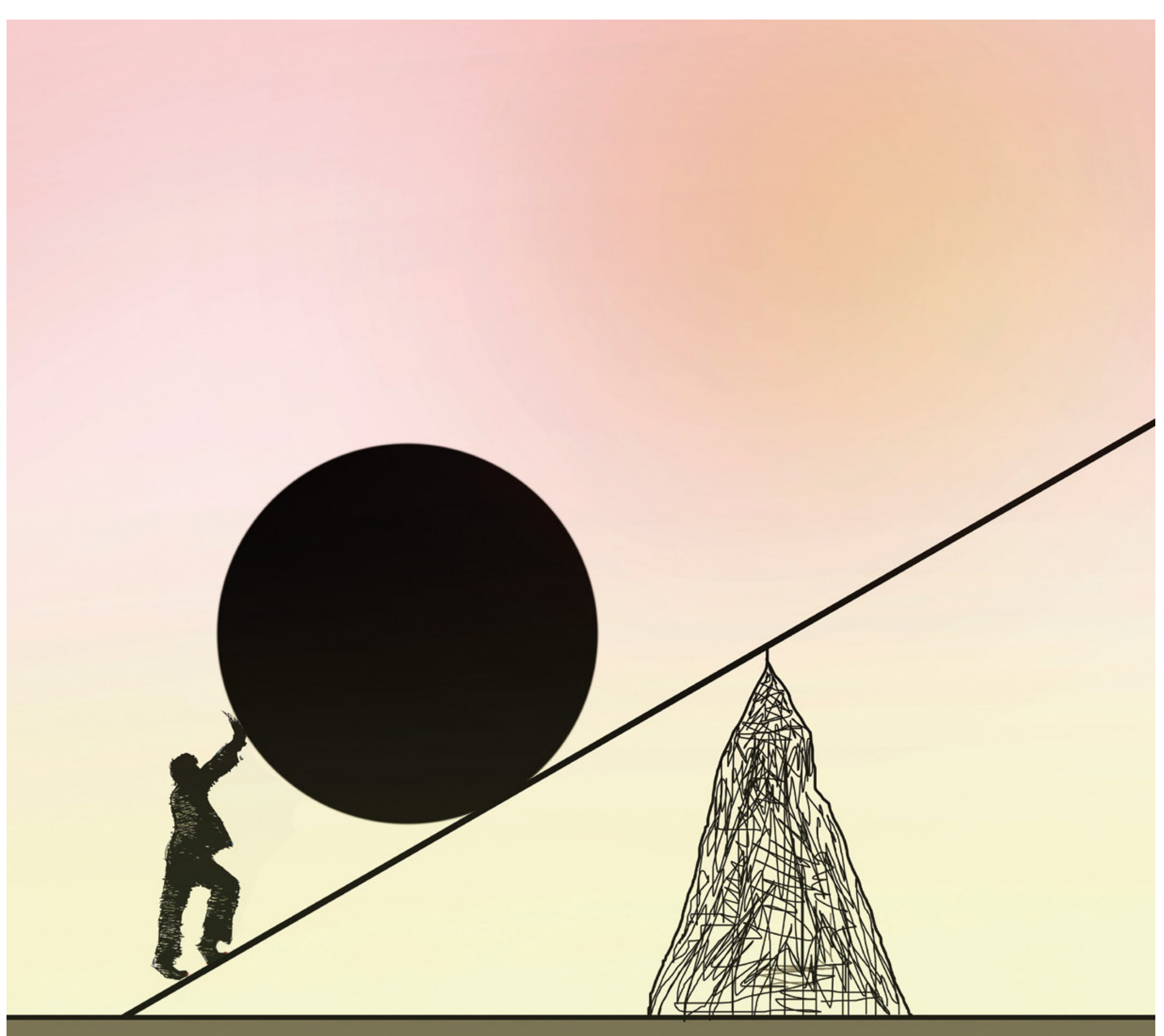
Responsible for English translation: Scope Ratings AG



"Whatever it takes"

Policymakers in Brussels and within European parliaments still face turbulence as they endeavour to encourage growth and restore unity. Treasurers are more sanguine, but likewise treading carefully. Ian Fraser reports

Back in July 2012, after a turbulent period when the euro's very survival seemed to be at stake following rolling sovereign debt crises that nearly saw Greece quit the EU, European Central Bank (ECB) president Mario Draghi pledged to do "whatever it takes" to save the single currency. Together with other ECB initiatives, including quantitative easing (QE), that was enough to put a floor under the euro and marked a turning point for Europe.

Four years on, the existential threat to the euro has arguably passed, but large parts of the 28-member economic bloc have yet to fully recover, suffering stagnant growth, high unemployment, low interest rates, below-target inflation and a refugee crisis that is causing fractiousness and disunity. Speaking at the World Economic Forum in Davos two months ago, Draghi admitted that Europe's economy was probably in need of another shot in the arm – possibly including further QE – as inflation remains stubbornly low.

The Italian-born central banker says the ECB has "plenty of instruments" at its disposal to rectify the situation and push inflation back up towards the central bank's 2% target. "We have the determination, the willingness and the capacity to act and deploy those instruments," Draghi told an audience in the Swiss ski resort.

That same week, French president François Hollande was forced to declare what he called a "state of economic emergency" in France, as he unveiled a €2bn job-creation plan aimed at reducing France's stubbornly high 10.2% unemployment and boosting the country's meagre 1% growth – as well as giving himself a chance of being re-elected as president. Hollande was galvanised into action after a package of liberalising reforms, spearheaded by economy minister Emmanuel Macron, failed to make any meaningful dent in unemployment. The declaration came hard on the heels of the national state of emergency Hollande declared after terrorist attacks in Paris and Saint-Denis killed 130 people on 13 November. Unemployment rates in other EU countries, such as the UK and Germany, are half those of France – but they are even higher in Italy and Spain.

Economic growth forecasts

In early February, the European Commission updated its forecasts for EU economic growth, saying it expected the bloc to grow at 1.9% in 2016, down from its earlier estimate of 2%. For the eurozone, it said growth would be a marginally slower 1.7%. Economic consultancy the Centre for Economics and Business Research (CEBR) said: "The trifecta of low inflation, accommodative monetary policies and a weak euro seem to be boosting the region for now."

Corporate treasurers are concerned that Europe's economy could once again go into reverse gear and are taking steps to ensure their firms are ready should conditions turn ugly. The treasurer of a large pan-European energy company, who asked to remain anonymous, says: "The euro crisis could raise its head again, and a lot of pain is still being felt in countries like Greece and Spain. I don't think it would take much."

Corporate treasurers are concerned that Europe's economy could once again go into reverse gear

Paul Wilkinson, head of corporate finance and treasury at serviced office provider Regus, says: "We'll see some market turbulence, with the possibility of another economic downturn. There are a lot of uncertainties out there, so flexibility is key." Regus, he says, continues to pursue growth, but only "discretionary" growth – which can be turned off quickly. "We are looking very, very carefully at any marginal new

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investments, preferring not to give them the benefit of the doubt."

Emile Raymakers, group treasurer at Dutch animal feed giant Nutreco, says the company, which was last year acquired by privately held Dutch conglomerate SHV, is well placed to ride out shocks to EU economies. "Nutreco is quite spread out across the world, and our most important markets are Canada, Norway and Spain. We're also in a sector that's less vulnerable to economic downturns – in 2008 we were only marginally affected by the crisis."

What if the UK were to vote to leave the EU in the event of a referendum on the subject? French prime minister Manuel Valls paints an apocalyptic picture. He warned delegates at Davos that European civilisation itself would be under threat were the UK to go it alone. "It would be a tragedy," says Valls. "Europe could lose its historical footing and the project could die quickly. Things could fall apart within months."

In its latest forecast, CEBR says: "A Brexit is still very much a real risk and while the long-term implications of this are debatable, the short-term ones are clearly going to be very negative."

What impact would a Brexit have?

Treasurers appear less agitated by the risk of Brexit, and it's either because they simply don't see it happening, or else because they don't reckon on a major impact for their business. "We're not scenario planning around Brexit," says Raymakers. "I am not aware of it being on the board's agenda."

Sridhar Ramamurthy, group treasurer at Unilever, says he is not the right person to ask about the possibility of either Schengen being scrapped or Britain leaving the EU. "We operate across the world. Yes, Europe is important, but it is only about 25% of our business. The more important thing is to ensure that Unilever, as a company, is prepared to respond in an agile and flexible manner," he says. "Producing thousands of pages of scenario planning will keep the intellectual juices flowing, but it makes more sense just to prepare the organisation to be agile."

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To be sure, there are specific policy-driven headaches for treasurers. Energy multinationals, for example, are concerned about the lack of a level playing field in subsidies for renewable energy across Europe, especially since UK energy secretary Amber Rudd announced a 65% cut in such subsidies in December, and since Germany decided to close down all its nuclear power stations. Some countries like Spain have "pretty much turned off that tap" [of subsidies] as a result of post-crisis, austerity-driven cuts, says the group treasury of a utility giant, whereas in Germany renewable subsidies from feed-in tariffs are expected to remain at about €25bn a year or €600 per German household. The source says: "It's blowing around a bit, so you can't make long-term decisions."

> "Producing thousands of pages of scenario planning will keep the intellectual juices flowing, but it makes more sense just to prepare the organisation to be agile"

Priorities for treasurers

Volatility in commodity markets, the oil price, FX rates and continuing uncertainty about when non-US interest rates will rise remain front-of-mind issues for treasurers, especially after an

extremely volatile start to the year when financial markets gyrated as a result of crude oil slumping to a low $27 per barrel, and the 16 December decision of Janet Yellen's US Federal Reserve to raise US interest rates for the first time in nine years. The changes hammered home the message that a major unexpected shock may be lurking around the corner at any moment.

All the more important then that treasury functions have fit-for-purpose systems that create maximum visibility. Developing real-time or near real-time treasury management systems is the "Holy Grail" for treasurers, says Regus's Wilkinson, and a key plank in their defences against such shocks. Ramamurthy says: "One of our treasury priorities at Unilever is to ensure our IT systems are fully leveraged. We are aiming for real-time information about liquidity and the FX exposures that are arising in different parts of our business, so the central treasury team can apply the right hedging strategy or the right liquidity management strategy."

> "We are aiming for real-time information about liquidity and the FX exposures that are arising in different parts of our business"

Nutreco's Raymakers says: "One of the immediate challenges we face is to achieve real-time insight into the development of cash, either from bank accounts or accounting systems, but also in the development of FX exposure." He added that: "luckily, we have quite stringent discipline where FX exposure is concerned. The businesses alert us to their FX exposures on a daily basis, and we hedge them for them."

European corporate treasurers also say keeping track of their banking partners has become more of a top priority, in view of the fact that some banks are shrinking – withdrawing from geographies and lines of business – potentially leaving clients in the lurch as they retrench back to their home markets in response to the stresses and strains, and balkanisation of regulation that followed the 2008 financial crisis.

Assume that volatility is here to stay

Some treasurers say they were caught off-guard when the Royal Bank of Scotland closed its global transaction services arm last year. At its peak, the unit provided 7,000 large corporates with cash management services, including overdraft facilities and trade finance products, but when RBS informed clients it was axing global transaction services in February 2015, the corporates were obliged to find alternative banking partners at short notice. Raymakers says Nutreco has already found alternative banks in affected markets. Ramamurthy says Unilever now keeps international banking partners under constant review, to ensure they're appropriate for the future.

Unilever's Ramamurthy says that treasurers should treat volatility like sea captains treat the weather. Volatility, within exchange rates, commodity prices or other moving parts of the global economy, is a fact of life that underpins everything Unilever's 25-strong central treasury team does. "Anyone in treasury should assume that the volatility is here to stay. To assume that things will normalise and stabilise would be the wrong thing to do." ◆

JURY OUT ON TAX REFORMS

Where tax is concerned, major changes are in the pipeline. The EU has, for some time, been targeting multinationals because of their ability to minimise corporation tax through the use of clever, but labyrinthine, corporate structures that often rely on 'captive' companies based in tax havens, and is seeking to claw back taxes from US technology giants like Apple. On 28 January, the bloc launched an ambitious package of measures aimed at clamping down on such behaviour. Building on the Base Erosion and Profit Shifting (BEPS) agreement hammered out by the Organisation for Economic Co-operation and Development and finalised last year, the measures include an anti-tax avoidance directive that is scheduled for sign-off by June.

Unveiling the European proposals, EU economic affairs commissioner Pierre Moscovici explained that the package aims to level the playing field between SMEs and large corporates. "The days are numbered for companies who avoid paying tax at the expense of others," he said.

Some corporate treasurers welcome the proposals, saying they will give businesses greater certainty by reducing disputes over the application of international tax rules. Others predict massive structural and behavioural change among corporates. The treasurer of one large European energy company says: "This will change how large European corporates structure themselves, fund themselves, pay cross-border interest and run their businesses across Europe, perhaps using more equity in certain positions as opposed to debt."

Regus's Wilkinson believes the proposals are going to be transformative. "BEPS changes both treasury and the thinking about how we do business," he says. He is also concerned that the EU proposals will cause some firms to pay "double tax" and significantly higher tax. "One of the frightening things about BEPS is the extreme transparency it potentially gives to tax authorities in different countries, enabling them to make comparisons and making it easier for them to challenge you."

Others are more relaxed about the EU's planned tax reforms. Raymakers says: "Nutreco's tax department, of course, is highly involved [with BEPS and the EU proposals]. There might also be some impact on treasury." Unilever's Ramamurthy says the proposals would have little impact on the workload of the consumer goods giant's treasury department.

Ian Fraser is an award-winning financial journalist and author

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HELENE CILLIERS
IN-HOUSE JOURNALIST, SAIBA
(SOUTHERN AFRICAN INSTITUTE
FOR BUSINESS ACCOUNTANTS)

South Africa **The Financial Executive's dream**

A look into financial regulation and promise of a growing investment destination.

The Southern African Institute for Business Accountants (SAIBA), the newest member of the International Association of Financial Executives Institutes (IAFEI), is the custodian of the official CFO designation in South Africa. The designation CFO(SA) is registered with the South African government and provides a home for all financial directors, financial controllers and chief financial officers in Southern Africa.

Economics and investments are important for CFOs as they adapt their company strategy and operations to changing conditions. Despite tough economic conditions CFOs in South Africa remain optimistic. Amidst uncertain economic policies and "heated" politics, South Africa remains an attractive investment destination, according to optimistic observers and CFO(SA)'s.

The South African "CFO Talks"

One CFO(SA) is Aarti Takoordeen, CFO of the Johannesburg Stock Exchange (JSE). In the first of a series of CFO Talks, a national platform operated by SAIBA, devoted to sharing ideas and conversations between CFOs, she said that large institutional foreign investors, who know the global emerging market funds well, are very impressed with the high quality of management in corporate South Africa. Takoordeen said South Africa is viewed as the country with the best corporate quality management of the emerging markets and is definitely the economic hub of Africa: "We must not underestimate the high quality and depth of experience in leadership in corporate South Africa."

South Africa is rated as one of the best corporate governance environments in the world according to the World Economic Forum's (WEF) Global Competitiveness Index.

The JSE itself is ranked in the top three in most indicators of corporate governance. For the past six years it has been rated as the best regulated market of all exchanges in the world. For five of these years it was rated number one on the strength of its auditing and reporting standards. It was also rated number one in terms of raising capital on the cash equities market in the world.

"We are really proud of those accolades and it shows in our King III advancements, it shows in our reporting capabilities, and it does come through to foreign investor sentiment in terms of foreign respect for leadership in South Africa," said Takoordeen.

The country's strict financial regulatory environment plays a huge role in this international vote of confidence in corporate South Africa

South African Finance Regulation

The country's strict financial regulatory environment plays a huge role in this international vote of confidence in corporate South Africa.

Several accounting bodies play their part to ensure accounting and reporting compliance.

The Southern African Institute for Business Accountants (SAIBA), as a member of the International Association of Financial Executives (IAFEI), supports its members by adopting and implementing international standards relating to ethics, quality, education, financial reporting, assurance and other engagements. SAIBA enables the sharing of knowledge and assists members in understanding all areas affecting accountants, CFO-s and financial professionals.

SAIBA has also engaged with the University of South Africa (UNISA) to become the official Leadership School for the CFO (SA) designation. Through this partnership, potential CFOs can obtain their MBA or MBL through UNISA, who offers a custom degree to meet the skills requirement for the education part of the CFO(SA) designation.

There are also a number of other professional accounting bodies that have similar statutory rights as SAIBA to set admission criteria, rules of conduct and continued education requirements that must be met before a person is deemed qualified, include the South African Institute of Chartered Accountants (SAICA), the South African Institute of Professional Accountants (SAIPA), the Chartered Institute of Management Accountants (CIMA), the Association of Chartered Certified Accountants (ACCA), the Institute of Accounting and Commerce (IAC), the South African Institute of Government Auditors (SAIGA) and the Institute of Chartered Secretaries of South Africa (ICSA).

As the custodian of the auditing profession, the Independent Regulatory Board for Auditors (IRBA), together with the profession, must maintain the quality and integrity of the audit system, thereby contributing to the protection of the financial interests of the public.

The WEF ranking brings confidence to foreign investors that they can trust and rely on our auditing strength despite the economic meltdown and other challenges that the country and the auditing profession have been experiencing, according to Bernard Agulhas, CEO of the IRBA.

South Africa's decision to adopt the globally recognized International Standards on Auditing (ISA) as well as the International Financial Reporting Standards (IFRS) as early as 2005 has had a direct effect on South Africa's leading ranking.

Agulhas emphasizes that South Africa, which has moved up the overall rankings to number 49 from 53, also has a vital role to play in supporting other countries on the continent to improve their financial standards and reporting processes so that Africa can become internationally respected in global markets. In addition, developing countries need to create stronger ties among themselves, with greater collaboration between the private and public sectors as well as between industry and government.

South Africa, the gateway to Africa

South Africa can also play a role in unlocking growth in the rest of Africa, said Takoordeen.

These opportunities exist through South Africa's support of regional integration and infrastructure development on the continent, as well as its support for Africa's Agenda 2063.

According to South Africa's Minister of Trade and Industry, Dr. Rob Davies, Africa has defined a developmental trajectory for itself that involves moving away from its current insertion in the global trading system as a producer and exporter of primary commodities and an importer of finished goods. "In this regard Africa has defined a very clear agenda to move up the value chain and industrialize through an ambitious developmental integration programme that combines market integration alongside infrastructure development and cooperation to develop regional industrial value chains", he recently said in Nairobi.

Some of the aspirations of Agenda 2063 is for Africa to transform, grow and industrialize its economies through beneficiation and value addition of natural resources; implementation of the African Industrial Development Action Plan; fast tracking the establishment of the Centre for African Mineral Development; promote sectorial and productivity plans and regional and commodity value chains to support the implementation of industrial policies at all levels, with focus on SMMEs and Agribusinesses; the establishment of Commodity Exchanges for strategic African products; strategies to grow the African Blue and Green Economies; the development of the African Private sector through engagement and a conducive climate; fostering Pan African businesses through the growth of regional manufacturing hubs and scaled up intra-Africa trade; consolidate the modernization of African agriculture and agribusinesses through scaled up value addition and productivity; expand the introduction of modern agricultural systems, technology, practices and training; connect Africa through world-class infrastructure with a concerted push to finance and implement the major infrastructure projects in:

• Transport: (including an Africa Integrated High Speed Train Initiative connecting all African capitals and commercial centres), improved efficiency and connections of the African aviation sector, strengthening the African port and shipping sector as regional and continental assets.

• Energy: harnessing all `African energy resources to ensure modern, efficient, reliable, cost effective, renewable and environmentally friendly energy to all African households, businesses, industries and institutions through building the national and regional energy pools and grids

• ICT: putting the continent on equal footing with the rest of the world as an information society, an integrated e-economy where every government, business and citizen has access to reliable and affordable ICT services by increasing broadband penetration by 10% by 2018, broadband connectivity by 20 percentage points and providing access to ICT to children in schools and venture capital to young ICT entrepreneurs and innovators.

Companies that invest in South Africa will have a sophisticated platform and support from where they can enter into other African markets.

The South African government, by way of the Department of Trade and Industry, already provides strong protection to investors in terms of the framework provided by the Constitution and other relevant legislation. It is also important to recall that, as a member of the WTO, South Africa subscribes to a range of disciplines and rules that provide multilateral guarantees to foreign investors, according to Minister Davies.

During a debate on the new Protection of Investment Bill 2015, Davies said the underlying philosophy of the Bill is

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to clarify the standard of protection that an investor may expect in the Republic, and to promote all types of investments by creating a predictable business environment that is readily understandable to an investor. The Bill guarantees the rights of investors in accordance with the Constitution. In addition to this, the Bill contains international investment law concepts such as national treatment, physical security of investment, legal protection of investment and transfer of funds in line with constitutional principles and applicable norms. This is aimed at re-assuring investors that South Africa is, and will remain, open to FDI and will continue to provide strong protection to investors.

"In developing the Bill, we have taken into account all the concerns raised. Our aim is to modernize South Africa's policy approach to foreign investment in view of national, regional and global developments," said Davies.

He said the current pipeline of potential investment projects that the department is monitoring and facilitating includes ZAR 25.3 bn from foreign and ZAR18.5 bn from domestic sources. Aggregating funding from both sources, it is expected that upcoming investments will likely be distributed as follows: ZAR28.8 bn for the green economy; ZAR7.96 bn for advanced manufacturing and ZAR5.74 bn for mainstream manufacturing.

He said the department has identified five key pillars of industrial development, namely:

• Infrastructure-driven industrialization;
• Resource-driven industrialization aimed at leveraging the mineral resources endowment to support higher levels of downstream beneficiation and value addition, whilst systematically building both the demand and competitive advantages South Africa enjoys in the upstream mining, transport and capital goods sectors;
• Advanced manufacturing-driven industrialization which focuses on key sectors of the manufacturing economy which upgrade the capabilities of the economy as a whole. We need to engage particularly intensively with global OEM's in these sectors and develop robust conditionality for public sector support so that growth of the sector achieves our developmental objectives. It also includes ongoing work, not yet completed, to build an integrated system of industrial financing, incentives and export support with a special focus on lead and dynamic companies that can compete effectively in export markets; and, finally, it encompasses a strong commitment to support emerging black industrial entrepreneurs.
• Procurement, focusing on strengthening the localization of public procurement; and
• Regional economic integration which centres on maximizing the opportunities presented to the domestic economy by a growing market on the African continent, driven by high growth in the region, strong consumer demand, infrastructure development and resource exploitation.

"The opportunities are significant, and must be energetically leveraged by unblocking obstacles to expanded regional economic trade and crafting clearly-defined programmes of complementary regional industrial development and value chain integration," said Davies.

After the Industrial Development Corporation recently hosted a conference themed: "Driving South Africa's Competitiveness through Industrial Development", Ms Chichi Maponya, Brand South Africa Chairman, wrote on Sanews.gov.za that there are significant opportunities for South African manufacturers, particularly within the African region which has seen growth rates exceeding those in the developed world – at an average of between 4 and 5% between 2002 and 2014.

"African countries provide investors with abundant prospects to access the growing consumer demand. In April 2015, Manufacturing Circle executive director, Coenraad Bezuidenhout, pointed out that the relative ease of access to sub-Saharan Africa and beyond, and an understanding of the region, South African manufacturers can get ahead of other investors looking to Africa for new opportunities.

"With an estimated 800 million people urbanizing on the continent in the past decade, there are huge opportunities in terms of fast-moving and durable consumer goods for manufacturers. The current economic conditions in Africa make it the prime investment destination and present a favourable time for South African manufacturers to introduce their products to the African market, particularly fast-moving consumer goods."

She says South Africa has the most diversified economy on the continent and plays an integral role in Africa's advancement. It is also in a great location for growing businesses in other parts of the African continent.

According to the Department of Trade and Industry, some of the sectors in South Africa which have high growth and investment potential, include:

Agro-Processing; Business Process Outsourcing and IT-Enabled Services; Capital / Transport equipment; Metals & electrical machinery and apparatus; Electro-Technical; Textile, Clothing and Leather; White Consumer Goods; Boatbuilding and associated services industry; Pulp, Paper and Furniture; Automotives and Components; Green Economy Industries; Advanced Manufacturing: Advanced Manufacturing - Laser technology; Advanced Manufacturing - Advanced Robotics; Biomanufacturing; Tourism; Chemicals, Plastic Fabrication and Pharmaceuticals; Creative and Design Industry; Infrastructure Development; and Oil and Gas.

Nimrod Zalk, Industrial Development Policy and Strategy Advisor at the Department of Trade and Industry wrote that manufacturing plays an irreplaceable role in driving growth and economic development. South African manufacturing continues to be heavily dominated by resource-processing sectors that are capital- and energy- intensive. A structural shift towards higher growth in more value-adding and higher labour absorbing manufacturing sectors is essential for South Africa to shift to a development path which generates more growth and higher levels of employment.

In conclusion, it is in all these areas that the need for a robust and quality designation for CFOs is so important. Michael Sass, the former Accountant General of South Africa and current SAIBA board member and CFO(SA) believes a crucial aspect that will drive the success of all the infrastructure development plans is the qualification and competence of public sector CFOs. That is why South Africa adopted a new skills framework for CFOs working for state departments or companies. They are also required by law to become a member of professional bodies such as SAIBA and the designation CFO(SA). ●

The fine art of negotiation

NEGOTIATING IS ONE OF THE MOST IMPORTANT SKILLS IN BUSINESS. NO OTHER SKILL OFFERS A BETTER CHANCE OF OPTIMISING PERSONAL SUCCESS AND THAT OF YOUR ORGANISATION. STEVE GATES EXPLAINS HOW TO EXERCISE YOUR POWERS

Your negotiations can only progress if communication flows and those who are directly or indirectly involved are allowed to make decisions. Understanding the role of empowerment in your negotiation is fundamental to managing the relationships and communications that stand between you and progress.

However, with empowerment comes exposure, and this brings with it risk. It is this risk that organisations seek to control by empowering individuals with limits, or caps, beyond which they must escalate to higher authority. Too much empowerment and any individual can become dangerous or vulnerable, and so can the organisation they work for.

The complete skilled negotiator will understand empowerment in terms of:

- How it can be used to protect you;
- How it affects your ability to be creative;
- How it affects your ability to build value; and
- How it affects the other party's thinking and behaviour.

Essentially, it is the degree to which you can negotiate and make decisions without having to refer or escalate them to a higher authority. In other words, empowerment relates to the scope and range of variables and the authority within which you have to negotiate or operate. If you regard empowerment as simply a gauge to broaden or narrow your trading opportunities, or to provide 'stop limits' up to which you can negotiate, you can start to get a feel for how empowerment can work *for* you, as well as *against* you.

To negotiate collaboratively requires the scope or empowerment to work with many variables and possibilities. Limiting this, as many organisations do, can help protect you from the escalation and disempowerment tactics sometimes used by others.

Great negotiators tend to be unsung heroes. Great deals become so over time as the contract delivers the value it was intended to offer, rather than necessarily at the time when the deal was completed. Negotiators often work as part of a team, which can involve specialist lawyers, corporate treasurers and others. Because the last person to become involved in the negotiation dealings is the boss, the act of negotiation is usually, and appropriately, delegated further down the

line, further diluting the transparency of who is actually controlling events. And when the deal is done, the need for confidentiality, as well as the need to protect the operations of those companies involved, means that the true facts and figures agreed are rarely publicised to the degree to which you can measure the relative performance of the negotiators involved.

One of my personal experiences as a negotiator involved facilitating a highly charged negotiation between a Japanese electronics company and a trade union in the UK. The level of trust between the parties involved, together with the climate of the meeting and the relationship, was poor, hence the need to bring in a neutral party to facilitate events. On my advice to my client, I was provided with no scope with which to negotiate, which allowed me to focus on the process and not be drawn on specific proposals. My role included helping the parties with establishing solutions, starting with why they thought they could not agree to the terms that had already been tabled.

Most high-profile negotiators tend to be political figures or union leaders, because they use PR as part of posturing during or leading up to discussions. However, these individuals neither work by themselves nor are they fully empowered to negotiate on all issues. Using the press and media is part of how they frame, anchor and publicise their position and progress to those they represent, the parties they are negotiating with and any other third parties.

How empowered are they?

Rushing into negotiations without qualifying whether the other party is empowered to negotiate is a mistake many eager and ultimately frustrated account managers have made. The need to question, qualify and explore requires patience. It is during this phase of initial discussions that the issue of empowerment should be qualified by simply asking: "Are you in a position to sign off the agreement?" or "Who else would you need to consult with as part of signing off this agreement?", or even "What limits are there that might prevent you from signing off the agreement?" All of these questions will help you to decide whether you are dealing with the right person or people.

Being disempowered

We are socially conditioned to conform, and most of us lead our lives respecting the laws of where we live and others around us. Laws provide, in some instances, freedom of movement, for example, effectively empowering us to travel and choose how and where we travel. Laws can also disempower us, in that we may not travel faster than a given speed or, when driving, having drunk alcohol, and so on.

The written word carries an assumed authority in that it has been published. It is designed to be legitimate. In your negotiation, the other party may present you with, say, a price list. Rather than accepting this as it is, you should regard it as their opening position. Different situations require different considerations, yet many will wrongly assume that, not only is the printed price fixed, but the person issuing it is disempowered to negotiate.

The more empowered you are, however, the more exposed you become. You may carry more risk to your business and therefore be accountable for the total impact of your actions. Organisations have a tough challenge in providing a level of empowerment to their employees, which helps the business conduct 'good business', but not with such risks that the 'good business' could be concluded with unintended consequences or unforeseen costs.

Many organisations actively promote business values, such as creativity, entrepreneurship and even empowerment. Yet when negotiating with suppliers and customers, they recognise that there have to be limits within which individuals are empowered to operate, otherwise the business will lose total control of its operation. They operate a disempowered structure to protect their own business operation.

This is an edited extract from: The Negotiation Book: Your Definitive Guide to Successful Negotiating, *2nd Edition, by Steve Gates (Capstone)*

Steve Gates is founder and director of The Gap Partnership negotiation consultancy

Warning: evolution needed

FINTECH, APPLE, REGULATION – THE THREATS LINED UP AGAINST THE MAINSTREAM BANKING SECTOR ARE PERVASIVE AND FORMIDABLE. TIME FOR A NEW APPROACH TO CUSTOMERS, SAYS MICHAEL BARRINGTON-HIBBERT

As banking consumers, we shop around for the best deal. We may have a current account with one provider; an ISA and mortgage with another; and savings, loans and investments with different providers again. We know that it is prudent to review our financial management regularly. So, why are corporate banking trends behind the curve?

The democratisation of the financial services sector – mainly due to the accessibility of information online – has introduced the notion of a 'shared economy'. Customers put their trust in independent and niche companies more than ever before; we know how to do our own research and due diligence.

These consumer banking trends have had a knock-on impact on the corporate banking and investment market, but many banks have been slow in responding to market needs. The result is that some former market leaders are finding themselves under threat from challenger brands coming into this sector.

Loyalty for one single provider is diminished due to the ever-growing choices we are offered as individuals, and the same is true for businesses and corporations, irrespective of long-standing relationships with banks. Many of the corporate and investment banks that have continued to stick to traditional product offerings and service experience are now finding themselves under pressure due to changes in client appetite.

With continued and sustained low interest rates, de-risking and the threat of challenger brands eroding their market share, many of the corporate banks are now looking to define their own unique and differentiated strategy in order for them to remain relevant. Recent research suggests that, by 2020, players in alternative banking will be worth €7bn, offering customers a suite of products and services tailored to their specific needs. Corporate clients will be able to cherry-pick services from

SHUTTERSTOCK

Corporate banks are ready for increased debt-market pressure throughout 2016

multiple suppliers, just as we do as consumers.

In addition to new products and services, banks also need a new style of leadership to drive new and evolving business models, identifying new markets and delivering new services: the ideal candidates are hybrid bankers, who possess not only leadership qualities, but a high level of experience in risk management and a broad understanding of the multitude of credit products, derivatives and enhancements that sophisticated corporate clients want and expect. Importantly, candidates must also be willing to embrace change. This type of talent comes at a premium, which is evident in the aggressive recruitment strategies we've seen in 2015 and highlighted in our *Corporate Banking Review Study for 2015*.

Each year, we interview more than 400 corporate bankers who work for the top 10 ranked UK corporate banking franchises in London. The 2015 study shows that there is a direct correlation between a bank's products and services, and how it compensates its coverage bankers. The study also shows that managing directors of the top five banks are being offered, on average, a 38% increase on salary packages to join a challenger bank. That's a hugely more competitive landscape on talent acquisition, and we predict that the war on talent in 2016 is only set to intensify.

The rise in executive pay is set against a starker backdrop of banks' compliance demands. Banks are not only having to pursue robust systems and processes to grow profitability, but also to demonstrate greater accountability as a result of tighter compliance regulation. Too much attention has been placed on 'running the bank' and maintaining the status quo rather than on innovation and 'growing the bank' and its products and services.

Corporate banks are ready for increased debt-market pressure throughout 2016. It is therefore critical that the hiring strategies of UK corporate banks remain robust to mitigate against increased stresses that this environment will bring.

Corporate clients and banks are also finding that they can no longer wholly depend on long-standing institutional relationships.

The UK government's current focus on financial inclusion for all represents an additional set of competitive pressures; especially targeting lower-income citizens. Financial inclusion not only helps individuals and their families, but it can also be a powerful driver of economic growth. The banking changes we are seeing year-on-year, particularly around digital access and mobile banking, have the potential to usher in a new era of financial inclusion and enable mobile money, branchless banking and unimaginable innovation. These agile new providers are flooding into the market to respond to an as-yet unmet demand. Nonetheless, it is still the case that two billion consumers worldwide currently do not have a bank account. Instead, they use on average 14 different financial services, and a staggering 91% save via informal systems. Are the corporate banks ready to serve these new, divergent breeds of financial customer?

As banks continue to retrench from regions or sectors where they are unable to meet specific demand and revaluate their operational strategies, they will need to be able to rely on their personnel more and more to deliver evolving products and services.

Michael Barrington-Hibbert is CEO of Barrington Hibbert Associates and oversees the firm's financial services practice

STAYING RELEVANT – A CORPORATE VIEW

It is clear that the digital revolution has caused significant disruption in the retail banking space, particularly consumer payments and lending. A plethora of new entrants have seized the opportunity to transform the customer experience. Challenger banks will hope to evolve to the corporate space; however, they are unlikely to be of significant relevance. Hefty capital requirements will also hamper their ability to effectively compete with traditional lenders.

The real threat to banks comes from the non-bank players. In the payments space, Amazon, Apple, Google, Microsoft, et al, bring serious and sustained competition with a loyal and digital-savvy customer base.

The banks have always invested in technology; however, the regulatory burden and the cost of maintaining legacy systems results in an inability to match the pace of change of the more nimble fintech companies. They have to change and be able to continually innovate or risk becoming marginalised to simply providing the pipes for others to use, resulting in falling profits and a real lack of opportunities to generate additional revenue.

The banks need a digital strategy to remain relevant – and how effectively they utilise new technology either via acquiring or partnering with fintech will determine who remains standing as we see further consolidation in the banking sector. British American Tobacco already partners with fintech companies to support treasury operations and e-commerce while currently assessing providers in the trade finance space. Over the coming years, we hope to see the banks make the necessary investment to support the domestic payment modernisation currently under way across the world. While we want real-time payments, they can't just be fast, they have to address concerns around reliability, risk, security, compliance and enhanced automation. We also expect significant improvements in cross-border payments, with fintech again leading the way. Distributed ledger technology is a game changer and it is reassuring to see the banks now starting to make the necessary investment and reassessing their approach to payments. Those that can commercialise their strategy and invest in digital infrastructure will be the clear winners in the long term.

Neil Wadey is group treasurer at British American Tobacco

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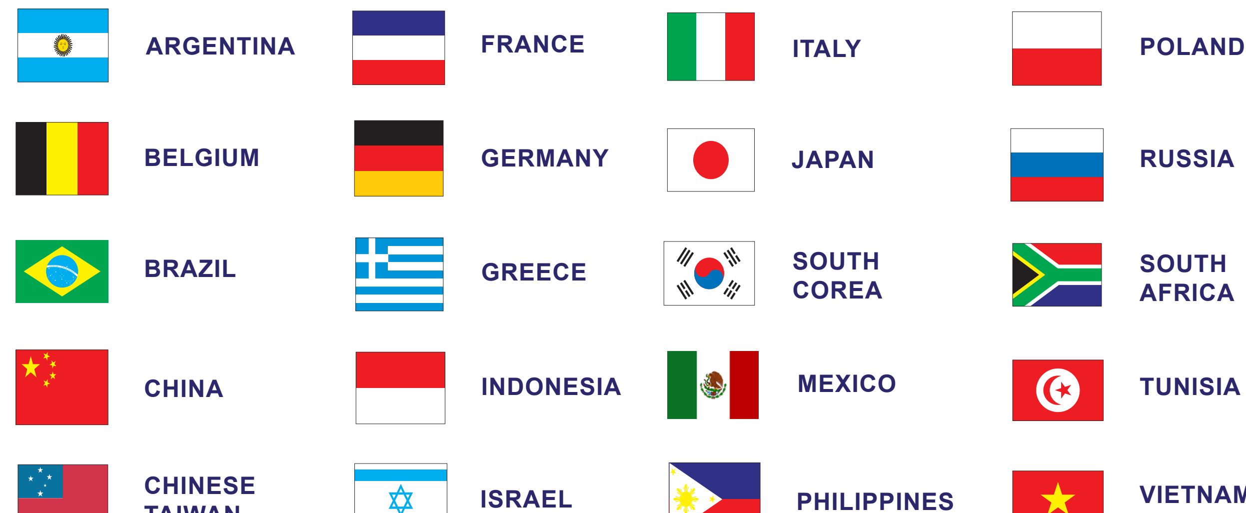

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