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# IAFEI Quarterly

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**Table of Contents**

**Letter of the Editor**

**Africa, Report:**

**Sub-Saharan Africa,**

By **Maurice Cleaves**, Global Head of Cash Management at Barclays  
from **The Treasurer**, September 2013, **ACT**, UK

**China, Article**

**China`s Financial System: Does a crisis Lurk in the Shadows?**

By Payden & Rygel, Los Angeles, California, USA, September – October  
2013, Point of View, Our Perspective on Issues Affecting Global Markets

**Europe, Article:**

**Regulation**

Treasurers must continually challenge the reshaping of the financial  
System.

By **Richard Raeburn**, Chairman of the EACT, European Association of  
Corporate Treasurers, from **The Treasurer**, July/August 2013, **ACT**, UK

**Europe, Article:**

**CoCo – Bond Issues are Slowly Coming Out of the Doldrums**

By Björn Godenrath, , Börsen-Zeitung, Frankfurt am Main, Germany,  
October 1, 2013

**Europe, Article:**

**A Unique Opportunity. SEPA: Where are we now?**

By **Michael Turner**, Head of Cash Management Corporates UK &  
Ireland at Deutsche Bank, from **The Treasurer**, September 2013, **ACT**,  
UK

**Europe, Article:**

**Emir Edges Nearer**

By **David Retana**, Managing Director at REGIS-TR, from **The  
Treasurer**, September 2013, **ACT**, UK

**G 20, Statement:**

**Shadow Banking Roadmap**

Statement by **G 20 St. Petersburg Meeting**, Russia, September 6, 2013

- Germany, Article:           The Risk Management is Becoming More Important**  
by **Dr. Werner Brandt**, CFO SAP AG, Germany, Chairman of the programme committee of the 67<sup>th</sup> German Business Administration Day, Member of GEFIU, the Association of Chief Financial Officers Germany, from Frankfurter Allgemeine Zeitung, Frankfurt am Main, Germany, September 2, 2013
- Germany, Article:           Point of View: Fragmentation of Financial Markets is Damaging the Real Economy**  
by **Dr. Matthias Zieschang**, CFO Fraport AG, Germany, Member of the Exchange Council of the Frankfurt Germany Securities Exchange, Member of the Board of Directors of GEFIU, the Association of Chief Financial Officers Germany
- Japan, Article:               Why Japan Matters**  
By **David Bowers**, Global Investment Strategist at Absolute Research, from **The Treasurer**, July/August 2013, **ACT**, UK
- Singapore, Article:         A Small City State against the Rest of Asia**  
By Christoph Hein, Frankfurter Allgemeine Zeitung, Frankfurt am Main, Germany, September 30, 2013
- Switzerland, Interview:    On Half Way**  
Interview with **Jürgen Brandt**, CFO Sulzer AG, Switzerland, Interviewed by **Sabine Paulus**, Finance, Das Magazin für Finanzchefs, Financial Gates GmbH, Frankfurt am Main, Germany, June/July/August 2013

**IAFEI News**

**Letter of the Editor**

**October 9, 2013**

**Dear Financial Executive,**

You receive the **IAFEI Quarterly XXII nd 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 variety of articles on financial subjects, all of which merit the reader's attention.

Especially noteworthy is the article "CoCo – Bond Issues are Slowly Coming Out of the Doldrums", an instrument invented by the financial markets themselves for the bail out of failing banks, instead of asking for a bailout by the taxpayer.

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

# Sub-Saharan Africa

The huge potential of this resource-rich region is clear, but it comes with cash and liquidity management challenges, says Maurice Cleaves

Sub-Saharan Africa is regarded as the land of untapped potential for many reasons. This vast part of the African continent is already home to over 900 million people, according to the UN, and its population is predicted to reach nearly two billion by 2050, when it will make up a fifth of the world's inhabitants. Its middle class is expected to surge by 50% in just over a decade from 400 million today to 600 million in 2025, which will drive consumer spending and demand for financial services. And, unlike China, which has been the great growth story of the past 30 years, the population of sub-Saharan Africa – and therefore its workforce – is young. In Botswana, the average age is 22.7.

In addition to its demographic advantages, sub-Saharan countries are also exporters of prized minerals needed by the construction, energy generation and manufacturing industries. South Africa is a major supplier of chromium,

manganese and platinum, while Zambia is a significant miner of copper and Namibia is a big producer of uranium. Meanwhile, the discovery of oil and gas fields in the region has sparked the intense interest of developed and emerging nations in what has been described as 'The Second Scramble for Africa'. Major infrastructure investment is taking place and Africa also has 50% of the world's uncultivated arable land, according to the World Bank.

Next year, the International Monetary Fund (IMF) expects the economic growth of sub-Saharan Africa to exceed 6% and many African governments are spending on housing, shopping malls and transport links. So the opportunities for companies that wish to invest in the region are increasing all the time. But sub-Saharan Africa is not necessarily an easy region for outsiders to do business in, not least because it consists of 47 different countries, each with its own customs and legal systems, as well as differing banking

practices, exchange controls, taxation regimes and levels of political stability.

## Banking in Africa

Sub-Saharan Africa is renowned for being a cash-based economy. In 2010, a survey by Gallup found that over 80% of residents don't have their own personal banking account, with that figure climbing to 99% for those living in the Democratic Republic of Congo or Niger. Nevertheless, the banking system in the region is more sophisticated than many Western treasurers probably realise. Most countries have their own automated clearing house, card clearing and real-time gross settlement systems and, because these have largely been introduced over the past decade or so, authorities have been able to learn from the banking systems of developed nations. There are also initiatives to develop intra-regional clearing systems in the east, west and south of Africa. As an example, the South African Development Community Integrated Regional Electronic Settlement System (SIRESS) will enable electronic cross-border settlement of payments in South African rand in the Common Monetary Area (CMA). The CMA comprises Lesotho, Namibia, South Africa and Swaziland, and the goal of SIRESS is the removal of cross-border payments in paper form.

Mobile phone penetration is high in sub-Saharan Africa. In 2012, a report by Deloitte put it at 54% and ownership levels are particularly high in Ghana, Kenya, South Africa, Tanzania and Uganda. Indeed, Kenya has become the world's leading mobile money transfer market. The potential for other countries to follow Kenya's lead and for mobile payments to become prevalent throughout the sub-Saharan region is substantial, especially as bank branch networks are often limited to major towns and cities.

Choosing the right bank or banks to work with in sub-Saharan Africa can make a real difference to the ease with which treasurers can do business in the region. They should look for a bank that has a strong regional footprint, good domestic branch coverage and relationships

## Regional file

**Population size in 2012:** 910.4 million

**Geographical area:** 23,587,900 sq km

**No of countries:** 47

**% growth in 2012:** 4.7%

**GDP in 2012:** \$1.288 trillion

**Urban population (% of total):** 37%

**Life expectancy:** 55

**Largest city:** Lagos, Nigeria

(Source: World Bank)

<http://data.worldbank.org/region/sub-saharan-africa>



## TOP TIPS FOR DOING BUSINESS IN SUB-SAHARAN AFRICA

1 Work with advisers who have good regional and local knowledge. Choose a banking partner that has good domestic coverage and can provide you with visibility of local accounts and assist you with central bank reporting. Use accountants and tax advisers who are affiliated to local firms.

2 Gain a deep understanding of the local political, economic and business environment of your chosen market by using sources such as UK Trade & Investment and your business partners.

3 Explore the logistics in the region. Review and understand the entire supply chain in your sector and prepare for any likely red tape or bottlenecks.



Nkhensani Nkosi, celebrated fashion designer, entrepreneur, television personality and mother of four, in her Johannesburg studios, South Africa

with other local banks in countries in which they do not have a presence. That way, treasurers can benefit from their banking partner's knowledge of how cash management works both domestically and across the region, manage their counterparty risk effectively and request useful introductions to local contacts.

### Challenges and risks

Doing business in a predominantly cash society naturally comes with challenges and risks. These include finding ways to collect payments from customers, making payments to suppliers and employees, and ensuring the physical security of cash when it is moved around. Although there are ways of overcoming these challenges, operating with cash can be expensive and logistically challenging. The good news is that many African countries are starting to move away from heavy reliance on cash as more people have access to financial services. In addition, cheque usage is also declining in favour of electronic transfers.



Infrastructure is also likely to be a concern for treasurers whose companies have operations in the sub-Saharan region. They want visibility and control of their cash across the different markets, so good communication is vital. But standards of technology and telecommunications vary widely across the region and internet coverage is often very low. Most banks offer internet banking to corporates although there can be restrictions – for example, on cross-border payments – and corporates can end up with a different internet banking product in every African country in which they operate. SWIFT and host-to-host connectivity have become commonly used in South Africa, which is one reason why many multinationals choose to set up regional treasury centres there.

Repatriating cash back to the centre remains an ongoing challenge for multinationals due to the tight exchange controls that exist in many countries, such as Angola, Mozambique and Nigeria. This means that treasurers have to pay acute attention to liquidity management in sub-Saharan Africa and familiarise themselves with local regulations so that subsidiaries are not financed in such a way that cash cannot be taken out of them. For example, when money is removed as an intercompany loan, issues such as transfer pricing or thin capitalisation may arise, so it is important to seek specialist tax advice.

There is only limited opportunity to use cash concentration and notional pooling structures in Africa, therefore treasurers must find other ways to maximise returns on the cash that they hold in the region.

### The opportunity

Sub-Saharan Africa is already the fastest-growing region in the world after Asia and the IMF has predicted that seven out of the 10 fastest-growing economies in the world will be African by 2015. These are Angola, Congo, Ethiopia, Ghana, Mozambique, Tanzania and Zambia. So the potential for corporates that decide to do business there is obvious. Nevertheless, it is important to remember that, according to the UN, nearly half of all Africans live below the poverty line, where they have less than \$1.25 a day to live on, and another 30% exist on between \$1.25 and \$2.50 a day. Those statistics alone reveal the gulf that exists between sub-Saharan Africa and the developed world. That's why it is vital that corporates looking to move into the region do their homework properly before setting up operations. ♥

### BARCLAYS AFRICA GROUP

In August 2013, Barclays Africa Group, a consolidated group of Barclays' African subsidiaries, began trading on the Johannesburg Stock Exchange. Africa is the group's largest region after the UK and US, and contributed 11% of Barclays' first-half profit before tax.



Maurice Cleaves is global head of cash management at Barclays Bank



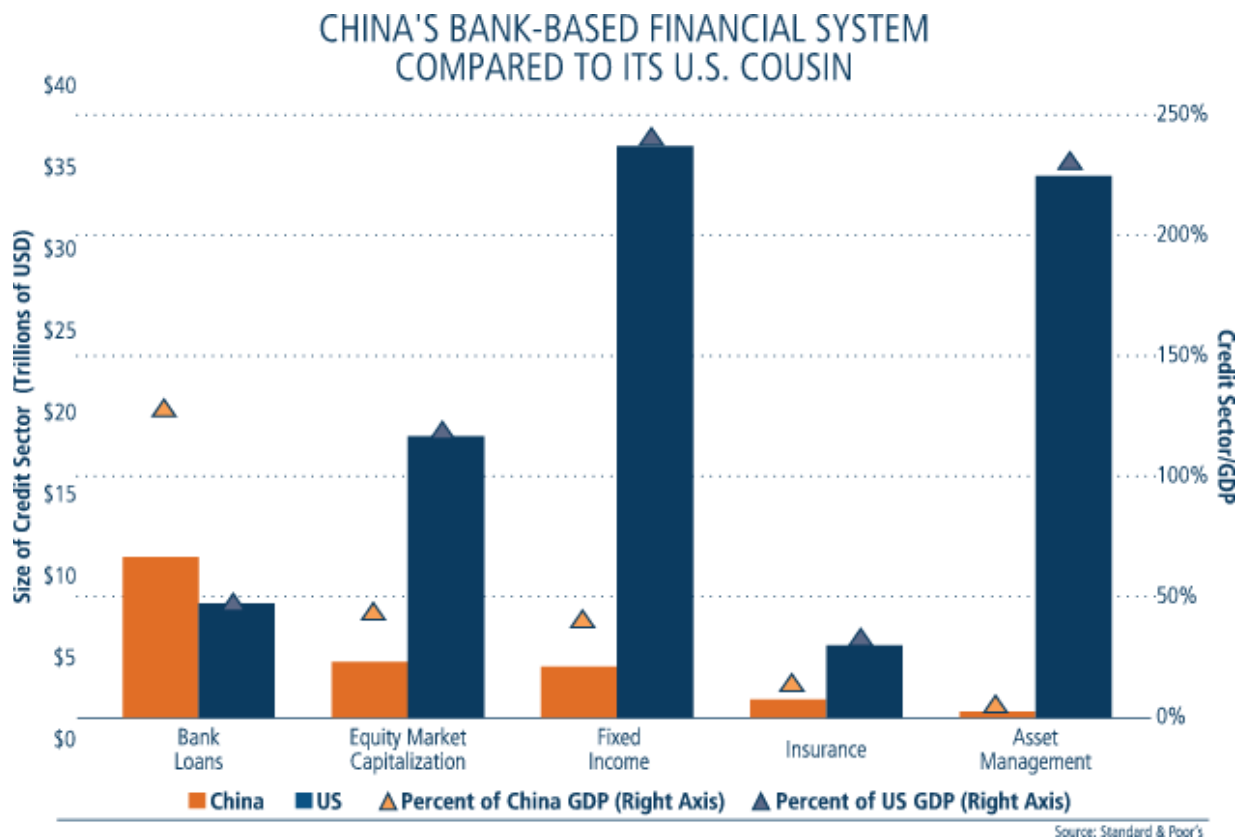
## China, Article: China's Financial System: Does a Crisis Lurk in the Shadows?

By Payden & Rygel, Los Angeles, California, USA, September - October 2013, Point of View, Our Perspective on Issues Affecting Global Financial Markets

Economies and financial systems are a bit like rivers. Restrict and constrain them you might, but contain them you will not. Every flood season and every financial crisis the forces of these natural systems humble the talented engineers trying to set them in line with human designs.

In no other economy do we see the contest between natural market forces and human engineering more clearly than in China. In fact, much of the “mystery” about the Chinese economy—the low level of household consumption as a share of gross domestic product (GDP), the real estate bubble, the Internet videos documenting empty shopping malls and high-rise apartments, the stories about exorbitant interest rates charged by non-bank entities in the shadow banking system—arises from market forces encountering a strict and unbending institutional framework imposed by intelligent economic engineers.

Simply shifting policies to liberalize interest rates or spark a “rebalancing” may not be as smooth as the financial markets anticipate. As with a mighty river, no matter how good and how bright the minds at work are, just because humans wish it wouldn't flood into a certain valley doesn't mean it won't.



**FINANCIAL SYSTEMS THEMSELVES  
ARE A BIT LIKE RIVERS.  
RESTRICT AND CONSTRAIN THEM YOU MIGHT,  
BUT CONTAIN THEM YOU WILL NOT.**

## **THE MISSISSIPPI**

The Mississippi River is responsible for the state of Louisiana, depositing sediment and creating landmass over thousands of years. It could not have done so by remaining in one channel. The river always took the shortest course to the ocean and if it had to switch paths to do it, then switch paths it did. But, with the development of Louisiana, the river became inconvenient—it became a threat. Human engineers attempted to corral and redirect its progress to serve human ends (they are still at work today).

Oliver Houck, professor at Tulane University, explains: “The greatest arrogance was the stealing of the sun. The second greatest arrogance is running rivers backward. The third-greatest arrogance is trying to hold the Mississippi in place. Human beings have tried to restrict the river to one course, that’s where the arrogance began.”<sup>1</sup>

The Army Corps of Engineers, like “roofers who had fixed a leak,” erected the Old River Control 500 miles north of New Orleans to keep the Mississippi from diverting from its current channel to a new one down the Atchafalaya River. In their words, “We harnessed it, straightened it, regularized it, shackled it.”

Why? The consequences of a naturally flowing Mississippi River were not comfortable for the world existing around it. Baton Rouge and New Orleans would be underwater if the Mississippi flowed free. By rerouting the river, commerce and industry thrive where otherwise they might not exist at all. Sound familiar?

Like the problems facing engineers in Louisiana, Chinese economic wizards must combat natural forces that do not fit comfortably with their desired ends. Liberalizing financial channels might dampen the growth of the export-focused Chinese economy. Capital seeks the highest return and those products in demand will find supply.

And as policy makers try to “rebalance” the economy from export and investment-led growth to consumption, they will have to try to root out and set right all of the old means by which money and goods used to find their way. Simple interest rate liberalization is not the answer.

And this is no small task. The Chinese economy we know today is the result of market forces adapting to policies attempting to impede it: just as the water from the Mississippi flows where it pleases and redirecting it is difficult, so too with the pathways of money and goods.





## THE EXCHANGE RATE REGIME

The first step in understanding the Chinese financial system is to understand its relationship to the rest of the world. This avenue is the exchange rate regime. The regime is best described as a “dollar standard.” In the 19th century, countries linked their currencies to gold (hence the “gold standard” moniker). Today, some countries link their currencies not to the yellow metal but to the US dollar.

The renminbi (RMB or yuan) has been pegged to the dollar since 1994. In order to establish the “link,” the central bank, the People’s Bank of China (PBoC) stands ready as a “dollar-buyer-of-first-resort.” That’s right, the Chinese central bank stands ready to buy dollars at a stated price/exchange rate.<sup>2</sup>

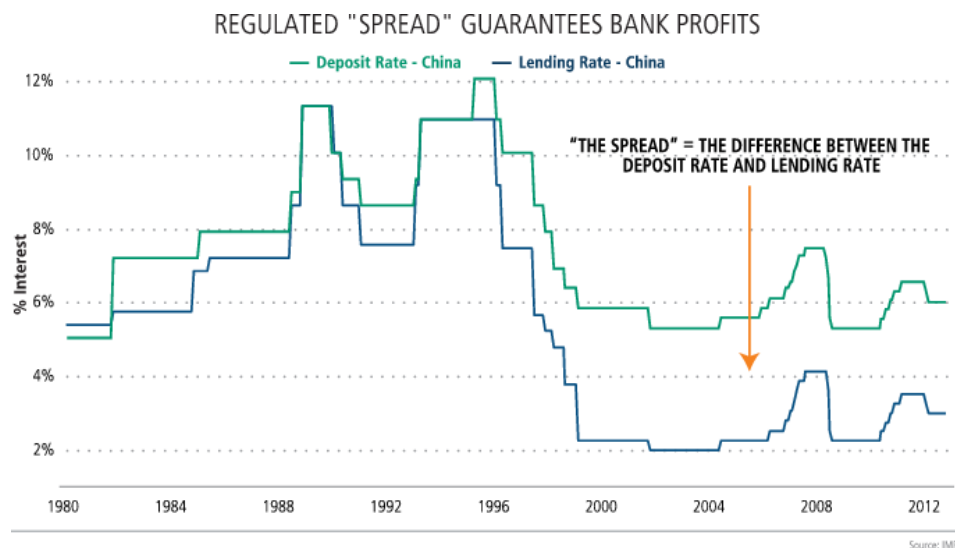
The purpose of this is twofold: first, like gold before it, the US dollar lends credibility to the domestic currency. Having only narrowly survived a bout of hyperinflation in the 1990s, China’s monetary policy record substantially improved after adopting the dollar.

**Much of the mystery about the Chinese Economy arises from market forces  
encountering a strict and unbending institutional framework  
imposed by intelligent economic engineers.**

But what if the rate differs from the market exchange rate? The evidence—in the form of accumulating dollars—will mount. Those with dollars will willingly disgorge their holdings. And that’s precisely what has happened in China. In effect, to the extent that the actual exchange rate differs from the prevailing market rate, a subsidy is provided to those who accumulated dollars.

That’s right: exporters. The global exchange of goods generates a steady flow of dollars. As the worldwide leader in goods exports, Chinese exporters have gained handsomely since the country’s ascension to the World Trade Organization (WTO) in 2001. In 1990, China’s exports accounted for 13% percent of GDP. By 2007, exports accounted for 56% of Chinese GDP—both a staggering rise and, for lack of a better word, imbalance.

In mid-2005, China modified the peg and the RMB has appreciated modestly since, rising by about 30% in real (inflation-adjusted) terms—but the accumulation of foreign exchange reserves (many in US dollars) topped \$3.5 trillion. Absent the PBoC acting as a dollar-buyer-of-first resort, the situation would be different. Under a free floating exchange rate regime, current account surpluses along with booming cross-border (“foreign direct”) investment over the last decade would have sent the RMB higher against the dollar much more quickly than policymakers (“the engineers”) had in mind. The consequence would also have been higher interest rates and slower economic activity than we witnessed.



## THE INTEREST RATE REGIME

As a direct consequence of the exchange rate regime, China’s domestic financial system is flooded with liquidity. By purchasing dollars (assets) on one side of its balance sheet, the People’s Bank of China creates a new liability (RMB deposits) on the side of its balance sheet. The banking system, in turn, holds these RMB deposits as “assets.”

Of course, this fact is not lost on the system engineers. How to control this flood of domestic liquidity? China imposes an implicit tax on the banking system by forcing banks to hold RMB-denominated deposits (“reserves”) and securities (such as central bank bills) that may offer sub-par yields. In fact, this cumbersome method for controlling liquidity means the Chinese banking systems reserve requirements are among the highest in the world at over 20% (compare to the US at 2%). This serves to “soak up” the excess liquidity and keep a lid on consumer prices.

This also explains extreme volatility experienced in the Chinese interbank market. Since the PBoC does not conduct regular open market operations like its developed world cousins to “smooth out” volatility in the overnight interest rate, the actual rate is subject to the tug and pull of liquidity. If the demand for liquidity from the banking system surges, so too does the rate of interest paid on overnight reserves.

But, to keep China’s banks profitable and avoid a repeat of the 1990s “bad loans” episode, the PBoC sets a “ceiling” on deposit rates and a “floor” on lending rates (see Figure 1 on page 7). The difference between the two—called the “spread”—provides a guaranteed source of profit to the banks. Governments often employ interest rate schemes to fix banking system problems—as was evident in the US banking system from the Great Depression in the 1930s until the mid 1980s.

## Did you know?

The problem of an evolving system trying to provide credit is not limited to present day China. Improbable as it may seem, consumer credit in the early 20th century in the United States looked very similar. A burgeoning urban population with new found consumption preferences needed ways to pay for the new goods and services available in the marketplace. So great was the demand for credit, early consumer lenders (“loan sharks”) charged annual rates of interest in excess of 1000%. How could they get away with such exorbitant charges? Such high charges exist today. Indeed, credit-starved consumers are always willing to pay later for money today.

## THE SHADOW BANKING SYSTEM

The financial press is abuzz with stories on the Chinese “shadow banking” system. What explains its recent rise?

First, households earn less than the rate of inflation on their bank deposits. The negative real interest rate is effectively a tax on household income and savings. Households must save even more than otherwise to keep up with rising prices. Alternatively, households speculate in the stock market and the residential real estate market. This explains to some extent the surge in China’s A-share index in 2006-2007 and the more recent run-up in housing prices. Across China, price-to-income (the most basic gauge of housing “froth”) is 10-to-1, a reflection of speculative fervor.

Second, a “market-determined” interest rate on loans is likely higher than the PBoC’s administrative lending rate. In an economy growing at 7% annual rate, there is a demand for credit that exceeds that which the regulated banking system provides.

**Seen in this light,  
a nascent “Shadow” Credit System seems inevitable.**

There is a need for a banking system willing to provide deposit services and credit services. This is what engineers often miss: they can regulate “money,” but credit is a more slippery thing.<sup>3</sup> Sprouting up across China are trust companies offering “wealth management products.”

Standard & Poor’s estimates that the size of China’s shadow banking industry was RMB22.9 trillion at the end of 2012, equivalent to 34% of total outstanding loans in the banking sector and 44% of the country’s economic output in 2012.

For example, the wealth management products often yield around 8% per annum, compared to bank deposit rates of between 3-4%. These wealth management products offer short-term maturities (often just one month) and “shadow” financial institutions lend these funds to companies (such as home builders) at double-digit rates, compared with official lending rates of around 6%.<sup>4</sup>

Seen in this light, a nascent “shadow” credit system seems inevitable. First, households seek out positive real returns on their deposits. Second, fast-growing private companies—which despite the “Communist, State-controlled” Western view of

China comprise 90% of the growth in activity—borrow from non-bank lenders to get access to credit, often at exorbitant rates.

What's the chief consequence of this? Private bank credit in China surged in recent years. As a share of GDP, private credit rose to 120% at the end of 2012. Like the flood waters surging near the height of levees, authorities are powerless to rein in rampant credit growth.

## **IMPLICATIONS FOR INVESTORS**

In 1973, the Mississippi River flooded, overwhelming the greatest technological barrier men had been able to put in its way. Is this what we should expect in China? Our best bet is that nature defeats the engineers' best efforts.

The good news is that China's shadow banking sector is much smaller than its North American and European cousins. As a share of GDP, US shadow banking reached more than 100% of GDP by 2007. Also, as shown in the Did You Know? box on page 4, China's financial system is dominated by banks (compared to the US). While this may cushion the blow of any panic it is not without the economic consequences discussed in this article.

Further, despite the negative connotation, the shadow system is serving the economy by providing credit-starved sectors with access to capital.

The bad news is that in terms of shadow banking, it's probably not the size that matters. If deposit-like instruments are subject to "runs" then the risk remains even if it is smaller than comparable systems around the world.

Whether shadow or traditional, bank runs "occur when large numbers of funding providers with near-term maturities decline to renew their contracts upon expiration."<sup>5</sup> No matter if the short-term debt is bank deposits or repurchase (repo) agreements, if the providers of funding don't rollover their short-term debts, cascading effects can cause entire markets to seize.

Worse still, as we detailed above, the existence of "shadow" institutions is prima facie evidence of economic and financial market distortions. While it is impossible to say what the outcome will be, it is possible to conclude that asset prices are distorted compared to what otherwise would be if the natural forces held sway over the economy instead of the engineers.

Specifically, in terms of investment activity, as a share of GDP, China's investment spending exceeded 40% every year since 2003, peaking at 48% in 2011. The high share of investment—particularly in capital-intensive manufacturing activity—is a consequence of policies pursued.

Historically, rapidly growing countries have difficulty sustaining such high levels of investment. Japan, South Korea, Thailand and Taiwan, briefly peaked at 39%, 40%, 43%, and 39% respectively. So this large portion of the Chinese economy will slow.

The key task—to keep China's GDP growing at a 7.5% annualized clip—would be to boost consumption to make up for the decline in fixed investment activity. What pace of consumption growth would be needed to offset the decline in GDP due to a slowdown in investment? On average, a 9.7% rate of consumption growth, which seems unrealistic.

The idea that consumption will replace investment also falls victim to the idea that in a multi-trillion RMB economy policymakers can substitute one large aggregate for the other. In reality, consumption depends on production activity.

Shifting production away from capital-intensive manufacturing to service-sector activities will impact consumption. Shifting to a more services-oriented production base will also require time—although it will ultimately benefit China as service-sector wages are higher than manufacturing wages by about 30%.

As with the Mississippi river, much of what we see in China is a result of previous engineering decisions. We doubt a transition to a different course will be smooth regardless of how skillful policymakers may be with their efforts.

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{ REGULATION }

# RICHARD RAEBURN

Treasurers must continually challenge the reshaping of the financial system

Some with long or perverse memories may just recall that when I retired at the end of 2008 as chief executive of the ACT, I had already taken on chairing the European Association of Corporate Treasurers (EACT). Earlier in that year – before the financial crisis plumbed its depths – I saw the core challenge for the EACT as one close to my heart given what we had been doing in the ACT: to build the internationalisation and potential of the treasury profession through sharing education and best practice.

And then the implosion of the global financial system changed everything. In 2009, we started to see how the G20 leaders planned to reform the system. A new – and by implication, necessarily more effective – approach to financial regulation was mandated at the highest political level possible. So it became the responsibility of legislators and regulators at EU and national levels to implement this expeditiously.

Since 2009, we have seen a veritable tsunami of proposals for financial regulation. None of this would have mattered terribly to the EACT and the treasury community had the proposals focused exclusively on global systemic financial risk without any direct relevance to the world outside the financial sector. This is not a trivial statement, I should add, since on many occasions I have argued in Brussels that regulators should take care in claiming that systemic risk in



## Our core focus has been around the regulation of derivatives

the crisis had any provable link with the best practice activities of corporate treasurers.

The global regulatory change campaign has, of course, kept the reduction of systemic risk as a central theme in its work, while also seeking to move away from the tarnished culture of 'light-touch', an approach so associated with the UK pre-crisis.

As soon as we saw the first draft regulatory proposals, it became clear that the real economy, represented by 'non-financial counterparties', faced a huge problem. A recurring theme in all the proposals has been regulators' abject lack of consideration for the impact on the users of the financial system as opposed to the impact on those whose business is contained within and limited to that system. There are many potential explanations of that

neglect. In my view, these range from the limited experience of those doing the drafting or preparing to implement (in the latter, if regulators have any 'real-world' background it will tend to be from within the financial sector) to the huge pressure of the deadlines they face. And the power of the banking lobby in Brussels and Washington should never be underestimated.

So the story of what we have been doing as the EACT since 2009 is dominated by one fundamental concern: to ensure that proposals for financial regulation take proper account of their impact on the real economy. Our core focus has been around the regulation of derivatives (the European Market Infrastructure Regulation), the implementation of Basel III

(Capital Requirements Directive IV and Capital Requirements Regulation) and the financial transaction tax. I am proud of the success we have had in opening the debate on each of these and achieving better outcomes for the real economy. I am also proud of the way we have been able to work on this alongside major companies and national associations such as the ACT.

There is more still to be done, both on the regulatory areas noted above and on the emerging issues such as the regulation of money market funds contained within the EU's shadow banking initiatives. Although the language of debate – at least in Brussels – has changed and, I would argue, improved over the past four years, it should be an overriding priority to ensure that treasurers continuously challenge the reshaping of the financial system. Without such a challenge, unintended (or intended) consequences may hobble the contribution that the real economy has to make to economic recovery and growth. This is not a battle that the EACT will win on its own, but so long as I defer real retirement, I will be working to ensure that at least one voice is heard. ♥



**Richard Raeburn** is chairman of the EACT. Follow him on Twitter @RichardRaeburn

## **Europe, Article: CoCo – Bond Issues are Slowly Coming Out of the Doldrums**

Bank of International Settlement, BIS, takes note of an increase of the issuing volume. - Heterogeneous supervisory regulations for the recognition as capital buffer are still hampering. - Uncertainty about the ratings.

The market for “Bail-In-Bonds” is assorting itself: The volume of issuance of so-called CoCo-Bonds is increasing. But as a brake turns out to be the differing national supervisory regulations.

By Björn Godenrath, Börsen-Zeitung, Frankfurt am Main, Germany, October 1, 2013

Börsen-Zeitung, October 1, 2013. In the jargon of the financial industry they are called crunchy nicknames like “Sudden Death Bonds” or “Wipe Out Bonds” - this is talk of Contingent Convertible Bonds. In short “CoCo-Bonds”. With the issuance of such debt securities the banks want to guard themselves from new regulatory requirements, which also call bond investors to step in, in case of a bank failure. Bond investors, five years ago, were well off, when financial institutions like AIG or the Hypo Real Estate Bank were bailed out with taxpayers money.

### **Absorbing Losses**

In order to change this mechanism with regard to the sequence of being held liable, the (European) bank Supervisors came up with the idea, to create a new form of hybrid capital which is qualified as capital buffer of a bank, and which in a stress situation, and tied to certain conditions, is converting from debt into equity. Exactly this is, from the point of view of the Supervisor, the objective and the purpose of the CoCos: The security of the banking sector is being increased, before a bank in trouble is calling for the state; the risk is indeed transferred to the bondholders.

These, however, let this risk be compensated by way of higher coupons. Between 6,5% and 8% had to be offered to the investors in the issuances so far. The most industrious issuer so far is Barclays, which has taken up 4 billion Dollars by way of CoCo-Bonds. The conversion of these bonds into equity would occur, when the hard core equity ratio of the large British bank would fall below 7%. Investors do regard this mark as too hard, and they are urging the national regulator, to formulate the conditions in a softer way. But the Supervisor is not agreeing to this, as it recognizes such a CoCo-Bond as core equity only, when the hurdle remains at 7%. This could cause Barclays, to cancel its CoCo-plans, respectively to find other ways for the issuance of hybrid capital.

Data of Dealogic show, that the issuance volume of CoCo-Bonds has increased in this year: Eight transactions of a total of 8,5 billion Dollars so far are dwarfing the total of 7,8 billion Dollars of the entire previous year. Is the market for CoCo-Bonds now coming out of the doldrums?

The signs for this are good because of progress in executing Basel III, although the issuers and the investors are increasingly bewildered because of nationally differing qualifications of such hybrid capital, as capital buffer. This is getting even more intriguing, as, when it comes to recognizing as equity, also the rating agencies are having a say. So, in July 2013 frowning occurred, when freshly issued CoCo-Bonds of Crédit Agricole and of Danske Bank all of the sudden lost their relevance for the rating at Standard & Poor's (S&P), after the creditworthiness raters had changed their rules for the recognition of subordinate debt securities as Risk Adjusted Capital (RAC).

To this responded the French Bank with a new CoCo-Issuance covenant, by which, in addition to the customary clauses for the conversion, also a rating – clause was added: The paper will be changed into a regular tier-2 instrument, should S&P change its rating method, and the coupon will be adapted accordingly. The bond itself - the first CoCo-Issuance in Europe - is being rated by S&P and Fitch with BBB-. The threshold for conversion, like at the Barclays issues, was set at 7%, after it had at first been attempted, to fix it at 5,1% with the option for additional payment obligations, should the core capital ratio recover. This model of a flexible threshold with proportionate conversion from debt capital into equity capital, though, has a malus, when a rating for this kind of security is being given.

This example does well illustrate, which complications are involved with CoCo-Bonds. National Supervisors, and private rating agencies, have often differing views about how to treat this capital market instrument. The heterogeneity in the Supervisory Sphere, again, is preventing a uniform rating methodology, criticizes the BIS. More than half of the CoCo issuances so far do not have a rating, Moody's only in May 2013 stepped into rating CoCo-Bonds.

## **Threshold for Conversion**

At S&P the situation is this, that the CoCo-Rating is at least two to three notches below the credit rating of the issuer, and not allowed to be higher than BBB+. On average, so the BIS analysis, the CoCo-Ratings must be positioned one notch lower than other subordinate debt. In the bond covenants one can also fix so-called "Discretionary Triggers": The conversion into equity is decreed by the Supervisor, when it regards the solvency of the bank as endangered and does therewith activate this CoCo-buffer.

In addition to this, the BIS points to an inherent conflict which is braking the issuance of CoCo-Bonds. It is said that there is a conflict of interest between the Supervisors of the issuing banks, and the supervisors of the bond investors who invest in such issues. The Bank Regulators have the interest, to pull as much capital into the automatic Bail-In. The Supervisors of the CoCo-purchasers must take care instead, that the potential losses of the bondholders remain within limits. According to this, they would be directed into debt instruments with a lower loss absorbing capacity.

To be observed as well, according to BIS, is, which names from the financial sector are buying themselves into Bail-In-Bonds. When, as is the intention, the systemic risks of the



sector, are to be restrained, then systemically relevant banks and very large institutional investors should not underwrite CoCo-Bonds.

That the CoCo-Bonds so far are an almost purely European phenomenon, has as cause, that the US-Supervisor does not regard this instrument as a capital buffer. In the USA the recognition is influenced by the latest financial crisis, when hybrid instruments turned out to be useless for the absorption of losses. In order to be admitted into the league of tier-1 capital, debt instruments would have to be accounted for in the balance sheet as such capital - which excludes the recognition of conditional capital, such as debt capital, which is convertible into equity. But, still, the last word has not yet been spoken on this subject, as US-Bank Holdings are being held to give to their financial structure a more long term nature - and this could pave the way for CoCos.

That the issuance of Cocos in the European area is gaining momentum, is, according to the BIS, also the consequence of progress at the definition and the implementation of the Basel III regulations. Depending on the design, the Cocos can be recognized as tier-1 or tier-2 capital. In order to be recognised as tier-1 capital, the trigger must be set high - the minimum here for a hard core capital quota is at 5,125%. In addition, the tier-1 recognition is also tied to issues without a set maturity date, otherwise it is positioned into the tier-2 league.

All in all, it is said, that the issuance model is strongly depending on the way, with which the supervisor on the national level is steering the introduction of Basel III.

### Hybrid Capital, as Demanded by the Capital Markets, source BIS Volume by Issuing Banks from Country, in percent:

	<u>Percent</u>
<b>Great Britain</b>	<b>20,7</b>
<b>Switzerland</b>	<b>15,2</b>
<b>Australia</b>	<b>7,1</b>
<b>Netherlands</b>	<b>5,7</b>
<b>Ireland</b>	<b>4,1</b>
<b>Others</b>	<b>17,1</b>

### A Patchwork Carpet

The result is a patchwork carpet, which reflects the regional needs of the banking sector. The British Banks, greedy for loss absorbing capital, are with a volume of so far 21 billion Dollars the largest CoCo issuers. Also the Swiss Banks became active, after their supervisor requested, that for 9% of risk weighted assets, loss absorbing capital has to be held against.

The Swiss Banks acted quickly and took up 15 billion Dollars through Bail-In Bonds. The BIS believes, that in Europe, after passing the EMIR Directive, a surge of CoCo issuances will follow.

The factor legal security is, though, not yet given in an important field, as this is in the hand of national legislators and regulators. Only when the fiscal authorities are treating the CoCos as debt, can the banks account for their interest expenses as tax deductible item. But in some states the tax deduction is not installed.

According to BIS data, 64% of the CoCo issuances have a tax deductible coupon, at 20% this is not the case. The tax treatment of the remaining 16% is under examination. A rogue is, who in view of this is not thinking about a harmonization of tax regulations in Europe.

Source: Börsen-Zeitung Nr. 188, October 1, 2013. All rights reserved. Copyright Börsenzeitung Frankfurt am Main, Germany. Responsible for translation: GEFIU, Association of Chief Financial Officers Germany; translator: Helmut Schnabel

# A UNIQUE OPPORTUNITY

**SEPA IS THE ENABLER OF MORE STREAMLINED TREASURY PROCESSES, GREATER CASH VISIBILITY, TIGHTER CONTROLS AND IMPROVED RISK MANAGEMENT. MICHAEL TURNER EXPLAINS HOW**

When treasurers think about the Single Euro Payments Area (SEPA), their first focus is naturally on the issues that ensure compliance, such as IBAN collection and project plans. Yet SEPA is not merely a compliance project, but also an enabler for improved efficiency, which can be applied with far-reaching benefits throughout the eurozone, Europe – and indeed, globally. It is thinking along these lines that can make a real difference to treasury operations.

## Centralisation

The opportunity to centralise processes that have historically been fragmented according to differing national laws and regulations is one of the main business advantages of SEPA. For receivables, in particular, the SEPA direct debit scheme is transformational, since it replaces the legacy systems of 17 different countries with a single instrument. In markets where direct debits have yet to be widely used, it therefore provides a convenient opportunity to move customers away from making cash and cheque payments, which can be inefficient and disrupt workflow (for example, by forcing sales teams to chase payments).

As a result, treasurers can benefit from faster access to cash (as well as the ability to move it into a central

location more quickly), greater visibility and better control. These combined factors should serve to boost working capital, generate operational efficiencies and reduce risk – advantages that will provide grounds for using SEPA as a driver for the future establishment of payment and collection factories.

## Automation

Thanks to the structured fields in ISO 20022 XML, the designated message format for SEPA transactions, groups will be able to denote when a payment is made on behalf of ('POBO') a certain subsidiary. Historically, it was often the case that the data, which did allow for such denotation, would become truncated in local legacy clearing systems.

## SEPA: WHERE ARE WE NOW?

◆ **For companies based within the eurozone, or with eurozone subsidiaries, the end date for compulsory migration to the SEPA direct debit (SDD) and SEPA credit transfer (SCT) schemes is 1 February 2014.**

◆ **For companies operating outside the eurozone, the end date for migration is 31 October 2016.**

◆ **Italy and Spain have requested a waiver of the rule that states all parties must provide files in the ISO 20022 XML format to their bank by 1 February 2014. As a result, corporates in these countries do not have to deliver files using the XML format to their bank until 1 February 2016. In the meantime, they do need to provide the relevant data to allow their transactions to be processed as SDDs and SCTs.**



As a result, a group that has one IT system for payables could use a single bank account for all its subsidiaries and beneficiaries, while still being able to identify the paying subsidiary. In addition, the standardised message format will enable automatic reconciliation between a group's enterprise resource planning system and its bank statement.

## Rationalisation

SEPA migration provides an opportunity for treasurers to review the number of bank relationships, electronic banking channels and bank accounts that their group holds. Growth through acquisition often results in a plethora of legacy banking partners. SEPA is a chance to re-evaluate such relationships and rationalise their number, thereby reducing costs. The move to SEPA is also an opportunity for treasurers to negotiate a standardised pricing structure for their operations throughout the eurozone, which will provide uniformity and can benefit company profit and loss.

## Next steps

When it comes to SEPA, the utmost desire of many businesses is a single euro

bank account for the entire group globally. At present, most companies are still a long way from that, with their sights firmly set on the end date, meeting compliance and making sure cash flows continue and salaries are paid throughout the transition. Once migration is complete, many will look to move to the next level by setting up a payment factory – and also a collection factory, if necessary – and reducing their bank accounts throughout the eurozone. Following completion of this process, they can then think about rolling out the ISO 20022 XML payment format to the global organisation. SEPA presents a unique, indeed golden, opportunity for transformation. It can only be realised, however, if treasurers treat compliance not as the end, but as the beginning. ♦



**Michael Turner** is head of cash management corporates UK & Ireland at Deutsche Bank

Deutsche Bank

## **Europe, Article:**

### **EMIR Edges Nearer**

By David Retana, Managing Director of Regis-TR,  
from **The Treasurer**, September 2013, ACT, UK

With European regulation of derivatives coming into force in 2014, David Retana outlines some pointer for choosing a trade repository

Please note: After first publication of this article, the enforcement date of EMIR has once more been moved further out to 1 February 2014.

The past few years have been awash with a continuing tsunami of new regulations. Understanding fully what it means to both financial and non-financial organisations is proving a challenge – not only in terms of what the regulations mean and how they all fit together, but also in terms of what needs to be done in order to comply with the changing environment.

It is no wonder that the back offices of financial services providers and corporate treasurers are anxious. The implementation cost of complying with all these regulations is swallowing a huge chunk of their investment budget. Some market players estimate that around 70% of their budget is currently being disbursed on internal projects focused solely on regulatory compliance. It is not unusual to see multimillion-euro bills for IT development alone.

Setting the financial considerations aside, uncertainty also exists over the specifics of these new rules and, although this is slowly being ironed out, it is a cause for concern. Earlier this year, the European Market Infrastructure Regulation (EMIR) published its Commission Delegated Regulations, which entered into force on 15 March 2013. Although there are still possible question marks around the timing for the implementation of EMIR, we now have a clear indication as to what this regulation will mean to the derivatives industry and what we must do to prepare.

### **What will EMIR mean for you?**

The European Securities and Markets Authority (ESMA) is the regulator responsible for the publication and implementation of EMIR, which was originally proposed to come into force earlier this year. Due to various hold-ups, the timeline has slipped into 2014, with an enforcement date currently set at 1 January, nearly a year later than originally expected. While this delay will undoubtedly offer some relief to many – particularly buy-side players – complacency would be a mistake. Time is running out and once the trade repositories have been granted their licence by ESMA – now scheduled from the end of September – there will first be the sizeable task of backloading the reporting of any trades undertaken since 16 August 2012. If organisations have not yet chosen their trade repository it is now time to do so or, at least, be well advanced in the process.

If you need a recap on what EMIR entails, here is a quick summary: EMIR will require that

certain standardised OTC derivatives be cleared through central counterparties (CCPs). Furthermore, all derivative trades – exchange-traded as well as OTC, whether or not cleared through a CCP – will have to be reported to a trade repository within the next business day. Any organisation – financial or non-financial – active in these instruments within the EU will be obliged to comply.

## Choosing a repository

**Whichever trade repository you choose  
must support your reporting obligations,  
handle reporting to regulators and provide  
you with a record of your registered contracts**

A number of trade repositories, such as REGIS-TR, a European-based repository, are already established. Each has a different scope of services and range of derivative types that they can handle. Choosing the right one will depend partly on how much you want your trade repository to do. For example, some will process exchange-traded as well as OTC-traded derivatives across all product classes; service corporates from within the EU; hold customer data exclusively in the EU; and, in future, will offer value-added services such as centralised collateral management and portfolio reconciliation. Other key selection criteria to take into consideration are the level of data protection, location of the database (EU-based or outside), service fees and simplicity in the communication and handling of the system, for example, mass uploads in XML and CSV. Certainly, whichever trade repository you choose must support your reporting obligations, handle reporting to regulators and provide you with a record of your registered contracts.

Another point to consider during your trade repository selection process is whether you want to undertake the trade reporting yourself or whether you would prefer to have your respective counterparty or counterparties handle it for you. This question very much depends on the extent of your activity with regard to the different product classes, the range of counterparties and their willingness to take on this reporting obligation of cleared and non-cleared derivative transactions at a reasonable price.

Like it or not, time is ticking and it may not be as simple as: “My bank or counterparty will do this for me.” Have you actually checked with your bank yet? Delegation could be complex and it is worth remembering that the legal obligation to report always remains on the corporate’s side. Do you yet know if your company falls under the category of ‘non-financial corporate plus’ (NFC+), meaning clearing, risk-mitigation and reporting obligation, or ‘non-financial corporate minus’ (NFC-), meaning reporting and some risk-mitigation obligation only, as defined in

ESMA's final report? Have you thought about the likely system changes that will be necessary to accommodate the new processing chain? Without a doubt, there is a lot to do in a short space of time.



### **What will these changes bring?**

So far, I have emphasised the challenges involved in preparing for EMIR. Now let us look at the benefits EMIR will bring to the financial services industry as a whole, some of which will apply to non-financial corporates as well, depending on their use of OTC derivatives and their existing processes. The biggest impact organisations should find post-EMIR is that they will have to deal with less paperwork. Long, complicated paper trails – as seen currently in the OTC derivatives market – will become confined to the wastebasket. EMIR's requirement that large numbers of OTC derivatives be cleared through central counterparties, confirmed on electronic platforms where available and reported to trade repositories, necessitates a much greater level of standardisation than can be seen currently in back offices.

In the past, OTC derivative trading has been a complicated and bilateral world. This is now set to change as standardisation will naturally result in a much more efficient process. This, in turn, will lead to less risk and greater security while the reduced paperwork will mean quick and lean processing – which will be far more environmentally friendly, too. And, for your company, having a centralised view of all your exposures that can be accessed at any time via a reporting and query tool will undoubtedly bring rewards.

## Looking for neutrality

Neutrality should also be an important aspect of a trade repository's service to its clients. EMIR, and its US counterpart Dodd Frank, will require all market participants to share their derivatives data, structures and strategies with trade repositories. Exchanging information in this way may leave some players a little worried that they may be giving information to a trade repository affiliated with a competitor.

So organisations may prefer to search for a trade repository that is not participating directly on its own account in the derivatives market and is therefore completely neutral to the information received, and which already has experience in data capturing and storage.

In conclusion, it is important to select your trade repository wisely because repositories will be here for a long time and all indications are that their scope will increase beyond derivative contracts. Many of the upcoming regulations, such as shadow banking regulation, the Regulation on Energy Market Integrity Transparency, the Markets in Financial Instruments Directive II and others, appear to indicate that trade repositories will be the EU regulators' data hub of choice for a range of other financial instruments, such as asset-backed securities, repo and lending transactions, wholesale energy contracts and more. You and your trade repository are set to have a long-term relationship.



**David Retana is  
managing director  
of REGIS-TR.  
Contact him at  
[dretana@regis-tr.com](mailto:dretana@regis-tr.com). For more  
information, see  
[www.regis-tr.com](http://www.regis-tr.com)**



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G20 Summits > St. Petersburg Summit



## G20 Roadmap Towards Strengthened Oversight and Regulation of Shadow Banking

September 6, 2013, St Petersburg  
[\[PDF\]](#)

November 2013	<b>International Organization of Securities Commissions (IOSCO)</b> will contribute its analysis of the global hedge fund sector to the <b>Financial Stability Board (FSB)</b> within the scope of the FSB's regular shadow banking monitoring exercise so as to enhance transparency and risk monitoring.
November 2013	<b>FSB</b> to publish results of its third shadow banking monitoring exercise.
2013 4Q	<b>FSB</b> to conduct its comprehensive quantitative impact assessment on haircut proposals for non-centrally cleared securities financing transactions.
End of 2013	<b>Basel Committee on Banking Supervision (BCBS)</b> to develop a supervisory framework for controlling large exposures (including exposures to shadow banking entities).
March 2014	<b>BCBS</b> to develop internationally consistent, risk sensitive rules for capital treatment for banks' investments in equity of funds (including funds engaged in shadow banking).
2014 2Q	<b>FSB</b> to complete recommendations on minimum standards on methodologies for calculating haircuts on non-centrally cleared securities financing



	transactions and for the proposed framework of numerical haircut floors.
2014	<b>FSB</b> to develop information-sharing process within its policy framework for other shadow banking entities by March 2014, start information-sharing thereafter, and report its progress to the G20 FM and CBG in late 2014.
2014	<b>IOSCO</b> to launch peer review on member states' implementation of its recommendations regarding money market funds (2012) and report its progress to the G20 in late 2014.
2014	<b>IOSCO</b> to launch peer review on member states' implementation of incentive alignment regimes (including risk retention requirements) and report its progress to the G20 in late 2014.
2014	<b>BCBS</b> to provide update on progress made in implementing policy reforms to mitigate risks in banks' interactions with shadow banking entities.
End of 2014	<b>FSB data experts group</b> to propose standards and processes for global data collection and aggregation regarding repo and securities lending markets.
2015	<b>BCBS</b> to report on the progress made in implementing the supervisory framework for controlling large exposures and rules for capital treatment for banks' investment in funds.
2015	<b>FSB</b> to launch a peer review regarding member states' implementation of its policy framework for other shadow banking entities. Based on the findings, the FSB should evaluate the case for developing further policy recommendations for relevant shadow banking entities and report the results to G20 FM and CBG in 2015.

[\[back to top\]](#)

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**Germany, Article:           The Risk Management is Becoming More Important**

by **Dr. Werner Brandt**, CFO SAP AG, Germany,  
Chairman of the programme committee of the 67<sup>th</sup>  
German Business Administration Day.  
Member of GEFIU, the Association of Chief Financial  
Officers Germany

The challenges for corporations are increasing: Rise of the Emerging Countries, digitalisation, financial market crisis, debt crisis. The multitude of crises is increasing uncertainty and risks - but also the number of chances.



Also five years after the outbreak of the worldwide financial and economic crisis the economic uncertainty in the global markets continues and is still restricting the framework for action for many German corporations, which operate in the field of global competition. Aside from coping with resolving the economic and state debt crisis, and with coping with the risks from the

financial sector and the currency system, however, the German corporations have to cope with additional global challenges: The Asian newly industrialised countries develop ever more into the motor for the world economy and they thus overtake more and more the role of the western industrial nations. Next to that, subjects like the aging of the population, the availability of natural resources, as well as the climate change, have to be considered. Also the close interconnection and digitalisation of the world economy are a challenge. Because of the speed in all these new developments there is significant uncertainty in the markets, and thus also in the corporations. It is to be assumed, that this uncertainty shall further grow in the future. Corporations and academia are therefore requested, to face these uncertainties and to accept having to cope with them.

Under the general theme “Managing Corporations in Unsecure Times” the 67<sup>th</sup> German Business Administration Day of the Schmalenbach Society for Business Administration in September 2013 ( the famous German association bringing together researchers from academia and managing practitioners from corporations) will shed light on the diverse facets of uncertainty and their effects on corporations. Experts from academia and industry will deal with chances and risks of managing corporations, the stabilising effects and costs of regulation, and possibilities and limitations of risk management in insecure times.

Since the breaking out of the crisis 2008, the corporations are hit by a flood of new regulation projects. Even when the regulation projects above all are directed at the stabilisation of the financial sector, the other sectors of the economy do not remain unaffected. Let us take Basel III, EMIR, or the threatening financial transaction tax, all these regulations have direct impact on the corporations of the real economy. The envisaged stabilising effects of the regulation efforts are often as little quantifiable as the costs for the corporations. Next to that, the uncertainties and risks of additional regulation in the area of corporations are difficult to calculate and thus create additional uncertainty.

Starting from the uncertainty, also the chances and risks profile of the corporations is changing. Therefore the risk management under uncertainty is having a significantly higher importance. Decisive for the success of the corporation is naturally the management of strategic chances and risks. Next to this, however, the risk management must also be tied into operational processes. Only when risk management is embedded in all segments of corporations, can risks be managed and chances be identified.

Without a net and a double bottom, today hardly can decisions be made. The Handelsblatt journal recently had the title “German Risk Abstention”. Who is not running risks, will as well fail to capture chances. Especially in insecure times, entrepreneurial decisions are therefore a must. Only thus can corporations meet crisis and insecurity in an undamaged way.

But achieved can this be often only, when one is dealing in a targeted way with innovation management - be it with regard to new markets or to new business models. This is all about developing, in a changing market field, new ideas in a systematic way, to weigh the chances and risks, and to promote proactively the changes of the markets, and even manage them in a new way - by way of new innovative processes, products and services.

Examples for this are the energy sector and the automobile industry. These sectors on the one hand have to fight with global challenges such as the scarcity of natural resources and the

climatic change. On the other hand, the state intervention such as subsidies for special technologies, the subsidised electricity compensation for renewable energies, and the tax on energy feedstock, which one is associated with significant additional cost for the industry, are creating essential factors of uncertainty. Uncertainty, however, does not only imply risks, it is also associated with chances. So, the successful corporations in the automobile industry and the energy sector are using the uncertainties in the markets and use them as a chance, and position themselves well with new offers and business models like ecological electricity or the electro-mobility, in order to get successfully through the crisis. This can be observed in many industries and sectors.

Aside from the risk management, the entire financial sector is strongly challenged in the present situation. Existing processes and contents have to be adapted: Corporate planning and treasury have to be able to react in a flexible way to the changing environment. Planning processes have to be revised, and simulations are of importance. It is further needed, to rethink target attainment ratios and to implement early warning indicators.

The tax field is characterised by state budget consolidation and competitiveness of state tax systems, as presently shows the discussion about BEPS ( Base Erosion and Profit Shifting, as per OECD ). The effects of the financial transaction tax on the real economy are keeping busy the corporate tax department and the corporate treasury (financial planning).

Also corporate accounting is affected by increasing uncertainty: The new standard DRS 20 ( German Accounting Regulation Standard 20 ), which regulates the risk reporting in the company situation report in the annual report, now requires an extensive risks and chances report. In addition to this, the accounting standards of the standard setter IASB are permanently being changed. Next to the new regulations on accounting for leasing, the IFRS 9 standard for the accounting of financial instruments is presently being fundamentally revised. Not unmentioned must be the efforts of the standard setter with regard to the realisation of sales. The complexity of accounting is increasing significantly with these changes.

Corporate management and liability of corporate managing bodies are additional main themes of the congress. In a field characterised by uncertainty, the adequate recognition of entrepreneurial decisions in the corporate accounting is decisive. Especially investors do rely upon financial statements showing the economic situation of the enterprise correctly. The individual managing bodies of the corporation are responsible for this. Also the requirements for the yearly financial statements audit are growing due to the rising uncertainty and the increasing complexity. External auditors today do not only need profound knowledge of accounting, in order to correct in time possible mistakes. They also must have a deep understanding of the individual industry and factors influencing the market, in order to be able, to adequately audit the financial statements.

The audit committee of the supervisory board is also ever more challenged. Next to understanding the increasingly complex accounting standards, it is therefore necessary, that the evaluation has to be made in view of the specifics of the industry. The same holds true for the Accounting Enforcement Supervisor in Germany. The annual financial statement external audit, but also the work of the audit committee of the supervisory board, as well as the Enforcement, do make sure that there is a true and transparent accounting, and they thus - under the given uncertainties - are once more gaining importance.

As entrepreneurial decisions are more often questioned in times of strong volatility of the markets, special care has to be practised by the corporate decision bodies. The management boards, the supervisory boards, but also the external auditor, must increasingly look to it, in volatile times, to implement necessary mechanisms. This is demonstrated in the presently often voluntarily executed Compliance Audits and leads to the question, whether members of the decision making bodies of the corporations do need a personal risk management.

The challenges of the increasing digitalisation and the tight interconnection of the economy will also be subjects to be dealt with. The speed, with which financial information is spreading, is increasing rapidly.

With this, reporting to the media and communication are increasingly becoming factors of insecurity.

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**Germany, Article: Point of View: Fragmentation of Financial Markets is Damaging the Real Economy**

by **Dr. Matthias Zieschang**,  
CFO Fraport AG, Germany, Member of the Exchange  
Council of the Frankfurt Germany Securities Exchange,  
Member of the Board of Directors of GEFIU, the  
Association of Chief Financial Officers Germany



The real economy today, more than ever, is depending on an efficient access to equity capital. Here, the securities exchanges play a key role, which, however, is in danger due to the increasing fragmentation of the trading of securities. From my point of view, the stock exchanges organisation fulfil four core functions, which, directly or indirectly are a benefit for the real economy.

First, and beyond doubt is, that securities exchanges provide access for the corporations to new equity. This is also true for medium sized corporations, which, at the German securities exchange through step-in segments like the Entry Standard get the possibility, to access the exchange with acceptable cost.

Second, exchanges provide in the opposite way the chance to investors, to participate in the growth of the real economy. To these investors belong as well private investors - be it directly through a direct engagement in shares, be it indirectly through their participation in funds and in insurance companies. Thus, the exchanges also contribute to the creation of savings and to building up pension entitlements. This, too, is an essential element of a functioning economy.

### **Fairness and Transparency**

Third, the securities exchanges do organise markets for all participants in a transparent and fair way. In order to fulfil this task, they are being regulated. Thus, they not only create the possibilities for trading, but they also produce prices, which are steering the use of scarce resources in a market economy. And also with this, they do fulfil a central macroeconomic function, which indirectly also serves the real economy.

Fourth, stock exchanges do reduce risks. Most important here are the accounting and matching counters, linked to the trade desk, the so-called Central Counterparties and Clearing Houses, which are insuring the participants against the failure of their trading partners. Another mechanism for the risk management is for instance the interruption of volatility, meaning the initiation of auctions in single securities, when price volatility increases too much. Through this means the way back to an orderly market is being initiated. Last but not least, also the stability of the electronic systems contributes to the lowering of operational risks, systems on which the trade and the ensuing processes take place.

The research institute LiquidMetrix compares the liquidity of the competing stock exchange and non-stock exchange securities trading platforms in Europe. Xetra, the electronic exchange trading system of the German Securities Exchanges joint stock corporation, regularly comes out as the best, as well as regarding the narrowness of the bid-ask range, as well as regarding the depth of the order book for German standard shares. This result shows expressly, that a transparent and transborder trading system together with securities exchanges regulation, is the best basis for a liquid market.

In the USA, an ever smaller percentage rate of securities trading is taking place at securities exchanges. Less regulated platforms, outside securities exchanges, are instead gaining ground. Concomitantly fragile and prone to shocks has there become the securities trading, which show the examples from the recent past. The probably most known one is the Flash Crash of May 6, 2010. At this time, the DOW Jones Index fell in a few minutes by 1000 points - this was roundabout 9 % - and recovered after that quickly again. During this turbulent market phase, the value of single stocks fell by up to 99 %, so the effects for the real economy were really dramatic. Only afterwards regulations were introduced in the USA which shall avoid in future such chain reactions.

But also in the European Union, and since the introduction of the financial regulation directive MIFID, a development towards less regulated trading platforms has taken place. The trading through so-called multilateral trading facilities, MTF, has led to a fragmentation of the markets also in the European Union. Whereas, however, platforms like for instance Chi-X Europe, similarly to securities exchanges, act with a totally open order book and thereby contribute to market transparency, the totally unregulated “Over the Counter Trade, OTC“, is detrimental for the markets. The OTC-trade is big, in an undefined way, because it has no disclosure requirement. Observers estimate it to account for 40 % of the market.

This development is driven, one, technologically. Two, it is driven politically. Technologically, the electrification of the trade has led to a separation between market participation and presence at the location of the securities exchange. As a matter of principle, this is positive, because it allows for the bundling of liquidity across country borders. The present revision of the European Union financial market directive Mifid should, however, urgently lead to measures for preventing a further erosion of the stock exchanges trading for the benefit of OTC platforms. At least the transparency requirements at the “outside the stock exchanges trading” should be strengthened.

### **Significant Cost Increase**

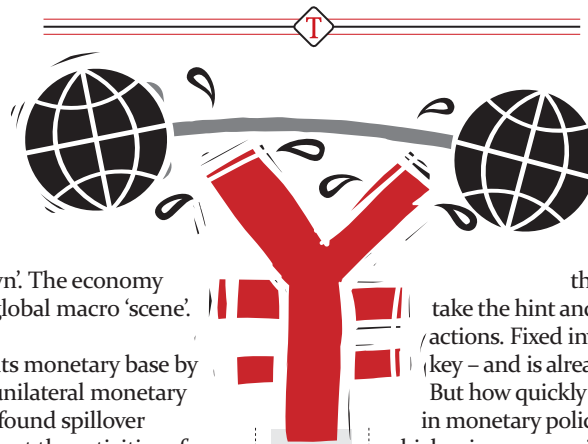
Detrimental for the liquidity are also the plans for the introduction of a Financial Transaction Tax in eleven European Union member countries. How negative the effects of such a tax are, shows the example of Italy, where this tax has been introduced in the beginning of March 2013. A broker, who is responsible for a quarter of turnover at the Borsa Italiana, has reported, that the costs per transaction have increased by 43 %, whereas turnover by comparison with the preceding months has sunk in March by one fifth. This is not only poison for this country financial market. Also the real economy is suffering from the thereby unavoidable lowering of liquidity - by way of an increase in the costs of capital.

Source: GEFIU, the Association of Chief Financial officers Germany. Responsible for translation: GEFIU, Association of Chief Financial Officers Germany ; translator: Helmut Schnabel



# WHY JAPAN MATTERS

The decision of the world's third-largest economy to double its money base in less than two years could seriously affect global capital markets



> Author TS Eliot once wrote: “However certain our expectations, the moment foreseen may be unexpected when it arrives.” For almost 20 years, investors – and corporate treasurers – have dismissed Japan as a market you wanted to ‘rent’, but never ‘own’. The economy was ‘a taker’ rather than ‘a maker’ of the global macro ‘scene’. That is, until now.

The Bank of Japan’s decision to double its monetary base by the end of 2014 is extraordinary. This is a unilateral monetary easing of global reach that could have profound spillover effects and unintended consequences. Forget the activities of the US Federal Reserve: the Bank of Japan’s move could be the exogenous monetary shock of 2013. Corporate treasurers need to get to grips with the Japanese experiment because it has the potential to transform the global financial landscape.

Not everyone may be familiar with Japan’s economic plan, which has a straightforward, if unorthodox, narrative. The radical Japanese government (supported by the US) seeks to revitalise Japan in the face of China’s rapid expansion. The problem is that boosting growth through microeconomic reform is tough to do at the best of times, and a deflationary environment does not make things any easier. So it has instructed the Bank of Japan to adopt a radical shift in monetary policy to end deflation. Doubling the money base in less than two years (something that’s never been seen in Japan over the past four decades) ought to go some way to taking Japan towards 2% inflation. The combination of micro reforms (especially labour market reforms), disincentives to hold cash (via negative interest rates thanks to higher inflation) and a 20%+ depreciation of the currency should be sufficient to persuade corporate Japan that the world has changed.

> The hope is that Japanese companies will stop ‘saving’ and start ‘spending’ to take advantage of the opportunities that this new policy ought to create. Increased fixed investment should go hand-in-hand with increased employment into a relatively tight labour market, which should boost real wages. The combination of rising incomes and rising asset values should, in turn, boost tax revenues and reduce the budget deficit. Japanese bond yields are likely to rise over the next three years towards 2-3%, but that need not be a disaster provided the economy is growing more strongly.

The reaction in the developed world has been fairly positive. While the Bank of Japan’s move is not synchronised with other central banks in terms of timing, it is nonetheless bold, unconventional and unorthodox... and therefore sits comfortably with the ‘War on Deflation’ that central banks have been waging.

The yen’s weakness is ‘collateral damage’ – and should only last until Japan’s Asian trading partners follow suit with their own policy easing. So what is there not to like?

A major uncertainty of this strategy is the speed with which corporate Japan will take the hint and respond rapidly to the Bank of Japan’s actions. Fixed investment by Japanese corporates holds the key – and is already historically low relative to consumption. But how quickly will corporate Japan respond to this change in monetary policy? Will corporates hold back until they see which microeconomic reforms are forthcoming? Will they wait to see at what level the yen stabilises? Having spent years outsourcing production to other parts of Asia because of the strong yen, just how quickly will corporate Japan move to onshoring? This is one of the biggest uncertainties, with some investors saying they need to be confident of double-digit capex growth next year before buying into the government’s new strategy.

> The longer the Japanese real economy takes to respond to the shift in Japanese economic policy, the more we should be focused on the investment implications outside of Japan. If the Bank of Japan is supplying liquidity at a faster rate than Japan can absorb it, that excess liquidity is likely to flow overseas – and that’s where things could get interesting.

You do not need to decide whether this Japanese policy experiment will succeed or fail. But what you do need to appreciate is that this has the potential to impact countries outside of Japan, and the potential to affect global capital markets. Could Japan’s new policy stance disrupt the Japanese bond market in a way that increases volatility in the US treasury market? What does the dramatic collapse in the yen mean for Asian trade flows and supply chains? Could a change of regime in Japan exacerbate or even destabilise a regime change in China through the violent depreciation of the yen against the Chinese renminbi? If Japan’s economy does not absorb the monetary ease, could that liquidity simply aggravate the global search for yield in a way that further misprices the global cost of capital?

The fact is that corporate treasurers have got away without thinking about Japan for much of their careers. Yet to ignore the spillover effects and unintended consequences of Japan’s policy now could ultimately prove career-limiting. Maybe TS Eliot was on to something. ♥

David Bowers is global investment strategist at Absolute Strategy Research. [www.absolute-strategy.com](http://www.absolute-strategy.com)

## Singapore, Country Report:

### A Small City State against the Rest of Asia

A control tower for the region: Singapore, with power, wants to reinvent itself and become more productive. This will be a stony way.

By Christoph Hein, Frankfurt Allgemeine Zeitung, September 30, 2013

Singapore, September 29, 2013. The fine praise from an unexpected side: “One knows Singapore as a financial and trading centre, where people are oriented towards money. But one is encountering a whole lot of human warmth, when one is moving around in this City”, said Aung San Suu Kyi. The peace nobel price winner and leader of the Burmese opposition would have had all the reason, to evaluate the South East Asian City State differently: Because over the years the generals of the military dictatorship and their business bosses did invest here. But the Buddhist Suu Kyi is looking for the positive. And she needs the Singaporeans, as they do train now a lot of government employees of the former military dictatorship.



Luxury and Security: *Singapore is one of the most expensive cities of the world*

The positive can easily be found in Singapore. As “exercise location in the tropical area”, and as “Asia Light” the city is often looked down to by those, who want to show, how strong minded they are with regard to Asia. Beyond doubt, the greenest and traffic wise best located metropolis of Asia is an outstanding model: Who lives in Jakarta, Manila, or Bangkok would rather like to exchange locations. If one would be able to pay for it. And if one would get a permanent residence permit. Singapore, for one, is one of the most expensive cities in the world. For two, the Singaporeans have become very choosy, about to whom they allow entrance.



## Singapore

Area (in square kilometers): <sup>1)</sup>	697
Population (2013, in Millions): <sup>2)</sup>	5,4
Inhabitants per square kilometer (2012): <sup>3)</sup>	7891
Growth of population (2011, in Percent): <sup>4)</sup>	2,1
GDP ( 2013, in billion Euro )	212,4
GDP per Inhabitant, in thousand dollar, 2013	53,9

This is doing damage to the city. Because it had been founded as trade post by foreign immigrants and nothing else it is today - dependent on talents, who immigrate. The city without raw materials grew with the region. By way of an extremely smart investment policy, she has always been two steps ahead. The government, with billions of money, has incentivised the incoming of industries and of high calibre scientists. But a few months ago, a corporation like Continental could not get hundreds of engineers into the city, whom it needed for a new factory. And luxury hotels do not find anybody, who cooks, sweeps, or makes the beds.

Almost overnight, the veil of uncertainty fell over Singapore. For this the government is at least co-guilty: It made the population insecure with the announcement that on the rocky island shall live roundabout 6,9 million people by 2030. Today it is already 5,4 million tight together. Would one apply this ratio to Germany, then in this country would live 2.65 billion people. But Singapore needs fresh blood, the birth ratio is threatened to fall, the number of retired people will triple to almost a million up to 2030. Roundabout 2,5 million foreign workers are said to be on the island by 2030. Anxiety jumped up with regard to foreign infiltration, especially from “China-Man”, as the Singaporeans like to call the Mainland China Chinese, coming into the City. The People’s Action Party, the leading party since the foundation of the state, in former years often governing like a landlord, came under pressure. And became nervous. And started such a machine fire against foreigners, that many in the city state did not recognize it any more.

At the same time, the younger Singaporeans know nothing but success: The harbour and the airport are among the best and biggest in the world. 8 Billion Dollars the government is spending for the further building of the harbour. Calculated in terms of purchasing power parity, the living standard of the Singaporeans comes only behind the one of Qatar and Luxemburg. On the small island live 101000 people who can invest more than 1 million Dollars, and 21 billionaires. With a good half billion Singapore Dollars ( 295,16 million Euros) the state is helping the poor for a lifetime. But because the rich become rich faster, the gap between poor and rich is getting ever bigger. The well to do are lured by the city with safe money investments, private airport, casinos, formula 1 racing, luxury real estate and top hospitals. Corporations are coming, because one lives here comfortably, but at the same time one can reach in five hours India or China, and because politics are so reliable as the tax rate is low. In asset management the city is in a leading position, for a similar position in raw material trading she is just now competing with London.

“Singapore shall become a control tower of the region”, speaks Yeoh Keat Chuan out as slogan, the managing director of the very active business

promotion agency EDB. With this he means: Singapore wants to have the corporate headquarters, the research institutes, and the trading location for South East Asia. Roundabout 9000 European companies are incorporated here, 4000 from India, and 3500 from mainland China. Low corruption, patent protection, security, are the aces in the sleeves of the city.

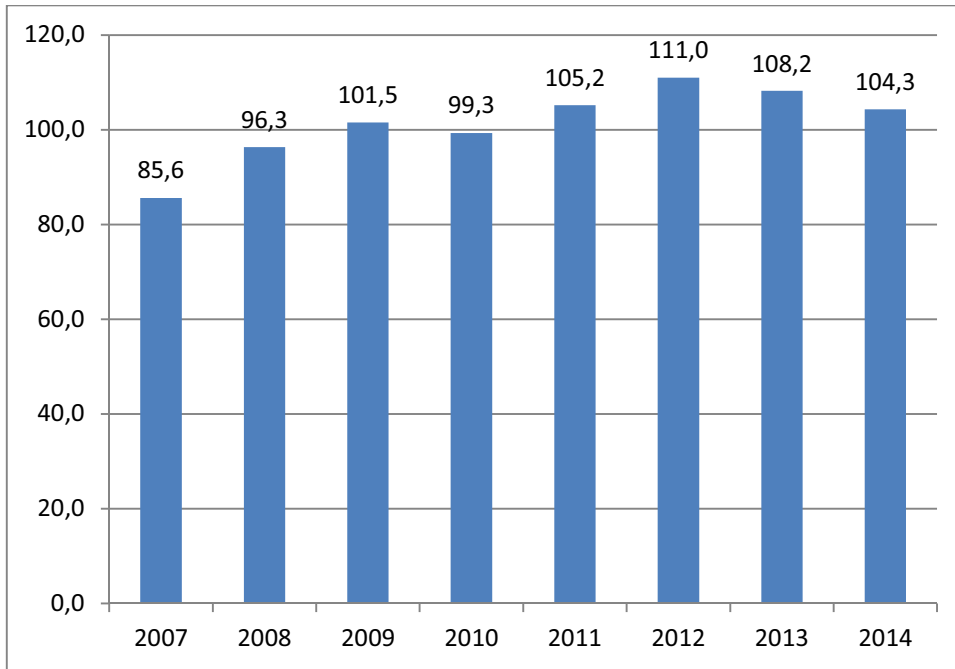
For production, however, the island is getting too expensive. The production shall emigrate to the free trade zone in the Indonesian Batam, or in the rapidly growing industrial zone Iskandar, a stone throw away from beyond the border in Malaysia. At the same time, the government of the predominantly Chinese descendant population is forging alliances around the globe. Even European negotiators gave up their request for human rights, in order to get a trade treaty with the republic.

But what is getting the Singaporeans going? It seems to be a fear that looks strange to foreigners: The fear from losing importance, to get overrun by the huge neighbouring countries, and losing security. This reaches up into the centre of power of the country, perhaps it has even its cause here: Lee Hsien Loong, prime minister, son of the founder of the state, husband of the head of the billions heavy state fund Temasek Holdings, is expressing it this way: "We are a small city state, .... We shall always be vulnerable to the changing circumstances of life in the rest of the world, as the financial crisis has shown. If we fail, nobody will bail us out. In a fast changing world, this will never change for Singapore". Thus the only help is, to increase the speed. "Business people, who are not adapting themselves, in order to survive in the high cost scenario of the city, will move away or fail", says Michael Wan from Credit Suisse. Productivity will soon be everything. "We look at what is restricting us. And then we deliberate, how with less land, less workforce, and less resources, we can continue to grow", speaks out as formula Teo Chee Hean, the deputy prime minister. Is there anything remaining, which the pulsing city state can learn from the very poor Burma, Missis Suu Kyi? "But yes: a somewhat more relaxed view of life".

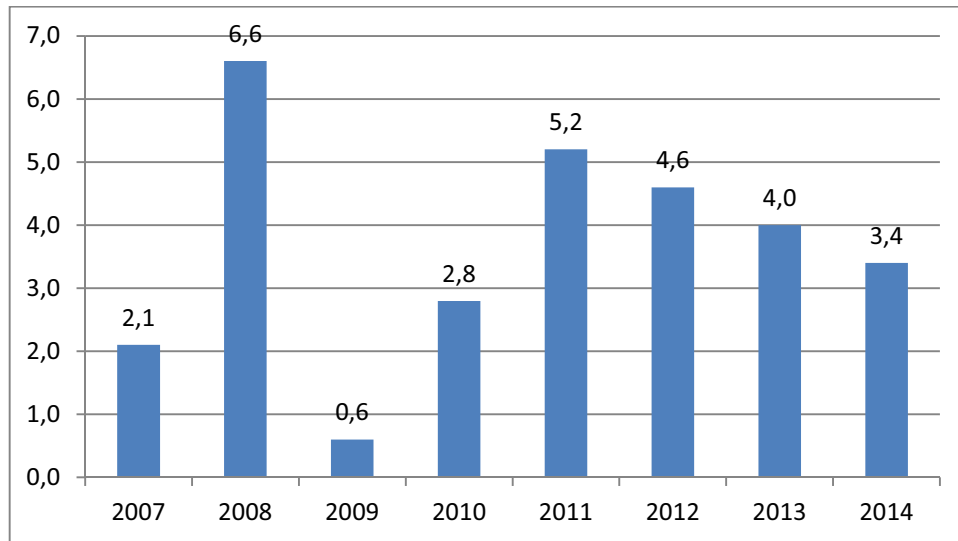
**See as well the graphs, next two pages**

Source: Frankfurter Allgemeine Zeitung, September 30, 2013. All rights reserved. Copyright Frankfurter Allgemeine Zeitung GmbH. Provided by Frankfurter Allgemeine Archiv. Responsible for translation: GEFIU, the Association of Chief Financial Officers Germany; translator: Helmut Schnabel

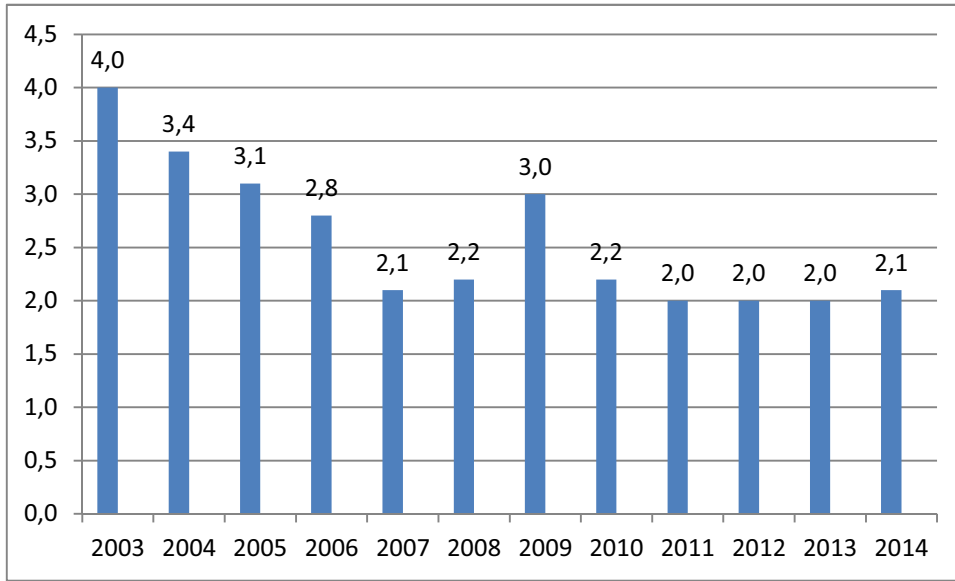
### Total Indebtedness Singapore in percent of GDP since 2007



### Inflation Rate Singapore in percent since 2007

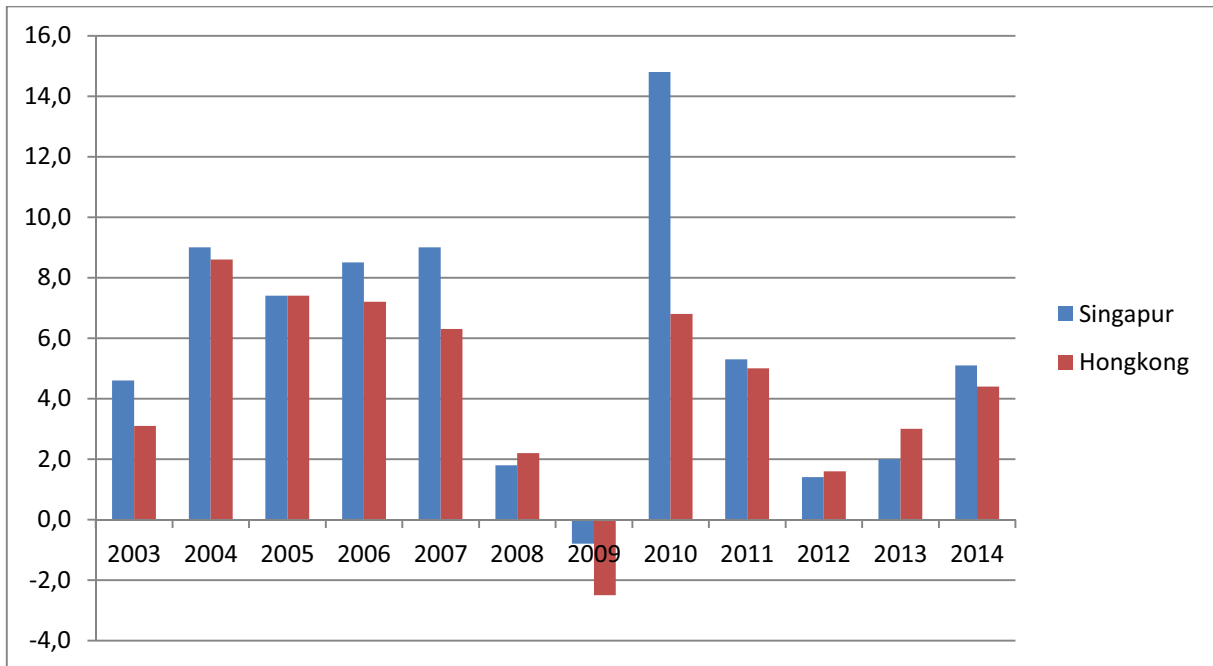


### Unemployment Rate Singapore in percent since 2003



### GDP Growth Rate by Comparison to Competitor Hongkong

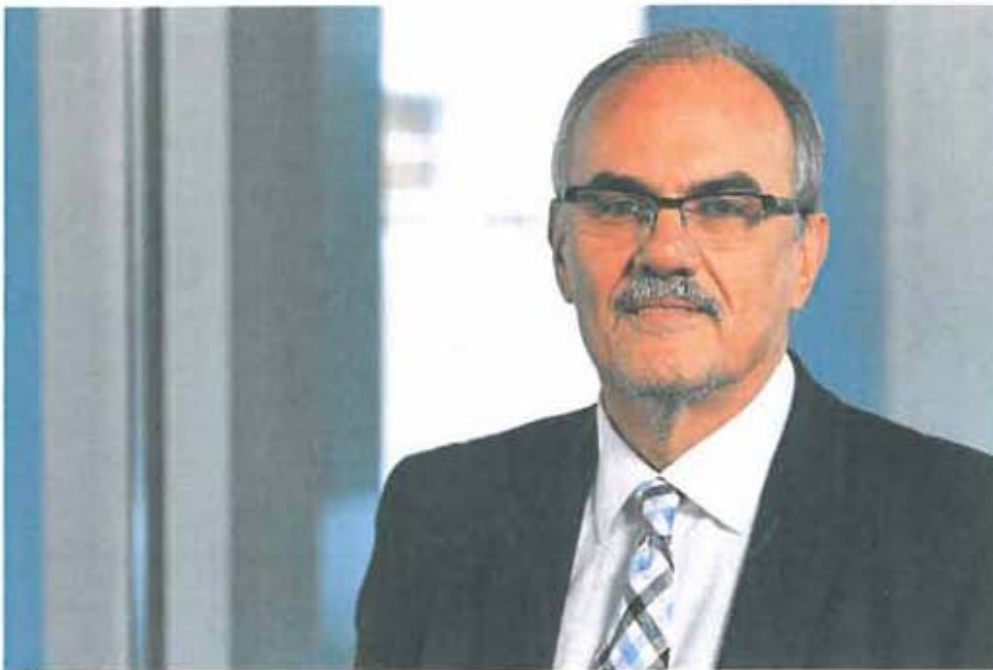
Change versus Previous Year in % since 2003



## Switzerland, Interview: On Half Way

Interview with **Jürgen Brandt**, CFO Sulzer AG, Switzerland,  
Interviewed by Missis Sabine Paulus, Finance, Das Magazin für Finanzchefs, Financial Gates GmbH, Frankfurt am Main, Germany, June/July/August 2013

The Swiss Industrial Group Sulzer has set up a Working-Capital-Management-Project. This is in the context of financing growth. But with the one time project alone things are not yet done.



Sales collapsed, orders rapidly decreased, and the customers did not want any more to pay their bills. These horror pictures many finance heads are still having in their mind, when remembering the financial and economic crisis of 5 years ago. Also the Swiss Industrial Group Sulzer has been confronted with this scenario. The incoming order volume decreased in 2009 by 29% versus the previous year down to a volume of 3 billion Swiss Francs, the volume of existing orders sank by about 11% to 1,9 billion Swiss Francs. Also with sales, Sulzer suffered a decrease by 9,8% to 3,4 billion Swiss Francs. The operating profit sank by 22.5% to 368 million Swiss Francs - all in all not a good development for the Group from the city of Winterthur.



## **2009: The year of weakness**

“We were stuck, between end of 2008 and beginning of 2010 in a phase of weakness”, admits Sulzer CFO Jürgen Brandt. “Like many other firms we had to fight”. Brandt, who only took over at Sulzer in November 2010 the finance function at the Swiss Industrial Group, did not himself experience this time of crisis at Sulzer. His predecessor Peter Meier was resolving this insecure time and brought the corporation “back on track”, as calls it Brandt. This was achieved, because in 2010 due to an improved economy the new orders coming in went up by 9% to 406 million Swiss Francs. “We came relatively well through the crisis, because there was always enough cash”, says Brandt. “But the real problem was somewhere else - and that is in the working capital”. This recognised Brandt when changing to the Swiss Industrial Group at the end of 2010.

Sulzer, in the phase of weakness after 2008, had lost the focus on working capital management. Especially inventory had increased significantly. From 2008 until end of 2011 the net working capital in the different divisions - pumps, coatings, separation columns, static mixers as well as turbine service - increased by a total of 300 million Swiss Francs. The Working-Capital-Ratio, that is the ratio of working capital to sales, increased in this period from 21 to 27%. “This was an alarm signal”, said CFO Brandt. Adding to this was, that also the Free Cash Flow 2010, by comparison to the previous year, collapsed by 71,7% to only 149,5 million Swiss Francs, and in 2011 even further to 82,3 million Swiss Francs.

## **New Incentive System**

It was more than time for CFO Brandt to act. “We want to grow profitably”, he said. For this as well new technologies, as well as acquisitions have to be financed.” “And for this we need cash”. In September 2011 he therefore started the project “Cash for Growth”. When applying it, he went step by step. “At first we had to declare to the various divisions and departments, why an efficient Working Capital Management is at all necessary”, said Brandt. After that, the managers in treasury, in sales, in purchasing, and in the various production sites were identified, who can influence the Working Capital Management via payment streams, management of inventory execution etc. They were trained, and they got a new incentive system: The Cash Flow is now a result target number in the compensation packages of the employees, who are made responsible for the Working Capital Management.

“The Working Capital Management is not alone the duty of the finance department” underlines Brandt. All departments participating in the value added chain are impacted. As a matter of principle, there are 3 maneuvering screws - purchasing, production, sales - at which corporations can become active in Working Capital Management. The industrial group has pulled all levers within the framework of this project. “We have worked in all units in a targeted way on the payment terms”, said Brandt. In the division Sulzer Metco, which offers coatings devices and -materials, and in the service division, the Swiss, for example, have decreased the number of days, after which receivables have to be paid. “In addition we now try, to pay our suppliers more in line with their efficacy”. Also the volume of inventories held and the flow through times in the production sites have been lowered.

All these measures already had a measurable effect on the Working Capital at Sulzer. In spite of the increased sales of 4 billion Swiss Francs, the item net working capital sank by 65,2 million Swiss Francs, and which led to an increase of the liquid assets by 84,7 million Swiss Francs. Also the free cash flow increased significantly in 2012 by 322,7% to 348 million Swiss Francs. The inventory sank by 52,5 million Swiss Francs, and there were higher prepayments from clients by 18,8 million Swiss Francs. At the same time sank the maturity of receivables from 2008 to 2012 from 81 to 76 days. The maturity of suppliers payables in the same period increased from 49 to 56 days.

But with this the subject Working Capital Management is not finished at Sulzer. 2013 the Cash for Growth has started into a new phase, during which, at selected sites, there is work on further improvements. Essentially it is now about optimising processes further and to establish a cash oriented thought process in the corporation. "It is an ongoing job", says Brandt. Therefore, the Working Capital Management continues to be on the agenda of the CFO. Until the end of 2014, the Working Capital Ratio is planned to sink to 20%. "We must once more take 200 million Swiss Francs out of the tied up capital", discloses Brandt. "We have not even covered half way of this. There is still much potential, and I am convinced, that we can still attain good successes".

Source: Finance, Das Magazin für Finanzchefs, June/July/August 2013, Financial Gates GmbH, Frankfurt am Main, Germany. Responsible for translation: GEFIU, Association of Chief Financial Officers Germany; translator: Helmut Schnabel

**Newly Created IAFEI Working Committees, starting 2013:**

- *IFRS Committee* - Committee Chairman, and Committee Liaison Officer: - IAFEI Executive Committee Member and IAFEI Treasurer, Emilio Pagani, Italy

- *International Tax Committee* - Committee Chairman Piergiorgio Valente, Italy. Committee Liaison Officer: IAFEI Executive Committee Member and IAFEI Chairman, Luis Ortiz Hidalgo, Mexico

- *International Treasury Committee* - Committee Chairman: Omar T. Cruz, the Philippines. Committee Liaison Officer: IAFEI Executive Committee Member and IAFEI Area President Asia, Nguyen Ngoc Bach, Vietnam.

- *International Observatory of Management Control Committee* - Committee Chairman: - Frédéric Doche, France. Committee Liaison Officer: IAFEI Executive Committee Member and IAFEI Area President Europe, Middle East, Africa, Armand Angeli

**IAFEI Board of Directors Meeting, Warsaw, Poland, October 15, 2013**

**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

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**44th IAFEI World Congress 2014, Manila, The Philippines, October 15 to 17, 2014**

**Hosting IAFEI member institute will be the Financial Executives Institute of the Philippines, FINEX**

**45th IAFEI World Congress, 2015, Milan, Italy**

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

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