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IAFEI Quarterly, Twenty-Seventh Issue, December 19, 2014

Table of Contents

Letter of the Editor

A.U.Group, Paris, France — **Silver Sponsor** of IAFEI

Argentina, Article:

Courtroom Drama
In July 2014, Argentina defaulted on a 539 million US Dollar interest payment on its sovereign debt in the latest round of its ongoing legal dispute with bondholders.
By **Andrew Wilkinson,** partner in Weil, Goshal & Manges´ European Restructuring Team
from **The Treasurer,** October 2014, **ACT**, UK

Australia, Article:

Australian Banks Ought to Increase Their Equity Capital,
By **Christoph Hein**, economic correspondent of Frankfurter Allgemeine Zeitung, Germany, Frankfurter Allgemeine Zeitung, December 8, 2014

Europe, Article:

An Era of Choice,
Corporate borrowers in Europe are moving from bank loans to the bond markets as they seek to diversify their funding mix. But is this a permanent change of behaviour ?
by **Adam Wotton,** head of corporate loan markets at Lloyds Banking Group, from **The Treasurer,** December 2014, **ACT**, UK

Euro-Zone, Article:

Ask Not for Whom the Bell Tolls,
After a recent run of bad news, what are the economic prospects for for the Euro-Zone in 2015 ?
by Alastair Winter, chief economist at Daniel Stewart & Co, from **The Treasurer,** December 2014, **ACT**, UK

Please turn over

Germany, Interview:

" The Investors Would Give Us Even More Money "
Interview with **Dr. Friedrich Eichiner,** CFO of BMW-Group, Munich, Germany, and member of GEFIU, the Association of Chief Financial Officers Germany. Article provided by German IAFEI Member Institute GEFIU

Italy, Article:

Do Banks Manage Reputational Risks ?
By
-**Niketa Mukherjee,** Marie Curie Fellow, Early Stage Researcher
Dept. of Economics and Management University of Ferrara, Italy,
-Stefano Zambon (PhD), Professor of Accounting and Business Economics
Dept. of Economics and Management University of Ferrara, Italy
-Hakan Lucius PhD, MSc, MBA, Head of Corporate Responsibility and Civil Society Division European Investment Bank (EIB), Luxembourg,
Article provided by ANDAF, the Italian IAFEI Member Institute

Japan, Article:

What Japan Teaches Europe
By Holger Stelzner, co – publisher of Frankfurter Allgemeine Zeitung Germany, Frankfurter Allgemeine Zeitung, December 8, 2014

Mexico, Article:

Options in MexDer & OTC
Risk Management
by **Emilio Illanes Diaz-Rivera**, and by **Fernando Alcantara-Hernandez**, chairman of the management board and chief executive of GFD Operador MexDer, respectively, and members of the national technical committee of comprehensive risks management of the Mexican IAFEI Member Institute IMEF, article provided by IMEF

Mexico, Article:

International Standards - Changes in Leasing
by **Nestor Gonzalez-Monroy**, and by **Javier Aranda-Navarette,** member and guest member respectively, of the national technical committee of financial information of the Mexican IAFEI Member Institute IMEF, article provided by IMEF

Mexico, Article:

Transnational Corporations - Global Synergy
by **Juan Ramon Sobero**, and by **Patricia Luna**, members of the nation technical committee of human capital and VP of the technical council respectively, of the Mexican IAFEI Member Institute IMEF, article provided by IMEF

Netherlands, Article:

Cocos Are Offering Relatively Attractive Chances of Returns
by **Caspar van Grafhorst,** Senior Credit Analyst at ING Investment Management, the Netherlands

Please turn over

OECD, Report:

OECD Secretary General Report to the G20 Leaders
Brisbane, Australia, November 2014,
Excerpts:
-Executive Summary
-A-Base Erosion and Profit Shifting

USA, Article:

Whodunit ? Oil and the Bond Market
What Does It Mean for the Economy ?
by **Payden & Rygel**, Los Angeles, USA, *Economic Update*,
Thoughts from Our Economics Team, December 10, 2014

IAFEI News

Letter of the Editor **December 19, 2014**

Dear Financial Executive,

You receive the **IAFEI Quarterly XXVII 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 contains a broad variety of articles on accounting, financial and tax matters from 11 countries, respectively country groups.

Thanks to our Mexican IAFEI Chairman Luis Ortiz Hidalgo we have received, for inclusion, three articles from Mexican financial professionals

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

Silver Sponsor of IAFEI, the International Association of Financial Executives Institutes:

(1 September 2014 to 31 August 2015)

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It is the sponsorship policy of IAFEI, to thereby enhance the value of the organization to is member institutes and its individual financial executives members, around the world, while, at the same time, entering into a professional dialogue, by various ways and means, with the sponsoring corporations. In so doing, IAFEI is striving for having such corporations as sponsors, which are world class corporations, and among the best in their business sector, and with a truly global scope and focus of activities. Thus, IAFEI and its sponsors, want to jointly serve financial executives, worldwide, for their professional benefit.

COURTROOM DRAMA

In July 2014, Argentina defaulted on a $539m interest payment on its sovereign debt in the latest round of its ongoing legal dispute with bondholders. Andrew Wilkinson explains

By any usual standards, the dealings between Argentina and a minority of its bondholders ought to have been a low-key last act to the drama of the country's 2001 default. Instead, it is turning into a morality play in which both sides claim the high ground and questions of national sovereignty and security of contract clash noisily in what is becoming an increasingly acrimonious dispute.

As sides are taken, Argentina's reluctance to negotiate can be seen as either principled or incendiary, while the activities of the bondholders are presented as either an entirely legitimate line of business or, to use the word of the moment, the behaviour of 'vultures'.

Amid the sound and fury, a fair-minded assessment of the whole affair – in which Argentina is now grappling not only with its creditors, but with the US legal system – is essential. Such an assessment would concede that changes might well be needed to the system of bond issuance to ensure that all bondholders support efforts at restructuring. It would concede also that Argentina has probably overplayed its hand through failing to recognise where the power ultimately lies in debt negotiations.

A history lesson

First, however, some history. The New York courtroom dramas of recent months can be traced back to 2001, and the debt default that followed Argentina's ultimately unsuccessful attempt to use a fixed exchange rate to the US dollar as an external discipline on its economic management.

The subsequent restructuring of $100bn of Argentina's debt in 2005 and 2010 saw a majority of creditors agree to swap the distressed debt for bonds with a much lower value, taking a 'haircut' on their investments of about 70%. These are the so-called exchange creditors.

As a result of the restructuring, the country's debt as a percentage of GDP fell from 166% in 2002 to 45% in 2012.

But about 7% of the creditors – now known as the 'holdout creditors' – did not accept the restructuring offer; indeed, they bought *more* distressed Argentinian debt. These are hedge fund specialists that focus on buying distressed sovereign debt cheaply and turning a profit, either by finding a buyer willing to pay more or by suing the debtor for full payment. And the holdout creditors subsequently demanded that Argentina repay its debt.

To many, this behaviour is offensive, and ought to be prevented by the insertion of collective action clauses into offer documents for bonds, which would bind creditors to abide by the majority decision. Objectors would also like to see amendments to the *pari passu* provisions that treat holdouts equally with other creditors. Such changes would undoubtedly be desirable. But they have been talked about for many years, and little beyond talk has been achieved.

Whether people like it or not, under the current dispensation, the holdout creditors were entirely within their rights to demand full payment totalling about $1.3bn on their investment, a right upheld by a US federal court in 2012. The court also prohibited any payments to the exchange creditors until the holdout creditors were paid in full.

Critics of the authorities in Buenos Aires suggest their flat refusal to negotiate drove the holdout creditors to law. This, in turn, they say, has had an entirely predictable courtroom outcome. Argentina's refusal to sit down with the holdouts has, say critics, given these minority creditors far more publicity and negotiating leverage than the position warranted.

Infringement on national sovereignty

But Argentina believes the court has infringed its national sovereignty, not least because the 'rights upon future offers' (RUFO) clause inserted into Argentine bonds prohibits paying the holdout creditors on better terms than the exchange creditors.

It is quite correct that Argentina, as a sovereign state, does not fall within US jurisdiction in its own territory. But the pivotal role of New York – and friendly jurisdictions such as London – in the world financial system means the banks through whose settlement systems Argentina would need to route payments to exchange creditors, in defiance of the US courts, most certainly do fall within US jurisdiction.

As a result of this 'long arm' of the American law, Argentina had to miss a $539m interest payment to the exchange creditors on 30 July. Rating agency Standard & Poor's declared the country to be in 'selective default'.

Since then, Argentina has clashed with the court again, by denying that it is, in fact, in default, and the court is threatening to find the country in contempt. It has also done little to endear itself to US judges by floating the idea of a scheme to make the payments to exchange creditors initially through its own central bank and then routed through various financial centres so as to skirt America's long legal reach.

Attractive though this outright defiance may be to Argentina and its supporters, there are real practical problems. A century ago, this 'financial bypass' of the US may have been relatively easy to achieve. It would be harder now, when capital markets are tied closely to the US, not least because of the key reserve-currency role of the dollar and the comfort provided to investors by the country's legal system.

Furthermore, even were this to be achieved, for Argentina to have set up a sort of parallel or 'grey' financial market for its own purposes may not put investors in the right frame of mind when the country next seeks to drum up international capital for economic development.

Grand finale

How will it all end? It is very difficult to say, and harder still to see how the pieces can be put back together.

While the issue continues to progress through the court of industry opinion, the market has already seen genuine change. The International Capital Markets Association recently announced changes to sovereign bond contracts, in a direct attempt to avoid similar disputes in the future. Under new terms, collective action clauses have been introduced, which allow a majority of bondholders to agree changes to bonds that are binding on all investors, preventing any minority from disrupting the restructuring process.

One possible end game would be a deal with the holdout bondholders, but there is no sign of this. Another would see the Argentine government sit tight and wait for the RUFO clause to expire next year. The trouble is, there has been a default in the meantime.

Thirdly, Argentina could go back to the exchange bondholder to try to change the terms of the bonds.

Whatever the rights and wrongs, it is hard to escape the conclusion that Argentina would have been better advised to have negotiated a deal right from the start. The exchange bondholders would have been more sympathetic had Argentina tried to strike a bargain with the holdout creditors, albeit on more generous terms. They would very likely be less sympathetic now.

The plain fact is that, in the world of restructuring, refusal to negotiate simply isn't practical. During the eurozone crisis, the Greek and Irish governments realised they had to negotiate directly with bondholders, when it came to the restructuring of their bank and sovereign debt, however unpalatable that may have been. In doing so, they ensured the capital markets would eventually welcome them back.

> Whatever the rights and wrongs, it is hard to escape the conclusion that Argentina would have been better advised to have negotiated a deal right from the start

LESSONS FROM THE GREEK AND IRISH DEBT RESTRUCTURING

There are two lessons here for all debtors, sovereign or corporate.

- **First, creditors ultimately hold all the cards. You have to negotiate, cut a deal and move on.**
- **Second, conflict with your creditors – whatever the apparent provocation and however strongly you believe you are in the right – is usually a bad idea, both for companies and countries, and ought to be avoided whenever possible.**

The real sadness is that Argentina, having put in so much hard work after 2001, ought now to be turning its economy around and starting to enjoy the fruits of its efforts. Instead, it is mired in a legal dispute that, as yet, shows no sign of being resolved in its favour.

This concern, fairly or unfairly, may result in investors thinking twice as Argentina comes looking for funds, not least to exploit a potentially huge shale gas field.

Argentina's history of expropriating both domestic- and foreign-owned assets makes it just that bit harder for the country to present itself as a reliable business partner that respects property and contractual rights.

Note: Argentina was due to make another interest payment to bondholders on 30 September, after this issue of *The Treasurer* went to press.

Andrew Wilkinson is a partner in Weil, Gotshal & Manges' European restructuring team

Australia, Article: Australian Banks Ought to Increase Their Equity Capital

By **Christoph Hein**, economic correspondent of Frankfurter Allgemeine Zeitung, Germany, Frankfurter Allgemeine Zeitung, December 8, 2014

SINGAPORE, December 7, 2014. The refinancing costs for the quartet of the Australian major banks are estimated to increase significantly. The Australian finance minister Joe Hockey presented the final report about the situation of the financial institutions at Sydney on Sunday. According to this, the Australian major banks CBA, Westpac Banking Group, Australia & New Zealand Banking Group and National Australia Bank are supposed to increase their equity capital by around 30 billion Australian dollar (20.3 billion Euro). Fitch Rating agency estimates that there is a capital lack of approximately 53 billion dollar for the banks.

The report demonstrated that the four major banks of Australia are only in the midfield as measured in terms of international standards for covering outstanding loans. Before, the business association Australian Banker's Association had declared that its banks would rate in the best quartile of international banks.

The authors of the study are estimating that the equity capital reserves (Tier 1 capital) of the "big four" are in the range of 10 to 11.6 %. However, 12.2 % would be necessary to reach the safest quartile of the international banks.

Since October 2010, the four banks have already increased their equity capital with almost 35 billion dollars. "Such crises mean enormous costs for the national economy and the corporations, and the circumstances, which had helped us in the last crisis, will prospectively not be there anymore", explained David Murray, the former chairman of Commonwealth Bank of Australia CBA who was leading the investigation commission. The Australian Banks overcame the crisis in 2008 widely undamaged.

Among other things, it was recommended to the Australian major banks to introduce general standards for granting mortgages. Up to now, the banks are deciding with their own individual internal standards which property purchasers are creditworthy. "The competition will limit the degree of passing-on the costs to the customers. Shareholders might bear a part of that by way of a smaller profit per share", the report tells now.

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

AN ERA OF CHOICE

CORPORATE BORROWERS IN EUROPE ARE MOVING FROM BANK LOANS TO THE BOND MARKETS AS THEY SEEK TO DIVERSIFY THEIR FUNDING MIX. BUT IS THIS A PERMANENT CHANGE IN BEHAVIOUR? ASKS ADAM WOTTON

One of the enduring legacies of the financial crisis has been the fundamental shift in the composition of corporate debt. Before the crisis, companies in Europe predominantly funded themselves using bank borrowing. US companies, in contrast, tend to use the capital markets as their primary source of term debt, while accessing bank funding for short-term requirements, such as working capital finance.

More recently, however, European corporates have begun a migration towards an American-style financing model. Companies are increasingly using capital markets instruments, either as an alternative to bank funding or as a means of diversifying their funding mix. While the issuance of European loans has reduced since 2007, the stock of outstanding bonds has doubled for investment-grade (IG) corporates in the same period – and has tripled in the high-yield (HY) market. (See graph, right.)

As corporates have sought greater flexibility in their debt structures, they have simultaneously accepted the associated levels of public scrutiny and information provisions that come with capital-market borrowings.

This shift towards capital market activity is not set in stone. Bank lending will, of course, continue to be key for European corporates, particularly with regard to liquidity management. Meanwhile, the split between use of bonds and loans continues to vary from quarter to quarter. But it is clear that corporate borrowers are adopting a more diversified funding strategy than they did in the past and they will probably keep moving in this direction over the coming years.

Drivers of change

Several factors have prompted this shift in Europe. For one thing, banks are facing higher capital costs against the backdrop of far-reaching regulatory change. As a result, banks have less appetite for large, capital-consuming exposures than they did a few years ago – and long-term bank debt is not as readily available as it was pre-crisis.

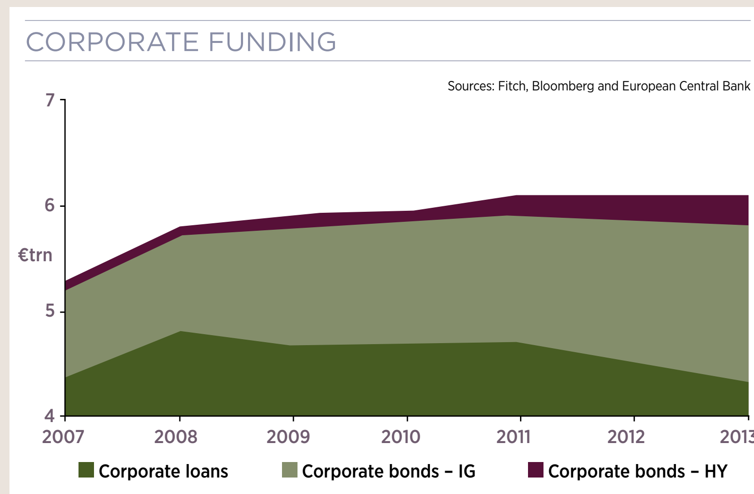
At the same time, the European bond market is now being accessed by a wider range of corporates than in the past. Historically, this market was accessed by only the largest multinational corporations, which have tended to use bonds as their primary source of long-term capital. More recently, however, the bond markets have become increasingly attractive to the next tier of borrowers in terms of market capitalisation. Many corporates that would not have historically considered capital markets issuance are now seeking ratings for the first time in order to achieve diversification.

Furthermore, the range of non-bank funding alternatives has expanded in the past few years, with a number of financing options becoming more accessible for a wider range of European corporates. In addition to bond financing, corporates have increasingly accessed term financing lines from long-term institutional investors, as well as government initiatives, such as the guarantee scheme sponsored by Infrastructure UK.

Other options available to European corporates include hybrid bonds, which have evolved from a niche offering in 2007 to become a core layer of the capital structure for a number of larger corporate borrowers. The US private placement (USPP) and Schuldschein markets are also attracting greater attention from corporates looking to diversify their funding mix.

The step change towards diversification – and the different approaches adopted by corporations in achieving this – can be illustrated by three companies that have dramatically changed their funding mix in the past six years. All three were 100% funded by bank debt in 2008/9, and all three adopted a more diversified approach to their debt structures following the financial crisis. (See graphs, opposite.)

◆ **Company A**, a rapidly growing company, has large capex requirements and lumpy cash flows. As such, the company needs to be able to access a significant level of liquidity alongside a growing level of core debt. Following the financial crisis, the decision was taken to diversify its capital structure in order to increase stability. The company



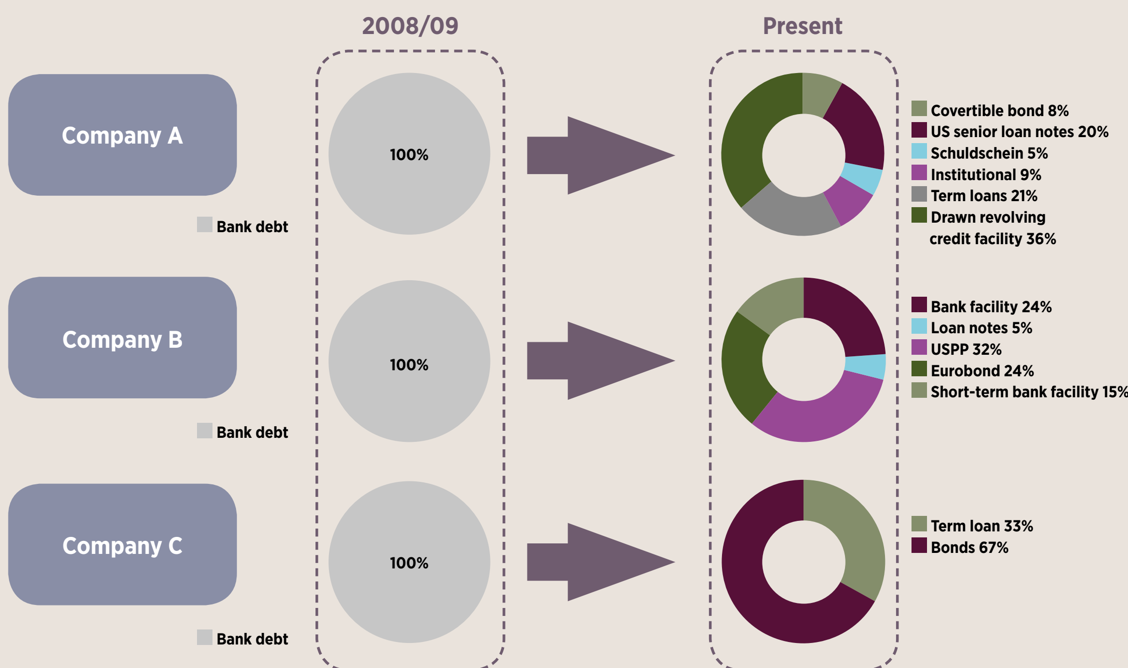
has achieved this by issuing a combination of convertible bonds, USPP and non-domestic Schuldschein loans, as well as term loans.

- **Company B**, a market-leading services firm, has become a globally diverse business following a series of strategic acquisitions underpinned by robust organic growth. Shortly after the financial crisis, the company executed a key transaction and took the opportunity to move away from relying wholly on bank debt. The company was looking to use debt instruments to manage its long-term funding requirements more effectively and, after a debut issue in the USPP market, it obtained a public rating, allowing it to issue public bonds.
- Meanwhile, regulatory change has prompted **Company C** to move into the capital markets in order to achieve the desired long-term, stable, fixed-rate exposures. As a result, the company is now more than two-thirds funded via bonds.

So is the corporate shift in funding strategy a temporary dynamic or a permanent adjustment?

While the impact of the financial crisis on banks' credit ratings may have had a short-term impact on corporate debt composition due to corporate borrowers' heightened concerns over counterparty risk, the other drivers discussed above may well continue to impact the market for years to come. As such, the shift in European debt composition seems likely to be a permanent change.

CHANGING FOCUS OF EUROPEAN CORPORATES – A SNAPSHOT



Pricing shift

The shift towards diversification is not the only notable trend affecting corporate funding decisions. Another consideration is the current downwards pressure on pricing for corporate borrowers. In the past few years, the banking industry has been putting in place a variety of regulatory changes intended to strengthen balance sheets, improve capitalisation ratios and increase liquidity. At the same time, corporates have been deleveraging and realigning their balance sheets and business models in response to the new financing landscape.

As a result of these changes, the debt-financing markets – including banks – are more liquid than in the recent past and are more available to support corporate borrowers.

In early 2012, pricing levels increased as a result of several factors, including concerns around regulatory change, growing capital costs and negative economic expectations (ie the euro crisis). More recently, however, with reduced funding costs driven largely by central bank monetary policy initiatives, the focus has moved to competition. Corporates are increasingly driving terms in this market, and banks are becoming more aggressive as they seek to support clients and win business.

Banks are also more focused on enhancing their client relationships as they expect corporates to adopt a more expansionist approach.

Looking forward

In the past couple of years, the majority of corporates have been focused on refinancing existing borrowings rather than funding new opportunities such as M&A. The pricing compression experienced over the past couple of years could plateau if this summer's M&A activity picks up significantly. Alternatively, if wider financial market jitters persist and M&A activity slows, we could see further pricing pressure as banks chase income into the new year.

Many corporates have analysed the figures for the past 18 months and concluded that funding conditions are unlikely to improve much further. As a result, they have taken the decision to pre-fund themselves while conditions are favourable. If the macroeconomic environment continues to become more volatile, and if capital expenditure and M&A spending don't accelerate as quickly as the market expects, corporates may decide that there is no longer any need to continue pre-funding themselves. This may lead to a lull in the markets that could drive bank competition even higher.

At this stage, it is difficult to predict how this trend will progress – but for the time being, corporate borrowers are able to access financing at attractive pricing. Meanwhile, the corporate funding market has become more flexible and accommodating than ever before, and there are no signs that this will change in the foreseeable future.

Adam Wotton is head of corporate loan markets at Lloyds Banking Group

LLOYDS BANK

ASK NOT FOR WHOM THE BELL TOLLS

AFTER A RECENT RUN OF BAD NEWS, WHAT ARE THE ECONOMIC PROSPECTS FOR THE EUROZONE IN 2015? ALASTAIR WINTER OFFERS A DIAGNOSIS

The European Economic and Monetary Union (EMU) is unwell. And with no obvious, fast-acting antidotes, its prospects for the next few years are bleak.

The graph (opposite) shows the actual GDP growth of the EMU's four largest economies since the financial crisis alongside that of the UK and the US. It also reveals the European Commission's forecasts for GDP growth. Unfortunately, average annual growth of 0.2% over an eight-year period compares very badly with the 50-year average of around 3%.

The decline has been going on for longer than 2008, however, and not just in the eurozone. While the term 'secular stagnation' has been given a controversial new airing by US economist Larry Summers and others, there is no doubt the eurozone is experiencing a prolonged period of low growth in both aggregate demand and aggregate supply. With trepidation, I offer my case for secular stagnation in Europe.

The case for secular stagnation

Globalisation has led to greater equality of incomes and costs between (but not within) advanced and developing economies. This is a double whammy to the competitiveness of richer countries: their exports are still expensive while their imports have become less affordable. Trade suffers as a result.

Meanwhile, population growth in the eurozone is falling to a rate below 0.2% per annum and is already negative in Germany and Italy. And after being a significant contributor to growth through greater productivity over the past 20 years or so, the dividends offered by technology appear to have plateaued. Many jobs have been lost for good, however, and the next wave of technological revolution is shaping up to be even more dramatic. Any further productivity benefits may be offset by the redundancies of white-collar workers, as well as blue-collar workers.

Furthermore, governments and businesses are both investing less, if for different reasons. Governments are giving priority to current spending while business investment is held up by uncertain demand and the limited availability of funding.

The damaged banking sector is another concern. Contrary to the myths conveyed by eurozone leaders about Anglo-Saxon culpability, many European banks were heavily exposed to the sub-prime bubble as well as reckless adventures in Greece, Ireland and Eastern Europe. Domestic lending still seems a low priority for many, despite government exhortations and the largesse of the European Central Bank (ECB).

Unaffordable public services are a serious issue in the eurozone. The post-war European welfare state appears to have become an end in itself. This has been a long process, driven by the aspirations of politicians and voters alike. It is now clear that the previous rates of growth in current public spending are unsustainable. So far, Germany has led the way while the bailed-out countries have been obliged to embrace outright austerity. But, to date, France and Italy have been unwilling and unable to do more than merely slow down the rate of the increase in spending.

Finally, consumer confidence has collapsed. Faced with the prospect of job losses, pay freezes, welfare cuts, tax hikes and new and/or higher public service charges, it is no surprise that consumers across most income groups are reining back on their discretionary spending.

The outlook in 2015

So are things going to get better? Unfortunately, this does not look likely any time soon, and certainly not in 2015. And here's why:

- **Long-term unemployed. Many of these people may never work again. Just as shocking is youth unemployment, which stands at over 50% in Spain and Greece, and at more than 40% in Italy. It will take a decade or more of structural reforms and investment in training to reduce this burden, assuming optimistically that demand for labour eventually does pick up again.**
- **Productivity. This has been poor over the past eight years, even in Germany and France, where higher labour costs have stimulated more capital investment. The spectacular improvement in Spain has been achieved at the cost of higher unemployment and lower earnings. Italy seems to have the worst of all worlds.**
- **Earnings growth. Low growth is another trade-off against unemployment, notably in Spain and the smaller countries and, of course, it signifies less spending power.**

- **The consumer price index. Deflation has not yet taken hold and it should be distinguished from disinflation, which can be a good thing (for example, lower oil prices). Nevertheless, there are dangers. The higher real levels of earnings, interest rates and the value of debt can lead to worker layoffs, delayed consumer purchases and a reluctance by businesses to borrow to invest.**
- **Retail sales. These are clearly depressed at present.**
- **Industrial production. This is caught in a vicious circle of lower demand, leading to lower supply.**
- **Private-sector debt. This is at levels high enough to deter anxious consumers from spending and businesses from investing.**
- **Capital formation. Acquiring capital is a worrying sign that business sees little scope for expansion in the next few years.**
- **Government borrowing. The Fiscal Compact sets a target of 60% for the public debt/GDP ratio for each eurozone country. Even if exceptions are allowed, the going will be slow and painful. Research from the International Monetary Fund has suggested that the (negative) fiscal multiplier of public spending cuts on GDP is almost two.**
- **Ease of doing business. There are only six other eurozone countries joining Germany in the top 30 easiest countries in which to do business and all of them are small, including Finland (9), Ireland (13) and Portugal (25).**

With challenges like these, politicians and central bankers need to face up to secular stagnation and stop pretending that it is 'merely' cyclical. It will take time for the required blend of corrective measures to work. Eurozone leaders are unrivalled in their ability to fudge apparently irreconcilable positions, but they will be tested to the full in 2015.

So which options are open to them?

1. Structural reforms

The most commonly cited structural reforms relate to the labour markets, for example, flexibility on hiring and firing, reducing employer costs and enabling training/retraining as job requirements change. The banking sector also needs a lot of attention, but at least the ECB's asset quality review exposed a lot of the sector's problems (notably in non-performing assets) even if the associated stress tests were a damp squib. Restrictive professional practices that affect professions ranging from lawyers to pharmacists to taxi drivers are another major barrier to growth. Then there are shop opening hours, complex tax codes and even the red tape involved in setting up a new business. The list is long, the obstacles large and the hard work has barely started.

2. Monetary policy

It is important to remember that the ECB was not designed to deal with stagnation, but rather to enforce German rectitude on inflation. ECB president Mario Draghi now seems to be seeking a shoot-out with the Bundesbank and the German government, but it may not just be about purchasing sovereign bonds. It is far from clear that quantitative easing (QE) would achieve much, since its main benefit appears to be providing liquidity to prevent meltdown in financial markets and Europe is currently awash with liquidity. It is, moreover, questionable whether new cash from QE would rapidly flow into lending by banks and spending by consumers or investment by business.

3. Fiscal policy

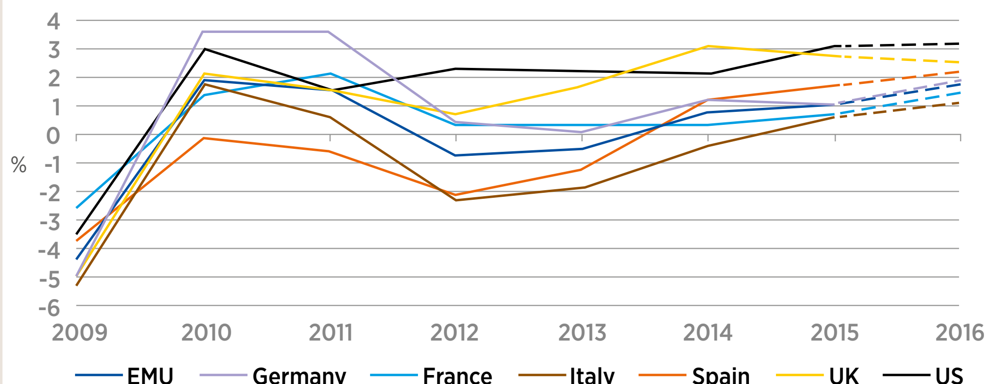
It is understandable that the French and Italian governments are refusing to toe the line on 3% annual budget deficits. They face powerful unions and wider voter opposition. Meanwhile, the direct and indirect cost of strikes and social upheaval could be severe. Moreover, investors have an almost infinite appetite for sovereign debt, albeit they might expect higher yields. The key is to win popular support for national budgets that restrict current spending in favour of investment.

4. Euro exit/break-up

A unilateral exit could be costly, involving capital controls and unfavourable rates for legacy debts without boosting exports. An orderly break-up would also be disruptive, but still preferable if the Germans and French cannot agree on a common fiscal approach, including eurobonds and other transfers. The Germans may also find it legally, as well as politically, impossible to support further monetary easing.

Summing up

Representing 18% of world output, the eurozone remains (just) the planet's largest trading block. Its travails affect us all and *schadenfreude* seems especially malapropos. No guesses needed, therefore, for whom the bell tolls.



Alastair Winter is chief economist at Daniel Stewart & Co

Germany, Article: "The investors would give us even more money"

Interview with Friedrich Eichiner, CFO of BMW-Group, Munich, Germany, and member of GEFIU, the Association of Chief Financial Officers Germany

From the point of view of the BMW CFO business mostly runs according to plan - European price war brings margin under pressure – full year and return target are reconfirmed

Interviewed by **Stefan Kroneck** and **Peter Olsen, Börsen-Zeitung,** Frankfurt am Main, Germany, October 18, 2014

Mr. Eichiner, at the Paris Autosalon talk has been on the fact that now there is also an increased pressure on prices in the premium class. How do you consider the situation?

The intense competition becomes furthermore tangible in some parts of Europe. Since the onset of the financial crisis in 2008, the sales volumes have decreased in two waves in

Southern Europe, at the same time the intensity of the competition has increased. An initial drop had come with the financial crisis, and after a short temporary recovery the negative trend has continued with the Euro-crisis. Since then, these markets are characterized by a low volume-level with a high price-competition.

Where does BMW stand today?

Also thanks to our attractive model portfolio, we are well on the way. From our point of view, all in all the market in Europe is just stabilizing again. First, we can recognize a light improvement of the price situation and the number of sales. But we are still – and especially in Southern Europe – and distinctly below the level of 2008, as well as the other producers. However, the overall economic situation in the countries like Italy and Spain has not reached the pre-crisis level as well. In Spain, the passenger car market had practically halfed in the crisis.

Is this a special European subject?

Yes, in the USA for example, the situation has already normalized for a long time. There, we have already reached the pre-crisis level concerning our prices.

However, it seems that this differentiated view is not understood by the investors everywhere. There are analysts who regard BMW being over the zenith already, whereas others believe in a profitable phase of harvest.

BMW Group finds itself in the middle of the biggest model-offensive in the company's history. This year alone, we introduce 16 new products on the market, of which 12 without predecessor. Just reference the high-volume 3 and 4 series: Here, we have just introduced additional derivatives and both series together are successful as never before. But also totally new models as the BMW 2 Active Tourer and the 2 Coupé are launched now and will win new customers. But not least the new models of the X-series, the currently presented M-vehicles and the new generation of Mini which is on the market with attractive derivates now: Our product-momentum is higher than ever before and this will continue in the following years.

So there is no reason for questioning your business targets for 2014?

No. Our understanding is that we are in a position to reach the planned objective of a significant earnings improvement for the group in the total year. Concerning the automobile-segment we are expecting an ebit-margin of 8 to 10 % which is according to our target corridor. The last years have shown: we do attain what we announce.

What do you mean with "significant"?

For us, that means the upper end of the single-digit percentage range in transition to the double-digit level.

What is giving you this equanimity?

In my opinion, our business is basically running as we planned. If a month in one market exceptionally does not quite correspond to our expectations by way of unexpected external factors, we will stand that. As an example: A drop in the market in the range of Russia, which has not that high volume, may not be nice, but we can handle this flexibly by equalizing it

with reallocation in other regions. As a global player you will always have to face an unexpected challenge or two at some place again and again – you have always to expect the often quoted Black Swan in our position, and you have to be able to cope with it. Our strategy Number One is the basis for a clear future orientation of our corporation.

How is your look ahead?

For the evaluation of the upcoming years it is too early for that, also considering the fact of the increasingly volatile scenario. Just consider the currency side. At the beginning of the year, from our point of view the development of exchange rates was not so pleasing, now the Dollar has significantly gained in comparison to the Euro in a reasonably short time.

And the general perspective?

In general, we are expecting a further growth for 2015 of course, because the many models having their start-up this year, will only have their full effect regarding production as well as sales in the upcoming year. In addition, we will introduce even further attractive new models in 2015. At present, it is difficult to see how large the related growth impacts will develop.

What is the role of the German domestic market in the premium competitive environment?

Basically, Germany has reached its pre-crisis level again. In Germany, the premium segment has the comparatively highest share of the total market with almost 30 %. On average of the markets, this share is only about 10 % worldwide.

What does that mean regarding the achievable price-level?

Of course, the high premium segment share leads to the fact that in Germany - which has always been the domestic market of the large premium-producers – the competition has always been particularly intense.

What does the discount battle in Europe cost to BMW?

We do not participate in discount battles and as a premium-manufacturer we are certainly trying to avoid a pure price competition as far as possible. But of course, at the sight of the intense competition we are not in a position to escape from that in some markets either. In the last years, a noticeable pressure has been raised at the price competition concerning the margins, which impacts our profitability. In spite of the slight improvements, we have already not reached our pre-crisis level in these markets by far.

How strong is the role of distortions in exchange rates concerning increasing production abroad?

In our business, currencies are still playing a major role. Anyhow, 60 % of our business is done outside the euro area. We are able to cover a part of the risk by localization of production and parts purchasing via natural hedging, but by no means everything. A significant exposure remains, especially because growth develops dynamically outside the euro area. In the fields of financial hedging we are following a clear strategy, we want to limit the risks as much as possible without waiving chances completely.

How high is the exposure, then?

This values in the double-digit euro-billion-range, especially the Renminbi is becoming more and more important due to the China-business. We are always hedging with a certain time buffer to ensure the operating business at any time.

Are you not running the risk to miss chances of profit with your hedging transactions?

If you have short-term fluctuations in currencies, it will be. But our intension is not to have negative surprises concerning this. We are orientated at an equilibrium exchange rate. So it is clear for example, that we are hedged in currencies for the remaining three months of this year as far as possible. Large positive results cannot arise from the current changes concerning the dollar exchange rate. But I do not say that there are no positive effects at all.

And mid-term?

If a sustainable change results of the current dollar-strength then we will certainly have a positive effect. We are hedging in a foresighted way and at the same time, we maintain chances for ourselves, but we are not speculating. In this respect, we are applying to so-called minimum hedges which are not questioned. In my opinion this went very well so far as our actions are not aiming at the highest profitable currency profits. We rather like to hedge our plans concerning the operating business and our guidance. The automobile-business is on a very long-term basis, therefore it is prohibited to peer at quick currency gains or to take hazards.

BMW at a glance

Group Numbers (1st half of the year)

Sales in billion Euro

2013 37,1
2014 38,1

Ebit* in million Euro

2013 4104
2014 4693

Profit before taxes in million Euro

2013 4035
2014 4826

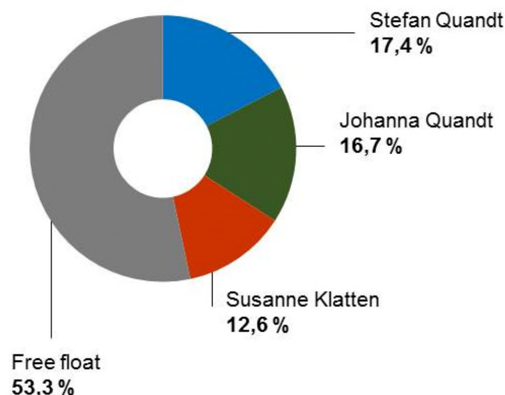
Return of sales, of auto division in percent

2013 37,1
2014 38,1

Rating	
Standard & Poor's	**A+ (stabil)**
Moody's	**A2 (stabil)**

*Earnings before interest and taxes

Shareholder-structure



Market capitalization
Status December 19, 2014
54 billion Euro

Source: Corporation, Thomson Reuters

The pressure of the Chinese authorities to premium-producers is increasing. The latest example is the topic of spare parts prices. In China, your import of cars was drawn down sharply. Are times of high margins coming to an end in China?

This is a short-sighted way of looking at things. I take a different view on China. Meanwhile, the People's Republic is the world's largest automobile market with over 18 million vehicles. This means a sales volume of 400.000 units for us by now and we are seeing even higher growth prospects. Because in the meantime a middle class has developed. This includes around 300 million households. This is approximately the total population of the USA. Formerly, we sold especially our larger vehicles like BMW X5, X6 and the 7-limousines to a small group of customers. Today, we are serving a significant larger client basis which is increasingly demanding for our compact and middle-class models – in addition to the upper-class models. Therefore, we still have a very positive attitude towards the development in China.

So in your point of view a new customer group is growing?

Definitely. We see the potential of a growing middle-class. Not only the high market volume ensures the high attractiveness of the market, but also the still low premium share of 8 % of the total market. Therefore, we have decided together with our Chinese partner to integrate 3 further models in our local production in China and to enlarge the dealer network.

Even under pressure of the tighter EU-emission-regulations your share of smaller cars will rise to around 40 % in the future. Does that make it more difficult for you to maintain the margin target in the automobile-segment?

We aim at an ebit-margin of 8 to 10 % of the automobile-segment in a sustainable manner. Due to our multi-brand architecture concerning front-wheel and all-wheel-drive we are in a position to achieve synergies in these vehicle-segments either. The higher share of smaller vehicles is caused essentially by the ambitious CO_2-regulations of the EU Commission indeed. The EU-aims for emissions for 2020 are extremely challenging for the entire industry. In our model program we have lowered the EU-fleet-average from – formerly – over 200 g CO_2 per kilometre down to meanwhile 133 g by extensive measures. That means, we have come a considerable way.

Now the automobile-industry has to work more according to the EU-stipulation.

Now we have to reduce another 30 % on top. And this within 6 years. All this is a challenge for the entire industry and it costs a lot of money – but we are aiming at this target for the BMW Group and are committed to achieve it as. But the question is how it will go on: We can only warn not to exaggerate with view to the future CO_2-targets in Europe after 2020. Otherwise one would endanger the automobile-industry as an important pillar for the business location Europe.

Will the margin-target now become more challenging with view on this fact?

As already said, we remain to our objective. To attain this target, we try to take countermeasures with intelligent efficiency programs. Therefore for development and production, we have introduced a common vehicle-architecture with a modular system for chassis modules, components and engines for the smaller models. So we are able to develop

and produce more efficiently our products and develop and produce them with a higher volume.

With respect to the increasing pressure, volume manufacturer as Fiat-Chrysler are turning again towards the subject of mergers.

I have hardly any idea of positive examples concerning mergers in the automobile-industry. We have made our own experiences with Rover. Now we are handling carefully with this topic. An automobile-company is a very complex thing. To unite two companies with completely different construction-principles and processes is a very difficult venture. Our industry had to learn that several times. Considering the great scope of our model-program as well as the clear positioning, I do not see the necessity for BMW-Group to think about mergers.

During the current second half of the year the costs for model-start-ups and more modern drives are increasing disproportionate. This is reducing the margin. How the growth in sales may moderate the cost increases?

We are preparing ourselves with a large number of projects for future challenges and set things up for a successful development of the BMW Group in future. Especially in our industry, this is of major significance with respect to the far-reaching technological transformation. Sales increase is important for reinserting the expenses for the development of new models. Insofar to my opinion it makes no sense to downsize. We need growth to be able to cover the immensely high costs for new technologies. All of our new vehicles are well placed in the market and are carrying our growth-course. But we pay attention to a profitable growth: the margin per vehicle and the quantities must be held in a reasonable balance. If you only have a look on the volume, the profitability will suffer – this is the dilemma of many mass-producers.

Regarding the debt-crisis, the worst seems to be over. How do you handle your liquidity in this context?

Our operative automobile-business is very well positioned with over 40 % equity and it is producing a positive free cash-flow into billions. However, the automobile-financing business represents more than two thirds of our balance sheet today. We have a business volume of over 90 billion Euro in the car- and dealer-financing. Also this business division is solidly financed with over 9 % equity. Today, this financing business is an important part of our value added chain. Without this instrument we would not be able to use the sales opportunities of the markets in Germany, Great-Britain, USA and China. But we must also be in a position to refinance securely these financial volumes in times of crisis. Hereto we have learned a lot by the financial crisis and therefore, we are holding significantly higher liquidity reserves since 2008 as well as enhancing our capital market access.

How high are these?

Presently, our gross liquidity accounts for roundabout 10 billion Euro according to our target figure. It was significantly less before the Lehman bankruptcy. Also the rating agencies require this significant higher liquidity buffer. Thus we are in a position to refinance ourselves even in times of crisis without problems. We have the best rating among the European automobile-producers which basically helps us a lot concerning our re-financing. Actually, the investors would let us have more money than we need. This shows that we are a very solid company also in the perspective of financial market participants.

How high is the regular volume of re-financing by way of bond issues?

The bond volume alone will amount to roundabout 10 million Euro during the next year. In this year, no further actions should be required.

What further lessons have you learned from the financial market crisis?

We have significantly refined our financing structures. Among others we have expanded our own banking business to reduce the dependency on the capital market. In the meantime, we have a European fully licenced bank. Germany, France, Italy, Spain and Portugal are integrated there. Hereby we have a significantly higher deposit volume of around 9 to 10 billion Euro which can also be used for re-financing. With this European bank, we would even have the possibility to borrow central bank money directly from the European Central Bank in case of a new liquidity-crisis.

The interest environment is favourable. How high are your financing interest rates actually?

Normally, our re-financing interest rates are at least as good as for the banks. Caused by our good rating, bank credits are not our first choice. With bonds and other capital market instruments we are achieving more attractive conditions and at the same time, we are enlarging the range of investors. Therefore we tap directly the capital market – with good success.

So what is the current situation with China, then?

China belongs to those countries where a direct access to the capital market is not yet enabled. In China, we are presently in a position to mainly use bank loans for re-financing our business. However, the capital market is opening up. In summer, we have successfully executed our first ABS-transaction with a counter volume of 80 million Euro as a test. We will expand the direct tapping to the Chinese market if the local regulations allow this. At the sight of the growing sales volume in this market this would be very positive for us.

As to the interviewed person

Well positioned

By virtue of his position as CFO, Friedrich Eichiner (59) belongs to the cautious top managers at BMW. The doctorated business economist appears relatively relaxed on the matter of fathom new perspectives of the Munich automobile-producer. The DAX-corporation is rather stable. It can cope well with impacts as in Russia due to its global orientation.

This is also the merit of Eichiner, after all as CFO, he made sure to strengthen the balance sheet and thus, resistance to crisis. He has learnt this from the financial market crisis. Today, the well positioned enterprise has the best rating in the European automobile industry.

The Bavarian is an original of BMW. He has been CFO for almost 6 years. Recently, the supervisory board has extended his contract prematurely by two more years till May 2017. Then, Eichiner will be 62 years old. So far, the age of 60 marked the age limit for managing directors at BMW – however, exceptions have always been possible as it is shown by the example of Eichiner.

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

Italy, Article: DO BANKS MANAGE REPUTATIONAL RISK?[1]

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"It takes 20 years to build a reputation and five minutes to ruin it. If you think about that, you'll do things differently."

Warren Buffet

1. Introduction

According to the Oxford English dictionary reputation is "the beliefs or opinions that are generally held about someone or something"[3]. As stated by Jenny Rayner in her book "Managing Reputational Risk," the definition itself embodies a certain complexity because beliefs and opinions need not be the same as reality. These beliefs are the result of years of relationships with organisations[4]. In their book "Invisible Advantage: How Intangibles are Driving Business Performance" Johnathan Low and Pam Cohen Kalafaut say:

"In a sense a company's reputation is the ultimate intangible. It's literally nothing more than how the organisation is perceived by a variety of people. It is slippery, volatile, easily compromised, impossible to control, amorphous."

This definition clearly talks about the invisible nature of reputation, its intangibility and hence the difficulty in calculating its value in monetary terms. A small incident or crisis can destroy years of building up a good reputation. A good reputation attracts investors, enhances a firm's market position and lowers the cost of capital[5]. It is a magnifying glass for an organisation in the eyes of others, it is fragile and delicate.

There have been many developments in the business environment that have made the management of reputational risk even more important and critical. Some of the key developments are changes in

[1] The research is purely based on publicly available information provided by the banks on their websites.
[2] Disclaimer: The views and observations are entirely those of the author and not the ones of the employer.
[3] Rayner, J., (2004) "Managing reputational risk – Curbing threats, leveraging opportunities", Wiley.
[4] Honey, G., (2009) "A Short Guide to Reputation Risk", Gower.
[5] Fombrun, C. & Shanley, M., (1990) "What's in a name? Reputation building and corporate strategy", *Academy of Management Journal*, pp. 233-258.

stakeholder perspective, globalisation, advanced information technology, radically changing media and the importance given to intangible assets. Reputation is part of that valuable hidden asset that only emerges as a gap between book value and market capitalization. Judy Larkin in her book "Strategic Reputational Risk" compares reputation to a "Cinderella asset" - one that is usually ignored but has a potential to shake the organisation's foundation. In the contemporary world of social networking it has become difficult to manage reputation and thereby the volatility of reputational risks have increased[6]. Businesses are under constant scrutiny by social media and there is no hiding place. An organisation might lose its reputation due to any of its stakeholders, internal as well as external. A well established reputation management cuts risk and increases opportunities[7].

Reputational risk as defined by the Basel Committee for Banking Supervision (BCBS) in their "Enhancements to Basel II Framework", July 2009 is[8]:

"*Reputational risk can be defined as the risk arising from negative perception on the part of customers, counter-parties, shareholders, investors, debt-holders, market analysts, other relevant parties or regulators that can adversely affect a bank's ability to maintain existing, or establish new, business relationships and continued access to sources of funding (e.g. through the interbank or securitisation markets).*"

The definition summarizes the impact of a negative reputation on a bank's performance. Reputation is critical in the financial services industry. There has been an increased interest in reputational risk in the financial sector[9] over the past two decades because of the occurrences of major operational losses due to internal fraud[10]. Despite the growing interest, few studies discuss the disclosures of reputational risk and its management processes by the banking sector, especially in Europe. Most of the studies associate corporate social responsibility (hereafter CSR) reporting and reputational risk management (hereafter RRM)[11]. Researchers in this field have highlighted the uses of CSR reporting "both as an outcome of and part of reputation risk management process"[12]. Managing reputational risk comprises five major steps according to Jenny Rayner:

i. Risk identification and definition
ii. Risk assessment
iii. Response to the risks
iv. Clarification on roles and responsibilities, and
v. Monitoring and reporting process.

This research studies the disclosures of 'reputational risk' using quantitative as well as qualitative content analysis for leading European banks. The sample chosen for the study are 3 multilateral and 2 bilateral banks, and 15 leading commercial European banks. The list is given in the Appendix in Table A.

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[6] Aula, P., (2010) "Social media, reputation risk and ambient publicity management", *Strategy & Leadership*, 38(6), pp. 43-49.
[7] Larkin, J., (2003) "Strategic reputation risk management", *Palgrave Macmillan*.
[8] Committee, B. & Others, (2009) "Enhancements to the Basel II Framework", Basel.
[9] Fiordelisi, F., Soana, M. & Schwizer, P., (2012) "The determinants of reputational risk in the banking sector", *Journal of Banking & Finance*.
[10] Dyck, A., Morse, A. & Zingales, L., (2010) "Who blows the whistle on corporate fraud?", *The Journal of Finance*, 65(6), pp. 2213-2253.
[11] Bebbington, J., Larrinaga, C. & Moneva, J. M., (2008) "Corporate social reporting and reputation risk management", *Accounting, Auditing & Accountability Journal*, 21(3), pp. 337-361.
[12] Ibid.

The 15 banks chosen for the study are among the largest commercial banks in Europe, and are selected based on their average total assets over the past three years.

This research seeks to answer the following question:

Research Question (RQ): How do leading European banks report on reputational risk in their annual reports, quantitatively and qualitatively?

To address this question the research covers the following approaches:

1. To quantitatively study the disclosures of reputational risk in the annual reports of the banks chosen for the study.
2. To qualitatively study the disclosures of reputational risk by the banks, by segregating the disclosures based on the steps of managing reputational risk as highlighted by (Rayner, 2004).

2. Methodology

In this study we adopt a similar quantitative methodology as used by Hogan & Lodhia (2011)[13]. In their research they analyse variations in reporting by using a quantitative method of content analysis examining publicly available annual reports, sustainability reports and the website of a major corporation in the extractive industry. This research includes an analysis of the annual reports and websites of the 20 selected banks over a period of 2007-2012. Only publicly available information, as provided on the respective websites has been used.

Firstly, we use the coding categories as shown in Table I for the quantitative analysis. The coding categories are designed to capture reputational risk disclosures. The "reputation" and "reputational risk" categories form the indicators of quantity of reputational risk reporting, while "reputation/al risk policy", "reputation/al risk team" and "reputational risk management" relate to the indicator of quality of the disclosure of reputational risk. The frequency of each of these indicators in each type of disclosure has been recorded for the years 2007-2012.

Table I – Coding categories for the quantitative analysis (cf. also Appendix)

Indicator	Description
Reputation	The frequency of usage of the word reputation
Reputation/al Risk	Out of the words where reputation has been used, the number when it was used as reputation risk or reputational risk
Reputation/al Risk Policy	Out of the words where reputation/al risk has been used, there exists a mention for policy
Reputation/al Risk Team	Out of the words where reputation/al risk has been used, there exists a mention for team, committee, group, senior management
Reputation/al Risk Management	Out of the words where reputation/al risk has been used, there exists a mention for process of managing reputational risk

[13] Hogan, J. & Lodhia, S., (2011) "Sustainability reporting and reputation risk management: an Australian case study", *International Journal of Accounting and Information Management*, 19(3), pp. 267-287.

Secondly, for the qualitative framework, we segregate reputational risk disclosures into categories of managing reputational risk based on the five reputational risk management framework steps defined by Rayner as given below:

	Reputational Risk Management Framework Steps
1	Definition and Identification of Reputational risk
2	Methodology for assessing risks
3	Methodology for responding to risks
4	Clarity on roles and responsibilities
5	Monitoring and reporting process

We use the annual reports of the year 2012 as the most recently available publications at the time of analysis.

3. Findings

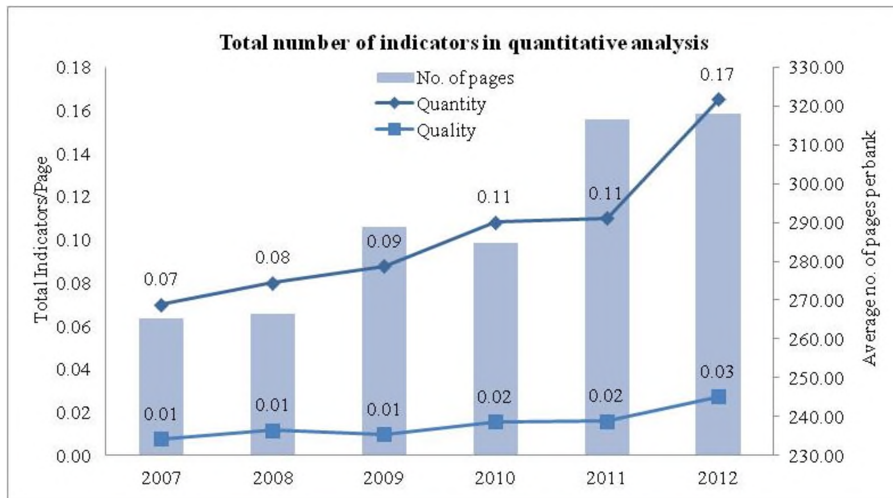
Quantitative analysis

The quantitative analysis as shown in Table II in the annex, reflects the average values for the indicators. There has been a significant increase in the quantitative reputational risk indicators, which on average have gone up from 18.55 in the year 2007 to 52.55 in the year 2012. When considering the number of indicators per page, the indicators of quantity show an increase of 10 percentage points from 7% (0.07) to 17% (0.17).

There was no change in the indicators of quality over the years 2007-2009, followed in 2010 by an increase of 1%, further accelerating to 3% in the year 2012. This implies an overall average increase of 2 percentage points. A web-search of the websites of the banks[14] shows the results as displayed in the Table II in the annex. Figure A below shows the changes of disclosures on reputational risk, with the higher line showing the indicators of quantity and the lower line showing the indicators of quality. The descriptive statistics of all the parameters considered for the quantitative analysis of reputational risk disclosures are given in Table III in the annex.

[14] On the date 15 March, 2014.

Figure A. – Number of indicators per page found in quantitative analysis



Qualitative analysis[15]

Definition and identification of reputational risk: 9 out of the 20 banks covered by the research provide a reputation risk definition, shown in Table IV[16] in the annex. Six banks mention reputational risk as a separate risk category and these banks state that reputational risk is inherent to their business operations. Out of the remaining banks that disclose information about reputational risk, 5 consider reputational risk as part of their operational risk strategy, 2 integrate it with conduct risk, 2 with compliance risk, and 1 with non-compliance risk. There are 2 banks that explicitly mention reputational risk to arise from environmental, social and governance issues as well. Banks emphasize reputational risk importance in various ways, stating:

"The safeguarding of our reputation is paramount..."

"...reputational damage may lead to a reduction in franchise value"

"Modern technologies, in particular online social networks and other broadcast tools which facilitate communication with large audiences in short timeframes and with minimal costs, may significantly enhance and accelerate the impact of damaging information and allegations."

"...reputation is crucial for attracting and keeping its clients."

Each of the above disclosures displays the importance of reputational risk and of managing reputation. These form the basis of the reputational risk management process. Banks identify many causes of reputational risk, either in their definition of reputational risk or separately in their related disclosures. These have been put together to form a word cloud as presented in the Figure B.

[15] The qualitative analysis of the annual reports of all the banks using the framework by (Rayner, 2004).
[16] The names of the banks are changed to "Group".

Figure B. – Cloud of the words used to represent the causes of reputational risk.

Reputational risk assessment

Banks assess reputational risk based on its causes and conduct their assessment based on those. Disclosure on methods used for assessment of reputational risk is 17% less than what is disclosed about the definition and identification of reputational risk. Out of the banks that disclose their assessment of reputational risk, 6 mention to have clear directives or policies for managing reputational risk, and 2 have adopted reputational risk assessment as part of their operational risk policies. They mention to conduct business taking into consideration reputational risk arising mainly from clients to whom the banks provide financial services, as well as environmental and societal considerations and the possibility that some clients may have a controversial reputation. 4 banks disclose to have enhanced their assessment of reputational risk based on scenario analysis techniques or dashboards and 2 mention to have enhanced their environmental and sustainability strategy to incorporate reputational risk.

Response to reputational risk: 11% of the disclosures relate to the response to reputational risk by banks. This step highlights how banks respond to reputational risk when it arises, whether they tolerate, transfer, terminate or treat it. 7 banks disclosed to have some steps to treat reputational risk when it arises and those were through stringent due diligence processes, auditing of reputational risk prior to an event, improving their compensation structure, accountability review processes, review processes for high risk transactions, processes to assess environmental and sustainable issues and forums for discussing best practices. 2 banks mention mitigation and training to terminate the risks and avoid future risks in particular scenarios. None of the banks mention the strategy applied for responding to reputational risk by transferring the risk, but 2 mention to tolerate the losses incurred by reputational risk during the year and to accept the related reputational losses.

Clarifications on roles and responsibilities: 15 banks disclosed information about the teams that handle reputational risk and their hierarchy. Table V in the annex gives the details of the teams that are responsible for handling reputational risk. The responsibilities of the committees or the teams handling reputational risk disclosed by banks are:

- Developing a reputational risk framework including the policies and processes for identification, assessment and management of reputational risk, an escalation matrix, delegation matrix, as well as strategies, methodologies and the limits for handling reputational risk,
- Monitoring methodologies of reputational risk (general guidelines for the management and control of reputational risk), defining the tasks that are carried out on a regular basis,
- Crisis management,
- Safeguarding and preventing the group from money laundering, financing of terrorism and developing a marketing policy for products and services,
- Measurement, analysis and evaluation of exceptional cases where the policies do not specify specific actions and thus formulation of mitigating steps to terminate the risk,
- Stakeholder communication by preparing reports on a timely basis, and supporting the reporting by quantitative analysis for the impact of specific products during the complete cycle of the product,
- Ensuring that reputational risk management is in line with the risk appetite of the group.

Six banks have mentioned that the board of directors and senior management are ultimately responsible for managing the group's reputation. The hierarchical structure of reputational risk management was also disclosed by one of the banks where the Group Operational and Reputational Risk Committee (GORRC) chaired by the parent company's head is responsible and provides information to the Group Risk Committee (GRC). These committees typically report to the board and senior management on reputational risk issues.

Management and reporting of reputational risk: Groups emphasize that they apply various processes for the management of reputational risk. Management of reputational risk has been highlighted to be realized through:

- Promoting and managing reputational risk through transparency and accountability, establishing a framework that supports compliance and risk monitoring, and through policies that guide people to handle those risks,
- Selection of customers based on the risk strategy of the firm,
- New products, services, projects and clients to have a written reputational risk assessment,
- Formation of committees that hold meetings on a regular basis to discuss incidents and to resolve and monitor those. These also report to senior management on a regular basis,
- Reviewing reports prepared and formulation of the lessons learnt,
- The Basel committee's four principles: independence, universality, impartiality, and sufficient resources, and
- Constant vigilance to preserve and enhance the reputational risk of the group through quarterly reviews and preparation of dashboards.

Some banks disclosed the number of transactions that were escalated due to significant reputational risk, e.g.:

"*102 transactions were escalated in 2012 to the regional and divisional reputational risk committees or to the Group Reputational Risk Committee on the basis of environmental or social criteria*" and

"*The corporate office of reputational risk was presented with 61 products/services considered not new for approval and resolved 171 consultations from areas and countries*."

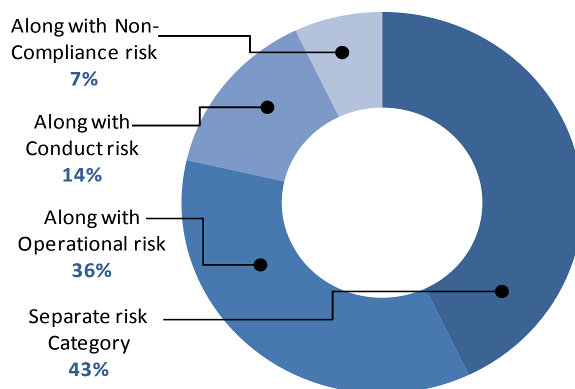
The reporting also covered high impact sectors and services to clients who operate in these sectors. Various sections of the annual reports mention reputational risk. The major sections used are given in Table VI in the annex. Out of the 20 banks, 6 banks disclose all 5 steps of reputational risk management in one way or the other.

4. Discussion

The quantitative indicators show a significant increase from 2007 to 2012, clearly depicting that the banks are becoming increasingly aware of the impact of possible reputational damage to their organisations. This supports the survey done by the Economist Intelligence Unit in 2005 (Unit, 2005) where most of the respondents agreed that "Reputation is becoming a key source of competitive advantage as products/services become less differentiated" and also of the survey of the ACE Group in 2013 (ACE Group, 2013) where 81% of the respondents agreed that "Reputation is our company's most significant asset".

The indicators of quality did not show as much increase as compared to the indicators of quantity (the latter only being a reflection of the number of times the word reputation has been used) indicating the difficulty in assessing the impact of reputational risk and thus the challenges in manage it. These results also align with previous surveys done by the Economist Intelligence Unit and by the ACE Group. The importance attached to reputation is confirmed and the difficulty in quantifying and managing based on the present advancement in the field of social networking and information technology is discussed. Some of the impacts as described by the disclosures could be summarised as: 1. Loss of franchise value, 2. Loss of earnings, 3. Negative perception, 4. Ability to acquire new customers, and 5. Loss of current employees and inability to hire new ones.

Figure C – View of reputation risk under the various risk categories



The definitions disclosed by banks show similarity with the definition given by the Basel Committee in (Committee & others, 2009); with some having made changes in their definition of reputational risk by adding specific areas covered by their group. Many view reputation as part of their operational risk (36%) or as a separate risk category on its own (43%), with a minority aligning reputation risk with conduct risk (14%) and compliance risk (7%). They view the sources of reputational risk as: 1. association with controversial clients, 2. doing business in an appropriate manner, 3. failure of corporate governance, and 4. failure to comply with environmental and social standards.

The policies and standards adopted by the banks do cover the assessment of reputation risk when acquiring new customers and selling particular products and services, but since the sources of reputational risk are, both, internal and external, the assessment is particularly difficult.

Out of the banks that disclosed data on roles and responsibilities assigned to various teams and committees, 53% disclosed that they manage the risk through a reputational risk committee and/or compliance committee. Banks also appeared to put top management as the ultimate responsible for the reputational risk management issues. The disclosures of responsibilities assigned to teams show the effort made by banks to protect their reputation, and to clarify roles and responsibilities. Even though, crisis management has often been mentioned as part of these responsibilities, none of the banks provided any details of the strategy or processes for handling a possible crisis.

Banks state to have improved reputational risk management over the last few years, but still continue to face a challenge in quantifying the cost of a reputational damage. The disclosures on the reputational risk management suggest that policies and standards differ significantly from one bank to the other. Trainings provided to employees depict the sense of responsibility assigned to each individual and of promoting a culture of risk management. Regular meetings on the issue are also held, which ensure the tracking and monitoring of reputational risks. Banks were often transparent about their processes, and even disclosed transactions which they rejected due their reputational risk.

5. Conclusive Remarks

The aim of the research was to find out the ways in which leading European banks disclose reputational risk in their annual reports. It varies from previous studies since we treat reputation as an independent dimension rather than as part of the CSR paradigm. The findings of the research show variations in the process of identification, assessment and management of reputational risk as reported by these banks. The assessment and response to risks have not been disclosed explicitly by most of the banks which could imply a lack of a common risk assessment framework. With the rise in online communication and social networking, reputation of any organisation is at a greater risk than before. A better crisis management capacity and an ability to speedily recover from unforeseen reputational risk events are essential for banks going forward. This study documents a general lack of crisis management mechanisms in the reputational risk management framework for most banks.

Banks consider each individual responsible for the day-to-day management of reputational risk, but top management needs to promote a culture of reputational risk awareness for this approach to be effective. This was depicted by some of the banks in the research. Banks manage reputational risk to a certain extent, but whether those management frameworks are adequate or not have not been highlighted.

The findings of this research assist risk managers with an understanding of the disclosure of reputational risk. The heterogeneous quality of disclosure of reputational risk could be linked to a lack of proper reporting guidelines. Future research in the field could include a market-wide review of reputational risk disclosure. Content analysis, surveys and interviews could also help better explore the processes of reputational risk management and reporting.

Appendix

Table A – List of banks selected

Sl. no.	Names of Banks
1	(EIB) European Investment Bank
2	(AFD) Agence Française de Développement
3	(EBRD) European Bank for Reconstruction and Development
4	(IFC) International Finance Corporation[17]
5	(KFW) Kreditanstalt für Wiederaufbau
6	(HSBC) HSBC Holdings Plc
7	(DB) Deutsche Bank AG
8	(BAR) Barclays
9	(RBS) Royal Bank of Scotland Group Plc (The)
10	(BSSA) Banco Santander SA
11	(SG) Société Générale
12	(LTBP) Lloyds TSB Bank Plc
13	(UNI) UniCredit SpA
14	(ING) ING Bank NV
15	(BPCE) BPCE SA
16	(RABO) Rabobank Nederland-Rabobank Group
17	(CSI) Credit Suisse International
18	(DANK) Danske Bank A/S
19	(STANC) Standard Chartered PLC
20	(BNP) BNP Paribas

[17] IFC has a significant European shareholding.

Table I – Coding categories for quantitative analysis

Indicator	Description
Reputation	The frequency of usage of the word reputation
Reputation/al Risk	Out of the words where reputation has been used, the number when it was used as reputation risk or reputational risk
Reputation/al Risk Policy	Out of the words where reputation/al risk has been used, there exists a mention for policy
Reputation/al Risk Team	Out of the words where reputation/al risk has been used, there exists a mention for team, committee, group, senior management
Reputation/al Risk Management	Out of the words where reputation/al risk has been used, there exists a mention for process of managing reputational risk

Table II. – Results of the quantitative analysis

Indicator of	Indicators	2007 Annual Report	2008 Annual Report	2009 Annual Report	2010 Annual Report	2011 Annual Report	2012 Annual Report	2012 Website
	No. of pages	265.25	266.50	288.95	284.85	316.60	318.10	1.00
Quantity	Reputation	13.60	15.20	18.00	21.10	22.95	34.65	251.05
	Reputation/al Risk	4.95	6.15	7.35	9.70	11.85	17.90	54.00
	Total	18.55	21.35	25.35	30.80	34.80	52.55	305.05
	Total/page	0.07	0.08	0.09	0.11	0.11	0.17	305.05
Quality	Reputation/al Risk Policy	0.45	0.70	0.75	1.30	1.35	2.50	16.20
	Reputation/al Risk Team	1.10	1.35	1.50	1.90	2.65	3.80	20.95
	Reputation/al Risk Management	0.45	1.05	0.60	1.25	1.00	2.35	22.90
	Total	2.00	3.10	2.85	4.45	5.00	8.65	60.05
	Total/page	0.01	0.01	0.01	0.02	0.02	0.03	60.05

Table III. – Descriptive statistics

Indicators of Quantity	No. of pages	Reputation	Reputation/al Risk
Mean	290.04	20.92	9.65
Standard Error	14.97	2.28	1.43
Median	223.50	12.50	2.00
Mode	166.00	1.00	0.00
Standard Deviation	164.03	24.95	15.63
Sample Variance	26907.12	622.31	244.18
Kurtosis	0.20	3.60	7.52
Skewness	0.95	1.90	2.59
Range	752.00	118.00	82.00
Minimum	56.00	0.00	0.00
Maximum	808.00	118.00	82.00
Confidence Level (95.0%)	29.65	4.51	2.82

Table III. – Descriptive statistics (continued)

Indicators of Quality	No. of pages	Reputation/al Risk Policy	Reputation/al Risk Team	Reputation/al Risk Management	Total/page
Mean	290.04	1.18	2.05	1.12	0.01
Standard Error	14.97	0.28	0.33	0.22	0.00
Median	223.50	0.00	0.00	0.00	0.00
Mode	166.00	0.00	0.00	0.00	0.00
Standard Deviation	164.03	3.06	3.64	2.41	0.02
Sample Variance	26907.12	9.39	13.26	5.78	0.00
Kurtosis	0.20	19.08	10.73	11.79	2.00
Skewness	0.95	4.06	3.02	3.13	1.66
Range	752.00	19.00	21.00	15.00	0.08
Minimum	56.00	0.00	0.00	0.00	0.00
Maximum	808.00	19.00	21.00	15.00	0.08
Confidence Level (95.0%)	29.65	0.55	0.66	0.43	0.00

Table IV. – Definitions disclosed by banks in their annual reports

	Definition
1	The risk that illegal, unethical or inappropriate behaviour by the Group itself, members of staff or clients or representatives of the Group will damage Group's reputation, leading, potentially, to a loss of business, fines or penalties.
2	Within our risk management processes, we define reputational risk as the risk that publicity concerning a transaction, counterparty or business practice involving a client will negatively impact the public's trust in our organization.
3	Reputation risk is the risk of damage to Group's brand arising from any association, action or inaction which is perceived by stakeholders to be inappropriate or unethical.
4	Reputational risk is defined as the risk "of brand damage and/or financial loss due to a failure to meet stakeholders' expectations of the Group's conduct and performance."
5	The reputational risk is that linked to the perception of the Group by its various stakeholders, both internal and external, of its activity, and which could have an adverse impact on results, capital or business development expectations. This risk relates to juridical, economic-financial, ethical, social and environmental aspects, among others.
6	Reputational risk: risk arising from a negative perception on the part of customers, counterparties, shareholders, investors or regulators that could negatively impact the group's ability to maintain or engage in business relationships to maintain access to sources of financing.
7	Reputational risk is the current or future risk of a decline in profits as a result of a negative perception of the Bank's image by customers, counterparties, bank shareholders, investors or the regulator.
8	The Group defines reputational risk as: "any action, transaction or relationship with a Politically Exposed Person which poses an unacceptable level of risk to the reputation"
9	Reputational risk is the potential for damage to the Group's franchise, resulting in loss of earnings or adverse impact on market capitalisation as a result of stakeholders taking a negative view of the Group or its actions.

Table V – Committees or teams responsible for handling reputational risk

Committees or Teams	No. of banks
Reputational risk committee	5
Compliance/Audit team	3
Investment and advisory committee	1
Sustainability or Ethics committee	2
Risk committee	2
No single owner specified	2

Table VI – Sections of the annual report where reputational risk issues have been discussed

Sections of the Annual Report
Letter to Supervisory Board, Directors and Committees
Business Ethics
Compensation Report
Compliance Report
Corporate Governance Report
Sustainability and Corporate Responsibility
Risk Management Report
Independent Assurance Report
Shareholder Information

Article provided by ANDAF, the Italian IAFEI Member Institute

Japan, Article: What Japan Teaches Europe

by **Holger Steltzner,** co-publisher of Frankfurter Allgemeine Zeitung, Germany, from Frankfurter Allgemeine Zeitung, December 16, 2014

By the election victory of Shinzo Abe in Japan, critics of the European fiscal reform policies by Federal Chancellar Angela Merkel, which critiques are mostly defamed as austerity and consolidation dictate, feel encouraged. "Just look at Japan! Abe is showing to the Europeans how right crisis policy is to be done, how to come back on the feet by cash-injections of the central bank and with government expenditure programs. Although the opposite is true, this is not told as easily as an accusation against a supposed Berlin austerity and consolidation dictate.

Europe is heading into a lost decade, just as Japan has done it in the nineties. But it is said, that not the heavily indebted Southern European states should be blamed for the threatening disaster in the meantime, but Germany is said to ruin its neighbours. This is said by the economist Paul Krugman who has been honoured with the Nobel price. If there was any country which has learnt nothing from the crises, it is said, then it would be Germany. The export-world champion would export its deflation to the neighbouring countries and the call for more competitiveness for Europe would only distract from the fact that the German industry would achieve large export surpluses at the costs of other Euro-states.

Thereby Krugman is omitting the fact that the German exports to the Euro-countries are massively shrinking since the crisis, and that in the meantime almost 2/3 of the German exports go to countries outside the Euro-area. Krugman is also concealing that the Euro exchange rate is lapsing as a consequence of his propagated ultra-low monetary policy, which is spurring the exports criticised by him. The doping of Krugman makes impact on the markets. The monetary injections show effects, and be it by their risks and side-effects. However, the monetary expansion especially favours banks and investors so far.

It is a staircase joke that especially Krugman is warning of lost years à la Japan as he – and other Wall Street consultants - have prescribed the Keynesian medicine to the Japanese. Since over 20 years, Tokyo has adopted an ultra-relaxed monetary as well as a extremely expansionary fiscal policy. What is the consequence? Instead of the economy, only indebtedness is growing. When the price bubble was bursting in 1990, Japan counteracted with Keynesian incurring of debt. One government expansion program, financed by debt, was quickly followed by the next one. Since then, the government indebtedness has climbed up from 67 to 245 % of annual GDP.

Since decades the bank of Japan is showering the country with its money. From 1998 until now, the interest rates have quasi been set to zero. In the meantime, the central bank, which depends on Abe, is purchasing 85 % of all newly issued government bonds, also in order to weaken the Yen even more. Now, a comparable European situation is demanded by Krugman.

Recently, Abe invited Krugman to Tokyo. Finally, the former and new prime minister has followed his advices. And if it does not work for Japan? Then – Krugman says – the monetary and fiscal policy will have to become even more expansive. But his recipe "much more is helping even much more" has not liberalized the Japanese economy from depression. The wisdoms of Krugman are not helping in Japan – and they will not in Europe.

Nevertheless, ECB-president Mario Draghi seems to be absolutely determined to fulfil the wishes of Krugman at least in part. By January already, the European Central Bank might start with large-scale purchasing of government bonds in the market. The applause of the governments in Rome and Paris would be sure and probably also the support of the new EU-commission president Juncker who is pushing his idea of a government expansion program by more than 300 billion Euro at the same time, which, however, is said to be financed only partly by debt.

Krugman and his disciples see the use of printing money especially in the fact that demand is created. If people had money, they would spend it. Krugman considers that growth would be created in that way. However, the fact is that Japan, the country with the highest government debts, the lowest interest rates and the largest decrease of population, is remaining in stagnation. If it was possible for an over-indebted state, to get rid of its debts by taking up more debts, Japan should live without any worries.

Out of longing for a simple solution, many find it difficult to accept, that also the monetary policy has limits as it can be seen in Japan. The more questionable it is, how deflation-fear is instilled in Europe in order to force the purchase of government bonds by the central bank. There is obviously no indication of a permanent decrease of the Euro price level. Also an overstating of the mild deflation in Japan is precluded (four percent in 20 years).

As his predecessors, Abe has always only announced structural reforms for Japan, but has never realized them. But the economic history teaches, however, long-term growth will not be created by a straw fire of government administration-demand, but by entrepreneurial activity, by risk-taking as well as innovation.

If one could buy growth by way of incurring more debt, Japan would be the strongest growth-country in the world. And Greece would be the motor engine of the Euro-area.

Source: Frankfurter Allgemeine Zeitung, Germany, December 16, 2014. Responsible for translation: GEFIU, the Association of Chief Financial Officers Germany; translator: Helmut Schnabel

Mexico, Article: Options in MexDer & OTC, Risk management

by **Emilio Illanes Diaz-Rivera**, and by **Fernando Alcantara- Hernandez**, chairman of the management board and chief executive of GFD Operador MexDer, respectively, and members of the national technical committee of comprehensive risks management of the Mexican Institute of Financial Executives, IMEF

Investors' aggressive moves for derivative instruments in financial markets motivate regulatory entities around the world to issue schemes to reduce risk exposure and guide resources towards formal stock exchanges.

During the last months, the Mexican economy has shown signs of economic slowdown as a result of the reduced activity of world economy, risks associated with United States Federal Reserve (Fed) debate on its monetary policy, and of the unconventional measures that the European Central Bank could take to strengthen the economy in the zone.

These factors will bring a high degree of uncertainty over the world financial markets that will become evident in a greater volatility of such markets. The high degree of volatility that international financial markets could face shows a clear need of a "financial risk hedging" that could make possible to reduce the exposure of so many domestic companies nowadays.

Because of their very nature, derivative markets anticipate to conventional markets in the explanation of future performance of economic prospects, so that they are the most effective instrument to implement and diversify an efficient and secure "financial risk hedging".

Over-the-counter (OTC) markets, or off-exchange markets, are private and formal markets recognized by the financial authorities of the entity in which they operate. They are not standard contracts but "tailored" contracts fit to certain amounts and terms. The counterpart is the financial institution with which a contract is held and therefore purchase price formation is made at the discretion of such institution.

Derivative markets anticipate to conventional markets in the explanation of future performance of economic prospects.

The exchange constitutes a formal, recognized, authorized and regulated markets by the financial authorities of the region where they operate. They are standard contracts referring to size and term, and can operate in one or more stock markets. The counterpart is a clearing house and purchase prices are set by current forces of demand and supply.

In Mexico, the Mexican Market of Derivatives (MexDer) is the only recognized exchange to trade futures and options.

Chronology, MexDer relevant events.

1996 Rules of operation are delivered by the Authority.
1997 The prudential framework is established.
1998 Start of operations.
2001 Inclusion of brokerage houses and banks to “shape markets”.
2004 Start of operations of the options market.
2005 Admission of new domestic and foreign members.
2007 Proclaimed as the “Emerging Market of the Year”.
2009 Public offering in the Mexican Stock Exchange.
2012 Partnerships with CME, the largest derivative exchange in the world.
2013 Launching of corn financial futures.

Market Fundamentals

The MexDer is based on three main international criteria about “organized markets” and “self-regulated markets”:

Ethics. Perform under the eight basic principles:

1. Act in accordance with the applicable provisions.
2. Conduct in a professional manner.
3. Let the client’s interest prevail.
4. Avoid conflicts of personal interest with a third party.
5. Provide truthful, clear and opportune information.
6. Protect the clients’ information confidentiality.
7. Not use or disclose privileged information.
8. Compete in a fair way.

Administration. It operates under a self-regulatory scheme:

> MexDer as exchange: issues the rules and operational manuals to which exchange participants must abide. Keeps permanent monitoring and surveillance of operations and intermediaries through a regulatory controllership.
> Asigna as clearing house: Asigna acts as a backup in all the operations, preventing counterparty risk.
> Clearing partner: it is a financial institution thereof duly authorized, acts as liquidator and administrator of the monetary resources of the participants.
> Financial authorities: the National Banking and Securities Commission (CNVB for its name in Spanish) act as supervisor of the stock exchange and the intermediaries.

Operation. Implements risk coverage mechanisms for the instruments with the greatest impact in the Mexican financial system such as:

> Money market. Underlying: 28-day TIIE rate, 91-day CETES rate, M-Bonds of the federal government.
> Exchange rate market. Underlying: peso/dollar and peso/euro.
> Capital market. Underlying: BMV (Mexican Stock Exchange) index and its most representative shares.

Another difference that makes one market to stands out over the other is the way of making contracts, due to the legal framework governing both markets.

“Undoing” one position implies low flexibility when making contracts in OTC exchanges. On the other hand, in the case of MexDer, “undoing” a position implies just to execute an opposite operation without extra procedures, without incurring in additional costs when trying to close open positions, just for the market prices (either favorable or unfavorable).

Exchange participants.

Institutions that attend as suppliers and users of this market seek to:

MEXDER
1 PROVIDE facilities for electronic operations.
2 ISSUE the rules and keep supervising all participants.
3 WATCH for transparency and integrity during price formation.
4 MONITOR the certification of all intermediaries and staff involved.

ASIGNA (AAA rating):
1 COUNTERPART for all transactions.
2 CLEARING and settlement of transactions.
3 SETS a level of security for underlying collateral.
4 RUNS the security network.

CLEARING PARTNER. Authorized financial institution:
1 TRUSTS that establish the contractual relationship among all concerned parties.
2 ISSUES adhesion contracts to the trust, confirmations and official statements of account.
3 DETERMINES excess collateral required by the leverage level for each underlying.

OPERATORS. Financial institutions or authorized legal entities.

Operational differences:

COUNTERPARTY RISK
MEXDER. Operates upon a clearing-house (Asigna) with AAA rating.
OTC EXCHANGE. The counterparty is the institution to have a contract with.

LIQUID FUNDS RISK
MEXDER. Due to trading volume, there is an immediate exit at market prices. Zero-sum market (what one participant gains, the other one loses.)
OTC MARKET. The early-exit is executed when the institution decides so, usually with a penalty on the market price. Whatever the institution gets or loses is not compensated.

PRICE FORMATION
MEXDER. Price formation is made through the market. It is made public in order to demonstrate transparency. There is no price speculation, only a commission is charged.
OTC MARKET. There is no price formation with the participation of the market therefore causing price speculation and they are not made public.

1 PROMOTION and consultation services to the general public about hedging and negotiation of futures and options listed in MexDer.
2 BROKERAGE and execution of self and clients accounts operations in technology platforms supplied by the clearing partner and MexDer as well.
3 TAKE risks others want to cover.

Clients. Every legal entity or individual participating in the Mexican financial market has access to MexDer, which is a natural market for hedging and trading when operating the instruments that impact the most.

After the debacle in derivative financial products, some financial entities and corporations damaged their wealth and some of them even went bankrupted. That is why regulatory changes worldwide and Basel III provisions, are trying to transform the OTC derivative in accordance to established stock exchanges process with the aim to avoid crisis in the future.

Regulatory changes worldwide look up to transform OTC derivative markets to avoid financial crisis in the future.

Hard learned lessons from the misuse of these products were taught:

> **The corporate governance**, the board of directors and the audit committee, being the collegiate bodies responsible of mitigating the risks, did not have the know-how neither the mechanisms for a proper use of derivative instruments.
> **Not all derivatives** are hedges or work as hedges when volatility in financial markets is very high.
> **A corporate approval process** must be followed, including the fixing of limits for operation or loss.
> **An independent expert must carry out this process** with different report directives than those of the treasury or the finance department of the company.

All these lessons are automatically considered and corrected when operating an organized market as the MexDer. It sets parameters, restricts capabilities, operating and clearing partners inform on a daily and prompt basis about their current status, the clearinghouse activates the safety net in times of high volatility or whenever a participant gets out of bounds.

Recognized exchanges as MexDer, protect investors from high leverage risks (a favorable or unfavorable mechanism), to restrict in this way their capacity at the time of contracting.

For example, if a participant shows evidence of one million pesos liquidity in his financial statement, his maximum capacity to operate in MexDer will fluctuate around 300 thousand pesos. This is to protect the investor and prevent him to expose 100% of his capability, due to high risk regarding the operation in these markets.

On the other hand, OTC exchanges accept any amount as long as investors accept to cover in advance security levels and established prices by the issuing bank.

In Mexico, most of the financial risk is uncovered. Only the big treasuries that already cover this risk, do it in a great extent in OTC markets, in spite of bankruptcy or decreased creditworthiness of large financial institutions that acted as counterparts in these markets.

All this makes it necessary for big treasuries and public participating in the domestic exchange to come to MexDer, which by its own nature offers hedging of the most common financial risks as a result of internal economic prospects. (Rates: 28-day TIIE, M-type bonds, peso/dollar, euro currency exchange, etc.), outstanding over other organized and OTC markets in:

> **Service** and language.
> **Price** and depth (enough cash flow reserve to satisfy any treasury size).
> **Ease** and flexibility of doing contracts and operations.
> **Regulation** supervised by financial authorities and above all, transparency.

History

Reaction to the crisis.

MexDer records date back to the Mexican economic crisis of 1994. Securities intermediaries and financial authorities, concerned about high loss in many sectors, including the financial sector, started the Mexican Market of Derivatives project (MexDer) as a formal market for hedging financial risks.

The starting of operations of MexDer in 1998 represented a very significant progress in the development and internationalization of the Mexican Financial System. The effort made by interdisciplinary teams made up of professionals from the Mexican Stock Exchange (BMV for its name in Spanish), Mexican Association of Securities Intermediaries (AMIB for its name in Spanish), and SD Indeval, have allowed the development of the operational, legal and systems architectures necessary to comply with legal, operational, technological and prudential requirements jointly set up by the Ministry of Finance and Credit Public (SHCP in its name in Spanish), the National Banking and Securities Commission (CNBV for its name in Spanish) and the central Bank of Mexico (Banxico).

Article provided by IMEF, the Mexican IAFEI Member Institute

Mexico, Article: **International Standards - Changes in Leasing**

by **Nestor Gonzalez-Monroy**, and by **Javier Aranda-Navarette,** member and guest member respectively, of the national technical committee of financial information of the Mexican Institute of Financial Executives, IMEF, the Mexican IAFEI Member Institute

Two approaches, the operational and the financial in the accounting record of assets will force the eventual adjustment in the IFRS to establish clearer criteria for lessors and leaseholders.

We will probably soon be seeing changes in both the international and the American accounting standards for finance leases, due to complaints and comments from readers and analysts of financial statements.

The biggest grievances are summarized as follows:

- **Lack of clarity** in the information about lease obligations, considering that firms real degree of leverage is not always exhibited in the assets and liabilities balance sheet related to renting.

- **Unequal treatment** to financial and operational leases, even though the two of them create commitments to the companies.

- **On several occasions users** of financial statements have to make adjustments in order to capitalize operating leases without discounting back to present value amounts, and sometimes users do not have all the information required to make proper adjustments.

- **Analysts of financial statements** from vehicles and equipment lessors have commented to the boards cited below, that it would be beneficial to be able to differentiate between the company's own credit risk of accounts receivable to be charged to tenants, and the risks associated with residual values of underlying assets.

In order to address those complaints and comments the Financial Accounting Standards Board (FASB) of the United States have worked together with the International Accounting Standards Board (IASB) to make proposals published as *Exposure Drafts*.

Dated in May 2013, the last document is available to the public and interested parties to provide with their own comments which will be taken in consideration before issuing the modified standards. The aforesaid boards stablished a due date to receive comments on September the 13th of 2013.

The standards to which we refer are the International Financial Reporting Standards (IFRS) and the United States Generally Accepted Accounting Principles (US GAAP).

Properties have a relatively long life span and a significant part of lease payments are related to land.

To lessors, the most important aspects or requirements of the proposals are as follows:

- **Little changes** are expected for the lessors accounting records in financial leases.

- **For operational leases**, lessors of diverse assets other than properties will be entitled to display in their financial states the residual value of underlying assets separately from their accounts receivable for leasing, in addition to provide information about the way they handle their exposure to such residual value.

- **The degree of change** on operational leases will depend on whether the underlying asset is real state or equipment (movable property). A lessor should differentiate between real state leases and equipment leases.

- **In the case of operational** leases of real state, the accounting treatment to be applied by the lessor remains unchanged.

- **In regard** to operational leases of vehicle or equipment, important changes have been planned already; lessors would do as follows:

1. Unregister the underlying asset.
2. Recognize accounts receivable for each leasing.
3. Recognize the interest portion kept in the underlying asset (the residual asset).
4. Recognize interest income from lease accounts receivable.
5. Recognize interest income from underlying asset during the lease term.
6.

- **In circumstances** where lessors are also manufacturers or distributors of equipment, they could recognize income from leasing when the underlying asset is available to be used by the tenant.

About leaseholders:

- **Leaseholders** should present in his balance sheet, assets and liabilities from all of the leases in a period of no more than 12 months, so the readers of his financial statements have a better understanding of tenant leverages and assets used in the operation.

- **Tenants** would recognize the right of use and a liability on the lease for all leases within a term of up to 12 months. This recognition would be optional for leases less than 12 months.
- **New standards** would demand the leaseholder to recognize assets and liabilities originated from lease rights and obligations. It was considered that at the beginning of a rental contract, the tenant has the right to use the underlying asset for a period of time while the lessor provides the right of use.

- **The tenant** would have to estimate at the beginning of the leasing the present value of payments to assets with the right of use and to liabilities as well. Assets also include lease contractual costs. In this way, users of financial statements will provide better information about future cash outflows derived from lease contracts. The liability from leasing is estimated in the same manner, regardless of the nature of the involved underlying asset.
- Non-fixed payments and those made by the tenant in optional periods would be excluded unless there are significant financial incentives to exercise the renewal option of assets and liabilities on leasing to minimize costs and complexity. Only variable payments are included due to their link to and index or an interest rate.

- There are a variety of leasing operations with a different economic nature, therefore a dual approach is proposed to recognize, estimate and display expenses and cash flows from a lease.

A key element to determine which approach to apply is based on the expected consumption amount of the underlying asset given that there are leases for which tenants pay a part of the underlying asset and others for which they pay for its use only.

That is because equipment and vehicles are depreciating assets which value not only decreases during their life-span but generally decline faster during the early years than in the later years of its life-cycle. In such leases, lessors set the prices in a way that allow them to recover the value of the part consumed of the asset, and to obtain a return over the investment on the asset.

Most of the lease contracts on equipment and vehicles would be classified as Type A Leases. In such leases, tenants purchase the corresponding part of the consumed underlying asset. In this case, lessors would display in their financial statements the asset amortization (due to right of use) and debt interests for leasing included in the same concept as interests for similar financial liabilities.

In the cash flow statement, the main part of cash payments in Type A leases is displayed within the financial activities and the interest part could be shown in the operational activities or in the funding part.

Identifying the amount consumed of underlying asset during the leasing term will determine the approach to apply.

Most of the property lease contracts would be classified as Type B contracts, where tenants use an underlying asset by consuming a very small part of it. As we know, property has long life span and a significant part of property payments are related to land. Land has an indefinite life span and its value is not consumed by the lessee. The landlord sets the price in such way that he can get profitability over the asset.

In Type B leases, tenants are evenly charged the use of the assets displayed in their income statements. Payments to Type B leases are displayed in cash flow statements within the operational activities section.

Interpretation

Without registration

Under the current accounting standards, leases that are similar to purchase operations of assets (referred to as underlying), are categorized as financial and are reported in the tenants' general balance sheet.

Nevertheless, when the economical nature of leasing is not similar, they are categorized as operational and they are not displayed in the balance sheet. This situation have led some entities to register leases as operational.

Article provided by IMEF, the Mexican IAFEI Member Institute

Mexico, Article: **Transnational Corporations - Global Synergy**

by **Juan Ramon Sobero**, and by **Patricia Luna**, members of the national technical committee of human capital and VP of the technical council, respectively, of the Mexican Institute of Financial Executives, IMEF, the Mexican IAFEI Member Institute

Their large-scale corporate strategy and diversity in human talent are a competitive advantage against other worldwide firms.

We are living now in a globalized world that has become very relevant thanks to trade policies in different countries. This increases the productivity potential, trade opportunities and attraction of foreign investment. Globalization integrates people, companies and governments from different nations and cause interactions among them.

Transnational companies are a good example of globalization. They are not just located in the country of origin, but they also build in other countries to expand their production capacity, distribution and sell power, regardless of their type of integration whether it be vertical or horizontal.

Transnational corporations tested and efficient processes allow them to reach certain degree of influence, power and control in corporate governance and affiliated or subsidiary companies, because they always follow a uniform way of operation and compliance with certain performance indicators that later become industrial standards.

On the other hand, in a context of strategic and global generic leaders, these companies impact each and every country where they operate and have influence in a varying extent in the business environment, cultural or national identity and within domestic companies.

Through the years, several studies on globalization have shown that transnational corporations impact on the identity of countries with their products, ideas and experiences, in a way that a wide offer with great diversity of brands and a high level of technological development, suggest that some traditions and cultural traits from different nations might converge.

The current business environment is dynamic. More than ever strategies tend to boost their components to meet the challenges of anticipation, adaptation, innovation and competition.

The prospect of finding solutions to business problems in transnational corporations increases when a diversified group attacks them.

The essence of the strategy is not the organizational structure anymore. Neither products nor markets, but harmonization of human talent and the way central processes are executed

(and must be continually reinforced and made difficult to copy), in order to have a differentiating element against competitor. In this way, companies will steadily deliver a greater value to their customers or final consumers, while strategic and mature competitive capabilities are developed inside the organization.

Strategic Approach

How to know if a capability is a strategic one? Just by looking at the central process, if it starts (identifying or creating necessities) and ends with the customer (satisfying the necessities).

Most of the big transnational companies are structured in a complex way as corporates from which one or more business units (SBU), also known as affiliates or subsidiaries, depend. It is a corporate responsibility to set the strategic direction and objectives for a defined horizon, and clearly communicate them to each and every one of the affiliates or subsidiaries so in certain periods a follow up is carried out together with an assessment of their work towards the achievement of the strategic goals.

Every transnational company develops its strategy from observing the world as a whole, as a unity where a learning, comparison, differentiation and adaptation attitude dominates.

Experience have demonstrated that if competitive schemes are applied to a country and then replicated to others, there are high vulnerability and chance of failure. That is why these organizations define their competition strategies as worldwide schemes in general, and as segmented international markets in particular to finally adapt to domestic markets.

This makes the strategic process to be complex because it implies carrying out market and competition analysis in different nations, and identifying common opportunities and conditions that allow foreseeing success and making easier to lead a strategy at a local level. The combination of local efforts and synergy gradually fulfill the expected strategic worldwide performance.

Globalization responds to the strategic needs of the international expansion of the companies, where exports and direct investment under certain conditions induce to display and make use of their competitive advantages in several foreign markets. They even allow to develop new competitive advantages or distinctive attributes in markets where competitors are located, not just in the domestic market.

Transnational companies primarily seek out in their own strategic approach for:

A. **Cost advantages** through economies of scale or through replication.
B. **Efficiency through diversified activities.** When certain processes are located in different places, transnational corporations get advantages in human resources, materials and production or distribution costs.
C. **Creation of new knowledge** originated from new ideas, new experiences and new practices by interacting with different national cultures that transcend local borders.

Transnational companies, especially in legal entities that operate in a country, somehow represent the local culture but have global characteristics at the same time, because they put into practice globalized policies like environmental care, human rights, gender issues, quality of life, respect for ethnic groups, social liability, and others. This favors an influence that becomes homogenous while breaking down cultural barriers and paradigms.

All of the above mentioned have forced employees to understand how the organization works and execute operations in both a local and a global level, so as the fundamental characteristics or attributes of the corporate culture and the distinctive features of the local culture.
One of the main current corporative challenges of these organizations is to transmit their work cultures from headquarters to every subsidiaries, since it depends on the correct identification of employees themselves with company culture and values, and to overcome in the way difficult situations created by different cultures, races and peculiarities with the aim to comply with operational expectations so as with tactic and strategic results.

The role of a leader in every single subsidiary companies is critical because he has to jointly implement a global strategy in local terms with his senior management team. Besides, he must settle correctly the corporate values and traits identified by the headquarters as fundamental to communicate the true value and identity of the enterprise. In relation with this, the local leader is the true responsible of communicating to the headquarters that the spirit of their main policies and values are being adapted in a right way and that each employee identifies himself with the organization values.

Greater Diversity

Diversity consist in the promotion and celebration of the contribution made by different persons to an organization, different ways of thinking and reasoning based on knowledge acquired from past experiences of each individual, that enrich the way of addressing and understanding problems and making decisions. Very different people with different backgrounds and varied approaches to problems.

This is an area of strategic focus; nevertheless, it is not just about comprehending and disseminating the concept but knowing how to manage different teams and different people. This implies the discovering and understanding of differences with no intention to get rid of them. To be inclusive in order to attain good business results requires the creation of a learning environment that allows the transformation of the individuals that make up the organization and the organization itself.

"Cultural diversity advantages are obtained from adopting strategies that shorten the communication and attitude breaches among individuals."

Patricia Luna Arredondo, Vice President of the Technical Board of IMEF

Inclusive actions free the potential, provoke the generation of ideas and create a surrounding where the best people with the greatest talent is more productive, where expectations are surpassed. The true significance of diversity appreciation is to respect, enhance and enjoy a wide range of cultural and individual differences.

The goal of a diversified organization is that people of all the different cultural backgrounds could reach their full potential, without limitations due to group identities such as gender, nationality, race or religion.

In a tactic level, an organization confronts important challenges to get the employees diversity to become a competitive advantage or even an important differentiating factor, since really appreciating the diversity of employees, balancing individuals needs with group justice, exceeding the resistance to change, encouraging group cohesion, ensuring open communication, preserving and helping the best employees to improve themselves, and managing competition for the capitalization of opportunities, allows organizations to quickly react to threats from a highly competitive, fast-changing environment with an interesting degree of complexity.

Strategy must be based on the observation of the world as one; if the schemes are applied to just one country there will be a high probability of failure.

Cultural diversity offers a competitive advantage to the company, but in order to capitalize it, it is necessary to implement structures (organizational policies, job positions, standards) and strategies (planning, programming, objectives and goals) needed to reduce communication and attitude differences among individuals.

It is not enough to offer employees training courses or eventual training about cultural diversity. People responsible of human resources, especially the leadership team, must be able to include diversity management actions into the organizational development strategy.

Organizational development strategy besides integrating cultural elements, should be aligned with the corporate talent strategy and the context of its subsidiaries, and local employees expectations as well.

Best practices for transnational companies include, as part of the talent development strategy, the following objectives:

> **Talent models** to export. This is to say, development of local, regional and global careers.
> **Mobility program** for executives to acquire international experience and develop management skills through the leadership of teams in different cultural, political and economical contexts.
> **Crisis management**, where executives can face adverse and highly stressful conditions, to be able to adapt themselves and resolve difficulties.
> **Allocation programs** for a period of time in special high impact projects.
> **Succession plans**.
> **Retention strategy** based in leadership programs.

> **Training and development** programs in virtual platforms based on external factors to the company such as demographic, competition, market, technology trends and innovation.

The main results of the above mentioned objectives impact in the efficient management of cultural diversity and leadership development. They can also reduce administrative costs. Additionally, a more effective management of cultural diversity can increase job satisfaction levels of different teams or groups, therefore reducing staff turnover, absenteeism and related costs.

A diversified organization that supports and help in the development of a variety of employees, will keep for a longer time its minority and culturally different team members. In the same way, the effective administration of diversity helps to avoid costly lawsuits due to allegations of discrimination based on age, race or gender.

The companies with a successful history in cultural diversity management have an evident advantage in hiring talented people. Companies that are well known for embracing diversity in a positive way, attract the strongest applicants among women and ethnic and racial minorities.

The workforce scarcity has boosted cultural diversity. In periods of workforce shortage, companies cannot afford to be racist, sexist or to be selective for reasons of age or any other cultural affinity. Diversity in workforce of the company can contribute with useful ideas for publicity and advantageous promotion.

A culturally diversified workforce together with communication management, can help companies to get a favorable situation in presence of target cultural groups. A heterogeneous workforce offers a creativity advantage to a company. The probability of finding creative solutions to problems is higher when a diversified group deals with them.

The value of cultural sensitivity refers to the awareness and disposition to survey the reasons why the people from another culture act in the way they are used to. A person with cultural sensitivity recognize certain nuances in usage and habits that will help him/her to build better relationships with people with a cultural background different to his/hers (i.e.: rules of protocol from different countries).

Cultural sensitivity implies concern connotations or interest in cultural differences, which in turn suggests certain ability to know the best way to get close, touch or capture the "essence" of individuals or groups, which make up the organizational population. Therefore, it could be said that sensitivity transcends knowledge because certain cultural understanding of the other person is assumed (at the same time).

Article provided by IMEF, the Mexican IAFEI Member Institute

Netherlands, Article: **Cocos Are Offering Relatively Attractive Chances of Returns**

by **Caspar van Grafhorst,** Senior Credit Analyst at ING Investment Management, the Netherlands

One of the lessons from the banking crisis is that first of all equity-holders and creditors should contribute their share to the salvation of failing financial corporations before the state is helping out with tax money or small savers have to fear for their savings. To come closer to this objective, in the context of the Basel-III-banking regulations, the European banks have started with the issuance of a new type of loss-absorbing capital instruments which are known as Contingent Convertible Bonds or Cocos.

This is a type of convertible bond where the right of converting is not in the hands of the convertible bond's owner, but the conversion is tied to equity capital falling below a pre-defined ratio. Therefore, Contingent Convertible Bonds are also referred to as Mandatory Convertible Bonds.

Strong growth

The market is growing: Although these instruments have been issued only since last year, the experts are already estimating the market volume at 65 billion Euro. In Germany, the Deutsche Bank is the only institute that has put Cocos on the market, its issue had a volume of 3.5 billion Euro. Cocos are following a simple principle: If the equity capital of a bank falls below a pre-defined level, the bonds will be converted into real equity by conversion into shares or they will be written off. The triggering point is defined by the core capital ratio. It describes the equity of a bank which is essentially composed of common stock and retained earnings in relation to the risk weighted assets. According to Basel III, the minimum ratio for the core capital ratio is at 5.5 % in 2014, in the upcoming year this ratio increases to 6 %. The conversion threshold for a Coco-bond is at a minimum of 5.125 %, but it can also be set at a higher level.

If a bank runs into difficulties and its core capital ratio falls below the conversion threshold, the Cocos will be converted into core equity with an amount which is necessary to attain the core capital ratio of 5.125 % (or higher in case of this has been fixed). In case of such a lowering of the convertible bond's nominal account, the coupon is being paid on the reduced nominal amount. A complete conversion can be made either. The financial position of the troubled institute is being improved by the conversion or the depreciation of the Cocos, so that governmental rescue-measures should not be required at first. The buck is passed to the Coco-owners: They are held liable for the losses of a failing bank with their bonds, and by conversion into shares or the (partial-)depreciation of their bonds, they are losing the payments of the interest coupons.

Two varieties

As with classic subordinated bonds, also mandatory convertible bonds are distinguished in two varieties: "Tier2" and "Additional Tier1" (AT 1). The AT 1-Cocos are "eternal" bonds without a fixed maturity, its interest payments can be deferred when the financial corporation cannot achieve a sufficient profit. AT 1-cocos are counted into additional core capital, therefore, the banks do issue them especially on purpose of meeting the new core capital requirements.

Supplementary capital

Tier 2, or T 2-Cocos, are higher ranked dated bonds. They have a final maturity, and they are normally equipped with a solid coupon which is disbursed independently of the profit situation of the issuing bank. T 2-Cocos are regarded as additional equity capital and they are issued to create a buffer as a protection for preferred creditors and shareholders. By investing in Cocos, investors have to precisely pay attention to the several conditions. For instance, if the conversion threshold is higher than 5.125 %, the risk is namely increasing, but the investor also receives a higher interest rate. Furthermore, there are instruments with a permanent write-

down as well as a temporary write-down. In the second case, an impairment of Cocos is possible after a lowering of the nominal value; however, this depends on the discretion of the issuer.

Different profiles

AT 1-Cocos bear two risks: Firstly, the coupon-payments can be deferred, and secondly, the capital amounts can be written off. Because of the improved equity capital ratios in the banking sector within the last years, ING Investment Management presently regards the cancellation of coupon-payments as the main risk. Concerning the returns, there has been a strong decline in the last 12 months, above all because of the high demand by investors. On average, the AT 1-mandatory convertible bonds had a return of at last 6 %. If a bank did not provide new equity capital by the way of issuing Cocos but by the way of issuing shares which are able to absorb major losses as a last buffer in the capital structure before AT 1-Cocos, investors would expect a return of about 10 % due to the high risk.

With the view to the depreciation- and coupon-risks of AT 1-Cocos which are comparable with the risks of issued shares, we regard the price difference as too large. Concerning volatility, it is to be expected that AT 1-Cocos will behave similarly to issued shares, at least in stress-situations on the markets.

Significantly higher Beta

In comparison to classical convertible bonds, the AT 1-Cocos have a significantly higher Beta. Their correlation with regard to German and US government-bonds is bigger than to conventional hybrid instruments. Therefore, these would be the better choice if investors liked to protect themselves against a sell out of government bonds. Compared to classical convertible bonds with the same rating, the return premium of AT 1-Cocos is around 200 basis points, especially due to the higher risk of the conversion to absorb losses.

By comparison to the AT 1-Cocos, the risk profile of the T 2-Cocos is significantly lower because the coupon-payments cannot be deferred. Opposite to “normal” T 2-bonds which only absorb losses when the bank is declared as insolvent, their risk profile, however, is significantly higher due to the automatic triggering of the loss absorption. Accordingly, the average return of 4.5 % for T 2-Cocos which have been issued by European banks, is significantly higher than the average return of conventional T 2-bonds which is around 2.4 %.

Because of the new bank-regulations, the authorities have a lot of leeway in case of splitting the losses between shareholders and creditors by liquidation of a failed bank. However, the recent past has shown that in case of emergency especially the holder of subordinate bonds are the first to be touched to minimize costs and burdens for savers and tax payers. It is unlikely that there should be a difference between T 2-Cocos and normal T 2-bonds with the same ranking. Therefore, T 2-Cocos are offering interesting investment opportunities, because their risk premium compared to normal T 2-bonds is attractive, the risk-profiles of both interest instruments are basically similar, though.

Attractive for banks

If European banks are interested in improving their equity capital-structure, Cocos will be the significantly cost-efficient solution in comparison to the issuance of shares. For this reason, many European financial institutes are expected to use the issuance of Cocos to improve their equity capital-position in the future. Therefore, the market of Cocos is expected to grow quickly in the next years, and it is offering relatively attractive chances of returns. Thus, also investors should pay more attention to Cocos.

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

Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

DECEMBER 10, 2014

Whodunit? Oil and the Bond Market

Much has been made of declining oil prices in 2014. Both West Texas Intermediate (WTI) and Brent crude oil prices have fallen 40% year-to-date. Nobody saw it coming. At the start of the year, forecasters guessed oil would be near $100 by December 2014. It counts as one of the largest annual oil price moves on record.

Investors often seek the smoking gun cause of any major market move. But we doubt there is a singular cause in the oil rout. Ignore analysts touting a simple explanation (e.g. the Saudis did it!). Supply, demand, broader US dollar strength and shifting investor sentiment are all at work. Bond investors should focus on how the decline in price will impact the bond market. For now, worries about disinflation have outweighed hopes that lower oil prices will spur economic growth.

Whodunit? Supply and Demand

Both supply and demand factors help explain the move in oil prices. On the supply side, despite all the talk in recent years about "peak oil," the world has never produced more oil than in 2014, with 93 million barrels per day produced as of October, up from 82 million per day in 2007. US oil production over the last three years outpaced any period in American history—dating back to the 1920s! The US is producing more than 9 million barrels per day, up from 5 million to start the decade. Combine that with recovering global production (Libyan crude oil produced has risen nearly 800,000 barrels/day this year), and you get a global supply shock.

Meanwhile, global demand for crude has been weak due to slower global growth. Demand for crude rose just 0.8% year-over-year through October. Demand from the euro area, Japan, and emerging market countries has slowed. The IMF global growth forecasts have been consistently revised lower. The most recent forecast published by the international body has the world economy growing at only 3.8% in 2014, down from 5.4% in 2010.

Whodunit? Investor Sentiment

But more than supply and demand play into recent oil price declines. Oil also may be caught up in a bigger trend of a stronger US dollar and overall weaker commodity prices. Iron ore prices have dropped 48%. Copper has trudged 13% lower. The Continuous Commodity Index is down 32% year-to-date.

On a related note, the last decade's growth in commodity ETFs and derivatives means that investor sentiment—at least in the short-term—plays a pivotal role in oil prices. Here's how it works: if speculators believe the peak oil hype then their demand for oil futures will be high, and, as a result, the price of oil for future delivery will rise. Producers of oil may, in turn, withhold supply today and prefer to sell it later, at higher prices. Spot prices then rise.

Since 2008, speculative financial demand in oil futures has far outpaced actual oil demand. In effect, investors/speculators have been betting that "peak oil" and US dollar weakness would mean higher oil prices—and for a while this bet worked. We suspect some of the recent move lower in price could be evidence of a speculative unwind. Net long positioning, according to the Commodity Futures Trading Commission, has dropped dramatically from historically high levels in the summer.

The whodunit does matter: if the drop in prices were due primarily to slumping demand, we'd be more worried about a global growth slowdown *a la* 2008-2009 given the magnitude of the move. But in light of the above complexity, we are less concerned. And, absent a demand surge (which we do not anticipate), a supply cutback (we'll keep watching the weekly updates from US shale production for clues) or a change in investors' views on the US dollar, it is difficult to see oil prices return to $100/barrel in 2015.

What Does It Mean For the Economy?

On the one hand, falling oil prices mean marginally better consumer spending and stronger net trade. A one-dollar decline in the average price of gasoline at the pump translates into almost $100 billion in annual savings for consumers if the price declines persist for a year. At just 5% of consumer spending this will be small but still a decent tailwind for the US economy. In terms of trade and the impact on GDP, the US's net importer status means it will spend fewer dollars on oil imports. All else equal, fewer imports translates to stronger GDP growth.

However, consumption and trade aren't the only components of GDP: investment matters, too. Many recent US oil and gas investments were made with oil prices above $100/barrel. Some ventures which might have been profitable at higher prices will no longer be economical. Investors pull back. As a result, we might expect cooling oil and gas investment to ding 2015 growth. The good news is that oil and gas investments account for less than 3% of GDP in the US and the US is still a net importer of energy.

And, globally, the growth impacts will also be mixed. Estimates from Bank of America Merrill Lynch suggest that a 30% decline in oil prices, if sustained over the course of next year, could add 40-50 basis points worth of GDP growth. The meager boost is because countries that are net importers of energy will benefit from the cost savings while net

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exporters will likely see export revenue decline. Country wise, net oil importers should benefit from a growth perspective in the first year of lower oil prices (+1.4% for Turkey, +0.8% for India, 0.6% for Japan, 0.5% for Brazil, and 0.4% for the US). Net oil exporters, we anticipate, will suffer in terms of GDP for the first year after the price shock (-0.7% for Mexico and -1.4% for Russia).

What Does It Mean For Bonds?

What, then, do oil price declines mean for the bond market? Any increase in GDP growth due to lower oil prices would likely nudge interest rates higher. That said, lower energy prices mean that headline inflation and inflation expectations will act as a countervailing force on interest rates. As gas prices and headline measures of inflation fall, so too will inflation expectations. The bond market is already anticipating lower inflation readings in the months ahead. A smaller inflation premium baked into bond prices translates into lower yields.

For now, the disinflationary pressures seem to be winning the interest rate battle.

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IAFEI News **December 19, 2014**

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

This Board of Directors Meeting made the following elections/ reelections of IAFEI Officers, for 2015:

Elections, reelections of IAFEI Officers, for 2015:

Luis Ortiz Hidalgo, Mexico	Chairman IAFEI
Fausto Cosi, Italy	Vice Chairman IAFEI
Victor Y. Lim, Jr., the Philippines	Secretary IAFEI
Emilio Pagani, Italy, Interim 2015	Treasurer IAFEI
Juan Alfredo Ortega	Area President the Americas, IAFEI
Hiroaki Endo	Area President Asia, IAFEI
Armand Angeli, France	Area President Europe, IAFEI
Armand Angeli, France, Interim 2015	Area President Middle East, Africa, IAFEI

Please turn over

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

46th IAFEI World Congress, 2016, in Russia

Hosting IAFEI member institute will be RCFD, the Russian Club of Financial Directors.
Location, and exact time, not yet determined.