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IAFEI News

Letter of the Editor **December 20, 2012**

Dear Financial Executive,

You receive the **IAFEI Quarterly XIX th 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 again offers a broad range of articles on financial subjects.

The article on **Japan: A Contrarian View** is especially recommended for attention, and so is the article on **Belgium**, the article on **France**, and the article on **Hedge Accounting**.

All other articles of this issue, as well, have their distinct merits, and are worth the reading.

Once again:

I repeat our ongoing invitation to IAFEI member institutes, and to 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

Belgium,

Country Report: "Solid Labour Market – Economic Diversity with High Degree of Openness – Saddening World Record in Finding a New Government"

By Dr. Christian Melzer

A poor country looks different: In Belgium, in 2011, a gross domestic product (GDP) of € 33,700 per inhabitant has been achieved. With this, the Belgians have left behind themselves the big Euro-countries Germany, France, Italy and Spain. In comparison: Germany achieved a GDP of € 31,700 per capita. Relatively speaking, Belgium is positioned in place 6 with a share of 4 % of GDP of the European Union, before Austria and behind the Netherlands.

Belgium is having a top position within the European Currency Union by economic external financial openness. As measured against GDP, the proportion of exports is at 85 %, Germany achieves a number of 50 % here. This high external economical interdependence was mainly responsible for the shrinking of the total economic activity of Belgium throughout the World Economic Crisis 2008/2009. The most important foreign trade partners for Belgium are Germany and France with a share of 19 % respectively 17 % of the total Belgium exports. Western Europe as a whole achieves a portion of 75 %.

An important Belgium export-good becomes visible in looking at the stock index EuroStoxx50. There, the Belgian enterprise Anheuser-Busch Inbev is represented in a unique position. The company group is regarded as the World's largest beer-brewer with 114,000 employees and 200 beer-trademarks. Among them are names as Beck's, Löwenbräu, Franziskaner, Stella Artois and Budweiser. In the German beer-market Inbev is number 2 behind the Radeberger Group measured by volume sold. In the segment of consumer goods corporations, AB Inbev is holding place no. 6 in the global league.

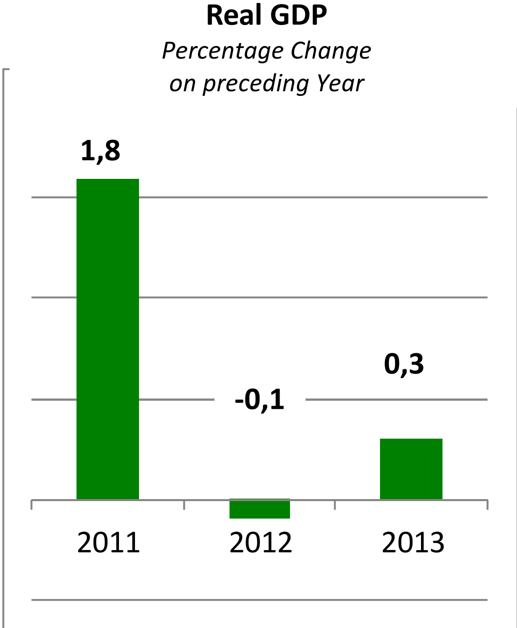
The heavy-weights in the Belgium stock-index Bel20 are AB Inbev, Gaz de France Suez (French energy supplier), Solvay (chemicals) and Group Bruxelles Lambert (diversified group). Together, the four achieve a portion of 41 % of the total index. However, the Bel20 index is still far away from a recovery after the World Economic Crisis in 2008/09. Whereas the German stock-index DAX30 is only 12 % below its all-times high achieved in 2007, the Bel20-index has halfed itself since then. This development is comparable with the Spanish stock-index IBEX. In mid-November, the Belgium stock-index stood at roundabout 2,350 points – a mark, which had been achieved for the first time in 1997. Among the four large single stocks in the Bel20, however, the group AB Inbev is standing out permanently, by comparison to the all-time high 2007 its share-price has

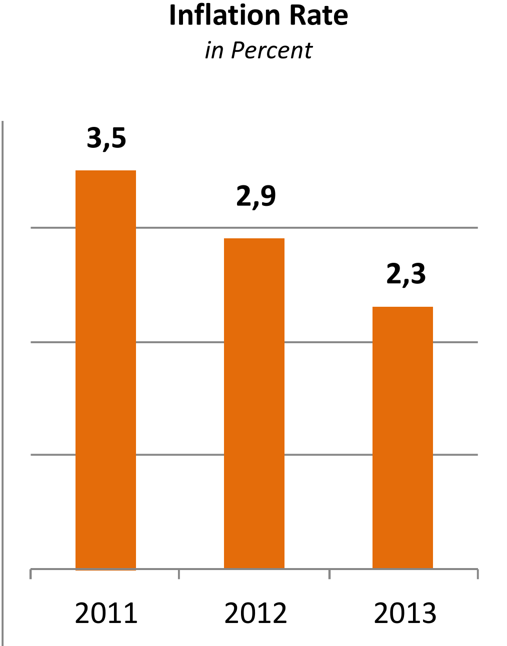
increased by 60 %. The significant handicap in the past years were instead the financial stocks Ageas (formally Fortis), the KBC Group and Dexia. Since March 2012, Dexia is not part of the Bel20-index any longer.

Hub city Antwerpen

It would be wrong to call the Belgian Economy a mono-culture prone to crisis. For a small country with only 10.9 million inhabitants, Belgium is offering a remarkable diversity, as a look on Antwerpen and Brussels shows. As an example, there is one of the world's largest chemical parks in the region Antwerpen. As hub city of the Belgian economy, Antwerpen is characterized by two more emphasis: The harbour is the third largest container harbour of Europe behind Rotterdam and slightly behind Hamburg. Furthermore, the city is traditionally regarded as the most important market place for diamonds. Today, according to estimates, half of the raw diamonds worldwide are being traded there. Another important business factor for Belgium is more than 1,000 public and private international organizations. As an example, the European Council, the Council of the European Union, the European Commission and the Head Quarter of NATO have their headquarters in Brussels. These organizations, with their employee-staff, directly and indirectly provide thousands of incomes with strong purchasing power.

Country Report: Belgium





Country Report: Belgium

	Figures given for 2011
Capital	Brussels
Population	10.8 millions
Currency	Euro
Euro Exchange-Rate (September 7, 2012)	---
Monetary System	Free Floating
Nominal GDP	515 Billion Dollar
GDP per capita (in purchasing power parities)	37,800 Dollar

	2011	*2012*	*2013*
Government Balance *as a share of GDP*	- 3.7	- 3.0	- 3.4
Dept Level *as a share of GDP*	97.8	99.9	100.5
Current Account Balance *as a share of GDP*	1.0	0.7	0.9
Foreign direct Investments *as a share of GDP*	---	---	---
Foreign Debts *in Billion Dollars*	---	---	---

Ratings of Foreign Currency Bonds:

- S&P AA
- Moody's Aa3
- Fitch AA

Source: DekaBank, IMF

The biggest weak point and therefore the biggest risk factor for the international investors is the national policy in Belgium. Through this a deep split between French speaking Walloons and Dutch speaking Flemings exists since decades. Preliminary peak of the Belgian regional conflict was the extraordinarily difficult formation of a new government after the break-up of the governing

coalition under Prime Minister Yves Leterme in April 2010. As a result of the elections which took place two months later, 12 parties became part of the Parliament. For the first time the N-VA (Nieuw-Vlaamse Alliantie) became strongest party with 27 of 150 seats. It is regarded as social-liberal, however also as clearly separatist with the aim to create an independent Flanders. The second strongest party with 26 seats became the Walloon PS (Partie Socialiste). Though the Flemish block has the majority, it is politically divided itself. The formation of a new government was therefore difficult. 541 days had to pass by before the present government was able to take up business at the end of 2011. Thereby, Belgium holds a solitary world record for the longest lasting formation of a government. An important pusher for an agreement were finally the markets for government bonds. In summer of 2010 and in the following months, the bond markets remained relaxed and regarded the tough negotiations only as the usual power-play between Walloons and Flemmings. The rates of return of the 10-year-Belgium-government-bonds had even fallen to 2.5 % until autumn of 2010, whereas Portugal and Italy had already to pay 7.0 % respectively 4.5 %. With more and more time going by for government formation and several failed attempts the market participants however became increasingly nervous.

With a debt quota at that time of 95 % as measured against GDP with an increasing trend and an exacerbating debt-crisis in the periphery states in the back, it was a play with the fire by the Belgian parties, especially after the politicians introduced clear plans for the division of Belgium into the public discussion. And also the rating agency Standard & Poor's downgraded Belgium to "AA" in November 2011 and Moody's had already put Belgium on negative watch The patience of the markets was then used up. The return of 10-year-government-bonds reached almost 6 % on November 25, 2011. Belgium was short of being put in the same bracket with Portugal, Italy, Ireland, Greece and Spain.

Coercion of the markets

The politicians finally had understood the message. On December 6, 2011, a new government was put sworn. It is a coalition of Christian democrats, socialists and liberals, each one in in two implementations, that is French and Dutch speaking groupings. Socialist Elio di Rupo became Prime Minister, the first Belgian head of government from the French speaking part of Belgium since 1974. The strongest party in the Belgium parliament, the Flemish-separatist NV-A, is not represented in the government. The new government started with two substantial achievements for appeasing the regional conflicts. Firstly, the end to the dispute existing since 1963 about the bilingual election and legal district Brussels-Halle-Vilvoorde. Secondly, the sixth state-reform was passed which is strengthening of the regions. The markets have accepted the agreement very positively. From almost 6 % in November 2011, the rates of

return of the 10-year-Belgium-government-bonds have fallen down to below 2.5 % in the meantime. Belgium has got around it barely. It would have been tragic if the Belgian economy had fallen to a heavy recession simply because of regional disputes.

The macro-economic data of the country is quite attractive. Whereas the Euro-currency-area on average showed an annual GDP-growth-rate of 0.5 % throughout the crisis-years from 2007 to 2011, Belgium achieved a respectable 1.0 %. And so, the Belgian labour market looks quite good. At the beginning of 2010, the country started in the upcoming Euro-debt-crisis with an unemployment-rate of 8.4 %. In the meantime it is at 7.4 %, whereas in the Euro-currency-area a historic increase to 11.6 % has taken place. The greater real-economic dynamic, however, also led to a higher inflation-rate. The Belgian average between 2007 and 2011 was at 2.4 %, and in the Euro-currency-area at 2.0 %. This year, however, for Belgium there will be hardly more than a stagnation of the GDP-development. Too heavily is weighing the tight interdependence with the Western European countries in view of the recession in the Euro-currency-area, caused by the periphery-states. But Belgium will also be above the Euro-currency-area-average in 2012.

High indebtedness

Below the line it is to be stated that Belgium is not to be put into the corner of Portugal, Italy, Ireland, Greece and Spain. Whether this will be so in future as well depends essentially on the Belgian politics. From the point of view of the real economy, Belgium has good prerequisites that this remains. But with a government indebtedness of roundabout 100 % as measured against GDP and an on-going Euro-overindebtedness-crisis, there is little manoeuvring room for the Belgian politics to allow its regional split to escalate again. The elections in the cities in October made the separatist NV-A in Flanders as well as on national level the strongest party. In the bond-markets this has been accepted without repercussions. The rate of return of the 10-year-Belgium-government-bonds is at 2.25 %, one of the Spanish however at 5.9 %. The NV-A is not represented in the government so that the election results in the cities do not automatically change the power distribution situation in the coalition, the next parliamentary election will only take place in 2014. Then, also the important sixth state reform will become effective which should somewhat appease the regional conflict.

Dr. Christian Melzer is economist at the DekaBank, Frankfurt am Main, Germany.

Source: DekaBank, Frankfurt am Main, Germany. Responsible for translation: GEFIU; translator: Helmut Schnabel

Inflation Rate

France, Interview: **"Low Interest Rates are damaging France"**

Interview with Patrick Artus, Chief Economist
of Natixis bank and Professor at the Paris
Sorbonne University,
interviewed by **Christ Schubert** from Frankfurter
Allgemeine Zeitung, Frankfurt am Main, Germany.

The pressure for reforms will thereby be reduced, says Artus. France, in economic terms, is losing ground since twenty years. The French government bonds are nevertheless bought, because the French are repatriating a lot of money, and because the Asians are diversifying their foreign exchange reserves. Germany alone cannot meet the demand.

Mr. Artus, which effect will have the downgrade by Moody's?

It will have no effect, in any case not a sustained effect. The big purchasers of government-bonds make their own analysis. Many of them come to the conclusion that they want to continue to be invested in French government-debt.

Already, the loss of the "AA"-rating from S & P in January had no influence. Why are the interest rates, which France has to pay, on the lowest level in spite of its economic difficulties?

This, in a certain way, is bizarre. There are several factors influencing this: First, there is the very large sector of life insurance companies in France, which is administering the investment of assets of 1.600 billion Euros. The French insurers are repatriating their investments, that means, they are exchanging foreign bonds against government bonds from France. And also in countries like Germany, Italy and the Netherlands, this process is going on. In addition, all the great central banks in Asia, among of them the Chinese one, as well as in the Gulf States, have decided that they want to support the European-currency-area. This, for political reasons, has to be seen in the context that they do not want to be confronted alone with the world power America. For economic reasons, they want to diversify their investments and they do not want to have everything invested in US-dollars.

What does this mean in real terms for France?

For instance, the central bank of China has received the guidance from its government to hold 26 to 27 % of its huge foreign currency reserves in European investments. For this, the government-bonds of Germany and of smaller countries like the Netherlands are not enough of a supply at all. The French government-bonds have the advantage that they are very liquid and that they are available in large portions. Therefore, these bonds can rarely be substituted. Against this background, many investors believe, that there will not be a French government-bond-crisis like in Spain and Italy – although the situation of the French economy has deteriorated significantly in the last 12 months. Germany alone cannot guarantee for the entire Euro-currency-area, without France the entire bail-out-system would break down. And another point: The German government-bonds deliver an even lower return than those of France. The pick-up of a return makes the French government-bonds attractive additionally.

Is nobody worried about the fact that the government-bonds may eventually not be paid back one day?

We are no yet at this point. France has government-debt of around 95 % of gross domestic product, Germany is at 90 % like the United States. In the United States, however, there is a trend for a rapidly growing government-debt. Italy is at 130 %, Japan at 220 %. The new annual additional net-government-indebtedness in France is at 4.5 %, compared with 8 % in the United States and Great Britain and 7.5 % in Spain. The French gross-domestic-product per capita amounts to 98 % of the German amount. Since 20 years France is permanently deteriorating in economic terms, a tendency which will continue. But I do not see a cause for an abrupt, brutal crisis. Politically, the situation is stable, the government has a majority in parliament until 2017. Social unrests I do not expect either. Therefore I expect that many international investors will maintain their French government-bonds-investments. Because they do not know where else to invest their money.

A comfortable situation for the government?

Yes, unfortunately. The low interest rates for government debt in France are disadvantages, because they decrease pressure for reforms. What the government has shown in terms of measures, is not at all sufficient. The tax reliefs for the corporations amount, on balance, to eight billion Euro per year – but necessary would be 100 billion Euro, when the aim would be to have the French burden with taxes and social welfare levies be equal with the average in the Euro-currency-area. That, by way of the tax reliefs, 300.000 jobs should be created, as says the government – is nonsense. Until the end of 2013, I expect an increasement of unemployment from 3.1 to 3.5 million persons. France needs a

renewing at all levels. It is the only country, in which the unemployment and the wages are increasing. Since the introduction of the Euro, the French corporations in the world market have lost market share of 40 %. No country in Europe is so poorly tuned to the globalization like France. The politicians here continue to believe that for them other rules apply than for the rest of the world.

Can France achieve the decrease of the deficit?

Also, when interest rates had not increased, Francois Hollande is very much afraid of this scenario. For this reason, he seriously pushes for the reduction of the deficit. It may well be possible that the government will not achieve the 3 % deficit-mark in 2013 because of a light shrinking of the economy, and it might end up only at the 3.4 %-mark. But the direction is right. Nevertheless, the government is hoping that the EU-commission will allow a loosening of the plans for consolidation for France and several other countries.

Do you have signs that corporations and individuals are leaving France because of the high taxes?

There are such cases, but from a micro-economic point of view they are only a few. What is worse is the fact that the corporations are reducing their capital expenditure, according to information from our customers, at between 10 and 20 % in the next year. We run the risk that there will be soon a kind of a capital expenditure strike by the corporations in France.

When shall we have the Euro-crises behind us?

I am afraid, it will last at least 10 years.

Source: Frankfurter Allgemeine Zeitung, November 21 , 2012. All rights reserved. Copyright Frankfurter Allgemeine Zeitung GmbH. Provided by Frankfurter Allgemeine Archiv.
Responsible for translation: GEFIU; translator: Helmut Schnabel

"WE ARE FAR FROM A CREDIT CRUNCH"

Under pressure from politicians, markets and customers, the banking industry reinvents itself. Germany's Commerzbank is a prime example of the remaking of the industry. Sven Gohlke, the bank's regional manager for Europe, talks about the situation of mid-sized European companies and the strategic reorientation of the bank.

By Armin Häberle

// Mr Gohlke, how are mid-sized companies in Europe affected by the ongoing crisis in the euro zone?

The picture differs across countries, of course, but I can give you a detailed impression of the situation in Germany, where we have recently conducted our annual survey amongst 4,000 mid-sized companies. One of the key findings was that macroeconomic uncertainty acts like a major brake on investments. As a result, investments are mainly financed with cash and equity, and not through external financing. This means that investment volumes are, on average, smaller than they could be, and that overall credit demand is low.

// Would you say that there is a lack of demand or supply for bank credit?

Definitely a lack of demand. Despite all discussions about Basel III and banks' balance sheets, we are far from a credit crunch. Banks could and would like to do more credit financing, but only few companies are looking for it. In addition, a lot of mid-sized businesses are starting to approach capital markets in one way or another, further reducing credit demand. Schuldscheins are becoming attractive instruments for longer-term funding needs.

// That's a very German instrument...

That's true, but we see increasing interest from abroad as well. Clients in Austria, France, Italy and the Netherlands are interested in schuldschein-style funding. It's a very suitable product for today's environment, as it allows long-term funding for companies without tying up much of a bank's capital.

// Do you embrace this trend, or would you rather have companies looking for more credit?

We support our clients in all areas of funding, of course. I think having short-term credit funding for working capital and longer-term funding via capital markets makes perfect sense. But it is also true that with such structures, banks, to a certain degree, lose close contact with their regular clients. During the tenure of long-term credits, you are in constant dialogue with your clients, which is good for client relationship management. Capital market instruments are different, as the dialogue with the client ends with the placement of the instrument, at least formally.

// Do mid-sized companies run the danger of burning their bridges to banks by betting too much on capital markets these days?

No. On the contrary, I think finance divisions in mid-sized companies have become much more professional since the crisis started in 2008. You can see this in their bank relations as well. In particular, CFOs have diversified their funding bases, which should make their companies more resilient. This might come in handy, should macro-economic conditions really worsen in 2013.

// Commerzbank has recently reorganised its corporate business operations in central and eastern Europe. What will the business model for the region be?

In order to expand and constantly improve business with corporate clients in the Czech Republic, Hungary, Slovakia and Russia, we have started to implement the successful and well-proven business model of what we call our Mittelstandsbank in these markets. It is focused on what we call "connectivity" to Germany or Poland. We at Mittelstandsbank support German and Polish companies abroad as well as local companies with a turnover of EUR 250 million or more if they have a significant business relationship – hence connectivity – with Germany or Poland. Reorganising our corporate business in central and eastern Europe around this principle makes particular sense in this region, as most internationally-oriented companies in the region will have Germany as a major trading partner. Additionally, we supplement our strategy with the coverage of local clients in the Czech Republic, Hungary and Slovakia.

// What services do companies demand most when going abroad?

Just like there certain consecutive steps exist when building an international presence, there are certain banking products that build upon each other. First, companies need straightforward export finance products such as letters of credit. Once local business

Capital market instruments have an effect on the dialogue with clients.«

Commerzbank

grows, they especially need FX products, cash and liquidity management.

// How many of the banking products will be restricted in the future due to Basel III and other regulations?

Letters of credit and the like will not be affected at all. There are almost no limits on growth for this kind of business. Long-term finance for tenures lasting 10 years or more will be affected. For example, plant manufacturers who have projects abroad will experience this very acutely. Such funding will become more scarce, more complicated and more expensive. Even if this kind of business is attractive in terms of its risk profile, as export insurance agencies usually cover them, banks will have problems with the capital requirements and the refinancing of such funding with matching maturities.

// In which currencies do you fund such projects?

Most of them will be funded in euros, but some of them in US dollars as well.

// Can EU banks get US dollars again?

It still is not easy for European banks, but it is once again possible, especially in volumes that are relevant for mid-sized companies.

// How do you view the macro-economic situation in Europe?

Obviously, the euro crisis is far from over. It might be hidden behind what one could call a veil of liquidity, but it is certainly not resolved yet. I don't think it will be resolved until we move towards a deeper political union.

// What is the more pressing policy issue in this respect: reducing sovereign debt or supporting demand through public spending?

Ideally, you would do one without neglecting the other. Clearly, governments in many crisis-struck countries in Europe need to consolidate, but they also need to adequately spend to ensure that their economies may rebound. We need a mechanism that allows individual states to cut national deficits while at the same time getting targeted support that allows them to undertake structural reforms. «

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The banker and his bank

Commerzbank is a partner for the export-oriented SME sector in Germany and worldwide. It has a dense network of branches, is present in 52 countries and serves almost 1 million business and corporate clients worldwide. In April, Sven Gohlke has become the new Regional Manager Europe. He brings with him many years of experience with international clients. Before becoming regional manager, he headed the bank's centre for major clients in Berlin.

Japan, Article: Japan: A Contrarian View?

By Payden & Rygel, Los Angeles, California, USA, Third Quarter 2012 Point of View, Our Perspective on Issues Affecting Global Financial Markets

Japan. We hear "basket case," we hear "lost decades," we hear a nation "on the verge of implosion." For some time Japan has been the great cautionary tale of fiscal deficits, depressed interest rates and slow growth. Now as much as ever, with low interest rates and stalled growth in many parts of the developed world, talking heads wax philosophic, asking in grave tones the foreboding question: "Are *we* Japan?"

As inflaming as this question is for media, as much "doom and gloom" sentiment as it inspires, is all the apocalyptic rhetoric misplaced? After all Japan still ranks as the world's third largest economy, is a top competitor in high technology exports (both goods and services) and plays home to the world's most economically powerful city.[1]

Japan. We hear "basket case,"
we hear "lost decades," we hear
a nation "on the verge of implosion."

We are not ignorant of the manifold problems Japan faces. However, neither are we ignorant of Japanese resilience. Taking as our beacon Sherlock Holmes' immortal words, "there is nothing more deceptive than an obvious fact," we present a contrarian look at the Japanese economy.[2]

POLLYANNA'S WE ARE NOT

To be clear from the outset, Japan is not an angel in disguise. One cannot ignore the high levels of debt to Gross Domestic Product—GDP (207% in June 2012), the under performance in economic output and unfavorable demographic trends.[3]

But soothsayers have predicted a collapse in the Japanese bond market for years. As early as 1994 a New York Federal Reserve Bank study argued that Japanese security markets posed significant dangers for global trade and growth; chief among the losers, so the paper suggested, would be "US institutional investors [who] are supplementing Japanese institutions' own recycling of the Japanese current account surplus."[4]

Five years later, academic worries over the fiscal health of Japan became more acute. Studies across the board proclaimed the need to save Japan from "an explosive and unsustainable trajectory."[5] Despite the admonishment and the assurances of severe consequences, with little changed more than a decade later Japan continues to persevere through all the theoretical adversity.

THE "BEAR" CASE: DEBT AND DEMOGRAPHICS

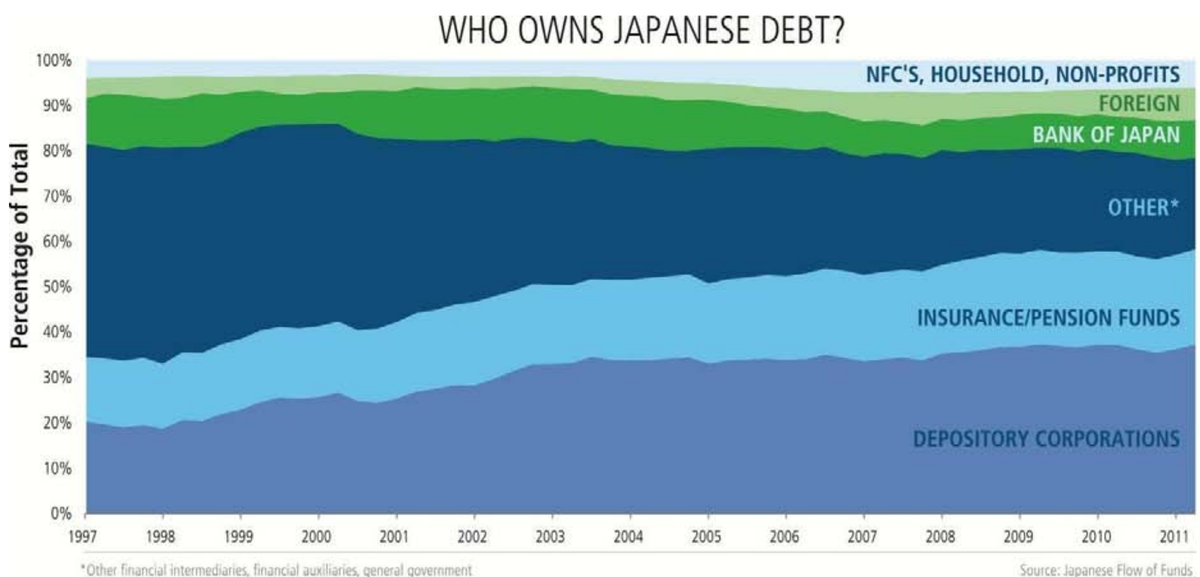
When economists make the case for the collapse of Japan the argument usually follows one of two lines of reasoning. At the most superficial level many marshal the out-sized debt to GDP ratio as sure evidence of Japan's impending economic disaster. These investors and economists argue too that with sluggish growth prospects, debt service payments will soon become too onerous, forcing a Japanese sovereign default. Indeed, recent credit events in Greece have served as a sufficient primer to reignite concerns of the same for Japan.

The more nuanced argument advanced by so-called Japan "bears" also takes as its starting point the bloated debt to GDP ratio. Unlike the first argument, though, proponents of this second line of reasoning suggest that Japan can sustain high levels of debt to GDP only because "about 95%" of its government debt is domestically held. See Figure next page.[6]

This means that the Japanese government does not have to put out its hat to global investors to sell their bonds (hereafter JGBs). The assumption is that once the Japanese sovereign debt market opened to foreign investors, given the questionable fiscal fundamentals, the Ministry of Finance would need to offer much higher yields to entice willing buyers. Yields would have to rise.

And that day may soon arrive. The bears argue that interest rates have remained

low only because of the elevated rate of domestic savings. Now that is changing. With an aging population, "by 2022, 30 percent of all Japanese citizens will be aged 65 or older." The bearish analyst might contend, "with so many citizens preparing for retirement the stock of domestic savings (denominated in yen) will decrease, forcing Japan to borrow abroad at much higher yields than we see today. All banks in Japan will fail."



REFINING THE MACROECONOMIC STORY OF JAPAN

What is the counter argument to such ominous premonitions? While it is tempting to treat the government like a household, which must finally default if it consistently borrows more than it produces, there are important distinctions between the two borrowing units.

A government in the modern era of "fiat" money (money that is not backed by a hard asset) is the ultimate currency issuer. In theory a household could issue its own currency—but who would hold it or be able to use it to settle transactions?

As a result, the peril that sovereign debt holders face is not default but *debasement*. In other words a country that issues its own currency cannot—unless by choice—default on its debt. If debt payments become too onerous, the

monetary authority issues more money to cover the country's liabilities. However if a country "prints" too much money, the value of the currency begins to erode, decreasing the real value of previously issued debt.

But the purchasing power of the yen has not eroded, at least not compared to a basket of goods and services (CPI) or other currencies (foreign exchange value). To the contrary, the yen has steadily appreciated against the dollar since 2007. This trend combined with the related fact that Japan has not had a positive reading for its core consumer price index (CPI) since 2008 ought to ameliorate fears that the Bank of Japan's debt monetization threatens the value of the yen.

The "difficultly of debt service" argument is not the only one that Japan bears advance with regards to the country's fiscal outlook. Often skeptics simply point to Japan's uniquely large debt to GDP ratio as the most worrisome statistic. When "doom and gloomers" quote the Japanese debt to GDP ratio at 207%, they refer to the ratio of gross debt to GDP—a measurement of the total outstanding government debt as a percent of GDP.

But, there is another, perhaps more sensible means of measuring debt to GDP: the net debt to GDP ratio. Different from the gross debt to GDP ratio, net debt to GDP measures the government's total financial liabilities minus the government's total assets as a percent of GDP.

For large economies like Japan, this simple change of metric makes an enormous difference. In 2010, Japan's gross debt to GDP ratio was 229%: their net debt to GDP ratio was only 127%. Why does it matter? In theory, if Japan had suddenly to pay off a large amount of its outstanding debt, liquidating some of its many assets (e.g. Treasury bonds) would ease the burden.

Contrast this with an economy like Greece in 2010 whose gross debt to GDP ratio was 163% and whose net debt to GDP ratio was also 163%.

While this consideration does not clinch the argument, it does shed a more modest light on the economic situation, allowing us to see clearly that Japan is not Greece.

Soothsayers have predicted a collapse

in the Japanese bond market for years.

MICROECONOMIC DIAMONDS IN THE MACROECONOMIC ROUGH

Most neglected by the Japan bears is the country's robust microeconomic strength. Recall that in contrast to economic studies evaluating data gleaned from the economy as a whole (such as GDP, national unemployment, consumer prices, etc.), microeconomics studies particular markets and interactions within the larger economy. Of Japan's many microeconomic strengths, here we focus on the success of two markets: education and health care.

Japan is an exceptionally well educated society. According to a 2011 Organization for Economic Cooperation and Development (OECD) study, Japan is the third best educated country in the world. And education is not just the privilege of wealth. Indeed, over the last 50 years Japan leads the world in overall rates of attainment for tertiary (higher) education.[7]

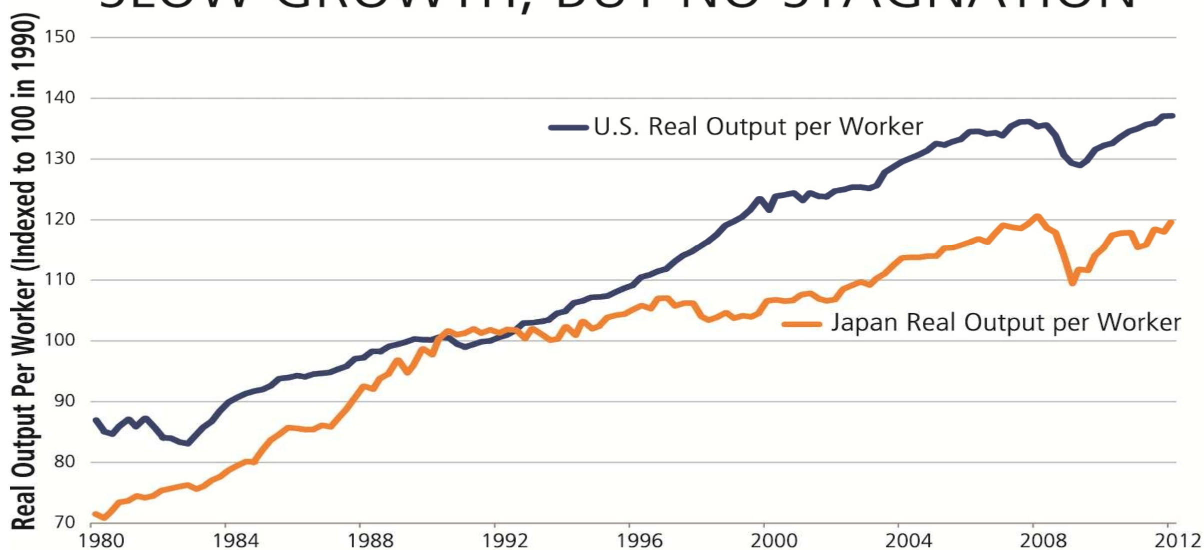
Not only do the Japanese boast breadth in the education of their populace they also achieve tremendous depth. Since 1999 (the start of the second "lost decade") Japan has produced more patents per capita than any other country in the world.[8] They are also the country with the third most Nobel laureates, claiming eleven (the US has produced 133, the UK, 25). Moreover, in 2011, of the 25 best universities in Asia Japan claimed more than any other Asian country with 10 (Hong Kong had 8, China 6).[9] Though these data are not infallible, they testify to Japan's excellence in a leading economic indicator—education.

Among the many consequences of a well educated population is a well-educated workforce. As the developed world moves away from producing goods to producing services, education levels will in part determine which of today's G7 countries most ably adapt to what has been heralded variously as a "flat" or, if you like, "post American" world.

Here Japan shines. In terms of value added (measured in USD), the only country that exports more services than Japan is the United States—and the two are the only countries with service exports totalling more than one trillion. From this we may infer that the Japanese are not the only ones who think highly of their own capabilities in the service sector: global demand attests to the same.

This fact, in tandem with the exceptional productivity of Japanese workers, reflects the excellence of education in the country. Though the U.S. outperform Japan in terms of output per worker, Japan managed to grow 20% relative to 1990 start levels.

See Figure next page.



Japan fares well in other measures of standards of living besides education. Another bright spot in the dark clouds of the Japanese economy is their health care. In addition to maintaining the highest life expectancy in the world for countries with a population over 50,000 (82.9 years), the Japanese run an efficient health care system and spend less as a percent of GDP on health expenditures than any of their peers in the G7.[10] The efficiency and efficacy of the Japanese health care system enables more workers to stay productive for longer; consequently, Japan maintains the world's third highest retirement age.[11]

More efficient health care infrastructure and longer working lives in Japan mean that, despite a dwindling savings rate and an increasingly aged population, entitlement spending troubles may yet prove more navigable.

Taken together, the microeconomics of the education and health care sectors of the Japanese economy hold up remarkably well compared to the rest of the world.

To be sure, economists and investors may care less for this "softer" data. While these market participants are not wrong, they neglect other important pieces to the puzzle that is the Japanese economy. Those hunting for yield or placing large short term bets will naturally avoid and decry the state of the Japanese economy. For investors with an eye trained on a more distant horizon, though, this data

should register more significantly. Often times the more ineffable elements of life prove vastly more important in determining long run success.

For the economist in Sherlock Holmes, the obvious fact—Japanese debt overhang—may have truth in it, but the story of the Japanese economy is far more complicated.

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TOO HOT TO HANDLE?

ASIAN CURRENCIES ARE RENOWNED FOR THEIR UNPREDICTABILITY. BUT UNDERSTANDING THE RISKS IS THE SECRET TO MANAGING THEM. VISHNU VARATHAN EXPLAINS

When addressing currency risks in Asia, it is important not to miss the wider point that heightened FX volatility swings appear to be the 'new normal' in the context of ongoing 'global rebalancing'. The confluence of economic/financial crises in the developed world, unprecedented, unconventional monetary policy response and a fundamental shift in debtor-creditor dynamics has demanded a rethink about global asset valuations. And FX is certainly no exception. Put simply, currency risks are not peculiar to Asia, or emerging markets for that matter. Rather, they are a global phenomenon.

Nevertheless, there are four aspects of Asian FX markets that perhaps magnify currency risks. The first is liquidity, or to be precise, the lack of. Asian currency markets are generally not as deep and liquid as those of developed markets. Consequently, not only are bid-ask spreads wider, but Asian currencies are rendered inherently more volatile. Secondly, there are more regulatory/political risks to contend with. Many economies in Asia are still in the process of liberalising their capital accounts, sometimes by trial and error. What's more, political stability is not always a given, while improvement in governance has some way to go. Thirdly, Asian economies are by and large export-dependent, accentuating FX sensitivity to global demand dynamics. In many instances, where the currencies are also not freely floated, this translates into hues of mercantilist policies coming through exchange rates. Finally, with a more 'flexible' Chinese yuan (CNY), Asian currencies could be more volatile, too. Ever since steady CNY appreciation policy took effect in mid 2005, Asian currencies have been increasingly predisposed to an appreciation trend – in tandem with deepening trade and investment linkages with China. But the days of one-way bets on yuan appreciation (*vis-à-vis* the US dollar) are numbered, if not over. Accordingly, this foretells more two-way FX forces in the offing.

Similar, but not homogeneous

There are, however, drawbacks to taking a broad-brush approach. An under-appreciated fact is that Asia is not homogeneous and neither are the associated currency risks. Asian economies are rich in nuances such as export dependence, fiscal/debt position, growth performance, inflation dynamics, level of development of financial and real infrastructure, monetary policy mechanism and political systems. All of these ultimately contribute to currency valuation. What's more, cross-Asia differentials are anything but static. The upshot is that any framework for managing Asian currency market risks must allow for two key factors. Firstly, the risks across Asia are dynamic, evolving in response to both structural and cyclical forces. And secondly, there is abundant scope for quality differentiation within the Asia FX space. Hence, there is a constant reordering of currency risk profiles in Asia, although some are generally more vulnerable than others.

For instance, the Indonesian rupiah (IDR) was by far the most volatile currency during the Asian financial crisis, plunging a heart-stopping 86% between Q2 1997 and Q2 1998. This was an obvious (with the benefit of hindsight, of course) consequence of an unsustainable investment bubble, inflated by massive (but light-footed) capital, bursting abruptly. Chronic current account deficits being financed by volatile capital, and worsening asset-liability mismatches in currency and duration, are telltale signs of impending trouble.

> With the exceptions of Singapore and Hong Kong (both financial centres), the rest of Asia, to varying degrees, lacks full capital mobility

In contrast, during the post-Lehman crisis, the South Korean won (KRW) took the hardest knock, dropping almost 35% between mid 2008 and Q1 2009. This was mainly due to the initial shockwaves that were triggered by a freeze in trade-finance and interbank liquidity. Hence, adverse FX shocks from the trade channel, given the highly export-reliant economy, were compounded by financial market shocks from rapid reversals in foreign funding.

More recently, the Indian rupee (INR) has emerged as the runaway underperformer, tumbling 20% since mid 2011. INR woes are due to a toxic combination of high oil prices adding insult to the 'twin deficit' problem (a trade deficit and budget shortfall); political gridlock amid policy missteps and the conundrum of slowing growth alongside 'sticky' inflation.

Finally, the Vietnamese dong (VND) highlights another facet of currency risk: policy devaluation. For example, when most Asian currencies were

For a lack of alternative, and to better reflect growing intra-Asia commerce, cross-holdings of Asian assets will inevitably grow

appreciating (1-3%) in Q1 2011, VND tumbled some 7% due to a policy-imposed step-devaluation. Market pressures often trigger policy devaluations and, although they are deemed necessary to correct economic imbalances, they undermine confidence in the currency nevertheless.

Evidently, there are some notable common threads pertaining to currency risks. These include: the health of external balances; indebtedness; policy positioning; and political threats. At the risk of oversimplifying, exchange rates reflect the traded value of an economy. In that vein, the above-mentioned factors represent the sovereign equivalent of corporate balance sheet, income and cash flow and strategic/event risks.

In Asia, freely floated currencies are the exception, not the rule. To some extent, scars from the Asian financial crisis predispose against freely floating exchange-rate regimes. Most of Asia operates on a scale traversing currency pegs to 'managed floats'. With the exceptions of Singapore and Hong Kong (both financial centres), the rest of Asia, to varying degrees, lacks full capital mobility. Exchange controls are necessarily a double-edged sword. On a positive note, these controls sometimes offer stability (for example, the CNY). Nonetheless, regulatory compliance costs and red tape can add to the frictional costs of doing business in some parts of Asia.

Get a grip

In order to manage currency risks in Asia, it is important to first recognise these risks correctly. So, good, old-fashioned optimisation of cash management is imperative. This entails optimising the foreign currency to Asian currency cash buffer as well as delicately balancing Asian currency revenues with liabilities. In addition, employing a variety of hedging tools (non-deliverable forwards, forwards, options and swaps) adds to the arsenal of currency risk management. Finally, it is imperative to stay on top of regulatory changes. In addition, keeping abreast of macro risks helps to determine the direction of FX/liquidity policy.

This brings us back to where we started: global macro risk, dominated by the rolling European debt crisis. Admittedly, negative global demand or financial shocks will initially undermine export-oriented Asian currencies. Nonetheless, devaluation of European assets alongside euro and US dollar debasement risks (from policies tending towards debt monetisation) will prompt a reallocation of global FX reserves – with a significant portion belonging to Asia. For a lack of alternative, and to better reflect growing intra-Asia commerce, cross-holdings of Asian assets will inevitably grow. In turn, this should prompt more enduring appreciation in Asian currencies further out, ultimately leading to greater currency stability. But for now, until the dust settles, volatility is the order of the day.

Vishnu Varathan is senior economist with Mizuho Corporate Bank in Singapore

THREE MANIFESTATIONS OF CURRENCY RISK IN ASIA

VALUATION
This is probably the most prominent 'headline' risk. Sudden shifts in FX valuations due to global macro or country-specific factors can have a potentially huge income and balance sheet impact. Significant depreciation in the INR over the past 12-15 months is a more gradual version versus sudden VND devaluations.

LIQUIDITY
The ability to seamlessly convert Asian currencies at an acceptably low cost cannot be taken for granted. This constraint arises from capital controls undermining FX funding in domestic markets or simply due to the lack of depth in the local market. One example is the strain on US dollar funding in Vietnam's banking system.

REGULATION
Given the ongoing capital market deregulation in many parts of Asia, changes to FX regulation come with the territory. The more benign are incremental tweaks to policy, such as restrictions on non-trade FX dealings and permissible FX hedging. Not as common, but of far greater impact, are abrupt impositions of capital controls, such as those in Malaysia, during the Asian Financial Crisis, and Thailand, following the coup in 2006.

SUCCESS IS FASHIONABLE

The Spanish textile company Inditex is currently the bearish Spanish stock exchange's only star. The fashion group, based in Galicia, attracts investors with an extraordinarily, solid financial structure.

By Stefanie Claudia Müller

The founder of Inditex, Amancio Ortega, its current chairman, Pablo Isla, and its CFO, Ignacio Fernández, have one thing in common: they do not really like to appear in public. It is the strategy of the group, but also a Spanish custom, for executive managers to steer clear of the media as much as possible.

At Inditex, it is more important to stay closer to the nearly 120,000 employees and the clients, than to public opinion. This is why you will find the big guys at Inditex having lunch in the same cafeteria as their normal staff. Modesty and understatement are both tradition at the company, and it is also part of the Galician mentality that Mr Fernández reflects.

Nevertheless, the 49-year-old has a great deal to be proud of. The company is one of the biggest textile retailers in the world and one of the most successful Spanish businesses listed on the Madrid stock exchange. And to some extent, Mr Fernández is the master

of its current financial success. In the first half of the year, the group achieved a net profit of nearly EUR 1 billion, a 32 percent increase on last year, despite the current economic situation. In the same period, turnover increased by 17 percent to EUR 7.23 billion. "This means that nearly 15 percent of turnover is profit. This is incredibly high for the sector and also for publicly traded companies generally," says Jordi Fabregat, a finance expert at the Business School Esade in Barcelona.

Thanks to the good management team around him, the 76-year-old Mr Ortega is today considered to be the third-richest man in the world. He still owns 60 percent of Inditex, which was first listed in 2001 and has now achieved a market value of more than EUR 60 billion.

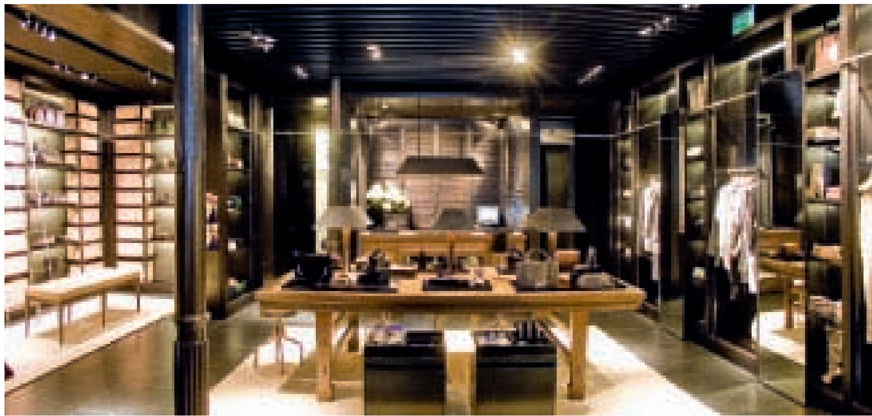
There are several reasons for the company's success. Inditex, with its flagship brand Zara, has about 6,000 shops in 85 markets. Due to its global positioning, Inditex is not really affected by the Spanish and European crises. The corporation's biggest business is now in Asia, where consumption is still holding up. Then there are the well-known, highly efficient distribution and production models of the eight store formats – Zara, Zara Home, Stradivarius, Bershka, Oysho, Pull & Bear, Uterqüe and Tempe.

However, the company now also profits from its financial strategy. "With very high margins, the company manages to have an enormous cash flow which allows the group to be almost completely independent from banks," says Mr Fabregat. Cash flow in 2011, for example, was EUR 2.6 billion from an annual turnover of EUR 13.8 billion. This allows the company to be almost completely independent of the credit crunch in its home country. While Spanish banks and most of the country's companies, not to mention the Spanish government, are suffering through a lack in investor confidence and, hence, very high interest rates, Inditex continues to attract international investors. It is no surprise, then, that Inditex shares gained more than 60 percent in the last 12 months.

But the attractiveness of the company is not just due to its finance strategy, its worldwide store expansion via strong cash flows or its investment in real estate assets well-suited for its sales points. Equity investors also like the strong cost control in production and distribution as well as a business model that can be applied virtually anywhere around the globe. Mr Fernández, who has been CFO of Inditex since 2009, is part of the impressive resistance that insulates the company against lacklustre European demand and the financial crisis. The CFO, who studied business administration in the historic Galician town of Santiago de la Compostela, is not only an expert on fiscal issues, he also knows how to control costs, which is the company's main goal in everything it does. For example, basic salaries for production and retail employees are around EUR 1,000 per month. This has been heavily criticised by many former employees who express their frustration mainly via social networks. On several occasions, Inditex has even been accused of abusing labour forces in the developing world. So far, however, the company has been able to calm down criticism and has made sure that good news about the business dominates reports. With the diverse social initiatives of the Amancio Ortega Foundation and the fact that Inditex is a reliable job-creation machine in a jobs-shedding Spanish economy, they have managed to present the image of a socially responsible company.

Despite its drive for cost-efficiency, the company has so far resisted outsourcing almost entirely. It still closely controls the design of its fashion lines, the manufacturing and assembling of clothes, and also most of its stores. Only transportation and logistics have been outsourced. Around 40 percent of Inditex's production is still located in Europe. This also allows the company to directly control and manage a big part of their supply chain, which is important for quality and reliability. "We apply a just-in-time strategy, which means we really manage to have nearly no stock at all. This saves us a lot on costs," says chairman Mr Isla, who has never had anything to do with fashion, but is an accounting guy, just like Mr Fernández. "To me, Inditex is just a normal company where you have to try to maximise your profits by reducing costs, while still creating a good ambiance for employees," he says.

Before joining Inditex as vice president in 2005, Mr Isla was running the tobacco company Altadis. "But my background always had to do with finance," says the Spaniard. Today, he is the company's chairman, while his former right-hand man, Mr Fernández, has moved to the CFO position. Eventually, according to public speculation, Mr Fernández might even become Mr Isla's successor. Until that day, Mr Fernández' job is to ensure that the value of the company keeps increasing, regardless of what happens in the broader Spanish economy. «



Inditex

Inditex, with its most commonly known brand Zara, is a rare success story from Spain even in the midst of the Spanish crisis. It has grown strong through smart internationalisation, control over its value chain and strict cost control.

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ALWAYS IN FLUX

With almost EUR 12 billion in revenues, Electrolux is one of Sweden's largest companies. To remain competitive, it strives for operational excellence. It has already come a long way, but the need to improve efficiency never stops, says CFO Tomas Eliasson.

By Armin Häberle

Electrolux

// Mr Eliasson, you became the CFO of Electrolux just this year. What's your assessment of the company?

For more than 25 years, I've been with companies like this – European-based companies with a global presence. And to be honest, from a structural point of view, many of the challenges and the questions – short and long-term – are exactly the same. How do you interact with your customers? What should your market presence be like? How do you expand in an emerging market? How do you leverage on your scale and optimise production, supply management and administration?

// But Electrolux is new to you in that it deals in consumer durables.

I was going to come to that, exactly. I have never been in consumer durables before. The difference between this and my previous business-to-business companies is that here you need to have more consumer insight, understand consumer behaviour better and put more focus on branding. I'm not saying that this is not important in other companies as well, but here it is just a bit more important.

// Is managing volatility harder at a B-2-C than at a B-2-B company?

Not necessarily. Volatility is much more driven by the balance between the need for investment and recurring revenues. If you take a business which is very dependent on, say, the construction of new factories or new power stations, then the business becomes very volatile. When the business cycle is up, then there is huge demand. When the business cycle is down, it dries up pretty quickly. But the larger the proportion of recurring revenues you have, the more stable the business is. I don't think it matters as much if it's consumer or non-consumer.

// But does that really affect your work as a CFO?

You make a good point. It does not affect my core finance work that much, but this is not to say it is not important.

// Electrolux wants to achieve operational excellence. How far has the company progressed in this area?

Our manufacturing restructuring programme that we launched in 2004 has yielded annual savings of about SEK 3 billion (EUR 281m) to date. Last year we communicated further such measures, which we anticipate will add further annual savings of at least SEK 1.6 billion. Aside from this, we are reducing product costs and lowering capital intensity by utilising our global strength in

modularisation, shared services and better aligned purchasing and R&D. These initiatives have already started to yield clear results, and expect to generate annual savings of SEK 3 billion with full impact from 2015.

In addition, we target safety, quality, inventory reduction and environmental impact. On that note, we have already achieved our 2012 goal to reduce energy use in operations by 28 percent compared to 2005, and even exceeded it by 8 percentage points with a reduction of 36 percent. This is not only good for the environment; it also saves us more than SEK 300 million a year. I can't give you more numbers, but I can tell you that improving efficiency never stops.

Since Lehman, debt markets behave more like equity markets. Lenders are very careful about whom they lend to, and it will stay that way.«

// Can you be a bit more specific on your future plans?

Well let me answer the question like this: Electrolux has been very good at defending its Ebit margin, rationalising and increasing productivity in areas such as purchasing, costs, working capital and so on. It's a machine, an operation, which is running very well. We have a strong cash flow, sound balance sheet, good cash position and good returns on assets. What is missing is growth. If you adjust for sell-offs, spins-offs and so on and just look at the core business, then we haven't really had any substantial growth for 10 years. And that is what is missing. You cannot survive on cost-cutting and productivity increases alone. You need to combine operational excellence and growth. So for me, profitable growth is on the top of the agenda. That's what we have to do.

// Where will this come from?

Everyone knows that the majority of the growth over the next 10 to 15 years will come from emerging markets. Nevertheless, our mature markets are still there, and they are big. And they will continue to be there. They make up 65 percent of our business. But going forward, these markets will not create a huge increase in demand. That's why it is very important for us to redirect our resources to cover a wider range of markets. We have said that, in a five-year period, we believe that 50 percent of our sales will be in emerging markets.

// What does that mean for your operational and financial excellence?

If we talk about product cost and competitiveness, we have to find a way to be competitive everywhere – in mature and emerging markets. In this respect, entering emerging markets means striking a fine balance between costs, logistics and market presence. It's not just a question of high-cost and low-cost countries. It is extremely important when entering new markets, especially emerging ones, to get an operational arbitrage in terms of costs. But if you stop there, you make a big mistake. You need to apply the same requirements for productivity, efficiency and skills to everything in those plants that you have in western Europe, North America and Australia. Otherwise you save money but you lose productivity.

// Does your presence in emerging markets change your funding structure?

Not really. We have a typical global, centralised funding structure with a central treasury function and central financial services units. We have one team dealing with all the banks and capital markets that distribute funding to all of our subsidiaries around the world. We do some local funding, but this is very limited.

// Are you happy with the way it is?

Very happy. I think it's the most cost-efficient way you can have it. It's really about two things when you talk about funding, and they are equally important. One is cost. And the other is availability. Can you get the money when you need it and can you get it there for the right cost?

// Are you concerned that governments might raise capital controls again, making such a centralised system less efficient for your global operation and forcing you to go back to more local funding?

These are political discussions that I prefer not to comment on.

// Have you experienced funding problems because banks have not been able to meet your needs?

No, because we don't really finance ourselves through banks. We go to the capital markets with bonds, commercial papers and so on. We have very limited direct bank relations.

// You have an established mid-term eurobond programme and a Swedish krona bond programme. How is the situation on the bond markets at the moment?

There is no lack of money, really. The margins are pretty good for companies at the moment, but I probably shouldn't be overly optimistic. Our average maturities depend on the balance between short-term commercial papers and the bond portfolio. We »

The company...

Electrolux is a global producer of household appliances and appliances for professional use, selling more than 40 million products to customers in over 150 markets every year. Electrolux products include refrigerators, dishwashers, washing machines, air conditioners and small appliances such as vacuum cleaners. In 2011, Electrolux had sales of SEK 102 billion (EUR 11.8bn) and 58,000 employees.

Electrolux

We have a strong cash flow, a sound balance sheet and good returns on our assets. What is missing is growth.«

» really use commercial papers almost as if they were a bank overdraft. It can go down to zero and then it can go up to a couple of billion krona, depending on the season. The bond portfolio, in contrast, is really the backbone of our funding structure and has a very deliberate and well-thought-out maturity profile. It is important for us to have no more than a couple billion krona maturing each year.

// Would you say you have been able to benefit from the current situation where companies can soak themselves up with cheap money?

I would like to answer this question with a broader perspective. The big change in corporate funding, I would say, came in 2008 after the crash of Lehman Brothers. After that, debt markets started to behave more like equity markets. That is to say lenders started to be more careful and do much more research about whom they would lend money to. The result is that if you are a well-run company, you have good access to capital markets. If you are not, it is more difficult and more expensive. And it will stay like that in the future.

// Have you seen suppliers struggle with this new reality?

I can't really comment on that.

// More generally, does Electrolux, with its good access to funding markets, offer financing to suppliers?

As in investing in suppliers or lending to them? No, we don't do that.

// Let me come to a more recent situation about planned plant closures in France. Can you elaborate on that?

As we speak, there has still been no decision made regarding the French plant. What we have done is initiated consultations with the local labour unions in order to discuss a potential stop in production of top-loading washing machines in the plant, as well as spend two years to find an entrepreneur for the site.

// In any case, this would really just be the continuation of a long-running programme of shifting production.

Yes. For eight years, we've been running our manufacturing footprint programme in order to stay cost-competitive in both mature and emerging markets. We started this in 2004, and in 2011 we communicated that this programme will continue for at least another four years. We can see that we need to do more regarding productivity and the manufacturing footprint. So the discussions regarding the site in France, for example, are nothing new. They are part of a larger strategy that also includes aspects like leveraging purchasing power or developing modular components for more efficient production.

// Is the finance division also part of an efficiency programme?

We are consolidating as many of the finance functions from around the world as possible into central shared service centres. We have one such centre in Poland, for example, with 600 employees doing accounts payable, accounts receivable and the general ledger. We also have a centre in Kuala Lumpur, Malaysia and will build up more over time.

// But have you outsourced any of those functions?

No, we haven't. We do it all in-house.

// As a final point, what will be your main management priorities for next year?

There are many things, but what is really important is to support and drive growth and to continue our programme for operational excellence. If I were to choose two top priorities, it would be these two. «

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...and its CFO

Tomas Eliasson has been chief financial officer and senior vice-president at Electrolux since 2012. Before joining Electrolux he held management positions within ABB Group (1987 to 2002) and was CFO at Seco Tools (2002 to 2006) and at ASSA ABLOY (2006 to 2012). He was born in 1962 and holds a Bachelor of Science degree in business administration and economics.

A PEEK OVER THE HEDGE

THE IASB HAS ISSUED A REVIEW DRAFT OF THE ACCOUNTING STANDARD THAT WILL REPLACE IAS 39. JOHANN KRUGER AND GERRY DALY EXPLAIN WHAT'S IN STORE FOR DERIVATIVES

Since November 2008, the IASB has been working to replace IAS 39, *Financial Instruments: Recognition and Measurement* with an improved and simplified standard. The replacement project was divided into three phases. Phase one concerned the classification and measurement of financial assets and financial liabilities. This phase was completed early, but will require limited changes due to the development of other parts of the new standard and accounting for insurance contacts. Phase two is ongoing and concerns impairment methodologies for financial assets. Phase three, hedge accounting, is the subject of this article.

The eagerly anticipated first draft of the general hedge accounting model was issued late in 2010. But despite well-communicated intentions to improve the standard, many issues were identified both in the comment letters received by the IASB and through the outreach activities subsequently initiated by the IASB. After many delays, a review draft (RD) was issued on 7 September 2012. This draft will be available for comment on cosmetic changes until early December 2012, the final general hedge accounting standard being issued shortly thereafter. Due to the extensive consultation process it has followed over the past three years, the IASB does not plan to make any further fundamental changes to the proposed general hedge accounting model.

The proposals do not cover open portfolio hedging (macro hedging), which will proceed independently of the general hedge accounting module. The proposed mandatory effective date is any annual periods beginning on or after 1 January 2015, but early adoption will be permitted.

The standard will only become available for use in the UK and the rest of the EU after endorsement by the relevant European bodies, hopefully during 2013. This is provided that the EU does not insist on completion of both the impairment and portfolio hedging components before they begin the endorsement process.

Unlisted UK entities with calendar accounting year-ends must apply a form of IFRS for the first time on 31 December 2015 (with opening balance sheet necessary as at 1 January 2014). Therefore, current UK GAAP reporters are recommended to consider the RD as key IFRS guidance on hedge accounting that would apply to them.

Summary of changes

The RD fundamentally changes the current rules-based approach to hedge accounting to a principles-based approach. It seeks to align the management view and information produced internally for risk management purposes with the accounting recognition of gains and losses.

The general basis for a hedging instrument to qualify for hedge accounting is as follows:

- There must be an economic relationship between the hedged item and hedging instrument;
- The effect of credit risk should not dominate the value changes in the hedging relationship; and
- The hedge ratio must be based on the actual quantities of the hedged item and hedging instrument used to meet the risk management objective.

The required journal entries for the three hedge accounting models remain substantially the same.

Risk components in non-financial items

The RD allows any risk component (of fair value or cash flow) that can be separately identified and reliably measured to be designated as hedged separately. For non-financial items, IAS 39 currently only allows separation of FX risk. The RD provides considerable flexibility compared with current rules.

> Many hedges of commodity components should qualify for hedge accounting for the first time

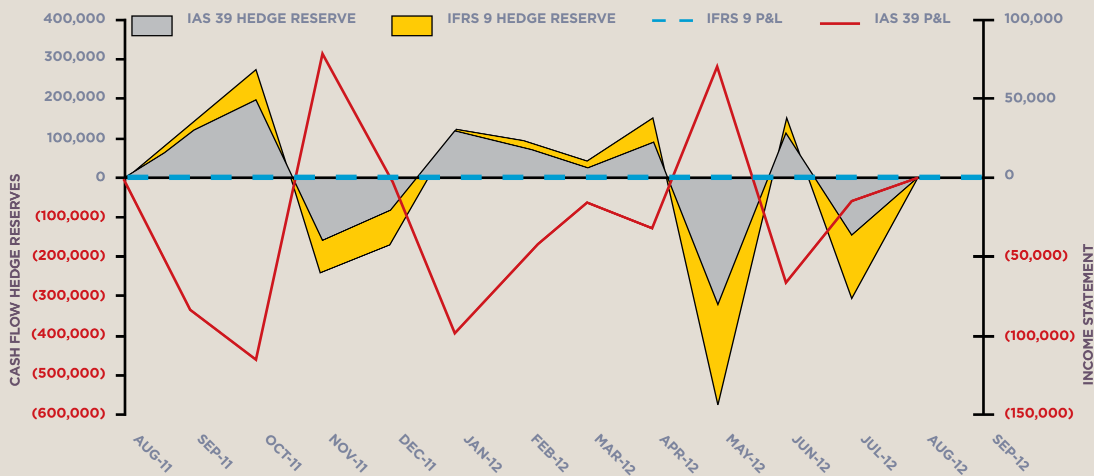
For example, inflation hedges of forecast revenues where the inflation component of future cash flows (for example, rent received) is explicit could now qualify as an eligible underlying item. This should align accounting presentation with common risk management practice, allowing companies to make choices on economic grounds only.

Many hedges of commodity components, such as the oil price component of jet fuel, should qualify for hedge accounting for the first time. Entities would also no longer have to adjust business practice, such as separating purchase contracts of commodities from any added-value manufacturing, to ensure appropriate financial reporting of activities.

Abolition of the 80-125% effectiveness corridor

A qualitative prospective test will be the main effectiveness qualification criteria. Ineffectiveness must be recognised in the income statement as per current

HEDGE ACCOUNTING FOR AN OPTION UNDER EACH FRAMEWORK



methodology. More hedges should therefore qualify for hedge accounting. The cost of hedge accounting compliance should decrease for most entities.

Rebalancing and overlay hedges

The RD permits hedge relationships to be adjusted with the aim of improving effectiveness without necessarily terminating and potentially restarting hedge accounting from scratch. The so-called 'derivative-on-derivative' prohibition is also effectively abolished. This should, at a minimum, simplify restructuring of hedges and management of synthetic interest rate exposures using short-dated swaps, thereby reducing the costs of hedging.

FX forwards

Income statement recognition of forward points on FX contracts may be spread over the life of the contract.

Hedging of net positions

Hedging of net positions can, subject to certain restrictions, qualify for hedge accounting. However, cash flow hedging of net positions is limited to FX risk.

'Time value' of options

IAS 39 has been heavily criticised for its treatment of the time value of options. The IASB proposes to consider options as analogous to insurance and therefore recognise gains and losses of option time value based upon the purpose of a hedge. For example, for so-called transaction-based hedges (such as cash flow hedges of forecasted transactions), subject to certain conditions, the full fair value changes of the option are deferred in reserves and released to the income statement to match the timing of the impact of the underlying hedged item.

The chart above illustrates this change to the treatment of the time value of a purchased $10m USD put/GBP call option hedging a forecast $10m sale. The left axis shows the amounts deferred in the cash flow hedge reserve and the right axis shows the impact of the time value on the income statement under the existing IAS 39 framework. As expected, this income statement volatility is quite significant in contrast to the impact on the income statement under the new RD model.

In general, Basel III capital and liquidity costs are likely to make options become more attractive compared with forward-based instruments. In future, corporates will be able to take advantage of the flexibility offered by options without worrying about misaligned financial reporting.

Potential pitfalls

The RD is not without bad news, though. Corporates with experience of managing liabilities using cross-currency swaps will be aware of the volatility currency basis risk can cause if it cannot be reported as part of a hedging reserve. The cross-currency basis spread represents the difference in credit cost between domestic rate quotes and the liquidity premium charged for exchanging one currency for another. Currency basis is not a component of single currency debt, but certainly affects the valuation of a cross-currency swap.

Before 2008, this was not an issue at all due to the relative stability of currency basis. When the crisis hit in 2008, currency basis widened significantly due to the increased demand for dollars combined with a decrease in supply as US banks held cash to conserve liquidity. The impact of this non-cash volatility on cash flow hedges was mitigated by calculating hedge ineffectiveness using the hypothetical derivative method as a proxy for fair value changes in the underlying exposure. Unfortunately, the RD indicates that the hypothetical derivative cannot include features that only exist in the hedging instrument and that are not included in the hedged item, for example, currency basis. This will lead to increased income statement volatility, which is not decision-useful to users. Isolating currency basis at inception, excluding it from the hedge relationship, similar to option premium, and amortising it to the income statement over the term of the hedge, would provide a simple solution. However, the RD would have to be amended to allow this.

An entity is also prohibited from voluntarily de-designating a hedge that continues to meet its risk management objective. Once adopted, hedge accounting is mandatory and cannot be revoked unless the risk management objective itself changes.

In summary

IAS 39 is rule-based, a legacy of having been modelled on the equivalent standard in the US. The IASB has now taken the lead to transform accounting for financial instruments to be based upon principles, supplemented by rules to prevent abuse. In essence, the changes in the RD are overwhelmingly positive.

Companies relying on 'underlying profit' reporting to accurately reflect the results of their commercial activities may in future not have to adjust for non-cash IAS 39 volatility. It is hoped the US standard-setters will follow this initiative in support of global convergence towards standards of the highest quality.

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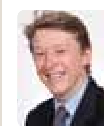

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LLOYDS BANK

KNOW YOUR OPTIONS

TREASURERS LOOKING TO MINIMISE THE COST OF SHARE BUYBACK PROGRAMMES HAVE A CHOICE OF STRATEGIES. MARK DALTON EXPLAINS

In an era where the majority of share trading is done through the use of algorithmic tools to achieve best execution, I find it interesting that many companies, both in the UK and abroad, continue to execute their own share repurchases in a relatively hands-on fashion, relying on a good dose of human intuition, rather than using the tools that most of the market employs.

Typically, execution is benchmarked against the volume-weighted average price (VWAP) of shares traded during the same period as the repurchase is undertaken.

It strikes me that these companies are more concerned with the day-to-day execution of the buyback than with an overall strategy that minimises the cost.

Why is it important to minimise the cost of a buyback in absolute terms? Unlike a dividend, which benefits all shareholders equally, a share repurchase programme benefits the continuing shareholders. The shareholders selling to the company almost certainly do not know that it is the company buying their shares, and so they see a direct benefit only in so far as the repurchase programme allows them to sell at a higher price than they might otherwise, or in volumes that might otherwise be difficult to achieve. For most mid- to large-cap companies, a share repurchase programme will be designed and executed so as to avoid either of those situations, as they don't want to create an unsustainable situation in the trading of the shares that is likely to be detrimental to continuing shareholders.

For a company that executes its buyback continuously throughout the year (handing over execution to a broker during closed periods), it is implied that the company does not have a view on whether its shares are over- or undervalued, and as such it should simply minimise the impact on the market of any repurchases.

> Unlike a dividend, which benefits all shareholders equally, a share repurchase programme benefits the continuing shareholders

But is that the right way to look at it? Management almost invariably has a view on the valuation of its shares. So, if this is the case, shouldn't that view be reflected (or at least considered) in the company's approach to share buybacks?

Designing a buyback programme

Let's think about four scenarios:

- A company feels that its shares are undervalued today. In this case, arguably, it should buy as many shares as possible, as soon as possible, to maximise the value for its continuing shareholders.
- Conversely, if the company feels that its shares are overvalued, share repurchases should either not be used at all and only executed once the share price has fallen, or only executed if they can be done below market.

As an example, UK retailer Next uses an interesting strategy to achieve below-market repurchases in the form of its contingent forward purchase contract programme, whereby it is able to buy shares at a fixed price that is a significant discount to the market price at the time of entering into the contract. In these contracts, Next commits to buying a fixed number of shares each week for a set duration, whether or not the share price rises or falls. But if the share price rises significantly, above a pre-agreed threshold, the contract terminates early.

- Perhaps neither of these is the case, and the company feels that its shares are fairly valued at present, but wishes to execute its buyback over a longer period of time. If the company is worried that the share price might increase before it can execute its repurchases, it should consider tools for capping the share price at which it buys those shares. Buying call options (explicitly or implicitly in a repurchase contract) could make sense. For a company that does not wish to pay the option premium that such a strategy would require, selling a put (or embedding

EXAMPLES OF DIFFERENT SHARE REPURCHASE STRATEGIES

STRATEGY	EXPECTED PERFORMANCE	IMPLIED GOAL OR VIEW
Type 1: No options component		
Buy a fixed number of shares every day	Match average of daily VWAPs	Purchase a fixed number of shares – no view on share price
Buy a fixed value worth of shares every day	Slightly beat average of daily VWAPs	Return a fixed amount of cash – no view on share price
Actively managed share repurchase	Approximate or beat VWAP	Company expects to beat VWAP through active management
Type 2: 'Vanilla' options-based strategies		
Capped share repurchase (buying a call)	Buy fixed number (or value) of shares over a period of time, subject to a maximum price	Minimise cost of buyback if stock price increases – pay for the protection
Collared share repurchase (buying a call, selling a put)	Buy fixed number (or value) of shares over a period of time, subject to a maximum and a minimum price	Minimise cost of buyback if stock price increases – take risk of buying above market if stock price falls
Put option sales	Buy fixed number of shares if the stock price drops	Earn money through sale of options, only buy shares if stock becomes 'cheap'
Type 3: 'Exotic' options-based strategies		
Contingent forward purchase contracts	Buy shares below market price	Purchase shares below market – most effective if shares are range-bound
Guaranteed discount to VWAP over a term	Beat average of daily VWAPs over a (variable) period of time	No view on share price – desire to outperform VWAP
Guaranteed discount to VWAP each day	Beat VWAP each day purchases are made	No view on share price – desire to outperform VWAP

a minimum purchase price in the repurchase contract) could be an effective way to reduce that cost.

In the US, many companies have used these strategies in the form of capped and/or collared accelerated share repurchase programmes.

Alternatively, a company could sell put options on its shares, generating option premium (cash in hand for the company) upfront, and agreeing to buy the shares if the stock price falls (and presumably becomes cheap).

A frequently cited example in the UK is Vodafone's put sale programme from 2004, although this strategy has also been used in the US market by several issuers.

◆ A fourth possibility is that the company truly does not have a view on its share price, or does not wish to imply a view in the construction of its share repurchase programme. In this case, it should consider a buyback programme that minimises the expected purchase price in relation to the VWAP over a reasonable period of time.

To that end, most large investment banks can offer a range of strategies (some widely used, others very bespoke) in which they will guarantee to match (or beat) VWAP, subject to the company providing some flexibility to the bank.

For example, if a company is indifferent as to the exact period of time during which it will execute a share buyback, but wants the buyback to be completed by no later than three months' time, and has a fixed number of shares that it wishes to buy (or a fixed amount of money it wishes to spend), a bank could guarantee to deliver those shares at a guaranteed discount to VWAP during the execution period, subject to having flexibility over the exact timing. For instance, it could offer a 0.5% discount to the VWAP, with the obligation to terminate the execution period no sooner than two months and no later than three months after the start date. Regardless of the exact date of termination, the company would be able to show that it had achieved a discount to VWAP during the period it was undertaking the buyback.

An alternative structure could allow the company to buy the shares at a discount to VWAP on any given day, but give flexibility to the bank over volumes on each day (subject to a minimum and maximum). By providing such volume-based flexibility, the bank can buy more on down days and fewer on up days, and, in exchange, guarantee to beat VWAP on every day for the company.

Of course, there are jurisdiction-specific rules that companies must follow in the execution of any share buybacks. The examples in the table are designed to demonstrate the points, but the inherent logic should still hold when designing a programme within those regulatory constraints.

Success of a buyback programme relative to its benchmark is typically measured in basis points. Perhaps it is time for more companies to embrace strategies that can outperform those benchmarks by a significantly wider margin.

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THE BASICS OF BORROWING

Treasurers must understand lenders, markets and instruments to help their companies raise debt, says Will Spinney

Lenders, markets and instruments are three key dimensions to consider when a company raises debt. This article should help you to understand who or what is in each list and why there is some overlap between them.

Lenders

Lenders to corporations are as follows:

- **GOVERNMENTS (AND AGENCIES)** – may support selected industries, usually at times of crisis.
- **SHAREHOLDERS** – may support their businesses, especially in intercompany situations.
- **BANKS** – still significant as lenders.
- **CUSTOMERS** – may pay in advance or finance certain assets.
- **SUPPLIERS** – give trade credit, often considered 'free'.
- **EMPLOYEES** – on a small scale, they may pay expenses in advance (also, they usually get paid monthly in arrears).
- **INDIVIDUALS** – may buy bonds (wealthy individuals who may also lend).
- **NON-FINANCIAL CORPORATIONS** – might participate in many types of debt-raising and seek security, liquidity or yield by investing in other non-financial corporations.
- **HEDGE FUNDS** – might lend to support a particular trading strategy.
- **PRIVATE EQUITY**, for example, 3i – might lend to support a long-term relationship with a company.
- **INSTITUTIONS**, for example, insurance companies and pension funds – these organisations are naturally long of investable cash and are long-term investors, hugely significant as lenders.
- **MONEY MARKET FUNDS** – as well as mutual funds (and equivalent).
- **PENSION SCHEMES** – are natural investors, especially in bonds, and are significant lenders.
- **SOVEREIGN WEALTH FUNDS** – in support of a long-term relationship with a company.

Banks and institutional investors are probably the largest and most important class of lender. It is useful to consider their relative importance, but this does vary geographically. In the US, institutional investors dominate lending, whereas the reverse is true in Europe (although in this decade, institutions are taking an unusually high proportion of corporate debt, a trend that is more likely to continue than not).

Markets

The concept of a 'market' in terms of borrowing can be quite confusing. Sometimes a 'market' is a fully operating public market, with two-way prices quoted by market makers in a very transparent way. Sometimes, however, it merely refers to the 'standard way' of doing things, or to the price for a product related to 'other current similar transactions'.

The most important markets for corporations are as follows:

- Bank market, comprising mostly lending banks, but some non-banks participate in different tranches of some bank loans. This operates worldwide.
- Bond market, including euro medium term notes (EMTN). This is mostly an institutional investor market. It operates predominantly in domestic (and the euro) arenas.
- Commercial paper market. This is a short-term institutional market and is focused on the US and Europe.
- Private placements, mostly US-based with insurance companies participating.
- Leasing, or asset finance, which is predominantly, but not totally, bank-led.
- Factoring and supply chain finance generally, which is broadly bank-originated.
- Convertibles, hybrids and payment-in-kind securities, plus others, form the rest of the lending markets.

Only the bond and commercial paper markets operate as fully public markets. All the others do operate as a 'market', but with less transparency. So if a borrower approaches several different banks for a loan, the quotes should reflect market conditions and, probably, be fairly similar.

Clearly banks as lenders operate in bank markets, but other lenders can be found in most other markets.

Bond markets

Bond markets are normally very liquid and large and so are important barometers of the appetite and price of credit generally. Supply and demand in the bond markets drive long-term interest rates and credit spreads, thus affecting the rate at which corporates can borrow. This spills over into the bank and other markets, leading borrowing and asset prices. Many valuations are driven from bond markets and equity valuations are also partly driven from them.

Instruments

Within each category of market, many different instruments are used. Within the bond market, for example, we see instruments such as:

- Fixed-rate bonds;
- Floating-rate bonds;
- EMTN; and
- Islamic instruments such as sukuk.

The bank market has an enormous variety of instruments, including:

- Term loans;
- Revolving credit facilities;
- Syndicated loans, both term and revolving;
- Overdrafts; and
- Bills and acceptances (for further discounting).

Will Spinney is associate director of education at the ACT

HANDLE WITH CARE

Treasurers should approach derivatives with caution, but not with loathing, says Sarah Boyce

Over the years, the public has increasingly associated derivatives with financial disaster. Regulators now want to impose greater control on them to try to avoid a repetition of the events of 2007/8. But is this 'fear' justified?

What are derivatives?

A derivative instrument can be defined as 'one whose value depends on the value of an underlying asset'; ie a share option is a derivative of the underlying share.

Derivatives are based on a very wide range of underlying assets, including commodities such as metals, wheat or energy and financial assets such as shares, bonds or foreign currencies. The one thing they have in common is that as the value of the underlying asset changes, so will the value of the derivative and there is no need to own the asset itself.

There are four main types of derivative product from which all others evolve:

◆ **FORWARDS AND FUTURES** – a contractual agreement between two parties with a known outcome. Forwards are bespoke, ie traded OTC, while futures are traded on an exchange in standard sizes and maturities.

◆ **SWAPS** – an OTC agreement to exchange payments on regular dates, where the payment legs are calculated on a different basis.

◆ **OPTIONS** – a contract that gives the buyer the right to buy or sell an underlying asset at some point in the future.

Who uses derivatives?

Derivatives are used to manage risk, to speculate on the price of assets and to arbitrage transactions. Hence, two distinct groups of users have evolved:

◆ **TRADERS** can be split into:

– **Speculators** who 'bet' on price movements in an underlying asset by speculating on price movements in the relevant derivative. They take advantage of the leverage effect (where derivative contracts, which may be worth millions if the markets move in a particular direction, only cost a fraction of that to put in place). Derivatives can be much more flexible than the underlying asset and are generally settled in cash.

– **Arbitrageurs** who are risk-averse, but will trade derivatives when they see market inefficiencies.

◆ **HEDGERS** (predominantly corporates) face risks associated with the price of the underlying asset (for example, the foreign currency) and they use derivatives to reduce or transfer this risk.

Market makers do not use derivatives as such, but create liquidity by quoting simultaneous bid and offer prices to the market, at which they are willing to buy or sell an asset.

Managing the risks

The risks associated with derivatives can be managed if you follow a few key steps:

◆ Define your risk policy.

– Set clear policies and monitor them.

– Take limits seriously – do not ignore limits because profits are being made (losses can easily follow).

– Make sure a hedger doesn't become a speculator; be cautious about making the treasury department a profit centre.

– Implement segregation of duties to mitigate the risk of fraud or error.

◆ Recognise that you can't always outguess the market, so don't even try.

◆ Diversify your risks – use a basket of solutions to any problem and remember that derivatives transform rather than eliminate risk.

◆ Carry out scenario analysis and stress testing to understand all possible outcomes (remember to always consider adverse movements whatever your bank or board might suggest).

◆ Make sure you understand the latest accounting rules and reporting regulations before entering into any transaction – the board will not thank you if you unwittingly reduce profits as a result of an accounting rule.

◆ Products can be complex and great care must be taken to ensure they are recorded and valued correctly.

◆ Do not ignore liquidity risk – particularly with the increasing introduction of margining and collateral calls. Margining exists so that any changes in value are settled on a day-by-day basis rather than at maturity, but can result in large cash flows.

Treat all structured products with caution (particularly overlaid derivatives). Financial products are sold to make a profit and the 'glitzier' products are likely to carry a higher margin for the seller. But do not exclude derivatives from your toolkit. If used in the right place at the right time, they make an extremely valuable tool.

> Derivatives are used to manage risk, to speculate on the price of assets and to arbitrage transactions

Sarah Boyce is associate director of education at the ACT

IAFEI Board of Directors Meeting, Cancun, Mexico, November 14, 2012

Traditionally a physical IAFEI Board of Directors meeting is being held on the occasion of the annual IAFEI World Congress. The 42nd IAFEI World Congress took place in Cancun, Mexico, November 14 to 17, 2012. The concomitant IAFEI Board of Directors meeting took place on September 14, 2012. This Board of Directors Meeting made the following elections/ reelections of IAFEI Officers, for 2013:

Elections, reelections of IAFEI Officers, for 2013:

Luis Ortiz-Hidalgo, Mexico	Chairman IAFEI
Fausto Cosi, Italy	Vice Chairman IAFEI
Victor Y. Lim, Jr., Philippines	Secretary IAFEI
Emilio Pagani, Italy	Treasurer IAFEI
Fernando Liceaga, Mexico	Area President the Americas IAFEI
Nguyen Ngoc Bach, Vietnam	Area President Asia IAFEI
Armand Angeli, France	Area President Europe, Middle East & Africa IAFEI

This IAFEI Board of Directors Meeting, in addition, decided on the
Creation of the following IAFEI working committees, starting 2013:

- ***IFRS Committee*** **-** Liaison IAFEI Executive Committee Member **-** IAFEI Treasurer Emilio Pagani

- ***International Tax Committee*** **-** Liaison IAFEI Executive Committee Member **-** IAFEI Chairman Luis Ortiz-Hidalgo

- ***International Treasury Committee*** **-** Liaison IAFEI Advisory Council Member **-** Dr. Conchita Manabat. Name of committee may be revised to expand coverage.

-***International Observatory of Management Control Committee*** **-** Liaison IAFEI Executive Committee Member **-** IAFEI Area President Europe, Middle East & Africa **-** Armand Angeli. Frédéric Doche from French IAFEI Member Institute DFCG will be the Technical Leader.

43rd IAFEI World Congress, Warsaw, Poland, October 15 to 17, 2013

Hosting IAFEI member institute will be FINEXA, the Financial Executives Institute of Poland, in cooperation with Financial Gates GmbH, Germany/CFO-Insight magazine.

44th IAFEI World Congress 2014, Philippines

Hosting IAFEI member institute will be the Financial Executives Institute of the Philippines, FINEX. The exact location and date have not yet been determined.

45th IAFEI World Congress 2015, Italy

Hosting IAFEI member institute will be the Financial Executives Institute of Italy, ANDAF. The exact location and date have not yet been determined.