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IAFEI News

Letter of the Editor **March 14, 2014**

Dear Financial Executive,

You receive the **IAFEI Quarterly XXIV th Issue**.

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

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

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

This issue again offers a broad variety of articles on financial subjects, all of which merit the reader´s attention.

Two special articles relate to presently widely debated international tax matters.

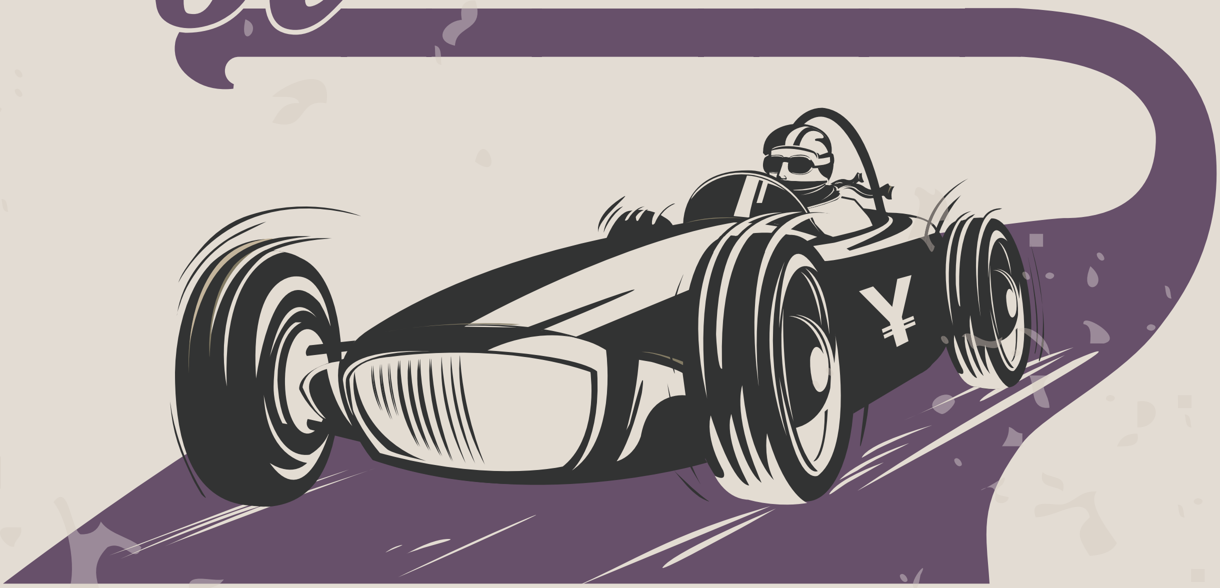
Once again:

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

Helmut Schnabel

RACE FOR THE Renminbi



COMPANIES SHOULDN'T WAIT TO TAKE ADVANTAGE OF THE OPPORTUNITIES THAT COME WITH THE INTERNATIONALISATION AND LIBERALISATION OF CHINA'S CURRENCY, ARGUES MONIE LINDSEY

As the world's second-largest economy and largest exporter, China currently accounts for over 10% of nominal global GDP. But its currency accounted for less than 1% of global FX turnover as recently as 2010. Through its deliberate and measured efforts to internationalise the renminbi, which began in the early 2000s, but dramatically accelerated from 2009, China seeks to better align its currency with its place in the global economy.

Now, the internationalisation of the renminbi is moving at a dizzying pace. Already trading as a major global currency, the renminbi is destined to become a global reserve currency within a decade, if not sooner.

Significant events in 2013 accelerated both the processes of internationalisation (making the renminbi a fully convertible currency) and liberalisation (relaxation of government restrictions on the currency). As a result, they opened up further opportunities for corporates doing business in and/or with China:

◆ Offshore renminbi clearing centres were established in Singapore and Taiwan, and London secured its position as a global hub for China's currency. Sterling is the fourth currency to trade directly against the renminbi and the euro is expected to follow shortly.

◆ China-based companies were allowed to lend renminbi overseas to offshore parent, subsidiary and/or affiliate companies. This means multinationals can include China in their global treasury-pooling scheme and it addresses the huge pain point of 'trapped cash'. A pilot programme is currently under way for renminbi loans from multinationals into their China-based companies.

◆ The China Securities Regulatory Commission loosened restrictions to enable foreign funds based in Hong Kong and offshore branches of Chinese banks to apply for renminbi-qualified foreign institutional investors scheme status. This move opens up

CORPORATE NEED	RENMINBI LIBERALISATIONS
Payments/trade	• Renminbi settlement for cross-border trade • Relaxation of physical evidence/documentation requirements for cross-border settlement transactions
Liquidity	• Renminbi overseas lending/sweeping for China-based companies to offshore parents, subsidiaries, affiliate companies • Ability to net payables and receivables • Renminbi and foreign currency cross-border cash pooling
Risk management	• Renminbi settlement for cross-border trade and CNH liquidity pools, enabling centralisation • Ability to net payables and receivables, reducing FX exposure • CNH deliverable forwards

China's domestic investments, improves domestic equity markets and encourages further use of the Chinese currency for trade.

Efforts to internationalise the renminbi are already paying off as the following developments show:

- Renminbi made the list of the 10 most actively traded currencies in 2013, according to the Bank for International Settlements. Renminbi turnover increased almost fourfold from $34bn in 2010 to $120bn in 2013, reflecting a 2.2% share in global trading volumes. A recent report by messaging provider SWIFT placed it as the eighth most traded currency in the world.
- In October 2013, SWIFT identified the renminbi as the 12th-largest global payments currency, up from 20th in January 2012 and virtual non-existence prior to 2009.
- The Standard Chartered Renminbi Globalisation Index (with a base of 100 at 31 December 2010) stood at 1,148 as of August 2013. The index measures renminbi offshore deposits, dim sum bonds, certificates of deposit, trade settlement and other cross-border payments, and FX turnover.

And the pace of reform is expected to accelerate. Up to 35% of China's trade is forecast to be denominated in renminbi by the end of this decade, and the continued opening of China's capital account will facilitate direct investment flows. Offshore investors will have greater access to onshore capital markets and China is set to have a fully operational renminbi clearing system – China International Payment System – by 2015.

Corporate needs

Liberalisation of the renminbi is facilitating solutions to address companies' needs with regard to liquidity, payments and risk. (See table on page 38.)

Adoption of renminbi by foreign corporations is uneven. Some are fully embracing the renminbi in their payments, liquidity, hedging and intercompany lending practices, and others are adopting it as business requires (for example, local China operations receiving and making local payments).

According to SWIFT's *RMB Tracker*, Asia (beyond China and Hong Kong) has led adoption of the renminbi to date, although Europe has more recently come close to par in absolute value with Asia, reflecting the strong trade ties between China and Europe. The US has lagged due to challenges including inertia and systems set up to invoice only in US dollars.

A survey by Treasury Strategies of global companies last year found that renminbi adoption varied according to annual turnover. For example, 77% of companies with annual turnover in excess of $10bn are receiving and making cross-border renminbi payments, compared with 40% for companies with turnover between $2bn and $10bn. Similarly, 83% versus 53% have seen their volume of renminbi payments increase in the past 24 months while 54% versus 13% maintain a CNH (offshore renminbi) pool in Hong Kong.

Banks are stepping up

Banks have been as quick to introduce solutions for the corporate market as liberalisation has allowed. This includes facilitating trade; managing liquidity; investing or borrowing; providing credit; and managing FX risk. (See box – Recent developments in bank renminbi solutions – above.)

Given the fast pace of renminbi internationalisation and liberalisation, and the equally fast evolution of accompanying bank solutions, understanding what is the right course of action can be daunting for corporates. It is premature to talk about 'best practices' since China and associated renminbi solutions are not unlike the 'Wild West': there are tremendous opportunities and myriad routes to pursue them. Solutions are available as never before to more effectively manage liquidity, risks, payments and trade. Waiting for regulations and practices to settle down and become more standardised is a mistake.

There is too much benefit to be realised now. Current 'best practice' for a company means proactively assessing renminbi flows, exposures and processes. Companies need to work with their banks to implement the accounts, structures and solutions that enable them to take best advantage of renminbi internationalisation and liberalisation.

RECENT DEVELOPMENTS IN BANK RENMINBI SOLUTIONS

October 2013 – Citi Peru is the first bank in Latin America to issue a letter of credit denominated in renminbi.

September 2013 – Bank of America Merrill Lynch announces developments in its China trade and supply chain finance product suite to facilitate domestic renminbi draft settlements.

September 2013 – Citi is the first bank to launch a renminbi cross-border automatic sweep.

July 2013 – China grants HSBC a renminbi investment licence to invest renminbi onshore.

May 2013 – Deutsche Bank executes the first Singapore dollar/renminbi spot trade that will be cleared out of Singapore.

May 2013 – Citibank China launches a multi-currency notional pooling with renminbi capability.

March 2013 – HSBC implements a renminbi cross-border payments and collections solution in China.

November 2012 – Standard Chartered introduces the first industry benchmark to track the progress of renminbi business activity – the Renminbi Globalisation Index.

June 2012 – Deutsche Bank China completes the first cross-border renminbi payment under the People's Bank of China simplified payment pilot scheme.

June 2012 – Hong Kong Monetary Authority, Euroclear Bank and JPMorgan launch a cross-border collateral management service.

October 2010 – Standard Chartered issues the banking industry's first renminbi bid bond.

July 2009 – HSBC becomes the first foreign bank to settle cross-border trade in renminbi.

RENMINBI LIBERALISATION: CORPORATE PAIN POINTS

1. The lack of technology and automated solutions in place with mainland China banks:
   - While they initiate SWIFT FIN messages, they show few signs of developing more sophisticated connectivity and other technology solutions; and
   - Making domestic payments in China is painful.
2. The absence of CNH options in risk systems – price and risk management database systems do not include CNH as an option, limiting automation/straight-through confirmations. Manual intervention is required.
3. The discrepancy between the promise and the reality of liberalised regulations:
   - China-based banks are more flexible in their interpretation of new, more liberalised regulations; and
   - Foreign banks are under closer scrutiny from the government and are therefore more cautious and less flexible, often demanding more onerous documentation.
4. The situational nature of doing business in China – the lack of consistency and predictability makes planning and forecasting more challenging.

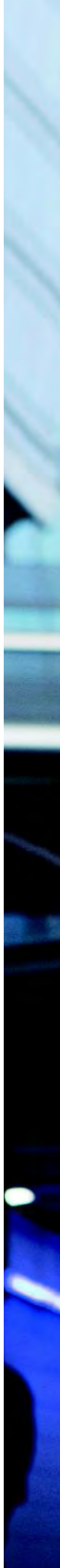
SOURCE: INTERVIEWS WITH US-BASED MULTINATIONALS, TREASURY STRATEGIES

Monie Lindsey is managing director at Treasury Strategies. For more, see www.treasurystrategies.com

OILING THE WHEELS

How does treasury help to fuel the world's 10th-largest company? Total group treasurer Humbert de Wendel explains

Words: **Sally Percy** / Photos: **Sébastien Dolidon**



As group treasurer for French oil and gas giant Total, Humbert de Wendel holds one of the top jobs in treasury. But while he's been in that post (and in mainstream treasury, as it happens) for just under two years, he's racked up more than 30 years' service in finance roles with the company that he joined as a graduate in the early 1980s.

"Why change, I would ask?" he responds in excellent English, when probed as to why he has never taken his talents elsewhere. "It's a very nice company to work for. It's not just me; most of my colleagues have tended to stay with the company. That's because it offers a variety of opportunities. You don't need to go to another company to do something different."

De Wendel's latest 'opportunity' – if you can call it that – entails moving Total's treasury function – along with its investor relations team – lock, stock and barrel from Paris to London in June 2014. "More than ever, London is the centre of financial activities of the kind that we're engaging in," is his explanation for the move. "Also, our activities are more and more dollar-based and less and less euro-based so it makes more sense to be close to the dollar market in Europe, which is obviously London. We can get close to our counterparties, our investors and where things are happening." Around two-thirds of Total's 60-strong treasury team will relocate to the UK capital and de Wendel is positive about the change. "I love London as a place to live," he says. "It will be a challenge to move the whole team there, but it will be an adventure. You don't have adventures of that kind every day in treasury."

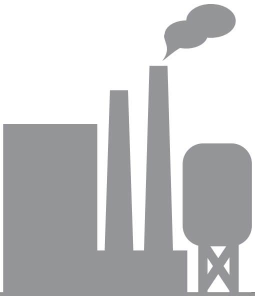
Indeed you don't, not even when you're the treasurer of the 10th-largest company in the world, according to the Fortune Global 500 list, with the kind of credit rating and cash reserves that some treasurers can only dream of (more on this later). But that's not to say that the office move is de Wendel's only workplace challenge. Total has set itself the ambitious target of producing three million barrels of oil and gas a day by 2017, up from 2.3 million a day in 2012. As a result, it is investing heavily in its operations, which is inevitably gobbling up cash. "There's a lot of stress on treasury because we are in a very heavy period of cash-flow consumption," explains de Wendel. "Oil and gas are challenging, both technically and financially. The amounts at stake are ever-growing. Some of the projects we're engaging in can be \$30bn to \$40bn in size."

Although de Wendel describes the company's cash flow as 'stressed', according to both its own and industry standards, he acknowledges that other companies would see it as 'relaxed'. Nevertheless, he points out: "We are generating rather less than is needed to fund our activities and pay our dividends. So we need to ensure the security of funding for the group and make sure there is ample liquidity for the group's financial activities. In treasury, we are central in making sure that the strategic priorities are being achieved because cash is king."

Total has around €33bn in long-term and short-term debt, and raises the vast majority of its funding (some 85%) through the bond markets. "We tend to be very opportunistic in which financial markets we tap," de Wendel explains. "The good thing about being a large company with very good ratings is you have access to good markets." Total taps the US bond market most often, but it also goes to markets elsewhere. In 2013, it raised \$10.8bn altogether, of which \$6bn was from the US, while the rest came from the euro, Hong Kong renminbi and Australian dollar markets among others. "The US market is deepest and easiest to tap," says de Wendel. "But you can tap other markets and get better conditions than we would get in the US market."

Where Total does have bank loans, these take the form of bilateral agreements rather than syndicated group facilities. "If times get tough, renegotiating with all your banks at the same time can be a very difficult thing to do," de Wendel points out. "We're in a very

"There's a lot of stress on treasury because we are in a very heavy period of cash-flow consumption. Oil and gas are challenging, both technically and financially. The amounts at stake are ever-growing"



TOTAL IN NUMBERS

€22.94bn
was Total's gross capital expenditure in 2012

€12.4bn
was Total's adjusted net income in 2012

€2.34
per share was the dividend paid by Total in 2012

130
is the number of countries in which Total operates

87%
of Total's share capital is held by institutional shareholders

14,725
is the number of service stations in 68 countries run by Total

2.3 million
barrels of oil a day are produced by Total

10
was Total's ranking on the Fortune Global 500 list of the largest companies in the world in 2013

97,000
people is the size of Total's global workforce, including more than 40% outside Europe

9
natural gas liquefaction plants in Africa, Asia, Europe and the Middle East have Total as a shareholder

favourable position *vis à vis* banks. But what I would advise in general is to keep your options open, diversify sources of funding as much as possible and try not to have all your eggs in the same basket."

Total holds cash reserves of around €13bn and these provide security in the volatile environment in which it operates. "We have to deal with commodity prices that can vary tremendously," notes de Wendel. "That puts a lot of stress on our cash need. At all times we want to have enough cash to be able to repay our debts plus we need to be able to withstand a dip in our cash generation. We also have variations in our working capital that are very wide." Indeed, Total's variations in working capital from one quarter to another can change by as much as $3bn.

It will come as no surprise, then, that Total is very cautious about what it does with its reserves. "We are extremely prudent with our cash," confirms de Wendel. "We don't take any risk. We have a very well-developed counterparty policy, so we only leave our cash with the most secure counterparties." In 2011, it trusted most of its money to the French central bank – "It doesn't pay much, but that's the most secure place to leave it" – and it also deposits with the highest-rated global banks. It buys some sovereign and corporate paper, but doesn't use money market funds "because we like to manage the cash ourselves".

Overall, 33 banks from all around the world provide credit lines to Total and these are a mixture of global and local banks. While the group historically preferred to work with banks that shared its high credit rating (it has a prized AA rating with Moody's and Standard & Poor's), practicality now dictates that it must work with banks that have a slightly lower rating than its own. "We want to have relationships with banks from all

over the place," says de Wendel. "We have a centralised approach. Our middle office monitors all the banking relationships that our subsidiaries have around the world. When they want to work with a bank that doesn't match our credit requirements, they have to ask us. We look at the reasons why they ask and we do a deep analysis." Meanwhile, the contracts that Total has around the world enable it to keep its cash in US dollars and, almost always, in offshore bank accounts.

Given that it does business in 130 markets, you might expect Total to have difficulties with trapped cash. De Wendel says this is not a huge issue in most countries, however, "because normally we have exemptions from foreign exchange controls". He continues: "It's not trapped, but it's not always where we would like it to be. 'Trapped cash' is not the way I would describe it. It's more 'cash in transit'."

While Total's business mostly operates in dollars, it pays shareholder dividends in euros, which inevitably creates a huge FX risk for the company. "The volatility is such that we can jeopardise our returns to shareholders if we're not careful," says de Wendel. "They want us to take the business risk of exploring oil and gas, not FX risk." Total's treasury handles between $80bn and $90bn in FX each year, "which I'd guess is on the high side", de Wendel says. Therefore, it has very strict rules as to how it calculates and mitigates FX exposures so that it takes as little risk with FX as it can. Usually it hedges FX upfront once a decision has been made to launch a project. "We have very precise rules and we abide by them. We don't take chances."

Another risk that the treasury team monitors closely is interest rates, due to the large debt sitting on Total's balance sheet. "We evaluate what percentage of debt needs to be on fixed rates and what percentage needs to be on floating rates and hedge day-to-day risks that we have in these areas," de Wendel explains. Overall, around 20% of Total's debt is fixed while the rest is floating. "We have a very volatile cash flow so one way or another we feel that keeping interest rates floating is a better hedge than fixing them," he says, "for contractual reasons and because of the link between inflation rates and the price of oil."

The group treasurer's role is actually de Wendel's second stint in treasury at Total. Back in the 1980s and early 1990s, he headed the treasury's trading room for a while. Over the past three decades, he has held a range of other finance roles, including FD of a joint venture, M&A, product finance, basically "everything you can think of in finance in a company like this". In his present role, he has had to get to grips with treasury's sizable and complex IT systems and with running a large team since previously he had mostly led groups of between five and six people. So what's the trick to running a successful treasury at Total? "It's like running any other team in any other business. You have to make all these people from different backgrounds draw the cart together. It's one of the interesting aspects of the job."

Sally Percy **is editor of *The Treasurer***

HUMBERT'S TOP TIPS FOR SUCCESS:

1

"Keep your options open and have your debt profile maturing on a tiered basis."

2

"We have the ability to be opportunistic. So it's important to organise things so that you can pick the opportunities."

3

"I'm a member of L'Association Française des Trésoriers d'Entreprise. Membership of a treasury association brings a lot in terms of being able to exchange technical views regarding how you centralise cash."

4

"I'm not a man for gadgets, but I live with my iPad at the moment. My wife would tell you that I'm using it for business too much. I use it to look at my email when I'm travelling. I also use it for music."

5

"I like to be precise and accurate. I also like to avoid personal controversy."

6

"What's the most difficult question my CFO could ask me? It's part of the job description to be asked difficult questions all the time, so I wouldn't like to say. But I would not like to answer this one: 'How do we recover the money that has been stuck in the demise of one of our counterparties?'"

HUMBERT'S CURRICULUM VITAE

January 2012 to present
Group treasurer, Total, Paris

2006-2011
Senior vice president, corporate business development, Total, Paris

1997-2006
Vice president, financial operations for various group divisions, Total, Paris

1995-1996
Finance manager, Total Middle East, Total, Paris

1992-1994
Deputy CFO, TMR (Total joint venture), London

1982-1992
Various financial positions, Total, Paris

Qualifications
Graduate of the Institut d'Etudes Politiques de Paris and ESSEC Business School

Germany, Article: Considerations on Capital Structure, Cost of Capital and Financial Flexibility

March 2013

Steffen Diel

is Head of Treasury Finance, a team within the Global Treasury organization of SAP AG, responsible for capital market strategy & transactions, global financial risk management, external funding, bank relationship management, Treasury-related reporting, and group-wide financial planning. Prior to joining SAP in 2006, Steffen was Head of Finance/Treasury at a German listed mid-cap plant engineering company. He started his career at Deutsche Bank as a Relationship Manager. Steffen has a degree in International Business Administration from the Worms University of Applied Sciences.

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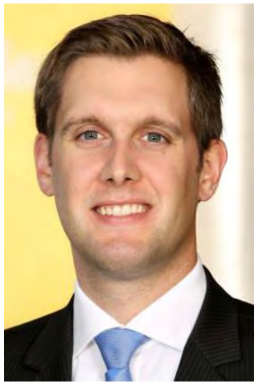
Simon Regenauer



is a Director Capital Markets within the Group Treasury organization of Merck KGaA. The Capital Markets team is responsible for Merck's credit ratings, funding transactions and pension asset management. Additionally, the team is involved in activities related to working capital management and venture capital investments. Prior to joining Merck KGaA in 2012, Simon was a Finance Specialist in the Treasury Finance team within the Global Treasury organization of SAP AG. Simon graduated at the Ludwigshafen University of Applied Sciences.

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ABSTRACT

Based on the authors' experiences, this article provides a discussion on capital structure, cost of capital, and financial flexibility considerations for large software companies such as SAP as part of their strategic task to establish and maintain an effective financing framework. Nonetheless, the findings of that discussion should also be applicable to other industries. The aim of such a discussion is to improve the strategic financing framework in 4 aspects:

1. Enhance the awareness for the importance of the Treasurer's advisory role to Senior Management with regard to capital structure considerations

2. Proactively provide a valid foundation for future financing decisions

3. Increase the company's financial flexibility as it directly corresponds to the realization of business opportunities and the financial support of corporate strategy

4. Develop a financing framework which sets the stage for a strategic dialogue with company's core banking group in order to optimally prepare for future financing needs ("strategic funding partnership").

KEYWORDS

Capital structure, software sector, financing framework, financing policy, financial flexibility, target rating, shareholder value

1. INTRODUCTION

This article provides a discussion on capital structure, cost of capital and financial flexibility considerations focused on large software companies such as SAP as part of their strategic task to establish and maintain an effective financing framework. Sections 2 and 3 review the relevance of the capital structure and its impact on cost of capital. Section 4 provides a general framework for capital structure decisions. Section 5 and 6 discuss specific software sector characteristics, their link to target rating considerations and potential applicability to other industries. Section 7 concludes the main findings of this article. The discussed topics are relevant for Treasurers mainly from two perspectives.

1. They form an important part of the Treasurer's curriculum as part of recurring strategic funding discussions with Senior Management.
2. The discussion broadens the scope of capital structure considerations with regard to the growth and increased importance of intangible businesses (e.g. knowledge based industries) in the global economy during the last two decades versus the role of traditional, i.e. tangible, business models.

2. IMPORTANCE OF CAPITAL STRUCTURE

How important are capital structure considerations when trying to determine its optimum for a given company? In doing so, we purely take the practitioner's perspective and abstract from the academic literature around capital structure and enterprise value. We refer to generally accepted models where suitable for this purpose.

The determination and management of the capital structure is a key component of a company's strategy. The capital structure strongly influences the weighted average cost of capital (WACC) which is the most relevant benchmark for the creation of Shareholder Value (SV).

The WACC constitutes the basis for determining the discount rate in a Discounted Cash Flow model, the most widely used business valuation method. In addition, the capital structure and several key financial ratios derived from it form an important basis for the analysis of the creditworthiness of a company by third parties (e.g. rating agencies) and debt investors (e.g. banks or bondholders). The determination of a target capital structure by the Senior Management could serve as a starting point for setting up an appropriate framework for financing decisions. This target capital structure and the accompanying financing decisions have to be well understood by investors if deemed to be successfully implemented.

The rather young history of enterprise software companies has been characterized by low financial leverage compared to other industries (e.g. discussion and examples can be found in research from Bank of America-Merrill Lynch). During the last few years, a trend towards more aggressive financial policies, i.e. a higher proportion of debt financing in corporate capital structures (higher financial leverage), has been fueled by shareholders and analysts with the goal to increase shareholder returns at the potential expense of debt investors. In the years prior to the financial market crisis companies with low financial leverage were partly criticized for conducting their business based on an under-levered balance sheet. It has been argued that the WACC of those companies might be too high as a consequence of its high reliance on equity (instead of financial debt) and value could be unlocked by leveraging up, lowering WACC and potentially return cash to shareholders. The financial market crisis since 2008 has considerably changed that view with investors putting much more focus on corporate cash balances and low financial leverage (“cash is king”) given a volatile environment of uncertain funding opportunities and rising refinancing costs. This renaissance of a generally more conservative sentiment towards financial policy peaked, for instance, in a cash position that more than doubled between 2006 and 2011 in major U.S. technology companies according to Moody’s.

3. IMPACT OF CAPITAL STRUCTURE ON COST OF CAPITAL

Equity and debt investors expect different rates of return based on their diverging risk profile. While equity investors bear a higher risk and as a consequence expect a higher return, the cost of debt is further reduced by the tax shield (tax-deductibility of interest expenses). Therefore WACC might be reduced by replacing equity with debt. However, the increase in the company’s leverage will simultaneously increase the required cost of equity since more debt leads to even more risk for the shareholders.

At low debt levels the effects from replacing ‘expensive’ equity by additional debt (including tax shield) will over-compensate the increase in the cost of equity resulting in an overall decreasing WACC. Plugged into a Discounted Cash Flow valuation (DCF) model, the reduced WACC will yield a higher net present value (NPV) of the relevant cash flows and consequently a higher Enterprise Value (EV). With an increasing leverage and a higher dependence on debt investors the company not only loses financial flexibility, but its costs of financial distress rise. Bankruptcy costs are a common example of direct costs of financial distress (e.g. out-of-pocket costs such as auditors' fees, legal and other fees). But significant costs of financial distress can also occur even if bankruptcy is avoided (so-called indirect costs, e.g. higher refinancing costs). Additional debt puts stress to the company’s cash flow as a defined part of it has to be used for interest and redemption payments. If cash flows decrease due to an economic downturn, the company might get into trouble. Debt investors start to worry that repayments could be endangered and, just like the equity investors, are likely to defend themselves through higher compensation requirements for their risk-taking, i.e. by demanding higher credit spreads which increases the cost of debt.

Taking these effects into consideration, at a certain level of financial leverage the rising costs of equity and debt just offset the positive effect from replacing equity through debt capital. This level marks the theoretically optimal leverage with the lowest WACC. If the leverage is increased beyond that point, WACC starts to increase again. In practice, this point is not easily found and depends also on other, rather qualitative variables, such as business risk and financial policy.

Figure 1.1 illustrates graphically the theoretically optimal leverage; it plots the cost of equity and debt as well as the WACC against the range of rating categories displaying an increase in financial leverage when moving from left to right. For most companies, the WACC curve reaches its minimum at a rating category of BBB/BB which is often stated to be the optimal rating from a cost of capital point of view. This optimal leverage certainly varies depending on the industry the company operates in and other company-specific characteristics.

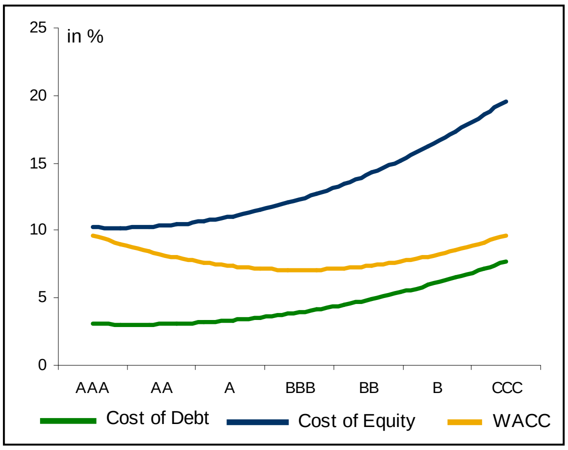

Figure 1.1 Cost of Capital and Optimal Leverage (illustrative)

4.FRAMEWORK FOR CAPITAL STRUCTURE DECISIONS

This raises the question whether a company should aim for a theoretically optimal rating of BBB/BB as a starting point for capital structure considerations? Does it make sense for companies to pursue that rating range to achieve optimal leverage and implicitly the WACC minimizing capital structure? In addition to the minimum WACC paradigm, companies have to consider further parameters when deciding on the target capital structure than merely heading for the optimal leverage. The following list of parameters should be taken additionally into account:

- Business risk profile
- Industry framework
- Distribution policy
- Assessment of creditworthiness by third parties (e.g. rating agencies, debt investors, banks)
- Liquidity needs of the company
- Financial flexibility: e.g. ‘dry powder’ for acquisitions
- Degree of access to debt capital markets, i.e. a profile that provides the company with access to a variety of debt instruments
- Stability and magnitude of Cash Flows

Financial policy is a question of finding an overall alignment of capital structure (financing), liquidity needs (investing), and dividends / share buybacks (distributing) while at the same time maintaining consistency with corporate strategy and market expectations. Companies need to trade-off the benefits of debt against its costs. This trade-off involves the effective use of debt capacity while safeguarding the company’s ability to execute its business strategy without disruption.

5. SPECIFIC SOFTWARE SECTOR CHARACTERISTICS

Large software companies’ business risk profiles provide positive elements of mature companies (for SAP e.g. market leadership, broad and well-diversified customer base, and a high proportion of stable maintenance cash flows) while, at the same time, showing a high growth and innovative profile as a precondition for long-term survival in the highly dynamic and disruptive IT industry. Business risk can be measured as the volatility of a company’s earnings (e.g. EBIT). Following the strong business risk profile of SAP as a single example for a software company there would be no need to restrict financial leverage to a low level.

However, the software sector as a whole provide some rather unique features which reflect on the assessment of creditworthiness and the strategic liquidity needs.

The majority of the Enterprise Value of companies in the software sector consists of intangible assets and future prospects of its innovation strength and business growth potential as estimated by the net present values of growth opportunities (e.g. per end of 2012, SAP's market capitalization amounted to ca. 75bn € compared to an equity position of ca. 14bn €). Consequently, financial flexibility, strategic liquidity and continuous access to debt capital markets are key value drivers. These factors are indispensable to be able to seize value-enhancing growth opportunities through investments in innovation and Mergers & Acquisitions as they arise. Any risk that materially reduces financial flexibility (e.g. lower target credit rating) to the point of impairing access to additional capital, potentially endangers strategic business plan execution which in turn could diminish Enterprise Value. Higher growth expectations generally imply a greater need for, and value of, financial flexibility. Thus, a more conservative capital structure, with a low or no financial leverage, can be of vital importance to optimally support the corporate strategy. In addition to a low financial leverage profile, a considerable cash level contributes to financial flexibility. The opportunity cost of a strong liquidity position (cash holdings represent a negative NPV investment as the after-tax return on cash does not meet the required return on capital, the WACC) can be a fraction of the economic value it supports. Liquidity reduces the risks that stem from markets closing to the issuer, i.e. refinancing risk. Rating agencies are particularly sensitive to liquidity for companies in the software sector inherent to the nature of the industry and the associated technology risk.

The heavy reliance on intangible assets can be viewed negatively in case of debt funding through banks. The value of intangible assets, which often are not even recognized on the balance sheet, is difficult to assess for such debt providers and therefore they often cannot use them for collateral purposes. Thus, in times of a severe downturn in the operating business, external financing can be very expensive or simply unavailable for software companies. Consequently, their cost of debt curve (i.e. cost of debt corresponding to different rating categories) might be steeper (compare Figure 2.1) due to higher costs of financial distress compared to other industries. Sector specific pace and dynamics can lead to severe materialization of business risks in case growth opportunities cannot be realized by way of acquisition or internal development of innovative products. Thus an appropriate financial flexibility is a necessary foundation for future revenues.

Customer relationships of Enterprise Resource Planning (ERP) software providers like SAP are mutually long-term oriented. Customers have to be sure about the long-term ability of their partner to continuously develop and maintain the delivered software solutions. Again, a conservative capital structure with sufficient equity cushion to allow for additional debt capacity, if required, constitutes an important sign to a software company's customers since they demand a high solvency on their supplier side. Too much debt might reduce customer confidence and in turn negatively impact the company's sales performance.

6. TARGET RATING CONSIDERATIONS FOR SOFTWARE COMPANIES

Returning to the question whether SAP (as one example for a large software company) or a company from an industry with similar business characteristics should focus on the theoretically optimal rating of BBB/BB in order to minimize WACC. The sections above make clear that Treasurers must determine their optimal capital structure by balancing business and financial risk with the need to access debt capital markets at reasonable costs. Low financial leverage increases financial flexibility and creditworthiness which drives not only the cost and availability of debt, but also serves as a positive signal to the markets, customers, and suppliers of overall financial viability.

As a consequence, large software companies should target a rating category offering a higher financial flexibility than offered by their theoretically optimal rating. Figure 2.1 illustrates that exactly such a move towards a higher rating category can optimize Enterprise Value.

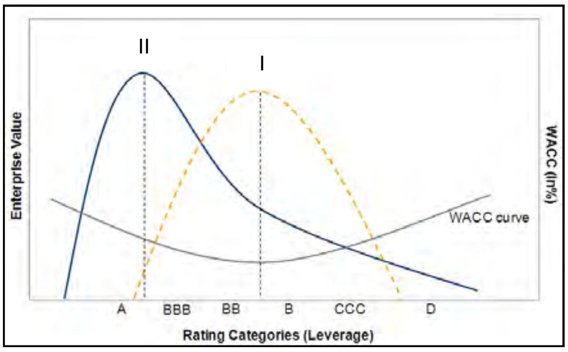

Figure 2.1 Enterprise Value and Rating Categories (illustrative)

Graph I follows the theoretically optimal leverage approach where value is maximized at the WACC minimum since it is assumed that financial flexibility has no significant impact on future Cash Flows. In contrast graph II shows its value maximum at a much lower leverage ratio. This constitutes a more appropriate mapping for large software companies as an increased leverage might impair future investments, revenues and cash flows.

To provide for a prudent and risk-oriented approach, it is important to determine a target and a fallback rating category. If business environment worsens and cash flows deteriorate, management is prepared to allow its financial leverage ratio to move to a temporarily higher level (corresponding to the lower fallback rating) in order to fund necessary capital expenditure. The target rating determines the long-term debt capacity while the fallback rating determines the optimal amount of cost-effective reserve debt capacity that the company can draw upon when needed. A gap of at least one rating notch between target and fallback rating adds significant value as compared to an inflexible capital structure.

7. CONCLUSION

The article outlined that Treasurers, as part of their strategic task to establish and maintain an effective financing framework, can add significant value as a business partner to the Senior Management by constantly providing advice on capital structure and financial flexibility. This value-add can be broken down into 4 aspects.

1. Enhance the awareness for the importance of the Treasurer’s advisory role to Senior Management with regard to capital structure considerations
2. Proactively provide a valid foundation for future financing decisions
3. Increase the company’s financial flexibility as it directly corresponds to the realization of

business opportunities and the financial support of corporate strategy
4. Develop a financing framework which sets the stage for a strategic dialogue with your company's core banking group in order to optimally prepare for future financing needs ("strategic funding partnership").

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Italy

Country report: Only Hopelessness

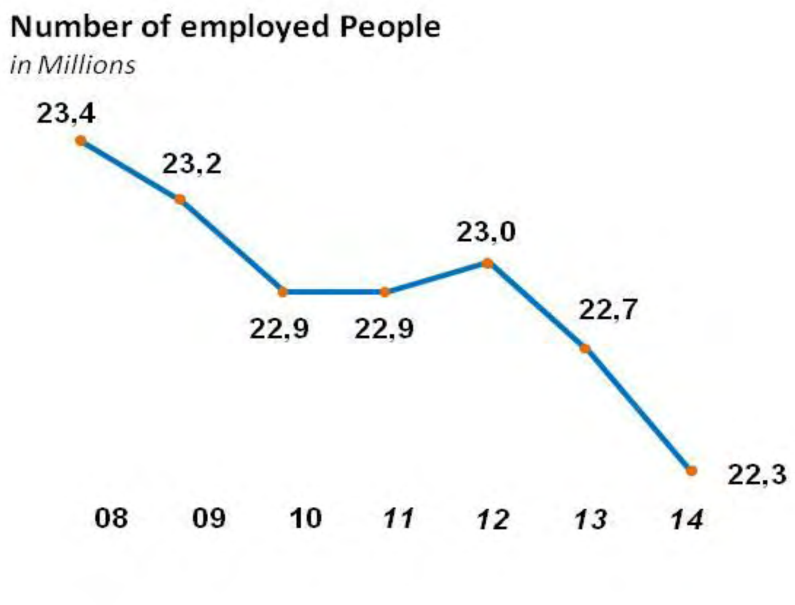
The government of Italy has made many announcements, but nothing has been achieved. The best educated young people are now emigrating.

By Tobias Piller

Rome, February 16, 2014 – In the meantime, the otherwise so mild and patient chairman of the association of Italian entrepreneurs, Giorgio Squinzi, has lost his patience: “We are showing the yellow card to the government and to the country”, says Squinzi. “We have to be afraid of our country becoming an industrial desert”, is the emergency call. “The distance between the real policy and the real situation of the country has never been as big as at this moment. Either the government proceeds faster now or we are going to new elections”, is the resume of the Italian successful entrepreneur who is represented worldwide with the tile-glues and construction materials under his trademark Mapei. Squinzi, with his loud protest, has contributed to the failure of prime minister Letta and his 64th post second world war government. Now the party leader of the democratic party, Matteo Renzi, is promising a large renewal of Italy.

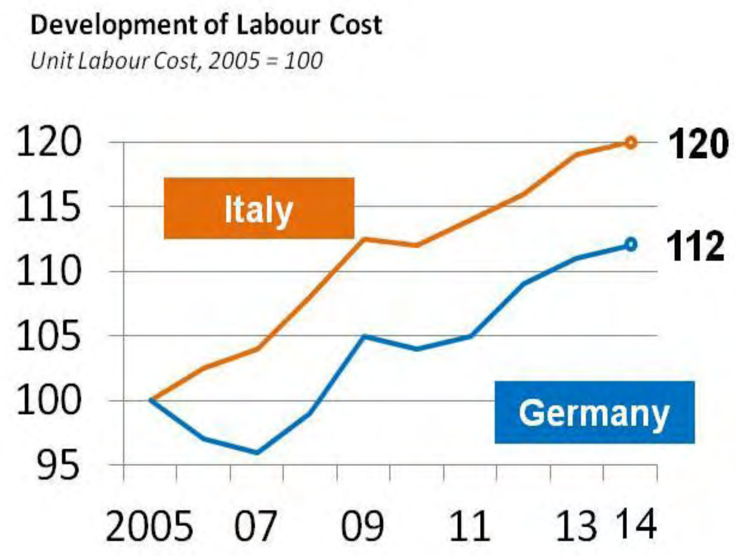
However, there has not already been shortage of announcements so far. Since 2011 there have been diverse legislation packages with promising names: After “Saving Italy” and “Grow, Italy” by prime minister Mario Monti, his successor Letta was launching a package called in terms of “We are doing something”, the legislation package “Investors in Direction of Italy”, and he was even launching a new government program under the title “Mission for Italy” a day before his resignation. But packages composed of many small steps did not attain the desired effect to infuse new growth strength into Italy.

In the flats of the economic daily routine in Italy, the calculated optimism of Mario Monti and Enrico Letta had no effects. The number of employed has further decreased by 400,000 to now 22,3 million in December 2013 within one year. Within 6 years, Italy has thus lost 1,1 million jobs.



The unemployment rate among young people in the age of 15 to 24 years has almost doubled from the end of 2007 to 2013, from 21,6 to 41,6 %. All in all, 3,2 million Italians are without a job, among them almost 700,000 young people.

Although a few privileged employees of large corporations get extraordinary contribution for “short time work hours zero” even for many years, whereas for others the unemployment benefit is only short and bare, there are no general programs for social help or subsidies for rents. Closings down of corporations, dismissals or the expiry of limited work-contracts are thus developing into a special drama. Demonstrations or a “round table” at the Ministry of Industry are belonging to that rite. Of those there exist 150 presently, some of them since years already, without concrete results.



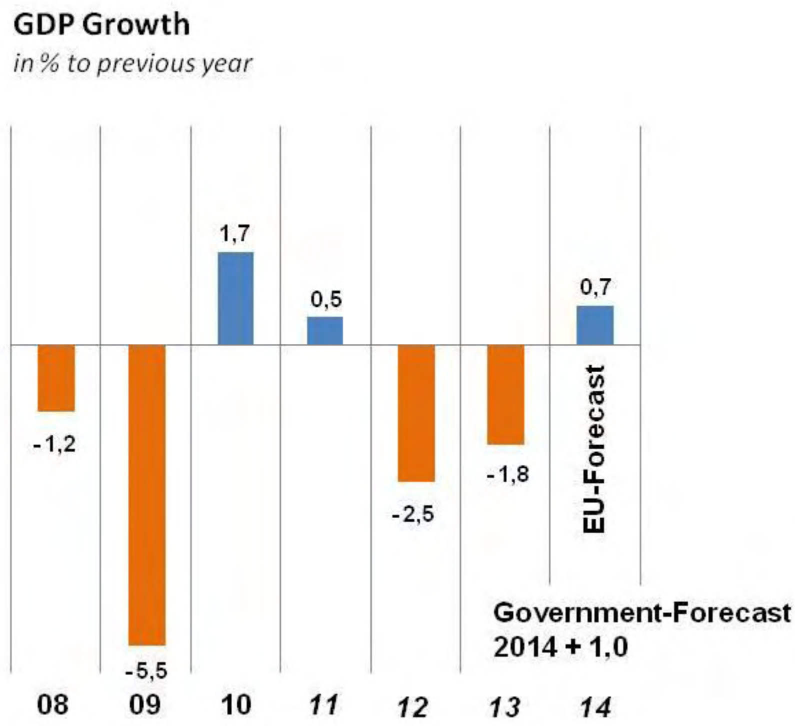
In the South of Rome the picture of the "industrial desert" is developing into reality even more. Because provincial cities of the region Latium like Rieti, Frosinone or Latina served as the extended workbench of northern Europe until the 70's. When the Iron Curtain was still existing and nobody was having an anticipation of the competition from China, many foreign corporations created their factories south of Rome to receive public subsidies for the Mezzogiorno on the one hand, on the other manufacturing facilities in these cities, like for electronic components. At Rieti, in the mountains of the Appeninnes, after several passages there is still a factory of the French group Schneider which is now dismissing the last 180 employees. The labour unions react with occupations of factories, demonstrations and a visit of a Pope-audience.

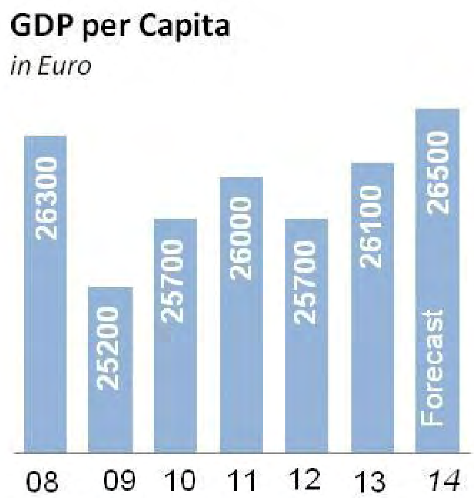
Further considerations about the Italian competitiveness do not exist. At another focal point, in the north-eastern region Friuli, the Swedish group Electrolux is threatening with the closing of a factory, nevertheless there is no readiness on behalf of the labour unions to negotiate about cancelling wage increases on national level.

To these economic structures and ways of behavior the European Central Bank president Mario Draghi was relating at Rome a few months ago saying that the success of the currency union has covered up for many years the growing risks of many countries. "The member countries, excepted Germany and few other countries, are holding back structural reforms whereby the competitiveness of obsolete economic structures could have been recreated."

Italy

Area in Square Kilometers	**301340**
Population in Millions	**61,0**
Population Growth in % (2012)	**0,3**
Inhabitants per Square Kilometer	**202**





But there is not a bit of the improvement of competitiveness, of establishments of new enterprises like in the 70’s or of creating new jobs. The only visible change for the Italians was the strong increase of the public taxes and levies ratio from 42.5 % of the gross domestic product in the year 2011 to at least 44.3 % in the year 2013. Italian media is emphasizing that with this Italy is only slightly below the level of Sweden, without, however, enjoying the comparable social welfare offers or of a functioning state organization. Vice versa the thunderstorms in recent days is increasing the feeling at the Italians to live in a badly organized state and to be left alone in a fragile territory.

From north to south there were inundations, landslides, road closures. Symbols are crashed city walls at Rome or at the Tuscany city Volterra or a derailed train hanging between sea and mountain at the Riviera since 4 weeks by now.

As a result, for the young Italians arise a perspective of hopelessness. For 2014, no improvement in the labour market is in sight. Who wants to work, must already be thankful for a low paid time limited contract and has little hope for a permanent position. According to the Statistical Office, 2 million young Italians in the age of 15 to 29 years have neither a job nor are in an education program. It is also fitting into the picture that 3.5 million young Italians in the age up to 35 are still living with their parents. Further a serious poll revealed that 28 % of the Italians in the age of 35 to 40 years are still dependent on "pocket money" by their parents. The same, is being said, applies for 43 % of the Italians in the age between 25 and 34 years.

No wonder that there is more and more the talk of the "flight of the bright heads". The latest data dating 2013 reports of 140,000 emigrants, among them tens of thousands young, well educated Italians in the age of up to 40 years.

The radio station "Radio24" of the business publishing corporation Il Sole 24 Ore is presenting the curriculum vitae of young emigrants since 4 years. As an example the engineer Marco Vismara, 28 years old, who opened an own enterprise at Berlin saying: "The Italian leaders stopped in the 80's and they only talk instead of doing something." Or Luana Ricca, a 36 years old surgeon who conducts liver transplantations as a free-lancer at Paris, but is not employeed in Italy because of lack of relations. The young Italians abroad are wishing everything for Italy which they had not found in their homecountry so far: meritocraty instead of patronage systems when it comes to hiring, responsibility and independent work also for young employees, and finally also attractive wages.

On the other hand, apparently lifted with too few practical solutions, the Italian political class is living in the trivialities of their daily business, with 950 parliamentarians in two parliamentary chambers, which cost 1.6 billion Euro in total in 2013. The pompously announced reform packages, however, are showing practically no results, because there are still missing almost 500 regulations of execution for the concrete applications. In this situation the entrepreneurs are now protesting even outside of the parliament: "Give us a normal country", says Squinzi, the president of the entrepreneurs association, "and we will show what we are capable of."

Italy

Interview: Our Politicians are Talking Like Coming from Mars

Interview with Mr. Luca di Montezemolo, President, Ferrari Corporation.

The president of Ferrari is advertising for his country. For the deep crisis of this country he holds responsible politicians without rootedness, and self-satisfied functionaries.

Interview made by Tobias Piller

Italy seems to be caught into an internal contradiction: a country with so much talent and potential - and with so many problems. Is Italy remaining eternally the country of many missed opportunities?

Unfortunately the answer is yes by looking at the numbers and facts. Answering this question with no would mean to pull one's leg oneself.

Has Italy maintained itself its basics for economic growth?

We are a country with four important strengths for the economy: Industry, craft manship, tourism and the culturate category which is related to tourism. When looking at our competitors, there are only few where these branches are offered and combined by the same extraordinary way. How much potential Italy is possessing, you can also fix on surprising details. The industry which is exporting much more than others to Japan, is not the fashion- or food-industry, but the precision machine industry. 25 % of our exports are machinery and equipment. This is the proof of how much the Italian corporations have improved their technical level since the crisis of the 90's. Fortunately, the globalization has given an impetus to this. Our manufacturing industry in Europe is continuing to be number 2 behind Germany. In the past years Italian corporations have grown to a multiple of their previous dimension, let us take the spectacle producer Luxottica with its dozens of fashion labels as an example, let us take Prada or Tod's.

But if it is like that what does not work in Italy?

Based on my personal experience I can report about an investment by a private operator of high-speed-trains, a big success with more than 1,000 permanent employees. Also the other Italian shareholders are successful in international competition, be that Diego Della Valle with Tod's, Alberto Bombassei with Brembo or the family Seragnoli as the world market leader of packing machines. But when we created a corporation which needs the dialogue with official institutions, it became a tragedy. Because the State is also the holder of the old monopoly company. Now we get no answer, we are confronted with always new difficulties and this is hindering competition.

Can you transfer this example to entire Italy?

Instead of rolling out the red carpet for those who invest and create jobs, the politicians have not been interested in economic development. There was no clear strategy and it was missing a common plan. This is like in a beautiful concert: It is helpful to have the best soloists - but then you will need a conductor who creates an orchestra. Therefore we have not moved forward in the last twenty years, at best we have remained where we stood. But remaining means to lose positions. And in many areas Italy had suffered setbacks.

Also in the tourism industry Italy has fallen back strongly.

Capri, Pompeii, the Vatican and the Alps are still there where they always have been. But we have not worked enough for this. So, in the world ranking list for tourism we have fallen back versus an increasing number of competitors - from the Maldives to the Arabian Gulf. In the past years China or Spain have attracted 57 million tourists, we were at 46 million - half as many as France.

How could that happen?

I do not want to rant about politicians only. But there have been many historic mistakes - e. g. concerning the constitutional reform which transferred the responsibility for tourism to the regions without any strategic coordination at national level. So we have wasted much money. During my travelling to China, I have met delegations from Italy again and again which were only there to organize dinners among each other. We have not put up a national strategy starting with an airline which is bringing Chinese people to Italy and Italians to China without one having to change planes at Paris, London or Frankfurt. It lacks a strong tour operator, a strong hotel chain with international standard. For instance, I wish that around Pompeii there is everything available a visitor is expecting, with an awesome shop like at MOMA in New York or like a hotel relevant to the subject as at Disneyland. Even in a small town like Maranello we have shown what can be done: Our Ferrari-Museum was attended by 320,000 visitors the last year. With this we are among the 5 most visited museums in Italy.

If tourism does not function well, will "made in Italy" lose its appeal overall then?

When somebody is buying a luxury product from Italy, he has also in mind the landscapes, monuments and lifestyle. Therefore we cannot allow ourselves a decline of tourism when we want to avoid consequences for other products. Also the industrialists have to be concerned about what is shown in the showcase of Italian offers.

At the same time there still exists the large pride of the name "Italia". You present yourself often as an ambassador of "made in Italy" as the president of Ferrari.

Thereby I see that there is a great longing for Italy especially in the emerging countries, for the culture, for beauties of the landscape, the lifestyle. The trademark "Italia" is also very attractive in the countries from which millions of tourists have not yet come. This also helped to let grow the exports of Italian corporations to all over the world. Nobody can only depend on the domestic market alone. Ferrari, for instance, has sold less than 3 % of its production in the home market in 2013 - also because of masochistic tax policies. The real advantage of “made in Italy”, however, are the small, craftsmanship oriented enterprises. For instance in Tuscany, their customers are worldwide luxury enterprises like Gucci or Hermes. In Italy, there is the breeding ground for this kind of enterprises, the tradition, and the supply chain up to major enterprises. But they are suffering from tax pressure, problems of successorship and the lack of a system for professional education.

Are there qualifications in the Italian entrepreneur-world which convey advantages in competition for you?

Italy has much creativity and much talent to create trademarks. During a meeting in Brazil the former president Lula told me that he would be jealous of the Italian people, as the Brazilians would produce the Bresaola-ham, but the Italians would pack the product in a nice way, they would have an attractive name for it and could sell the whole thing well. And taking very simple products as tomatoes or leather: We have the trademarks and the instruments to make a premium product of a very simple thing, and this has enormous potential.

What are the most difficult experiences when you are representing Italy abroad?

When being abroad I try to speak only positively about my country. Nevertheless it is told to me again and again that Italy would be absolutely unpredictable. Recently, prime minister Letta was in Abu Dhabi for paving the way for negotiations about a participation of the Arabian Airline Etihad to Alitalia. One decided about intensive negotiations for a month - and only a few days later the government does not exist anymore. Renzi is still not known. In this situation I vouched personally, saying that Alitalia would be a big occasion. Of course I am asked what should happen now.

What is to be done?

One has to tackle the problem of bureaucracy, have another union culture and facilitate the work of corporations. Either we are creating the conditions for that those, who are risking something and investing in Italy, can also have success - or nobody can save us anymore. Because, if an entrepreneur can only remain competitive by emigrating to Croatia or to Switzerland, then he has the duty to go to these destinations.

What do you think about the reforms which Renzi has announced?

He has the right to say that one has to start with a reform program again - the other Italian politicians have done it much less. Now, they are also talking in a way, as if they have just arrived from Mars this morning. In order to find out that reforms are necessary here. But where have they all been during the last years?

What is the difference between Renzi and the other politicians?

As the former mayor of Florence, Renzi is coming from a city which is international. At the same time he has personally gone through the problems of Italy, at the basis of the country. He is more in a position to recognize the problems than the professional politicians. Those have partly lived half their lives at Rome, at the location which is simply called “the Palazzo” in Italy, and they have distanced themselves ever more from the reality of their country.

The Ferrari-Principal

The 66 year old Luca di Montezemolo is - according to his occupation title - a lawyer. He studied at Rome and at the Columbia-University of New York. Shortly after the final degree, he became assistant of Enzo Ferrari, then he became head of his Formula-One-Racing-Team which he led to a World-Championship-title with Niki Lauda in 1975. In 1990, he was chief-organizer of the World-Soccer-Championship in Italy. A year after he took over the leadership of the then crisis-riven sports-car-producer Ferrari. Its turnover has increased tenfold under his leadership. Until 2010 Montezemolo was also president of the entire Fiat-Group.

International

Prof. Dr Hans van den Hurk*

Starbucks versus the People

In this article, the author provides his opinion on the current debate on tax avoidance by multinational enterprises.

1. Introduction

Even in the face of opposition to tax evasion and tax avoidance from a rising number of states, more and more other states are trying to create all kinds of agreeable tax incentives to attract more companies. The result is a deadlock. The President of the European Council, Van Rompuy, talks about a trillion euro in revenue losses.[1] More and more citizens are turning against companies and governments that permit or take advantage of massive tax reductions. This article takes a closer look at all these developments.

2. Who Are the Key Players in this Discourse?

At the time of the writing of this article, the newspapers were full of stories about companies trying to reduce their effective tax burdens through all kinds of structures. This is not a new phenomenon. In the last few years, angry citizens have been the driving force behind movements that express their vehement discontent with companies paying as little tax as possible. Non-governmental organizations (NGOs), such as SOMO, Tax Justice Network, ActionAid, Christian Aid, Robinhoodtaxes.org, are waging war against the behaviour of these companies. Some NGOs have published articles and reports on their fight against tax systems like the one in place in the Netherlands – with incentives like the participation exemption being branded "antisocial".

Other organizations, on the other hand, have opted for a sort of "preventive approach": "We are not saying your company is doing something wrong, but just tell us what you are paying." They simply protest against the company until it answers the question on what it effectively pays in taxes and in which country. Vodafone was faced with various groups occupying its shops in protest against tax avoidance amounting to GBP 6 billion.[2] Robinhoodtaxes.org even uses professional actors to make impressive short movies to influence public opinion.[3] The Dutch beer brand Grolsch was beset by a professionally set up action that received worldwide attention.[4] Many tax consultants consider these NGO-induced agitations to be a rearguard action on a road to nowhere. But, are they really? Is this a movement fed by public outcry befitting the spirit of the crisis when some companies still generate quite magnificent profits that are totally out of proportion to the tax they pay every year? A movement that implodes once the crisis has ended? This author does not think so.

The world is going through a lot more. People in the western world have become accustomed to solving international tax law issues using the OECD Model. [5] And when any western company invests in non-western economies, it is immediately assumed that those countries will follow the OECD interpretations. By including mutual agreement procedures in tax treaties, any risk of double taxation should be avoided.

The economy's globalization has not been beneficial in all respects. New countries have risen, with far more financial and economic power than many of those in the West. The most important countries are grouped under the umbrella title "BRIC countries": Brazil, Russia, India and China.[6] While Russia's real economy may not exactly count as huge, the opposite is true of the other three countries. Their size means that a globally operating company must be present: either for business-to-business operations or simply because they are home to a vast number of consumers whose income is growing strongly – income they are eager to spend.

These are exactly the countries that the western countries should be concluding tax treaties with. However, this is difficult as BRIC countries are not likely to accept the OECD Model. The following example illustrates this:

Example

Company A establishes a sales company in India. The sales company is converted into a stripped distributor to avoid the margin generated in that country from becoming too large. This means that certain functions of the sales company will be performed by another group company outside India. This company does not just manage the risks for the sales company, it actually bears them. Since the sales company bears little or no risks and a group company outside India performs most functions, much less profit is allocated to India based on the OECD Models and the OECD Transfer Pricing Guidelines.[7]

As these structures are considered to be artificial, many countries no longer accept them. They think that the pres-

* © Hans van den Hurk 2013. Professor of European Corporate Income Taxes, University of Maastricht. The views expressed in this article are the author's own and do not necessarily represent those of any of the organizations for which he works. The author can be contacted at hans.vandenhurk@maastrichtuniversity.nl.

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2. *See* www.youtube.com/watch?v=FCKcQraoedc.
3. *See* www.youtube.com/watch?v=qYtNwmXKIvM.
4. *See* www.youtube.com/watch?v=alcKsti_8QQ.
5. Most recently, *OECD Model Tax Convention on Income and on Capital* (22 July 2010), Models IBFD.
6. "BRICS" is the more common term since South Africa's tremendous growth. A second layer of growing economies is on the rise (e.g. Indonesia). Most of these countries rely heavily on the *UN Model*. Most recently, *UN Model Tax Convention on Income and on Capital* (1 Jan. 2011), Models IBFD.
7. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2010), International Organizations' Documentation IBFD.

ence of a distributor in their country is the reason why the company generates profit there. They simply want to tax this profit, irrespective of any tax treaties. Companies facing this issue are frequently forced to take their case to national courts where the outcome is uncertain, to say the least.

Brazil and India are countries with their own distinct tax interpretations. They are the foremost examples of countries that refuse to accept the tax standards that the western countries find acceptable. Even if all the transfer pricing models show that eliminating functions and risks means that no more than 10% profit needs to be generated over the costs, these countries' tax authorities regard such a distributor as an ordinary sales company and they feel that 30% is a more reasonable percentage. Many legal proceedings involving India relate to this issue. Brazil follows a different approach. It was the first country in the world to require an electronic corporate income tax return. However, it started to amend the forms very often, so that few companies could be compliant, which resulted in heavy penalties. Brazil also has its own view on what constitutes a reasonable profit allocation. If any model treaty provides guidance for such interpretation, it is the model treaty drafted by the United Nations. However, even this will not stop countries like Brazil from applying a much broader source state approach than the United Nations has ever intended.

What is the response of the Western world? As early as 2007, the OECD set up a Steering Group to tackle aggressive tax planning. Part of the strategy is creating a database solely accessible to tax authorities. The idea is to record as many examples of aggressive tax planning as possible, so that the participating states can share a great deal of knowledge. In addition, the OECD has published several reports.[8] The western world has awakened to the growing pressure from the rest of the world on tax structures solely designed to minimize tax liabilities. In particular, the BEPS Report (OECD 2013) stirred up a hornet's nest. Although an OECD report is not binding, this report is likely to influence multinationals' tax structures. Their corporate social responsibility makes companies anxious about newspaper reports on investments in poorer countries because the wages there are still conveniently low, about tax avoidance through debt financing and about all kinds of transfer pricing structures. Companies are increasingly aware of what it means to be living in an information society in the year 2013. The internet is a sure-fire way to have anything happening on the other side of the world revealed immediately.

And the European Union? Of course, the European Union had to act. In December 2012, the European Commission issued an Action Plan to reinforce the fight against tax fraud and tax evasion.[9] One of the tax planning instruments subject to scrutiny is the hybrid loan.

EU legislation would have to be enacted to make it impossible for the income from a hybrid loan to be tax free in one country and for interest on such a loan to be deductible in another one, but is this a realistic solution? In other words: what are the chances of the European Union being able to change the Member States' tax laws, knowing the strong focus on taxation of some of these countries and knowing that some of them will unequivocally reject any interference in their tax systems.

Ultimately though, these questions need not be answered. In a world where NGOs force companies to act responsibly vis-à-vis the global society, major investment countries no longer stomach the erosion of their taxable bases, and, as the political call to arrive at a more equitable taxation grows ever louder (in Western countries too), it seems impossible to reverse these processes. The European Union has one additional instrument available to challenge the tax systems of the Member States which are "too competitive"; namely the State aid provisions.[10] It is expected that we will see more cases investigating the question of State aid in the future.

Section 3. describes an example of a company with what is called a fully tax efficient structure. It discusses whether such a company engages in culpable behaviour and the role of governments in this respect. How much blame should companies shoulder for paying no tax on very high profits? As long as states continue to create legislation while proclaiming the adage "every man for himself and the devil take the hindmost", the culpability, at the very least, is shared.

3. How Google Optimizes Its Tax Position[11]

3.1. Introductory remarks

The choice of Google is a random one. Being able to find a wealth of information about the structure's elements by simply googling around a bit helps. However, instead of Google, the author could equally have picked Starbucks, Vodafone or Amazon, which are merely a limited subcollection of a mammoth group of companies that know how to find extremely innovative ways of reducing their tax burdens.

Over the years, Google has carried out a solid expansion of its operations. It has evolved from merely administrating the largest internet search engine in the world to being the owner of YouTube. In some parts of the world, Google is now also known as the organization where you can book the cheapest plane tickets and holidays.

Google was incorporated in California in 1998. In 2011, its revenue reached nearly USD 38 billion and its profit USD

8. *See*, for example, OECD, *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (OECD 2012), International Organizations' Documentation IBFD, also available at www.oecd.org/ctp/aggressive/HYBRIDS_ENG_Final_October2012.pdf; OECD, *Addressing Base Erosion and Profit Shifting* (OECD 2013), available at www.oecd.org/tax/beps.htm; OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013), available at www.oecd.org/tax/beps.htm.
9. European Commission, An Action Plan to Strengthen the Fight against Tax Fraud and Tax Evasion (COM(2012) 722 final), EU Law IBFD.
10. Articles 7-1 of the Treaty on the Functioning of the European Union (TFEU) (consolidated version), OJ C83 (2010), EU Law IBFD.
11. The author would like to thank Nicole Rode, Phd student at Maastricht University, for her support with fact finding regarding Google.

10 billion. The effective tax rate was 2.4% in that year, while the statutory tax rate in the United States was 35%. The big question is how Google, rooted in the American business community, managed to realize this fantastic result: normally the part of the profit paid out as a dividend should effectively have been taxed at 35%.

3.2. Building blocks

3.2.1. Initial comments

Section 3.2. provides an outline of some of the features of the US tax system corresponding to the four principles that Google's tax structure is based on. The US tax system has always predominantly followed the maxim that with respect to large countries it should make no difference to companies whether they invest in the United States or elsewhere (capital export neutrality). The tax burden will always relate to the rate levied on domestic profits. Nevertheless, this maxim exists only in theory.

3.2.2. Principle 1

The United States taxes US companies on their worldwide income. The US tax rate of 35% is quite high compared to the applicable rates in other Western countries. Profits of non-resident companies are taxed only if they are repatriated to the United States.

3.2.3. Principle 2

The United States, like any country, has rules for the avoidance of double taxation. The first option is a system of deducting foreign taxes from the US taxable base, which does not eliminate double taxation in full. The second option (the credit system) is more effective in avoiding double taxation. Under this system, foreign profits are included in the US taxable base on which the related US tax is calculated. The foreign tax charged is deducted from the US tax liability. The deduction cannot exceed the US tax due on those profits (ordinary tax credit). This is why most companies opt for the tax credit method instead of the deduction system.

Companies have an obligation to reduce their foreign tax burden as much as possible.[12] Companies should seize any opportunity to go to court if valid reasons exist to dispute the application of a tax rule in the foreign country. Failure to do so will result in the losses involved being qualified as voluntary taxes, which are unavailable for a set-off.

3.2.4. Principle 3

Like many credit systems, the US set-off system is fairly easy to get around. To counter this, the United States has implemented tax legislation to prevent tax avoidance: Subpart F rules target foreign passive income and income generated through inter-company transactions. This legislation seeks to safeguard the US taxable base from taxable revenues being artificially transferred to third countries at the cost of the US taxable base. Since the introduction of the check-the-box-regulations in 1997, the application of the US CFC legislation can easily be avoided.

3.2.5. Principle 4

The fourth basic assumption is the application of the OECD Transfer Pricing Guidelines. This means the remuneration in inter-company transactions should be at arm's length.

3.3. Google's tax planning toolkit

3.3.1. Shifting of intellectual property rights

Some years ago, Google directors anticipated that the value of their intellectual property (IP) rights would rise in the period ahead of them. As exploiting these rights in the United States would result in a high tax burden, transferring IP rights to another country through a sharing agreement seemed to be perfectly reasonable. Ireland became the country of choice, inspired by an agreeable tax rate of 12.5% and the availability of appropriate personnel.

The cost sharing agreement involved two elements. The first was to have the parties bear the costs for the IP development in proportion to the opportunity to develop this right. In other words: from that time on, the IP right was enhanced with value from locations all across the globe. Since the value was no longer created solely in the United States, this left the US Internal Revenue Service (IRS) largely empty-handed.

The new group companies outside the United States could acquire the entitlement to the existing IP rights at an arm's length price. After some negotiation, the IRS agreed to the proposed transfer prices.

The next question was how all of this should be structured effectively. Google set up a subsidiary in Ireland (Ireland Holdings Limited, IHL). This new subsidiary acquired the rights to exploit Google's IP rights for Europe, Middle East and Africa (EMEA) through the cost sharing agreement. In 2006, Google concluded an advance pricing agreement, obtaining certainty on the price for the relevant transfer prices. All profits generated within the EMEA were to be taxed in Ireland and no longer in the United States, except if repatriated.

3.3.2. The Double Irish

The Double Irish involved the incorporation of a second Irish company (Google Ireland Limited, GIL) which was responsible for managing royalties earned in EMEA countries and coordinating activities for the EMEA region. The company was to be incorporated by a Dutch intermediate holding company. Ireland Holdings Limited, which holds the intellectual property right, granted the Dutch intermediate holding company a licence and, in turn, this company granted Google Ireland Limited a sub-licence.

As a result of this structure, Google enterprises within the EMEA pay Google Ireland Limited for the right to use the IP rights. In Ireland, those payments are taxed at 12.5%,

12. *See* www.forbes.com/sites/lowellyoder/2012/03/06/beware-of-double-taxation-of-foreign-profits/.

whereas in other EMEA countries they are deductible at the local regular rate. Newspapers report that 88% of the non-US royalties are directed through this Irish sub-subsidiary.[13]

3.3.3. *Checking the box*

The US tax system allows foreign companies to choose their status (check-the-box rules): they can be treated either as transparent entities or as corporations.[14] Some companies are not allowed to choose a transparent status (per se corporations). The IHL is not a per se corporation and may opt for being treated as a transparent entity.

The activities of the Dutch intermediate holding company and GIL are attributed to IHL. This holding company is a passive company subject to US Subpart-F legislation, since its activities do not go beyond receiving royalty payments. It is basically subject to US legislation on controlled foreign companies (CFC) and the profits are deemed to have been distributed to the US based holding company, where they are taxed at 35%.

By choosing the transparent status, GIL's activities can be attributed to IHL. Since GIL effectively coordinates the activities within the EMEA region, this company is active. This attribution means the core activities of IHL become "active operations". Hence, the profits can continue to be amassed in Ireland, making the holding company lose its passive character.

3.3.4. *The hybridization of IHL*

The next step was to prevent income from being taxed within IHL at the rate of 12.5%. For this purpose, IHL's place of effective management was moved to Bermuda, where the rate is 0%. This decreases further, the tax difference between the tax savings due to deducted royalties (in countries where the rate is usually higher than 12.5%) and the amount of tax that is finally paid on the right to use IP.

3.3.5. *The fiscal relationship between the Netherlands and Ireland*

Transferring the effective management of IHL to Bermuda does not lead to any tax consequences in the United States. The United States still deems IHL to be an Irish company, while Ireland considers that company to be a Bermudan company. And then the interposition of a Dutch company suddenly makes sense: Ireland has not concluded a tax treaty with Bermuda, so the royalties can be subject to 20% withholding tax.

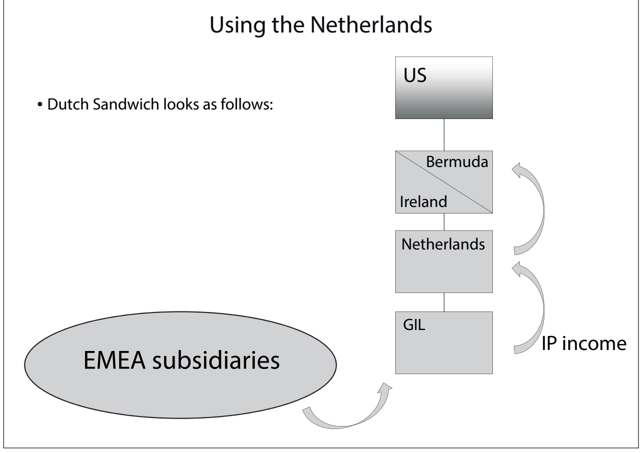
Having the royalties flow through the Netherlands means that the benefits of both the EU Interest and Royalties Directive[15] and the Netherlands-Ireland Income and Capital Tax Treaty (1969) can be reaped.[16] The royalties flow to the Netherlands without any withholding tax and, as the Netherlands does not levy withholding tax on outgoing royalties, they enter Bermuda tax free.

The Dutch intermediary company (NLH) is a *besloten vennootschap* [private limited liability company] (BV), which may choose a transparent status in the United States. In practical terms, it is a conduit company. According to the *Vraag en Antwoordbesluit Dienstverleningslichamen* [Decree on Questions and Answers relating to Financial Services Entities], the requirements of section 8c of the Dutch Corporate Income Tax Act 1969[17] cannot be applied directly to a situation in which royalties flow through the Netherlands. If this occurs, agreements with companies are concluded on a case-by-case basis.[18] With revenue exceeding EUR 40 billion, 88% of which flows through GIL, an agreement with Google would appear to be a very interesting opportunity for the Netherlands.

The question is often raised as to whether the Netherlands can be held liable for the culpable behaviour of companies. The Dutch substance requirements have been amended in 2001 to be in line with the international standards. While the Dutch tax regime offers many attractive features (tax treaty network), lack of withholding tax on interest and royalties), those features also benefit "legitimate" companies.

The following diagram illustrates the Google structure. The table shows how this structure caused the effective tax burden to drop to 21.96/1,000 = 2.2%. For simplification purposes, it assumes hypothetical revenue of EUR 1,000.

Diagram: The structure of Google



The calculation of the effective tax burden	
Google Ireland Limited receives	1,000.00
Assumption: 2% remains in Ireland	- 20.00
The Netherlands receives	980.00
Assumption: 0.2% is paid in the Netherlands	- 1.96
Net to Bermuda	978.04

13. *See* www.businessweek.com/magazine/content/10_44/b4201043146825.htm.
14. Treas. Reg. 301.7701-2.
15. Council Directive 2003/49/EC of 3 June 2003 on a Common System of Taxation Applicable to Interest and Royalty Payments Made between Associated Companies of Different Member States, OJ L 157 (2003), EU Law IBFD [hereinafter EU Interest and Royalties Directive].
16. *Convention between the Government of the Kingdom of the Netherlands and the Government of Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital* (11 Feb. 1969), Treaties IBFD.
17. NL: Corporate Income Tax Act (Wet op de vennootschapsbelasting, Vpb) 1969, sec. 8c, National Legislation IBFD.
18. *See* Decree of 11 Aug. 2004, IFZ 2004/126M.

3.3.6. *And Bermuda?*

Two directors have been appointed for INL in Bermuda to effectively manage this company. Although both of them are also lawyers at a trust office in Hamilton, they have already showed that they can act in Google's best interest. One of the first actions these gentlemen took was to convert the legal form of limited liability company into unlimited liability company, which means that the financial statements no longer need to be published.

3.4. "All's well that ends well" for Google's shareholders?

Once the money has reached Bermuda's shores, the shareholders will still not be able to get their hands on it. If they wish to have their dividend and enjoy it, profit should first be repatriated from Bermuda to the United States. However, this comes at a cost of 35%. Thus, their profits have turned into what is referred to as "locked-out profits". A fantastic tax structure has been implemented, but nobody can get to the money. This outcome is definitely not one that the shareholders had in mind. It may seem that as a consequence of the chosen structure, a deferred tax liability could be recognized in the amount of the overseas tax profits. However, according to the US rules, an exception is made for income which will be reinvested overseas (permanently reinvested earnings). It is clear that this exception is being used by the companies.

How could shareholders obtain their dividends? The simple way is to sell shares, realize a capital gain and then buy back the shares. However, these shares are expensive (the value of one share exceeds USD 1,000). Companies would need money to implement this solution (e.g. loans from overseas banks).

Google is not the only company to have this problem. Together, US multinationals apparently have accumulated between USD 1.3 and USD 1.6 trillion in tax havens.[19] If repatriated to the United States, this money would alleviate the high national debt by at least 33%. Regrettably, the shareholders do not want to accept this consequence. Having gone through much effort to concoct a wonderful tax structure, one does not want to find out that it is useless if one wishes to obtain dividends. Companies like Google are doing well in the eyes of stock exchange analysts because of their tax optimization. But what is the point in performing well if the gains cannot be realized?

It would be strange if the United States had not tried to solve this issue. Over the last couple of years, multinationals with a Google-like structure spent more than USD 1 billion[20] on lobby organizations to push for a repatriation tax holiday (a one-off voluntary disclosure scheme to be able to distribute dividends stashed away in Bermuda or elsewhere without having to pay the US tax). The first time a repatriation tax holiday was allowed was in 2004: companies had to pay only 5.25% in taxes, provided the amounts repatriated to the United States would be used for creating new jobs, research and development activities, and other socially desirable expenditures. The 2004 American Jobs Creation Act was one of the results of this deal. The idea behind the repatriation tax holiday was to bring USD 312 billion to the United States.[21] However, the deal between the government and businesses could hardly be regarded as a success. Companies took advantage of this one-off tax reduction, but failed to uphold their part of the bargain.[22] Despite being highly successful in providing reasons as to why they were unable to do so, they managed to antagonize President Obama: a strong advocate of a fair tax system. In March 2011, the Obama administration announced that it would refrain from introducing another repatriation tax holiday. Later on, Obama changed his mind and is now considering this.[23]

Low-taxed profits belonging to US multinationals are in limbo in the tax havens. Companies failed to capitalize on the chance they had in 2004 of repatriating them at a favourable tax rate in exchange for proper investments. It remains to be seen which way the wind blows under the next government.

4. Companies versus Governments

Companies like Google, which employ sophisticated tax planning structures, have evidently crossed the lines of what is acceptable. Once they have committed themselves to using such structures, they should accept the consequences. If the shareholders want their dividends, they should have them distributed and pay the US tax due. In view of these events, it is, nevertheless, annoying to see that some elements of the tax system (like the participation exemption in the Netherlands), which were designed to promote economic development of businesses, are now allegedly used for avoiding income tax.[24] Since corporate income tax has usually already been paid in the country where the subsidiary is established, there is no need to do so in the Netherlands. Recently, a Dutch newspaper reported that this participation exemption is disadvantageous for developing countries.[25] In the author's view, this is incorrect. If a developing country is trying to create employment, the common practice would be to reduce its corporate income tax rate. If the Netherlands did not have the participation exemption, the benefits granted in

19. *See* http://americanactionforum.org/research/ending-the-lockout-of-overseas-earnings-an-update.
20. *See* http://usaction.org/2011/11/new-report-fool-me-twice-corporations-pay-congress-to-rip-off-taxpayers-again/.
21. *See* www.rhsmith.umd.edu/smithbusiness/fall2012/KnowledgeTransfer/TaxHoliday.aspx.
22. *See* http://dealbook.nytimes.com/2012/10/03/overseas-cash-and-the-tax-games-multinationals-play for an example of how a company like HP was able to escape the 5.25% taxation.
23. Recently, President Obama has announced a possible introduction of a tax repatriation holiday. *See* http://blogs.marketwatch.com/thetell/2013/07/31/repatriation-tax-holiday-push-resumes-after-obama-proposal-goldman/.
24. *See* S.S. Johnston, *U.K. Lawmaker Calls for Tax Inquiry Into $130 Billion Vodafone-Verizon Deal*, World Tax Daily, Tax Analysts (5 Sep. 2013), on Vodafone's sale of its stake in Verizon Wireless via its Dutch intermediary company, which made the capital gain tax free due to the Dutch participation exemption.
25. K. McGauran & I. Romgens, *Nederland stimuleert belastingontwijking* [Netherlands stimulates tax avoidance], Financieele Dagblad (5 Apr. 2013).

the developing country would be cancelled out by the application of the Dutch tax rate to profits repatriated from the developing country.

How can bilateral tax treaties play a pivotal role in the tax avoidance system? This does not seem possible even if a company performing some administrative tasks wants to access them. The existing Dutch treaty network may be used to reduce the withholding taxes on interest and royalties, but only if certain (substance) requirements are met. For financing activities, the requirements of article 8c of the CITA 1969 must be satisfied. International tax law is built on the concept of the "ultimate beneficiary", whereas journalists usually search for the "ultimate ultimate beneficiary", which is usually the top holding company.[26]

In the author's opinion, NGOs target the wrong international tax law elements: Google has argued its case with a clean conscience, albeit not accepting the consequences of the game, i.e. taxation upon repatriation. This is what should warrant the attention of the NGOs.

The tax position of companies is one of the issues their stakeholders hold them accountable for. Can those companies be blamed for taking advantage of the differences in rules between the various states to reduce their tax burden? In general, all companies take the opportunities international law offers them. But there is nothing wrong with that. Global organizations would not be efficient if they failed to have a structure under which as little tax as possible is paid. Revenue and cost optimization involves not only tax considerations: many companies relocate to or create subsidiaries in countries where the cost of labour is low. The shareholders have a role to play in testing a company's corporate social responsibility policy

It seems that it is only a matter of time before some of the traditional tax planning building blocks will be abolished. One of them is the hybrid loan. The problem is not so much the company employing this type of financing arrangement but rather countries not charging tax on the revenue from hybrid loans, even if interest has been deducted in the country where the company paying the interest is established.[27] Both the European Union and the OECD would like to discourage companies from using such structures. It seems that other traditional tax planning options will increasingly be targeted in the coming years.

In the author's view, companies should stick to all the rules of the game. If a company is deemed to be active, then it should actually be active. A letterbox company with few management meetings a year may be perfectly suited to managing IP rights. Management of IP rights can be undertaken in a relatively simple manner, but establishing an intra-group finance company is considerably more complicated. Even if a finance company based in Switzerland employs 50 people, it is still doubtful whether the effective management of that entity is not located somewhere else. Should the group feel the need to set up a new factory in India and should this partly be achieved through "borrowed" capital from the Swiss financing company, the decision about how much will be funded and at what price is unlikely to be taken in Switzerland, more likely by the CFO in consultation with the Executive Board.[28]

If a company is set to perform activities, those activities should actually take place (which is, however, not always the case).[29] Situations where companies claim to perform activities in certain countries/islands but where those activities are actually non-existent, constitute tax evasion and not tax avoidance. The same can be said of situations where a trust office exercises the control over a company in circumstances in which no reasonable shareholder would leave the company management to such a trust office.

What exactly is the role of states in all of this? They determine both the tax burden they impose on companies and the parties to and conditions of the bilateral tax treaties they conclude. However, their willingness to cooperate is still limited. Where a company has the world as its playing field, countries are only concerned with one thing: having as much of that "world" flowing through their territory as possible, as this generates funds. This outlook has sometimes led to quite extraordinary situations. The British minister, George Osborne has appeared in the headlines for proposing tax changes to make the United Kingdom the most favourable place to do business in the world, with the lowest corporate income tax rate. What is more, an innovation box has been introduced in the United Kingdom and certain withholding taxes have been abolished. Additionally, Osborne has appointed 2,000 new tax inspectors to tackle companies that are utilizing the more favourable tax laws of countries other than the United Kingdom. Thus, the entire world should operate through London; a failure to do so (opting for another favourable country) will, at the very least, create major difficulties with Her Majesty's Revenue and Customs. This reveals a huge imbalance: enterprises cannot simply change the rules, whereas the states can. Thus, companies should not be blamed for going to other more favourable countries. Even a lot of state-controlled companies optimize their tax positions in this way: Energie de France has a Dutch holding company and the Dutch national railway company which leases train carriages through Ireland.

Who engages in culpable behaviour? The companies, which exercise the rights created by the states? Or the states with their two-pronged policies of attracting companies, while at the same time coming down on companies trying to explore better alternatives? In any case, the catch-all term "tax avoidance" for companies opting for the most beneficial route to reducing their tax burdens has a strong contender in the term "tax competition": states trying their best to coax companies into establishing themselves on their respective territories.

26. Companies, such as Philips or HP, are organized in sectors involving a lot of subsidiaries. An "ultimate beneficial owner" approach would lead to major tax disadvantages as far as withholding taxes are concerned.
27. Sec. 13(4) Vpb 1969.
28. This will only be different if it has been established that the CFO and the CEO physically attended the important meetings in Switzerland.
29. *See* www.youtube.com/watch?v=XAenlYsV7A4.

Both camps should take their fair share of the blame. Companies can be accused of culpable behaviour if their tax structure is perfect to the point that they can no longer distribute dividends at which they want the state – the one party to suffer most from these actions – to help them out, of if their structures for routing of cash flows are not supported by the facts. The latter situation is simply called tax evasion and deserves a tough approach. At the same time, states display similar behaviour. The United Kingdom policy towards tax competition is an example.

5. The Changing World

Companies go for the lowest possible tax burden. States have their own reasons for facilitating this. However, these days, people (who are also the customers of those companies) no longer accept that no tax is paid in the countries where the profit is made.[30] The actions of the NGOs have become more forceful and more professional. NGOs increasingly use the possibilities that modern times have to offer. The internet has made the world smaller, so nothing can be kept secret any more. The NGOs' campaigns will not be ignored, as corporate social responsibility is a prominent topic in the boardrooms of many multinationals. No one wants coverage in the press, the risk of being damaged is just too big.

Likewise, there are rising economies to contend with: China, Brazil and India. Not long ago, the BRIC countries were countries whose economies were still burgeoning – which is the reason why many tax treaties with Brazil contain a tax sparing credit. But the world has changed rapidly. Nowadays, the BRIC countries are listed among the more important countries in the world.[31] The BRIC countries and South Africa will join efforts to incorporate their own World Bank because of their discontent with the one in place.[32] The BRIC countries have become major investors in the Western world. They also attract investment, because their economic growth has increased the spending power of their people. These countries start to recognize the superb structures Western countries can create, but fail to accept them, as can be witnessed in the numerous tax proceedings pending in India.[33]

As regards tax matters, the BRIC countries have largely gone their own way. The source state principle seems to be of major influence in this respect.[34] Why should they accept their countries being used for cheap labour without a fair share of corporate income tax? Globally operating companies cannot afford to disregard Brazil or India. However, other developing countries do not have such a strong position. Companies have high requirements before they establish factories there: the land should be given away preferably for free, the infrastructure needs to be good and the corporate income tax rate should be low. Once again, the NGOs lend a helping hand here.

Recently, the United Nations issued its Practical Manual on Transfer Pricing for developing Countries (the "UN Manual").[35] In this Manual, the UN aims to take a leadership role in an attempt to draft global transfer pricing guidance that can be used by countries all over the world in developing and implementing transfer pricing regulations. Does it make any sense that the UN takes the lead? It would if it meant that almost all countries around the world will apply the same principles. This would reduce double or non-taxation. Yet in practice, the outcome is not that positive. The principal merit of the UN Manual is that it shows how four of the main UN states (Brazil, China, India, and South Africa) view inter-company pricing. Surprisingly, these four states have four different views, which obviously further complicates the matter, as shown in the examples below.

Brazil argues that the "arm's length" principle produces immoral results, for instance, where a cost plus arrangement is set up, simply because it does not accept the "plus" that can be determined using the regular comparisons. The country introduced fixed margins for gross profits and markups. Brazil effectively applies a system that has elements of formulary apportionment. The Brazilian perspective is that the conventional use of the resale price and cost plus method implies uncertainty and legal instability, since these are implemented by the taxpayer without previous consent by the tax authorities.

China, on the other hand, has quite different problems, facing certain challenges that are not addressed by the OECD Transfer Pricing Guidelines. The situation in China is believed to be so unique that there is a lack of appropriate comparables coupled with difficulties in quantification and allocation of location-specific advantages, as well as issues relating to the identification and valuation of intangibles. In practice, this means that the Chinese tax authorities will always try to adjust the comparables to create a more reasonable arm's length price. An example is a Chinese manufacturing plant paying royalties to a Western affiliate since 2003. In ten years' time, the innovative character of the Chinese company could demand the Western affiliate to pay royalties in China instead.

India's approach differs from that of China. Profit allocation is normally based on three factors: functions, assets and risks. India believes that the allocation of risks can be artificial. Contractual risk allocation would imply that an R&D plant in India is operating risk free; consequently, this subsidiary would only be entitled to a lower cost plus remuneration. The Indian tax authorities do not accept this approach. India believes that if the core function or

30. At least, this is how the NGOs portray it. However, if an individual opens a coffee bar next to Starbucks, he will never generate the same revenue as Starbucks does, because the popularity of that brand is the consequence of worldwide investments. Therefore, it is understandable that its profit is not fully taxable in the source country.
31. Similar countries are: Ghana, Indonesia, Korea (Rep.), South Africa, and Taiwan.
32. *See* www.bloomberg.com/news/2013-03-25/brics-nations-plan-new-bank-to-bypass-world-bank-imf.html.
33. Companies like Vodafone, Galileo International and Rolls Royce have major legal proceedings pending in India.
34. H. van den Hurk, *Voorwoord en Introductie* [Introduction] in: *Fiscaal Innoveren in Nederland* [Fiscal innovation in the Netherlands] p. IX (Kluwer 2012).
35. United Nations, *Transfer Pricing: Practical Manual for Developing Countries* (Oct. 2012), available at www.un.org/esa/ffd/tax/documents/bgrd_tp.htm.

R&D services are located there, important strategic decisions by management and employees of the subsidiary are required. The Indian subsidiary is deemed to control its operational and other risks, resulting in a higher remuneration.

South Africa has difficulties in determining the proper arm's length prices, for the same reasons as China. It is clear that hardly any comparables are available from South Africa, while Western comparables cannot be applied. Therefore, South Africa uses a more holistic approach with respect to, for instance, service fees. The current two-step OECD approach (has a service been rendered? Is the charge at arm's length?) is applied in an alternative way. The tax authorities investigate whether the recipient has an economic and commercial benefit, whether the services are performed by the recipient and whether the service fees include shareholder services. Hence, they go beyond the paperwork supporting the system and look at what actually happens from their perspective. In many situations, this approach will obviously shift the income and the tax burden to South Africa.

Although the UN Manual aims to take the lead in the transfer pricing world, the whole world does not pursue the same line of argument. Not even all UN countries apply the same approach. Several relatively small upcoming economies have their own perceptions. They have learned to understand the way companies approach pricing and try to prevent their tax bases from eroding.

The application of the OECD Guidelines and commonly used databases will not always help determine an acceptable profit allocation. Most databases do not provide information on developing countries. In particular, inter-company pricing between OECD states and non-OECD states should be tailor-made. The UN Manual provides some guidance but nothing more than that.

Will all these developments result in the end of tax planning? In the author's opinion, some of the structures are based on economic principles and should not be challenged, even if this means that the source state can levy less tax. For example, the right to use a famous brand can be sold at arm's length to a group entity in a tax-friendly country. It can be sufficient to have lawyers who manage the IP rights in that country and to send an invoice for their use once a year (whether this structure is acceptable depends on the circumstances of an individual case). However, once companies have opted for a structure, they should accept the consequences and not ask the state to help them repatriate profits.

In the Tax Annex to the St. Petersburg G20 Leaders' Declaration, it reads that actions are identified in the area of transfer pricing to put an end to the disparity between the location of profits and the location of real activities.[36] It is not impossible that there will be a move from applying the arm's length principle to a system which will ultimately be close to formulary apportionment. The path would probably go via country-by-country reporting in combination with a full exchange of information to a system where profits are taxed where they are actually generated.[37]

6. Conclusions

The author is astonished at the extremely dogmatic nature of the discussion on tax avoidance – the difference between tax avoidance and tax evasion seems to have vanished completely.

This debate on tax avoidance evokes a lot of emotion. Tax law will almost certainly change. But the changes should not mean multinationals will be allowed to perform passive activities in the head office country only – this would really be a step too far. The NGOs have become part of the world of taxation; and there is little wrong in that. Tax evasion should be tackled vigorously, but tax avoidance is a different story. While some things are no longer appropriate, some of the tax structures are perfectly reasonable. And if there is a desire to change this, new laws have to be created, preferably initiated by the OECD and the UN. That which has yet to be changed cannot be used against a company.

36. G20, *Tax Annex to the Saint Petersburg G20 Leaders' Declaration* (2013), available at www.g20civil.com/newsg20/4071/.
37. Id., at p. 3 (an analysis of how G20 looks at the automatic exchange of information).

BETTER POLICIES FOR BETTER LIVES

PART I

OECD SECRETARY-GENERAL REPORT TO THE G20 FINANCE MINISTERS AND CENTRAL BANK GOVERNORS

Base Erosion and Profit Shifting (BEPS) and Automatic Exchange of Information

February 2014

A - BEPS

Following the endorsement of the *Action Plan on Base Erosion and Profit Shifting* (the Action Plan) by G20 Leaders in Saint Petersburg, the G20/OECD BEPS Project was launched in September 2013. The Project is developing measures that, once implemented, aim at putting an end to double non-taxation, while securing the elimination of double taxation and a level playing field for business. G20 countries are participating in the Project on an equal footing with OECD member countries. The relevant OECD bodies dealing with BEPS have been opened to all G20 countries, which are playing an active and leading role. As the timeline is very ambitious, work started immediately after the launch of the G20/OECD BEPS Project in September 2013 and is on good track to deliver the actions on time. The success of the Project will also depend on your collective ability to find compromises and to move in the same direction. While we are fully aware of some current divergencies, we strongly hope that your joint efforts will put an end to BEPS, help build an innovative international tax framework, level the playing field, eliminate double taxation and prevent double non taxation.

Overall, we are impressed by the commitment of your teams to advance this agenda. Efforts have been made by all at this early stage. More will be needed on all sides to find balanced compromises. Beyond the technical challenges, there are different country and political interests. The success of the project will depend on your ability to compromise with each other to reshape the international tax environment and make it truly global.

Work on the BEPS deliverables is under way and outputs will be delivered according to the timeline

The Action Plan to tackle BEPS has three key overarching objectives: (i) establishing international coherence of corporate income taxation, (ii) restoring the full effects and benefits of international standards, (iii) ensuring transparency while promoting increased certainty and predictability. Substantial progress has been made in relation to the 15 deliverables identified in the BEPS Action Plan to achieve these objectives. This applies in particular to those deliverables scheduled for September 2014, which include the work on the tax challenges of the digital economy and a study on the feasibility of a multilateral instrument to implement the measures developed in the course of the Project and modify bilateral tax treaties. Details about progress made in the different areas are included below.

Addressing the Tax Challenges of the Digital Economy is challenging but must be successful (Action 1)

The work is advancing, business models in the digital economy and the features that exacerbate BEPS issues are being analysed by an ad-hoc Task Force, together with options to address the key tax policy challenges are under discussion. The work is taking into account not only recent but also likely future developments that will affect the economy. There is an emerging consensus that the digital economy pervades, and will increasingly pervade, all aspects of the economy. The Task Force is therefore examining the challenges raised by the "digitalisation" of the economy and is wary of the risks of sectorial solutions which may ultimately unlevel the playing field. The focus is on the key features of the digital economy, on determining which of those features exacerbate BEPS concerns, and on developing approaches to address them. These key features include for example the heavy reliance on intangibles, the mobility of customers and users, volatility due to low barriers to entry and rapidly evolving technology, as well as the spread of global value chains, network effects - understood with reference to users' participation, integration and synergies. The work in this area touches on some of the underlying core international tax issues, such as the definition of permanent establishment and whether changes should be made to address the key challenges raised by the digital economy, how payments under new business models such as cloud computing should be characterised, and the overall interaction between direct and indirect taxation. The Task Force mandated to carry on this work will produce its report for September 2014.

Establishing international coherence of corporate income taxation

Work to establish the coherence of corporate income taxation at the international level is focused on four key areas, namely hybrid mismatch arrangements, Controlled Foreign Companies (CFC) rules, rules on the deductibility of interest expenses and harmful tax practices:

- *In relation to hybrid mismatch arrangements (Action 2)*, i.e. arrangements which achieve multiple deductions for one single expense, or that allow deduction in one country without the income being taxable in the hands of the recipient in another country, there is agreement that provisions should be drafted in a way that prevents double non-taxation, whether the other jurisdiction concerned has or not such rules. Technical issues currently under discussion relate to the precise scope of the rules, and whether certain third party transactions, where double non-taxation is clearly not the aim of the arrangements, should be carved out. It will be key nonetheless to send the right messages and not leave any loophole while not creating too heavy a burden on businesses.

- *Harmful tax practices (Action 5)* are being assessed, with a focus on Intellectual Property Regimes such as "patent boxes", with the review of OECD member countries' regimes to be finalised in 2014. The assessment will then be extended to non-OECD members, whether G20 members or not. One key technical issue under discussion is how to determine whether a preferential regime is designed to attract purely mobile activites, and should therefore considered as harmful, or whether it requires the carrying out of a substantial activity to benefit from it.

- *The work on CFC rules (Action 3) and interest deductibility (Action 4)* is analysing design features of these regimes and will be ready by September 2015.

Restoring the full effects and benefits of international standards

Work in this area will realign taxation with economic substance and focuses essentially on transfer pricing rules. The work on the prevention of treaty abuse is also part of it. More specifically:

- *The work on the transfer pricing aspects of intangibles (Action 8)* is nearing completion. The work goes into the direction of aligning taxation with economic substance and will be supplemented with the second phase of the work on hard-to-value intangibles, risks and capital. Special measures within or outside the arm's length principle will be analysed in relation to these areas, to ensure that transfer pricing outcomes are in line with value creation. Progress in this area is challenged by very conservative approaches from many stakeholders and this makes it more difficult to devise pragmatic and effective approaches.

- *The work on treaty abuse (Action 6)* is advanced and a number of technical provisions are under consideration. Standardisation of clauses to prevent treaty abuse will ensure that the paradigm of bilateral tax treaties is not upset by the interposition of intermediate entities which have little, if any, economic substance. At the same time, this will provide increased certainty to business with the application of one common standard in this area. Work has also started to design rules which prevent the use of artificial arrangements to avoid permanent establishment status and hence taxation in the country where the income arises.

Ensuring transparency while promoting increased certainty and predictability

Preventing BEPS implies transparency at different levels and work streams in this area focus on a number of different elements:

- There is consensus on the objective of a *country-by-country template* in the context of transfer documentation *(Action 13)*. This is to provide relevant tax administrations with useful information for risk assessment purposes. It is considered that the information sharing be limited to tax administrations and shall be kept confidential. At the same time, a number of technical details have to be analysed very carefully to ensure that the measures achieve their intended purpose and do not increase the compliance burden for taxpayers unnecessarily. For these reasons, a discussion draft detailing a number of different options was published to request input from the public in early February. Consultations with stakeholders will be of great importance for this work stream.

- Other work streams in this area are due for September 2015. They relate to the establishment of rules that require taxpayers, advisors and any other promoter to disclose aggressive tax planning arrangements before they are put in place (*Action 12*). Importantly, another work stream in this area will establish methodologies to collect and analyse data on BEPS and its economic implications, in particular in terms of spill-over effects (*Action 11*). Last but not least, mechanisms that make dispute resolution more effective, like arbitration, are being evaluated to ensure that not only double non-taxation but also double taxation is avoided (*Action 14*). This is key due to the introduction of new rules, for instance in the areas of transfer pricing or of abuse of tax treaties. The aim is to provide business with the certainty and predictability they need to make investment decision..

Ensuring a swift implementation of the BEPS deliverables (Action 15)

The development of a multilateral instrument to implement the measures ultimately agreed to tackle BEPS will make it possible to promptly implement BEPS measures, without having to wait for decades to modify all bilateral tax treaties. Developing the appropriate solutions to BEPS is a very important first step and discussions, as well as the engagement by all G20 countries, will need to continue in the implementation and monitoring phases. At this stage it appears that none of the technical issues which would arise from the use of a multilateral instrument are insurmountable and a feasibility report will be ready by September 2014.A multilateral instrument will ensure consistency in approaches and at the same time provide the flexibility needed to reflect the specificities of certain bilateral relationships. Beyond implementing measures to tackle BEPS, the multilateral instrument could prove an effective instrument to foster the elimination of double taxation while preventing double non-taxation.

Developing countries are engaged

Regional consultations are taking place to gather input. Ensuring that developing countries' perspectives are taken into account when designing measures to curb BEPS is key and this input is also important to identify any issue not in the Action Plan that developing countries consider important to tackle, as for example it appears to be the case in relation to tax incentives. Developing countries' views will feed the work of the technical working groups, so that the legal and administrative framework of developing countries can be taken into account. The OECD's Tax Inspectors Without Borders initiative is also ensuring that developing countries are supported to address BEPS problems and opportunites.The Secretariat of the OECD Task Force on Tax and Development has been asked by the Development Working Group (DWG) to provide a report on the main challenges of BEPS in developing countries, how these relate to the BEPS Action Plan, and how these countries can meet those challenges. The Report will be submitted in two phases in April and September 2014.

Stakeholders' input is being gathered

The business community, trade unions, NGOs and academia are actively contributing to the G20/OECD BEPS Project. A number of mechanisms to obtain input at the early stages and in the course of the Project are in place. Discussion drafts in relation to the different measures are published throughout the process and public consultations are held to discuss the input received. A live webcast, to which more than 3 000 people registered, was held on 23 January 2014 to provide stakeholders with an update on the status of the Project. This engagement will ensure that the final outcome of the work is not only effective but also workable and balanced. The large majority of businesses recognise the need for reform and underline the importance of coupling this with sound and efficient dispute resolution mechanisms.

Next steps

Discussion drafts in the areas where deliverables are expected for 2014 will be published soon and public consultations to discuss the comments received will be held. These deliverables include changes to tax treaty provisions, changes to the transfer princing rules, as well as new instruments to prevent that the interaction of domestic laws results in double non-taxation. The technical working groups will then take the input received into account and refine their work accordingly. The box below contains an overview of BEPS deliverables for September 2014, September 2015 and December 2015. Further progress made and issues requiring political resolution will be reported to the next meeting of G20 Finance Ministers.

BEPS Deliverables

September 2014:

- Report identifying tax challenges raised by the digital economy and the necessary actions to address them (Action 1);
- Recommendations regarding the design of domestic and tax treaty measures to neutralise the effects of hybrid mismatch arrangements (Action 2);
- Finalise the review of member country regimes in order to counter harmful tax practices more effectively (Action 5);
- Recommendations regarding the design of domestic and tax treaty measures to prevent abuse of tax treaties (Action 6);
- Transfer pricing rules in relation to intangibles – phase 1 (Action 8);
- Transfer pricing documentation and country-by-country reporting template (Action 13);
- Report on the feasibility of a multlilateral instrument to implement BEPS measures (Action 15)

September 2015:

- Recommendations regarding the design of CFC rules (Action 3);
- Recommendations regarding the design of domestic rules to limit base erosion via interest deductions and other financial payments (Action 4);
- Strategy to expand participation in the Forum on Harmful Tax Practices to non-OECD members (Action 5);
- Tax treaty measures to prevent the artificial avoidance of permanent establishment status (Action 7);
- Transfer pricing rules in relation to intangibles – phase 2 (Action 8);
- Transfer pricing rules in relation to risks and capital, and other high-risk transactions (Actions 9 and 10);
- BEPS economic analyses and Recommendations regarding data collection on BEPS (Action 11);
- Recommendations regarding the design of domestic rules to require taxpayers to disclose their aggressive tax planning arrangements (Action 12); and
- Tax treaty measures to make dispute resolution mechanisms more effective (Action 14);

December 2015

- Changes to the transfer pricing rules to limit base erosion via interest deductions and other financial payments (Action 4);
- Revision of existing criteria to counter harmful tax practices more effectively (Action 5);
- Multilateral instrument (Action 15).

B - AUTOMATIC EXCHANGE OF INFORMATION

At your meeting in Moscow, Russia on 19-20 July 2013 you fully endorsed the OECD proposal for a truly global model for automatic exchange. At the G20 Leaders' meeting in St. Petersburg, Russia on 6 September 2013 the Leaders provided their full support for this work and said:

> *"We commend the progress recently achieved in the area of tax transparency and we fully endorse the OECD proposal for a truly global model for multilateral and bilateral automatic exchange of information. Calling on all other jurisdictions to join us by the earliest possible date, we are committed to automatic exchange of information as the new global standard, which must ensure confidentiality and the proper use of information exchanged, and we fully support the OECD work with G20 countries aimed at presenting such a new single global standard for automatic exchange of information by February 2014 and to finalizing technical modalities of effective automatic exchange by mid-2014. In parallel, we expect to begin to exchange information automatically on tax matters among G20 members by the end of 2015. We call on all countries to join the Multilateral Convention on Mutual Administrative Assistance in Tax Matters without further delay. We look forward to the practical and full implementation of the new standard on a global scale... We also ask the Global Forum to establish a mechanism to monitor and review the implementation of the new global standard on automatic exchange of information."*

The OECD, working with G20 countries and in close co-operation with the EU, has been making very good progress in developing the new global standard of automatic exchange of information and I am very pleased to be able to deliver the requested single global standard within the ambitious timelines that you have set. The standard consisting of a **Model Competent Authority Agreement (CAA) and the Common Standard on Reporting and Due Diligence (Common Reporting Standard or CRS)** is contained in Annex A.

A growing number of countries and jurisdictions have already decided to join this approach. Following the commitments to automatic exchange made by the G8 leaders at their summit in June 2013, and by the **G20 leaders** in September 2013, **more than 40 countries have now joined a pilot group** and committed to early adoption of the automatic exchange standard developed by the OECD. Finally, in response to your continued call, many countries have also signed the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, which will be a key instrument for the implementation of the new standard.

(i) The Standard

The standard incorporates the most recent developments in the area of automatic exchange by drawing extensively on work of the OECD, developments on automatic exchange of information in the European Union, anti-money laundering standards and the Model Intergovernmental Agreements (IGA) to improve international tax compliance and implement FATCA. As the first global standard on automatic exchange of information it breaks new ground, addresses the tax compliance needs of residence countries and avoids a proliferation of different and inconsistent standards which would lower effectiveness and increase costs for businesses and governments alike.

Under the standard, jurisdictions obtain financial information from their financial institutions and automatically exchange that information with other jurisdictions, as appropriate, on an annual basis. The information is collected by financial institutions on the basis of common reporting and due diligence rules.

The standard consists of two components: a) the CRS, which contains the reporting and due diligence rules to be imposed by participating jurisdictions on their financial institutions; and b) the Model CAA, which contains the detailed rules on the exchange of information.

To prevent taxpayers from circumventing the CRS it is specifically designed with a broad scope across three dimensions:

- The financial information to be reported with respect to reportable accounts includes all types of **investment income** (including interest, dividends, income from certain insurance contracts and other similar types of income) but also **account balances** and **sales proceeds** from financial assets.

- The financial institutions that are required to report under the CRS do not only include **banks** and **custodians** but also other financial institutions such as **brokers, certain collective investment vehicles and certain insurance companies**.

- Reportable accounts include accounts held by **individuals** and **entities (which includes trusts and foundations),** and the standard includes a requirement to look through passive entities to report on the individuals that ultimately control these entities.

The CRS also describes **the due diligence procedures that must be followed by financial institutions to identify reportable accounts**.

The CRS will need to be translated into domestic law, whereas the CAA can be executed within existing legal frameworks such as Article 6 of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters or the equivalent of Article 26 in a bilateral tax treaty. Before entering into a reciprocal agreement to exchange information automatically with another country, it is essential that the receiving country has the legal framework and administrative capacity and processes in place to ensure the confidentiality of the information received and that such information is only used for the purposes specified in the instrument. Where this is not the case, automatic exchange is not "appropriate".

(ii) Completing the standard: The next step

The completion of the standard will still require further work by the OECD and by participating jurisdictions.

Work at the OECD is focussing on technical modalities including (1) a **commentary** to both the CRS and the CAA to ensure a consistent application and operation of the standard and (2) the **technical solutions** regarding IT aspects, in particular the presentation of the information (including schema and user guide) and standards on the secure transmission of the information. Work on these technical modalities is well advanced and will be presented to you at your September 2014 meeting.

At the same time countries will need to translate the CRS into domestic law, enter into CAAs (based on the Model CAA) with other participating countries and put in place the necessary administrative procedures and IT systems.

(iii) Legal basis for automatic exchange of information: the Multilateral Convention on Mutual Administrative Assistance in Tax Matters

Different legal bases for automatic exchange of information already exist. Whilst bilateral treaties such as those based on Article 26 of the OECD Model Tax Convention permit such exchanges, it may be more efficient to establish automatic exchange relationships through a multilateral information exchange instrument.

The Multilateral Convention on Mutual Administrative Assistance in Tax Matters, as amended in 2011, is such an instrument. It provides for all possible forms of administrative co-operation between States, contains strict rules on confidentiality and proper use, and permits automatic exchange of information.

Automatic exchange under the Multilateral Convention requires a separate agreement between the competent authorities of the parties, which can be entered into by two or more parties thus allowing for a single agreement with several parties (with actual automatic exchange taking place on a bilateral basis). Such an agreement would activate and "operationalise" automatic exchange between the participating countries. It would specify the information to be exchanged and would also deal with practical issues such as the time and format of the exchange. The Model CAA serves that function and can be used within the context of the Multilateral Convention but also under bilateral treaties. It could also easily be adapted to a multilateral agreement as permitted by the Multilateral Convention.

I am glad to report that the Multilateral Convention is now a **truly global instrument** and that your call on countries to sign it is being responded to positively. Following a recent signing ceremony in Indonesia, there are now **64 signatories** to the Convention, including all G20 countries, and **13 jurisdictions** are covered by way of territorial extension. Additional countries have expressed interest in signing, including Azerbaijan, Kenya, and Mauritius, and we expect further signatures in the near future.

The work cannot be limited to the G20 and OECD. The G20 has mandated the Global Forum on Transparency and Exchange of Information for Tax Purposes to monitor the implementation of the standard once it is fully developed and to ensure a global reach and a level playing field. The Global Forum already established a new Automatic Exchange of Information (AEOI) Group to respond to that mandate (see also Part II). The OECD stands ready to work closely with the Global Forum and others as this work progresses.

DEALS OF THE YEAR

European treasury team of the year category winner
UNILEVER

FAST MOVERS

UNILEVER'S TREASURY TEAM IS BOLD AND AMBITIOUS, AND IT DOESN'T DRAG ITS FEET

What the judges said

"The breadth of activity undertaken by Unilever's treasury was impressive given the timeline involved."

Michel Pinto: The secret to success is having "a strategy that you apply whether you're in crisis or not"

Peter Zegger: "The board regards us as very skilled professionals and, at the same time, very good businesspeople"

You would expect one of the biggest names in the world of fast-moving consumer goods to have one of the best teams in treasury. And Anglo-Dutch giant Unilever, the owner of well-known brands such as Domestos bleach and Ben & Jerry's ice cream, does not disappoint.

Over the past 36 months, its treasury has achieved what the nominating professional services firm described as an "extraordinary transformation". In 2011, it moved its four front-office treasury teams – which were based in Brazil, India, the Netherlands and the US – to Switzerland. Here, it has established one centralised treasury centre of excellence that has streamlined processes and controls, and is responsible for managing group-wide risks and supporting all operating units.

Michel Pinto, Unilever's VP treasury international funding and banking relations, explains the rationale for the move as follows: "We had small treasury teams, but not a critical mass in every location. Also, we thought it would be better to have everybody in one place so we could react speedily to the market." He says the benefit of having everyone within 10m of each other makes things "very efficient in terms of communication". Incidentally, English is the agreed common language of the team and anyone who accidentally slips into their native tongue at work must pay a tongue-in-cheek 'penalty' of CHF2 into a pot, which goes towards team drinks each month.

Over the past decade, Unilever has followed a policy of centralisation and rationalisation, which has involved the group significantly cutting the size of its supply chain. Unilever's treasury team has contributed to this effort by achieving a 20% reduction in the number of banks it works with globally since 2011. It has identified banks in each location that can provide best-in-class service, closed bank accounts and set up effective pooling structures.

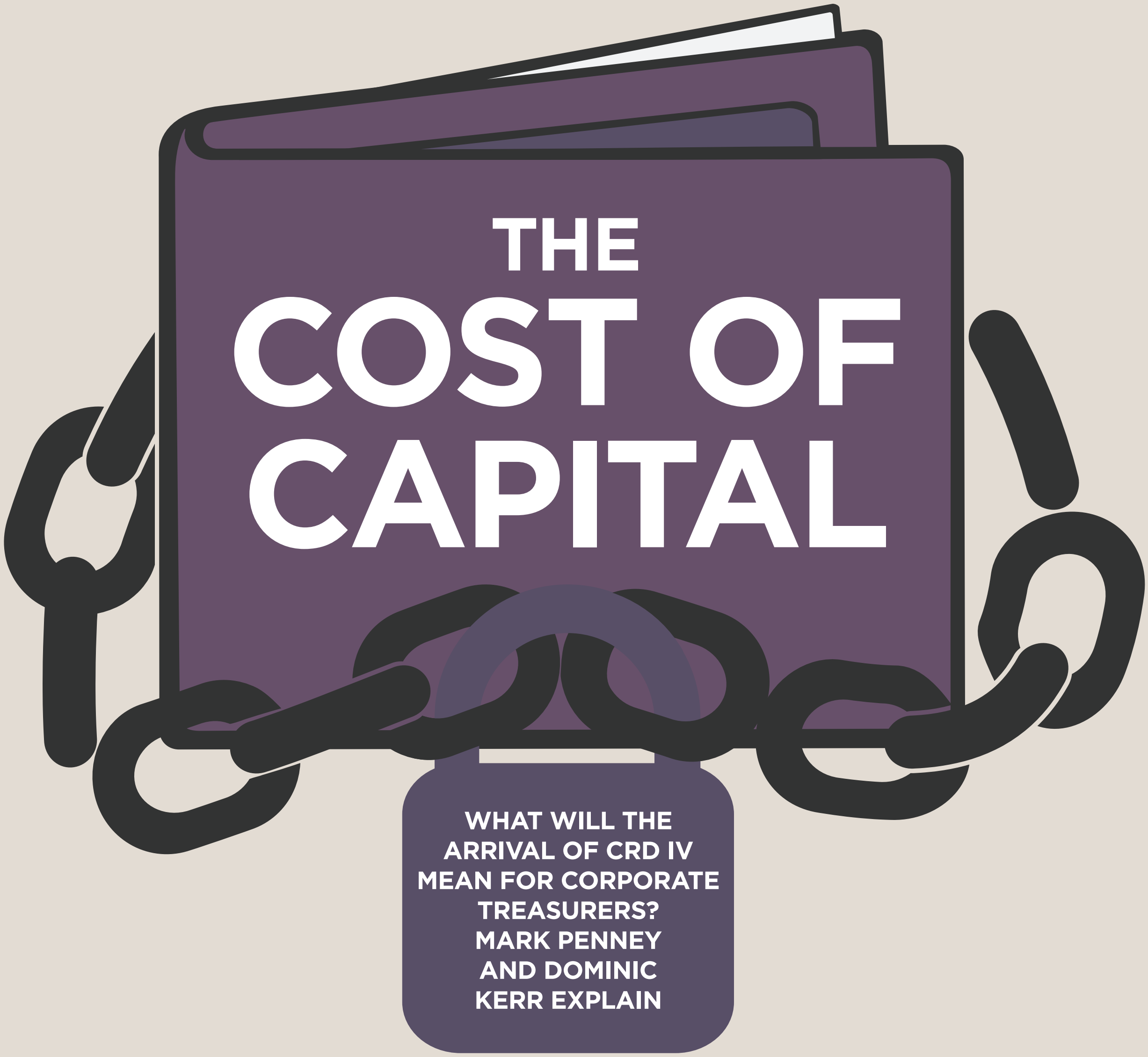
Unlike most international treasuries, Unilever's treasury team manages interest rate risk on an after-tax basis using advanced modelling techniques. "We can't manage treasury in isolation because doing so would increase the risk for the group as a whole," says Peter Zegger, Unilever's VP treasury and insurance. "In all the decisions we make, we try to take into account all impacts, including FX movements, interest rates, liquidity, pension and tax. We stabilise Unilever's bottom-line earnings per share." The team has also set up a risk board to regularly review all the treasury risks that Unilever faces, including country, currency, FX, interest rate and liquidity risk.

Unilever's front-office treasury team is 25-strong (including two professionals who are based in Singapore) and comprises both treasury experts and generalists from the finance function who join treasury for two- or three-year stints on a rotational basis. "The flow of high-potential generalists helps us a lot," says Zegger. "They bring intimate business knowledge, which strengthens treasury's understanding of the business, and they go back into the business with a lot of treasury know-how." Unilever's top finance executive team – which comprises seven people, including the CFO – boasts three ex-treasurers as well as current group treasurer Steve Weiner.

Reflecting on the team's achievements in 2013, Pinto says the year was busy due to Unilever's M&A activity. In particular, it paid out €2.4bn to up its stake in Indian consumer goods company Hindustan Unilever. "The refinancing of this project was done by treasury," Pinto explains. The secret to success in treasury, he adds, is quick decision making, being close to the business and having "a strategy that you apply whether you're in crisis or not". Zegger says that what makes the team special is the "sheer amount of projects that we have to deal with".

Last year, Unilever's treasury gave a half-day presentation to the board of directors. "The board regards us as very skilled professionals and, at the same time, very good businesspeople," Zegger explains. "We're good experts, but we're also doing what's relevant for the business."

Summing up the achievements of Unilever's treasury team, the nominating professional services firm put it as follows: "Overall, Unilever's treasury has achieved and delivered incredible value to the business. It has developed a future-proof function capable of embracing change. It has helped to enhance the credibility of treasury professionals at board level and demonstrated integrity, courage, respect, teamwork and innovation."



THE COST OF CAPITAL

WHAT WILL THE ARRIVAL OF CRD IV MEAN FOR CORPORATE TREASURERS? MARK PENNEY AND DOMINIC KERR EXPLAIN

The bulk of the rules in the EU legislative package Capital Requirements Directive IV (CRD IV) took effect at the beginning of January. These prudential rules implement the Basel III agreement on bank capital requirements in the EU and they impose strict capital and liquidity restrictions on banks, building societies and investment firms.

CRD IV is unquestionably the biggest regulatory change to affect the banking industry for decades. Its aim is to prevent another crisis by strengthening the resilience of the EU banking sector so that it can better absorb economic shocks while continuing to finance economic activity and growth. But the scale of the changes, which are being phased in between January 2014 and January 2019, means that their effect will be felt not just within the banking industry itself, but also within the wider economy.

While every bank and corporate will have a different experience of CRD IV, all treasurers need to make sure that they understand the main principles of the legislation [see box – CRD IV in brief] and, equally importantly, its implications for financing their business.

CRD IV and corporates

When implementing CRD IV, banks have different starting positions and different pressures. It is likely, however, that the directive will bring long-term, industry-wide changes in the cost and availability of funding to European corporates. So far, low interest rates have been masking the costs of increased bank regulation but if interest rates rise over the next few years, those costs will become more apparent. Capital needs to be paid for and the cost will be partly borne by the customers that use it.

In theory, European banks have until January 2019 to meet the more stringent capital requirements of CRD IV. But, in practice, individual countries are speeding up the process and making their own stipulations. In November 2013, the UK's Prudential Regulation Authority announced that it expects the major UK banks and building societies to meet a 7% common equity tier 1 ratio and a 3% tier 1 leverage ratio from 1 January 2014. This is a stricter requirement than that specified by CRD IV and a five-year acceleration in the

> The aim of CRD is to prevent another crisis by strengthening the resilience of the EU banking sector so that it can better absorb economic shocks

capital process from the original timetable.

Meanwhile, the European Central Bank's Asset Quality Review and accompanying stress testing will affect major eurozone banks in 2014. Eurozone banks will need to pass a threshold of an 8% common equity tier 1 ratio.

Leverage, liquidity and funding

It is not just capital that will affect costs for corporates. The Basel Committee on Banking Supervision is continuing to deliberate the leverage ratio, which is the ratio intended to set the amount of capital that banks need to allocate against their actual or potential financing without any adjustment for credit risk. If the leverage ratio is too low, a bank will either need to hold more capital, or reduce its assets, or both.

In addition, banks are being asked to hold more assets that can be turned into cash quickly and easily. Since these assets don't make a good return, the cost of holding them will be reflected in the overall cost of lending to customers.

Banks are also being asked to improve their mix of funding arrangements, putting greater emphasis on deposit funding and longer-term debt. Both of these are expensive and that cost, too, will be passed on to customers in the long term.

Ring-fencing risks

From 2019, the UK will have retail banks that are ring-fenced from their wholesale counterparts. With this comes the risk that corporates will concentrate their deposits in the retail bank, which will be perceived as safer, while they will want their main relationship to be with the wholesale bank, which can offer a wider product set. This could create further distortion in the funding market.

CRD IV IN BRIEF

The main principles of CRD IV include:

◆ Enhanced requirements for quality and quantity of capital. A bank's capital is calculated as the value of its capital as a percentage of its risk-weighted assets (RWAs). The riskier the assets, the more capital a firm needs to hold. Some elements, such as deferred tax assets, are being excluded from the calculation of capital. Currently, institutions must have total capital of at least 8% of their RWAs. But under CRD IV, the percentage of tier 1 (high-quality, going concern capital) must increase from 4% to 6%, while the percentage of common equity tier capital within tier 1 (for example, shares and retained earnings) must increase from 2% to 4.5% from January 2015.

◆ **A new liquidity coverage ratio (LCR) and a net stable funding ratio (NSFR). The LCR measures the stock of liquid assets against net cash outflows in a 30-day stress scenario period. It is being phased in between 2015 and 2018. The NSFR will measure the amount of reliable stable funding available to a firm over a one-year period of extended stress against the amount of stable funding that the firm requires.**

◆ Leverage ratio. This is a firm's tier 1 capital divided by a measure of its non-RWAs or exposures. It is not yet a binding requirement although its introduction is expected in 2018.

◆ **New rules for counterparty risk. Modelling of future exposures for derivatives is enhanced to include a stressed period, lengthened margin period of risk and wrong-way risk. A credit valuation adjustment risk is introduced, though most corporate derivatives will be exempt.**

◆ Five new capital buffers. These are: the capital conservation buffer, the counter-cyclical buffer, the systemic risk buffer, the global systemic institutions buffer and the other systemic institutions buffer.

◆ **Enhanced corporate governance rules. The management of a firm has to take greater responsibility for its overall risk strategy.**

◆ Remuneration ratios. The ratio of fixed salary to variable bonus will be 1:1 although the ratio can be raised to a maximum of 1:2 if a majority of shareholders agree.

◆ **Standardised EU regulatory reporting. Banks must report on their risk (Common Reporting Standard or COREP) and financial information (Financial Reporting Standard or FINREP).**

Consequences of CRD IV

The effect of regulatory change will vary between banks, with each making different deals with their corporate customers. But, overall, costs for corporates are likely to increase. Meanwhile, where banks need to achieve higher capital ratios and want to avoid raising new money, there could be a contraction in supply. This is likely to be where a bank engages in marginal activities or has a small market share in certain countries or business sectors. At some point, it may no longer be efficient for banks to provide expensive funding for their corporate customers. This will make the option of going direct to the capital markets more attractive to companies. Ultimately, it is one of the objectives of CRD IV to rebalance the provision of finance away from banks towards the markets. ◆

THE EVOLUTION OF THE DEBT CAPITAL MARKETS

◆ **The trend for European corporates to diversify their funding sources away from banks has steadily increased in the years since the financial crisis.**

◆ In the UK, net bank lending to UK corporates has fallen by 20% over the past five years, while bond and private placement issuance has increased by 48% over the same period, according to rating agency Standard & Poor's.

◆ **In many European countries, where banks are relatively less well capitalised and less able to lend, this trend is even more pronounced. In December 2013, the Bank for International Settlements revealed that the bond market had met more than 50% of the funding requirements of euro-area corporates since early 2011.**

◆ In 2013, high-yield bond issuance in Europe reached a record level. By mid December, $110bn had been raised compared with $74bn for all of 2012. Around 75% of the high-yield issuance in 2013 was used for general refinancing, while 25% went to fund acquisitions or dividend payments. Overall, 64% of issuance was from repeat borrowers and 36% from first-time borrowers. Around 30% of high-yield first-time borrowers came from peripheral geographies such as Ireland, Greece, Italy, Portugal and Spain.

◆ **Both the Schuldschein and US private placement markets lent in reduced volumes in 2013 compared with 2012, although investors were liquid and ready to lend. But both markets favour investment-grade borrowers and require covenants that are similar to those demanded by banks. This may explain why covenant-light investment-grade and unrated bond markets have been more attractive to some borrowers.**


Mark Penney **is head of capital management, global markets, and** Dominic Kerr **is head of European corporate origination at HSBC**

HSBC

COMPETITIVE DISADVANTAGE

GREATER RIVALRY BETWEEN BANKS IS NOT NECESSARILY A GUARANTEE OF FINANCIAL SOUNDNESS. PHILIP DAVIS AND DILRUBA KARIM EXPLAIN WHY

Bank competition and how it affects risk within a banking system has become a central policy concern since the sub-prime crisis, which was thought to be partly caused by excessive competition. On the one hand, the academic literature suggests policymakers can improve financial stability by promoting bank competition. This is the 'competition – stability' view, but it contrasts with the opposing 'competition – fragility' view, which suggests that *less* competition is better for financial soundness.

Under the competition-fragility view, in an uncompetitive banking system, a banking licence or 'franchise value' is prized, and banks therefore limit risk taking since they are unwilling to jeopardise their market advantage. Indeed, banks may voluntarily choose to maintain large capital buffers against losses. As deregulation of the sector ensues, allowing new competitors to enter the market, the competitive advantage of incumbents is eroded and so the franchise value declines. Now, to maintain the same profitability as before, banks may develop riskier activities in search of higher returns. The quality of borrowers on the bank's balance sheet declines, as does capital and provisioning against losses.

Within the competition-stability concept, informational asymmetries between the bank and the borrower play a central role. Even at a low level of market competition, banks know much less about the borrower's true repayment ability than the borrower. This 'asymmetric information' may lead to 'adverse selection' whereby the bank ends up with poor-quality borrowers, which increases risk on the loan book. This is thought to be particularly likely in uncompetitive systems where

Within the competition-stability concept, informational asymmetries between the bank and the borrower play a central role monopolistic banks charge high interest rates so that borrowers with good repayment prospects do not seek loans. Risk may also increase for large banks that may predominate in uncompetitive systems as, due to their complexity, supervision of larger banks becomes more difficult. Furthermore, large banks may take on excessive risk, knowing that they are 'too big to fail' and that public bailouts are likely if losses materialise.

Much of the work that has tested these contrasting theories has relied on bank-level data from the pre-crisis period. Given that banking architecture has changed in many economies following the crisis (either as a result of mergers or regulatory proposals, such as the Vickers Report in the UK), it is important to test the competition-risk relationship both pre- and post-crisis to assess the impacts of these reforms.

KEY LEARNINGS

Competition in banking is in general a good thing since it leads to readier and lower-cost availability of credit and higher deposit rates. But there remains a risk that such competition may lead to instability, since over-lending at excessively narrow margins leads to borrower default and banks facing problems of illiquidity and insolvency.

The resolution of this difficulty includes use of the tools of banking regulation, namely minimum capital/asset ratios (to protect banks from insolvency) and appropriate levels of liquid assets (to protect against illiquidity). What may also be needed is macroprudential policy that requires higher capital and liquidity during boom periods when competition and risk are rising rapidly. Our work implies that such a policy applied in the pre-crisis period would have mitigated the impact of the crisis on banks, and hence on the wider economy.

Meanwhile, measures that deregulate banking markets and hence abruptly increase competition should warrant particular vigilance by regulators and market players, since they can raise the fragility of banks, particularly those entering new areas of business and that accordingly lack experience in appropriate credit analysis. The failure of most of the demutualised building societies in 2007/8 in the first major downturn after their change in status is a case in point.

Finance and fragility

In December 2013, the National Institute of Economic and Social Research published our discussion paper exploring the short- and long-run links from bank competition to risk. In our study we distinguished between existing *levels* of competition, to which banks may have had time to adjust, and *changes* in competition, which may have required banks to alter their business strategy in order to survive. Hence, our empirical aim was, firstly, to assess competition among banks in each EU country over the period 1998-2012, and, secondly, to investigate how those levels of competition impacted on the fragility of banks. To undertake our study, we used financial statement data for 6,008 banks from the 27 countries of the EU, drawn from the Bankscope database.

Our main measure of competition is the 'Panzar Rosse H statistic'. The intuition is that competition in a market has an effect on the degree to which changes in cost impact on market prices and hence revenue for the individual firm, be it for banks or for companies. Accordingly, if rises in bank costs (interest costs, staff costs, other costs) affect revenues one-to-one, it is an indicator of a highly competitive market. In contrast, if bank costs feed into revenues at a lower rate, it is indicative of a less competitive market. In the extreme, a very uncompetitive banking system might show a negative response of revenue to costs.

We ran the statistical tests of banking competition separately for the periods 1998-2006 (pre-crisis) and 2007-2012 (post-crisis). A number of countries, including the UK, show a marked fall in the level of competition in banking after the crisis. Other large declines in competition are apparent in countries such as the Netherlands, Finland and Denmark. In contrast, in Germany, France and Italy, which were less affected by the crisis, banking competition was unchanged or even increasing. Some Eastern European countries that had very uncompetitive banking sectors include Bulgaria, Latvia and Slovenia, as well as Greece.

Rise of risk

We went on to test whether changes in competition or different levels of competition have an impact on banking-sector risk. The chosen indicator of risk was the Z-Score for each bank, which is the sum of the return on assets (a measure of profitability) plus the capital-to-assets ratio (a measure of safety and soundness) divided by the volatility of the return on assets (a measure of risk). It shows how many standard deviations profitability must fall for the bank to be insolvent.

Our principal result is that a sharp rise in competition is a robust indicator of greater risk in the banking system. Errors in risk management are very likely to occur in such a situation – for example, when margins are narrowing, and consequently management is pressuring lending officers to make more loans in order to maintain profitability. This result was confirmed by our second indicator of competition, namely the Lerner Index, which seeks to measure the difference between price and cost over the bank's range of operations.

Our results for the effect of the *level* as opposed to the *change* in competition on banking-sector risk were less clear-cut. The results for the H Statistic imply that banking risk is *reduced* by competition in the long run. This is entirely plausible, if banks adapt appropriately to a level of competition and find it sustainable, especially if profit margins are maintained. But a fall in the Lerner Index, which measures profit margins directly, indicates that a higher level of competition increases risk in the long run. Where competition affects margins as well as pricing behaviour *per se*, it becomes dangerous for the stability of banks and the banking system.

The work underlying this article was financed by the Economic and Social Research Council under Project No ES/K008056/1, entitled *The Future of Banking*. It is published as National Institute Discussion Paper No 421, *Exploring The Short- And Long-Run Links From Bank Competition To Risk – Reconciling Conflicting Hypotheses?* For the full paper, see www.niesr.ac.uk/sites/default/files/publications/dp421.pdf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PREPARING FOR KICK-OFF

HOW CAN YOU GET YOUR COMPANY READY FOR AN IPO? ADAM FARLOW EXPLAINS

Although the market for newly floated companies was severely depressed during the financial crisis, the initial public offering (IPO) market is recovering. In 2013, €26bn was raised through 71 IPOs in Europe alone, according to data from ING. The signs point to a continuation of this robust opportunity for companies to fund their growth.

An IPO timetable will be prepared by the underwriters and agreed at the all-parties kick-off meeting. Typically, it will cover a three-to-six month period with various deliverables and events taking place along the way to a successful closing. There are nine steps that companies can undertake well before kick-off in order to:

- Remove potential road bumps that could hinder, delay or prevent the flotation entirely;
- Maximise the company's potential value through the IPO;
- Streamline the preparation process and reduce the overall demands on management time (management does, after all, have a business to run);
- Reduce the overall transaction cost; and
- Minimise the time between the formal kick-off meeting and closing, ensuring the project is able to take advantage of market windows for placing.

THESE NINE STEPS ARE:

1. Conduct an 'IPO readiness audit', from both a legal and accounting perspective.
This can be done months, and even years, in advance. Outside legal counsel (which should be familiar with the local corporate and regulatory regime and have international capital markets experience) can help to identify and remove road bumps before they become roadblocks. The process will often include a review of documents in a data room (see point 4) and management interviews. It will pick up most, if not all, of the issues raised below.

2. Ensure financial reporting readiness.
One of the traditional methods of financial due diligence (particularly in the UK premium-listing context) was the 'long-form report' from the company's auditors. But preference is shifting towards a 'financial reporting readiness report', identifying matters such as weaknesses in a company's financial reporting system. If nothing else, the company should engage its auditors very early in the process. Three years of audited (IFRS) financial statements will be required at a minimum, and additional details and reports may be necessary, for instance, if there have been significant changes to the business during that period or other complex financial/accounting histories.

3. Get the team right – both internally and externally.

- Determine who within your company will have overall practical responsibility for the process, and who will have critical, but supporting, roles. The team will at least be comprised of representatives from the treasury, investor

Outside legal counsel can help to identify and remove road bumps before they become roadblocks

relations, accounting, tax and legal functions. There should be one single point of contact with decision-making power who 'knows the business'.

◆ Consider appointing issuer counsel early in the process. Even if there is no time for an IPO readiness audit, experienced IPO counsel can make readiness preparations much more efficient, avoiding unnecessary work and cost.

◆ Begin to narrow down your potential list of underwriters. Your lending banks will have coverage bankers anxious to speak to you, but there are lots of possibilities to consider, such as: which banks underwrote the IPOs of industry peers? Which banks have strong research teams for your industry and potential listing venues (not necessarily your home market)? And will you want an underwriting syndicate with a mix of international and local banks? Investors are pushing for smaller, tighter underwriting syndicates. It really is best to start with a small core group – and be choosy. Not every bank can be on the cover of your prospectus, so make sure any additional underwriters are additive. Under no circumstances should you sign an underwriter engagement letter without experienced IPO counsel review.

◆ Although there will often be a number of other outside parties involved (a financial printer, depositaries, PR consultants), their appointment can generally be done after the kick-off. Counsel and underwriters can be helpful in sourcing quotes and advising, based on past experience.

4. Begin to gather key documents.

IPO counsel will ultimately agree a formal, finalised list of documents that will need to be made available for documentary due diligence purposes. Before appointment of underwriter counsel, experienced issuer counsel can provide an indicative list of documents that can be gathered in advance and put into a data room. That room can be a physical site on the company's premises, but more often it is a virtual data room provided by an external provider. These providers are often also financial printers, so try to achieve a discount for prospectus printing. But don't lock the company into choosing a particular printer until much later in the process.

5. Resolve any outstanding issues.

Material risks and issues must either be resolved or disclosed in the prospectus. Which issues are critical to resolve rather than to simply disclose? There is no single list for every company. Some issues could be deal-breakers; others could delay flotation pending resolution. Meanwhile, resolving others will improve the sell-story and valuation. It's often best to deal with the problem in advance to avoid the need for ugly public disclosures that, at best, distract potential investors and, at worst, attract regulatory attention or decrease valuations. Examples include perfecting title-to-material assets, resolving any issues with key licences or other regulatory issues (including privatisation irregularities), wrapping up major litigation, and obtaining any third-party consents.

6. Conduct a pre-IPO business restructuring, if necessary.

Many private businesses evolve, and were not founded with a view to life as a public company. As a result, a pre-IPO business reorganisation is often crucial to establishing the integrity of the group to be floated. Are there material subsidiaries that need to be consolidated? Are there relationships with affiliated entities that should be brought into the group? Similarly, do the shareholders have ancillary businesses that need to be removed from the group to be floated? Further factors to consider in any pre-IPO reorganisation will include the degree of transparency of the group structure (will investors understand that structure?), and the degree to which members of the group cooperate or are otherwise economically dependent.

A properly organised group structure can decrease taxes and increase transparency and attractiveness, and hence valuation. Reorganising early in the process helps to ensure that financial statements for the consolidated group can be prepared in a timely and clear manner. It also avoids unnecessary work and delay.

7. Focus on corporate governance.

Put in place the best practices required of listed companies in the target listing venue. It can often be a difficult and time-consuming process to disentangle financial relationships with founding shareholders. Perhaps even more difficult is ensuring that appropriate financial-reporting and sanction-compliance regimes (and, where necessary, related attitudes) are put in place. Does the company have robust, effective compliance policies? Although few non-US companies are directly implicated by US sanction regimes, such as those administered by the US Treasury's Office of Foreign Assets Control, or the Foreign Corrupt Practices Act, past and current compliance with these regimes is a key focus area for underwriters. On the other hand, the appointment of independent non-executive directors and formally adopting changes to corporate charters to deal with minority shareholder protections can often be done during the post-kick-off period.

8. Get the tax structure sorted.

Closely tied with points 6 and 7, there are several issues to consider with pre-IPO tax structuring. These issues include not only corporate income tax for the company, but also the tax implications for exiting shareholders (for example, capital gains) and for new investors (for example, withholding taxes on dividends).

9. Lock down publicity about the deal.

Although typically not an issue well in advance of a transaction, publicity about any potential float becomes a bigger threat the closer it is to launch. The issuer's IPO counsel will agree a formal set of publicity guidelines with underwriter counsel post kick-off. In the meantime, the best answer to any question from the press or research analysts is always "no comment". Publicity about a transaction is one of the most likely ways for a high-profile transaction to need to be delayed.

'IPO readiness' is all about starting on the right foot. Not all of these recommendations will fit every company, and certain companies in particular industries will find that there are additional areas of concern. Equally, if your kick-off meeting is next week and none of the above has been done, don't worry, there is still hope.

Adam Farlow is a partner in the capital markets group at Baker & McKenzie

Ukraine,

Country Report: **Shortly Before the Collapse**

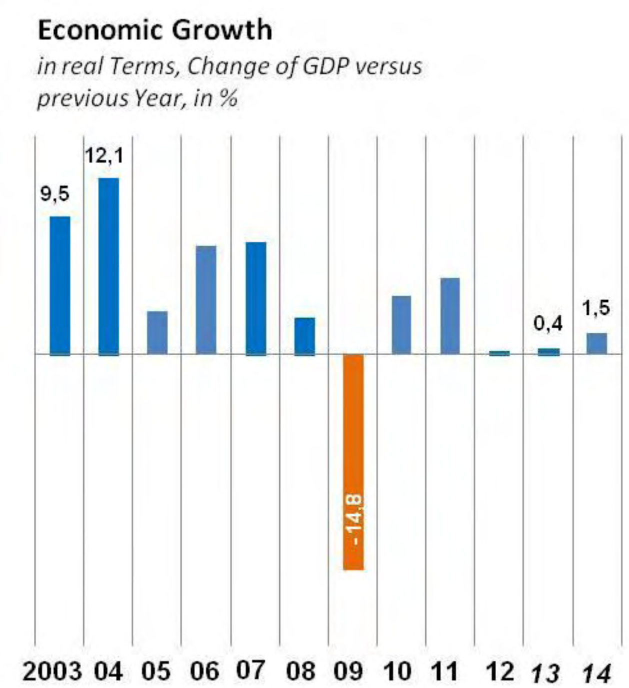
The Ukraine is going trough dramatic days and the future government will urgently need money. How long the economy will keep up?

By Konrad Schuller

Kiev, February 23, 2014 - The Ukraine is dependent on foreign money as much as an addict on drugs. Indeed, following years of plundering by the oligarch-elites of the previous ruler Viktor Janukowitsch, the economy is on the point of collapse. The financial straits have had direct effects on his politics towards the civil protests which escalated last week. After Russia had interrupted the delivery of the promised credit line of 15 billion dollars in December, the evaluations by the rating agencies went down significantly. But on Monday the week ago Russia's prime minister, Anton Siluanow, said suddenly to resume the payments. And the day after the regime switched to stubborn, after having before passed positive signals to the European minded opposition. An initiative for the reform for the constitution was stopped in the parliament. The violence resumed in the street, the city was in fire, dozens of people have died since then.

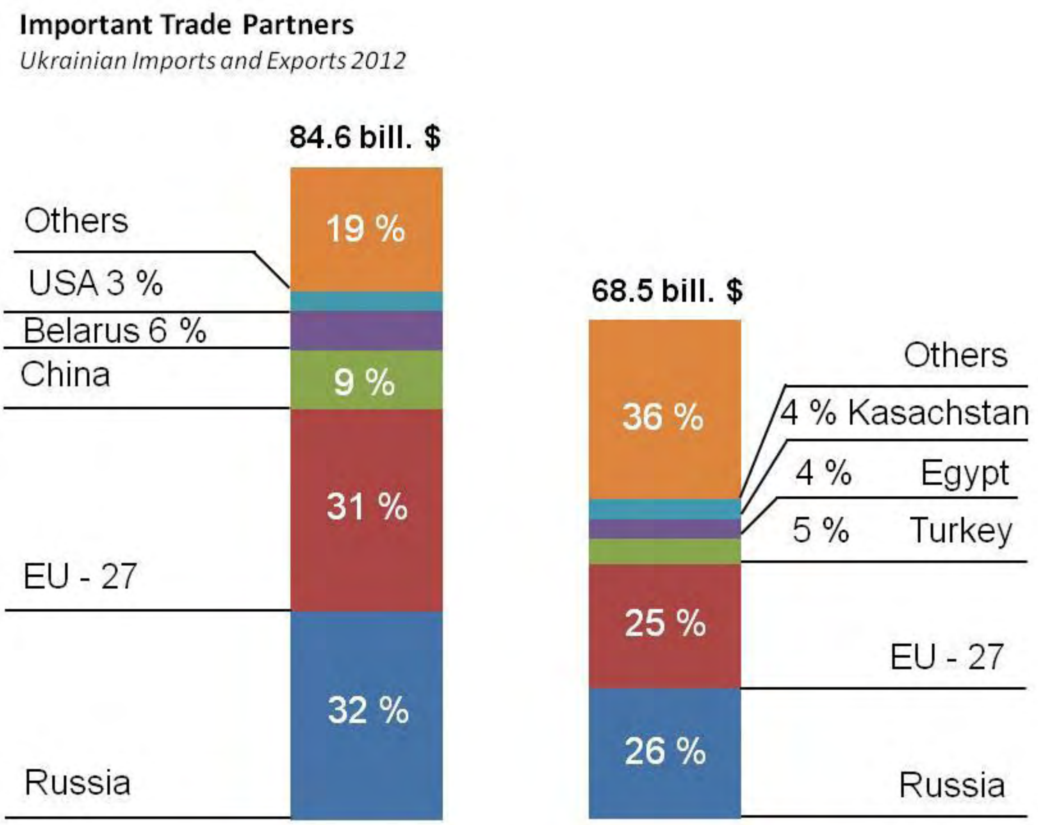
Area in Square Kilometers	**603550**
Population (2013, Millions)	**45.5**
Population Growth in % (2013)	**-0.6**
Polulation Density (2013, per Square Kilometer)	**75.4**
Exports to Germany (Bill. Euro, 2012)	**1.5**
Imports from Germany (Bill. Euro, 2012)	**5.7**

In this inter-relationship between politics, credit flows and overall economic situation, the basic characteristic of the Ukrainian economy becomes visible: for better or worse it is dependent on the mercy of the Russian president Vladimir Putin. For the first time this was shown by the "trade war" in summer 2013: Russian import-chicanes were building up enough pressure to discouraging Janukowitsch from integration with Europe which has long been pursued. At the last minute he refused to sign the association agreements with the European Union. Shortly after that, in mid December, he was reaching out his hand to Putin. Other than Europe, the Russian had 15 billion dollar credits in his hand, in addition an impressive gas discount and above all without any inconvenient demands for reform.



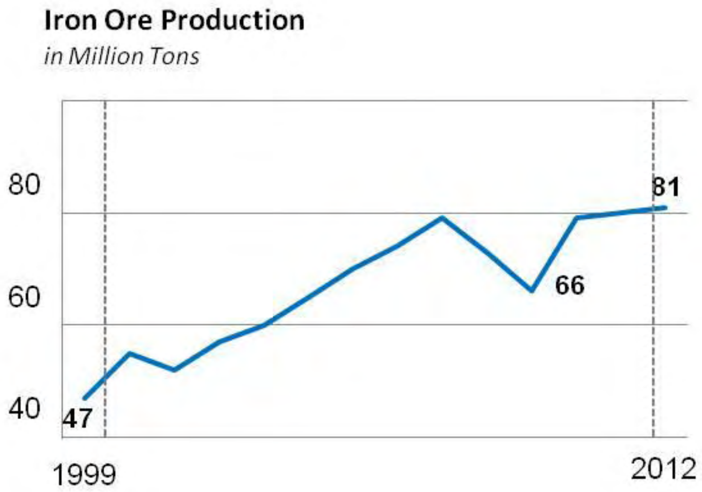
What Putin was hoping to get for this, was never being said clearly. But that, however, he may have expected that Janukowitsch would end the uprising of the "Europeans" at Kiev in a robust way finally, and would bind his country for a long term to the Russian "brother-nation", is more that an in opinion of one only. Anyway, the favour by Putin, since, always switched into rigidity, when the regime at Kiev was giving in too much to the opposition.

When Janukowitsch dismissed his longtime Russia influenced prime minister Mykola Asarow as a sign of goodwill for the opposition at the end of January, Moscow stopped the payments immediately - with the effect that Standard & Poor's rated the Ukraine to the junk level B- . On Friday Standard & Poor's downgraded the country more and reduced the credit rating down to CCC out of concern of an insolvency of the country.



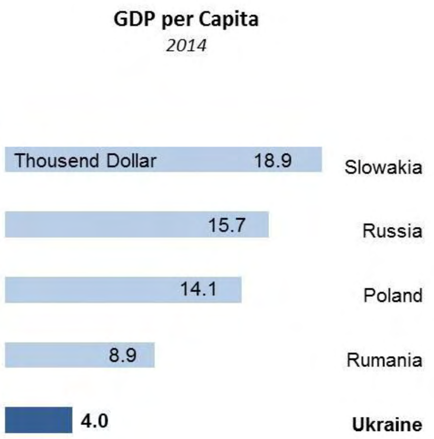
On the index of corruption perception of Transparency International the Ukraine, last year, was positioned between Guinea and Papua New Guinea at place 144, out of a total of 175. Therewith, the Ukraine is the most corrupt country of Europe. For the European Bank EBRD lawlessness, oppressive enterprise-takeovers and arbitrariness of public authorities are paralysing the economy. In this context, the World Bank is talking about the “Capture of the State”.

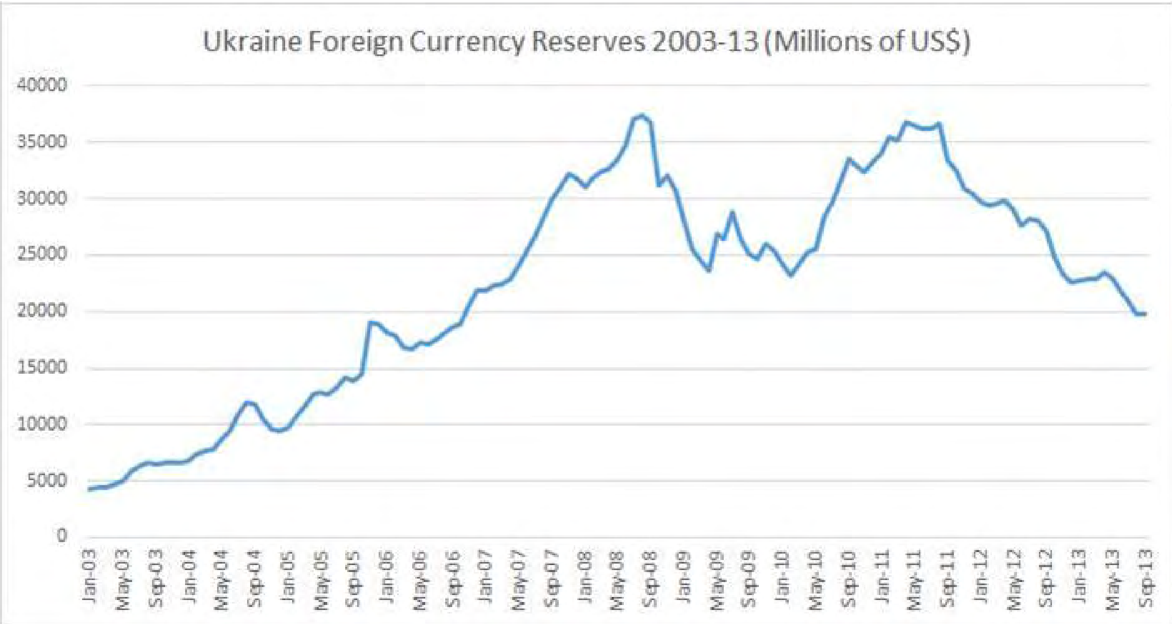
But one thing remained the same: Friends and relatives of the previous president have become more and more rich in the last years. Oleksander, the son of Janukowitsch, has been estimated on 367 million dollar by the magazine “Korrespondent” recently. Lately, his former governor, Serhij Ljowotschkin, debuted on the list of the 100 richest Ukrainians with 425 million dollars.



The consequences of this buccaneer-economy are devastating as the World Bank is describing: Corruption leads to a stagnating structure of the industry, low foreign investments and a minor role of the middle class. Therefore, the bank EBRD is of the opinion that the “key priorities” for Ukraine should be reforms in the “institutional environment” of the economy and measures against the “endemic corruption”.

But Janukowitsch has done nothing of that. He seeked his salvation in the distribution of pre-election donations and adhered to ruinous gas-prize-subsidies for budgets. Last year, the national budget ended with a deficit of more than 7 % including the losses of the state-owned energy supplier Naftogas, by the estimations of EBRD and IMF. Additional fact is a current account deficit of 8 %, the foreign exchange reserves of the central bank are melting rapidly, in January alone it has lost 12.8 % of its reserves.





Without foreign cash injections the Ukraine seems not to be survivable. Western credits, however, are tied to painful reforms, which at least Janukowitsch did not want to accept.

To him, only Russia was remaining as emergency-assistant, even though the Russian money helped at best short-term, because of lack of reforms at the same time. This also holds true for Putin's billion-credit of December. Ricardo Giucci of the "Deutsche Beratergruppe Wirtschaft" of the Ukraine wrote that this financial injection might have stabilised the Ukraine for a short time and kept away the feared bankruptcy. Though the Russian aid package is said not to contribute to a solution of the fundamental problems of Ukraine, namely the reduction of the state budget deficit and the county`s current account deficit.

So Ukraine is depending on grace and favour of Moscow - and again this depends on how things will continue in the country after the revolutional events of the past days. The events after dismissal of the prime minister Asarow illustrate this: Moscow stopped payments and immediately the ratings of the rating agencies fell through the bottom. Olena Bila, chief economist of the Kiev Investment bank Dragon Capital, said to this newspaper at this time, that - considering almost 10 billion dollar of foreign currency debt, which will become due in this year - the Ukraine could at most stand up alone to the second half of the year without foreign assistance. With bankruptcy in mind, the Ukrainian plundering economy remains at the mercy of Russia.

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

USA, Article: **Yellin' About Yellen: The Next Revolution in Monetary Policy?**

By Payden & Rygel, Los Angeles, California, USA, January – February 2014, Point of View, Our Perspective on Issues Affecting Global Financial Markets

Janet Yellen is set to become the most powerful woman in world history. Of course, Maggie Thatcher and Angela Merkel have blazed a trail, but Ms. Yellen will ascend to the helm of the world's most important central bank where her every word will command the undivided attention of politicians and financial market participants.

Inquiring minds want to know: what does Yellen portend for monetary policy and the markets? Fed Chair Ben Bernanke led us into the "zero lower bound", will Janet Yellen lead us out? To answer these questions and more, let's take a few steps back. Once we see the road behind us, perhaps we can see better what lies ahead.

THE HISTORY

When Janet Yellen first joined the Fed in the late 1970s, secrecy, not transparency, ruled the marbled halls of central banking. A wink and a nudge coupled with the obscure mutterings of the central bank chief often signalled shifts in monetary policy. Grizzled bond market veterans may even recall the excitement surrounding Thursday afternoon's release of the US money supply report, from which traders would glean information on the shifting winds of monetary policy.

Over time the conduct of monetary policy evolved. In 1994, the Fed began releasing its target for the federal funds rate, the overnight rate which served as the key tool for monetary policy. The Fed also began providing more details on policymakers' thinking in post-meeting policy statements.

The evolution in central bank transparency is no accident. As Ms. Yellen herself points out, scholars think better central bank communication drives better monetary policy. Better communication does not mean better technology, or a wish to see her words "posted, tweeted and blogged about" as the path to a better economy. Scholars believe that monetary policy affects employment, incomes, and inflation through its influence on the public's expectations about future policy.

Mark Carney, now ensconced at the Bank of England and the former Bank of Canada chief, argued that the reason clear communication, or as he phrased it, "guidance," worked for Canada was because it "was exceptional, explicit and made a "clear, simple statement directly to Canadians." One could well insert Americans, Britons, or Europeans into that sentence to summarize the revolution in monetary policy.

THAT AWKWARD TERM: FORWARD GUIDANCE

As the Yellen era begins, we already have a fairly long history of "guidance" from which to draw (**see Figure 1**). After a trial run in 2003, the FOMC gave forward guidance in late 2008 that the Fed funds rate would be low for "some time." Soon after realizing the depth of the crisis, in early 2009, guidance on future policy interest rates changed to indicate that rates would remain low for "an extended period." But the vague communique was neither explicit nor clear; in fact, the pronouncement left market participants wondering, "What exactly do they mean by an 'extended period'?"

fig. 1 THE LONG HISTORY OF FORWARD GUIDANCE

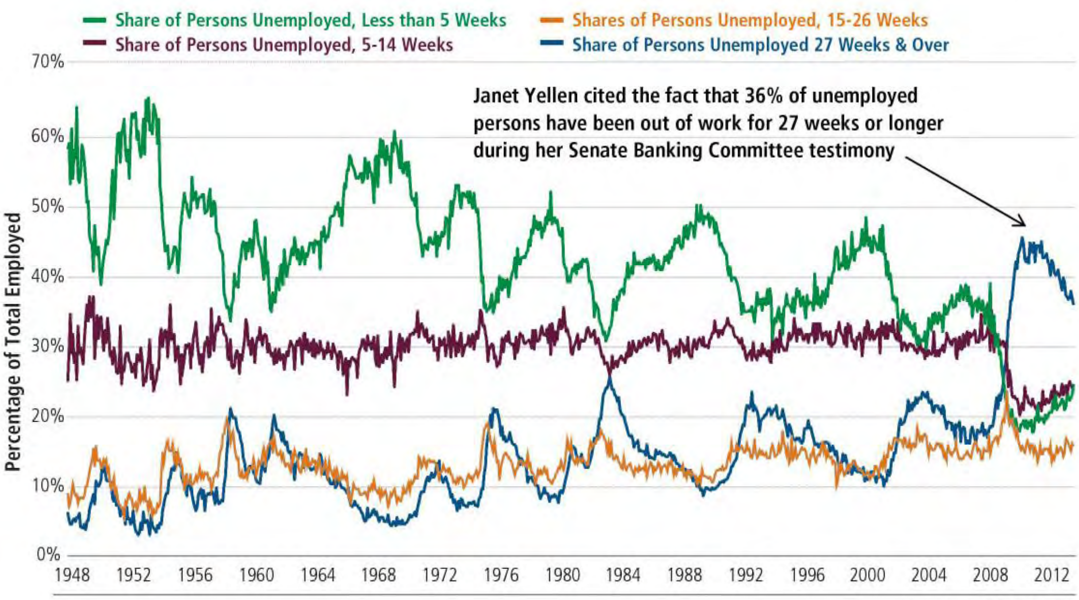
Date	Federal funds rate (%)	FOMC forward guidance language
Pre-crisis Experience		
8/12/2003	1	"Policy accommodation can be maintained for a considerable period"
1/28/2004	1	"The Committee believes that it can be patient in removing its policy accommodation"
5/4/2004	1	"Policy accommodation can be removed at a pace that is likely to be measured"
6/30/2004	1.25	"Policy accommodation can be removed at a pace that is likely to be measured"
Crisis and post-crisis Experience		
12/16/2008	0-0.25	"Weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time"
3/18/2009	0-0.25	"Economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period"
8/9/2011	0-0.25	"Economic conditions…are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013"
1/25/12	0-0.25	"Economic conditions…are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014"
9/13/2012	0-0.25	"A highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens…exceptionally low levels for the federal funds rate are likely to be warranted at least through mid-2015"
12/12/2012	0-0.25	"At least as long as the unemployment rate remains above 6½ percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored"
6/19/2013	0-0.25	"It would be appropriate to moderate the monthly pace of purchases later this year...we would continue to reduce the pace of purchases in measured steps through the first half of next year, ending purchases around midyear...when asset purchases ultimately come to an end, the unemployment rate would likely be in the vicinity of 7 percent, with solid economic growth supporting further job gains"

The initial lack of clarity gave way to the next step in the evolution of monetary policy. In the summer of 2011, with the unemployment rate still high, FOMC moved to a "calendar-based" approach stating, "economic conditions…are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013." Yet again, market participants were left wondering what the FOMC wanted to see from the economy by that date.

Continued confusion under the date-based approach catalyzed yet another shift in guidance. Economic expectations finally became explicit: the fed funds rate would remain at zero until the unemployment rate fell below 6.5%, as long as inflation was not expected to exceed 2.5% over the next 1-2 years. Immediately investors began speculation as to when such an economic scenario might occur, collectively concluding the 6.5% "threshold" was at least two years away.

Into this storm of projection and prediction, Yellen will descend. Under the Yellen regime, the central bank will endeavor to shape expectations about the future path of the federal funds rate through further guidance. As of this writing, the unemployment rate is at 6.7%, a whisker away from 6.5%. On the other hand, inflation is well below the FOMC's target, at 1.1% year-over-year. Are we at the end of the road? How will the Fed respond to persistently low inflation? How does the Fed view the 6.7% level on the unemployment rate?

fig.2 THE CHART JANET YELLEN FEARS MOST: LONG-TERM UNEMPLOYED



Source: Bureau of Labor Statistics

PATH AHEAD: TAPERING AND TALKING

Despite some signs of improvement and a hint of optimism about the US economy's prospects, the labor market is far from healthy. Yellen points to the fact that approximately 36% of those unemployed have been unemployed for six months or longer, a level unprecedented in the post-war era (**see Figure 2**). For the new central bank chief "there is more work to be done." Even as asset purchases wane, Yellen will stress the Fed's "balanced approach" to monetary policy laid out by the forward guidance; the FOMC is willing to accept (nay, welcome!) up to 2.5% inflation for a period in order to "catch up" for the period of below target inflation, particularly if anything can be done to boost the employment situation. Until then, target interest rates will remain low.

Not only that, stronger forward guidance could come in the form of a lower unemployment rate threshold (closer to 6.0%, for example) or a switch to a broader metric of unemployment. Or, in addition, the FOMC could institute an inflation floor, promising to keep rates low until inflation reaches the 2.0% target even if the unemployment rate falls to 6.0%.

Improvements to the Fed's communications about the future path of the federal funds rates will continue. As recently as the December FOMC meeting, policymakers softened the threshold for the unemployment rate, suggesting that zero fed funds rate would remain until the actual unemployment rate was "well past" 6.5%. The guidance is muddled but the message is clear: forward guidance is still a work in progress!

Each step along the evolving path of forward guidance aims to reduce uncertainty by offering clearer distinctions about the future path of interest rates. Strengthening and clarifying the economic thresholds would be the next logical step along that path. If markets respond, pricing in lower interest rates for longer, the economy enjoys the stimulus today.

UNDER YELLEN, WE MAY EVENTUALLY SEE "LIFTOFF"

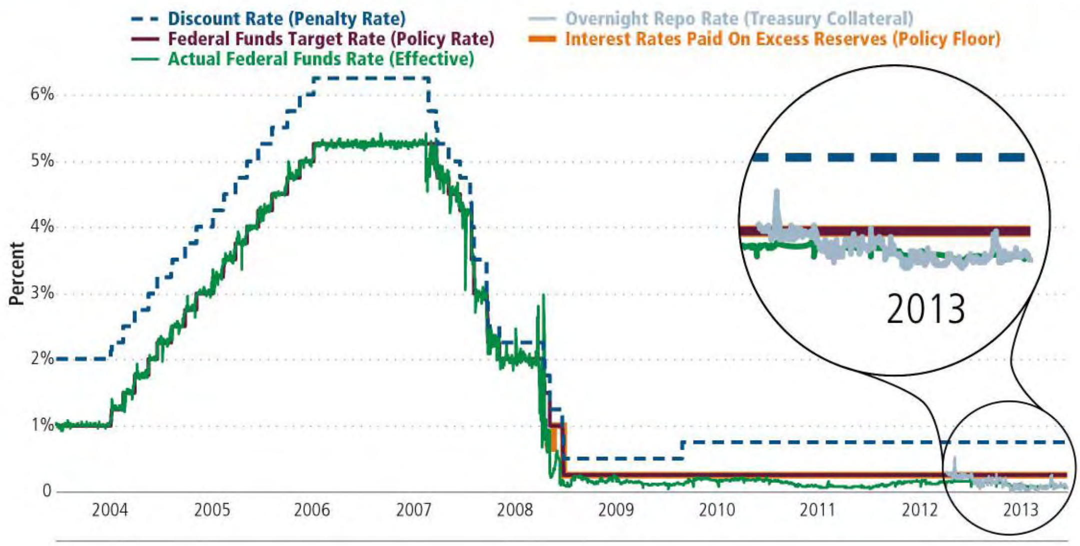
What's more, even after the initial liftoff of the federal funds rate, work must still be done to shape investor expectations. Among the many Fed documents released to the public, investors should watch the "Statement of Longer-Run Goals and Monetary Policy Strategy" (which debuted in January 2012) carefully. The longer-run goals differ from the policy statements released after each FOMC meeting in that they present a "more enduring expression" of longer-term objectives. These are views that will not change in a month or two.

In 2012, Janet Yellen suggested that these longer run goals represent a "consensus statement [that] will be reaffirmed each January, perhaps with minor modifications but with the core principles intact." Clarity and certainty for market participants on these longer-run goals will help control expectations and smooth out short-term fluctuations in the economy as interest rates rise.

CHARLIE BROWN, LUCY AND JANET: THE PROBLEM OF FORWARD GUIDANCE

But is "talking" enough? Will clear communication boost the economy? Even in theory, forward rate guidance only boosts economic activity today if the Fed commits to keeping the funds rate low until well beyond the period which might otherwise justify a hike: and the market has to believe the commitment. As it stands, policymakers do not expect the "terminal" fed funds rate to reach 4% until at least 2017, at which time they project the unemployment rate will be 5.5% and inflation about 2%.

fig.3 KEY US OVERNIGHT INTEREST RATES: IS THE FED FUNDS RATE OBSOLETE?



Source: Federal Reserve

While the commitment to do so sounds good on paper, practice is another thing. Former Bank of England Monetary Policy Committee Member, Adam Posen, commented on the move toward forward guidance in 2012 at the Jackson Hole conference saying, "I worry that this dichotomy between forward guidance and asset purchases, while perhaps useful for research purposes, is much exag-gerated in practice." Posen suggested that central bank actions (purchasing assets or cutting rates, for example) complements words and boost the credibility of its promises to keep policy rates low in the future.

DID YOU KNOW?

If No Trades Occur In The Federal Funds Market, Does It Make a Sound? Will The Fed Funds Market Become Obsolete?

For decades, the federal funds market served as the key overnight lending market. Forced by law to maintain reserves and by bank function to clear payments, banks would borrow (or lend) in the unsecured overnight market for "federal funds" based on excess cash needs. The rate at which they borrow is the "federal funds rate." The effective or actual federal funds rate was determined by transactions. Of course, the Fed influenced this rate, adding new reserves or removing excess reserves, in order to push the actual rate toward its desired policy target each day.

Since 2008, however, one might notice that the actual federal funds rate (**the green line in Figure 3 on page 3**) has traded below the Fed's target. That's because in the wake of its decision to pay "interest on excess reserves" or IOER, banks chose to keep money at the Fed rather than transacting in the federal funds market. However, several large market participants (e.g., the Federal Home Loan Banks, Fannie Mae and Freddie Mac) without access to Fed IOER facility still remain active in the federal funds market. The result? As show in our diagram (**see Figure 3**), the actual federal funds rate trades below the policy target and the IOER! In other words, some market participants remain willing to lend out reserves at a rate below the IOER.

But does this mean the fed funds rate is obsolete? One possible solution being tested by the Fed is the reverse repo facility dubbed the Fixed-Rate Allotment Facility. Bureaucratic jargon aside, the aim is to open the number of counterparties available to trade with the Fed (currently it consists of only the primary dealers) which could improve the Fed's grasp of the federal funds rate. In our view this makes sense: if the central bank intends to influence short-term rates, it must evolve to focus on global money markets that now dwarf the fed funds market. Perhaps this is a first step.

So while we expect the Yellen Fed to push ahead with the guidance revolution and focus on clear communication, in the end, the market's trust of central bank guidance reminds us of our favorite cartoon character, Charlie Brown, and his decades-long struggle with Lucy and the football. Lucy would yank the football away just as Charlie approached to take the kick, leaving our cartoon hero tumbling on his head, embarrassed and injured. Yet time after time Charlie Brown returned to attempt the kick again, convinced that this time Lucy's commitment was credible.

We doubt investors will fall for that.

SOURCES:

1 Janet Yellen. "Revolution and Evolution in Central Bank Communications." Remarks by Janet L. Yellen Vice Chair Board of Governors of the Federal Reserve System at Haas School of Business, University of California, Berkeley, Berkeley, California, November 13, 2012.

IAFEI News **March 14, 2014**

Election on February 20, 2014, of IAFEI Officer
Area President the Americas, for 2014:

Mr. Juan Alfredo Ortega, of IMEF-Mexico

IAFEI Executive Committee Meeting, Mexico City, Mexico, March 27, 2014

IAFEI Executive Committee Meeting, Manila, The Philippines, October 15, 2014

IAFEI Board of Directors Meeting, Manila, The Philippines, October 15, 2014

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, Milano, Italy, October 15 to 17, 2015

Hosting IAFEI member institute will be the Financial Executives Institute of Italy, ANDAF