

# IAFEI Quarterly

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## 47<sup>th</sup> IAFEI WORLD CONGRESS

Latin America & Global Connections

## XXVIII CONEF

Brazilian Financial Executives Congress

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## GLOBAL CFO SURVEY

CFOs to Trump:  
Stop Tweeting,  
Lose the Border Tax,  
But Continue Some Reforms



INTERNATIONAL ASSOCIATION OF FINANCIAL EXECUTIVES INSTITUTES

## LETTER OF THE CHAIRMAN

*Dear Colleagues,*

*At a global level the economy seems unable to consolidate a growth phase: despite low interest rates, moderate oil prices, and numerous government incentives promoting investment, generally speaking growth rates are not high, and in several geographical areas, including Europe, they are spectacularly unimpressive.*

*Political uncertainty and instability plays an important part in this equation, and we appear to be living in a moment of transition, awaiting that several big questions be resolved at a geopolitical level before we can expect the world economy to pick up generally.*

*Furthermore, it would appear that the beneficial effects offered by rapid technological evolution are not being fully harnessed, indicating that perhaps companies (and their managers) are unable to react fast enough to progress and to new scenarios as they occur.*

*And it is in this context that I believe it is worth underlining the role and the usefulness of professional associations like ours, as vital tools for the education, information, and networking so necessary for keeping up with the times in the modern fast-changing world.*

*My invitation to you our members is to participate systematically in the activities proposed by your local and national institutes, and to follow with interest the conferences organized by IAFEI.*



*We are currently working on the arrangements for the upcoming Annual World Congress, scheduled for September next in Sao Paolo, Brasil, and other interesting events are already planned for 2018, while we actively and continuously work to increase our membership with the affiliation of new national institutes around the globe.*

*Make sure you follow us and participate as much as possible, and best of luck with your business!*

*Fausto Cosi  
IAFEI Chairman*

## LETTER OF THE CHIEF EDITOR

*Dear Financial Executive,*

*You receive the IAFEI Quarterly XXXVI 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 professional information tool of our association, destined to reach the desk of each financial executive, or reach him, her otherwise, at the discretion of the IAFEI member institutes.*

*This issue is the Sixth One under the regime of the New Start for the IAFEI Quarterly. This new start has been backed up by the IAFEI Board of Directors decision of October 13, 2015, to establish an Editorial Board consisting of now 11 IAFEI representatives from all continents.*

*Once again, the layout and the visual design have been further improved by the Italian IAFEI Member Institute ANDAF, for what we are grateful. Also it is user-friendly in a state of the art manner.*

*Most articles of this issue are from inside IAFEI sources. But still: More member institutes should contribute articles. Let us jointly strive for this.*



*I repeat our ongoing invitation, to all IAFEI member institutes, and to each of their individual members, to send us articles for inclusion in future IAFEI Quarterlies, and to also send to us your suggestions for improvements.*

*With best personal regards*

*Helmut Schnabel  
Chief Editor*

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## “CFOs TO TRUMP: STOP TWEETING, LOSE THE BORDER TAX, BUT CONTINUE SOME REFORMS”

IAFEI and a Group of partners, among which Duke University, USA, and Grenoble Ecole de Management, France, produced the Survey of CFOs across the world, for the first quarter 2017. The survey was running from 21 February to 9 March 2017.

DURHAM, N.C. -- Chief financial officers in the United States are concerned about how President Donald Trump's off-the-cuff Twitter feed and public comments affect business, a new survey finds. Two-thirds said it would be better if the president stuck with prepared remarks in public and stop using Twitter. Results also show CFOs are feeling the most confident about economic growth than they've been in more than a dozen years, and they strongly support several of the president's initiatives.

“CFOs are very clear,” said John Graham, a finance professor at Duke's Fuqua School of Business and director of the survey. “They don't like the fluctuations and uncertainty that result from how President Trump communicates to the public, but they say many of his ideas will be good for business, even some of the more controversial ones”.

### Advice for the New President

The survey asked CFOs what advice they would give President Trump for the good of the business community.

- 67 percent said the president should stop using Twitter;
- 70 percent said he should stick to prepared remarks during speeches;
- 85 percent oppose reducing H1-B visas for highly skilled workers;
- 64 percent are against building a wall along the Mexican border;
- 68 percent favor retaining the current leadership at the Federal Reserve Bank;
- 58 percent support the president's plan to restrict immigration from specific countries.

### Mixed Bag on Tax Reform

- CFOs strongly support plans to reduce the corporate income tax rate to as low as 20 percent, with 86 percent indicating this would be good or very good for the economy.
- Likewise, 75 percent say easing the repatriation of foreign profits will give the economy a boost, and the same number said allowing companies to immediately deduct new investment will be beneficial.
- Seventy-four percent said reducing the top personal income tax rate to 30 percent will be good or very good for business prospects. CFOs are not in favor of all the proposed tax reforms.
- Fifty-seven percent said a substantial tariff on Chinese and Mexican goods would be bad or very bad for the US economy, as do 58 percent with respect to a proposed elimination of the debt interest deduction.
- A similar 55 percent say a border tax would be bad for the business outlook.

“Among firms that say their firm would be directly affected by a border tax, 85 percent say their company’s bottom line would suffer as a result,” said Campbell R. Harvey, founding director of the CFO Survey. “Even if the US dollar were to appreciate by 20 percent, 73 percent say their bottom line would take a hit.”

Among Mexican CFOs, 25 percent say the Mexican government should retaliate in kind against any trade penalties imposed by the US, and another 50 percent said they should resist the US policy but not retaliate. Sixty-five percent of Mexican CFOs believe their own firms should remain neutral. More than half of European CFOs believe their countries should retaliate or resist US trade proposals, with 65 percent of French companies favoring such action. Forty-two percent of Canadian firms believe their government should resist U.S. trade proposals but only 8 percent say Canada should retaliate.

**Strong Optimism, Hiring, and Spending.** The Optimism Index jumped this quarter to 69 (on a 100-point scale), the highest level in 14 years and much higher than the long-run average of 60.

“The jump in business optimism is leading to strong hiring and spending plans for 2017,” Graham said. “Our analysis of past forecasts shows that the Optimism Index is an accurate predictor of GDP growth and employment over the next year.”

Sixty-one percent of U.S. firms plan to increase their payrolls in 2017, with an average increase of approximately 3 percent (median 1 percent). Wage hikes are expected to average nearly 4 percent. Capital

spending is expected to increase 6 percent on average (median 3 percent), a notable improvement from flat or negative spending plans for most of 2016.

**Top Concerns.** US CFOs list current government policies and economic uncertainty as their top business concerns. In signs of a tightening labor market, difficulty in attracting and retaining employees is close behind. The rising costs of benefits is another top concern, with health care costs expected to rise by 6.8 percent over the next year.

**Reduced Public Trust of Government and Business.** More than 80 percent of US companies say lack of public trust in business and government is harming the business environment. Forty-seven percent say the negative influence is harming the economy moderately or a great deal. Nearly half of CFOs say their firms have altered business decisions, increased transparency, and strengthened governance to try to offset reduced public trust.

**Fixing Economies around the World.** We asked countries around the globe about issues that must be addressed to improve the business climate in their home countries.

- **Latin America:** more than two-thirds of CFOs say corruption and a weak judiciary are important problems that must be addressed to improve the business climate. About half indicate that improving infrastructure and reducing crime are also important. More than 80 percent of Latin American companies say that lack of public trust is moderately or greatly harming the business environment. Still, economic optimism rebounded from near-historic lows last quarter. **Mexico** in particular shrugged off last quarter’s decline in optimism and returned to 61 this quarter, on a 100 point scale. Optimism increased in all surveyed Latin American countries, except **Peru** (63). Other optimism ratings include **Chile** (47), **Colombia** (57), **Brazil** (58), and **Argentina** (70). Eighty percent of Brazilian CFOs say their optimism is higher now than six months ago, when President Temer took office.

Averaged across Latin America, capital spending plans are up 2 percent. Full-time employment is expected to grow a modest 1 percent. The recent Odebrecht corruption scandal made headlines and implicated government officials in Peru and Brazil; however, only about 15 percent of firms in these two countries say this caused them to reduce planned investment spending in 2017.

- **Asia:** Approximately 70 percent of CFOs in India and The **Philippines** say that corruption is a significant problem holding back the economy, and 40 percent of Chinese CFOs say the judiciary must be fixed. Nearly 40 percent of Asian CFOs identify the corporate tax system, and 34 percent say other government regulations, must be reformed to improve the economy. Half of Asian CFOs, including two-thirds in Japan, say they lack the human capital necessary to respond rapidly to a sudden increase in demand. 70 percent of Asian companies say that lack of public trust is moderately or greatly harming the business environment.

Asian Business Optimism averaged 58 this quarter, ranging from 45 in **Singapore**, 46 in **Malaysia**, 56 in **Japan**, 61 in **China**, and 64 in **India**. Concerns that are dampening Asian optimism include economic uncertainty and currency risk. Capital spending should increase a robust 7.5 percent (median) across Asia, though by less than 2 percent in China. Employment and wages should both increase by about 5 percent in 2017, with wages increasing 2.5 percent in Japan versus 7.7 percent in China. Fully 100 percent of Chinese CFOs say that air pollution harms the Chinese economy, with 29 percent saying the effect is very negative. Half of Japanese CFOs believe that the government’s initiative to reduce work hours will improve worker productivity but only one-fourth think it will help the bottom line.

- **Africa:** Two-thirds of African CFOs say that corruption is a significant problem that must be addressed to improve the business climate, and more than half say the same about infrastructure. Sixty percent of Nigerian CFOs say that inflation must be tamed to fix the economy and 63 percent of South African CFOs say that political instability must be reduced. Nearly half of South African CFOs say they lack the human capital necessary to respond rapidly to a sudden increase in demand. 53 percent indicate that a lack of public trust is greatly harming the business environment and another 29 percent say the harm is moderate.

**South African** optimism fell to 39 this quarter, from 45 last quarter, while **Nigerian** optimism increased from 49 to 52. Capital spending will rise by a median 5 percent, and wages should increase 7 percent over the next 12 months. Fulltime employment will decrease. African CFOs are worried about economic uncertainty, government policies, currency risk, and in Nigeria, inflation. Nearly 80 percent of African CFOs say that their companies are not even halfway to implementing the UN Sustainable Development Goals.

- **Europe:** CFOs say that reducing business regulations is the top item that must be addressed to improve the business climate, followed closely by reducing political instability. European CFOs rank improving public education and the judiciary as the third and fourth most important items to improve the economy. Nearly 60 percent of Italian CFOs indicate that reducing corruption and a strengthened judiciary is essential to improving the business climate. Wages should increase by 2 percent over the next year, and employment will remain essentially unchanged. Capital spending is expected to rise 3.3 percent (median). Top European concerns include economic uncertainty, regulatory requirements, government policies, and attracting qualified employees. Business Optimism fell by one point to 56 this quarter (on a 100-point scale). Optimism is particularly strong in the **Netherlands** (69) and **Germany** (65) and weakest among surveyed countries in **Italy** (50). Optimism in **France** (55) and the **UK** (54) is moderate.

- **Canadian** optimism jumped to 67 this quarter, up from 63 last quarter. Capital spending and employment should both grow by about 3 percent. 55 percent of Canadian CFOs think that business regulations must be reduced to improve the business environment, and 48 percent say the same about improving infrastructure.







## EXPLORING ECONOMIC OPPORTUNITIES IN AFRICA

**AFRICA IS A LAND OF GREAT OPPORTUNITY. IT'S ALSO ONE OF THE MOST COMPLEX ENVIRONMENTS ON THIS PLANET TO OPERATE IN.**

By **NATASHA KIRCHMANN**, Project Executive for Copper Quail (Africa wide human capital solutions) Oil & Gas exploration trip – Mozambique, November 2016, article provided by DFCG, the French IAFEI Member Institute.

Especially if you come from a first world economy where the basic tools of business are in place, namely; electricity, water, reliable transport, roads, common culture, political understanding. Africa is a colourful environment and is rich with diversity. If you can manoeuvre around the obstacles and challenges without becoming frustrated or demotivated it could be the perfect place for you.

Africa is set to steer the new economic order in 15 years' time, per a report by Bloomberg, as it constitutes some major advances in production and output. The continent is favourable with untapped wealth, oil and gas supplies and uncultivated arable land, and has a young demographic with 50% of the continent's population under the age of 34. Coupled with an urgent need for infrastructure across Africa's 54 countries to support other essential developments, the opportunities are there.

The largest industry on the continent is agriculture, which attributes a large portion of GDP for most countries on the continent, followed by oil and mining. The agricultural sector employs about 60% of Africa's workforce, with the main income sources from large farms which produce products such as coffee, cocoa, cotton and rubber.

The prospects of growth for the continent are looking up, with the vibrant and young population of Africa set to make strides in various industries that are set to boom. These being; agriculture, mining, infrastructure, services, banking and finance, information & communication, entrepreneurship, transport & logistics, entertainment and tourism. This opens massive opportunity for education and training.

Finance and logistics are key areas of development and Africa boasts two hugely successful French logistics groups such as, Bolloré and Necotrans, who hold numerous port concessions in Africa.

We have seen a dramatic increase in investment through the channels of private equity houses and major brands. The role players in development finance have increased substantially, e.g. sovereign wealth funds, specialised programmes increased roles of development finance institutions. This is why it is essential for company reps in Africa to have an understanding of development finance and the various export and investment incentives offered by French agencies such as COFACE.

It is of major importance to understand local cultures and the need for local partners and the strong wave of local beneficiation that African governments are demanding. Sensitivity to local circumstances is vital. This is very much a contact game and good people skills are a major requirement as is patience. Consumerism is on the rise and so the effects are creating massive opportunity. There is no shortage of investable money available, only a shortage of safe investment mechanisms alternative to the traditional banking structures. For visionaries, there are masses of opportunity on the continent and by partnering with the right groups, associates or individuals there are plenty dynamic and innovative opportunities for either investment or employment.

There are 26 French speaking countries in Africa at least 50% of those are showing steady to slight increase in GDP and the trend for foreign investment into Africa is growing. Francophone Africa needs professional skills with the correct language ability.

Finance is hot on the list. Without the right financial leadership companies will not survive. More than ever economies are conforming to global best practice and solid CFO capabilities are in need. It is also becoming more the norm that a CFO fills the role of full operational understanding and event extends them self into developing new business strategies. The role has become all-encompassing and very dynamic.

To find opportunities in Africa I would suggest contacting a professional who deals with recruitment into Francophone Africa. Prepare a profile on yourself with specific sector experience relative to the growth sectors mentioned above and be specific about the role you would like to play. It always helps if you have had experience working in Africa in the past. It is no exaggeration when you hear that Africa is seriously different and very challenging. The risk to companies employing someone who comes from a much more "gentle" environment is that they won't cope with the immense change and won't stay for long.

Challenges you may experience: There may be hours with no electricity, depending on where in Africa you are. This is improving, it is still very much a reality. Some areas have stringent water restrictions or so much rain that roads are often washed away. Time is also a challenge. Where 8am to most of us means 8am sharp, in many cultures it may mean some time after 8am, or there about, "when I get there" in many cultures in Africa this is perfectly acceptable. Internet connectivity is still a challenge in some places. Security is always a concern for expats and to say there are no risks would be untrue. Most African cities are safe to operate. If ever there are security alerts security is provided for protection. On the flip side, the lifestyle can be incomparable, with social clubs, sports clubs, wildlife, 5 star African experiences with beauty beyond your imagination, outdoor activities and warm and open cultures and opportunities for economic growth that make most business people salivate. There is still nothing better than enjoying a good wine overlooking Africa's beauty. Most African people are peaceful, other than the occasional inter-tribal dispute or political disagreement it's all good and for the adventurous opportunist this is where you need to be.

Relocation can be a challenge and may take some time so don't hold your breath and go with the flow. There are cases of arranging relocation in 3 months, there are cases where it has taken up to a year.

Don't try and do this on your own, leave it to a professional based in Africa. Other than us, many of the top international law firms facilitate this service from in continent. This is the best way. You don't ever want to get your self-caught in a situation where money is exchanged for speedier services. It always backfires. On that note, bribery and corruption is not tolerated in developing Africa. Global compliance is adhered to and ethical best practice is pushed as a priority of many countries. That is how ever a whole different conversation.

Other than a full relocation, rotatory contracts are also very popular where you would enter your country of work for 4/6 or 8 weeks at a time with a lengthy break in-between. This means that you constantly update your visa and benefit from the very often attractive financial incentive that comes with this type of contract.

International and French schools are situation in and around most economic hubs in Africa and the cost ranges from \$25 000.00 per child per year (International schools) and \$4 500.00 per child per year (French schools). General accommodation can range from \$3,500.00 to \$7,500.00 USD per month. Food can be wonderful in some areas and rather horrific in others, this is all depends on location. There are many French expatriates living semi-permanently in Africa in major centres such as Abidjan and Dakar.

As a passionate citizen of this beautiful continent I would urge anyone looking for an adventure to explore the opportunities in Africa, I love this continent and believe wholly in its growth and extraordinary offering.

Background Information :

A few important Africa macro-economic indicators (sourced from Paul Runge of Africa House)

The *International Finance Corporation (IFC)* estimates the value of the **HEALTHCARE SECTOR IN AFRICA** at over USD 30 billion.

According to *Financial Times: Analyse Africa*, **FOREIGN DIRECT INVESTMENT TO EAST AFRICA** grew in 2015 despite a drop across Africa from USD 87 billion to USD 66,5 billion. FDI into the whole African continent represented eight percent of the world's total.

According to *McKinsey*, the estimated **AFRICAN CONSUMER AND BUSINESS SPEND** in 2025 is about USD 5,6 trillion.

The demand for **HOTEL ROOMS** in Africa is likely to grow between three and five percent over the next three years.

The number of **MTN MOBILE SUBSCRIBERS** has increased one percent to around 230 million.

The consultancy firm, *EIU Canback* has reported that **AFRICA'S MIDDLE CLASS** rose to 6,2% of the continent's total population in 2014 compared to 4,4% in 2004. It puts the African middle class number at 130 million with about half living in North Africa. Such estimates vary considerably according to the definition of middle class used.

A report by the *African Development Bank (AfDB)* on the **AFRICAN DIASPORA** reports that every year, some 30 million African migrants living outside their countries send home about USD 40 billion.

The *Organisation for Economic Cooperation and Development (OECD)* and the *United Nations Food and Agricultural Organisation (FAO)* have issued a joint report stating that **AGRICULTURAL PRODUCTION** in sub-Saharan Africa may rise 2,6% annually until 2025.

The results of *W Hospitality's* 8th Hotel Chain Developments Pipelines in Africa 2016 survey show an increase of 42,1% over 2015 for Sub-Saharan Africa's **HOTEL ROOMS IN THE PIPELINE**.

The annual *Ernst & Young Africa Attractiveness Report* has confirmed that Africa is the world's **SECOND- FASTEST GROWING CONTINENT** after Asia. The number of foreign direct investment projects into the continent increased in 2015.

The **GROWTH FORECAST FOR AFRICA** by the World Bank has been lowered to 3,3% from a previous forecast of over 4%. Growth in 2015 was 3% due to the slump in world commodities

In its preliminary financial results for the twelve months ending 31 December 2015, **OLD MUTUAL** reports a 31% profit growth and an increase in customer base to 4 million.

The **TRANSPARENCY INTERNATIONAL CORRUPTION PERCEPTIONS INDEX** 2015 that covers 167 countries placed Botswana at 28th, Cape Verde at 40th, Seychelles at 40th, Rwanda at 44th, Mauritius at 45th, Namibia at 45th, Ghana at 56th, Lesotho

at 61st, Senegal at 61st, South Africa at 61st, Sao Tome and Principe at 42nd, Burkina Faso at 76th, Zambia at 76th, Benin at 83rd, Liberia at 83rd, Mali at 95th, Djibouti at 99th, Gabon at 99th, Niger at 99th, Ethiopia at 103rd, Côte d'Ivoire at 107th, Togo at 107th, Malawi at 112th, Mauritania at 112th, Mozambique at 112th, Tanzania at 117th, Sierra Leon at 119th, Gambia at 123rd, Madagascar at 123rd, Cameroon at 130th, Comoros at 136th, Nigeria at 136th, Guinea at 139th, Kenya at 139th, Uganda at 139th, Central African Republic at 145th, Congo Republic at 146th, Chad at 147th, DR Congo at 147th, Burundi at 150th, Zimbabwe at 150th, Eritrea at 154th, Guinea-Bissau at 158th, Angola at 163rd, South Sudan at 163rd, Sudan at 165th, Somalia at 167th. Many sub-Saharan Africa countries showed an improvement over 2014 including South Africa.

The **SABMiller ANNUAL REPORT FOR 2015** reveals an increase in lager volumes of 4%, an increase in soft drink volumes of 9% and a profit improvement of 9%. One million hectolitres were sold in Nigeria within two months of launch.

The US-based *Corporate Council on Africa* is advertising its various Africa business events with the following **FORECAST STATISTICS**:

- Mobile phone subscribers: Africa Today: 316 million and Africa Tomorrow: 850 million.

- Infrastructure Development: Africa Today: USD 45 billion and Africa Tomorrow: USD 93 billion.
- Agricultural Output: Africa Today: USD 280 billion and Africa Tomorrow: USD 880 billion.
- Oil, Gas and Mineral Production: Africa Today: USD 430 billion and Africa Tomorrow: USD 540 billion.
- Middle Class Households: Africa Today: 335 million and Africa Tomorrow: 1,1 billion.

**Contact:** website: [www.africacncl.org](http://www.africacncl.org)

**SHOPRITE** reports that its supermarket sales in the rest of Africa increased by 15% for the half-year whereas sales in South Africa decreased.

According to the *Deloitte A360 Degree View: Africa Construction Trends Report 2015*, the value of **INFRASTRUCTURE PROJECTS IN AFRICA** rose from USD 325 828 million in 2014 to USD 375 410 million in 2015. The number of Projects over USD 50 million rose from 257 to 301.



# BUSINESS

## A GREAT TIME FOR INVESTMENTS IN BRAZIL

By **JOSÉ CLÁUDIO SECURATO**, President of Saint Paul Business School, President of the Brazilian Institute of Finance Executives of São Paulo, IBEF SP Doctor by FEA / USP.

and by **LUIZ ROBERTO CALADO**, President of Andato Consultoria, Vice-President of the Brazilian Institute of Finance Executives of São Paulo, IBEF SP Postdoctoral degree from the University of California at Berkeley.

Article provided by IBEF, the Brazilian IAFEI Member Institute.

Brazil had a unique opportunity to promote itself abroad over the last few years, given the exposure it got for hosting the 2014 Fifa World cup and the 2016 Olympic Games, which attracted more than 6,4 million foreign visitors in 2014, and 6,6 million in 2016. If Brazil successfully exported its image during these sports events, the current flow of tourists could reach a higher level and offer the country an opportunity to consolidate its image abroad as a destination for tourism and, more importantly, for business.

Brazil is the biggest and most populated country in Latin America (more than 200 million inhabitants). It is also the largest GDP in the region, at US \$1.8 trillion (2016). The country has a rich and diversified economy, led by sectors like agribusiness, non-agricultural commodities and the aerospace, automotive and financial industries. Brazil is the 8th largest producer of cars (65 plants in its territory) and the 4th largest internal market. The country has also a developed aerospace industry, led by Embraer, one of the 4 biggest aircraft producers.

In agribusiness, Brazil is the largest producer and exporter of sugarcane (50% of world production), coffee (27% of the world production) and orange juice (85% of

the world). The country is also the largest exporter of soybeans, chicken and the largest exporter of beef, pork, corn, soybean oil and soybean meal. When it comes to non-agricultural commodities, the country is the second largest iron ore exporter (20%). The country has one of the largest consumer market in the world, worth around US \$ 400 billion annually. In the last decade, a new middle class promoted in the expansion of the market, bringing new opportunities for the industries, the retail and the services sectors.

Brazil is the 4th largest democracy in the world, with direct presidential elections being promoted since 1989 and pacific and democratic transitions since then.

São Paulo is Brazil's main financial hub and headquarters of **B3 (Brasil Bolsa Balcão), the most important Exchange of Latin America and one of the most important of the world**. The city has 63% of the multinational companies headquarters for Latin America, 8 of the 10 biggest brokers and 5 of 10 biggest insurance companies. The city has more than 240 thousand stores, 2 thousand bank branches and nearly 200 Heli points, the second largest helicopters fleet in the world. Three airports serve the city, with more than 40 Airlines.

Brazil has reached important milestones in its political

and institutional systems. It has consolidated its position as a democracy, with regular, direct, and multi-party elections, and there is no sign of any relevant internal or external security conflict. However, it faces important challenges in institutional aspects related to the economy, associated to its complex tax system and bureaucracy. Regarding the former, it must be mentioned how difficult and complex it is for companies to calculate and pay taxes.

#### **Brazil Infrastructure, Connectivity and Image**

**Physical infrastructure:** the availability of basic services within Brazil's urban centers is adequate, with 99% and 85% of the urban population having access to clean water and basic sanitation, respectively. In this regard, Brazil performs better than other Brics, and it is close to the level of OECD nations.

**Financial infrastructure:** Brazil has solid financial regulations, for which it is recognized worldwide. Its rules of prudence, for example, make fraudulent market schemes, such as the Madoff affair, more difficult to happen in the country. This is probably the pillar in which Brazil stands out the most compared to other investment and business hubs. It was largely due to the solidity of its banking infrastructure that Brazil weathered the 2008 financial crisis so well.

**Connectivity:** Brazil captures a major share of Latin America's inward foreign direct investment (fdi). In 2011, 41.1% of the total fdi in Latin America went to Brazil, and it is the major destination of large north American, European and Asian companies.

**Image of the country:** Brazil has a positive image as a tourist destination, according to the Anholt-GfK Roper Nation Brands Index, and cities such as Sao Paulo and Rio de Janeiro are recognized as some of the best places to do business in Latin America, as shown in the ranking published by the *Américaeconomía* magazine.

***It is true that the last three years were not good for the Brazilian economy. The accumulated drop in GDP reached 7% in the period. However, the outlook is optimistic.***

There are three factors that dictate the recovery of the Brazilian economy: political, economic factors and investigations of corruption.

**Political factors.** The country needs to approve the urgent reform of the social security system to control the expenses of the public budget. President Temer, as an experienced politician, is well placed to secure the necessary support for this important definition.

The repositioning of Brazil in Latin America, far from Venezuela, Bolivia, Ecuador and Cuba - although not in itself an economic change - should further stimulate the already high attraction of foreign capital into the country.

**Economic factors.** The economic team represents names of great respect for the market, led by Finance Minister Henrique Meirelles and Central Bank President Ilan Goldfajn. In a short period of time, the team brought inflation close to the target (reduction from 10% to below 5% per year); although aided by the deceleration of economic activity, market-based inflation forecasts highlight how the perceptions of domestic market participants towards public and private conduction of the economy have improved.

**Fight against corruption.** The set of coordinated investigations of the Brazilian federal police, such as Operation "Lava Jato" (carwash) brings to the country unprecedented gains in the reduction of impunity, regarding both political leaders and high-profile private sector executives. Historically, for instance, executives of large financial and political conglomerates have never been imprisoned, but this time, there has been many politicians already indicted, forced to return to the country the patrimony that they had illegally obtained.

The punishments helped to change the view that in Brazil rich people do not suffer sanctions for their mistakes. **Recent examples will certainly discourage corrupt behaviour, positively affecting the image of the business environment in Brazil.**

In terms of image as a place to do business, Brazil could increase its efforts to promote itself within a broader context, which are still quite limited. Here one could mention the BRAiN initiative, which presents Brazil's financial and capital markets to foreign investors, as well as APEX, a public sponsored organization aimed at promoting the country's foreign trade.

In summary: Brazil is moving towards an environment consistent with renewed economic growth, job creation, subdued inflation, surplus in the internal and external spheres in the medium term, which will all help overcome the lack to improve the investment participation in GDP, thus fostering overall growth. The hurdles to make all this concrete are high, as are the stakes for the future of the country, and therefore the moment demands serenity to note that political, economic and anti-corruption gains are not yet reflected in economic data and the well-being of the population. **The deeper these adjustments take place in Brazil, the stronger we will recover.**



## VONOVIA SE PLAYING ON THE ENTIRE FINANCING KEYBOARD

**THE RESIDENTIAL REAL ESTATE GROUP IS LIBERATING ITSELF FROM SECURITIZED STRUCTURES. CFO: THE INDUSTRIAL LOGIC FOR A MERGER WITH DEUTSCHE WOHNEN GROUP (DEUTSCHE RESIDENTIAL REAL ESTATE) DOES EXIST.**

Interview with **DR. STEFAN KIRSTEN**, CFO, VONOVIA SE, from *Börsen-Zeitung*, March 11, 2017, article provided by GEFIU, the German IAFEI Member Institute.

**Mr. Kirsten, you have repaid the last large structured financing (Commercial Mortgage Backed Securities, CMBS) prematurely a few weeks ago. Why this has been important?**

CMBS as instruments had been massively utilized after the year 2000 and have played the role of a fire accelerator in times of financial crisis. The main problem of CMBS is the lack of transparency. No matter how you address it, the contracts are – inclusive evaluation – always several thousand pages thick at the end. To handle these consistently is almost impossible. When we took over the listed Gagfah Corporation, we couldn't execute a due diligence because of legal reasons and we were left with publicly available information. As we found out, the CMBS contained penalizing break-up costs which were breathtaking.

**What was the amount of it?**

It would have been around 200 million Euro if we had repaid immediately upon takeover. We had calculated with significantly less than that. As the penalty, over the course

of time, is being reduced in a pattern of stairs, there is for each of these loans an optimal repayment point of time. When repaying, we naturally have paid attention to that we reach in each case the optimal point. As regards the first Gagfah structure, this was August 2016, the second one was November 2016 and now it is February 2017.

**How long would the securities have been outstanding without a prepayment penalty?**

Till 2018. Though, one has to say that in principle, in the last year no penalties have existed in order that the debtor may have time for re-financing.

**That means that you could repay the last structure without a prepayment penalty?**

In principle, yes. There is always a point, at which the penalty is exactly as high as the saving of interest expense. I do not have a problem with paying prepayment interest of 18 million Euro knowing that this is the interest expense advantage of a short period of time.

**How does your financing strategy look like without CMBS?**

In principle, we are financing 50 % in an unsecured way. This we need for the rating. And we are financing at least 10 % in a secured way. This is the absolute minimum. We need the contact to the mortgage banks, simply in order to have this option as well. The remaining 40 % are financed opportunistically.

**How is Conwert Corporation financed and how quickly can you substitute the securities after finalizing the takeover?**

Conwert has outstanding only secured liabilities, predominantly in very small tranches. Where and how we can phase them out efficiently, depends on details, such as change of control clauses, premature repayment-possibilities, penalties and similar matters. It is important that the maturity structure is balanced. The mix should be relatively good in order to reach all keys on the keyboard.

**What does financing opportunistically mean?**

In the past year, f. e., we have realized a private placement. We have raised 500 million Euro for two years, at total costs incl. fees of 8 basis points. There, we naturally have not said no. The departure from CMBS-structures does offer broad possibilities of diversification. Only this does open the possibility to choose the most favourable way in every situation. The disadvantage is: there is more work to do. In principle, we prepare for 3 to 4 products parallelly. Only two weeks before the issuing window do we reduce to two products, and then one week before the decision is being made.

**The departure from CMBS-structures does offer broad possibilities of diversification.**

**Though, against this background it is surprising that your average interest rate is still at 2,1 %. Your competitors are more favourably on their way.**

The reason for this are two hybrid bonds which are bearing interest of 4 % and 4,6 %. The hybrid papers we issued because we wanted to use long-term equity bridges. The first hybrid we issued in connection with the Vitus-transaction in 2014. The second hybrid bond we issued while taking over the Gagfah Corporation. In this case we had to act quickly in order that nobody else should come into our way. Honestly, I am a little bit disappointed that at this time we could not make it known to the market how shareholder-friendly the product is.

**Has the total debt financing not been doable, from the point of view of rating?**

The investment-grade rating is untouchable.

**When do you have the possibility to prepay for the first time?**

The debt hybrid is gone in two years. Decisive from my point of view, however, is that we are presently financing ourselves at 1,4 %. The pretended “horrible” interest rate increase which took place since September at the long end of the interest rate curve has hardly taken place.

**The price reaction which followed in the autumn after the meeting of the Central Bankers has in spite of this not been negligible.**

This was clear. In addition, then first of all, it relates to the most liquid shares, that is of Unibail-Rodamco and Vonovia. The reason for this is, that the hedge-funds, as base materials for their bets, always use liquid shares. It was also clear that we would be hit less strongly than the shares of a few of our competitors. Because we are part of the German DAX stock index, more passive funds are invested in our share and they do not react to early indicators. For me, these are the chances and side-effects of belonging to the Dax stock index .

**Does this mean that you have more hedge funds in the boat today than when you were a member of the German MDAX stock index (for medium sized corporations)?**

Clearly. This is connected with our liquidity. However, we are one of the most liquid shares in the sector, but the sector itself is comparatively illiquid. So, as an example, the Deutsche Lufthansa has the same daily turnover volume like us, although it has only short of 50 % of our market capitalization. Accordingly, the stock price reaction, in times of a turning trend, is more pronounced at our share, independently from that our fundamental data have not changed.

**Since the IPO of the company in summer 2013, the stock price has roundabout doubled, what is the recipe of this success?**

At the end, we can reduce the success of the corporation to a few decisions: First of all, the industrialization of our business. This has as a consequence standardization and thereby insourcing, but also the observation of the tenant, the lessee as client, inclusive of additional services close to the rental business. Then the way into the unsecured financing – at present, we have already 18 bonds outstanding – and the decision to grow country-wide in the cities, what influences the selection of investments and divestments and which accelerates the modernization. The gaining of speed only goes along with our own craftsmen, whereby the circle towards industrialization is again closed. After the takeover of Gagfah Corporation, we had achieved the right size in order to practise our strategy. For this, we would not have needed a takeover of Deutsche Wohnen Corporation. Our offer for this has



been motivated rather tactically, at least as relating to the timing.

**It is known that there has only been an attempt for the takeover. Which lessons have you learnt from this?**

In an industry which is capital-intensive and has low margins at the same time, you simply do not achieve synergies which would justify a premium of roundabout 30 %. This, one needs however, when making a hostile takeover. From this results, that takeovers can be effected only by mutual agreement. Another lesson is, though, that one makes oneself ready to be attacked, when departing too strongly from one's own capital market story.

**With this you are alluding to Deutsche Wohnen Corporation**

The Deutsche Wohnen has tested how the capital market is seeing it. The answer is: In Berlin. However, there further growth is presently very expensive.

**The limited external possibilities for growth are not only relating to Deutsche Wohnen. For you and also for LEG it looks similarly.**

Attention. In the first 2 years after our IPO, we grew faster in the capital market than Facebook.

This is looking into the rear view mirror. Looking forward, value creating acquisitions presently are hardly possible. Not without reason, all listed residential real estate groups have lately increased their investment budget.

Also here, we have been before the curve. We have increased the personnel resources and the capital budget already before that. But I want to argue differently. We have three options. We can extend the value added chain, buzz word: craftsmen organization. For us, this is reasonable because it is efficient at our size. We can go into a different asset class. We do not want to do so. Or we can go into another region.

**Do you also want to build up investments outside the German border?**

For the managing board, it is our duty to examine all options. Can we imagine this presently? No, it is not part of our present strategy. Convert Corporation is a total

different story. Convert had, from the point of view of governance, a challenging environment. When you have a 25 % participation which is changing from one hand to the other, then you have a problem. At the end, the management is only concentrating on who is the owner in the present week.

**At the Convert Corporation already some competitors had failed to take it over before you came. What have you done differently?**

The question was: How do we capture such a heterogeneous governance-structure? This one cannot achieve by putting all in one room. Therefore, we have separately negotiated with the large investor, and this parallelly. Rolf Buch was in Vienna and I was in London. It was clear to us from the beginning that we would only have a deal when both negotiations would work positively. Our exchange offer for shares was attractive, indeed. That the stock price dropped afterwards, was destiny.

**Out of the assumed share-deal, has now almost become a pure cash deal. How do you evaluate this?**

In this case, cash is better because we thereby got Convert at a price below the net asset value. In the last four years there has been no transaction over 300 million Euro with a discount to the net asset value. This is an absolute pearl. Now, we have given a guidance, inclusive a first indication, for Convert. The effect: Our numbers will be very good. At present, we have an increase in incoming cash per share (Funds from Operations, FFO) of well 10 %. Everybody says: wow! With Convert it is even roundabout 18 %. By the way, as we hardly issue new shares nobody will be diluted and we are replacing at the end our evaluation increase by way of new real estate investments, that is new assets.

**How do you mean that?**

Our competitors are decreasing their debt ratio because they are writing up their investments heavily in terms of value. By contrast, we have significantly lowered our indebtedness-ratio and we have enough leeway thereby, in order to finance the transaction with debt.

## Vonovia Group Numbers

### Rental Income in million Euro



### FFO\* in million Euro



### Net Profit in million Euro



### Net Asset Value (NAV)\*\* in million Euro



### Debt Quota (Loan-to-Value)



\*FFO: Funds from Operations, without divestments  
 \*\* adjusted by Goodwill

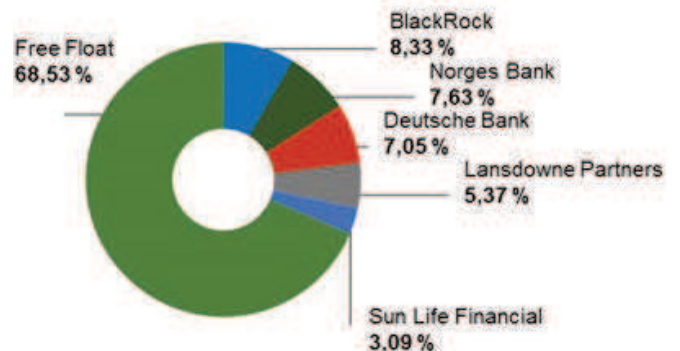
**Where is your debt ratio (loan-to-value, LTV) presently?**  
 Without Convert the LTV has decreased to 41,6 %. With Convert it rises up to 45 – 46 %. We have reduced our indebtedness, at the same time the funds from operation per share will increase significantly because there is little dilution. The takeover is positive in every regard.

**How much goodwill is coming into the books with Convert Corporation?**  
 As per our estimate roundabout in the amount of our deferred taxes. With a participation of 75 % this will be less than 200 million Euro.

**But you have already 2,7 billion Euro of goodwill in the balance sheet.**  
 With a balance sheet total of 33 billion Euro, this is only just 8 %.

# VONOVIA

### Shareholder-Structure



### Market capitalization

Status April 7, 2017

15.8 billion Euro

Source: Corporation, Thomson Reuters

At this one can also look differently. I still remember vividly what happened while market valuations were sinking dramatically in 2008/2009. The goodwill is unrelated to LTV. When I have to depreciate the goodwill, then I will do it.

**But goodwill is part of the net asset value.**  
 Here, one must differentiate between the Epra-NAV ( Net Asset Value adjusted as per recommendations of the European Public Real Estate Association) and the adjusted net asset value, at which the goodwill has been taken out. Today, the Epra-NAV is not any longer of importance for the investors. As per the balance sheet day end of 2016, we have an adjusted net asset value of 30,75 € per share. This is the evaluation without goodwill. Including goodwill, we are at a good 36 € per share. What will happen when the market is moving in the wrong direction? The V at loan to value will change, accordingly the loan to value will increase again. In 2009 we have depreciated short of 200 million. Would we have to mirror this in our size of today, then we would slide with the loan to value from 45 % to 51 %. But then, we are still capable of issuing more mortgage bonds.

**Where is the hurdle for the capability of issuing mortgage bonds?**

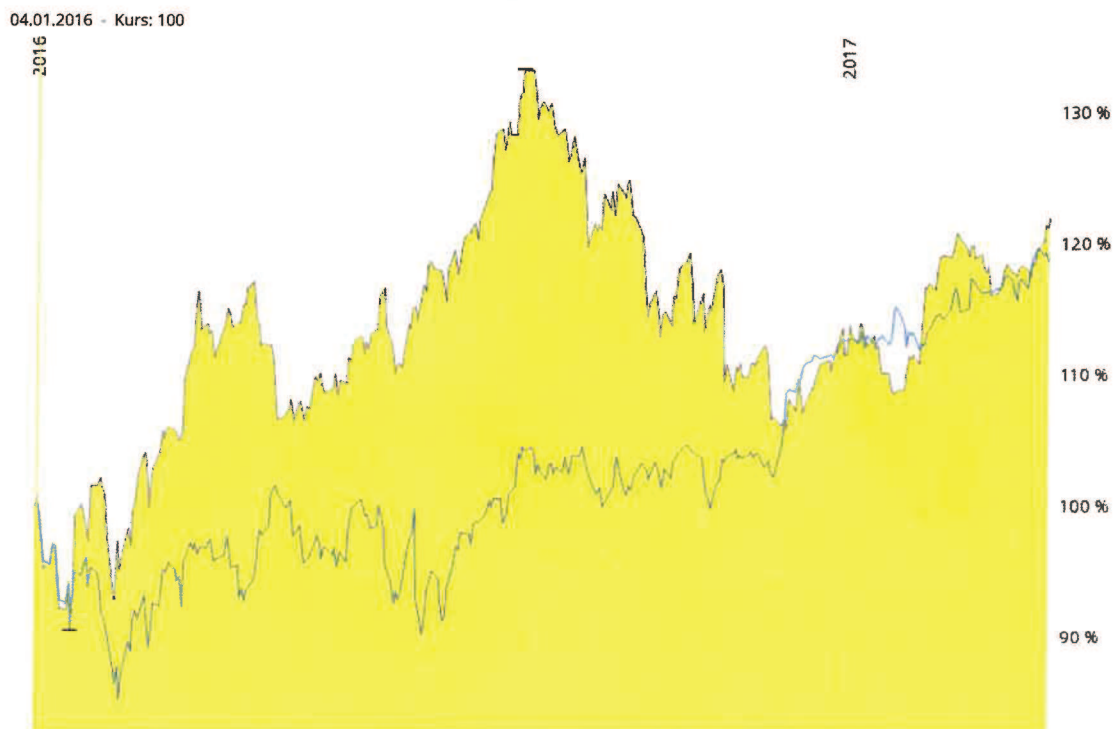
Up to 54 % we are capable to issue mortgage bonds. I am not saying that I want to get there, because who wants to refinance oneself by way of expensive mortgage bonds? This company is coming from a loan to value from beyond 80%. Now, we are at 41 %. One must not forget that we also have increased the equity significantly. Regarding the valuations, nobody in our industry is really worried.

**Vonovia SE 33,81 Euro Share Price as of April 7, 2017, German Stock Exchange Xetra**

Index Price Chart, Index-base as of January 4, 2016 = 100

**-Upper black line: Vonovia SE Share**

**-Lower blue line: DAX German 30 Companies Large Cap Stock Index**



**The 12-months-period which prevented you from making a new attempt for taking over Deutsche Wohnen has elapsed. How quickly an offer will come?**

Presently, this is not a subject for us.

**The Vonovia-boss Rolf Buch mentioned that he has still not written off the merger with Deutsche Wohnen Group. Are you already in talks with them?**

No.

**I am surprised that analysts continue to assume that this merger will come sooner or later, although the shareholders of the Wohnen Group have very explicitly refused to accept this.**

First of all, one has to take account that our shareholders have agreed by 78 %. This is due to that we have more generalist share investors and passive funds among our shareholders. For generalist share investors, size and liquidity are important. By contrast, the specialist share investors want a list of shares from which they can make stock picking. The offers for specialists have been significantly reduced. This started with the Deutsche Wohnen Group which took over the GSWGroup, then we bought the Gagfah Group and Vitus which was close to going public.

**For generalist share investors, size and liquidity are important**

**By contrast, the specialist share investors want a list of shares from which they can make stock picking.**

**Do I understand correctly that you are convinced that the investors would welcome the merger?**

The industrial logic does exist in any case. But I also understand those investors who want to have a choice between the few listed German residential real estate groups. It is also clear that we have less specialists among our shareholders. The large funds like Black Rock or the Norwegian State Fund have been backing the deal.

**With short of 5 % you are still having a participation of Deutsche Wohnen Group. Why do you retain these shares?**

There are three arguments: Firstly, it increases our investments at Berlin, please note that the shares are accounted for in our fixed assets. Secondly, we have confidence in the management –team. Otherwise, I could not justify such a participation internally. The other way round – and this is thirdly – the participation can be liquidated very quickly in case that we need urgently own funds. The investment in Deutsche Wohnen has a market value of 530 million Euro. So far, we have a gain on the

books of short of 130 million Euro and we have received a dividend of 9 million Euro. Not a bad business.

**Are you not enhancing speculations for a merger?**

You are right in so far that every unexplained movement always effects speculations. But we are behaving as a quite normal investor – and we are treated like this by the Deutsche Wohnen-Group.

The interview was made by Annette Becker, Börsen-Zeitung

### **About the person: The Self-Confident**

Stefan Kirsten who is responsible for the finances of Vonovia since 2011, Germany's largest commercial real estate lessor, the rapidly quick thinker is not only strong in calculating by brain, but he also understands to express complicated situations in a generally understandable form. Thereby, he likes to talk about the real world, which makes him so much more interesting as conversation-partner. Or did you already know the new notion of "Shotgun marriage", used in investment banking? Cheekiness together with a sip of self-irony are additives by Kirsten to an interesting conversation.

The professional qualification for the demanding job at the well-oiled M-&-A-machinery Vonovia, the MBA with a doctorate degree does self-evidently have. His first achievements earned the very self-evidently acting man from Berlin at the external auditing firm Arthur Anderson. After this followed employments at Rheinmetall and EMI, before he changed over in 1996 to the merchant group Metro and there made it to the CFO. In 2002, he went in the same position to Thyssen-Krupp. After a short intermezzo between 2007 and 2009 in Dubai at the conglomerate group Majid Al Futtaim, the 56 year old seems to have found his vacation at Vonovia, the former Deutsche Annington Group.

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



Speech

Dr Jens Weidmann President of the Deutsche Bundesbank

## Welcome remarks

at the 9th Annual IIF G20 Conference "The G20 Agenda under the German Presidency"

Frankfurt am Main | 15.03.2017

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- [2 Priorities of the German presidency](#)
- [3 G20 achievements](#)
- [4 Conclusion](#)

### 1 Introduction

Timothy Adams

Ladies and gentlemen

It's a great pleasure for me to welcome you to this conference, which is a joint event of the Institute of International Finance (IIF) and the German G20 presidency.

Many thanks to you, Tim and the IIF team, for organising this conference, which is taking place for the ninth time, this year just ahead of the meeting of G20 finance ministers and central bank governors in Baden-Baden.

The economist John Kenneth Galbraith is quoted as joking that "Business conventions are important because they demonstrate how many people a company can operate without."

I don't want to get too drawn into the merits of his humorous remark, or whether it applies to banking conferences as well, but I will say that there are compelling reasons why this conference is, indeed, an important event.

One reason is that it provides a good opportunity for dialogue between official and private sector leaders. This dialogue is particularly important in such challenging times, which is also reflected in the focus on very topical issues over the next two days.

"A global crisis requires a global solution."

This simple statement by the G20 heads of state or government back in April 2009 – in the middle of the financial crisis – captured the essence of the cooperation between the key industrial countries and emerging market economies. And although the G20 is an informal body – or perhaps precisely for that reason – it is an important source of impetus.

As the financial crisis unfolded, the G20 grew in status to become the dominant forum for economic cooperation worldwide. It played a key role in drawing the right conclusions from the crisis. But the job isn't finished yet. Additional efforts are necessary to make the global financial system more stable and the world economy more prosperous.

There are therefore several issues of global importance on the permanent agenda of the G20 that will continue to be pursued. In this regard, the German presidency is building on the important achievements of preceding presidencies, with the aim of ensuring continuity in the G20's activities. Just think, for example, of the growth strategies of the Brisbane summit or the structural reform agenda of the Chinese presidency last year. And some of you may also remember the debt reduction targets of the Toronto summit.

Beyond continuing the work of the existing G20 work streams, it is also the privilege and, indeed, the duty of every presidency to generate new inputs.

## 2 Priorities of the German presidency

The German G20 agenda rests on three main pillars: building resilience, improving sustainability and assuming responsibility.

To this end, Germany has set three main priorities for discussions between finance ministers and central bank governors and among the G20 working groups within the "Finance Track". These are

- Enhancing resilience
- Promoting investment, especially in Africa; and
- Shaping digitalisation

Let me go a bit deeper into these issues, starting with resilience.

The recent financial crisis has underpinned how important resilience is. While the crisis is considered to have passed, its negative consequences have not yet been completely overcome. Making our economies more resilient means improving their ability to cope with economic shocks, but also responding appropriately to longer-term structural challenges like demographic change or digitalisation.

The more resilient national economies are, the more resilient the world economy is as a whole. In economic terms, strengthening national resilience is a positive externality.

In order to strengthen national resilience, the German presidency is seeking an agreement on a set of principles in Baden-Baden.

Rather than prescribing specific measures or reforms, such principles can act as a guide for G20 members when considering different actions aimed at enhancing the resilience of their economies. Moreover, they complement other ongoing G20 initiatives and priorities, including the 2016 Hangzhou Enhanced Structural Reform Agenda.

The principles on resilience, which are currently being discussed in the G20, should aim to ensure sound public finances and to reduce vulnerabilities in the private sector. With respect to the real economy, they should advocate a favourable business environment, flexible labour

Furthermore, monetary policies should be in line with central banks' mandates and should not overstretch them or undermine the legitimacy of central banks' independence.

Finally, G20 members should remain committed to the principle of open markets and cross-border trade – a point I come back to later in my speech.

The second priority of the German presidency within the Finance Track is related to the objective of stimulating investment, particularly in Africa. In an increasingly interconnected world, it is more important than ever to build global partnerships.

In order to create new and competitive jobs, the conditions for private-sector investment and investment in infrastructure need to be improved. Setting up a 'Compact with Africa' initiative is therefore intended to create better investment conditions, for example by improving legal certainty, making taxation more reliable, and reducing investment risks with the help of international guarantees.

Furthermore, the G20 will provide political support for specific investment agreements between African countries and international organisations and – if desired – with developed partner countries.

In addition, transfers of money from migrant workers to their home countries are an important source of funds for many countries – not only in Africa. In several countries, these remittances account for more than one fifth of GDP and significantly contribute to domestic consumption and investment. The aim is therefore to improve the conditions for frictionless and efficient money transfers. Rules against money laundering and the financing of terrorism are important, but they should be applied in a way that does not discourage banks from providing correspondent banking services.

Last but not least, the third priority of the German presidency relates to digital finance and its implications for the financial sector.

From an economic point of view, digital finance can deliver a wealth of benefits. First of all, digital financial services can bring about significant efficiency gains – and I'm sure all of you know this much more than I do.

But digitalisation can also boost competition within the financial system, because new competitors, like fintechs, are stepping onto the field. What some of you might regard as a threat to your business – because it could intensify the problem of narrowing profit margins among traditional banks – has, on the other hand, a positive impact on overall welfare.

The question of whether digitalisation will lead to a revolution in financial services and infrastructure, as some commentators argue, remains unanswered for the time being, in my view. However, one certainly can't deny that new technologies like blockchain, robo advisors or crowd funding could have the potential to make financial markets and services faster, more efficient, more convenient, and more inexpensive for everyone.

This is why some central banks are carrying out research, especially with regard to the implications of blockchain technology. And the Bundesbank is among them.

To identify the requirements which central banks might need to meet in future in connection with blockchain-based instruments, the Bundesbank and Deutsche Börse AG have jointly

unveiled a prototype for a securities settlement system based on blockchain technology. The idea behind this joint project is to analyse the technological performance and scalability of blockchain-based applications. It is not the intention to issue a digital euro coin.

New technologies may also represent a source of financial stability risk. Herding behaviour, for example, could be amplified by automated advisory services in portfolio management. Robo advisors might exacerbate financial volatility and pro-cyclicality if the assets under management reach a significant level, which is not yet the case.

Pro-cyclicality might result from weaker customer relationships and the interoperability of access points.

This calls for the regulation of fintechs, at least to a certain extent. A lot of corporations using technology-enabled financial innovations operate either on a global scale or carry out a large number of cross-border transactions. Identifying key regulatory issues to safeguard financial stability is therefore a goal that the German presidency is aiming at in cooperation with the Financial Stability Board and other standard-setting bodies.

Another pressing issue in a digitised world is cybercrime. Cyber-attacks can potentially undermine peoples' trust in the financial system. In order to avoid jeopardising the positive impact of digital finance, it will be crucial to address these cyber risks. It is therefore on the Baden-Baden agenda to start work in this area at the G20 level.

A further implication of digitalisation, which was already an important topic at the G20 digitalisation conference in Wiesbaden, in January, is financial literacy.

It is an indisputable benefit that new technological developments have enabled the financial inclusion of people who would otherwise lack access to financial services – for example, there are five countries in Sub-Saharan Africa where more people have a mobile money account than a conventional bank account.

That said, more and more people with insufficient knowledge and understanding of financial concepts and risks are getting easier access to financial services. And this is true not only for developing countries but for industrialised countries, too.

If it becomes easier for people to become their own "fund manager", so to speak, they should at least have basic knowledge of economic concepts like compound interest. Therefore, financial literacy is not just an issue for consumer protection authorities, but also for schools and the financial industry as well.

For central banks, financial education is an issue, too, because effective monetary policy communication relies on people having a basic grasp of concepts such as inflation and interest rates. Ensuring the public has basic knowledge of these issues is therefore important for the success of central banks, as the ability of the latter to maintain price stability depends, not least, on public support for a stability-oriented monetary policy.

Ultimately, all of us should have an interest in consumers being well-informed about financial services.



In addition to the key topics I have mentioned, Germany will also be continuing the G20 agenda in a number of other fields. This includes a further strengthening of the international financial architecture and additional progress on the international regulatory agenda.

### 3 G20 achievements

Ladies and gentlemen

What are the greatest achievements of the G20 so far?

In my view, there are two.

The first is that the G20 member states by and large resisted temptations to implement protectionist measures to stimulate their national economies after the great recession in 2008/09. "Beggar-thy-neighbour" policies were not chosen to improve the economic situation at home at the cost of other economies.

This success was due, not least, to the explicit rejection of protectionism by the G20 and the renewed commitment to an open, global economy.

The other great achievement of the G20 is that, through common efforts, important lessons were drawn from the financial crisis.

All the milestones of regulatory reform were endorsed by the G20. The tightening of bank regulation under Basel III, for example, would hardly have been imaginable without the political support of the G20.

It's now all the more important that these achievements are not given up.

Open markets and a competitive economic system are the pillars on which the prosperity of our economies rests. A greater variety of inexpensive and good-quality products are available on open markets, and this increases citizens' purchasing power. In this way, free trade and competition result in a quantifiable increase in prosperity, particularly for those who have to consider their spending carefully. Moreover, spurred by international competition, industries are more innovative and new ideas are spread more rapidly.

But today we are seeing mounting scepticism of globalisation, a sentiment by no means confined to the United States. In Europe, too, globalisation fears are on the rise and people are increasingly shunning open markets. According to a recent poll, 45% of Europeans view globalisation as problematic, and among the voters of populist parties more than two thirds see globalisation as a threat.

Public concerns like these need to be taken seriously. It can't be denied that globalisation puts particular pressure on certain groups of people. Although open markets boost prosperity overall, they don't necessarily boost it for all people all of the time. But it's also safe to say that barriers and exclusion would be the wrong response to these concerns.

In advanced economies, low-skilled workers feel the pressure of globalisation, particularly those who work in industry sectors that are exposed to low-cost competitors from abroad. And that's why inclusive growth is so important.

In order to have more inclusive growth, however, we need to ensure that enterprises and their employees are properly equipped to harness the opportunities presented by globalisation and technological progress and that they are able to manage structural change.

I already mentioned the need for a favourable business environment. That means, for example, less red tape, limits to increasing social-security contributions or creating innovation-friendly conditions by an efficient product market regulation.

Investment in education and lifelong learning are important for improving employees' adaptability to a changing environment. People who lose their job have to be able to find another position swiftly.

And a target-driven and transparent tax and transfer system is able to act as a cushion for those who are not able to benefit from new job creation. Policy must help those who lose from globalisation, and the positive effects of trade should provide scope for such policies.

Regarding the second great achievement of the G20, I am somewhat concerned, too. While, on the one hand, the regulatory agenda has not been completed yet, calls for de-regulation are on the rise again.

I already mentioned Basel III. I'm fully aware that the implementation of the new standards is challenging for banks worldwide. But the new standards have significantly improved the capital adequacy of the banking system and have made the global financial system more stable. And although banks sometimes criticise the higher capital requirements, a more stable financial system is beneficial for them as well – as greater stability is also reflected in lower funding costs.

Nevertheless, in contrast to the original plans, there was no final agreement on Basel III last year. While most of the residual work has been completed, one important issue still remains unresolved. This is the question of how far credit institutions should be permitted to use their own internal models to determine their capital adequacy requirements for credit risk – or to be precise, whether to fix a lower threshold for capital adequacy requirements calculated with the aid of the internal model and if so, how to calibrate this threshold.

The negotiations on that issue are currently on hold because the positions of the US chief negotiators have not yet been filled. A swift resumption of negotiations would be in our common interest, especially as the ongoing regulatory uncertainty caused by the delay in finalising Basel III is undoubtedly a burden for the banks.

And so I hope that the upcoming meetings in Baden-Baden and Basel will lead to a return to the negotiation table.

Ladies and Gentlemen

One lesson of the financial crisis was that banks, especially the global systemically important ones, need more capital. The second lesson was that public bail-outs of banks should be avoided in future.

And so it is completely understandable that President Trump recently declared, in his executive order of 3rd February, that the prevention of taxpayer-funded bailouts is a core principle of regulation.

That said, achieving this aim also makes it essential to refrain from adopting regulatory measures which would make public bail-outs more likely or which would destroy the level playing field.

Thus, I fully agree with Mario Draghi, who recently said that "the last thing we need at this point is a relaxation of regulation." That does not, of course, exclude us from regularly evaluating our regulation and its effectiveness and fine-tuning it if necessary. But the G20 should stick to its commitment to regulatory reforms and its clear rejection of regulatory arbitrage.

Carrying out deregulation in the hope of stimulating the economy could backfire. Insufficiently regulated financial markets can do significant harm to economic prosperity if a crisis occurs, as the latest financial crisis has painfully demonstrated.

Back in 2013, the then Secretary of the US Treasury, Jack Lew, said that "(...) the global financial crisis (...) underscored the need for strengthening financial sector regulation across the globe. In particular, the crisis highlighted the need for building much stronger and more resilient financial institutions, greater market transparency, and a high quality level playing field across borders that protects against regulatory gaps, arbitrage, and a race to the bottom."

I think this is still true.

## 4 Conclusion

Ladies and gentlemen

On this note, I would like to bring my speech to a close.

In times of uncertainty, international cooperation is particularly important, and we are certainly living in a period of heightened uncertainty at the moment.

In times like these, the G20 is a precious treasure. The German presidency is seeking to guard this treasure and ensure its value is further enhanced.

Thank you for your attention.

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RISK

## SOUTH AFRICA: INTEGRATING COUNTRY AND INDUSTRY LEVEL IDENTIFIED RISKS INTO CORPORATE GOVERNANCE STRUCTURES AS A COLLABORATIVE EFFORT FOR A SUSTAINABLE FUTURE

By **ELSIE MARITZ**, Senior Programme Manager, Human Sciences Research Council (HSRC), Pretoria, South Africa, article provided by SAIBA, the South African IAFEI Member Institute

The call for exceptional leadership and invigorated, integrated corporate governance has never been more appropriate and almost become a cry for our beloved country. Country wide and industry risks for South Africa were recently published in a report by The Institute of Risk Management South Africa (IRMSA, 2017).

The top 10 risks are reflective of real challenges associated with current political instability, economic influences, sociological trends, technological innovations, ecological factors, legislative requirements and industry analysis. Risks in general implies change and thanks to great thought-leaders such as Professor Mervyn

King, there is hope for the country and those who understand the need for rapid change, global and integrated thinking as well as collaborated efforts to curb corruption.

The recent release of King IV (Institute of Directors South Africa (IoDSA), 2016), promotes good corporate governance as:

*“The exercise of ethical and effective leadership by the governing body that results in the achievement of the following governance outcomes: an ethical culture; performance and value creation; effective control; and legitimacy”.*

### Country and Industry level risks

IRMSA published the latest Risk Report on South Africa's risks in January 2017. The Risk Report content was obtained through quarterly risk profile monitoring to capture the country's dynamic risk profile over short intervals. The report contains inputs

from members, risk management professionals in both public and private sector as well as strategy, scenario planning and subject experts. 1557 survey and workshop participants contributed to the report compiled over an 18 month period (IRMSA, 2017:6). Industry participation comprised of:

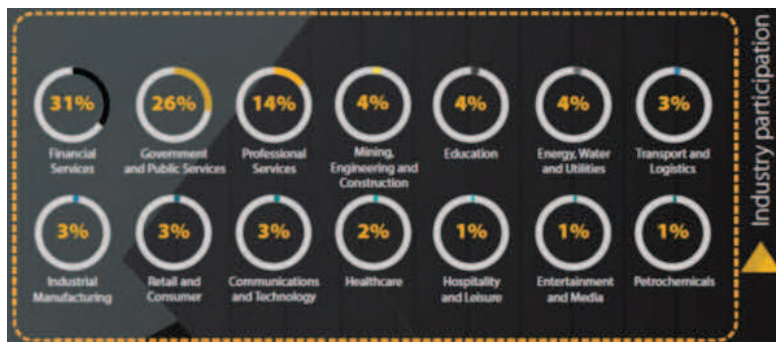


Fig 1 - (IRMSA Report, 2017: 2)

### Results

The top 10 South African Country and Industry level risks were identified as:

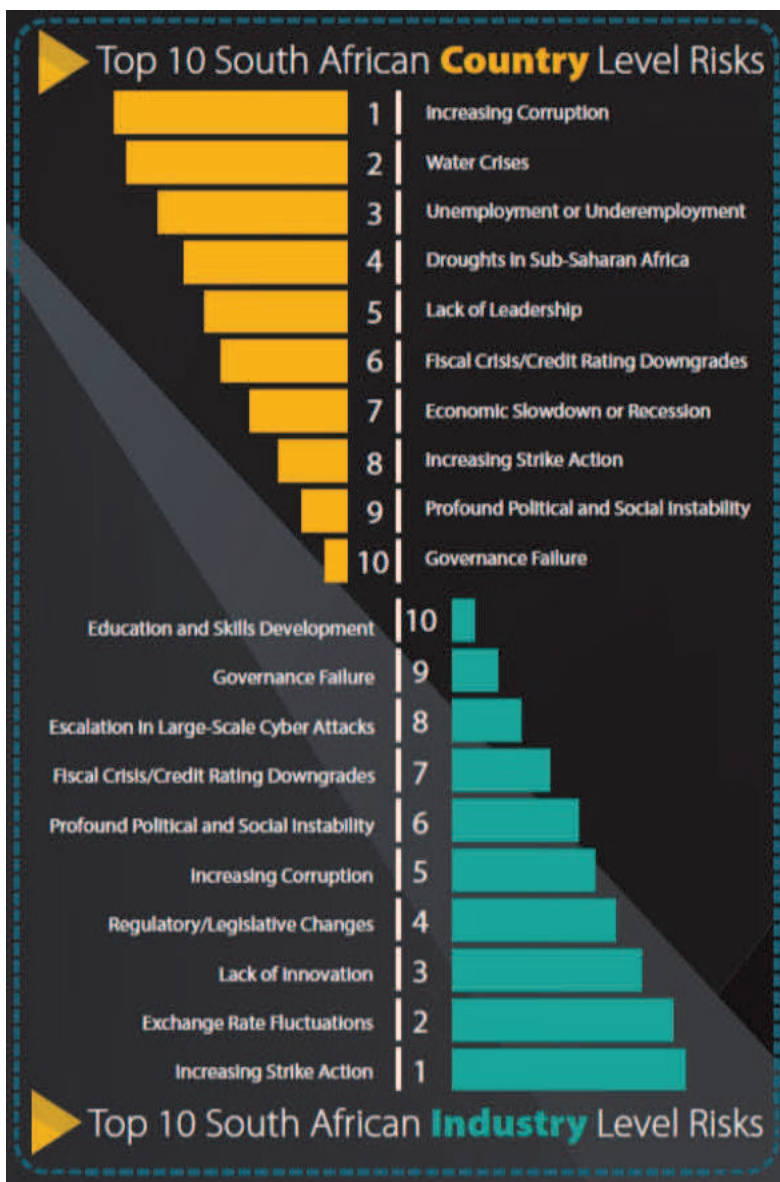


Fig 2 - (IRMSA Report, 2017: 3)

### Key findings

Three key findings emerged from the results (IRMSA, 2017:29):

- There were no major shifts in priority risks or new emerging risks compared to prior year assessments and were reflective of the socio-political and economic landscape of South Africa;
- IRMSA believes that many of the risks can be adequately addressed both at company and country level with a recommendation of sectorial coordination for more inclusive and collaborative efforts; and
- Placing governance at the centre of risk management is imperative to re-emphasise the importance of transparent and legitimate positions of organisations during a volatile and dynamic period in light of continued resource constraints and lack of “managing confidence”.

IRMSA identified risks, also feed into the efforts to support realisation of the National Development Plan (NDP) of South Africa (IRMSA, 2017:29). The socio-economic drivers that shaped the prioritised risks, encouraged new approaches to governance through influenced policy to address our challenges. Responsive and responsible leadership are required and participation in early stages of policy development was recommended to avoid reactive responses, once policies are passed and signed into law (IRMSA, 2017:29).

Feedback from subject matter experts on specific risks in affected industries was also provided. Of critical importance is the responses from the experts on the risks associated with “Lack of Leadership” and “Governance Failure” (IRMSA, 2017:63-63 & 84-90). Feedback was provided in the form of responses to specific questions centred on the relevance and impact of the risks in achieving the NDP objectives for South Africa.

#### Lack of Leadership

For the question, “What is your opinion of this topic as a risk to the achievement of the NDP objectives for South Africa?” the below responses were provided (IRMSA, 2017:63-64):

*“Lack of leadership will result in difficulty in achieving the NDP objective of eradication, poverty, reducing inequality and creating more employment opportunities” – (South African Institute of Entrepreneurship, 2017:63)*

*“It is the most crucial aspect for delivering on the NDP objectives. The current lack of leadership is directly responsible for the current precarious state of affairs*

*that South Africa finds itself in” – (T Singh, 2017:64)*

Primary causes identified for the lack of leadership risk were (IRMSA, 2017:63-64):

- Widespread corruption;
  - Outdated and irrelevant political system;
  - Non-service delivery;
  - Misguided policies; and
  - A social view that leadership is about self-serving instead of society serving individuals
- Both experts listed government and public services as the most affected industry if the risk materialises. Political revolution, strong active citizenry, strengthening of national institutions to address leadership and corruption were provided as appropriate risk responses to address the risk on a National level.

#### Governance Failure

For the question, “What is your opinion of this topic as a risk to the achievement of the NDP objectives for South Africa?” the below responses were provided (IRMSA, 2017:84-90):

*“Economic development depends on trust and on a dependable law and order system. Any failure of these will reduce the ability of the economy to provide for poverty alleviation, economic growth and employment opportunities” – (C van Wyk, 2017:84)*

*“Governance failure risk does pose a threat to the achievement of the NDP objectives for South Africa, as sustainable business (in all sectors) has a significant role to play in achieving the NDP goals of poverty reduction, economic growth, economic transformation and job creation, amongst others. King IV defines corporate governance (CG) as a leadership issue. Leadership cannot exist in a vacuum and King IV supports it through setting sustainable development as the ultimate goal for organisations. The NDP objectives give content/effect to the quest for sustainable development so there is a good fit between CG and NDP” – (P Natesan, 2017:86)*

*“In broad terms, the NDP is currently the country’s overarching strategy, whereby the South African government has set out an ambitious set of goals to reduce poverty, as well as transform and improve the country’s ailing economy. Clearly without new jobs being created, and such where the relationships between government business and civil society remains volatile, these goals will be difficult to achieve; and they will remain a set of goals without any real tangible value or benefit” - (T Booysen, 2017:90)*

Primary causes identified for the governance failure risk were (IRMSA, 2017:84-90):

- Economic decline;
- Disjointed decision making;
- Incoherent long term strategies;
- Absence of Integrity, Competence, Responsibility, Accountability, Fairness & Transparency;
- Inept leadership, low benchmarks and standards;
- Government fails to set the “tone from the top”, ineffective and unskilled leadership;
- Increased factionalism in governments groups;
- Compliance of King IV seen as another regulatory framework opposed to a value-add proposition; and
- Failure to apply and explain King IV;
- The experts highlighted two sectors that could be affected most if the risk materialises and these relates to professional services as well as government and public services. Recommended risk responses to address the risk at a National level incorporated views of better leadership, accelerated forward political thinking, holding governance role players accountable for the lack of ethical and effective leadership, a shift in focus on governance outcomes as advocated in King IV, moving away from a “tick box” approach and Training directors according to the IoDSA Director Competency Framework (IRMSA, 2017: 84-90).

#### **King IV in supports ethical & efficient leadership**

King IV is not a legislative document but the attention it draws upon release or review provides an authenticity per excellence. King IV differs from King III in the sense that the report endeavours to shift the mind set of authorities, executives and those responsible for good governance to move from regulatory “tick box” functioning to integrated thinking and pushes the boundaries to an approach of value-adding, outcome based performance that fosters an ethical culture with effective controls to gain greater shareholder confidence, taking into consideration the complexities of various landscapes and emerging risks.

King IV also highlights the importance and acknowledgement of a “good corporate citizen” status, similar to one of the recommendations from IRMSA to mitigate the ‘lack of leadership risk’. IRMSA on the other hand supports a number of principles of the King IV report but one that specifically stands out is that governing bodies should display

characteristics (individually and organisational) of integrity, competence, responsibility, fairness and transparency which are embedded in organisational strategy and outcomes (IoDA SA, 2017).

King IV also incorporates local and international developments on the governance front and provides critical guidance of remuneration issues and strengthening the case for professional directors (IoDA SA, 2017).

King IV further emphasize the importance of risk management as an integral part of decision making in setting and achieving strategic objectives which articulates the importance of planning, monitoring and continuous evaluation to understand the constant changing environments in which good governance need to anchor itself for the purpose of a sustainable future.

*(Please note that the views, opinions and positions expressed by the author is her own and do not necessarily reflect the views, opinions or positions of her employer).*

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South African Reserve Bank  
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## RECENT DEVELOPMENTS IN INTERNATIONAL AND DOMESTIC FINANCIAL MARKETS AND THEIR IMPLICATIONS

Remarks by **DANIEL MMINELE**, Deputy Governor of the South African Reserve Bank, at the annual Financial Markets Department cocktail function, Pretoria, 4 April 2017

Good evening, ladies and gentlemen.

It is once again that time of the year when we welcome you all to the annual cocktail function of the Financial Markets Department of the South African Reserve Bank (SARB). Thank you for accepting our invitation and joining us tonight.

### **Introduction**

As you are aware, the main idea behind this function is to create a networking opportunity between SARB staff members and other market participants in order to facilitate an exchange of views on financial market developments in a more relaxed environment. This annual event also provides an opportunity for us as the central bank to convey our appreciation for the cooperation we have been receiving from market participants over the past year, both in the execution of open market operations and when we conduct financial markets research to enhance our understanding of market dynamics. These interactions

are crucial for our role in the financial markets as we seek to give effect to the monetary policy stance which underpins the execution of our price stability mandate.

My colleagues in the Financial Markets Department remind me every year that this is not the occasion to deliver my 'speech of the year' but that I am merely a curtain-raiser to the main event, namely conducting 'special' liquidity management operations.

In welcoming you to the SARB, allow me to make a few remarks to take stock of the recent developments in international and domestic financial markets and their implications, last year's cocktail function being the reference point. Before I conclude I would also like to touch briefly on market conduct issues. I will try and heed the advice that Franklin D. Roosevelt once gave: "Be sincere, be brief, be seated."

## Developments in global financial markets

Since the previous cocktail function, policy uncertainty has come to dominate price action in global financial markets. Among other things, this is due to what Marvin Barth has called the ‘politics of rage’<sup>1</sup>, referring to the rise in anti-globalisation sentiment, populist rhetoric, and countries increasingly turning inward. While an element of this uncertainty may have diminished, at least as far as the election outcomes in certain parts of the world are concerned, the outcomes themselves have ushered in a period of unusually high levels of uncertainty as regards policy direction, the timing with regard to the adoption of policies as well as the likelihood of successful implementation. The risks stemming from the possible election outcomes across Europe this year appear to be receding, but one thing last year taught us is that impossible things are possible.

As a result of this, global financial markets may well be in for further bumpy rides, not least because market risk indicators such as high-yield corporate bond spreads, the spread on foreign currency emerging market debt, and general equity market volatility – which often reflect investor nervousness – remain low, pointing to a possible dislocation that could understate the downside risk profile to economic growth. Nevertheless, as is the norm, markets have moved ahead of ‘the fact’, for instance pricing in a higher trajectory for US<sup>2</sup> economic growth. Analysts expect real GDP<sup>3</sup> in the US to average 2.2% in 2017<sup>4</sup>, more or less in line with the median projection of the Federal Open Market Committee (FOMC). The positive momentum in terms of growth prospects is not confined to the US and is relatively broad-based, particularly when it comes to advanced economies.

Against a backdrop of an improving growth trajectory, economic policy uncertainty presents a new challenge for the already complex environment in which central banks operate – more so because the actual and expected inflation figures are seemingly on an uptrend. For central banks, who have said for so long that rising inflation is a necessary precursor to ‘normalising’ their policies, the macro-financial implications of this increasingly uncertain political environment could complicate monetary policy normalisation. As the forward guidance thresholds are being reached, the question remains whether central banks (specifically those in Europe) will once again re-emphasise the

broader notion of economic slack that may result from the current political landscape as an additional qualitative feature of their policies. The UK<sup>5</sup> facing headline inflation that is now above the central bank’s official target and, on the other hand, threats to its economic growth is a classic example. The US is in a slightly different position. Having gradually lowered the projected path of its policy rate since the time of our previous cocktail function, the FOMC changed its course in September 2016 and revised upwards the future path of interest rates that it deems most likely to foster outcomes for economic activity and inflation that best satisfy its dual mandate. The FOMC’s projections now point to two additional 25 basis point increases in the federal funds rate following the March hike. These expectations are in line with those implied from Fed funds futures and are also evident in the pricing of US currency and fixed-income markets. The US dollar index has appreciated by 6.2% since April 2016, reflecting the change in the outlook for US monetary policy. At the same time, the US Treasury curve has bear flattened, with yields at the shorter end rising by as much as 60 basis points.

In the emerging market economies, things look slightly better than over the previous year. Soon after last year’s cocktail function, we noted an increase in the universe of negative-yielding bonds that, in an environment dominated by the search for yield, benefited certain emerging markets. During this period, yields on emerging market local- and hard-currency debt declined and equities rallied, but currencies presented a mixed picture, although in most cases still with an appreciation bias. The rally in emerging market assets was largely driven by signs of stabilisation in China’s economy and financial markets, a rebound in energy and other commodity prices, and more supportive central bank policies in developed markets. Furthermore, on the back of the last-mentioned, net capital flows to emerging economies (excluding China) peaked at US\$26.1 billion in June 2016, according to estimates by the Institute of International Finance. However, after this June peak and for the remainder of 2016, the build-up to and outcome of the US presidential election sparked a wave of outflows from emerging markets, with portfolio flows estimated to have plummeted to a 41-month low as the so-called ‘Trump Trade’ favoured a stronger US dollar and higher US yields. Emerging market capital flows have since rebounded across the major developing regions but potential headwinds persist, especially given that it cannot be argued that such were in any way related to a change in economic fundamentals.

1 Marvin Barth, *The Politics of Rage*, 2016, Barclays, United Kingdom.

2 United States

3 Gross domestic product

4 This was the Bloomberg median forecast as at 23 March 2017

5 United Kingdom

## Developments in domestic financial markets

Price action in the South African markets was more or less in line with that of other developing economies. The most notable development has been the strengthening of the rand which, by last week, had appreciated to a low of R12.31 against the US dollar since our previous cocktail function. This was the strongest that the rand had traded since mid-2015. On a trade-weighted basis, the South African currency had appreciated by about 19%.

This rally can be attributed to a number of factors, including the pickup in commodity prices, investor positioning, and a reprieve from international credit rating agencies regarding a possible downgrade of South Africa to sub-investment grade. The rand was also supported by more favourable terms of trade and an improvement in the current account balance that has reduced the perceived vulnerability of the currency to possible capital flow reversals. This made the rand more resilient even during externally induced risk-off episodes, appreciating alongside a stronger US dollar and/or depreciating by less compared to its emerging market peers.

Other financial assets followed a similar path of appreciation over the year. Bond yields rallied and breakeven inflation declined. The yield on the benchmark R186 bond had declined from just over 9% a year ago to a low last week of 8.32% while breakeven inflation on the R197 (5-year) inflation-linked bond declined from 7.2% in April last year to around 5.8% last week. With the lower inflation expectations, the (FRA) market had, by last week, priced in more than one rate cut by the first quarter of 2018, with the 12x15 FRA trading below 7.0%.

The Monetary Policy Committee (MPC) noted the improvement in the inflation outlook, which over the past year had allowed multiple downward revisions to the forecast, and expressed last week, at the conclusion of its most recent meeting, the view that we may have reached the end of the moderate tightening cycle. According to our most recent forecast, we expect headline inflation to fall below 6% in the second quarter of 2017 and to remain within the target range for the remainder of the forecast horizon. Notwithstanding the fact that there was one member of the MPC who preferred a 25 basis point reduction in the repo rate at the March meeting, the general feeling was that evidence of a more sustained improvement in the inflation outlook is required before interest rates

can be reduced. The MPC remains concerned about the elevated levels of inflation expectations that are still around the upper end of the inflation target band.

As you are aware, some of the positive trends we had been observing were interrupted by political events during the last week, which triggered a significant movement in the financial markets. Since last Monday, the rand traded in a range of 163 cents, between its strongest level of R12.31 to the dollar on Monday and its weakest level of R13.94 around midday today. The currency did, however, appreciate somewhat and was at levels of around R13.55 to the dollar earlier this afternoon. The R186 yield also lost most of the gains it had made last year and is now trading at just above 9.0%. The 12x15 FRA is back to 7.49%, implying an unchanged repo rate for next year.

Financial markets will likely need more time to fully process the recent political events and their economic consequences. It remains to be seen whether the recent market developments represent a reassessment or a repricing of the South African credit. It is similarly too early to draw any firm conclusions on how these developments will affect SARB's own inflation forecasts. The MPC has previously cautioned that, should some of the factors which had contributed to a more favourable outlook reverse and undermine the inflation outlook, it may reassess its views; the MPC stands ready to respond appropriately in line with its mandate should the need arise.

Yesterday's decision by S&P Global Ratings to lower South Africa long-term foreign currency sovereign credit rating to sub-investment grade, with a continuing negative outlook, is a serious setback for the country. We will now need to redouble our efforts in providing assurance and communicating continued commitment to sound macro-economic policies and their consistent and predictable implementation, so as to reverse the current ratings trajectory. This will require a continued collaborative effort between Government, business and labour to boost domestic and international investor confidence.

## Market conduct developments

Before I conclude, let me touch on an issue that has been receiving some attention recently. While it is true that traders and investors need to continually evaluate the fundamental drivers of asset prices, the behaviour of market participants should always meet the highest conduct standards. Ensuring and continuously promoting adherence to high standards of ethical conduct is an integral part of contributing to the efficiency, integrity and reputation of our financial markets.

The Competition Commission of South Africa has referred for prosecution to the Competition Tribunal allegations of collusive and therefore unlawful practices among certain financial institutions in their foreign exchange trading operations involving the rand. As stated previously, the SARB views these allegations in a very serious light and is of the view that those found to have violated the law should accept full responsibility and bear the consequences. However, it is also important that we do not jump to conclusions and allow the steps now initiated to be completed, following due process.

Building on the review of foreign exchange operations of local authorised dealers conducted in 2015, National Treasury, the Financial Services Board and the SARB will soon embark on a more comprehensive review of conduct in the wholesale money, debt capital, foreign exchange, commodities and derivatives markets in South Africa in order to strengthen market conduct. The exercise is expected to be similar to the Fair and Effective Markets Review conducted in the UK. The review, which is scheduled to commence next month (with further details to be announced in due course), will look at the standards and practices in South Africa's wholesale financial markets, both regulated and unregulated, in terms of governance, accountability and incentives; it will ultimately develop recommendations for overall conduct standards to enhance the integrity of our financial markets.

The Bank for International Settlements is in the process of developing a Global Code of Conduct for Foreign Exchange Markets which will set out the principles of good practice in the foreign exchange market. The code will be released on 25 May 2017. The SARB participated in its development and is now in the process of consulting with a wide range of market participants via the Foreign Exchange Subcommittee of the Financial Markets Liaison Group with the view that

South Africa should be an early adopter of the code within any proposed time frames.

## Conclusion

Let me conclude by once again expressing, on behalf of the Financial Markets Department and the entire SARB, our appreciation to all the market participants for their cooperation and support over the years. We look forward to continuing our interactions in the future.

I would like to thank our financial markets team for the sterling work over the past year, for their dedication and commitment to the task.

Allow me to also draw to your attention some changes that have taken place in the senior management of the Financial Markets Department. In preparation for the upcoming retirement of Mr Callie Hugo in 2018, with effect from 01 April 2017 Callie assumed the role of Special Projects Manager in the office of the Head of Department. Mr Zafar Parker, who previously headed up our Reserves Management team, has taken over from him as Head: Market Intelligence and Operations this week. While Callie still has his work cut out for 15 months or so, it is only proper that we already thank him today for his tremendous contribution in guiding our money market operations over many, many years.

Thank you also to our staff at the Conference Centre for organising this event.

As in previous years, a newsletter called FMD Update has been prepared for the occasion, which provides information on some of the key strategic initiatives that the Financial Markets Department is involved in. It is available for you to take home, but you can also find it on our website.

Thank you for your attention. Enjoy the rest of the evening.



**South African Reserve Bank**

# TAX AVOIDANCE

## WHAT IS THE PPT RULE AND WHY SHOULD I BE CONCERNED?

### PPT IS PART OF THE ANTI-ABUSE RULES PACKAGE OF THE OECD PROJECT ON BEPS, BASE EROSION AND PROFIT SHIFTING

By **LUIS VÁZQUEZ RUIZ**, Member of the National Technical Committee of Fiscal Studies, of IMEF, the Mexican IAFEI Member Institute , April 2017

Of the 15 actions of the Base Erosion Profit Shifting (“BEPS”) project from the Organisation for Economic Co-operation and Development (“OECD”), several of these are directly involved tax treaties and their supposed abuse by taxpayers. These actions are Preventing the Artificial Avoidance of Permanent Establishment Status (“BEPS Action 7”), Preventing the Granting of Treaty Benefit in Inappropriate Circumstances (“BEPS Action 6”) and, of course, Developing a Multilateral Instrument to Modify Bilateral Tax Treaties (“BEPS Action 15”). The purpose of this document is to briefly summarize and raise concerns about a mechanism that was developed in BEPS Action 6 and incorporated in the Multilateral Instrument resulting from the work of BEPS Action 15. This anti-abuse mechanism is the Principal Purpose Test (“PPT”).

The PPT is part of the anti-abuse rules package that are included in the Multilateral Instrument that will simultaneously modify the existing double tax conventions executed between the parties that will sign the Multilateral Instrument.

Moreover, the PPT, alongside the Limitation on Benefits (“LOB”) clause, forms part of the minimum standard. This means that the PPT rule may not be necessarily elective for the signatories of the Multilateral Convention, except when other similar measures, such as the LOB are already part of the relevant double tax convention. As the main anti-abuse mechanism that makes up the Multilateral Instrument (because it is part of the minimum standard), the application and interpretation of the PPT rule has become of the utmost importance when structuring cross-border transactions.

#### Background and Context

Before directly analyzing the PPT rule, it is necessary to discuss the context where it was developed, which is relevant to understand and interpret such mechanism.

The G20 charged the OECD to develop an action plan to address BEPS, providing countries with domestic and international instruments that will better align rights to

tax with economic activity<sup>1</sup>. The action plan included two relevant actions that eventually derived in what we now know as the PPT rule: BEPS Action 6 and, of course, BEPS Action 15.

The purpose of BEPS Action 6 is to *Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. Work will also be done to clarify that tax treaties are not intended to be used to generate double non-taxation and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country. The work will be co-ordinated with the work on hybrids*<sup>2</sup>.

The purpose of BEPS Action 15 is to *Analyse the tax and public international law issues related to the development of a multilateral instrument to enable jurisdictions that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties. On the basis of this analysis, interested Parties will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution*<sup>3</sup>.

Given that BEPS Action 15's purpose is to collect and organize the measures that should be included in the Multilateral Instrument, the latter collected the measures that were developed as part of BEPS Action 6, including the PPT.

### What is the PPT rule?

The principal purpose of tax conventions is to promote the economic ties between the parties to that convention, namely direct investment and exchange of goods and services, as well as the movement of capital and persons. Additionally, tax conventions also aim at preventing tax avoidance and evasion<sup>4</sup>.

Furthermore, tax conventions have a guiding principle, which is in line with the bona fide application of treaties contained in the Vienna Convention on the Law of Treaties, that states that treaty benefits should not be afforded where the main purpose of entering into certain transactions or arrangements was to secure a more favorable tax position

1 idem. Page 13.

2 Idem. Page 19.

3 Idem. Page 24.

4 OECD (2014), Model Tax Convention on Income and on Capital: Condensed Version 2014, OECD Publishing. Paragraph 7 of commentary to article 1. [http://dx.doi.org/10.1787/mtc\\_cond-2014-en](http://dx.doi.org/10.1787/mtc_cond-2014-en)

and obtaining a more favorable treatment<sup>5</sup>. In other words, treaty abuse should be sanctioned by denying the treaty benefit it aims at obtaining.

Treaty shopping has been depicted in the BEPS project as one of the many treaty abuse practices that the OECD has identified as a factor in reduced tax collection. In essence, tax treaty could be described as the practice of taking advantage of a jurisdiction's tax treaty network in order to enjoy the benefits derived from such tax conventions. These benefits may include straightforward benefits, such as reduced withholding and exemptions or other much more complex. The PPT is part of the new provisions developed by BEPS Action 6 in order to combat tax abuse, particularly treaty shopping. The PPT is part of the three-pronged approach proposed by the BEPS Action 6 Final Report<sup>6</sup>, which includes acknowledgment that double non-taxation is not the purpose of a tax convention and the LOB clause.

In essence, double tax conventions require the following requirements to enjoy treaty benefits: a) qualify as a person; b) qualify as a resident of a Contracting State; and, where applicable<sup>7</sup>, c) meet the LOB requirements.

In addition to these requirements, the new PPT rule would deny treaty benefits to a resident of a Contracting State if one of the principal purposes of entering into an arrangement or transaction is obtaining such treaty benefits. The benefits that a Convention grants to a taxpayer evidently includes<sup>8</sup> the measures to avoid double taxation (e.g., reduced withholding rates, exemptions, credits), but may also restrict other benefits provide by the Convention such as application of the non-discrimination clause.

The PPT rule's language is the following:

#### Article 7 – Prevention of Treaty Abuse

*1. Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any*

5 Idem. Paragraph 9.5 of commentary to article 1.

6 OECD (2015), Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264241695-en>. Paragraph 19.

7 Before being introduced in the Multilateral Instrument and BEPS Action 15, the LOB clause was not included in the OECD Model Convention, but instead was originally developed by the US and included in the US Model Tax Treaty.

8 OECD (2015), Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264241695-en>. Paragraph 7.

*arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement.*

The PPT rule contains several elements, which are as follows:

- a) Reasonability to conclude
- b) Based on all relevant facts and circumstances
- c) Obtaining a benefit under the Convention was one of the principal (not the most important nor the only one) purposes of any arrangement or transaction that resulted in the benefit
- d) Except when granting the benefit is in accordance with the purpose of the Convention.

The first and second element are very closely linked, as these relate to the evidence to conclude that the PPT rule should apply to a specific case and thus, denying treaty benefits should follow. The reasonability and facts-and-circumstances tests do not require conclusive evidence<sup>9</sup> as to the intent and purpose of a transaction. However, the fact that a benefit has been afforded under the Convention does not automatically derive in concluding that the purpose of a given transaction was to obtain such benefit.

Therefore, all relevant facts and circumstances must be analyzed and, based on a reasonable analysis, conclude whether one of the arrangement or transaction's purpose was to enjoy a treaty benefit; the taxpayer's mere assertion regarding the principal purposes behind the transaction is not sufficient to support conclude the analysis. If no reasonable explanation for executing a transaction can be provided, then, it is reasonable conclude that obtaining the tax benefit was one of principal purposes driving the transaction.<sup>10</sup>

Regarding the third requirement, it must be pointed out that the PPT rule does not require the purpose of obtaining a benefit to be the sole purpose or the main purpose.<sup>11</sup> Obtaining a benefit among other purposes should suffice to fall under the PPT rule. This is a departure from the commentary to the OECD Model Convention that we have already described, given that the commentary states that obtaining the treaty benefit should be the main purpose<sup>12</sup>.

This departure may derive in very different circumstances and we will illustrate

9 Idem. Paragraph 10.

10 Idem. Paragraph 11.

11 Idem. Paragraph 12.

12 OECD (2014), Model Tax Convention on Income and on Capital: Condensed Version 2014, OECD Publishing. Paragraph 9.5 of commentary to article 1. [http://dx.doi.org/10.1787/mtc\\_cond-2014-en](http://dx.doi.org/10.1787/mtc_cond-2014-en)

The only exception afforded to a transaction that falls under the PPT rule is that granting treaty benefits to the taxpayer falls within the purposes of the Convention.

As opposed to the already existing requirements for granting treaty benefits to a taxpayer, the PPT rule is subjective. Tax Conventions contain definitions of person and tax residence; hence, making these requirements objective. The LOB clause contains several tests that are also objective.

In contrast, the PPT rule contains factors, such as "reasonability" and "subject to all relevant facts and circumstances" that make the analysis purely subjective. This makes its application and interpretation particularly complex.

This is further complicated by the exception where granting treaty benefits is in line with the Convention's purposes. Some of these complexities will be addressed in the following section, after we explain the relevance of the PPT rule and how this mechanism will function as part of the Multilateral Instrument, which explains why the PPT rule has become extremely relevant for cross-border transactions and structures.

#### **How does the Multilateral Instrument work?**

The BEPS Action Plan and particularly, BEPS Action 15, resulted in the Multilateral Instrument<sup>13</sup>.

The purpose of the Multilateral Instrument is to simultaneously modify the existing bilateral (and some rare multilateral) conventions currently in place. By doing so, the governments party to the Multilateral Instrument would avoid having to enter into particular protocols to amend such existing treaties, which can be extremely complex and slow in implementing.

Thus, the Multilateral Instrument will modify, but not amend, the existing conventions. The Multilateral Instrument will supersede (without amending) the provisions of the existing conventions, where the latter are not compatible with the former<sup>14</sup>.

The Multilateral Instrument is extremely flexible, as its purpose is to incorporate new rules into the existing conventions, which vary widely. It allows States to elect which sections will be adopted by means of an opt-out mechanism (e.g., arbitration clause). However, the signatory States must adopt a minimum standard, in order to insure the instrument's efficacy. As explained above, the

13 <http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm>

14 OECD (2015), Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 -2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264241688-en>. Pages 43 et seq.

PPT rule is part of that minimum standard. Therefore, the PPT rule should, in principle, become a part of many of the existing tax conventions.

On 24 November 2016, the members of the ad hoc Group on the Multilateral Instrument concluded the negotiations on the text of the Convention. A first high-level signing ceremony is expected to take place in early June 2017.<sup>15</sup>

As a requirement for the Multilateral Instrument to enter into force, five jurisdictions must have signed it and deposited the instrument of ratification. Then, the Multilateral Instrument will enter into force on the first day of the month following a period of three months following the fifth deposit of the instrument of ratification. With respect to the subsequent signatories, the Multilateral Instrument shall enter into force on the first day of the month following a period of three months following the deposit of the instrument of ratification by that particular signatory. Additionally, for the Multilateral Instrument to effectively modify an existing convention, the parties to that convention must all be signatories to the Multilateral Instrument. Over 100 jurisdictions have participated in the negotiation of the Multilateral Instrument and it could potentially modify over 2000 existing conventions<sup>16</sup>. Therefore, the breadth of the implications for treaty networks is astounding.

### Relevant Examples of PPT rule Application

The subjectivity of the PPT rule evidently raises some questions of application, particularly, given that the jurisdictions that will enter into the Multilateral Instrument have their own particular tax law and their own court history. Consequently, a particular set of facts will not necessarily be construed similarly by two different tax administrations. With this in mind, the OECD included examples in BEPS Action 6 in order to guide how the PPT rule should be applied and, in a way, create a basic general understanding of the mechanism. Below are some relevant examples (although all are relevant) that may illustrate the most common application of the PPT rule for commonplace (over)simplified structures or transactions.

#### Transfer of Receivable

*Example A: TCo, a company resident of State T, owns shares of SCo, a company listed on the stock exchange of State S. State T does not have a tax convention with State S and,*

15 OECD (2017), Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting – Information Brochure. <http://www.oecd.org/tax/treaties/multilateral-instrument-BEPS-tax-treaty-information-brochure.pdf>

16 OECD (2017), Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting – Information Brochure. <http://www.oecd.org/tax/treaties/multilateral-instrument-BEPS-tax-treaty-information-brochure.pdf>

*therefore, any dividend paid by SCo to TCo is subject to a withholding tax on dividends of 25 per cent in accordance with the domestic law of State S. Under the State R-State S tax convention, however, there is no withholding tax on dividends paid by a company resident of a Contracting State and beneficially owned by a company resident of the other State. TCo enters into an agreement with RCo, an independent financial institution resident of State R, pursuant to which TCo assigns to RCo the right to the payment of dividends that have been declared but have not yet been paid by SCo. In this example, in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that one of the principal purposes for the arrangement under which TCo assigned the right to the payment of dividends to RCo was for RCo to obtain the benefit of the exemption from source taxation of dividends provided for by the State R-State S tax convention and it would be contrary to the object and purpose of the tax convention to grant the benefit of that exemption under this treaty-shopping arrangement<sup>17</sup>.*

The facts and circumstances described in this example do not offer any additional insight as to other purposes for the transaction and thus, concludes that treaty benefits should be denied. Other similar examples exist for denying treaty benefits where title over income is transferred to another entity that can enjoy treaty benefits. One particular example relates to interest income, where the creditor transfers the right to collect the interest to a financial institution that is entitled to treaty benefits.

#### Holding Company

*Example G: TCO, a company resident of State T, is a publicly-traded company resident of State T. It owns directly or indirectly a number of subsidiaries in different countries. Most of these companies carry on the business activities of the TCO group in local markets. In one region, TCO owns the shares of five such companies, each located in different neighbouring States. TCO is considering establishing a regional company for the purpose of providing group services to these companies, including management services such as accounting, legal advice and human resources; financing and treasury services such as managing currency risks and arranging hedging transactions, as well as some other non-financing related services. After a review of possible locations, TCO decides to establish the regional company, RCO, in State R. This decision is mainly driven by the skilled labour force, reliable legal system, business friendly environment, political stability, membership of a regional grouping, sophisticated banking industry and the comprehensive double taxation*

17 OECD (2015), Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264241695-en>. Paragraph 14.



*treaty network of State R, including its tax treaties with the five States in which TCO owns subsidiaries, which all provide low withholding tax rates. In this example, merely reviewing the effects of the treaties on future payments by the subsidiaries to the regional company would not enable a conclusion to be drawn about the purposes for the establishment of RCO by TCO. Assuming that the intra-group services to be provided by RCO, including the making of decisions necessary for the conduct of its business, constitute a real business through which RCO exercises substantive economic functions, using real assets and assuming real risks, and that business is carried on by RCO through its own personnel located in State R, it would not be reasonable to deny the benefits of the treaties concluded between State R and the five States where the subsidiaries operate unless other facts would indicate that RCO has been established for other tax purposes or unless RCO enters into specific transactions to which paragraph 7 would otherwise apply (see also example F in paragraph 15 below with respect to the interest and other remuneration that RCO might derive from its group financing activities).*

In this example, the selection for a location of a holding company may be validly taken considering entitlement to treaty benefits, provided that the holding company has economic substance (carries on actual functions and assumes real risks). The relevance of this example is that, although one of the drivers for establishing the entity in a treaty jurisdiction is treaty benefits, the PPT rule is not triggered, because the transaction does not qualify as abusive. In other words, having a wide treaty network may be validly considered as a factor in determining the location of an entity. However, this entity should have economic substance. Furthermore, given that, in this example, the need for creating a holding company existed, and the creation of the subsidiary resulted in increased investment in a treaty jurisdiction, the entitlement to treaty benefits should not be construed as contrary to the purpose of the conventions.

#### Cash pooling<sup>18</sup>

Example F: TCO is a publicly-traded company resident of State T, which does not have a tax treaty with State S. TCO is the parent of a worldwide group of companies, including RCO, a company resident of State R, and SCO, a company resident of State S. SCO is engaged in the active conduct of a trade or business in State S. RCO is responsible for coordinating the financing of all of the subsidiaries of TCO. RCO maintains a centralised cash management accounting system for TCO and its subsidiaries in which it records all intercompany payables and receivables. RCO is responsible for disbursing or receiving any cash payments required by

transactions between its affiliates and unrelated parties. RCO enters into interest rate and foreign exchange contracts as necessary to manage the risks arising from mismatches in incoming and outgoing cash flows. The activities of RCO are intended (and reasonably can be expected) to reduce transaction costs and overhead and other fixed costs. RCO has 50 employees, including clerical and other back office personnel, located in State R; this number of employees reflects the size of the business activities of RCO. TCO lends to RCO 15 million in currency A (worth 10 million in currency B) in exchange for a 10-year note that pays 5 per cent interest annually. On the same day, RCO lends 10 million in currency B to SCO in exchange for a 10-year note that pays 5 per cent interest annually. RCO does not enter into a long-term hedging transaction with respect to these financing transactions, but manages the interest rate and currency risk arising from the transactions on a daily, weekly or quarterly basis by entering into forward currency contracts.

In this example, RCO appears to be carrying on a real business performing substantive economic functions, using real assets and assuming real risks; it is also performing significant activities with respect to the transactions with TCO and SCO, which appear to be typical of RCO's normal treasury business. RCO also appears to be bearing the interest rate and currency risk. Based on these facts and in the absence of other facts that would indicate that one of the principal purposes for these loans was the avoidance of withholding tax in State S, the loan from TCO to RCO and the loan from RCO to SCO do not constitute a conduit arrangement. Similarly to the previous paragraph, the use of an entity in a jurisdiction with a wide treaty network may be valid provided that the entity has economic substance (carries on actual functions and assumes real risks). Also, as in the previous example, the creation of such entity in a treaty jurisdiction is valid, as it addresses the need of a financial entity in the group justifies the need for an entity.

#### **Conclusions**

The Multilateral Instrument will modify the existing treaties upon its entry into force, and thus, the rules of the game for the covered treaties will change dramatically. What may have been clearly valid before may not be so after the modification. This will mean that companies will have to carefully review their existing structures and the structuring of transactions, because "business as usual" may now be questioned under the PPT rule.

Companies should revisit the basis for treaty benefit entitlement and, it is also advisable, to prepare a defense file to support such entitlement, as many tax administrations may attempt to overreach taking advantage of the new BEPS measures.

<sup>18</sup> Although this example is not contained in the PPT rule section, it is also described as a non-abusive transaction.



## LATEST DEVELOPMENTS ON COUNTRY-BY-COUNTRY REPORTING AN UPDATE AS FAR AS ITALY IS CONCERNED

by **PIERGIORGIO VALENTE**

Chairman IAFEI International Tax Committee, Managing Partner of Valente Associati GEB Partners, February 23, 2017

### **Introduction**

The Decree of the Italian Ministry of Economy and Finance for the implementation of Country-by-Country reporting (hereinafter, “CbCR”) in Italy was issued on 23 February<sup>1</sup> 2017. The latter provided for reporting obligations involving enterprises that meet certain criteria, defining the deadline and the related model to be complied with<sup>2</sup>.

The definition of CbCR terms and standards was expected after the issuance of Law No.208 issued on December 30, 2015 set forth that operational details of the mentioned reporting mechanism had to be determined by the Ministry of Economy and Finance.

However, the Decree represents only the last stage of a longer process started back in 2013 when the OECD launched the BEPS Action Plan, and specifically Action 13. In fact, the Decree introduces into the Italian tax system the minimum standards set under Action 13 as defined by the OECD 2015 Action 13 Report<sup>3</sup>, and implements the Directive 2016/881/EU regarding mandatory automatic exchange of information. As recommended by the OECD under Action 13, the collection of the reports by the tax authorities should have begun in 2016. In order

to review the implementation of its guidelines and recommendations, the OECD has recently published a detailed paper<sup>4</sup> that contains the criteria to be followed in assessing such implementation.

In this context, with the aim of increasing transparency on multinational groups even beyond tax-related issues, the European Commission launched in April 2016 its proposal<sup>5</sup> for a Directive on disclosure of income tax information by certain enterprises and subsidiaries, that will amend the 2013/34/EU Directive. Unlike Action 13 of the BEPS Action Plan, the proposal introduces public disclosure of corporate data, not strictly limited to tax authorities, in order to make citizens aware of the contribution made to the general welfare by such multinational groups. From a business perspective<sup>6</sup>, however, the proposed directive has raised some concerns, mainly on the risk of distorted competition and the different implementation means and procedures of such directive that might take place in Member States.

### **Reporting Entities and Obligations**

The text of the Italian Decree reflects OECD Model legislation related to CbCR as provided by the Country-by-Country Reporting Implementation Package<sup>7</sup>.

1 The official text of D.M. was published on the Italian Official Gazette (“Gazzetta Ufficiale”) No. 56 of 8th March 2017. Cf.: [http://www.gazzettaufficiale.it/eli/id/2017/03/08/17A01733/sg;jsessionid=kYvlfghrDMrLhN4oXwpsEQ\\_.ntc-as5-guri2b](http://www.gazzettaufficiale.it/eli/id/2017/03/08/17A01733/sg;jsessionid=kYvlfghrDMrLhN4oXwpsEQ_.ntc-as5-guri2b)

2 For a first review of the Decree, A. Della Rovere and F. Correa, Country-by-Country Reporting Finally Arrives in Italy, TP Week, March 20, 2017. Cf.: [http://www.tpweek.com/Article/3670840/Country-by-Country-Reporting finally arrives in Italy.html?ArticleId=3670840](http://www.tpweek.com/Article/3670840/Country-by-Country-Reporting%20finally%20arrives%20in%20Italy.html?ArticleId=3670840)

3 OECD (2015), Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. Cf.: <http://dx.doi.org/10.1787/9789264241480-en>

4 OECD (2017), BEPS Action 13 on Country-by-Country Reporting – Peer Review Documents, OECD/G20 Base Erosion and Profit Shifting Project, OECD, Paris. Cf.: [www.oecd.org/tax/beps/beps-action-13-on-country-by-country-reporting-peer-review-documents.pdf](http://www.oecd.org/tax/beps/beps-action-13-on-country-by-country-reporting-peer-review-documents.pdf)

5 The official text of the proposal, COM(2016) 198 final, is available at <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52016PC0198>

6 As the public consultation carried out by the European Commission indicated. The main takeaways are described in a report available at: [http://ec.europa.eu/finance/company-reporting/docs/country-by-country-reporting/160412-synopsis\\_en.pdf](http://ec.europa.eu/finance/company-reporting/docs/country-by-country-reporting/160412-synopsis_en.pdf)

7 Annex IV to OECD (2015), Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report.

Therefore, it initially offers a list of definitions and the regulation's scope of application.

With the aim of identifying such entities that are required to report, Article 1 specifies that only multinational groups of companies with total annual revenue equal to, or exceeding € 750 million, and either the parent or any of the subsidiaries of the group identifiable as Italian tax residents, must comply with the new regulation.

According to the Decree, the CbCR must be filed with the Italian Revenue Agency (hereinafter the "Agency") by Italian parent companies. However, a reporting obligation may arise also for Italian subsidiaries whenever the Agency is unable to obtain CbCR or any equivalent report regarding the respective multinational group, from either the parent company or other source.

Concerning, instead, the data to be provided by reporting entities, the Decree specifies that CbCR should include information both, of a financial nature (e.g., revenue, profit or loss before income tax, income tax paid and accrued, stated capital, and retained earnings) as well any data/information related to organizational aspects (e.g., jurisdiction of incorporation, activities carried out, and permanent establishments). The said information must be reported on an aggregate basis and reference must be made to each single entity that belongs to the group, filling in the CbCR form that has been published as an annex to the Decree with the function of guiding and supporting the required enterprises in reporting the relevant data. In this regard, more details related not only to the data to be included in the report and its format (e.g., language requirements), but also to the reporting process and the practical implementation of the Decree, will be clearly defined by the Italian Revenue Agency's Director in a specific guideline.

In addition to the CbCR filing, the Decree provides for a series of notifications by Italian entities belonging to multinational groups within its scope. First, the parent companies located in Italy must inform the Agency, within the deadline for filing the tax return, with regard to the fact that the group meets the conditions set by the Decree. Moreover, the Italian subsidiaries of the multinational group must communicate the details referring to the controlling entities required to file CbCR on behalf of the group.

#### **Timing and Deadlines**

The new regime is already applicable to the 2016 tax year. Taking into account that the deadline for CbCR submission is twelve (12) months from the last day of the relevant tax year, this, in essence, implies that the first CbCR shall be filed in Italy by the end of 2017.

#### **Data and Confidentiality**

Once the reports are filed for the relevant fiscal year and the required data are duly collected, the information exchange will take place within eighteen (18) months starting from the end of the fiscal year. Therefore, considering the above mentioned deadline for filing the report, the information collected will be exchanged by the Agency within six months from filing date.

The exchange of information must take place with a certain degree of confidentiality that should at least correspond to the standard specified by the OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters<sup>8</sup>, and which under Article 22 refers to an appropriate level of protection of personal data and to safeguards applicable according to the domestic law of the tax office transmitting the information.

In this regard, it is not clear if the supplementary guidance on the filing process, that the Italian Revenue Agency is expected to publish, will also include confidentiality matters related to exchange of data with other tax agencies. This is a major issue for multinational groups, considering their concern about such extensive sharing of sensitive corporate data between and among several tax offices. In this regard, Article 7 of the Decree sets some restrictions to the use of the collected information. In particular, the data contained in the CbCR filed by taxpayers cannot be used as the base for transfer pricing adjustments. Nevertheless, the same data might be used as a helpful indication for further investigations on pricing agreements or, in case of tax audit, for tax base adjustments. Therefore, the data reported potentially expose enterprises to investigations and assessments, which may lead to different adjustments.

To conclude, the new CbCR regulation poses some challenges for multinational groups:

- significant efforts, in terms of time and resources, required of such multinational groups that fall within the Decree's application scope.
- extent of disclosure under such regulation, where sensitive data about the group's organization and strategy are involved.

Therefore, it is necessary for Tax Authorities not only to establish some clear-cut boundaries to the use of such data by the tax authorities, but also to provide for a set of safeguards to guarantee a sufficient level of confidentiality to the same data while these are processed and shared.

<sup>8</sup> OECD/Council of Europe (2011), The Multilateral Convention on Mutual Administrative Assistance in Tax Matters: Amended by the 2010 Protocol, OECD Publishing, Paris.

Cf.: <http://dx.doi.org/10.1787/9789264115606-en>



# Press, Journal Article

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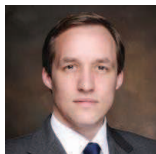


## PRICE POINT

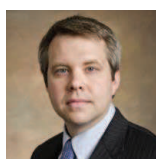
March 2017

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## Global Fixed Income **REFORM MOMENTUM OPENS UP INDIAN BOND MARKET OPPORTUNITIES**



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### KEY POINTS

- Recent reforms implemented by Prime Minister Narendra Modi's government in India have created an attractive opportunity set in the country's bond market for international investors.
- India's long-term disinflation trend and positive growth trajectory have also contributed to a positive environment for bond investing, while the market is gradually opening up to overseas investors.
- Indian government bonds may offer strong diversification benefits and have a higher yield than the bonds of many Asian peers, which are not on such a positive reform track.
- It is important to be mindful of a number of challenges including India's significant bad debt problem and its myriad political risks, which could obstruct further development of the market.

India's bond market has not always been a high priority for investors in emerging market debt. The perception that it is somewhat opaque and difficult for overseas participants to access has deterred many from exploring the market. But the Indian fixed income space has been gradually opening up to international investors in recent years, while a more attractive opportunity set has arisen on the back of the country's long-term disinflation trend, its positive growth trajectory, and the reforms implemented by Prime Minister Narendra Modi's government.

Despite this progress, however, potential investors in Indian bonds will also need to consider the hazards posed by the country's significant bad debt problem and its myriad political risks before embarking on what is still a relatively untrodden path.

The Indian bond market has traditionally been a largely domestic affair, with comparatively low levels of international investment, as regulation has restricted overseas investors looking to access the bond market to using interest rate swaps and

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foreign exchange as proxies. While access to overseas participants has started to improve in recent years as the Indian government has sought to open up the market to international investors, there are still limits on the amount of Indian bonds that foreign investors can hold.

**SOLID PERFORMANCE**

For international investors who have been able to gain access to the Indian market, it has been worth the effort. Indian government debt has performed relatively strongly since 2014, with yields on 10-year bonds declining from around 9% to less than 7% between early 2014 and late 2016 on the back of falling inflation and easier monetary conditions (see Figure 1). The government’s recent demonetization of certain high-denomination Indian rupee bank notes to crack down on the shadow economy has also fueled expectations of weaker growth and lower inflation following the large inflow of deposits to banks. This has further boosted bond prices, which are now more stretched than they were two to three years ago.

**Figure 1: 10-Year Indian Government Bond Yields—Yields Decline on Falling Inflation and Easier Monetary Conditions**

As of February 1, 2017



Source: FactSet. Past performance is not a reliable indicator of future performance.

However, while valuations are not as attractive as they have been, there are still a number of factors in favor of investing in Indian debt.

The currency itself also might be interesting to investors. The balance of payments is in strong shape with a low current account deficit and solid foreign direct investment inflows. The rupee seems reasonably valued, and we believe it has advantages over other Asian currencies given India’s strong growth and clear path to structural reforms, and the higher yield available on Indian debt.

**TACKLING INFLATION**

High inflation in particular historically has been a burden on India’s bond market, and it is here where reforms have had the most pronounced impact so far. Following the financial crisis of 2007–2008, India went through a period of double-digit inflation, driven partly by monetary stimulus measures implemented by the Reserve Bank of India (RBI), whose primary focus had not traditionally been to control rising prices. Then in 2013, newly appointed Governor Raghuram Rajan made it a priority for the RBI to bring inflation down, and under his watch it subsequently fell into single-digit territory. The accompanying decline in nominal interest rates created an attractive environment for bond investors.

In addition to the implementation of a formal inflation mandate, the RBI has also put in place further reforms designed to institutionalize the central bank’s policymaking process, including the creation of a monetary policy board to set interest rates (the responsibility for setting rates previously rested solely with the governor). This has

further strengthened the central bank's incentive to remain focused on inflation in the longer term and has been a boon to fixed income investors, who typically prefer central banks to be as independent as possible. The RBI's establishment of the monetary policy committee (MPC) and new inflation targeting mandate have helped to put India at the forefront among emerging markets in terms of pushing toward more independent monetary policy.

This progressive approach looks set to continue. Rajan stepped down as RBI governor at the end of his first term last year and was replaced by former Deputy Governor Urjit Patel, who authored the initial report recommending the establishment of an MPC and an inflation target. Under Patel's leadership, the RBI is expected to adopt a similar stance as it did under Rajan. The RBI's more institutional approach will also mean that the governor has less personal influence on policy than in the past.

### While there are challenges ahead, notably in the form of political risk and high levels of debt, the trend of opening up to foreign investors looks set to continue.

#### SUPPORTIVE MEASURES

India has also undertaken multiple reforms to reduce the size of its black market economy. In addition to the currency demonetization program discussed above, they have also introduced measures to reduce red tape around infrastructure spending and property development.

Another key reform that is potentially highly supportive for fixed income investors is the creation of a nationwide goods and services tax (GST). The GST removes certain barriers and tax distortions between states, with the aim of making India a more efficient internal market. It will probably not raise significant amounts of revenue for the Indian government at first but should be beneficial for growth over the longer term by simplifying the country's disjointed tax system and creating a genuine single market.

#### CHALLENGES REMAIN

While government influence over the RBI has been reduced, political risk nevertheless poses other threats to the development of the country's bond market. Even though the government has a commanding majority in the lower house of parliament, it does not control the upper house, making it more difficult for it to pass legislation. This could be a roadblock to the government's ambitious reform agenda.

Furthermore, Modi's government has entered the second half of its term, prompting concerns that it could focus more on short-term populist measures to raise its chances of reelection, such as offering loan waivers to certain groups, and less on enacting lasting legislation. More generally, Indian politics is gradually moving from a system dominated by a central party to one characterized by a number of smaller, regional parties. This again makes it more difficult to bring about significant reforms in the longer term.

India's bond market also faces several economic challenges. The country has a number of large conglomerate groups that are overleveraged—the top 1% of companies accounts for around half of the overall debt, according to the International Monetary Fund. There is also a large amount of debt in the country's banking system. The establishment of the country's first national bankruptcy law, passed last year, was intended to create a process to address this level of debt. However, while the law is widely considered a positive development for investors, it will likely take several years to develop the institutions and judicial expertise to effectively implement before investors begin to feel its benefits. Spending on fixed assets is lagging too: India's investment-to-gross domestic product ratio has been falling for a number of years, which is a concern for potential international investors.

Even so, Indian bonds may offer diversification potential for international investors. The market is less exposed to forced selling than some emerging market peers during periods of risk aversion, owing to the small proportion of overseas participants. Furthermore, the market has a fairly low correlation to U.S. Treasury bonds. Typically, any large swings in U.S. Treasury yields have a spillover effect on global and emerging market bond yields. Indian yields, however, can be less susceptible to these than other emerging markets. One example of this came in the immediate wake of the U.S. presidential election in November, which coincided with the government's aforementioned demonetization program. While yields on U.S. Treasuries and many other government bonds climbed by up to 40 basis points in the days following the election, Indian government bond yields actually fell.

More broadly, the country is gradually moving toward a more open, inclusive market in global terms, which should ensure that the demand for Indian assets will rise structurally over time, against what is currently quite a low base, particularly in the fixed income and foreign exchange space. What's more, Indian government bonds have a higher yield than the bonds of many Asian peers, which are not on such a positive reform track.

**TRADING PLACES, DIRECTION OF MERCHANDISE TRADE – DEVELOPED MARKET COUNTRIES AND EMERGING MARKET COUNTRIES**

Chart of the Week, For the Week Ending April 13, 2017 by **Payden & Rygel**, Investment Management, Los Angeles, USA, April 13, 2017.

**CHART OF THE WEEK**

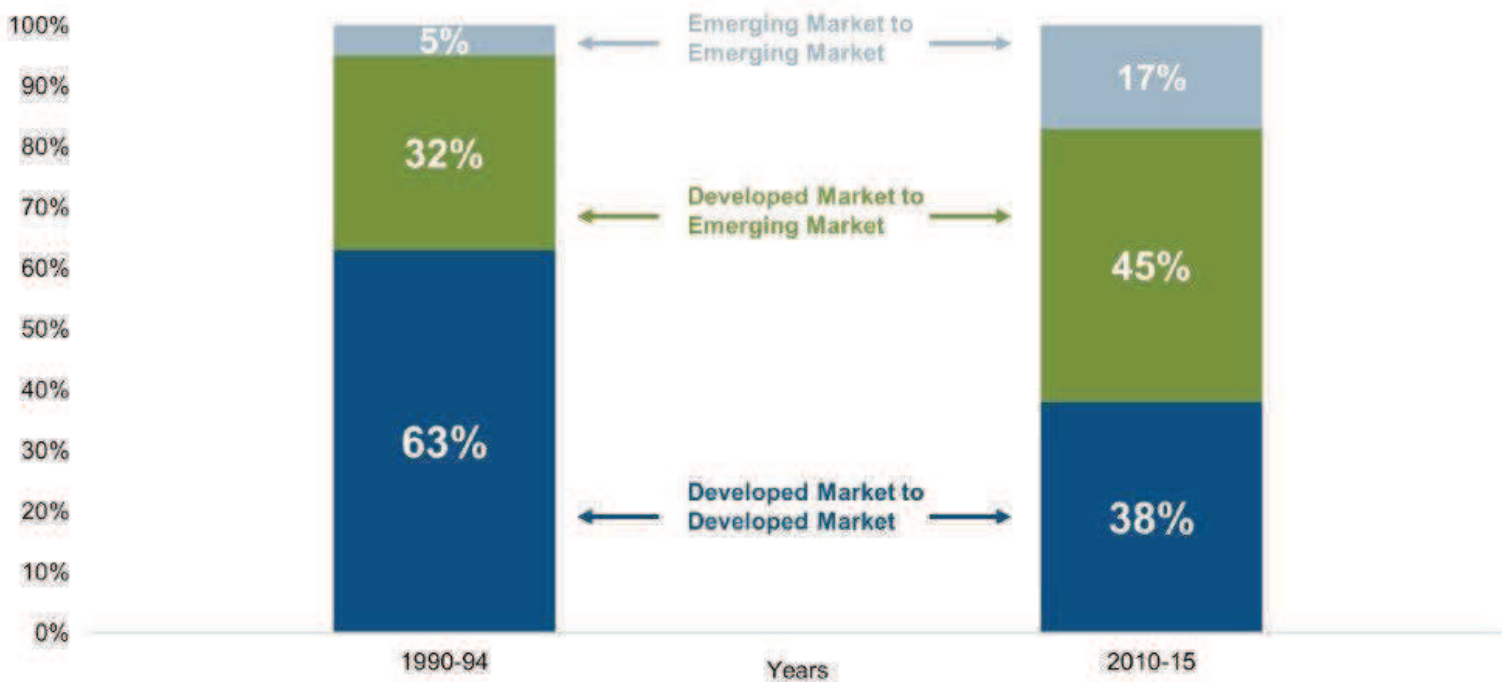
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**Trading Places**

Direction of Merchandise Trade - Developed Market Countries and Emerging Market Countries

For The Week Ending 04/13/17

% of Merchandise Trade



Source: IMF, World Bank, and WTO (2017). "Making Trade an Engine of Growth for All: The Case for Trade and for Policies to Facilitate Adjustment."

Much of the analysis of world trade in recent years focused on explaining a post-crisis slowdown in trade volume. Before the crisis, world trade grew at annual rates of 5-10%. Since 2008, 0-5% growth rates prevailed. Less attention was paid to changes in the composition of trade. Well, the world of buying and selling goods and services has changed enormously in the past 25 years. Developed market countries used to trade only among themselves. Today the world trade equation is considerably different. Intra-Emerging Market trading accounts for 17% of global merchandise trade, and emerging market ↔ developed market trade accounts for almost ½ of all world goods trade.

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