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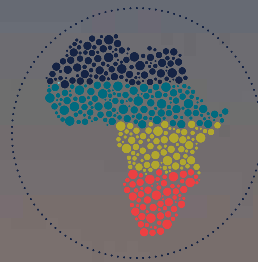

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LETTER OF THE CHAIRMAN

Dear Colleagues,

Some days ago Great Britain voted to leave the European Union. What happens now? Nothing immediate, legally speaking. The British referendum will be followed by withdrawal negotiations between the British government and the remaining 27 members over a period of two years, at most. First of all, the 2.5 million EU nationals n the UK are unlikely to suffer serious consequences from Brexit. However the destiny of those who will move to the UK from now on, and of those British citizens currently living in a EU country is less predictable. It's on the international financial market that Brexit has already shown its effects. In the aftermath of Brexit, the markets tumbled: sterling dropped against the dollar over 10 per cent and gold prices soared 22%, the fastest gold rally ever recorded.

Moreover, Brexit may embolden other countries' desire to leave Europe, to the point where the real risk of Brexit seems to be the domino effect, which may lead to the disintegration of the European concept. Eurosceptics in France, Germany, Netherlands, and Italy reacted with euphoria and may step up calls for referenda for their own countries.

Over the years, UK has become the western country most open to China and a strategic launching pad for Chinese investment into Europe. With Brexit this Golden era may come to the end and China may be forced to readjust its economic relationship with the EU. The very first reaction in China to the vote was the yuan suffering the biggest one-day drop since its devaluation last August.

Uncertainty is palpable, and the potential consequences of Brexit are hard to foresee at this time. Three scenarios are likely to emerge. In the first option, Britain remains a member of the European Economic Area, like Norway, and will preserve the so-called four freedoms of the EU, in which people, goods, services and capital move freely among countries. A more realistic option imagines a comprehensive Free Trade Agreement, based on the Swiss model. Lastly, UK may also pursue unilateral liberalisation and negotiate trade deals on better terms with single countries.

On another matter, I have the pleasure to communicate that IAFEI World Congress 2016 will be held in South Africa!
Inside and on the web site you can find more information about the event.
It's the first time in IAFEI's history that a World Congress will be held in Africa: it's a big opportunity, it's a symbolic but very important opening towards a new scenario, it's a step on an economic and cultural journey.
We will be proud if IAFEI can perform this task properly!

Fausto Cosi
IAFEI Chairman

LETTER OF THE CHIEF EDITOR

Dear Financial Executive,

You receive the IAFEI Quarterly XXXIIIrd 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 Third 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 all 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 BRAZILIAN SMALL & MEDIUM SIZED ENTERPRISES SECTOR FINANCING, THE BRITISH'S...

AND FINALLY, RECOMMENDATIONS THAT BRAZILIAN PRIVATE AND PUBLIC SECTOR SHOULD FOLLOW BUILDING ON THE BRITISH EXPERIENCE.

by **LUIZ ROBERTO CALADO,** Vice-President of the Brazilian IAFEI Member Institute IBEF
and **LEONARDO CAPPA**, Phd candidate in International Strategic Studies at the Federal University of Grande do Sul

Background

In August 2014, Dr. Luiz Calado and Mr. Leonardo Cappa were hired as consultants by the British Embassy in Brazil to draft a report and conduct a debate on its main findings with related Brazilian organizations (BNDES, CVM, CNI and SEBRAE), which was held in June 2015.
The three sections of the report consisted of analyzing the Brazilian Small and Medium Enterprises (SME hereinafter) sector financing, the British's (after extensive research and several meetings with public and private organizations in the UK), and finally, providing recommendations that Brazilian private and public sector should follow building on the British experience. Noting that financing difficulties faced by SME in both countries are rather similar - considering the bulk of both overall and SME credit is provided by loans from a concentrated banking industry, and that in both countries the SME sector is the larger employer, in this article we summarize the six main recommendations presented in the third section of the original report, while also mentioning a few relevant experiences in Brazil and updating some of the original report's findings.

I. Improving Statistics

Lack of SME sector statistics impairs comparison of companies' solvency likelihood, credit selectiveness, and policy design. Indeed, some databases with financial statistics available in Brazil lack the necessary breakdown, regardless of the definition of SME (by earnings or number of workers). As a result, risk aversion towards SME is disproportionately larger in Brazil than it would otherwise be, contributing to the higher average cost and lower overall availability of any source of funds. On the other hand, in the UK, one can notice continuing efforts of surveys even before data collection, through estimates of the company size breakdown most likely to be relevant for aggregation and comparisons. For instance, this enables one to include or exclude the individual entrepreneur from any given analysis. This can be especially helpful in countries, such as Brazil, where fiscal benefits are provided for this particular segment - and thereby possible uses of this breakdown could enhance policy decisions as well as deepen the usefulness of the statistical bases for credit purposes.

II. Foster mentoring

A relevant role in improving the cascade of finance options known to start-ups and small businesses in the UK was played by initiatives to foster the availability and quality of mentoring services. Mentoring can be loosely defined as a one-to-one relationship between a less experienced person (mentee) and an established professional (mentor), who provides consistent support, guidance and practical help, enabling the entrepreneur to gain skills, knowledge and confidence in order to perform at a higher managerial level.

In 1996, the UK government-recognized Standards Setting Body for Business Support and Business Enterprise (SFEDI) was established, and although it does have similarities with roles played in Brazil by SEBRAE (Micro and Small Business Support Service), SFEDI is responsible for the assessment of organizations willing to offer mentoring services. At the portal mentorsme.co.uk, for instance, SME looking for mentors can search lists of region and activity-based, SFEDI-approved organizations offering mentoring services, while also raising awareness of benefits provided by mentors. While the specific subjects covered in the process are more general, they in practice often focus on financial management – from discussing the funding options available to each type of business as well as supporting the loan solicitation and appraisal of its repayment ability.

III. Promote awareness about and the use of factoring and securitization products

Both Brazilian and British SME have a generally negative perception towards the use of factoring, resulting mostly from the lack of knowledge regarding this financing vehicle and from bad practices that – far from being the norm, did happen on occasion. Advances towards improving perception of factoring were targeted by the Asset Based Finance Association (ABFA) in the UK, building on efforts such as the adoption of an autoregulation and best practices code[1]. The code aims at protecting entrepreneurs and ultimately encourage them to adopt factoring as a regular source of financing. In addition, ABFA took measures towards raising awareness among accountants of factoring as a completely legal and desirable funding source, improving the image of the approach and further distancing it from bad practices that have occurred such as usurer money lending or loan sharks. Finally, ABFA has experienced a degree of success in creating a database with standardized, comparable credit information of SME – a welcome step toward overcoming the lack of relevant statistics as discussed in the first recommendation above.

With another, similar asset based approach, one could note that Brazil has seen a fast rise of its FIDC industry (the Portuguese acronym for credit rights investment funds), with new issuance topping the equivalent of US$ 10 billion in 2011[2]. A very successful case in Brazil was the VW suppliers FDIC. Usually those suppliers are SME, and in 2009 a FDIC was set up in which funds (amounting to approximately US$115 million at the time) were obtained using their receivables to VW as collateral. Since the holders of fund quotas were ultimately bearing VW risk, the fund was granted a AAA rating, thus improving interest in the fund for investors and substantially diminishing funding costs for suppliers. More recently the same approach was used again in Brazil for suppliers of Mitsubishi Motors of Brazil (MMCB).

IV. Developing the venture capital market

Here we start by pointing out that while Brazil has a representative private equity industry (sponsored mainly by the wealth management sector looking for higher returns, given the stability of its public equities market in the last many years), there is no pervasive culture of investing in earlier business stages. Thus, the development of the private investor presence in angel, seed, mezzanine or venture segments of business

1 For the most up-to-date version, please access: https://www.abfa.org.uk/standards/code.pdf.

2 Securitization of accounts receivable and its commercialization as investment funds have widely debated risks and advantages whose analysis escape the aim of this article, but it is worth reminding that banks also profit from this investment approach, often earning income as managers, administrators and/or custodians, thus seeing it as an income source and having interests in developing the sector.

financing offers both opportunities and difficulties.
Of the initiatives to tackle this issue in the UK, of special interest one can point to the establishment of AIM, or Alternative Investment Market of the London Stock Exchange. Targeting firms without size to access the traditional market, it offers differentiating conditions such as: i) regulation adapted to the realities of SME without letting investor protection go off rail[3]; ii) a global investor base and iii) access to a network of lawyers, accountants, brokers, etc, providing support to companies that have decided to join AIM. However, even if AIM is still the largest specific market for SME public equities, increasing disinvestment perspectives for venture capitalists, the effects of the global financial crisis and its aftermath have not gone unnoted to AIM participants, as can be seen by the diminished issuances, follow-ups and money raised in recent years[4].

Other initiatives worth mentioning include Angel CoFund, StartUp Loans, Enterprise Finance Guarantee and Business Finance Partnership; all of which have in common not only names that hint at their target approach or investor base, but also the fact that they are overseen by a single institution, the British Business Bank, set up in 2012 as an answer to the need to consolidate and seek synergistic outcomes for the different programs, acting as a one-stop shop. This development-like bank focus on providing funds to innovative partners whereby public money will be multiplied by private's. In this manner, the bank seeks at the same tim Via investments through BBB, where the bank would provide the remaining funds for applicants in cases where the first 90% of the credit requested had been granted by private individual lenders. e to foster the supply of finance to small business and start-ups, thus creating a deeper financial market with more options and suppliers while minimizing the impact on the fiscal budget, and to build confidence and awareness on these companies regarding the financial markets as an alternative and reliable source of funds.

Efforts in this regard have been conducted in Brazil mainly by the investment banking arm of the development bank BNDES, through: i) allocation in venture capital, private equity or mezzanine finance managers, focusing mainly in IT services growth, education, health and infrastructure; ii) programs directly supporting IPOs of medium sized companies; or iii) via its Criatec initiative, whereby it provides capital to a family of privately managed funds targeting seed and start-up investments in innovative businesses[5]. Though these efforts highlight BNDES's role in supporting venture capital in Brazil, they have experienced varying degrees of success at attracting private capital to multiply public funds and promoting SME alternative financing.

V. Regulating and promoting collective investment

Crowdlending, equity crowdfunding, peer-too-peer lending (p2p), mini-bonds, angel syndicates, start-up incubators. These names, as is often the case in the world of innovative finance, bring both dazzle and apprehension. Indeed, there have been cases around the globe in the segment more broadly termed collective investment in which platforms showcased stellar growth rates only matched by their rapid fall to disgrace. This highlights the need for public support in the form of discussing and formulating regulation to protect the interests of private investors and stakeholders, while paying close attention to entrepreneurial finance challenges in the age of collaborative economy, and balancing advantages offered and risks posed by new technologies. This, rather than simply a one-step regulatory framework, should be an ongoing process, as this young industry consolidates. Also, traditional players can benefit both directly and indirectly with as successful cases mount.

Turning to specific cases seen in the UK, several institutions noted initiatives of Funding Circle (FC), one of the leading p2p (aka crowdlending or debt-based crowdfunding) platforms in Europe, in obtaining synergies with both public[6] and private players. The key innovation was the Santander deal, through which, in case a micro or small enterprise loan application was denied credit, the bank would commit itself to refer FC as funding alternative. While later a similar deal was announced with RBS, two further points are worth noting. First, the deal was basically an anticipation of a new "bank referral legislation"[7] , which institutes that traditional banks will be obliged to offer credit-denied business a referral to a designated, online finance platform.

3 For instance, admission criteria is naturally more flexible, without a required volume of market cap, free float, and commercial operational historic

4 For the most up-to-date statistics, please check at: http://www.londonstockexchange.com/statistics/historic/aim/aim.htm.

5 There have been three Criatec funds since 2007, also providing start-ups with managerial and strategic support. Similar, though smaller and directly conducted efforts, have also been conducted in start-up financing by SEBRAE. Though such public funding and guidance initiatives are obviously welcomed, one could argue that combining them under the umbrella of a single institution could have synergistic results, as it has been the goal with the BBB model in the UK.

6 Via investments through BBB, where the bank would provide the remaining funds for applicants in cases where the first 90% of the credit requested had been granted by private individual lenders.

7 First aired in 2013 and later called Bank Referral Scheme but not fully implemented nor enforced at the writing of this article, and estimated by the alternativebusinessfunding.co.uk portal to be able to reach over 100,000 small businesses that could get over 2 billion pounds in loans additional to the amount they would get without the scheme in place.

This is to become especially significant when new Basel Committee on Banking Supervision regulation demanding a 300 per cent risk weight to be applied to small business credit at the banks' balance sheets go into effect. Second, this kind of arrangement is mutually beneficial for a number of reasons: the agreement is a two-way venue, with the online portal also referring its clients able to get traditional loans to the banks in cases where it may be better suited to the borrower's needs and for other traditional banking services. In this way, banks can focus on building relationships and providing a range of services for clients it deems more strategic while also better managing its capital ratios in light of the aforementioned new Basel rules.

Equity-based crowdfunding has also amassed public attention, increasing its total volume raised from 5 million euro in 2012 to over 110 million just two years later, according to a private report by Ernst & Young and Cambridge University based on a survey with several of the leading online platforms in the UK[8]. The importance of duly regulating this market can be best understood when one realizes that, as a new and inherently risky funding model, a single big platform fail or rotten investment scheme can have negative spillover effects. Thus, many platforms in the UK actually sought to be regulated, and voluntarily added risk warnings and disclaimers on their portals[9] even before the Policy Statement by the Financial Conduct Authority went into effect limiting the illiquid allocation of individuals - unless they either have professional support, or are considered high net worth or "qualified" investors, measures that should be emulated elsewhere[10].

Finally, the general perception towards collective investment in the UK on meetings with British institutions was that although it indeed had been playing a part in improving the scene for SME financing, it would hardly in the foreseeable future disrupt traditional banking primacy nor eliminate SME funding constraints. This can be noted, for instance, when one realizes that although the volume of loans provided by the leading platform FC was over 1.3 billion pounds as of June, 2016, the number of individuals who have lent through that portal was just over 50,000.

8 http://ec.europa.eu/finance/general-policy/docs/crowdfunding/150304-presentations-ecsf_en.pdf

9 Where one reads, for instance, quoting a warning at crowdcube.com: "The majority of start-up businesses fail or do not scale as planned and therefore investing in these businesses may involve significant risk. It is likely that you may lose all, or part, of your investment".

10 In Brazil, the regulator CVM builds on pre-existing rules to simplify the registration process provided that certain size parameters are observed, but a specific framework focusing on this investment approach is still undergoing public debate in 2016, and the country's largest online platforms are working via convertible debt issuance.

VI. Fiscal incentives

Fiscal incentives, unless a due cost-benefit budget impact assessment is provided, may be regarded by some observers as wishful thinking – especially against the current global economic setting, in which policymakers face growing fiscal constraints arising from diminishing tax receipts. Still, evidence support the key role played by fiscal benefits to equity investments in micro and small companies in the UK in recent years[11]. Thus, such benefits should be considered by any country seeking to improve SME funding possibilities, and private agents should strive to advance the policy debate.

Indeed, Brazil has taken steps in this direction in 2014 with the exemption of income tax in investments in SME's stocks by individual investors. However, the lack of a culture in stock investments (not to mention the poor performance of the overall Brazilian market in recent years) as well as the risk of steep losses stemming from such have hampered significant outcomes from this benefit. This point shed light on the importance of the mechanisms of the benefits provided by the British government, namely the SEIS, EIS and the VCT[12]. These programs, offered for investments via different kinds of platforms[13], have in common that not only a fiscal benefit will be obtained in case the initial investment appreciates, but, if held for a relevant period, can provide a substantial financial offsetting in case a young business fails and the capital invested would otherwise be lost.

Since fear of losing a significant part or all of its investment is usually the main constraint burdening the minds of individual savers, it is likely that similar initiatives, tailored to each countries' realities, would achieve positive results and ultimately aid in job generation with limited net budget impact, as it was consensual among relevant institutions, it is happening at some degree in the UK.

11 In particular, please see the document at http://www2.deloitte.com/content/dam/Deloitte/uk/Documents/about-deloitte/deloitte-uk-taking-the-pulse-of-the-angel-market.pdf, whereby one can note that around three quarters of investors surveyed said the fiscal benefits available to investors in the UK were crucial in their decision to invest, and 58% said they would in fact had invested less if such benefits weren't available.

12 For a detailed explanation of these schemes, we refer to: https://www.crowdcube.com/pg/eis-seis-tax-relief-overview-43.

13 Usually crowdfunding, angel syndicates, etc. However, fiscal incentives have also been provided in the UK to the banking industry, focusing on challenger banks, via subsidized rates from the Treasury's Funding for Lending Scheme - provided that funds were lent to SME.

THE NEEDLE WITHOUT THE HAYSTACK

TRANSPARENT CAPITAL MARKET COMMUNICATION IN TIMES OF INFORMATION OVERLOAD CANNOT MEAN: YET EVEN MORE. INSTEAD ANNUAL REPORTS MUST BECOME MORE FOCUSED.

By **RALF THOMAS**, CFO Siemens Group, Munich, Germany, from Frankfurter Allgemeine Zeitung, Frankfurt am Main, Germany, April 11, 2016

Baron Fürstenberg was not right with his famous saying: Shareholders are neither “stupid” nor “insolent”. They are intelligent, they know their rights and they have access to a large number of information sources. Companies have to draw the attention of investors and not vice versa. This is becoming increasingly difficult.

Digitalization has not only brought about an excess supply of music, pictures and films, but also of information about companies. Investors are facing the same endless choices as music or cinema lovers. The question is no longer: “How and when do I get the necessary information?”, but rather: “To which information do I have to direct my attention, and which one can I trust?”
At the same time, studies show that the attention span of humans keeps getting shorter while the volume of information is steadily increasing. Against this background, both, the standard setters, which determine how much information companies have to provide, and the companies must ensure transparency for the users of information. Capital market information must be, today and in the future, first of all clear and distinct, easily understandable and suitable for the target group. But it is not only on the users of the information to sift out from the abundance of information what is relevant to them. Just as much and more than ever before, the issuers of information, too, have to communicate in a form that suits the needs of the users.
To do so, companies today use a large number of instruments. Those days are long gone when investors depended once per year on the annual report which served for them as the main source of information for their investment decisions. By now, there is a constant flow of information, providing investors, analysts and journalists with a large number of comprehensive packages of corporate information around the clock.

As a consequence, the role of annual reports has also changed. While the report was one – if not even the central – building block of capital market communication in the past, today it is only one among many instruments. Despite this change, the volume of annual reports of many companies has significantly increased over the last years. The reasons for this development reach from a large number of new regulatory requirements – which have been issued in connection with various crises of companies, economies and the financial system – to the attempt to address a spectrum of recipients that is as broad as possible with one report only. The consequence: for the users it is becoming increasingly difficult to

distinguish material from immaterial information.
Siemens therefore had the objective to actively turn this trend around in the reports issued for its fiscal year 2015, while staying compliant with presently relevant regulations. By particularly focusing on information relevant for decision making, the volume of the financial reports could be significantly reduced while transparency increased at the same time.
To accomplish this goal, a bundle of measures was used. The financial section of the annual report alone could be shortened by over 100 pages. Much of the information which is no longer disclosed in the annual report, including e.g. the multi-year financial summary, is now mainly provided through other suitable channels, especially the company's internet presence. This new approach was received positively by almost all user groups.

But the companies' approach to bundle information which must be provided or to distribute it over various channels of communication is only one way to make it more understandable and more accessible to the users.
As a further step, a change of approach is needed from those that decide in the first place which information has to be disclosed and to which extent, which is the standard setters and the regulators. It goes without saying that the existence of strict accounting standards and disclosure requirements as such are achievements which have to be maintained by all means. But even here there is a need to always weigh whether particular standards effectively contribute to the desired transparency or whether they rather achieve the opposite.
This is now truer than ever as the increase of regulations has led to a phenomenon which in professional circles is called "disclosure overload". Standard setters and regulators have recognized this in the meantime and have started first initiatives which deal with approaches to resolve these issues. However, numerous projects of the standard setters in the past have shown that they take a long time and often end with a compromise on the smallest common denominator.

In order to work against "disclosure overload", the regulatory framework must be adapted. It would be desirable if respective authorities and standard setters accompanied a future development in this sense. Here are three examples where a change of mind must occur:

- New respectively revised regulations should really contain principle-based requirements rather than numerous regulations of individual cases, which make it possible to interpret the information provided even without extensive additional disclosures in the form of "footnotes".
- The cooperation of the national and international standard setters and regulators must be significantly intensified. Indeed, several institutions set regulations for companies, which partly leads to significant redundancies. As an example, German disclosure regulations for the use of performance measures in the group management report which are not defined in the accounting standards are being expanded by new standards on the European level.
- A stringent analysis of costs and benefits of a regulation should not only occur before the introduction of a new disclosure requirement, but should also take place regularly several years thereafter. The world is changing continuously, many products and processes are aging ever faster and are no longer necessary or useful. Accordingly, accounting standards and other reporting requirements should also be analyzed regularly to determine whether the requirements are still adequate.

Another development which is expected to lead to more transparency will be introduced this year by the national implementation of the European Union Directive on external auditor reform: the expansion of the auditor's opinion by so-called key audit matters. In this new paragraph, the external auditor in future will not only have to report what was audited, but also how and which areas of the audit needed particular attention.
In this case, it is worth the effort to look at examples in Great Britain or the Netherlands, where the expanded auditor´s report is already being applied. Depending on the preparer and external auditor, there are great differences as to the details of the explanation of the external auditing procedures. Especially when these explanations are extensive, it is not always clear at first sight why the explanations are so detailed because many of the auditing measures presented are difficult to understand for the layman, but appear obvious to experts. The expansion of the external auditor´s opinion is to be welcomed as an additional contribution to increasing transparency, but it should be limited to the really material information.

Trust is the highest good of a successful capital market communication.

from Frankfurter Allgemeine Zeitung, Frankfurt am Main, Germany, April 11, 2016.
Article provided by GEFIU, The German IAFEI Member Institute. Responsible for English translation: GEFIU, the Association of Chief Financial Officers Germany. Translator: Helmut Schnabel

"WE WANT TO BE A RELIABLE PAYER OF DIVIDENDS"

THE CFO OF LANXESS: THE JOINT VENTURE IN THE SYNTHETIC RUBBER BUSINESS IS STRIVING FOR AN ACTIVE ROLE IN THE CONSOLIDATION OF THE INDUSTRY - BUT THE FOCUS IS ON BUSINESSES WITH LESS CYCLICALITY.

Interview with Mr Michael Pontzen, CFO of Lanxess AG, Börsen-Zeitung, June 11, 2016, article provided by GEFIU, Association of Chief Financial Officers Germany

Mr. Pontzen, the closing of the contract with Saudi Aramco on the synthetic rubber business in the past year has been a milestone for Lanxess. What are you getting operationally from this joint venture (JV)?

With the joint venture Arlanxeo, which we have established with Aramco, we are closing a strategic gap. Because other than our largest competitors in the synthetic rubber business, we so far had not been backwards integrated. We are, though, still tied with long term supply contracts to other suppliers, but in the next four to five years we shall also conclude contracts with Saudi Aramco for raw material supplies.

Does this mean, as a reverse argument, that Lanxess, for the next three years, will not have operational advantages from the joint venture?

It is a strategic long term decision. On the short term we have overcapacities in the global synthetic rubber market, which will even increase in the next 18 months, because additional capacities will come to the market, and consequently price pressures will continue. These challenges, the joint venture, with two strong partners, can master better than one alone. Starting 2019 the situation should again improve.

The joint venture partners have bound themselves together for the next five years. What will happen thereafter?

We have obligated ourselves for five years for a joint path, and we thereby also want to accompany the expected consolidation of the market. How things will continue after five years, we shall decide by then.

Arlanxeo wants to accompany the expected consolidation. How has one to imagine this to be? Are there agreements as to how in the situation of a large acquisition the partners Lanxess and Saudi Aramco will be co-sharing the financing?

In a joint venture it is important, that the owners do agree as to the strategic orientation. There is agreement as to the evaluation, that the market will consolidate itself in the coming years.

we want to move away from cyclical businesses with high raw material cost components

There is also agreement, that we - Lanxess as the largest producer of synthetic rubber and Saudi Aramco as the largest integrated energy group of the world - shall actively, with Arlanxeo, join in the consolidation of the market and jointly will review upcoming opportunities.

If one subtracts at Lanxess the synthetic rubber business, then the Lanxess group in 2015 stood for a turnover of 5 billion Euro, and for operating earnings before depreciation of a good 500 million Euro. Is this enough for a standalone business?

These are purely hypothetical numbers. The entire clear vision for the "new" Lanxess is Growth. With this we want to increase the q uality of the portfolio and the returns. That means, we want to move away from cyclical businesses with high raw material cost components, and focus more on smaller and medium sized markets with less cyclicality. On this way we shall march forward in the coming years – by way of organic and non-organic growth.

This sounds as if you have already written off, at least in your thoughts, the synthetic rubber business.

To the contrary: We have bound ourselves at least for the next five years, and we are convinced, that there will be opportunities in this area. We are consolidating this business still for three years in the Lanxess Group, and we shall closely accompany the joint venture. The medium term focus, however, is clearly on the new Lanxess - this is the business with specialty chemicals, intermediates and high performance plastics.

The question, however, is, whether Lanxess - without the synthetic business - is still big enough, for being able to continue also its path as an independent company group.

For us it is decisive, to increase the economic value of the company group. This will be achieved, when we invest the money, available to us, in such a form, that the quality of the return increases - on the one hand by making the cake larger, on the other hand by way of more stable operating earnings.

As a publicly listed corporation, however, one cannot disregard the matter of size. Lanxess itself, here has special experience. After the rise into the DAX30 Stock Index of the largest German listed corporations in 2012, followed the descent last year into the MDAX Stock Index of the 50 medium sized German listed corporations, and thereby the loss of a number of institutional investors, due to the decreased size.

The evaluation of the corporation always takes place on the basis of the presented data and of the expectations. We are stepping up in order to increase the valuation, and we are convinced, that we are on the right path. This is also like the investors look at us.

Exactly against this background, there is the question, why Lanxess wants to put 200 mio Euro into the buyback of its own shares? Nothing changes through this as to the value of the corporation.

With the closing of the joint venture we have received a revenue of 1,2 mio Euro. We have decided, to put a part of the revenue into organic growth, a part into deleveraging, and a part into a share buyback. This form of allocation we do regard as adequate and reasonable. And with the share buyback, we increase the corporation value per share.

Has there been pressure from the investors?

No. We simply want to be transparent. We have various stakeholders, whom we want to serve. To our employees we have signalled, that we do invest, to the creditors that we are reducing the debt, and to the shareholders that we are giving back something to them because they have helped us two years ago at the start of our re-orientation.

You want to invest 400 mio Euro into organic growth. Do you have, other than the announced further investment into a production plant of fine chemicals, already other projects?

The further investment into the plant of our subsidiary Saltigo is presently the most prominent project. Further options we are presently investigating. First of all it is about extensions of existing plants and not necessarily about the building of new plants. But we are not in a hurry. This also relates to acquisitions. The capital expenditure into the organic growth we are stretching over the next three to four years.

Are you sure, that there is no hurry as to acquisitions? The consolidation of the industry of chemicals is indeed in full swing.

On the one hand the consolidation is happening, on the other hand, however, there are also business areas, which are being de-consolidated or de-merged. Also in the last ten years, there have again and again business units been offered in the market. Because of up to now our tense financial situation, we could not at all until recently participate in this process. This is now different. But at the end of the day it is all about creating added value. Therefore we do not let ourselves been hasted at M & A transactions, also given the fact, that we have just about announced an acquisition of the hygiene and disinfection business of Chemours. We have achieved in the past 18 months to deleverage the corporation group, to adapt the group structures, to get the cash flow again flowing, and to bring our synthetic business into a joint venture, and to initiate an acquisition. We have thus performed a lot in a short time.

When today an attractive business is put up for sale, then it will certainly not be available any more in six months.

We are putting ourselves, very consciously, not into a position in which we have to carry out an acquisition at the time of X. It is important, that it fits strategically and financially. Then we shall also be in a position, to act quickly, as one can see at the example of Chemours.

Your fine chemicals subsidiary is a "prolonged work bench" of the agrochemical groups. What does mean the just ongoing consolidation in this industry - Chemchina acquires Syngenta, Bayer is courting Monsanto, and from the merger of Dupont and Dow Chemical results another large agrochemical group - for Saltigo?

This we regard as neutral to positive for our business. Especially in the case of Dupont and Dow Chemical there will certainly result also new chances for strong supplier producers like us. In total, the consolidation is showing that all players regard the segment as a growth market. And we share this view.

You have announced, to reduce the rating – relevant financial debt by 400 mio €. If one looks at what Bayer is ready to pay for Monsanto, one could mean, that debt ratios today are not any longer so important. What is your view on this?

We have a slogan, which we apply since the first day of the existence of Lanxess: We want to have an investment grade Rating. This is also not changing by way of that actually there is much liquidity in the markets, and by that also corporations with weaker Rating grades have good access to liquidity. It is just about seven years, since when it has been difficult for corporations with investment grade Ratings, to get liquidity at all. At the time we were really glad, to have an investment grade Rating.

Do you have a concrete target Rating within the investment grade?

Today we are valued with BBB-, and we are thus on the

Lanxess at a glance

LANXESS Energizing Chemistry

Group Numbers

Sales in million Euro

2014 8006
2015 7902

Adjusted Ebit* in million Euro

2014 808
2015 885

Net Profit in million Euro

2014 47
2015 165

Earning per Share in million Euro

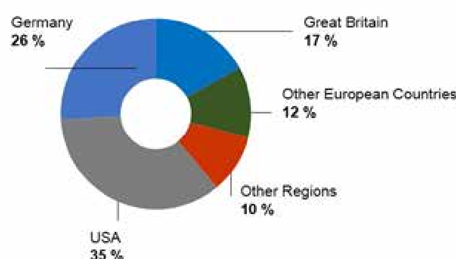
2014 0,53
2015 1,80

Longterm Rating

Moody's	Baa3
Standard & Poor's	BBB-

*Earnings before interest, taxes, depreciation and special factors

Shareholders by Region



Market capitalization
Status June 6, 2016
3.7 billion Euro

Source: Corporation, Thomson Reuters

lower limit of an investment grade Rating. Through the capital infusion from the joint venture transaction, our net corporate debt at the end of March has been practically equalised. The indebtedness is since defined by our pension provisions, which amounted to roundabout 1,4 billion € as of March 31. The present financial ratios permit a return to the “BBB-“ range. Whether the Rating Agencies will share this view, we will see during summer, when the yearly talks and reviews will have taken place.

With the further funding of the pensions by 200 mio €, you will reach a funding ratio of 51 %. The DAX Index 30 Corporations on average have a ratio of 65 %. Are you striving for the medium term for a higher funding ratio?

The size of the funding ratio is to be seen against the background, that the pension provisions are breathing with the interest rates. A swing by 100 basispoints, at us makes a change of around 250 to 300 mio € at the pension provisions, although nothing changes as to the cash flow. Therefore I can live quite well with the present funding ratio. When looking at the DAX 30 corporations, one has to be aware, that the financial corporations do have a very high funding ratio. If one limits the view at the industrial corporations, we are positioned along the same level.

How high are the pension provisions, which Arlanxeo is provided with on its way?

Only low pension provisions have been handed over to this joint venture, because the majority of the employees of Arlanxeo is employed abroad. The big synthetic plants are located in the USA, Brasil, China, Singapore and Belgium. There exist mostly pension plans, which are generally not permitting a funding by way of provisions, as they are customary in Germany. In the balance sheet of Arlanxeo there are practically no financial debts. This we have done consciously, in order to show on the one hand to the employees, that the company is structured and financed in an orderly way, and on the other hand that it can participate in the expected consolidation of the industry.

Pension provisions, one may think perhaps of ThyssenKrupp, can become a serious problem. Is the German special way suboptimal?

Pension provisions especially do come along with volatility. From this point of view, the internal financing is good only to a certain degree. It is necessary to find the right balance.

Are pension provisions playing a role when talking to shareholders, especially to Anglosaxon shareholders?

Anglosaxon shareholders do not look that much on pension provisions, but rather on the cash flow. It is especially the Rating Agencies and the debt providers, who have a precise look at the pension provisions. They interpret them as a loan given by the employees.

Which view, in your opinion, provides the better impression?

It is the triple accord of the balance sheet, the profit and loss account, and of the flow of funds statement. For increasing the corporation value, we must take care of the cash flow, which means, we must have control over the costs, and we must make reasonable investments. But the most beautiful cash flow serves no purpose, when too much debt is being taken up for this. To have this in a harmonic accord, at the end results in an investment grade Rating, and this is how we are steering the corporation group.

To generate cash is for the share investors only then attractive, when at the same time a related dividend is being paid. Especially as concerns the payout ratio, Lanxess is not very generous, apart from the dividend for 2014. How do you resolve this contradiction?

We have at last increased the dividend by 20 %. At the same time we have worded the objective, to hold the dividend at least stable, but increase it every year if possible. One has to balance between dividend and capital expenditure, in order to have at the end a higher return on the invested capital. We try to get this into a balance.

The payout ratio is thus no relevant measure for you?

Of course we are also looking at the payout ratio. But we do not commit ourselves to a fixed payout ratio.

With your statement, to pay at least a stable, but possibly an increasing dividend, you have started to go on a new path. What are the reasons?

The definition of the payout policy goes along with the objective, to - based on steady growth - decrease the cyclicality and to increase the cash flow. We want to be a reliable payer of dividends for our shareholders.

The most beautiful cash flow serves no purpose, when too much debt is being taken up for this.

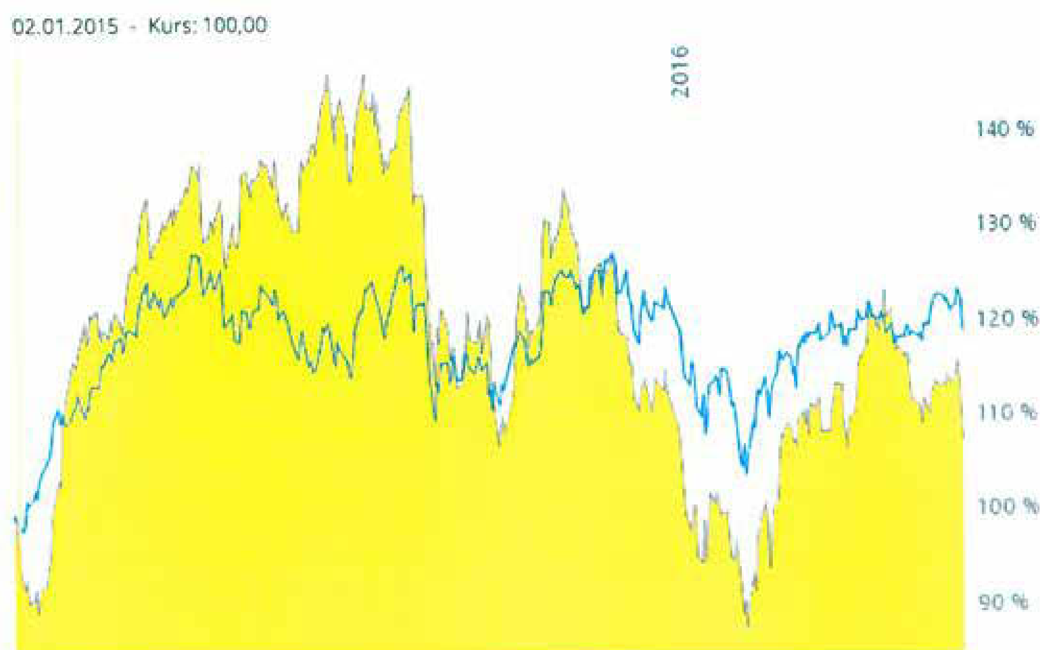
The re-orientation of the past 18 months has shown no effects at the share price. What, in your view, are the reasons?

If one considers, where we have been at the start of our re - orientation, then we have achieved much. The debt ratios are again in order, the portfolio has been streamlined, and we have again worked ourselves into leeway for new activities.

Lanxess AG Share, 40,80 € Share Price as of June 10, 2016

Index Price Chart, Index-base as of January 2, 2015 = 100

-Black line Lanxess AG Share
-Blue line MDAX Stock Index = 50 Medium Sized German Corporations Index



The rights issue you did place two years ago at a price of 52,00 €, but presently the market pays only a good 40,00 € for your share.

On the one hand, one cannot view the share price detached from the entire share market. On the other hand, we also say, that the situation in the synthetic rubber market can deteriorate again in the next 12 to 18 months. This is exactly the reason, why we want to become less cyclical and wish to increase the quality of the earnings. Thus, we want to get, over the medium term, to another valuation of the share.

Lanxess did start well into the new business round. But when lifting the forecast, you have at the same time warned, that the development is not sustainable. Why?

In spite of the good development, which also continues during the second quarter, we are standing before great challenges in the synthetic rubber business. We have overcapacities and price pressure. We expect, that the pressure will once more get stronger in the second half year, because new capacities will come into the market. Accordingly, the analysts are expecting, that the earnings in this business will go down somewhat in the second half of the year. At our businesses the earnings should however go up further.

About the Person

Sensibleness for Investors

Lax and settled appears Michael Pontzen at his first interview as CFO of the chemical group Lanxess. Nothing else, though, had to be expected, as the 46 year old belongs since the "birth" of Lanxess to the base team and thus knows the group perfectly well.

A home base game also for the man of numbers, the professional career of whom always took place in the financial function of the respective employer - apart from the start of the career, when the MBA started in 1997 as assistant to the managing board at Ferrostahl. After two years he changed over into the investors relations department of the then still independent producer of trucks, MAN. Again, two years later, he started to work for EADS (today Airbus), where he became head of investor relations.

When he got an offer into the same position in the city of Leverkusen at the Lanxess Group, the man, engaged in his family, could not resist to return to his home regional area. But the manager, born in the lower Rhine river area, was especially attracted, by bringing Lanxess, the spin off of Bayer, and often defamed as the remainder portfolio, to the stock exchange. As head of Investor Relations, Pontzen was co-writing the equity story, which until today is based on transparency. After that in 2008 he became head of Corporate Finance. A year later he also became head of Risk and Cash Management.

THE INTERVIEW WAS MADE BY ANNETTE BECKER, BÖRSEN-ZEITUNG, FRANKFURT AM MAIN, GERMANY, JUNE 11, 2016.
RESPONSIBLE FOR ENGLISH TRANSLATION: GEFIU, THE ASSOCIATION OF CHIEF FINANCIAL OFFICERS GERMANY, TRANSLATOR: HELMUT SCHNABEL

VALUATIONS OF TANGIBLE ASSETS FOR FINANCIAL REPORTING PURPOSES UNDER INTERNATIONAL FINANCIAL REPORTING STANDARDS

By **ROBERTO CUARÓN IBARGÜENGOYTIA,** Member of the National Corporate Finance Technical Committee of IMEF, Ing. **SAMUEL CAMPOS PAVÓN,** Senior -Transaction Advisory Services, EY México, article provided by IMEF, the Mexican IAFEI Member Institute

As IFRS continues to significantly shape how financial statements are prepared and presented around the world, the need for local and international market participants to have reliable and transparent information prepared following standardized accounting rules makes it imperative for companies to have the right tools and knowledge on hand to ensure their continued compliance with their IFRS reporting obligations.

There are still a number of issues regarding these tools and knowledge that need to be addressed by the management, boardrooms, advisors and auditors of today's companies, and in our experience, the accounting treatment of long-lived tangible assets (LLTAs) is one area that has been steeped in controversy in relation to the fair value measurement of these assets and compliance with guidelines regarding tracking and managing LLTA depreciation.

Measuring LLTA's for financial reporting purposes poses a significant challenge for companies and management is tasked with deciding whether to measure the LLTA's of their organizations using their own resources or outside specialists.

Having a broad view of this decision that considers all of the relevant accounting standards and the particular characteristics of the potential valuation specialist provides management with a clear understanding of its responsibilities both during and after the valuation process, which is particularly important for valuations of assets for financial reporting purposes.

The fair values of an entity's LLTA's are a key factor for ensuring appropriate compliance with accounting guidelines regarding the tracking and managing of the depreciation of these assets, and for financial reporting purposes as well. An effective LLTA valuation requires technical knowledge and an understanding of the applicable accounting standards

An outline of the LLTA valuation process is provided subsequently:

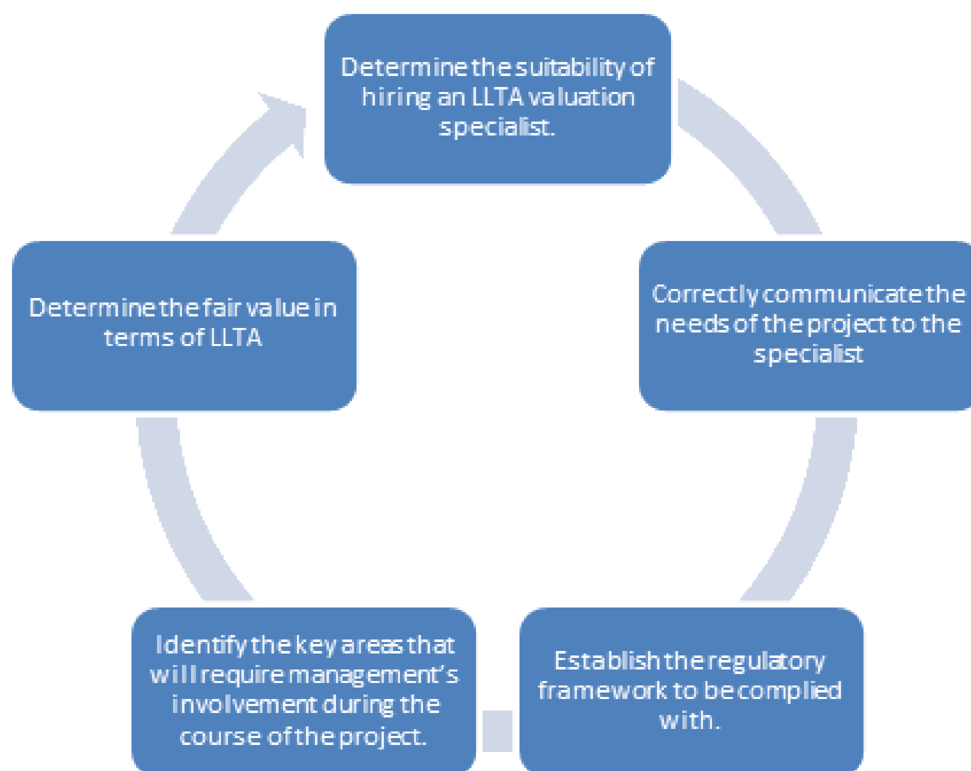


Diagram 1: LLTA recognition / administration process

Long-lived Tangible Assets and IFRS
Some of the accounting standards that address the identification, recognition, accounting treatment and valuation of LLTA are as follows:

IFRS 3 – Business Combinations: The objective of IFRS 3 is to improve the relevance, reliability and comparability of the information that a reporting entity provides in its financial statements about a business combination and its effects.

IFRS 13 – Fair Value Measurement: IFRS 13 provides guidelines for the valuation of assets and liabilities to estimate/determine their fair value for financial reporting purposes. The standard requires an entity to estimate an "exit price" for the asset being measured, which is the price that would be received by the entity from the sale of the asset on the measurement date.

IAS 16 - Property, Plant and Equipment: This standard is extremely relevant for LLTA fair value measurement and recognition. To measure fair value after initial recognition, entities may use either the cost model or the revaluation model. Although IAS 16 does not specify how often fixed assets should be revalued, generally speaking, fixed assets should be revalued when there are market indicators that provide evidence that the fair value of the relevant assets is materially different from their carrying amounts.

Some of these indicators relate to:

- Technological changes
- Inflation
- Market circumstances
- Environmental or governmental changes

Other requirements under IAS 16 that help entities determine the depreciation of the carrying amounts of fixed assets also help these entities better reflect the fair values of these assets in their financial statements. These aspects include (i) the separation of fixed assets into their component parts with different useful lives, (ii) the estimation of residual values of fixed assets, and (iii) the review of useful lives of fixed assets.

IAS 36 - Impairment of Assets: IAS 36 requires entities to identify whether the carrying amount of an asset or cash-generating unit (CGU) exceeds its recoverable amount and to record an impairment loss when this is the case. LLTA should be tested for impairment when there are indicators of impairment.

IAS 40 – Investment Property: This standard addresses the treatment applicable to investment property, which is land or buildings held (by the owner or by the lessee as a right-of-use asset) to earn rentals and/or for capital appreciation. IAS 40 establishes that investment property should be measured using either the cost model in accordance with IAS 16, or the fair value model to measure the carrying amount of the investment property based on the fair value of the asset.

IAS 29 – Financial Reporting in Hyperinflationary Economies: IAS 29 addresses the recognition of the

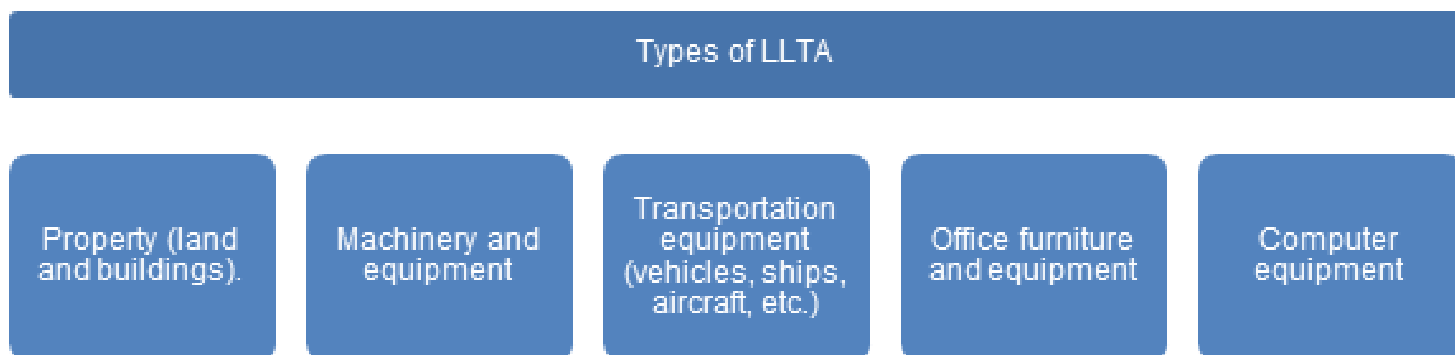
effects of inflation in the financial statements of entities whose currency is the currency of a hyperinflationary economy. An economy is considered hyperinflationary when the cumulative inflation rate over three years is approaching, or exceeds, 100%.

Fair value measurements

In our experience, fair value measurements may be approached from two different perspectives: the first approach is to consider the relevant accounting standards and the second approach is to consider the valuation methodologies applied by specialists. Companies do best when they combine these two approaches to fair value measurements, since this is the most reliable way to generate fair value estimates that are in line with the applicable accounting rules.

In order to reliably measure fair value, an entity needs to first classify its LLTA based on the nature of the assets and then determine the procedures and guidelines to be followed for each type of LLTA.

Diagram 2: Types of LLTA



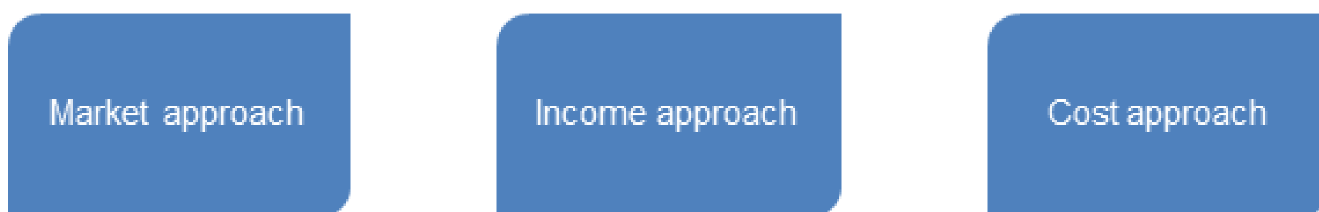
From an accounting standard and financial reporting standpoint, IFRS 13 defines fair value as:

"The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

An entity may estimate fair value by either using observable inputs or by applying one of the generally accepted valuation techniques, which are outlined below:

Diagram 3: Valuation techniques

Source: IFRS 13 - Fair Value Measurement - generally accepted valuation techniques



An entity's management needs to determine the most appropriate valuation technique based on the nature of the asset being measured. For the selection of the valuation technique, IFRS establishes a fair value hierarchy that categorizes into three levels the inputs to valuation techniques used to measure fair value.

Level 1 of the hierarchy consists of quoted prices in active markets for identical assets. Level 2 consists of quoted prices for similar assets or other indirect inputs, such as interest rates and yield curves. Level 3 consists of unobservable inputs that reflect little or no market information. The fair value hierarchy gives the highest priority to Level 1 inputs and IFRS requires entities to clearly disclose the reasons for selecting their valuation techniques.

The unit of account, the "highest and best use" analysis and access to working papers as support for audits are additional factors that an entity should consider during the process of estimating the fair values of its assets for financial reporting purposes. Some specialists are not familiar with the term "fair value" and may confuse the concept of fair value with other types of values. A comparison of the definitions of the different values under various sets of standards is shown below:

Fair Value	Market Value	Commercial Value
IFRS 13	IVSC	INDAABIN
The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.	The estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.	The highest amount, expressed in monetary terms, for which an exchange of an asset will occur in the current market, between a willing buyer and a willing seller in an arm's length transaction, in an open and competitive market, under the prevailing circumstances at the appraisal date and with a reasonable term of exposure.

Table 1: Definition of value standards
Source: IASB, IVSC and INDAABIN

The guides published by the American Institute of Certified Public Accountants (AICPA) underscore the various differences in the definitions of these value standards, which can significantly affect the results of valuations. These differences are illustrated below:

For Market/Commercial Value	For Fair Value
Must consider whether there is a willing buyer and seller for a transaction.	Need not consider whether there is a willing buyer and seller for a transaction.
Neither the buyer nor the seller may be under any compulsion to buy or sell.	Only specifies that the seller must not be under compulsion to sell.
Both the buyer and the seller must have equal and reasonable knowledge of the transaction.	This aspect is not addressed.

Table 2: Differences between Value standards
Source: American Institute of Certified Public Accountants-Understanding Business Valuation Fourth Edition.

Deciding whether to hire a valuation specialist or perform the valuation in-house.

Management must determine whether to engage the services of a specialist or perform the LLTA valuation in-house.

To make the right decision, management needs to analyze the risks and identify the costs and benefits of each option. To approach this analysis, we recommend that management ask the following questions:

- Do we have a clear understanding of the accounting standards applicable to the valuation?
- Do we have personnel with the right technical knowledge to perform the valuation?
- Do we have the resources we needed to perform the valuation within the required timeframe?

If the answer to any of these questions is no, the company will face a higher risk of determining estimates that are outside the range of reasonable values and the additional risk that the valuation results will be subject to stricter scrutiny by auditors and regulatory bodies.

If management wishes to participate in the valuation process, it may create a structure of shared tasks with the specialist, and it may establish a valuation scope and methodology that ensures that the valuation complies with the applicable standards and focuses on the entity's most significant assets.

We recommend that companies involve their auditors in valuation planning in order to get their input regarding the risks or potential oversights that they believe could arise during the valuation. The auditor should not be viewed as being part of the team executing the valuation, but instead should be seen as potentially offering valuable input to help the entity avoid deviations from the relevant accounting standards.

However, if management does decide to engage a valuation specialist, it is important to select the specialist based on the needs of the valuation project in question. We recommend that management consider the following points when evaluating potential specialists:

- Is the specialist familiar with valuations for financial reporting purposes? The specialist should have knowledge valuations to ensure the entity's compliance with all applicable requirements.
- Does the specialist have a work team that is qualified to deal with the complexities of the valuation

project? It is important to determine whether the specialist's area of expertise is best suited for type of asset being valued.

- Does the specialist have enough personnel to carry out the project? The specialist should have experience in similar projects and it should have enough resources and personnel to execute the project within the required timeframe.
- Does the specialist have credentials that demonstrate his/her experience in similar projects? Seeking feedback from the specialist's past and current clients will help you make the right decision.

Asking the specialists to provide alternatives for addressing project complexities that can be approached in different ways can help you select the specialist that is the best fit for your valuation project.

Management's responsibility during the valuation process

Lastly, regardless of whether it opts to have the analysis done in-house or through specialists, management is responsible for the results of an entity's valuations, particularly those performed for financial reporting purposes. In light of these responsibilities, we recommend that management take the following steps for valuations of intangible assets:

Diagram 4: Management's responsibilities

Building an effective working relationship with the specialist performing the valuation and maintaining transparent and clear lines of communication with the specialist through which the entity is able provide all of the information the specialist needs, and reviews and approves the project plan and results helps create synergy between the company's own perspectives and the perspectives of the advisor, who will be more likely to consider the specific needs of the organization for the valuation project.

Final considerations

Valuations of tangible assets for financial reporting purposes represent a singular challenge for entities because they require consideration of two discrete perspectives: the accounting standards addressing valuations and the selection of the right valuation approach and methodology for the valuation. It is common for those involved in valuations of tangible assets to perform their work independently, since it tends to be easy for these specialists to isolate themselves and focus exclusively on their areas of

Diagram 4: Management's responsibilities

expertise. Nevertheless, this go-it-alone approach general makes it difficult for specialists to maintain effective lines of communication with their counterparts as a medium for quickly identifying situations where they may need assistance and in this way ensure that the project results meet the objectives established initially for the project.

Members of senior management need to remember that management is accountable to outside parties for the accuracy of these valuations and that management is a critical agent for ensuring that the results of the valuation are in line with the relevant accounting standards and that the valuation estimates address the characteristics of the valued assets and the markets where they are bought and sold.

THE FINANCING OF STATES AT THE CROSSROADS

GETTING OUT OF THE HAMSTER WHEEL TREADMILL OF WISHFUL THINKING

By **LUDGER SCHUHKNECHT,** Chief Economist at the Federal Ministry of Finance, of the Federal Republic of Germany, Berlin, from Frankfurter Allgemeine Zeitung, Frankfurt, Germany, June 16, 2016

The consolidation of the financing of the states has been preliminarily finished by most of the Western World countries at the moment. This is proven by the latest forecast of the European Commission, and this is welcomed by many of the top economists of the Keynesian School of Thought. Also, most of the international organisations are satisfied, unless that they are even calling for more additional expenditure programs. It seems that one especially likes to shoot at Germany, in order to transform the last tiny space of “fiscal space” into more short term demand and long term debt. In spite of expense increasing politics in Germany for refugees, for more investments and for higher social entitlements, it is still not yet enough, as express experts like Joseph Stiglitz, several international organisations and several prominent politicians in other parts of the world.

In view of all the love for a strong demand, one likes to overlook, that there are reasons to continue the healing of the financing of the states. Because demand requires trust. This is not really created, when the fiscal virtue is deferred to tomorrow, or when it then again is also not considered as acceptable, to then to defer it further to forever and a day.

Firstly, things are not that bad for most of the Western World economies, in spite of exceptions, and the unemployment ratio is low. Europe is growing above average, the United States of America are growing in the seventh year. There is no convincing evidence of a global lack of demand or a crisis, which would call for such a global stimulus. In Germany, the situation is rather more one of full to excessive capacity utilisation, so that a stimulus here does not make any sense at all.

Secondly, there is neither in Germany nor in other countries the often quoted “fiscal space”, that is leeway for more government expenditures. Most of the industrial countries rather have the problem of record-indebtedness, which has been strongly increased after the Financial Crisis. On average for the Euro-Zone the government debt has increased by short of 50 % to over 90 % of GDP. In the G 7-countries, the total debt of the state is even at 120 %, in the United States of America higher than 100 %, and in Japan around 250 %. The debt ratio, though, is at the moment not increasing further in most of the countries, but it also does hardly go down, because there is hardly any progress when it comes to decreasing the annual government budget deficits.

Thirdly, the population is aging in Germany, America and in Asia very strongly. For this, not enough care has been taken. Neither by way of the reform of the social entitlement requests nor by the way of building up financial reserves by way of decreasing debt. Also Germany has a significant lack of carrying capacity for debt, and it should stay out of self complacency. The measures of the past years have again increased the expenses for social entitlements: the curse of the good deeds in good times.

Fourthly, the quality of the fiscal measures does decide about the results of the reduction of debts. Reductions, for example the reduction of state expenses for consumption, are better for producing growth and trust than increasing the taxes. As to this, one should know, that the most Western World Countries already have an excessive state quota in percent of GDP. In Europe, the expenditure of states on average is short of 50 % of GDP, in France and in Scandinavia it is significantly above this. In Germany, the state quota is at short of 45 % of GDP. In Eastern Asia, the states on the contrary, are spending only 20 or 25 % of GDP. Lower expenditures, in the right area, are improving, by way of more efficiency and less bureaucracy, the incentives for labour and investments, and they are also further lowering at the same time the budget deficits.

But there also exist other arguments for a growth friendly consolidation and reduction of debt. Only through this way we can guarantee, that in the next period of economic weakness or financial crisis, all countries will have enough leeway in order to not again loose the trust of the markets and in order not again to slide into a crisis of the financing of states.

A solid financing of the states is protecting from ad hoc saving measures in the “emergency”, which are often cutting back expenses in the wrong area, for instance, when it comes to investments. They are permitting a long term strategy, which also leaves more room for the financing of new challenges, like the costs for refugees or additional expenditures for the internal and external security.

Such a strategy creates trust, which leads to more consumption and investment. Economists are calling this non-keynesian (trust-) effects, which do work against the negative demand effects of the consolidation.

With this, we arrive at the subject of credibility of politics and institutions. When economist do argue that with higher expenditures one can accelerate strongly the economic growth, so that one can easily defer consolidation to tomorrow, because such measures do self finance themselves, then this is naïve. Politics is never so perfect and can never be steered in a way, as economists do assume. Such statements in addition create expectations in the population, which cannot be fulfilled. Expectations about the capability of planning of the economy, about the increase of income, about equality, about safety. The economists are sending politics into the hamster wheel treadmill of our wishful thinking, instead of giving recommendations how one can make the best out of the real world.

Naivety and levity are also characterizing, how several economists and politicians are dealing with the European Maastricht treaty for stability and growth as part of the Euro Currency
Treaty framework. Effectively, it is one of the most important institutional cornerstones of the currency union. It is meant to show to the governments limits for the indebtedness. But evermore exceptions and special situations are rather increasing the impression of an arbitrary application.

It is extremely regrettable, that the EU-Commission has just recently deferred the decisions about a tightening of procedures against deficit sinful countries. A lot is therefore speaking for an execution of the stability treaty by way of an independent authority, in order that trust will be created and expectations of a solid financing of states will be reinforced.

The solid financing of states is also necessary in order that for the European Central Bank the way out of the unconventional monetary policy will not be closed. Too high government indebtedness implies, that the European Central Bank, ECB, by selling off again and again its previous government bond purchases or by way of raising of interest rates, may cause market turbulences and thus the ECB may be hindered in the fulfilling of the European Central Bank´s mandate. This scenario the economists call “fiscal dominance”. It would do great damage to Europe, economically and institutionally.

Thus, there is much at stake. The financing of the states is indeed really at the crossroads.

Source: Frankfurter Allgemeine Zeitung, Germany, Frankfurt am Main, Germany, June 16, 2016.
Responsible for translation: GEFIU, the Association of Chief Financial Officers Germany; translator: Helmut Schnabel

THE IASB CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

By MARCO ALLEGRINI, Chairman IAFEI IFRS Committee

Introduction

The IASB has been working on the revision of the Conceptual Framework since 2012. It is not a standard, but it can be useful for preparers (and especially CFOs) in order to understand the concept and the underlying logics that the standard setter (IASB) is applying.

The Conceptual Framework is a practical tool that aims at supporting the IASB to develop standards on consistent concepts, preparers to develop consistent accounting policies when no Standard applies to a particular transaction or event, or when a Standard allows a choice of accounting policy; and assists others to understand and interpret the Standards.

Project stages

The IASB's existing Conceptual Framework was developed in 1989. The material on the objective of financial reporting and on the qualitative characteristics of financial information was revised by the Board in 2010.

IASB is revising its Conceptual Framework, since it believes that some important areas are not covered; the guidance in some areas is unclear and some aspects of the existing Conceptual Framework are out of date.

On May 2015 the IASB published an Exposure Draft (hereafter, called "ED") that sets out the proposals for a revised Conceptual Framework (hereafter, also called "CF"). The deadline for comments on this ED CF ended on 25 November 2015.

Since May 2016, the IASB Board aims to finalise the revised Conceptual Framework in early 2017.

Structure

The ED CF deals with these subjects:

- Objective of financial reporting and qualitative characteristics of useful financial information
- Financial statements and the reporting entity
- Elements of Financial Statements
- Recognition and Derecognition
- Measurement
- Presentation and Disclosure
- Concept of capital and capital maintenance

In this article, some of the high number of issues dealt in the ED CF will be presented and discussed.

Objective of financial reporting and qualitative characteristics of useful financial information

Stewardship

The current version of the Conceptual Framework describes the objective of general purpose financial reporting as: "*... to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit*".

The ED CF proposed to reintroduce the term 'stewardship' and give more prominence, within the objective of financial reporting, to the importance of providing information needed to assess management's stewardship of the entity's resources. To achieve this, the Exposure Draft proposed to identify the information needed to assess the stewardship of management as separate from the information needed to help users assess the prospects for future net cash inflows to the entity.

We agree with the ED CF that existing and potential investors, lenders and other creditors need information to help them assess both the prospects for future net cash inflows to an entity and management's stewardship of the entity's resources, but the ED does not include much guidance on the implications for standard setting of the objective of providing information useful for assessing the management's stewardship. Actually, many comments received on the ED pointed out that the objective or providing users information to help assess an entity's prospects for future net cash inflows. Conceptually, these two objectives may be aligned, but they still have their own meaning for users. We could think that stewardship might be better assessed through

a profit and loss account just based on realised revenues and the application of historical cost measurement basis, in so far it might reveal the value realised through transaction with third parties.
On the other hand the objective of assessing entity's prospects for future net cash inflows seems to fit more with the use of current values bases, being able to reflect also unrealised holding gains and losses and the current changes in values of assets and liabilities.
However, on 18 May 2016 the Board tentatively decided to indicate in the Basis for Conclusions on the revised Conceptual Framework that increasing the prominence of stewardship within the objective of financial reporting does not imply a preference for a historical cost measurement basis.

Prudence
The 'pre-2010 Framework' stated that financial statements should be neutral, which means free from bias, and went on to discuss the need for preparers to exercise prudence when preparing financial statements.
In 2010, the IASB removed the reference to prudence, because it was concerned that the term could be interpreted in ways that are inconsistent with neutrality.
The IASB acknowledges, in the Basis for Conclusion of ED CF, that prudence is a term used by different people to mean different things.
In particular:
(a) some use it to refer to a need to be cautious when making judgements under conditions of uncertainty, but without needing to be more cautious in judgements relating to gains and assets than for those relating to losses and liabilities ('cautious prudence');
(b) others use it to refer to a need for asymmetry: losses are recognised at an earlier stage than gains are ('asymmetric prudence').

The ED Conceptual Framework includes a reference to prudence, described as the exercise of caution when making judgements under conditions of uncertainty.
The IASB considers that prudence can help achieve neutrality in applying accounting policies. Thus, cautious prudence is a factor in giving a faithful representation of assets, liabilities, equity, income and expenses.
We favour the reintroduction of prudence, as "cautious prudence", but we agree with EFRAG (Final Comment Letter on ED/2015/3 Conceptual Framework for Financial Reporting) that this concept should stay separate from neutrality and should be addressed to the standard setter (IASB itself) more than to preparers (and thus CFOs).
On 18 May 2016 the IASB Board tentatively decided to confirm that the revised Conceptual Framework should include a reference to 'cautious prudence'.

Substance over Form
The existing Conceptual Framework does not include an explicit reference to substance over form. The ED CF states explicitly that a faithful representation represents the substance of an economic phenomenon instead of merely representing its legal form.
The meeting of the Board on May 16 confirms this approach.
We agree with EFRAG suggestion, asking IASB to explain the distinction between "legal substance" and "legal form".

Measurement uncertainty
According to 2015 ED CF, the level of measurement uncertainty affects the relevance of financial information. "*Measurement uncertainty arises when a measure for an asset or a liability cannot be observed directly and must instead be estimated. The use of estimates is an essential part of the preparation of financial information and does not necessarily undermine its relevance, but the estimate needs to be properly described and disclosed*".
On 18 May 2016, the Board tentatively decided to describe measurement uncertainty as a factor affecting faithful representation.
IAFEI IFRS Commission welcomes this last decision, since measurement uncertainties may undermine reliability and not necessarily the potential relevance of information.

Relevance and faithful representation
IASB ED CF continues to consider relevance and faithful representation as the two fundamental qualitative characteristics of financial reporting.
IAFEI IFRS Committee agrees with that choice.

Financial statements and the reporting entity
IASB ED CF states that "*in general, consolidated financial statements are more likely to provide useful information to users of financial statements than unconsolidated financial statements*".
IAFEI IFRS Commission believes that it a difficult generalization, is so far in some context and for some stakeholders unconsolidated financial statement could be even more useful than consolidated ones.

Elements of Financial Statements
IASB Conceptual Framework defines the elements of financial statements, as follows:
(a) An asset as a present economic resource controlled by the entity as a result of past events;
(b) An economic resource as a right that has the potential to produce economic benefits;
(c) A liability as a present obligation of the entity to transfer an economic resource as a result of past events;

(d) Equity as the residual interest in the assets of the entity after deducting all its liabilities;
(e) Income as increases in assets or decreases in liabilities that result in increases in equity, other than those relating to contributions from holders of equity claims; and
(f) Expenses as decreases in assets or increases in liabilities that result in decreases in equity, other than those relating to distributions to holders of equity claims.

It can be easily noted that income and expenses are just defined in terms of changes in assets and liabilities, with no explicit reference to transaction with third parties (sales of goods, sale of services, etc.).
It seems, therefore, that IASB is just carrying out an asset-liability view, called also balance sheet view. As a consequence, it could be inferred that the statement of financial position (or, as it was once called "balance sheet") is considered as the main financial statement, and statement of financial performance (income statement) is just an outcome of the former.
However, IASB clearly stated in its basis for conclusions that:
a) it is incorrect to assume that the IASB focuses solely or primarily on the statement of financial position. Financial statements are intended to provide information about an entity's financial position and its financial performance.
b) information about transactions is relevant to users. Hence, much of financial reporting is currently based on transactions and will continue to be so.
c) transactions that result in income and expenses also cause changes in assets and liabilities
d) an intention to match income and expenses does not justify the recognition of items in the statement of financial position that do not meet the definition of assets or liabilities.

Last statement clarifies however that the balance sheet view is still dominant in the IASB ED CF.

On 22 June 2016, the IASB Board tentatively decided to confirm that the definitions of income and expenses should be those proposed in the Exposure Draft, and not to include in the revised Conceptual Framework a discussion of the typical types of transactions and other events that may give rise to income and expenses.

Measurement
IASB ED defines the following measurement bases:
(a) historical cost or
(b) current value, which includes:
i) fair value
ii) value in use for assets and fulfilment value for liabilities.

It is worth pointing out that the IASB considers that, in some cases, consideration of the objective of financial reporting, and of the qualitative characteristics of useful financial information, will indicate that using more than one measurement basis for the same item in the same financial statements could provide useful information to the users of financial statements ("multiple measurement bases").
For instance, IASB suggests that in some circumstances:
a) a current value measurement basis for the asset or the liability in the statement of financial position; and
(b) a different measurement basis to determine the related income or expenses in the statement of profit or loss.
In such cases, the total income or total expenses arising from the change in the current value in the statement of financial position is split into two components:
(a) in the statement of profit or loss: the income or expenses measured using the measurement basis selected for that statement; and
(b) in other comprehensive income: the remaining income or expenses. The cumulative income or expenses included in other comprehensive income equals the difference between the carrying amount determined by the measurement basis selected for the statement of financial position and the carrying amount determined by the measurement basis selected in determining profit or loss.
This is, on the other hand, somewhat similar to what is happening with the application of the revaluation model, according to IAS 16, even though in this case depreciation charge is recognised in the profit or loss at a revalued amount and is not based on historical cost.
It seems that multiple measurement bases could allow the co-existence of different conceptual views on primary financial statements:

- asset-liabilities views for the statement of financial positions, allowing the extensive use of current value bases. The same views is applied through OCI (Other Comprehensive Income), which presents all the changes in the current values of assets and liabilities, not recorded in the profit and loss account;
- revenues-expenses view, with a specific focus on transaction with third parties, in the profit and loss account, using extensively the historical cost basis for operating revenues and expenses.

However, this distinction is not so clear, in so far as the profit and loss account still includes unrealised revenues, such as those from mark-to market valuation of financial instruments held for trading.

At this regard, we support the view that business model should inspire the process of allocation of revenues and gains to profit and loss account or OCI. We also support EFRAG views, according to which the term 'business model', that has been introduced with IFRS 9, could be retained and included in the Conceptual Framework and appropriately described for financial reporting purposes.
Presentation and disclosure
The 2015 ED CF deals with a fundamental distinction, in so far it states that income and expenses in the statement(s) of financial performance are classified into either:
(a) the statement of profit or loss, which includes a total or subtotal for profit or loss; or
(b) other comprehensive income.

Since 2009, amongst CFOs and practitioners there are some conceptual uncertainties on the role of Other Comprehensive Income (OCI) statement and the profit and loss account. However, the IASB ED CF does not clarify this issue. However, IASB clearly states that: *income and expenses included in the statement of profit or loss are the primary source of information about an entity's financial performance for the period*, and that "*The total or subtotal for profit or loss provides a highly summarised depiction of the entity's financial performance for the period"*. But, this does not mean the decline of OCI: *"Nevertheless, understanding an entity's financial performance for the period requires an analysis of all recognised income and expenses (including income and expenses included in other comprehensive income), as well as an analysis of other information included in the financial statements*."

We could expect IASB to provide a useful guide for the allocation of income and expenses to profit and loss or OCI. But IASB does not go in this direction. It simply says that "*there is a presumption that all income and all expenses will be included in the statement of profit or loss*".
For OCI, it is implied, consequently, a residual role. But, in case of selection of multiple measurement bases, income and expenses will be included in other comprehensive income when a current value measurement basis is selected.

The IASB ED CF also deals with the issue of recycling, i.e. the reclassification of income and expenses from OCI to profit and loss. It states that: "*If income or expenses are included in other comprehensive income in one period, there is a presumption that it will be reclassified into the statement of profit or loss in some future period. That reclassification occurs when it will enhance the relevance of the information included in the statement of profit or loss for that future period*". Therefore, there is still no clear rule on the application of recycling; the ED CF allows to keep the current situation in which different recycling rules apply to income and expenses allocated to OCI.

Concept of Capital Maintenance
IASB ED CF acknowledges two concept of capital maintenance:

- *financial capital maintenance*, under which profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners holders of equity claims during the period;
- *physical capital maintenance*, under which a profit is earned only if the physical productive capacity (or operating capability) of the entity (or the resources or funds needed to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners holders of equity claims during the period.

Under the former concept holding gains, increases in prices of assets are conceptually considered as profits.
Under the concept of physical capital maintenance, when capital is defined in terms of the physical productive capacity, profit represents the increase in that capital over the period. All price changes affecting the assets and liabilities of the entity are viewed as changes in the measurement of the physical productive capacity of the entity; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit.
IASB frankly states that, at the present time, there is no intention to prescribe a particular model other than in exceptional circumstances, such as for entities reporting in the currency of a hyperinflationary economy.

Once again, IASB is not, on our opinion, providing a unique consistent conceptual framework, able to define homogeneous accounting models and to ensure actual comparability amongst firms and countries.

IAFEI INVITATION BY THE EU COMMISSION TO PARTICIPATE TO THE PUBLIC CONSULTATION ON IMPROVING

DOUBLE TAXATION DISPUTE RESOLUTION MECHANISM AND ANSWER BY IAFEI INTERNATIONAL TAX COMMITTEE

by **PIERGIORGIO VALENTE**, Chairman IAFEI International Tax Committee
and **EMILIO PAGANI,** Assistant to the IAFEI Chairman, May 15, 2016

On April 11, the IAFEI submitted its contribution to the EU Consultation on Improving Double Taxation Dispute Resolution Mechanisms launched by the EU Commission on February 16, 2016.

This contribution represents an important step to heighten the visibility of IAFEI at both, international and European levels, and have its voice heard by the main players of the international tax arena. This contribution follows other International Tax Committee's initiatives such as our previous contribution submitted on September 8, 2015 on the EU Public consultation on further corporate tax transparency, and is part of our Committee's International Tax Priorities for 2016 (i.e.: share IAFEI's opinion/position with regard to EU measures and latest developments in the tax policy area [i.e. EU Action Plan to tackle tax evasion and fraud; transparency and tax Avoidance packages; CCCTB]; assess and analyze potential implications and effects of the new tax framework for EU and Non-EU Companies and their CFOs). Our aim, within the Committee, is to reflect our Members' concerns, using our best endeavors to achieve a better, clearer and more efficient tax framework, for the benefit of all stakeholders.

In light of the above, IAFEI's International Tax Committee took the lead to prepare such contribution taking into consideration the significance of the topic for all players.

Double Taxation is an authentic and cumbersome burden for our companies.

As such, it is of the utmost importance that present dispute resolution mechanisms be improved. The system as currently designed presents some inefficiencies and might create some disadvantages, hindering also investment opportunities and cross-border economic activity, while increasing compliance costs.

As we pointed out in our contribution, "*With the implementation of the new measures [set to counteract tax evasion and fraud], we foresee a potential increase of double taxation and on the number of tax disputes.*

TRANSFER PRICING related disputes will also most likely increase as well. The current insufficiency of dispute resolution mechanisms is self-evident, and it often acts as a deterrent for our foreign investment decisions".

The consultation at issue is part of the EU scheduled work within the Action Plan for a Fair and efficient Corporate tax system, released back in June 2015, and it was drawn up with the aim of gathering stakeholders' contributions on:

a) the need and importance of removing double taxation for companies carrying out cross-border activities;

b) the effectiveness of existing tools to solve double taxation within the European Union;

c) ways of improving such mechanisms.

This EU initiative is to ensure a coordinated EU approach to dispute resolution among Member States, through a clearer framework that includes more stringent timelines. The EU proposal is to build on the systems already in place and to find efficient ways of strengthening the enforcement of such mechanisms while improving efficiency.

We, within the International Tax Committee, stressed the need to ensure that:

- existing mechanisms are actually able to solve double taxation since they are in our opinion insufficient as far as scope, enforceability and efficiency are concerned
- double taxation be effectively removed
- the mechanisms under EU Tax treaties network be reviewed accordingly (mandatory binding arbitration should be ensured)
- the need of ensuring a timely resolution.

Furthermore, we emphasized that "*for CFOs, it is of the utmost importance ensuring the taxpayer's involvement within the procedure. Further transparency is desirable, as well as timely updates and reports to taxpayers involved.*
We need efficient and clear tools to eliminate/resolve double taxation; as well as the assurance of timely corresponding adjustments".

We hope that the other important IAFEI Technical Committees be able to operate this way because our Association needs to be better known in the international contest.

ANDAF CONTRIBUTION TO THE EU CONSULTATION ON THE CCCTB

by **PIERGIORGIO VALENTE**
Chairman IAFEI International Tax Committee Managing Partner of Valente Associati GEB Partners
March 10, 2016

On January 8, 2016, ANDAF (Italian CFO Association) submitted its position paper vis-à-vis the EU Public Consultation on the Common Consolidated Corporate Tax Base (CCCTB), launched on October 8, 2015. The main purpose of this consultation was to gather the key elements that should be included in the new CCCTB proposal, which is expected to be released before Summer 2016.

The EU Public Consultation on the CCCTB was part of the initiatives launched within the EU Commission Action Plan for Fair and Efficient Corporate Taxation issued back in June (COM(2015)302).[1]

This Action Plan sets forth five targeted areas to tackle tax avoidance and evasion effectively, while ensuring sustainable revenues to Member States and a level playing field for European companies. Among the key areas acknowledged by the Commission, the relaunching of the CCCTB proposed by the Commission back in 2011 was identified as an extremely effective tool for reaching the objectives of fairer and more efficient taxation. The CCCTB was also selected as an effective/valuable instrument to limit aggressive tax planning opportunities.

Through this consultation, and due to the sensitivity of the topic, which did not gather much consensus among Member States over the past few years, the Commission was willing to collect views of different stakeholders, in particular with regard to the following issues:

a) To what extent the CCCTB could function as an effective tool against aggressive tax planning, without compromising its initial objective of making the Single Market a more business-friendly environment.

b) Which are the determining criteria for companies that will be subject to the rules of a mandatory CCTB/CCCTB. Whether non-qualifying companies should still be given the possibility to opt for applying the common rules.

c) Whether a 'staged' approach, whereby priority will be given to agreeing the tax base before moving to consolidation, would be a preferable way forward.

d) Whether, in the short-term, it would be useful to agree on common rules for implementing certain international BEPS-related aspects of the common tax base pursuant to the current proposal until the Commission adopts the new (revised) CCTB/CCCTB proposal.

e) How should the debt bias issue be addressed?

f) Which types of rules would best foster R&D activity.

g) Whether a cross-border loss relief mechanism aimed at balancing out the absence of consolidation benefits during the first step (CCTB) could help in keeping the business in the CCCTB [2].

As outlined by Piergiorgio Valente, Chairman of ANDAF's (Italian CFO Association) Tax Committee, one of ANDAF's main concerns on the topic is the fact that the CCCTB is not, or shall not be, in and of itself, a tool to counteract base erosion and profit shifting. It is ANDAF's understanding that the CCCTB should revert to its original aim (addressing cross-border tax obstacles): by reducing administrative costs, compliance burdens and legal uncertainties (Transfer Pricing related matters/the off-setting of losses in Member States).
Another point of concern for ANDAF regards the fact that the Commission envisages re-launching the CCCTB in a two-staged approach.

The first stage would not include consolidation but only agreement on the tax base. Under the latter staged approach, consolidation would be available to companies only in a second phase. We would start by having a CCTB followed by a CCCTB.
It is ANDAF's view that, for the sake of ensuring a level playing field within the EU, a specific timeline should be agreed upon preliminarily to limit the possibility that Member States postpone consolidation as they deem con-

1 http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/fairer_corporate_taxation/com_2015_302_en.pdf

2 http://ec.europa.eu/taxation_customs/common/consultations/tax/relaunch_ccctb_en.htm

venient. Experience shows that the topic is rather sensitive and does not gather much consensus among Member States.
As far as the consistent implementation of certain OECD anti-BEPS best practice recommendations across the EU, the Italian CFO Association welcomes EU involvement to ensure that BEPS-related measures within the EU be consistently implemented. In the Italian CFO Association's opinion, BEPS-related measures should be implemented through a Directive or through other instrument ("Anti-BEPS Directive"), and should not be included in the CCCTB proposal.

With regard to the CCCTB scope, the EU Commission has been envisaging to set forth a new mandatory CCCTB proposal for all EU companies. ANDAF is of the view that an optional CCCTB would be preferable for companies taking into consideration their compliance burden, SMEs' needs and also because it would serve as a "trial period" to test and assess pros and cons.
Furthermore, ANDAF confirmed its support to the initiative, according to which companies which would not be subject to the mandatory CCCTB - because they do not fulfill the requirements of being part of a group - could still have the possibility to apply the rules of the system, and highlighted that specific instructions/guidelines should be provided in such case.

The Consultation also addressed anti-avoidance elements. The proposal requested specific input from stakeholders as to which of the elements of the CCCTB system they would strengthen so that the system could better settle tax avoidance related issues. ANDAF referred, under this point, that more robust rules on controlled foreign companies' regimes (CFC) would be required.

ANDAF's contribution also brought to the Commission's attention, that it would be essential to improve the existing dispute resolution mechanisms (mandatory binding arbitration), as well as extending Arbitration between EU and Non EU Countries.

Further elements addressed within the consultation, were the topics of Hybrid Mismatches as well as Research and Development.
ANDAF stated that the Association agrees that the risk of such arrangements would be removed in transactions between enterprises applying the common tax base rules within a consolidated group, although the risk might be expected to persist in relations with enterprises operating outside the common rules (as well as during step 1 of the staged approach to a CCCTB), in the absence of tax consolidation amongst the companies applying the common rules.

With regard to R&D provisions, ANDAF confirmed that the Association supports the existing R&D framework.
The Consultation included also questions on a temporary mechanism for cross-border loss relief, since the Commission envisages proposing a temporary mechanism for cross-border loss relief with tax recapture until the consolidation step (CCCTB) is reached and agreed upon. This would offset the absence of consolidation benefits during the first phase of the (CCTB) proposal. ANDAF stressed that it would prefer starting immediately with the CCCTB and not with the CCTB, taking into consideration business needs. In the event such solution is not feasible, the introduction of this temporary mechanism would contribute to minimize the effects of the absence of the desired consolidation.

Finally, in its contribution, ANDAF emphasized the need to improve current dispute resolution mechanisms, since it is the Association's understanding that the CCCTB can give rise to further disputes and possible interpretative issues for national Courts.

In conclusion, ANDAF used its best endeavors to explain that the strategy put forward by the EU Commission in the proposal to craft a common set of rules to be applied by companies operating within the EU to calculate their taxable profits as expected or outlined, cannot be accepted, as stated by ANDAF's President Fausto Cosi, without further considerations.

Press, Journal Article

Speech Munich | 01.07.2016
Dr Jens Weidmann President of the Deutsche Bundesbank

Hans Möller medal acceptance speech

at the annual meeting of the Munich Volkswirte Alumni-Club

- 1 Introductory remarks
- 2 Monetary policy and economic education
- 3 The principle of liability as a guide
- 4 Conclusions from the Brexit vote
- 5 Conclusion

1 Introductory remarks

Dear Mr Baader
Ladies and gentlemen

First of all, I would like to echo the words of welcome offered by our host and likewise welcome you to the Bundesbank's Regional Office in Bavaria.

The fact that you are holding your annual meeting here at the Bundesbank for the third time now after doing so in both 2012 and 2013 is a clear sign that you feel very much at home with us. But as you know, we do offer you a suitable venue and I can assure you, Mr Baader, that you didn't have to present me with this award to be able to hold your meeting here again.

Nevertheless, I am of course delighted to receive the Hans Möller medal and I would like to express my sincere gratitude for this honour.

You outlined the reasons for your choice just now, and I value them as support for my efforts to broaden my audience beyond narrow circles of relevant experts when discussing issues of European integration and monetary policy. I also feel encouraged to continue promoting a stability-oriented monetary union.

The fact that a club of economists is recognising my efforts to make economic issues accessible to a wider public is very fitting given the words of Hans-Werner Sinn in his farewell lecture - namely that economists must, first and foremost, serve the people.

2 Monetary policy and economic education

But I'm not just an economist - I'm also a central banker. In this capacity, I have a special interest in communicating with audiences beyond industry professionals.

This is because the successful functioning of any central bank hinges heavily on the support of the general public. Or, as Otmar Issing put it, "Ultimately, every society has the inflation rate that it wants and deserves."

It is without a doubt easier to implement a stability-oriented monetary policy when the general public holds monetary stability in high regard. What's more, the stronger the public's support for a central bank's stability-oriented stance and the greater the confidence it enjoys, the greater its level of independence becomes.

Appreciation of monetary stability is, of course, not to be confused with detailed knowledge of the mechanisms of monetary policy, although there is evidence to suggest that a person's appreciation increases in parallel with the knowledge he or she has about the way in which these two factors interact.

A number of studies indicate that economic education has - to put it diplomatically - some room for improvement. The Bundesbank has therefore expanded its economic education programmes in recent years.

By using educational materials and organising various types of events, we want to improve to the best of our ability the general public's understanding of monetary and foreign exchange policy issues. For example, our Regional Offices provide teacher training, visit school groups and organise public lectures under the motto "Forum Bundesbank". The feedback that we have received on these initiatives has been very positive.

I myself meet once a year with teachers and once with pupils. Time and time again, I see when young people visit the Bundesbank that they are very interested in our work and ask intelligent questions.

We should, of course, be aware that the impact that such measures can have is limited in terms of both breadth and depth. Such was the account recently given by the senior business editor of the *Frankfurter Allgemeine Zeitung* concerning her own offspring: "It is a positive thing that [the Bundesbank] goes into schools to raise awareness about monetary stability and to provide insights into the secrets of interest rate policy. It really is never too early to start tackling such topics in times such as these. However, it should be under no illusions as to the success of its efforts. My child took precisely one term away from the talk given by a Bundesbank representative to a year 12 class: marginal lending facility."

Incidentally, this technical term is even on the sixth form curriculum in Bavaria. That being said, it is also clear that the jargon that we have become accustomed to as central bankers should not detract from the essentials.

3 The principle of liability as a guide

But it is not just vocabulary that detracts from the essentials. Nowadays, economists' reasoning is highly mathematical and model-oriented, which often makes it difficult for non-economists to comprehend. However, institutional rules and regulations have also become so complex nowadays that often only a few experts are able to fully understand them.

Consider the federal financial equalisation system, for example. Addressing this subject, Peer Steinbrück once said, "There are only three people that really understood this concept. The first is dead. The second is in a mental asylum. The third is me - and I've forgotten everything."

Another example is the Stability and Growth Pact. With respect to the annual budget deficit ceiling, the old saying was, "3% is 3%." In the meantime, however, there are now federal states that have been flouting the deficit rule for seven years - and have been able to call upon the exceptional circumstances approved by the European Commission.

These days, even the experts are hard-pressed to judge whether fiscal rules are being observed or broken. The general public has long since bowed out of this discussion ...

But what members of the public certainly do understand are the basic principles of the market economy as taught to them by their own life experience.

Take the principle of individual responsibility, for instance. As Walter Eucken once put it, "Those who reap the benefits must also bear the costs." Conversely, however, the principle of liability also means that those who are liable for losses must also be those who, based on their decisions, are responsible for said losses.

To illustrate what this means, I always like to draw the following comparison for my audience. Imagine that your neighbour were able to go shopping using your credit card and you had no control over what he or she was spending. You would quite rightly say that such a situation is unacceptable - "I can't be liable for something that I have no control over."

However, the two propositions "Those who reap the benefits must also bear the costs" and "I can't be liable for something that I have no control over" go beyond the personal level and apply in an institutional context as well.

The principle of liability ensures that decisions are made more responsibly. This is also, and especially, true for the institutional architecture of monetary union.

When I gave my speech at the Volkswirte Alumni-Club three years ago, I quoted today's keynote speaker Harold James, who wrote in his book "Making the European Monetary Union" that, without a common fiscal regime and without a stable financial system, the monetary union had a very high centre of gravity that made for vulnerability and instability.

To stay with his allegory, the aim of an institutional reform in the monetary union must therefore be to lower its centre of gravity so that it cannot be blown off course so easily. But this will only work if the principle of liability is once again paid greater attention and a balance is struck between action and liability.

The essence of this argument was taken into account when financial regulation was overhauled and the banking union established. By tightening capital requirements and introducing a bail-in regime, the principle of liability is being more rigorously enforced in the banking sector: the greater the volume of liable capital that shareholders and creditors have available, the greater the losses that a bank is able to shoulder and the less likely a taxpayer bail-out becomes.

The principle of liability also plays an important role in the discussion surrounding a European deposit insurance scheme. It cannot be denied that a single deposit insurance scheme could have a stabilising effect.

However, as long as actions at the national level, such as drafting insolvency law or responding to very high stocks of government bonds on banks' balance sheets, can have a substantial impact on the welfare of financial institutions, savers from other member states should not be held jointly liable.

In this respect, I welcome the fact that the Economic and Financial Affairs Council will not decide on the European deposit insurance scheme until adequate de-risking measures have been taken. And it goes without saying that adequate measures also include regulatory steps leading to the end of preferential treatment of government bonds over loans to the private sector. In any case, risk-appropriate capital backing and limiting government bond investments would significantly reduce the risk of recourse being made to the deposit insurance scheme.

4 Conclusions from the Brexit vote

Ladies and gentlemen

I agree with the President of the European Parliament, who has called for "a more unified and cohesive European Union".

But this should not come at the price of increased joint liability unless joint control rights at the European level are agreed at the same time. And, in this case, we would have to make sure that the decisions made at the European level are also conducive to stability.

However, many of the proposals put forward before the Brexit referendum and aimed at "completing monetary union" only focus on elements of joint liability and disregard the issue of joint decision-making. They obviously anticipate and accept member states' reluctance to transfer national sovereignty to the community level.

Although such proposals might lower the centre of gravity of the monetary union, to stay with Harold James' allegory, they would also shift it to one side, which would not enable the monetary union to survive as a stability union in the long term.

Opinions on the future shape of the monetary union therefore differ greatly. However, even where common rules have been agreed - in the area of fiscal policy, for instance, - they are not taken seriously, and the Commission lets the major euro-area countries, in particular, do

largely as they please. Not only does this damage the reputation of the European institutions, it also impairs the soundness of public finances in the member states.

Unsound public finances can make it more difficult for monetary policy makers to fulfil their mandate of ensuring price stability. It was precisely to protect the single currency that these fiscal rules were agreed in order to prevent monetary policy from playing second fiddle to fiscal policy and from coming under pressure to make high levels of debt sustainable through low interest rates.

Ladies and gentlemen

It is not only in the United Kingdom that the EU is seen as a canvas on which to project the drawbacks of globalisation and migration. Euroscepticism exists in other EU member states, too, and is possibly even strengthened by the fact that Europe breaks its own rules. I can therefore only reiterate what the Federal Chancellor said on Tuesday: "A successful Europe is a Europe that respects its treaties and keeps its promises."

Euroscepticism in the United Kingdom was so strong that, despite numerous warnings about the economic consequences, the majority voted in favour of leaving the European Union. For the first time in the history of European integration, a country wishes to leave the EU.

This decision is very regrettable and, in my eyes, a mistake. But it should be respected and we will have to deal with it. It would appear that it is becoming harder and harder to convince people of the benefits of the European Union and to encourage them to believe in Europe.

The decision marks a turning point both for the United Kingdom and for the EU as a whole and we have no way of knowing exactly what the consequences will be.

Although the result of the referendum appeared to take the financial markets by surprise - at least judging by the sharp drop of 11% in the value of the pound sterling on Friday - all things considered, the reaction has not been disastrous so far.

The search for safe investments has led investors towards government bonds, which has pushed long-term interest rates back down and caused the yield curve to flatten again. The stock markets also recorded price losses and the pound sterling remains under pressure. But overall, financial markets responded calmly and there were no signs of panic.

This was probably because, among other things, the vast majority of banks and supervisory bodies had treated the Brexit scenario with the seriousness it deserved and had been prepared for that outcome. Another reason for the lack of severe disruption is that banks are now far more resilient than they were in the autumn of 2008. Nowadays, thanks to tighter regulation, they hold more capital and are therefore more robust.

Even so, it should be borne in mind that the fall in long-term interest rates and the further flattening of the yield curve will probably put more pressure on banks' earnings, which are already squeezed. That alone is reason enough to doubt that we are already seeing the new equilibrium prices in the financial markets. This means that a prolonged period of uncertainty is a distinct possibility.

The ECB, along with other major central banks, has therefore announced that it will supply additional liquidity if required. So far, this has not been necessary.

It is not clear at present how serious the economic impact will actually be.

In the run-up to the Brexit referendum, the International Monetary Fund (IMF) had voiced concerns that established trade links would be disrupted, causing serious regional and global damage. The IMF also predicts that, until the terms of the UK's withdrawal have been negotiated, the uncertainty will have negative implications for investment and will give rise to additional financial market volatility.

Although the sharp depreciation of the pound sterling is likely to dampen the impact on the aggregate UK economy for a time, it is important to keep the spell of uncertainty as short as possible.

It is in the interests of both parties for the EU and the United Kingdom to quickly enter into level-headed negotiations on their future relationship. Neither party will have anything to gain from erecting trade barriers.

Negotiations should not revolve around treating the UK better than other countries such as Switzerland or Norway, nor, however, should the objective be to make a political example of the UK.

Ladies and gentlemen

The UK economy will bear the brunt of the Brexit fallout, although the pace of euro-area activity might decelerate a little as well. And there is no way of telling what the political implications will be.

Brexit will probably also place a strain on Germany's economy, particularly since the UK is Germany's third most important export destination.

The Frankfurt financial centre alone might see new opportunities opening up, though that would also call for political backing. We should welcome any businesses that shift their activity from London to Frankfurt.

I see no need for any further loosening of euro-area monetary policy in response to the Brexit vote. Monetary policy is already in highly expansionary mode, and it is doubtful whether easing it further still would deliver any stimulus whatsoever. Monetary policy can be as easy as it likes, but that cannot prevent political uncertainty from dragging on the economy.

The crisis that has now engulfed the European Union is a political one that needs to be resolved in the political sphere.

5 Conclusion

Ladies and gentlemen

The Brexit referendum on 23 June marked a turning point in the history of European integration.

The vote should be regarded as a warning shot in the debate on institutional reform in the euro area.

It was, in my opinion, a grave error to increase mutual liability without simultaneously communitising fiscal control rights.

However, if willingness to transfer sovereignty to Brussels is also limited in the euro-area countries, the monetary union can only be stabilised in the long term by reinforcing individual national responsibility in order to strike a balance between action and liability.

Incidentally, I mentioned this three years ago in my last speech here at the Munich Volkswirte Alumni-Club.

On that note, I would now like to conclude my remarks and hand over to Professor James, whose speech I very much look forward to hearing.

But before I do that, I would like to warmly congratulate today's award winners, and to pass on my own thanks. I am delighted to receive the Hans Möller medal and see it as a token of support and encouragement.

Monetary policy and European integration are really not simple topics. Helping the general public to understand them is an important task. They are topics that do not just concern the experts, but all members of the general public.

Thank you very much.

*   *   *

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NEWS RELEASE

T. ROWE PRICE MIDYEAR 2016 MARKET OUTLOOK: MODEST REVENUE AND EARNINGS GROWTH EXPECTED GLOBALLY; U.S. RECESSION UNLIKELY THIS YEAR

Improving global growth could provide investors with attractive investment opportunities

Baltimore: June 14, 2016

NEWS

The first half of 2016 has been volatile, with the global economy facing several challenges that unsettled financial markets around the world. Abrupt swings in sentiment created a difficult environment for buy-and-hold investors, and markets were tested by slow global growth, the potential for rising inflation and interest rates in the U.S., and lingering concerns about China.

Despite these concerns, T. Rowe Price experts expect to see modest revenue and earnings growth. The fears plaguing the first half of the year are being slowly alleviated; stabilizing markets, a pause in the Fed's gradual monetary tightening, and easing fears of the financial volatility of China could turn a difficult start into a more promising finish. In this environment, security selection will be key, both in stock and bond markets.

MIDYEAR MARKET AND ECONOMIC OBSERVATIONS

- Signs of financial and economic stabilization in both developed and emerging markets appear to have set the stage for an improved global equity climate in the second half of 2016. However, this view depends heavily on stability in energy prices, the U.S. economy, and the Chinese financial system.

- Emerging market stocks outperformed developed markets in the first half of 2016. This has been a result of corporate earnings showing signs of improvement, and a short-term revival in commodities, oil, and currencies. In many cases, countries have improved their fiscal and current account deficits, debt positions, and inflation levels, leaving them in a better position to absorb economic shocks.

- Among the most important risk factors for emerging markets is the continued improvement of corporate earnings. Current valuations reflect pessimistic estimates for earnings growth and any positive surprises are likely to bring relief to markets. Companies will need to deliver over the medium- and long-term, however, to allay fears and bring about a re-rating of individual stocks and markets.

- Economic environments globally are struggling against two primary headwinds as they enter the second half of 2016: the need for emerging market economies (EMs) to deleverage and the end of the commodity "super-cycle." These winds are gusting forcefully over China and Brazil. Given that EMs represent 40% of global economic output, the impact is also being felt in developed economies.

- The Brazilian and Chinese markets have been challenging for investors. Brazil's economic and political travails have created an uncertain environment, but there is the potential for improvement with a transfer of political power and a renewed focus on long-overdue micro- and macro-

economic reforms. The new government has an opportunity to achieve significant steps toward structural reforms.

- China remains the largest influence on EMs. Two key concerns have been the currency drop and the amount of debt in the financial system. A further unexpected and sharp decline in the renminbi could hasten capital outflows and put more pressure on the economy.

- EM headwinds are also influencing U.S. interest rate policy. Because global capital flows often have more influence on financial conditions in emerging markets than do local policymakers, the U.S. Federal Reserve has to tread lightly in order to avoid stressing EM financial markets and economies.

- Fixed income markets appear to offer limited upside potential and greater downside risk, but astute investors can use bouts of risk aversion and subsequent rallies to their advantage. China's economic deceleration, the Fed's need to balance the risks of further tightening, divergent central bank policies, and suppressed yields globally are signs of caution. Investors are advised to consider a highly selective and risk-aware approach to best exploit potential opportunities.

- Overall, the path appears clear for the global equity rally to continue, especially as year-over-year earnings comparisons grow less difficult in the second half and into 2017. However, the election cycle in the United States could produce short-term volatility.

QUOTES FROM T. ROWE PRICE INVESTMENT PROFESSIONALS

Ted Wiese, Head of Fixed Income: "In coming months, fixed income markets seem likely to generate coupon returns but have less potential for additional price gains. Skittish investor sentiment, divergent central bank policies, and conflicting macroeconomic signals leave markets susceptible to bouts of risk aversion and subsequent relief rallies. These episodes will provide nimble investors with opportunities to profit from volatility, but strong macro and credit research skills will be critical."

Alan Levenson, Chief U.S. Economist: "While the U.S. economy has not been sheltered from the global headwinds, they are taking a much smaller toll on it. The weakness in commodities has led U.S. energy and mining firms to cut back investment in plant and equipment spending, which we calculate has reduced the annual rate of real GDP growth by 0.5% since the end of 2014. That drag appears to be fading at midyear, however. Following a weak first quarter, we expect a return to 2% to 2¼% annual growth over the balance of the year."

David Eiswert, Portfolio Manager, Global Stock Fund, on U.S. economic stability and U.S. equities: **"**U.S. economic expansion appears intact, although still subdued. The Federal Reserve's reluctance to force the pace of interest rate hikes means monetary policy should remain supportive, and U.S. consumers are in strong shape. Despite industrial weakness, continued economic growth driven by consumer spending should be supportive for equities in the U.S, A continued 'Goldilocks' economy (not too hot, not too cold) would also be a strong positive for financial markets and the global economy. However, the U.S. presidential election outlook reflects the general rise of populism globally and presents some complicated risks to sentiment."

Nikolaj Schmidt, Chief International Economist, on China: "The world cheered in early 2016 as Beijing finally intervened strongly enough to stop the downward growth spiral that has plagued the economy over the past few years. Whether the bounce that Chinese growth has experienced in recent months is more than temporary is highly questionable, however, as the improvement is largely the result of a more expansionary fiscal stance and an unsustainable acceleration in the pace of credit expansion."

Nikolaj Schmidt, Chief International Economist, on Europe: "EM headwinds are being felt more strongly in Europe than in the U.S., but these are being overcome by the domestic policy tailwinds. The

recent gain in both the euro and oil prices should moderate growth in the second of the year, however, to an annual rate of roughly 1.5%."

Nikolaj Schmidt, Chief International Economist, on Brazil: "Brazil appears to have turned a corner. Higher metals and oil prices have helped, but local asset markets caught fire as the country moved toward removing President Dilma Rousseff and the Workers' Party from power. We expect the new government to achieve significant steps toward structural reform, including progress in breaking the link between pensions and the minimum wage, which has drained government finances."

Gonzalo Pangaro, Portfolio Manager, Emerging Markets Stock Fund: "We continue to witness great dispersion among advancing countries, which we have highlighted for some time. The dispersion of EM fundamentals is as great today as it has been for over a decade. Reflecting this dispersion, valuation levels are mixed. EM equities are trading at a significant discount to developed markets, creating pockets of opportunity for us to identify quality businesses with reasonable valuations that offer an attractive balance of compounding growth potential and improving returns."

ABOUT T. ROWE PRICE

Founded in 1937, Baltimore-based T. Rowe Price Group, Inc. is a global investment management organization with $764.6 billion in assets under management as of March 31, 2016. The organization provides a broad array of mutual funds, subadvisory services, and separate account management for individual and institutional investors, retirement plans, and financial intermediaries. The company also offers sophisticated investment planning and guidance tools. T. Rowe Price's disciplined, risk-aware investment approach focuses on diversification, style consistency, and fundamental research. For more information, visit troweprice.com or our Twitter, YouTube, LinkedIn, and Facebook sites.

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POINT of VIEW

SPRING 2016

Our Perspective on Issues Affecting Global Financial Markets

MONETARY POLICY UNMASKED: OUR TAKE ON NEGATIVE INTEREST RATES

With four European central banks and one Asian central bank using NIRP (or "negative interest rate policy"), economics textbooks that teach that interest rates can't go below zero are out of date. What did our professors get wrong, where is the real floor on interest rates and what does it all mean? (oh, and why did I have to pay $120 for that relic of a textbook?) We inquire.

Monetary Policy Unmasked:
Our Take on Negative Interest Rates

Investors feel like Alice when she tumbled down the rabbit hole into Wonderland. Except instead of encountering talking rabbits, incorporeal cats, and time that can run backwards, investors find themselves in a land where they must pay a bank for the right to hold a deposit and the bank pays them to take out a loan.

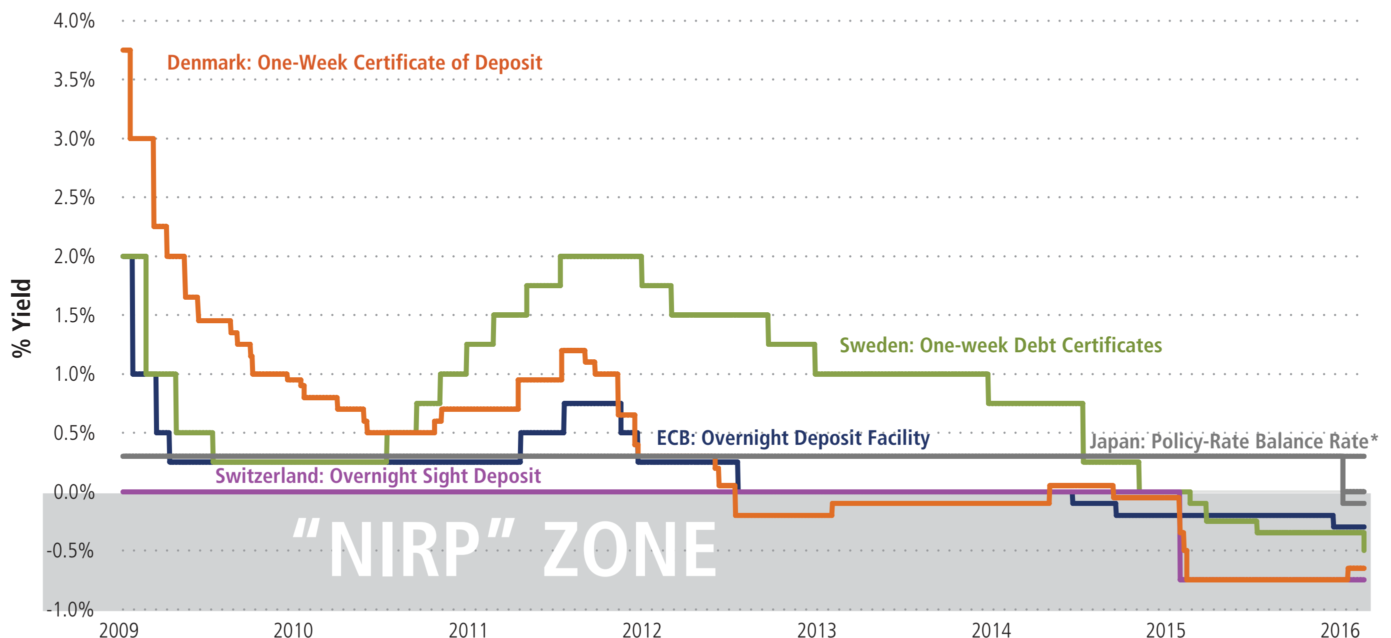
At least that's how it seems in our world where five global central banks have imposed *negative* interest rate policy (NIRP) (see *Figure 1* below). The NIRP brigade includes the European Central Bank (ECB), the Swiss National Bank (SNB), Sweden's Riksbank, Denmark's NationalBank, and, most recently, the Bank of Japan (BoJ). Unlike Alice, you may not soon wake from this bad dream. It's reality.

Worse, we were told by our professors that negative interest rates were impossible, sort of like how it's impossible to exceed the speed of light in space travel (see *Did You Know* on the next page). Since "zero" appears to no longer bind, how can we make sense of this new world?

As we will argue, upon closer inspection, the innovative policy is not all that innovative. The effective lower bound may just be a little lower than previously assumed due to financial frictions. Central banks, meantime, are still pursuing the same strategies as before: attempting to induce spending and investment by lowering interest rates.

«INSTEAD OF ENCOUNTERING TALKING RABBITS, INCORPOREAL CATS, AND TIME THAT CAN RUN BACKWARDS, INVESTORS FIND THEMSELVES IN A LAND WHERE THEY MUST PAY A BANK FOR THE RIGHT TO HOLD A DEPOSIT AND THE BANK PAYS THEM TO TAKE OUT A LOAN»

fig. 1 WELCOME TO THE NEGATIVE INTEREST RATE POLICY (NIRP) ZONE: FIVE GLOBAL CENTRAL BANK POLICY RATES ARE NOW BELOW THE ZERO LOWER BOUND (ZLB)



Source: Bank for International Settlements

*On Jan. 29, 2016 the Bank of Japan put in place a three tiered structure of rates, with one of their policy rates being negative (-0.10%)

The thing is, when operating below the zero lower bound, monetary policy is laid bare: it "works" by eroding your purchasing power in a more direct way than ever before. In the end, we doubt NIRP will help boost the economy.

TEXTBOOK THEORY: THE LOGIC OF POSITIVE INTEREST RATES

Here's a challenge for you: go down to the nearest town square, pub, or Starbucks and offer $10 bills in exchange for just a $1 bill. Try it; we dare you.

At first, each passerby might think you're crazy or a purveyor of counterfeit bills. But, soon, they may take you up on the lucrative offer, as $1 gets them $10—a guaranteed return for little risk/effort.

Then, on a subsequent day, try the opposite: ask for $10 in return for $1. The only taker would have to be as crazy as you.

Nobody wants to give up *more* today for *less* in the future.

The same intuition governs interest rates everywhere in the known universe. Since nobody is going to lend money at a negative rate when they can hold money at zero interest (in the form dollar bills, for example), interest rates could never go below zero.

Don't trust us? Take it from the pen of the godfather of modern economics, John Hicks, writing in 1937, "If the cost of holding money can be neglected, it will always be profitable to hold money rather than lend it out, if the rate of interest is not greater than zero. Consequently the rate of interest must always be positive."[1]

REALITY IS MESSY

Well, as it turns out, how low interest rates can go depends on the key assumption from our friend Hicks that depositors, will in fact, pull money out of the bank in the form of notes and coins that pay a zero nominal rate rather than save in investments that yield less than zero or lend money at a negative rate. But this assumption fails for two reasons.

First, as recently observed by the Bank for International Settlements, the actual implementation of NIRP equates to a tax or fee on a certain type of central bank deposit. At the BoJ, for example, a three-tiered system has been used, with only one rate a (barely) negative one, and it applies to just 1-2% of bank reserves (See *Figure 1 on previous page*).

In Europe, the SNB originally instituted an exchange rate floor to stem the cross-border capital tide from euros to Swiss francs in 2011. In 2015, when the ECB renewed its easing program, the SNB abandoned the currency peg and opted for a new strategy to fend off unwanted currency flows: a negative deposit rate instead.

But the SNB's move wasn't all that new. In 1973 the SNB also instituted a "deposit fee" of 2% per quarter on deposits by non-residents to stem the flow of capital into Switzerland that put upward pressure on the exchange rate. The Swiss later upped the fee to 3% per quarter in 1978. More broadly, for centuries central banks have raised or lowered discount rates to encourage or discourage capital inflows and outflows.

And that provides a good way of thinking about how negative rates have been implemented thus far: as a tax or a fee on certain types of deposits, namely those held at central banks. In short, the negative rates are charged to deposits that one must hold—they couldn't get around it even if they tried by selling them to someone else.

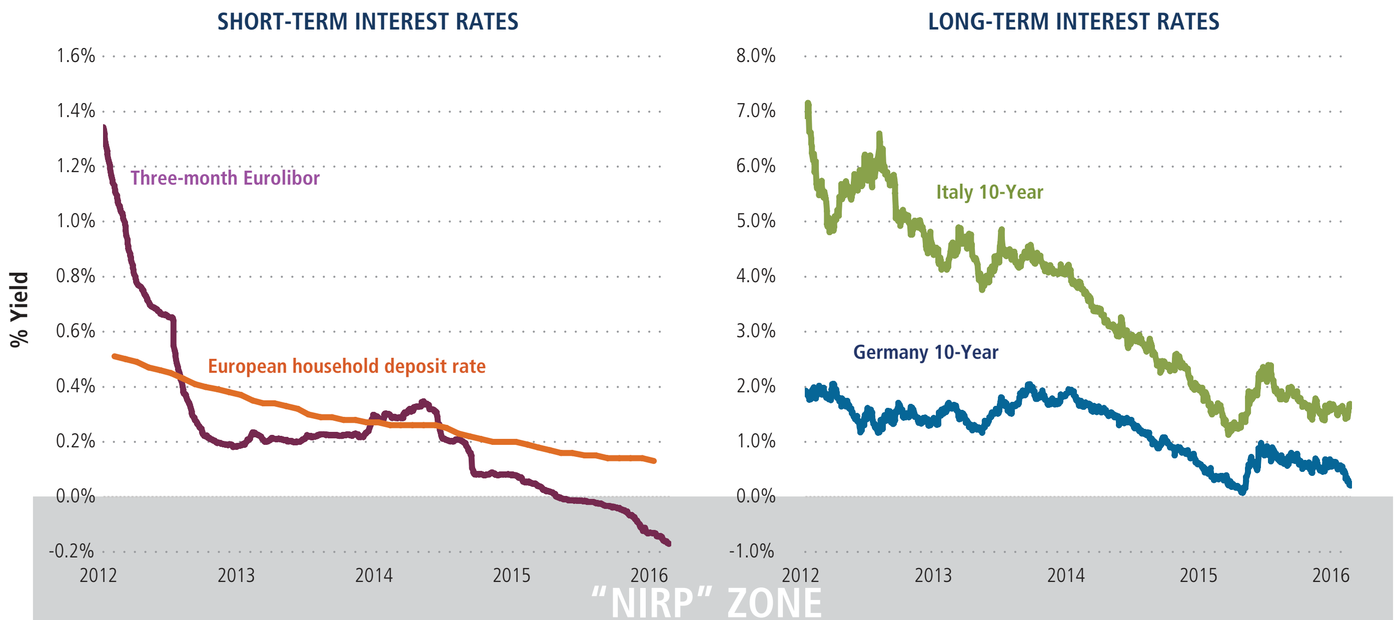
You might wonder though about negative yields on government bonds in Europe and Japan. Once again, these assets are "safe assets"—assets that must be used for capital requirements, liquidity, regulatory and collaterals purposes. As a study of US Treasury bonds reminded us, investors holding such bonds do so not for the juicy yields, but "because safe asset investors have nowhere else to go but invest in US government bonds."[2] This was true when rates were at just above zero and it remains true below the zero bound. There are no alternatives.

DID YOU KNOW?

The Textbooks Got It Wrong

We surveyed the top-selling macroeconomic textbooks. In fact, the top-sellers are woefully out-of-date. The most widely read introductory economics textbook in college, Greg Mankiw's *Principles of Economics*, discusses the zero-lower bound of nominal interest rates. The textbook declares that "nominal interest rates cannot fall below zero: Rather than making a loan at a negative nominal interest rate, a person would just hold cash." Another popular text by Paul Krugman and Robin Wells, entitled *Economics*, states that an interest rate below zero "isn't possible" and "nobody would ever buy a bond yielding an interest rate less than zero because holding cash would be a better alternative." Hopefully the new editions of these textbooks will fix these glaring errors. Until then, use those college economics books you keep as doorstops.

fig. 2 STILL FLOATING ABOVE? BOTH LONG-TERM AND SHORT-TERM RATES HAVE FALLEN IN THE EUROZONE, BUT HOUSEHOLD DEPOSIT RATES ARE STILL ABOVE ZERO



Source: Bank for International Settlements

Second, beyond central bank deposits and "safe assets," in the euro area, for example, household deposit rates are low but still positive (see *Figure 2* above), meaning NIRP has yet to hit retail investors and savers. When it does, we think savers will respond and seek out alternatives.

HOW LOW CAN THEY GO? IT'S UNKNOWN

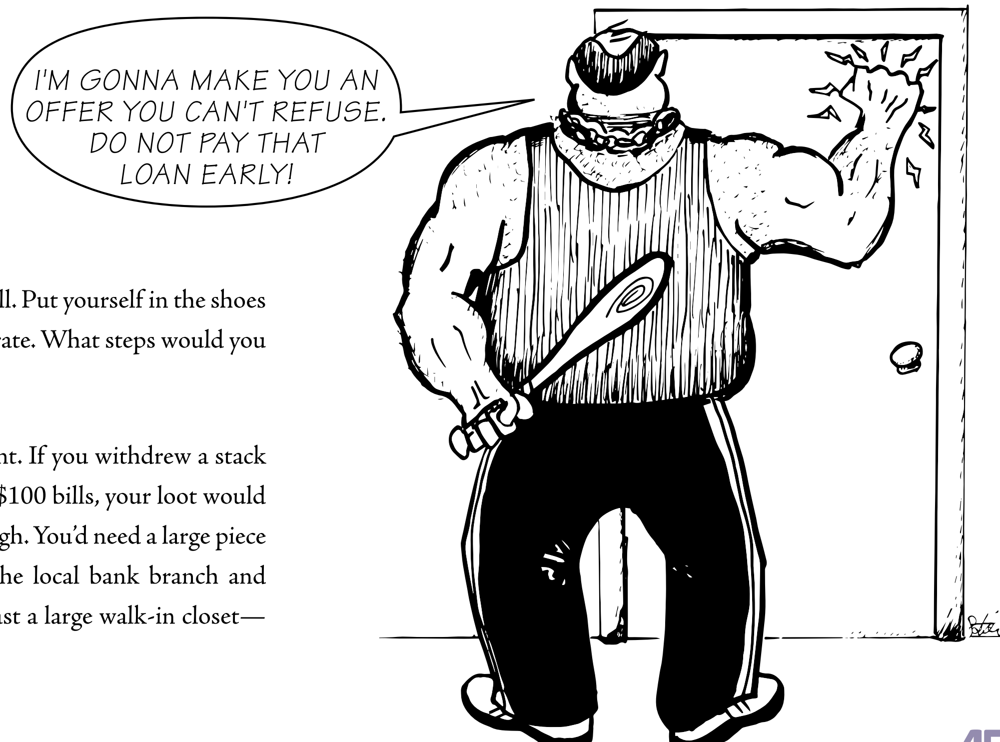
So how low can *nominal* interest rates go? It's unknown. Federal Reserve staff concluded in 2010 that negative rates below -0.35% would trigger currency hoarding among the American population. Both the Swedish Riksbank and SNB's negative rate regimes have exceeded that rate for sometime. The ECB's deposit rate just dipped to -0.4%.

In the short run, NIRP could go further still. Put yourself in the shoes of a saver facing the prospect of a negative rate. What steps would you take?

First, you could liquidate your bank account. If you withdrew a stack of 1 million US dollars comprised of only $100 bills, your loot would weigh 22 pounds and tower nearly 4 feet high. You'd need a large piece of luggage to haul the cash home from the local bank branch and probably require an entire room—or at least a large walk-in closet—in your house for storage.

But, your problems wouldn't end there. You'd have to hire someone to keep an eye on the cash, count it, organize it, and insure it. It would be subject to fire, flooding, environmental degradation. For the average person's wealth, this wouldn't be much of a hassle. For anyone with a substantial stash of cash, the problems would mount.

Not quite vault-ready with the size of your savings? You could purchase gift cards as a way to "store value" (but then you are an unsecured creditor to a retailer). You could store value in non-cash, non-



bank assets (real estate), gold, jewelry, and Bitcoin. You could prepay your taxes—or overpay—and expect a refund (at a zero interest rate) when the tax day arrives. You could prepay your rent.

> **«IF YOU WITHDREW A STACK OF 1 MILLION US DOLLARS COMPRISED OF ONLY $100 BILLS, YOUR LOOT WOULD WEIGH 22 POUNDS AND TOWER NEARLY 4 FEET HIGH»**

Think these activities are merely hypothetical? Think again. In January 2016, the Canton of Zug (a state in Switzerland) requested that taxpayers delay paying their tax bills. In fact, the interest rate that was charged on late payments was abolished. In the Canton of Lucerne, there used to be 0.3% interest paid on early payments, which was also abolished last year. These cantons are obviously finding that holding cash when interest rates are negative impacts their finances adversely.[3] In Japan, a chain of stores named Simachu ran out of a safe that cost $700 and saw sales of safes soar by 2.5 times in a year.[4] Presumably, Japanese savers are stuffing them full of yen notes.

Here's the important lesson: under NIRP, instead of boosting economic activity by saving and investing through the financial system, people waste precious time and resources circumventing the tax on their savings.

NIRP UNMASKS MONETARY POLICY

Oddly, the above horror story has done little to deter fervor for NIRP among monetary theorists. No, these folks, when faced with one obstacle, quickly find a novel solution. In this case, if the barrier to further negative rates is the ability of depositors to shift into cash (a 0% yielding asset), then why not just eliminate the asset? In Europe, talk of eliminating the EUR500 bill has emerged. In the US some economists have advocated the elimination of $100 bills.[5]

But, importantly, NIRP unmasks monetary policy. When nominal rates are above zero, central banks can use inflation to surreptitiously erode the value of money, lowering the real return earned and thus prompting consumers to spend and businesses to invest—or else lose purchasing power. Since inflation's effects are not spread uniformly across consumers and businesses, the effects are masked, less straightforward and perhaps less real.

By contrast, with low inflation and zero nominal interest rates, the NIRP tool is a full-frontal assault on purchasing power. Taxing or charging interest to currency holders or charging negative rates on deposits would be uniformly-experienced. In short, it makes the central bank's strategy plain: erode purchasing power to encourage consumption and investment rather than hoarding.

CONCLUSION

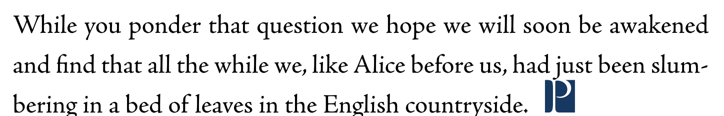
Seen in this light, negative rates are hardly an Alice in Wonderland-type oddity. Instead, it's better to think of negative rates like taxes or fees on specific types of deposit accounts. By "raising the fee" (lowering the rate of interest into negative territory), the central bank seeks to achieve its ends. Investors will tolerate a certain "fee" or "tax" before seeking alternatives to preserve purchasing power.

In the end, we think NIRP will prove counterproductive. Since all monetary policy works through the financial system, central banks need the banks and financial markets to create and distribute credit. Forcing investors, savers and depositors to divert liquid assets elsewhere will not support credit creation.

Finally, it is instructive to think about what monetary policy seeks to achieve: a boost to spending and investment by a carefully-crafted erosion of money's purchasing power. You may not like it, but that's the simple truth. The big question we're asking: will it work? We think not.

A rising portion of institutional investors and maybe soon retail savers will be forced to pay for safety and liquidity. We doubt they will willingly comply—unless they have no alternative. What innovations will such negative rates breed?

While you ponder that question we hope we will soon be awakened and find that all the while we, like Alice before us, had just been slumbering in a bed of leaves in the English countryside.



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2 "What makes US government bonds safe assets?" Zhiguo He, Arvind Krishnamurthy and Konstantin Milbradt, January 28, 2016

3 *Financial Times*

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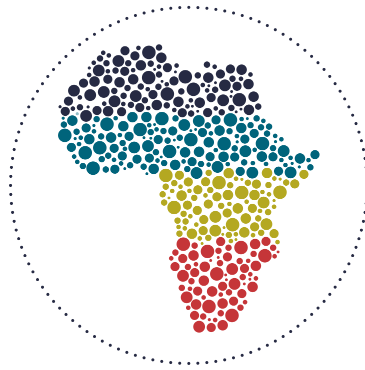
5 *Financial Times*



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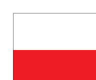
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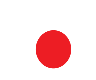
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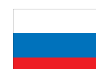
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