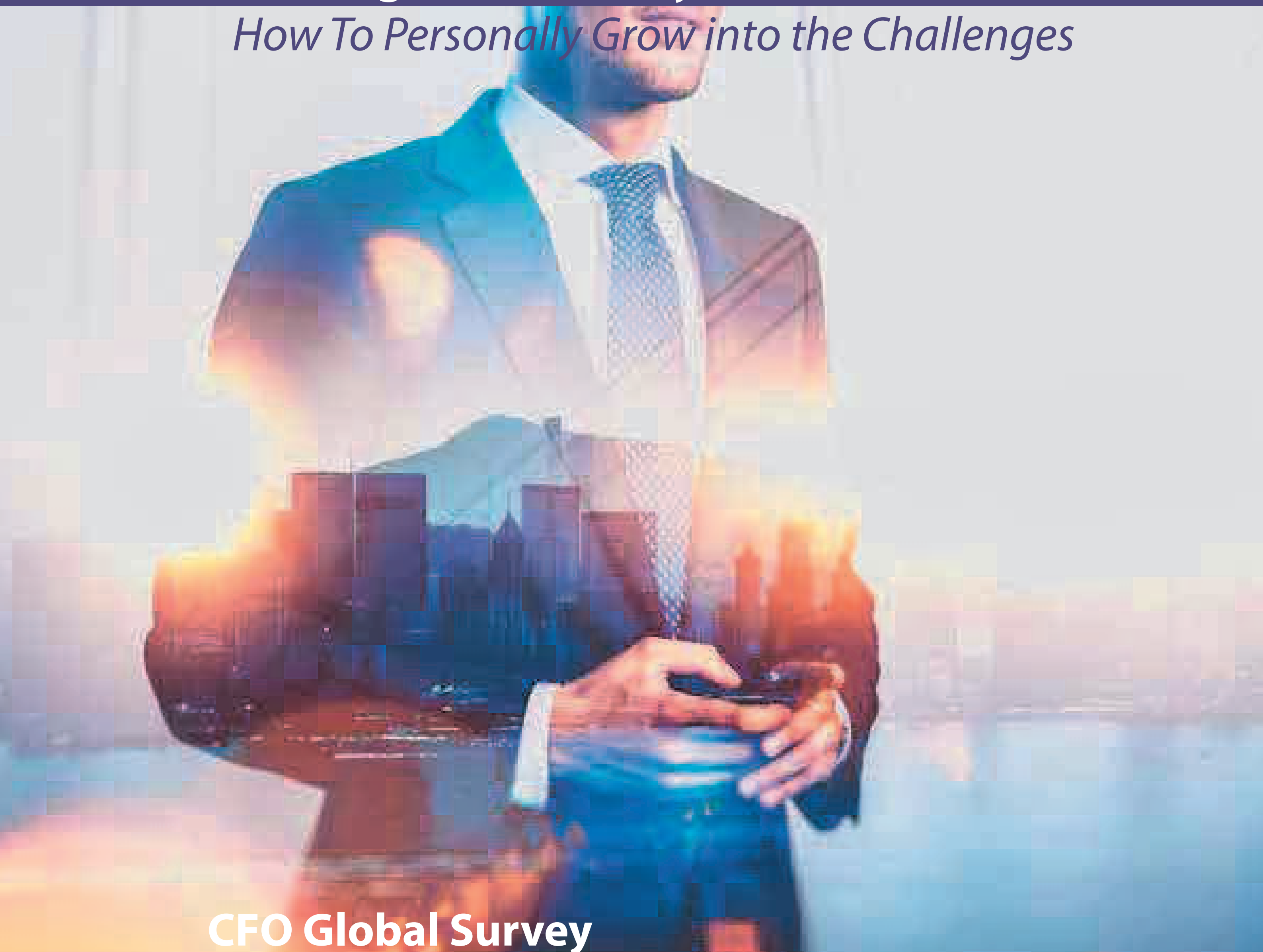
iafei QUARTERLY

41st Issue | 2018 July

The Role of the Finance Professional Has Changed Drastically in the Last Decades

How To Personally Grow into the Challenges



CFO Global Survey

Firms Being Hacked, Taking Action to Protect

- Mexico, Its Historical Moment and the Important Decisions to Be Made by the New Government
- Brexit Means Brexit - But What Does It Mean for Europe as A Financial Centre?

LETTER OF THE CHAIRMAN

Dear collegues,

I have the pleasure to announce you that the annual 48th IAFEI World Congress, will take place in Ho Chi Minh City (Vietnam), from the 14th to the 16th of November 2018.

This Event will be organized jointly by the CFOs Institute of Vietnam (VCFO) and by the CFOs Institute of Japan (JAFCO), whom I deeply thank for the commitment they have taken in order to promote the professional and the cultural growth of CFOs and strengthen the image of IAFEI.

For the first time, the IAFEI World Congress, will take place in Vietnam, an emerging country on the economic arena, considering the continuous growth in GDP, Consumer Spending and Living Standards. The above fueled by foreign investments and improvements on the road of a market economy.

The theme of the Congress, "Transforming Finance in the Digital Age", is very appropriate and updated, in order to understand how the extraordinary digital revolution (cybersecurity, blockchain technology, artificial intelligence, etc...) are impacting finance and our CFO profession.

Knowing the professional approach and the capacity of our Asian Colleagues, I am positive to say that the World Congress in Ho Chi Minh City, will be a successful Event !

I take the opportunity, offered by this Editorial, to inform all of you, that the French Institute (DFCG) has recently decided to withdraw from IAFEI.
I am very sorry and embittered of this unexpected and incomprehensible decision. I have always considered that the spirit behind an association should be service toward the associates in the interest of IAFEI, the Association I presently have the honor to Chair.
Personally, I believe, that the personal objectives and ambitions should not prevail on the common ones: IAFEI celebrates its 50th Anniversary and it is stronger than any one of its members.

See you soon and all in Ho Chi Minh City!!!

Yours sincerely,

Fausto Cosi
IAFEI Chairman

LETTER OF THE CHIEF EDITOR

Dear Financial Executive,

*You receive the **IAFEI Quarterly XLI st 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 associations.

This issue is the eleventh 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 10 IAFEI representatives from all continents.

Since the financial crisis, world financial markets are still working on the re-definition and possibly replacement of the Libor interest rate benchmark.
There is the possibility of LIBOR´s cessation after 2021. In this issue, remarks are reprinted by William C. Dudley, outgoing President and CEO of the Federal Reserve Bank of New York, on the transition to a robust reference rate regime for a new interest rate benchmark.

More IAFEI member associations should contribute articles to the IAFEI Quarterly.

Therefore I repeat our ongoing invitation, to all IAFEI member associations, and to each of their individual members, to send us articles for inclusion in future IAFEI Quarterlies.

With best personal regards

Helmut Schnabel
Chief Editor

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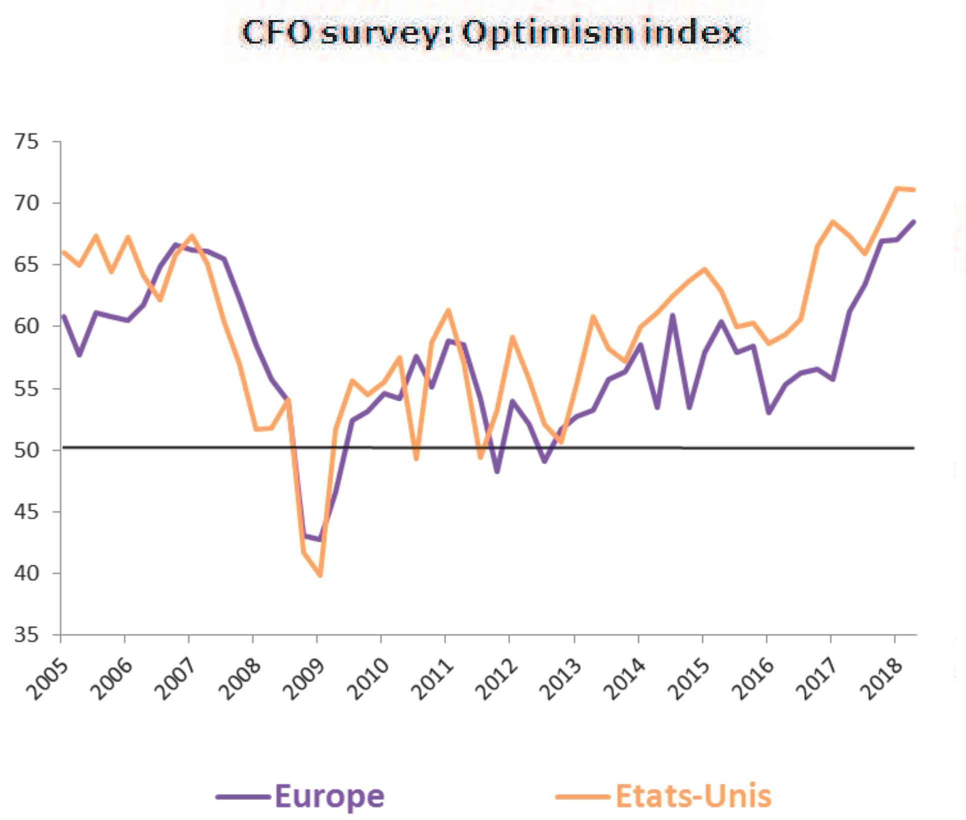
"SURVEY OF CFOs ACROSS THE WORLD FOR THE 2ND QUARTER 2018"

FIRMS BEING HACKED, TAKING ACTION TO PROTECT DATA

BY DR **JOHN GRAHAM** PROFESSOR OF FINANCE AT THE FUQUA SCHOOL OF BUSINESS AT **DUKE UNIVERSITY**, USA, AND DR **PHILIPPE DUPUY** ASSOCIATE PROFESSOR OF FINANCE AT GRENOBLE ECOLE DE MANAGEMENT, FRANCE, AND BY IAFEI AND OTHER PARTNERS. SURVEY OF CFOS ACROSS THE WORLD, FOR THE SECOND QUARTER 2018.
THE SURVEY WAS RUNNING FROM 13rd MAY TO 7th JUNE 2018.

U.S. companies lead the world in preventive cybersecurity policies, followed in order of preventive activity by companies in Europe, Africa, Asia, and Latin America.

The proportion of firms indicating they are having difficulty hiring and retaining qualified employees remains near a two-decade high in several regions of the world



OPTIMISM REMAINS AT RECORD LEVEL

The Optimism Index in the **U.S.** remained at an all-time high of 71 on a 100-point scale this quarter. This increased U.S. optimism appears to have increased expectations for M&A activity. More than 70 percent of CFOs expect more mergers and acquisitions to occur over the next year.

Optimism in **Europe** inched up to 68 this quarter, from 67 last quarter. Optimism in the **U.K.** fell to 57, while optimism remains strong in **France** and **Germany**, and has picked up in **Spain** and the **Netherlands**. Capital spending is expected to grow 6 percent, and employment growth should be nearly 3 percent. For the second month in a row, the top concern among European CFOs is attracting and retaining qualified employees, followed by economic uncertainty, regulatory and government policies, and data security. One-in-five European firms say their systems have been penetrated by hackers. Two-thirds have installed new software and 62 percent have taken steps like two-factor authentication to make it more difficult for hackers. Generally speaking, European companies are somewhat less active in taking anti-hacking steps than are firms in the U.S.

Optimism in **Asia** inched down from 61 last quarter to 60 this quarter. Difficulty attracting qualified employees, economic uncertainty, government policies, weak demand, and currency risk are top concerns in the region. Capital spending is expected to grow about 7 percent, and employment 3.6 percent, over the next 12 months. One-in-five Asian firms say their systems have been penetrated by hackers. Fifty-six percent have taken steps like two-factor authentication to make it more difficult for hackers, and 48 percent have installed new software. Overall preventive cybersecurity is lower in Asia relative to the U.S. and Europe.

Latin American optimism slipped this quarter, down to 64 in **Mexico**, 69 in Chile, 54 in **Brazil**, and only 36 in **Ecuador**. Optimism increased to 61 in **Peru**. Nearly half of firms in Peru say that economic prospects have improved since President Kuczynski resigned, compared to only 16 percent who say prospects worsened. Sixty-one percent say that the political and economic environment has stabilized.

Economic uncertainty is the top concern among Latin American CFOs, with 69 percent of firms listing it as a top-four concern. Other concerns include government policies, worker productivity, and currency risk. Capital spending is expected to grow 2.5 percent and employment 2.2 percent over the next year. Eighteen percent of Latin American firms say their systems have been penetrated by hackers. Nearly 55 percent have taken steps like two-factor authentication to make it more difficult for hackers, 38 percent have installed new software or changed procedures, and 32 percent have increased employee training on best practices. Generally speaking, Latin American firms have taken fewer anti-hacking steps than companies in other parts of the globe.

Business optimism in **South Africa** fell to 51 this quarter, down from 59 last quarter. **Nigerian** optimism fell to 54 from 62. Median employment should increase by 3.6 percent over the next 12 months, while capital spending will fall. Interest rates are expected to fall over the next year, leading to increased business spending next year. The biggest concerns for African CFOs are governmental policies, economic uncertainty, corruption, access to capital, and employee morale. Twenty-seven percent of African firms say their systems have been penetrated by hackers. Sixty-one percent have taken steps like two-factor authentication to make it more difficult for hackers and 52 percent have installed new software or changed procedures. The amount of preventive corporate cybersecurity policies is less in Africa than in the U.S. and Europe but is greater than in Asia and Latin America.

TIGHT LABOR MARKET IS TOP CONCERN

The proportion of firms indicating they are having difficulty hiring and retaining qualified employees remains near a two-decade high, with 41 percent of CFOs calling it a top concern. The typical U.S. firm says it plans to increase employment by a median 3 percent in 2018 and expects wages to increase 4 percent on average. The tight labor market continues to put upward pressure on wages and wage inflation is now a top five concern of U.S. CFOs.

Wage growth should be strongest in the tech, transportation, and service/consulting industries. U.S. companies expect the prices of their products to increase by more than 3 percent over the next year.

DATA SECURITY THREATS

Concern about data security is at an all-time high among U.S. CFOs. Nearly one out of every five companies say that their computer systems have been breached by hackers. Twenty percent of CFOs know they have been hacked. There is probably another 20 percent that don't even know their company's systems have been breached. Ten years ago, cybersecurity was not a C-suite responsibility. Now it is. Companies are defending themselves from near-continuous denial of service attacks and critical data breaches. To fight this battle costs money, which falls right off the bottom line. The cost is not just equipment, software and consultants, it is also reputation if you are breached.

Most U.S. companies are actively taking steps to reduce data security risks. Seventy-one percent have installed new software or introduced new procedures, 71 percent have introduced anti-penetration features like two-factor authentication or more stringent password protection, 54 percent have upgraded employee training, and nearly half have hired outside cybersecurity experts, among other measures.

U.S. companies lead the world in preventive cybersecurity policies, followed in order of preventive activity by companies in Europe, Africa, Asia, and Latin America.

RISING INTEREST RATES

U.S. companies expect their cost of borrowing to increase over the next year. The typical firm expects their long-term borrowing rate to increase from 5.2 percent currently to 5.8 percent in one year. Increased interest rates would lead the typical firm to reduce capital spending growth from about 8.3 percent this year to about 7.1 percent next year. Rising interest rates dampen the incentive of companies to borrow and spend, slowing economic growth. We also asked CFOs about their spending plans in a high interest rate environment. In their high interest rate planning scenario, long-term borrowing costs would average 7.5 percent and capital spending growth would increase by only about 5 percent.

GDP weighted Average Global Business Outlook
(World Bank GDP constant prices in USD)

Table 1: During the past quarter, which items have been the most pressing concerns for your company's top management team?

	Europe	Latin America	Asie	Etats-Unis
Economic uncertainty	**35.4**	**68.8**	**30.9**	**15.8**
Currency risk	25.3	26.0	27.8	5.7
Weak demand	10.2	22.1	30.3	12.7
Government policies	30.3	45.5	30.7	30.7
Access to capital	13.1	19.5	15.5	13.2
Regulatory Requirements	33.3	18.2	22.3	28.9
Difficulty attracting / retaining qualified employees	**36.4**	**11.7**	**32.9**	**41.2**
Employee productivity	16.2	29.9	15.1	22.4
Rising wages and salaries	10.1	2.6	24.8	28.5
Employee morale	24.2	2.6	10.8	16.7
Cost of borrowing	7.1	11.7	2.5	9.6
Data security	**28.3**	**14.3**	**19.5**	**30.3**
Geopolitical / health crises	8.1	5.2	17.9	2.6
Deflation	0.0	1.3	1.4	0.9
Rising input or commodity costs	15.2	10.4	10.7	22.4
Cost of benefits	4.0	15.6	9.4	27.2
Corporate tax code	5.1	13.0	10.8	9.2
Inflation	2.0	6.5	7.4	6.1
Other	7.1	6.5	9.4	7.5

Table 2: Relative to the previous 12 months, what will be your company's PERC ENTAGE CHANGE during the next 12 months? (mean by region)

	Europe	Latin America	Asie	Etats-Unis
Revenue	**8.3**	**5.0**	**4.8**	**6.9**
Inflation (Change in prices of own-firm products)	1.1	4.1	4.3	3.8
Capital spending	**6.2**	**2.5**	**7.0**	**8.3**
Technology spending	**6.6**	**3.2**	**6.0**	**7.2**
R&D spending	1.4	2.1	4.7	3.1
Advertising and marketing spending	4.5	4.2	3.9	1.9
Employment – full-time	2.9	2.2	3.6	4.5
Wages and Salaries	3.1	4.0	4.1	4.1
Health Care Costs	2.1	4.3	2.0	7.6
Earnings growth	7.5	9.1	5.8	8.1

About the survey: This is the 89th consecutive quarter the Duke University/CFO Global Business Outlook survey has been conducted. The survey concluded June 7, and generated responses from nearly 600 CFOs, including nearly 250 from North America, 62 from Asia, 99 from Europe, 151 from Latin America and 32 from Africa.

DUKE THE FUQUA SCHOOL OF BUSINESS CFO | DUKE CFO GLOBAL BUSINESS OUTLOOK

IAFEI INTERNATIONAL ASSOCIATION OF FINANCIAL EXECUTIVES INSTITUTES

GRENOBLE ECOLE DE MANAGEMENT TECHNOLOGY & INNOVATION

THE ROLE OF THE FINANCE PROFESSIONAL HAS CHANGED DRASTICALLY IN THE LAST DECADES

How To Personally Grow into the Challenges

by **TAMARA DZULE,** VICE PRESIDENT OF THE TECHNICAL COMMISSIONS OF THE BRAZILIAN INSTITUTE OF FINANCIAL EXECUTIVES (IBEF-SP), AND BY **LUIZ CALADO**, VICE PRESIDENT OF THE BRAZILIAN INSTITUTE OF FINANCIAL EXECUTIVES (IBEF-SP), ARTICLE PROVIDED BY **IBEF**, THE BRAZILIAN IAFEI MEMBER ASSOCIATION

The role of the finance professional has changed drastically in the last decades. The ideal profile for a finance executive is increasingly more that of an strategist and less that of a controller – even if one factor in the ever so important role of a risk controller.

In this context, luck no longer is a cause for someone to achieve the main role in the area of Finance.

Based on our experience, in addition to our close contact with senior finance executives over the past years, we could perceive that there is a consistent trajectory of successful CFOs. We found some common aspects of those executives who now occupy key positions in their organizations. And we are pretty sure that it was not luck! Everyone worked hard and today they deliver solid and consistent results. Many also know how to deal with rejections throughout their careers, and learned to be resilient.
But what about you or the executives of your company? What could you do to improve the likelihood of obtaining opportunities, instead of counting on the odds of being in the right place at the right time? Below, we share some of the lessons we've learned.

1. Seek continuous improvement - Careers are composed of levels and stages. Each function performed by you has a purpose and a set of requirements to meet the needs of the finance and business function. Be the best version of you every day. If the work is easy, difficult, complex or direct, never invest less than 100% of energy in it and work to offer the best possible output. But one important suggestion: be happy in what you do!

Also be attentive to the topics of the moment. For example: Blockchain. Know what it is. How does the relationship of the finance area change with banks, creditors, suppliers, investors, customers and government in light of this and other new technologies?

2. Set goals for your growth - Learn to act as a strategist. Realize what you want to achieve and make specific plans for it. Frequently analyze your performance to learn and improve, avoiding the temptation to being simply reactive. Do not stay in your comfort zone if you want to reach the top, but rather keep looking for new opportunities. Choosing your activities carefully and doing things to learn the right skills is essential. It is clear that maturity is important for this, but bear in mind there are several ways to read about successful professionals, understand what requirements they exhibit or what makes them a CFO or a convincing CFO.

Setting goals is undoubtedly the most required skill currently, and is closely related to the next point.

3. Add skills from other areas - Take advantage of opportunities to demonstrate business insight, especially if you want to get a CFO role someday. This means getting involved in projects not always related to the ROI or the quarterly financial statement. It can be an implementation of a system, an integration of acquisitions, a disinvestment, a capture of resources, an international expansion or anything like that. Also, be curious. You can only understand the business you are in (and business in general) by asking questions. Usually, the more thought provoking the subject is, the more you ask the right questions on a natural progression.

In this matter, it is worth noting that networking is fundamental. The experiences obtained with executives of other companies in the same role as you are extremely useful in a context in which the challenges faced are very similar - often regardless of the sector. To know if you are effectively building your own network, one has to know how to answer questions such as: have you exchanged an experience with a colleague? Have you gone to national and international events recently? In fact, once a year we organize the IAFEI congress, among the very best opportunities you can have to get in touch with other high level financial executives thus enhancing your personal network.

4. Learning to manage people - Work on your behavioral skills, because without knowing how to manage people, nobody goes anywhere. This is a differential for any professional who wants to take on a bigger chair. Agnostic of the utmost relevance of this? Then name a CEO or CFO that has reached that spot while working closely with a team he or she distrusts completely! Your team will most often be your greatest asset. Treat them well!

Keep in mind that it pays great dividend to attend courses and seminars that allow you to improve your managerial skills, since the subject is frequently pointed out as one of the deficiencies of those who occupy the role of CFO.

5. Learn how to manage data - Data analysis is becoming increasingly important in the business world, as companies grow exponentially. Thus, learning the principles and methods of analysis will help you reach an advantageous position. Develop the ability to analyze business, processes, controls, project requirements and critically evaluate arguments, strategies and proposals - all part of an analytical way of thinking. While you do not have to be a walking hard disk, knowing your numbers (and judging which are the really crucial ones) will give you all the necessary credibility.

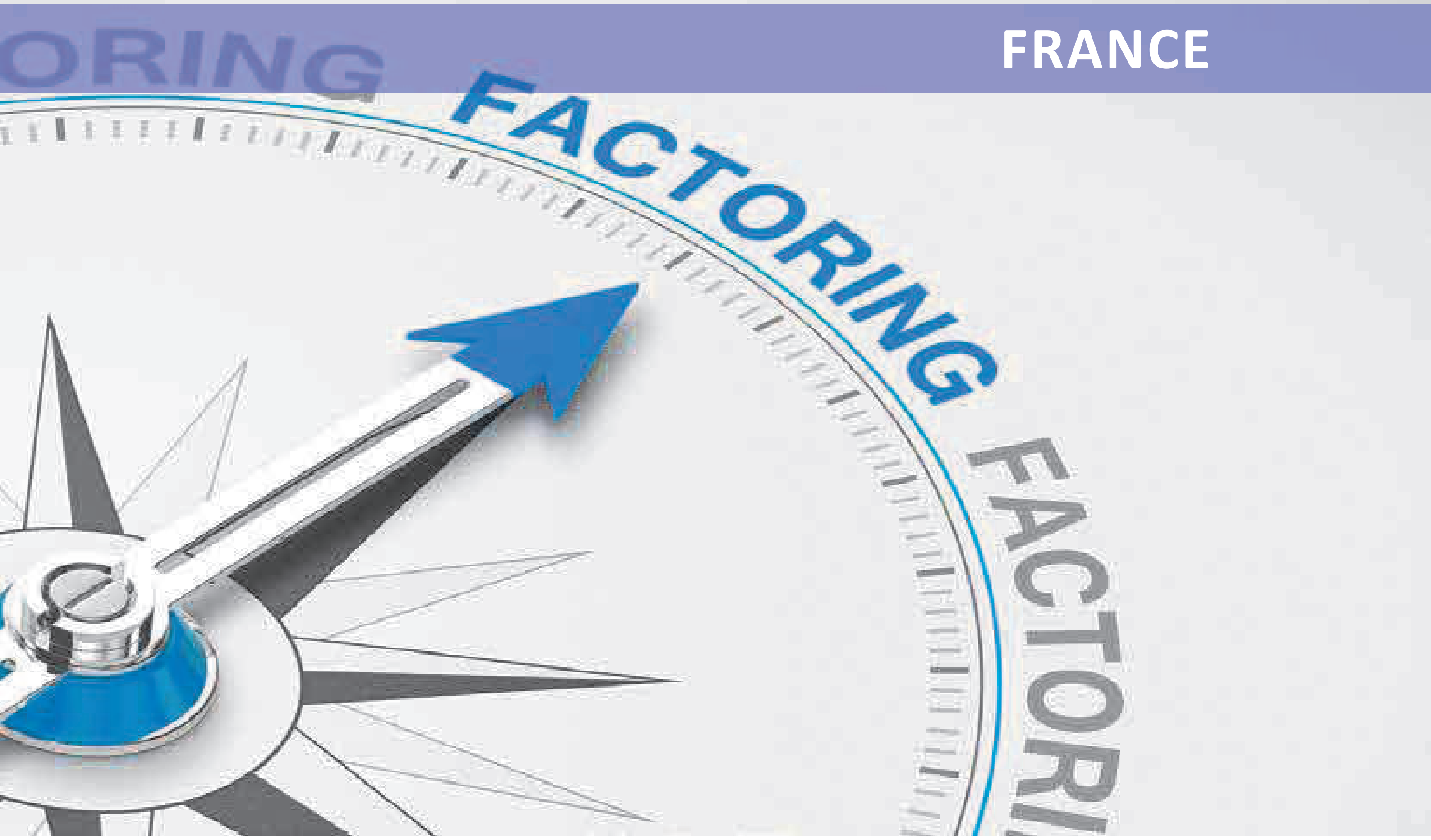
Aligning this theme with the previous one, a successful finance professional does not have to be a superhero, but should have a great insight on the data both of his company and industry and a good grasp on how to build and best manage the people on your team, while skillfully directing them with the your vision.

6. Understand the operation of the business in a broad way - one of the authors of this article had a manager who said: to be a CFO, you need to understand the business. This element is perhaps the main driver of performance and its ability to know what to do to control and manage performance. And you will only achieve it through experience, which in turn only accumulates as you ask questions, read, investigate, face real world problems head-on, reflect and learn through them. Of course, one can still reach the top management ranks after making a mistake. Know how to learn the most out of them, ponder if it is possible to leave as a stronger professional after facing a problem you couldn’t solve or taking a decision that didn’t turn out to result in the outcomes desired.

7. And, finally, one of the most essential elements: know how to communicate! Any executive must be able to explain the performance of the business to analysts, investors, directors, among others. You also benefit from having the skills to convince your peers in making strategic decisions. And remember that asking the right questions can be of great benefit here as well. All of that means working on adjusting communication style and content to different audiences and being able to translate financial concepts into a language understandable to all.

One more thing: do not try to be absolute perfect, the goal should always be more right rather than wrong.

This roadmap to success in a finance career may not be completely effective for everyone, since people have different skill sets and learning curves. But knowing and studying the elements we addressed in this brief essay will definitely not hurt someone looking on improving his or her natural abilities, and reach the top ranks of the ever-evolving career of finance professionals.



INTERNATIONAL FACTORING HELPING COMPANIES TO GROW

TO OPTIMISE THE FINANCING OF WORKING CAPITAL REQUIREMENTS (WCR), COMPANIES ARE ABLE TO TURN TO INCREASINGLY SOPHISTICATED AND EFFECTIVE DEBT FINANCING SOLUTIONS. THIS PARTICULARLY APPLIES TO INTERNATIONAL FACTORING PROGRAMMES.

BY **BOZANA DOURIEZ**, DIRECTOR AND CEO OF BNP PARIBAS FACTOR, ARTICLE PROVIDED BY DFCG, THE FRENCH FINANCE DIRECTOR

International factoring programmes continue to offer durable WCR management solutions that are especially effective at meeting company needs.

The international development of companies, regardless of their size or life cycle, may appear to be a highly complex matter. How can risks be controlled? How to obtain financing? How can receivables be secured? In short, how can a company operate with peace of mind?

At the heart of a company’s development lies the Chief Financial Officer. As the guiding force, the CFO must have the right tools at his disposal, irrespective of the currency. These tools must not only enable him to confront a constantly changing world, but also support his decisions.

The CFOs I meet frequently tell me of their growing inclination towards this type of financing. The major advances in terms of dematerialisation, remote access, and interconnections with credit insurers have raised the profile of factoring over recent years, to the point where it is referred to as an efficient and vital financing strategy. The effective implementation of factoring has turned many finance professionals into “addicts”.

Let us take a practical look at how the various mechanisms of export factoring, multi-local factoring, and pan-European factoring operate.

The major advances in terms of dematerialisation and remote access… have raised the profile of factoring… an efficient and vital financing strategy.

EXPORT FACTORING

A preliminary comment about factoring: companies use factoring to optimise their cash management, and to meet their liquidity requirements and timing issues caused by the payment terms granted to their customers. As a third-party company, the factor acquires the invoice by paying cash, and then subsequently handles the collection process.
Factoring covers three main types of services, namely - the financing of receivables, providing guarantees against payment delinquencies, and accounts receivable management. And of course, beyond one's domestic market, its merits are multiplied.

Export factoring safeguards international sales

Let us take the example of a small company that only achieves part of its sales in export markets. Should it encounter any difficulties in an unfamiliar country, such as a credit downgrade of one of its customers, delegating the collection management to a factor can be of great interest. A factor can provide the company with certain information enabling it to secure its transactions.

Export factoring is also useful for large companies, for example after they land a major contract. They must reassess their cash requirements and modify their sources of financing. In such cases, export factoring is the ideal tool.

Furthermore, dunning customers and collecting their receivables abroad is more complex. You have to take into account the time difference, and master both the language and the local legislative framework. Outsourcing to a specialist therefore simplifies many aspects, thus enabling companies to concentrate on their growth and business development.

Export factoring – a modular and flexible service pack

Irrespective of the size of the company or business sector, or whether the invoices are in euros or foreign currency, export factoring offers an easy solution towards overcoming geographical, linguistic, and legal obstacles.

Depending on the specific requirements, export factoring includes invoice financing, administration of export accounts receivable, and payment dunning issued at the local level.

The Factor covers the whole of Europe as well as the other main countries worldwide. The Factor's membership in Factors Chain International (FCI) enables supporting its customers in over a hundred different countries under optimum security conditions. It should also be noted that each year FCI recognises the achievements of Factors worldwide at its Awards for Excellence. It recognises both the quality of customer service and the level of services provided.

Still within the context of international factoring, there is currently a decentralised solution: multi-local factoring.

MULTI-LOCAL FACTORING

If a company decides to use factoring for its subsidiaries in Europe, it may opt for a decentralised structure. It is then a question of empowering its personnel in matters relating to WCR management.

How multi-local factoring works

Instead of entering into a single contract with a Factor, the Factor's client company and its foreign subsidiaries each sign a factoring contract with the local factor of the Factor's network (assuming the Factor has one, of course). Each contract is therefore drawn up in the local language and in accordance with local law and market pricing.

The drawing up of the contract is coordinated by the Factor initiating the relationship, known as the sponsor. It is the point of contact for the parent company. For their part, the subsidiaries communicate with the local Factors.

The Factor's client company can therefore optimise its processes in light of the specific requirements of each subsidiary, while maintaining oversight via the sponsor.

By way of illustration, let us take the example of a French group with subsidiaries in Italy and Germany. The parent company finances its subsidiaries via current accounts, which may sometimes overburden its cash position. It therefore wishes to provide them with financial autonomy, while retaining control over their accounts receivable. The German subsidiary, new to the group, has a fragile financial profile. As sponsor, the French factor proposes the multi-local solution to the group. It implements a bespoke factoring solution in each country thanks to the presence of the Factor's local operators who understand the local market.

The use of multi-local factoring enables a group's finance department to manage and control the entire financing mechanism.

Following on from the multi-local solution, let us finally, and conversely, consider a pan-European centralised factoring solution.

At a time when the economic recovery is generating fresh financing requirements, enjoying the support of a factor is becoming indispensable.

PAN-EUROPEAN FACTORING

In practice, this solution meets the ever increasing need of large groups requiring support on an international level.

Pan-European factoring is designed for companies that centrally manage their receivables. They require a uniform solution for all the European countries in which they operate. It consists of offering a single contract establishing a harmonised programme, based on French law, for companies operating in multiple European countries.

Why choose this solution? Firstly, because all the subsidiaries covered by a pan-European contract enjoy the same conditions as the rest of the group. Secondly, the treasurer has a centralised overview of the outstanding cash position and of the entire factoring programme.

The advantages of pan-European factoring

Just as with other types of factoring, this system, first of all, enables optimising the working capital requirements of the whole group, as well as limiting the risks associated with international trade and minimising the impact of payment periods (which can be extremely lengthy in some countries).
Above all, pan-European factoring creates a structure, as it encourages companies to harmonise their international credit management processes and the entire process of managing accounts receivable from one country to the next.

The Factor issues its reports globally online, providing a comprehensive panorama of the financing and management of the group's receivables. Each subsidiary has access to its own information and the group benefits from centralised reports.

Their parent company is well-known and benefits from good financing terms, which is frequently not the case for recently established subsidiaries, for example. In this case it will enjoy the same advantageous terms as its parent company.

At a time when the economic recovery is generating fresh financing requirements, enjoying the support of a factor is becoming indispensable. You now understand the fundamentals of export factoring, multi-local factoring, and pan-European factoring, all of which create the impetus for a robust company structure. Here's wishing you a successful international development!

"WE ARE ONE OF THE PUREST REINSURERS"

THE CFO OF HANNOVER RÜCK ABOUT THE CONSEQUENCES OF
THE GEOPOLITICAL RISKS, THE CAPITAL INVESTMENT AND DIVIDEND STRATEGY AND THE DIGITAL CHANGES

INTERVIEW WITH MR. ROLAND VOGEL, CFO OF HANNOVER RÜCK, FROM BÖRSEN-ZEITUNG, JUNE 16, 2018, ARTICLE PROVIDED BY GEFIU, ASSOCIATION OF CHIEF FINANCIAL OFFICERS GERMANY, THE GERMAN IAFEI MEMBER ASSOCIATION

Mr. Vogel, in a few days it will be two years that the British have decided to leave the European Union. The Brexit is part of the geopolitical risks which have increased in recent years. How is Hannover Re reacting to this?

This is not a good development. Protectionism is in contrast to the basic idea of reinsurance: Atomization of risks in free markets. The world wide diversification of risks should not be hindered by way of hurdles and barriers.

But reinsurers are benefitting from the fact that new requirements are arising for the customers, aren't they?

Indeed. Local hurdles are causing additional requirements which at least partly can be mitigated by reinsurances. However, on the bottom line, developments like the Brexit have to be deplored.

Will you remain in Great Britain?

You can be sure about this.

In the previous set up?

In Great Britain, we are having two branches for the life-insurance and for the property & casualty-reinsurance-business and we expect that it will be possible to maintain this concept also after the Brexit. In the past year, we bought a Lloyd's-syndicate in Great Britain. If there will be no solution for our branch in the future, we will be able to underwrite business by way of this acquired company and to service it.

How strongly does the "America first" policy of the US-president impact Hannover Re?

The decided tax-reform determined by President Trump end of 2017 had the effect that we had a very busy

Christmas business. We had to change the setup for the US American life reinsurance-business. This was a heavy exercise. The profitability and the tax ratio had been affected by positive and negative effects which have balanced off against each other by and large. We have received all authorizations. The solution is ready.

What are you saying about the trade dispute between USA and the European Union?

Each interference on free trade is not helpful for our business.

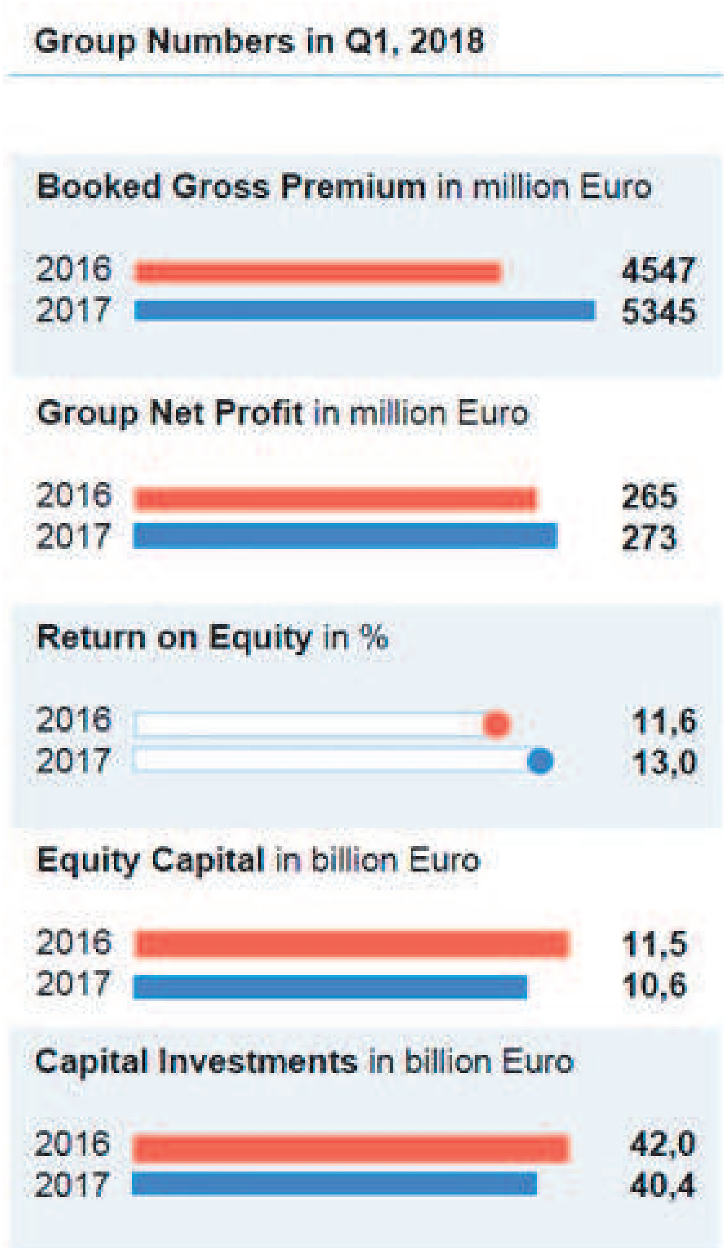
Should the new government in Italy start a course of confrontation with the European Union, which consequences would that have?

From Italy, we are not directly threatened with dangers. As to our capital investments, we are only with a very low portion invested in Italian bonds. Essentially, our position here is the same as to the Brexit.

The rate of price increases in the Euro-area is close to the inflation target of the European Central Bank. How do you evaluate the monetary policy of the Central Bank?

Like many, also we are wishing a turnaround in the interest rate policy. It is time now to reduce the monetary support measures in Europe. In the US, interest rates are increasing step by step already since some time. With such small interest rate increases we as reinsurer and capital investor can live very well. Naturally, our hidden reserves in our dollar capital investments are shrinking significantly. But this is the logical consequence of interest rate increases. We would also wish to have normalized capital investment returns for our Euro capital investments.

Hannover Re at a glance



What would that mean for your investment-strategy?

Our investment-strategy will not change much with the changing interest rate-policy of the European Central Bank. It will continue to be essentially determined by our liability side, by our future liabilities. We invest parallel as to currencies and as to maturities. We can only realize this congruence of maturities with the fixed interest securities. For this reason, fixed interest securities will continue to be the core of our capital investment strategy.

The contribution which capital investments can perform for the reinsurance prices is the lower the lower the interest rates are.

Yes. But the fact is that in the past five of the past six years – in the middle of the low interest rate phase – we could achieve record results. Our reinsurance prices contain the interest income and in most cases, they are newly defined each year. When one is looking at the combined damage-cost-quotas, one realizes that they have been reduced together with the interest rates.

Are increasing interest rates not providing a windfall profit for you?

No. What has not been so much of a damage to us during the low interest rate period namely the yearly adaptation of the reinsurance prices to the interest rates, will also in a phase with increasing interest rates not provide excessive profits to us. Our customers will aknowledge increasing interest rates in our reinsurance prices. This is part of our business model.

In the past year, you have sold your amount of listed equity investments. With 2 % of equity investments in relation to your total capital investments of over 40 billion Euro, do you regard this as a good positioning?

Insurers, and reinsurers, when making their equity investments, do regard different factors. The share of equity investments at us, not only depends on the evaluation of the capital investment committee. A significant role also play the capital requirements as per Solvency II or as per the rating agency models. Equity investments have to be balanced off with a high own equity position, in contrast to the fixed interest rate security investments.
In addition to that and with a view to the accounting regulations, they show an increased volatility of results.

Does this mean that your engagement in listed equity investments will, independently of market movements, also in the future be in a single digit percent range?

You must have this in mind: When we always want to invest with congruence with maturities, then we cannot utilize equity investments which have no maturity at all. We do not have to be invested in listed equities. Equity investments, however, as a matter of principle, have also always been part of our capital investment strategy. Here, nothing will change. We shall, however, continue to proceed opportunistically. In so far, we are ready to reinvest again when there will have been market corrections.

Where is the line of action for you?

We orientate ourselves at the development of a three month average of a basket of share market indices. When a certain lower line has been achieved, then within 24 hours our capital investment committee convenes which is composed of the CEO, the CFO and the Central Business Head of Capital Investments. Then, we must have a quick decision.

Do all three have to have the same opinion or is it sufficient to have a 2:1-decision?

A 2:1-vote has not yet happened to us. Also we would certainly not make a marked capital investment decision, when one member of the committee would be strictly against it.

Which role are the asset-classes real estate and private equity playing in your investment strategy?

Real estate and private equity have been especially in the past two years the key drivers of our capital investment return. The significance of these asset classes might even further grow. Even though they – too – have no fixed maturities and are relatively illiquid. The disadvantage of the ongoing valuation is less material. And they do indeed provide a high ongoing return.

How high could be the portions of these asset classes in the future within your total capital investment?

Concerning real estate, we recently also look at South America and Asia. Our realistic quota of presently 5 % we could certainly further increase to 6 – 7 %. However, one must not forget: Our capital investment volume has been growing significantly. Already in order to maintain the existing percent-ratio, we must find new investment opportunities. The private equity portion of our total capital investment portfolio presently is at 2 % and could increase to 3 %. In the very short term this, however, is not to be expected.

The capital investment volume is presently at 40 billion Euro. What do you regard as possible over the medium term?

The capital investments should grow proportionately with the reinsurance business. We continue to pursue the objective in the reinsurance business, to grow up to 5 % per year. And this over the long term and beyond the cycle when overproportionate und underproportionate growth will match off against each other. Year after year, the reinsurance business will not grow by 10 %. Assuming a growth of 5 %, an increase of the capital investments to over 50 billion Euro in the next 5 years would be imaginable.

Is the importance of the capital investment management growing in relation to the property & casual and the life reinsurance business?

No. Because this would then mean, that we would direct more capital towards the capital investment. But we are not planning to increase the risk appetite within our capital investment.

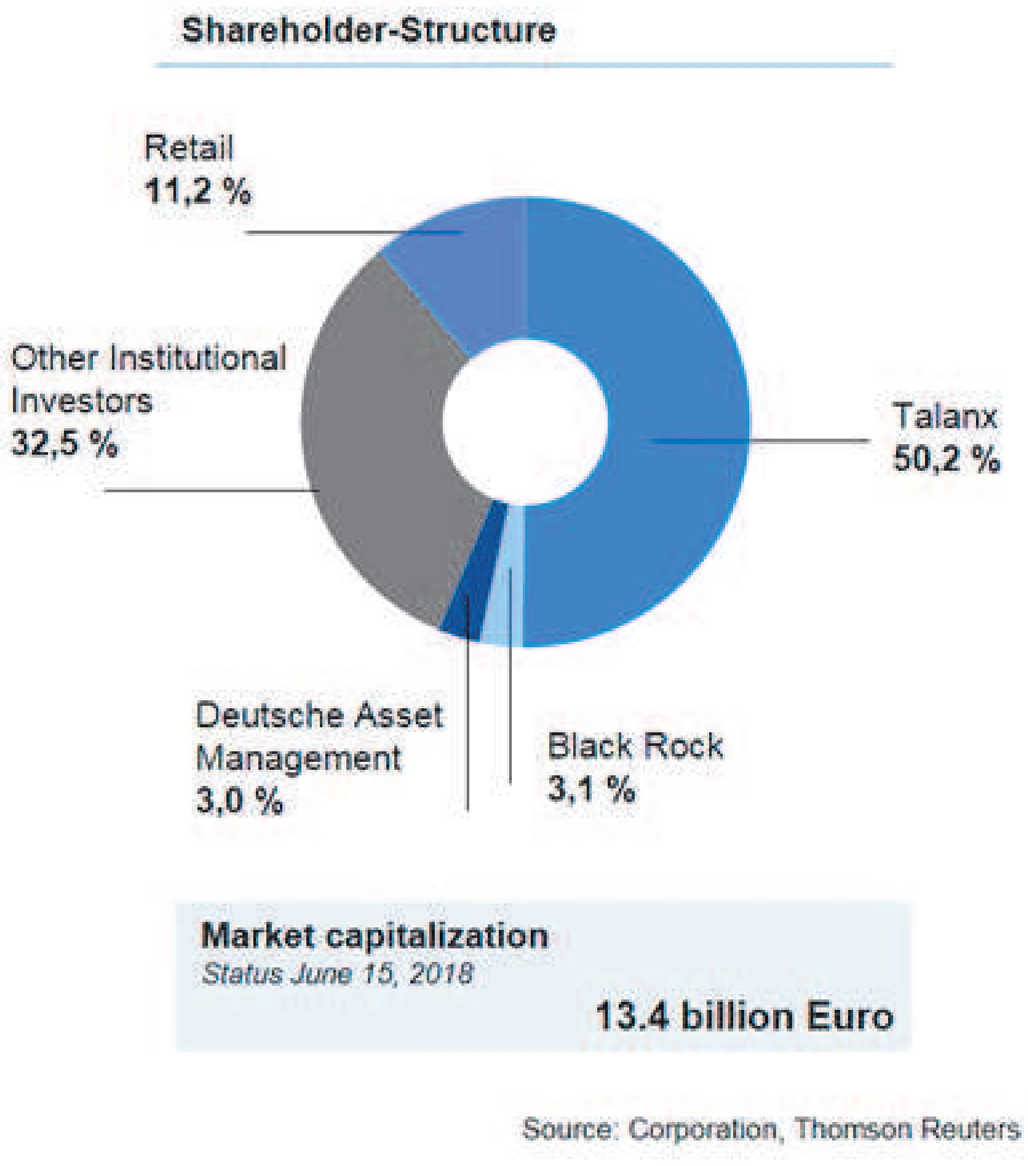
Why not?

Because we are a reinsurer and because we will remain this. Investing capital is something which others can do as well. We need the capital investment for an optimal risk diversification as much as possible. Our risk is almost by 40 % at the capital market risks, by almost 40 % in the area of property casual reinsurance and by around 25 % in the area of life reinsurance. This distribution of risk we regard as reasonable and sustainable. Adaptations, in dependence of market cycles, are always possible. But to expose us more strongly to capital market risks and to capital market fluctuations, would also not be in the interest of our shareholders.

Don't you have to incur higher capital market risks, because you are a reinsurer?

Yes, we are one of the purest reinsurers. Competitors who are also active in front end insurance, usually are positioned higher in capital market risks. We want to concentrate on reinsurance. Would we move more of our capital into capital market risks, then this would mean that the reinsurance does not provide enough for us. This is not the case.

hannover re®



You are aiming at an equity capital return which is at least 900 basis points above the 5-year-average-return of 10-year-German Government Bonds. This objective has always been achieved in the past years. At last with slightly 11 %, however, not so remarkedly any more. Would it be more difficult in future to achieve the minimum target?

It has not become easier with the regulatory requirements with which all of us have to fight. With our competitive advantages of a better cost quota and an efficient capital market management, however, it is also for the future our objective to be above the average of our industry. With this, we also want to justify a price to book-ratio of 1,5, with which we differentiate ourselves significantly from the competition.

Equity capital is by comparison expensive. The issuance of hybrid capital and risk-securitisation are helping to reduce the capital costs. Will you use these instruments more strongly?

We have already reduced our equity by additional dividend payments and are utilizing our own reinsurance for the optimization of the capital costs. By way of the positive equity capital development of the past years, we have a buffer at hybrid bonds which we can utilize. However, we have presently no concrete plans.

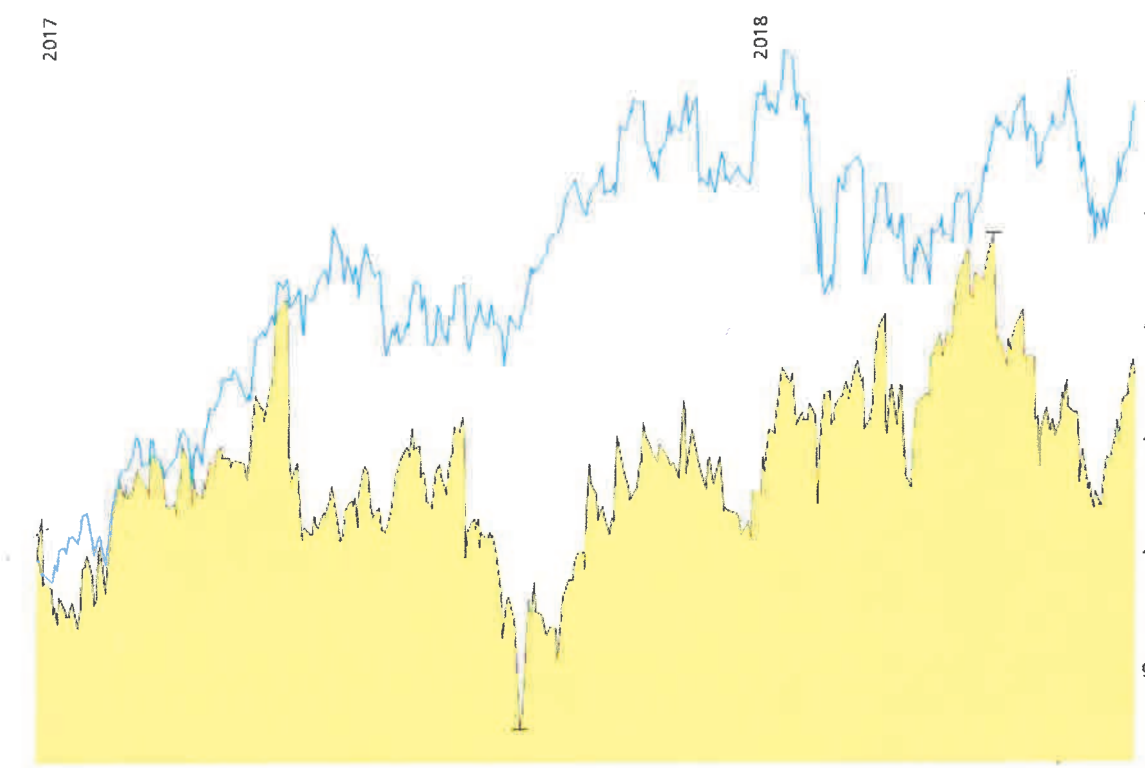
Hannover Re SE, 112,90 Euro Share Price, as of July 18,

German Stock Exchange Xetra

Index Price Chart, Index-base as of January 2, 2017 = 100

-Black line: Hannover Re SE Share

-Blue line: MDAX German 50 Companies Mid Cap Stock Index



Keyword dividends: When will you increase your payout-ratio?

Our profitability has developed in the past years so positively that it might really make sense to adapt the regular dividend payout to the upside. At last, we have achieved the upper limit of 40 % since 2011 or even exceeded it.

What is to be expected for the current business year?

We remain at what we have said: When negative events at the capital markets as well as catastrophies of nature like in the past year do not happen, then we should remain at the payout of 5 Euro dividend per share, including special dividend.

In this year, there is a good development for Hannover Re at the premium revenues. What is the reason?

In the past year, there have been overproportionately high damages with the 3 great hurricans which we name with the abbreviation "HIM", namely "Harvey", "Irma" and "Maria". This had the effect that the average return of the reinsurance industry has only been between 3 and 4 %. This is not sufficient. So, there have been price increases at the programs and the reinsurance contracts. However, they have not been as high as we would have wished it.

Are the objectives for the growth in this year for the two business lines unchanged after the second quarter?

We have in the first quarter increased the forecast for the premium growth in this year at over 10 %. Reason for this was especially the dynamic development in the property & casualty reinsurance business and here especially in the area of structured reinsurances. This yearly forecast we continue to maintain.

With this success, can one also explain the alltime high of the Hannover Re-share at 122,20 Euro as of May 7, 2018, with the announcement of the numbers for the first quarter?

The result of the first quarter has certainly supported the equity price. Even when we say that growth is, compared with profit, not the most important: Growth is indeed a positive news for the capital market. The capital market does honour, when a corporation not only achieves to be profitable but when it also achieves to grow profitably. The profitable growth , together with an attractive dividend return, has enhanced the equity price as of our annual shareholder meeting on May 7.

In the insurance industry starting 2021, the accounting standard IFRS 17 is applicable which is aiming at providing comparable accounting regulation information for insurance contracts, in order to make the effects on the state of assets finance and profit situation as well as the cash flows of a corporation understandable. What means the change for Hannover RE?

The new norm is applicable starting 2021, but we also want to deliver comparisons with the previous year. That means, at the end of 2019 everything has to be in place. We are in the middle of the preparations for this change. With this goes along a very high expense, which competitors of ours have already compared with the preparation for Solvency II. It will necessitate a new view at the balance sheet and at the profit and loss account. A contract will be evaluated with all expected returns until the end of its maturity. With the change, however, there go along higher balance sheet uncertaincies, because assumptions have to be made for a longer time frame. Profit and loss statement and the balance sheet will become more volatile.

Are you happy with this reform and the requirements?

We have started with the requirement to make the numbers of the insurers more transparent and clearer in order to better show the hidden values. With this goes the expectation to bring the price to book ratios and the price to earnings situations at a higher level. The set of regulations which has now been established, partly also with our cooperation, is, however, very complex. It will be a difficult task to present this in an understandable way.

Can you show the potential?

A share of Hannover Re which is traded at 1,5 or 1,6 times the IFRS-book value, is today just about slightly above the Solvency II-book value, which shows the economic value. The industry as a total is being traded significantly below the economic Solvency II-book value. If it is achieved to show the component of the economic balance sheet in a transparent way, then the insurance corporations should be traded at least at the economic book value and they should therefore show a significant stock price potential. However, this transparent presentation will be a challenge.

You are also responsible for IT. Where stands Hannover Re in the digital change and how big is the need for action?

In the past year we have defined a digital strategy. The strategy paper comprises two components: On the one hand, the Hannover Re is setting up itself completely digitally and in an automated way in order to maintain its cost advantage. Our prerequisites are good. Our operations, for example, already are running worldwide since long on a single reinsurance administration system. Next to the internal automization, we must adapt ourselves also to digital customers and must be in a position to market products in one country also in other countries. With investments in single insurtechs and fintechs, however, we have up to now been largely restrictive.

Why?

We are not orientated towards discovering the “Amazon”of the insurance business. But we want to be prepared for market changes which are happening especially in front end insurance. We are working at the development of new products and we are invested, for example, in the fintech incubator Finleap at Berlin. We are pursuing projects worldwide and we are setting up ourselves to export special innovations and to find customers in other countries. We have orientated ourselves towards the digital change and we have formed a team with specialists, which among other things is dealing with artificial intelligence. We are member of the Blockchain-Initiative B31, the objective of which is the execution of reinsurance contracts by way of the blockchain-technology. We also do not want to pursue a digital strategy in the ivory-tower. Every underwriting area must deal intensely with digital opportunities. We need this knowhow for our business with our clients.

Which changes do you expect over the medium term in your industry?

I see that the demand for reinsurance capacities continues to grow, and naturally the framework will change. But it has also been in the past years the case that the one has success, who adapts oneself in the fastest and best way to dynamically changing framework-conditions. This continues to be our objective.

The interview was made by Carsten Steevens.

About the person

The Communicator

About Hannover Re and the reinsurance industry, Roland Vogel could speak endlessly. He perfectly knows the third largest reinsurer worldwide, where he started in 1989 in internal audit, and where since 2011 he is member of the board of management, responsible for finance. The 58 year old, who is from Mosbach in Northen Badenia, but who lives since long in the Hannover area, diligently gives information about the Group. His daily record with meetings with investor groups, presently is at 11 meetings on one day. Vogel also likes to talk about soccer, where in the seventies he played in a selection team of the county of Hannover. As fan of the German federal soccer league team Hannover 96, he expects Spain to become the next world Champion.

From Börsenzeitung, Frankfurt am Main, Germany, June 16, 2018.
Responsible for English translation:
GEFIU, the Association of Chief Financial Officers Germany, translator: Helmut Schnabel

BREXIT MEANS BREXIT – BUT WHAT DOES IT MEAN FOR EUROPE AS A FINANCIAL CENTRE?

SPEECH DELIVERED AT THE ANNUAL RECEPTION OF THE ASSOCIATION OF FOREIGN BANKS IN GERMANY
FRANKFURT AM MAIN | 20.06.2018

Ladies and gentlemen

It gives me great pleasure to be able to speak to you today about the future of Europe as a financial centre after Brexit. There are three aspects which I would particularly like to address.

• The first of these is that banks looking to relocate their business to the EU or expand their presence here after Brexit will be asked to satisfy the same minimum prudential standards that foreign banks already operating within the Union and domestic institutions are expected to comply with. At the same time, we will need to find solutions that prevent any unnecessary additional expense.
• My second point is that in future, institutions that conduct cross-border business will be heavily dependent on how the respective supervisors oversee third-country institutions – as they will then be – and how the authorities involved will cooperate internationally.
• And third, when considering Brexit, we tend to dwell on the negative side of things and think about how best to cushion the impact. As important and justified as these considerations are, we nonetheless need to continue to press ahead with our vision of a harmonised financial market in the EU – a digital financial centre of Europe which offers as yet untapped potential.

2 Leaving the single market means separate supervisory regimes

Two years on from the Brexit vote, we can only assume that cross-border economic relationships look set to face noticeable headwinds going forward. For the financial markets, this means one thing: the financial services passport is dead.

This immediately raises the question: could it be feasible to have something like a diet version of the financial services passport, or to perhaps create a range of exceptions?

The clear answer to this is that there cannot be, nor will there be, any permanent exceptions. Institutions that relocate operations to the EU or expand their presence here following Brexit will have to comply with the same high supervisory standards that apply to the institutions that already operate here.

This answer is underpinned by the fundamental belief that supervisors must be capable of intervening in the business activities of institutions operating within their own jurisdiction at all times. This is a sine qua non, and it should not be up for grabs.

At the same time, this credo should not prevent us from thinking about whether, and if so where, we can cushion any additional operational outlay caused by time pressure.

A transitional period, at least as outlined in principle in March, could help with this. It would lower the long-term costs of exit by allowing firms to reflect on their options and decide which markets they want to operate in and which organisational structures would best allow them to strike the right balance between compliance and profitability. However, we cannot count on there being a transitional period right now, since negotiations could break down at any time.

3 Supervision of future third-country institutions: requirements and cooperation

But whether or not there is a transitional period, one thing is certain: what standards apply to the future third-country institutions will ultimately boil down to how they are treated by the relevant supervisor after Brexit and how the authorities will work together in this context. To shed light on this issue, the SSM has already adopted a whole bundle of supervisory policy stances.

However, in the SSM, our baseline assumption is still the worst case, ie a no-deal scenario. And judging by recent developments in the United Kingdom, this seems more than appropriate.

With the next meeting of EU heads of state or government fast approaching, it doesn't look like solutions to a number of quite fundamental issues concerning the future partnership will be found any time soon. The border with Northern Ireland is just one of these sensitive topics. This means that a huge package of agreements would have to be hammered out at the next summit but one in October, which would then, in turn, have to be reviewed by the parliaments in the shortest of timeframes. And even if this all went smoothly, it would be no more than a framework that would have to be fleshed out in detail to forge a future treaty – which would itself take many years. And because a breakdown in negotiations – and therefore a hard Brexit – remains possible at any time throughout the entire process, enterprises should be prepared for this.

That is why we banking supervisors are so concerned that a number of banks are easing off in their efforts to establish a licensed and operational entity in the EU or UK in good time ahead of March 2019. Let me say in no uncertain terms that these institutions cannot rely on our leniency. We expect all banks to make provisions for a hard Brexit. And that's why I would strongly urge all institutions to make the necessary preparations to keep their business operations running even if there is a hard Brexit on 29 March 2019. Institutions that submit an application after the end of the current quarter will find that the likelihood of their licensing procedure being concluded in time will diminish considerably.

We also expect these applications to satisfy our supervisory policy stances. Let us take a brief look at the key aspects.

- First, there are the principles for authorisation and for governance, risk management and outsourcing. In essence, the several hundred pages of requirements boil down to this: "empty shells" will not be permitted. Banks in the euro area must be able to manage all their material risks independently and locally. To achieve this, they need to have control over their books and all their positions, and have locally independent governance and control functions that report to the local board of management – particularly in the areas of risk management, compliance and internal audit.
- That brings us to the question of booking models. Will back-to-back hedging still be accepted? Here, the SSM expects banks in the euro area to have sufficient local capacity to manage at least an evident portion of their euro-denominated business themselves and not to fully outsource it to other entities within the group. The local entities have to be established in the local market, to ensure that, in the event that other group entities fail, they can participate in the market autonomously. However, we at the Bundesbank naturally see the economic advantages of back-to-back hedging. To some extent, transactions such as these serve as a pipeline to international capital resources at other locations.
- Some parties are hoping for an overarching supervisory or legal solution to the issue of the continuity of financial contracts. In response, I warn against relying on us for this, as it is not so much a supervisory issue as a civil law problem.
- One very important issue – and not just for foreign banks – is the supervision of future third-country CCPs from the UK. In the Bundesbank's view, there have to be clear rules and safeguards here ensuring that continental European authorities have both sufficient rights to obtain information and robust powers of intervention in respect of UK CCPs – otherwise, it seems a relocation to the EU would be all but unavoidable.

The more we look at the whole issue, the more clearly we can see just how serious the repercussions will be when CCPs we consider to be systemically important leave our jurisdiction. Volker Brühl from the Center for Financial Studies gave a systematic summary of many aspects in a recent study on the topic. He set out and simulated with painstaking accuracy the implications of problems at a third-country CCP for:

- monetary policy transmission in the euro area,
- the functioning of our resolution regime,
- having recourse to national central banks, especially the Bundesbank, as alender of last resort.

These scenarios, over which I would have no supervisory influence whatsoever, fill me with increasing unease.

And if my colleague, Brian Bussey from US Commodity Futures Trading Commission (CFTC), stresses that a lead supervisor is crucial, but says the US has more interest in LCH than anyone else in the world, then I think we are already back in third place. Given the CCP's systemic importance for the euro area, this would be unacceptable.

The ECON Committee of the European Parliament has recently taken an initial stance regarding migration – and here, too, the possibility of relocation continues to play a major role.

For us at the Bundesbank, this is not a matter of structural policy or trade issues. We are competitively minded and neutral. Our mandate is to safeguard price and financial stability, and these decisions affect this stability in a major way.

These policy stances already stake out a clear, transparent framework of expectations in the SSM.

4 The future of Europe as a financial centre

Ladies and gentlemen, as much as we greatly regret the United Kingdom's decision to leave the EU, we must nonetheless look forward and consider how financial services can be delivered in the European Union in the future.

First, we need to observe the consequences of Brexit from the perspective of each individual bank. Banks have so far avoided making any major changes, not least because they are also busy coping with large-scale acute challenges and their financial implications. So it is easy to lose sight of strategic issues. It's not just Brexit that's shifting the tectonic plates under banking – digitalisation and regulation are two other key drivers of change. When traditional structures and markets are broken up this way, the cake will be redivided – some will lose out, but some will get a bigger slice. There is a real danger that adhering at all costs to traditional positions in London risks missing out on new opportunities in the EU – though not by everybody: those who don't will be the winners. So I would urge you not to lose sight of medium and long-term strategic options.

Second, we also have to consider the repercussions of Brexit in terms of its impact on the EU financial market as a whole. What we are looking at here is nothing less than the financing of the European economy, especially at a time when the global economic and financial order is becoming increasingly shaky. Earlier EU initiatives – the single financial market, the banking union, and the capital markets union – all had an inward focus. And with London, Europe had an international financial centre. This will now change. Hence the question of whether we in the EU 27 should aspire to developing a globally competitive financial centre that is more than the sum of its parts here in Frankfurt, Paris, Amsterdam or Dublin. François Villeroy de Galhau, the governor of the Banque de France, recently spoke of an integrated network with centres specialised in various activities – and I am thinking along the same lines, which include major efforts to harness digital potential as well.

I would like to help kick off a broad, forward-looking debate surrounding the concept of a digital financial centre of Europe.

It's an idea based on three pillars.

First, a networking pillar. Today, Europe's financial services potential is spread over various locations. It does not have a cumulative effect. However, for a fully-fledged financial ecosystem to truly flourish, there needs to be enough providers and users of financial services in the local market. At present, no European financial centre can tick this box. The continental venues could, however, tap into an aggregate potential if they were to form a network in which any financial product can be bought and sold in any quantity at any time, just as you would expect from a globally competitive financial centre.

The second pillar is digitalisation. Financial centres in continental Europe need robust digital market infrastructure that leverages all the state-of-the-art digital capabilities – of which distributed ledger technology (DLT) is but one. Only then can these centres overcome fragmentation and replicate agglomeration effects of physical proximity. The Eurosystem will also be expected to contribute here, seeing as it already provides a key piece of infrastructure for payments in the shape of the TARGET system.

These first two pillars create a digital network across European financial centres. But to make the most of Europe's potential as a "financial Amazon", market-driven specialisation will also be needed as a third pillar. Specialisation can help deliver economies of scale, increase the potential for innovation, and achieve excellence. In an environment of "coopetition" – a neologism merging the words cooperation and competition, European financial centres could cooperate, compete and, at the same time, hone their own areas of expertise. But this is a vision for the future.

It's a picture of the future that is also very much in our own inherent interest as a central bank, because the more that financial flows end up where our system is in force, the more we are able to promote financial and price stability as well as a strong currency.

5 Conclusion

Ladies and gentlemen, “Brexit means Brexit” – but at the end of the day, what this means for the financial centre of Europe is very much up to us.

This goes for those of you who are domestic and foreign banks, for those of you who make policy at the regional, national and European level, and for us as central banks and supervisors.

Now a change of perspective is in order: let’s see Brexit as an opportunity for us, not by naïvely whitewashing what is a regrettable development, but by planning a sober yet forward- looking model.

Thank you for your attention.

Deutsche Bundesbank
Communications Department

Wilhelm-Epstein-Straße 14, 60431 Frankfurt am Main, Germany
Internet: www.bundesbank.de | E-mail: info@bundesbank.de
Tel: +49 69 9566-0 | Fax: +49 69 9566-3077

DEUTSCHE BUNDESBANK
EUROSYSTEM

THE FISCAL STATE AID FRONT
SOME REMARKS ON THE RECENT DEVELOPMENTS

BY **PIERGIORGIO VALENTE**, CHAIRMAN OF THE INTERNATIONAL TAX COMMITTEE IAFEI, JULY 2018, ARTICLE PROVIDED BY **ANDAF**, THE ITALIAN IAFEI MEMBER ASSOCIATION

Introduction

On June 20th, 2018 the European Commission issued its decision on the Engie (prior GDF Suez) case concerning fiscal state aid, following a 2-years' investigation[1] . The decision requires Luxembourg to recover around € 120,000,000 from Engie granted in violation of European Union (EU) law on state aid through tax rulings.
The Engie decision follows a series of decisions regarding illegal state aid considered to have been granted through tax rulings by Member States. Many of them have made headlines, involving some of the largest multinational groups worldwide, such as Apple[2] , Amazon[3] and Starbucks[4] and amounts that can reach billions of Euros. More are expected in the near future, e.g. in the case of McDonald's[5] and IKEA[6] .
Since 2013 the Commission is showing a strong commitment to the scrutiny of Member States' tax ruling practices in order to ensure that they do not serve as a means to circumvent EU law on state aid. In this context, a number of Member States' tax rulings have been invalidated.
However, tax rulings have been one of the most important tools for multinational corporations to gain advance certainty on the tax treatment of their transactions. The scrutiny of national tax rulings by the European Commission and their invalidation in several occasions is therefore a source of serious concern for business with EU activities. On the one hand, there are reasonable doubts as to the value of obtaining a tax ruling in the EU. On the other hand, corporations that have obtained and implemented tax rulings have to be prepared for the case such rulings are considered invalid and they are asked to pay considerable amounts of taxes considered

1. European Commission, State aid: Commission finds Luxembourg gave illegal tax benefits to Engie; has to recover around € 120 million, Press Release 20 June 2018.
2. SA.38373 $ - Aid to Apple.
3. SA.38944 $ - Aid to Amazon – Luxembourg.
4. SA.38374 State aid implemented by the Netherlands to Starbucks.
5. A.38945 Alleged aid to Mc Donald's – Luxembourg.
6. SA.46470 Potential aid to IKEA – Netherlands.

unpaid.
In such a framework dominated by uncertainty, this article seeks to provide a brief update on the latest developments in the area of fiscal state aid and to put forward some of the question-marks arising from the Commission's approach.

The Engie Case

The recent Engie case focuses on two tax rulings granted by the Luxembourgish tax authorities to two local subsidiaries of the Engie group (Engie Treasury Management and Engie LNG Supply). Both rulings concern the tax treatment of a specific financing instrument used for the financing of each of the companies: an interest-free mandatorily convertible loan.
In a nutshell, each one of the aforementioned Engie subsidiaries issued the above type of loan to a related company, without an obligation to pay interest but with the obligation to pay an amount increasing the issue price of the loan, so-called "accretion". The amount of the accretion was not stable but changed every year depending on the profit of the debtor[7] . Nevertheless, the amount of the accretion was not paid to the related company – lender but was accumulated in the debtor company. At the end of the loan agreement, the loan would be converted to shares in the debtor company. At that point in time the accumulated accretion would be transferred to the lender/new shareholder along with the shares.
The tax treatment of this financing structure was the content of the rulings. In essence, the amount of the accretion was not taxed in the hands of the debtor company as profit; it was regarded as expense in connection with the loan and it was deducted from such profit. Such amount was also not taxed in the hands of the lender company. The reason is that it was received by such company only once the loan was converted to shares and such conversion "does not lead to realization of capital gains"[8] according to Luxembourgish law. This implied that a certain part of the accounting profit of the debtor remained untaxed in Luxembourg, due to what seems a mismatch in the national tax law.

The Commission considered the above non-taxation unacceptable, disagreeing with the interpretation of Luxembourgish law endorsed in the tax rulings. Its basic argument was that the financing instrument described above should have been classified as taxable distribution of profit and not as debt. Thus, it would have been taxed as profit of the debtor company. The Commission refers also to an alternative scenario. Should the financing instrument be considered debt and hence deductible expense, Luxembourgish tax authorities should not have applied the provision regarding non-taxation in case of conversion[9].

Luxembourg disagreed with this line of reasoning, arguing that the rulings are a mere confirmation of Luxembourgish provisions, applicable equally to all taxpayers. As a result, they do not confer a selective advantage to the specific taxpayer – Engie subsidiaries – and cannot constitute state aid.

Question-marks from the Commission's decision

The Commission's decision identified lack of taxation in Luxembourg of part of accounting corporate profit of Luxembourgish entities. Cases of double non-taxation tend to give rise to furious reactions of public opinion, taking into consideration the recent financial crisis and the several findings of unfair distribution of tax burden.
However, the finding of low effective tax rate is not per se sufficient to ensure that a decision on illegal state aid is correct. Instead, the merit of such decision needs to be assessed in the context of EU state aid rules, taking into account their scope of application and the specific powers granted to the Commission. In this regard, the Engie case has raised questions, already from the time of the opening decision.

A first issue regards the competence of the Commission to assess the interpretation and application of national tax law by the authorities of the Member States[10]. The Engie case is illustrative of this issue: if the same national law provision can be interpreted in two ways, is it for the Commission or for the Member State to establish the correct interpretation?

Assuming that the Commission can assess the application of national law by Member States' authorities to safeguard the function of the Single Market, it has to exercise its powers within the limits of state aid law. Finding of state aid requires identification of an economic advantage having been granted to some taxpayers, while it has not been granted to other taxpayers under comparable circumstances. In the Engie case, the Commission

7. In practical terms, the Luxembourgish companies issuing the loans (debtors) were considered taxable in Luxembourg for a fixed profit margin and not for their whole accounting profit. The difference between the latter and the former constituted the amount of the accretion.
8. SA.44888 Aid to GDF Suez.

9.These conclusions arise from the combined reading of the press release issued by the Commission on the Engie decision and the Commission's decision opening the case, released on 19 September 2016. The final decision has not been published yet; hence it cannot be excluded that it includes further arguments.
10. E. Nuku, H. Vermeulen, The Engie Case: Fiscal State Aid and Mismatches in One Member State, in 19 Derivatives & Financial Instruments 4, 2017 (29 June 2017).

is in fact, invoking discriminatory application of national tax law by Luxembourgish tax authorities through tax rulings in favor of Engie subsidiaries. Such finding should then be supported by evidence of different application of the same law on other Luxembourgish taxpayers in comparable circumstances. For example, the state aid decision in the Apple case takes into account a number of tax rulings granted by the Irish tax authorities[11]. The final decision on Engie should include such comparison; yet this does not arise from the press release or the Commission's decision opening the case.

Conclusions

The Engie case gives rise to important questions, similarly to several previous fiscal state aid decisions of the Commission. In fact, many Member States involved in such cases have appealed the respective negative decisions before the Court of Justice of the EU. As a result, the Court shall now have the last word in Apple, Starbucks etc. and very probably in Engie case as well. Hopefully, the Court shall provide clear responses to the questions raised, giving an end to the uncertainty dominating the area of fiscal state aid. Until that time, the business world shall need to devote appropriate resources to tax risk management, in order to be prepared for all scenarios.
Beyond the responses awaited from the Court though, the fiscal state aid area is undergoing a notable amendment as a result of measures taken at EU and OECD level to counter base erosion and profit shifting. In this context, national tax rulings of cross-border interest are now being exchanged automatically among Member States' authorities[12]. Purpose is to increase transparency, discouraging national authorities from granting favorable rulings to specific taxpayers while ensuring that all involved tax authorities have a thorough overview of the taxpayers' obligations in the EU. It may be expected that such transparency shall have a positive impact in the decrease of state aid cases through tax rulings.

11. SA.38373 $ - Aid to Apple.

12. Directive 2015/2376/EU, regarding automatic exchange of cross-border rulings between EU Member States; OECD, 2015 Final Report on BEPS Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance.

MEXICO, ITS HISTORICAL MOMENT AND THE IMPORTANT DECISIONS TO BE MADE BY THE NEW GOVERNMENT

BY **JOSÉ JAIME DÍAZ GONZÁLEZ**, CAMPA MANAGING PARTNER GSG CONSULTORES ASOCIADOS S.C., ARTICLE PROVIDED BY IMEF, THE MEXICAN IAFEI MEMBER ASSOCIATION

On July 2nd, 2018, Mexico defined a major change in the Government model. For the next 6 years it will have a leftist style President.

The President-elect, had been a candidate on two previous presidential elections. As the term of the outgoing President had questionable results, people decided by majority vote to give the opportunity to be president to Andrés Manuel López Obrador.

Mexico, the United States and Canada have been negotiating for almost a year now, on a change of the Nafta trade contract and model. New political arguments have been put on the table between long standing friend and neighbour countries. The argument has been made that NAFTA is not even or fair. In the same context, President Trump has had differences with almost all the other governments of the world.

The economic argument has been made, that most countries have taken advantage of the United States. The North American market is undoubtedly the largest in the world in terms of GDP. This is due to two phenomena. One, the size of the population. The latest numbers indicate that there are 320 million people for the USA alone. At the same time the size of the US economy to 2017 is 20 trillion dollars with a GDP per capita of 62 000 dollars. Being the economy number 1 in the world, the rest of the countries in the world want to sell their products in that market. This is a very important issue, as the income of people is higher in the US than in any other country, the component of labor in products and services that are sold to the USA will be cheaper than if they are produced locally in the USA.

I should mention that the United States accounts for 50% of direct foreign investment in Mexico, and it goes to manufacturing companies. Therefore, to a large extent, the trade deficit that the United States has with Mexico is composed of products and services that have components of foreign direct investment by the United States in Mexico.

Among all international capital investments worldwide, the United States received in 2016 about 26% of total, at the same time Mexico received 1.5% of the same component.

Mexico is a leader in the export of some fruits and agricultural products. It is the third country in export levels of motor vehicles. However, its trade balance is in a global deficit as Mexico has lost its export levels of crude oil.

With this context, the new government seeks to develop the domestic market and encourage consumption of products made in the country. It is not wrong. However, in order to be self-sufficient in many of the products that Mexico consumes, it is still needed a very strong investment in infrastructure, education and development in many regions of the country that currently have a very strong cultural and economic backwardness. This delay is not eliminated overnight.

Mexico comes from a period in which public investment was the lowest in the last 70 years. A good part of public spending goes into pension payments, government payroll expenses and very little investment in long-term projects. It has been decided to offer social programs, subsidies so that a large percentage of the population subsists. But it does not help to create sustainable economies for tomorrow.

There are great opportunities in some sectors such as technology and tourism. These areas can generate income to regions that have a great potential and can become places to visit from all over the world.

The products and services that are exported are destined by 80% to the United States.

Mexico has more than 40 trade agreements with other nations so turning to other countries to bring what is produced in Mexico will make us less dependent on our number 1 customer.

On the other hand, I invite investors from all over the world to get to know Mexico. Invest your capital here. Mexico will become a great economic power in the next 15 to 20 years.

We hope that this vision exists within the new Mexican Government. The vision of abundance, of opportunity and of taking advantage of the historical moment.

THE TRANSITION TO A ROBUST REFERENCE RATE SYSTEM

REMARKS BY **WILLIAM C. DUDLEY**, PRESIDENT AND CHIEF EXECUTIVE OFFICER OF THE FEDERAL RESERVE BANK OF NEW YORK, AT THE BANK OF ENGLAND´S MARKETS FORUM 2018, LONDON, UK, 24 MAY 2018, FROM BIS, CENTRAL BANKER SPEECHES

Thank you, Mark, and thanks to the Bank of England for the opportunity to talk about the important issue of reference rates. I will focus my remarks today on reference rate reform in the United States—where we have been, where we are, and where we are headed. In short, I will argue that while much has already been accomplished, we still have a lot more to do—and it must happen within a compressed time frame. This is an important point that Andrew Bailey usefully underscored for us last year. Because of the great uncertainty over LIBOR's future and the risks to financial stability that would likely accompany a disorderly transition to alternative reference rates, we need aggressive action to move to a more durable and resilient benchmark regime. As always, what I have to say reflects my own views and not those of the Federal Open Market Committee (FOMC) or the Federal Reserve System[1].

1. James Bergin, Raymond Check, Caren Cox, Gerard Dages, Joshua Frost, Matthew Lieber, William Riordan, and Kevin Stiroh assisted in preparing these remarks.

LIBOR Scandal Demonstrated the Imperative for Reform

Although the backdrop to current reference rate reform efforts is well known here, some historical context is useful when considering the issues facing us today. That history highlights why alternatives to LIBOR are needed. It also illustrates the importance of continuing to focus on bank culture and proper incentives in order to support financial stability over the longer term.

At its core, the problem we face today is that the financial system has built a tremendously large edifice on a structurally impaired foundation. While many in the industry cannot recall a time when LIBOR did not exist, in fact, it was only developed in the 1980s. Since then, the use of LIBOR as a reference rate has exploded—with the size of financial contracts referencing U.S.-dollar LIBOR today estimated at close to $200 trillion[2]. The vast majority of these exposures are

2. See Alternative Reference Rates Committee, Second Report, March 2018

derivative obligations, such as interest rate swaps. But, that tally also includes trillions of dollars of cash products, such as residential and commercial mortgages, corporate bonds and loans, and securitized products. And, with new contracts referencing LIBOR still being written, this balance continues to grow significantly.

Broadly speaking, reference rates are vital to efficient market functioning. They facilitate trading in standardized contracts, which lowers transaction costs and increases market liquidity. Robust reference rates can also reduce information asymmetries and the risk of misconduct by providing transparent, independent pricing.

But, in the case of LIBOR, the foundation had serious flaws. Most notably, LIBOR was (and is) based on submissions from individual banks—which, in turn, were based on hypothetical borrowing rates or expert judgments, and not actual transactions. Moreover, deficiencies existed in regulatory oversight and governance of the rate-setting mechanism. These vulnerabilities enabled the manipulation of the rate for the financial benefit of individuals and institutions. Amid profound breakdowns in controls and compliance, individual traders conspired with rate submitters at their own institutions or traders at other firms to manipulate the setting of the rate to improve their trading results. During the global financial crisis, panel banks also reportedly submitted lower borrowing rates than they could actually obtain in the marketplace. They did so to disguise their financial fragility at a time when uncertainty over bank liquidity and solvency was high[3].

The resulting scandal was particularly disturbing because of its scale and flagrancy, including collusion by employees across firms. It led to billions of dollars in fines, jail terms for some individuals, and severe reputational damage to the financial industry as a whole. The global financial crisis exposed excessive risk-taking and a long series of lapses in judgment, and the LIBOR scandal further undermined trust in the ethical standards of the banking industry.

The scandal provides many cautionary lessons, including the ways in which poor technical design can be exploited, the limitations of self-regulation, the problems that arise when loyalty is to one's trading co-conspirators rather than to one's institution, and the need for robust controls. It also underscores the power of incentives to drive individuals and firms to do things that are imprudent and/or unethical[4]. And, the governance and control framework that the banks and the LIBOR administrator had in place proved woefully insufficient to prevent misconduct that stemmed from poor incentives. In this context, one could say it was a situation ripe for exploitation.

The openness and brazenness of misconduct as captured in the recorded transcripts also point to serious deficiencies in bank culture. My New York Fed colleagues and I have commented frequently on the need for sound culture and incentives as a complement to effective regulation and supervision. While there has been some progress on this issue in recent years, the LIBOR and other rate-rigging scandals—not to mention more recent breakdowns at individual banks—point to the need for further strengthening of bank culture[5].
I look forward to the discussion with Minouche and Andrew on improving culture in the fixed income, currency, and commodity markets in the following panel.

One of the key lessons from the financial crisis was that critical pieces of financial system infrastructure must be both strong and resilient, and the LIBOR scandal underscored this need[6].
The essential problem with LIBOR is the inherent fragility of its "inverted pyramid," where the pricing of hundreds of trillions of dollars of financial instruments rests on the expert judgment of relatively few individuals, informed by a very small base of unsecured interbank transactions. Moreover, that base has contracted further in recent years, due to many factors, including regulatory reform and the quantitative easing programs initiated by central banks in many of the major advanced economies. Relative to the vast sums of U.S.-dollar LIBOR contracts I mentioned earlier, the median daily volume of unsecured three-month U.S.-dollar wholesale borrowing is minuscule, at around $1 billion, and many days see less than $500 million in volume[7].
This lack of market liquidity means that these rates cannot be sufficiently transaction-based to be truly representative, and rates that are not transaction-based are more at risk to be manipulated.

So, despite efforts to improve LIBOR in recent years—and there undoubtedly have been important changes that have strengthened its administration and governance—the lack of underlying market liquidity for nearly all currencies and maturities remains a problem, and there is no obvious solution[8].
The setting of LIBOR still depends heavily on expert

3. See remarks by William C. Dudley, Restoring Confidence in Reference Rates, October 2, 2014
4.See remarks by William C. Dudley, The Importance of Incentives in Ensuring a Resilient and Robust Financial System, March 26, 2018

5. See for example:
6. William C. Dudley, Enhancing Financial Stability by Improving Culture in the Financial Services Industry, October 20, 2014
7. William C. Dudley, Opening Remarks at Reforming Culture and Behavior in the Financial Services Industry: Expanding the Dialogue, October 20, 2016
8. William C. Dudley, Remarks at the Culture Imperative – An Interbank Symposium, January 11, 2017

judgment. Even for U.S.-dollar LIBOR, actual transactions are the basis for only about one-third of the ratesubmissions for tenors of one and three months. This is noteworthy because these are the maturities that are referenced by the bulk of financial contracts[9].

In light of the history of LIBOR—and in the context of more than $320 billion in overall misconduct fines since the crisis—banks are naturally reluctant to assume the legal risks associated with submitting quotes based on very shallow markets[10].
Indeed, that is why some banks have left individual LIBOR panels in recent years[11].
Andrew Bailey drove home this point in his July 2017 speech. He explained that the Financial Conduct Authority had to press hard to persuade banks to remain on the panels and voluntarily submit LIBOR quotes through the end of 2021[12].
LIBOR's potential cessation after 2021 poses a clear risk to financial stability, and prudent risk management means that all of us must prepare for a world without LIBOR.

The Official Sector Response

In recent years, international and domestic authorities alike have actively worked with the private sector to address LIBOR's shortcomings and to find alternative rates. One notable development has been the publication of an international set of principles for financial benchmarks, developed by the International Organization of Securities Commissions (IOSCO) in 2013[13].
These principles—which include 19 specific standards across governance, benchmark quality, methodology, and accountability—have emerged as the international standard. IOSCO has rightly focused on tying benchmarks more closely to observable, arms-length transactions. This represents an important step toward eliminating excessive reliance on expert judgment.

The Financial Stability Board (FSB) has been a galvanizing force at the international level. The FSB and its members have published proposals, plans, and timelines for reference rate reform and have promoted the strengthening of the major interest rate benchmarks. The FSB has been carrying out work on the development and introduction of alternative benchmarks, developing a plan to accomplish a transition to new benchmarks, encouraging work by the private sector on contract robustness, and reporting regularly on the progress made[14].

The Federal Reserve has played a lead role in the development of these recommendations as applied to U.S.-dollar LIBOR, working closely with the other major financial regulatory agencies in the United States. This effort has also involved coordinating with the official sector sponsors of similar efforts around the world[15].
In late 2014, in response to FSB and Financial Stability Oversight Council recommendations, the Federal Reserve convened the Alternative Reference Rates Committee (ARRC)—a group of market participants established to identify more robust alternative U.S.-dollar reference rates that are risk-free or nearly risk-free, fit the needs of the derivatives market, and are compliant with IOSCO principles[16].

This effort paralleled similar

ones in other jurisdictions to find reference rates that are well-suited to local conditions and market needs—including the UK's Working Group on Sterling Risk-Free Reference Rates. The ARRC was also tasked with developing a transition plan to facilitate the adoption of these rates in a voluntary and orderly manner, and with considering best practices in contract design to prepare for the possibility that LIBOR ceases to be published.

Publication of Alternative Reference Rates by the Federal Reserve

The ARRC has made important progress in achieving its mandate. Notably, in June 2017, it selected the Secured Overnight Financing Rate, or SOFR, as its preferred alternative to U.S.- dollar LIBOR. SOFR is a broad measure of the cost of borrowing cash overnight using U.S. Treasury securities as collateral, and is thus relevant to a wide range of market participants. The rate is entirely transaction-based, and the underlying market is robust, with current daily volume of more than $700 billion. (By comparison, unsecured three-month U.S.-dollar wholesale borrowing totals roughly $1 billion per day, as I mentioned earlier.) SOFR moves closely with LIBOR and other money market rates over time, and because it covers multiple segments of the repo market, it provides

9. William C. Dudley, Reforming Culture for the Long Term, March 21, 2017
10. Michael Held, Reforming Culture and Conduct in the Financial Services Industry: How Can Lawyers Help?, March 8, 2017
11. Kevin J. Stiroh, Misconduct Risk, Culture and Supervision, December 7, 2017
12. See remarks by William C. Dudley, Lessons from the Financial Crisis, November 6, 2017
13. See Alternative Reference Rates Committee, Second Report, March 2018

14. The U.K. Wheatley Review led to changes in many areas of LIBOR, including statutory regulation of LIBOR, selection of a new administrator, new governance and oversight regimes, and a code of conduct for submitters. See The Wheatley Review of LIBOR: Final Report
15. See ICE LIBOR Quarterly Volume Report – Q1 2018
16. See Boston Consulting Group, Staying the Course in Banking, March 2, 2017

scope for future market evolution[17].

Besides being more resistant to manipulation, this nearly risk-free rate should also prove much more resilient during periods of financial stress, because the U.S. Treasury repo market is likely to remain deep and active during such episodes.

The New York Fed administers and produces SOFR in cooperation with the Office of Financial Research. We began publishing this rate on April 3 of this year, along with two other repo rates: the Tri-Party General Collateral Rate and the Broad General Collateral Rate[18].

This work complements steps by the Federal Reserve to promote greater transparency in rates in unsecured markets through enhancements to the calculation of the effective federal funds rate (EFFR) and the launching of an entirely new rate, the overnight bank funding rate (OBFR)[19].

I have long been a proponent of the idea that central banks are well suited to take on this responsibility. Reference rates have strong public good properties, and the private sector faces notable coordination challenges in this area. Central banks have a long history in producing such measures—recognizing that traditionally this has been for purposes related to monetary policy—and are trusted independent parties. In my view, central banks also ultimately "own" the financial stability risks that are present when key reference rates are flawed. Better to recognize this responsibility and move proactively to mitigate such risks than to step aside and hope that someone else will take up the mantle of reform.

The Federal Reserve has designed these benchmarks to be compliant with IOSCO principles, with regular review by oversight bodies and comprehensive ethics and conflict-of-interest policies for staff[20].

Best practice also dictates that administrators periodically review the rates they produce to assess whether changes in the underlying markets require changes in how those rates are administered. We have dedicated significant resources to these efforts, and are committed to the continued production of rates so that market participants can have confidence about their long-term viability.

For these reasons, the Federal Reserve concurs with the ARRC that SOFR represents a compelling alternative to U.S.-dollar LIBOR—particularly for most derivatives transactions, where a near risk-free rate is more appropriate than a rate that incorporates a bank credit risk premium.

17. See FCA statement on LIBOR panels, November 24, 2017

18. See Andrew Bailey, The Future of LIBOR, July 27, 2017

19. 13 See The Board of the International Organization of Securities Commissions, Principles for Financial Benchmarks: Final Report, July 2013

20. See the Financial Stability Board's publications on financial benchmarks

Nevertheless, market adoption of SOFR faces its own challenges, such as the development of sufficient liquidity in derivatives that reference SOFR, and the establishment of a term reference rate, which I will discuss in a moment. These elements will have to be built over time. The ARRC's Paced Transition Plan lays out a timeline for the milestones that must reached over the coming quarters and years for a successful transition[21].

I am confident that the ARRC will succeed, but it will take considerable attention and effort.

Progress is already evident. The Chicago Mercantile Exchange began offering SOFR futures contracts earlier this month, and trading activity has gotten off to a good start. Development of SOFR derivatives, in turn, will support the creation of a term reference rate. Although the ARRC's transition plan anticipates that this will be completed by the end of 2021, it would be better for this to occur more expeditiously. The good news is that is broadly appreciated. In this vein, the Committee's second report discussed some of the term rate alternatives, and development of proposals for a term reference rate was recently added to its mandate. In this regard, I would also encourage market participants, academics, and other interested parties to contribute to the effort to develop a term reference rate.

Another key area of focus—further motivated by Andrew's warning—is the development of fallback contract language in the event that LIBOR ceases to be published. The absence of such language creates the potential for large-scale disorder in global financial markets should LIBOR go away. Put simply, this is an unacceptable risk. The International Swap Dealers Association (ISDA) has been working on this issue for the derivatives market and is expected to issue a consultative document soon that should prove instrumental in making further progress. The ARRC has also been coordinating a similar effort across cash products of all types. The goal is to achieve consensus on a consistent approach across markets whenever feasible.

Looking Ahead

As I have noted previously, LIBOR continues to have significant shortcomings despite strengthened governance in recent years, and uncertainty about its future will only grow over time. This uncertainty reflects the limited liquidity underlying LIBOR and the corresponding legal risks I discussed earlier. But, I am also skeptical about whether LIBOR can ever be adequately transaction-based. As Andrew highlighted, there is no guarantee that LIBOR will continue to exist beyond December 2021. In my view, LIBOR is likely to go away—and it should, because it is not supported by a sufficiently robust

21. See Remarks by Jerome H. Powell at the ARRC, November 2, 2017

regime. The LIBOR countdown clock should provide an impetus for action, but it should also make market participants and regulators increasingly nervous as we approach the deadline—especially if longer-term solutions are not in train or in place. Time is of the essence, and we must manage it well. The ARRC and others have laid out valuable transition plans, and we need to ensure that they are executed expeditiously and well.

Of course, I do not mean to minimize the costs involved. This is a monumental and complicated effort—one that the industry has never undertaken—and it will entail overcoming many obstacles. It requires collective action by a wide variety of market participants, some of whom may not be fully convinced of the need for change. And, there may be others with a direct interest in the preservation of LIBOR—such as its administrator—who may not support moving away from the status quo. There also undoubtedly will be those who seek a free ride on the efforts of others. And, of course, the effort will encounter inertia and wishful thinking. All of this is to be expected in such a large undertaking with significant upfront costs. Nevertheless, delay is not a viable option.

This task is borne out of necessity. Financial crises typically result when we fail to identify vulnerabilities, and then unexpected triggers turn those vulnerabilities into points of weakness that can lead to catastrophic failure. The discontinuation of LIBOR, however, is different. We can see it coming, and we know the impact of a disorderly transition would be huge. Therefore, a half-hearted effort or a failure to act would be inexcusable, especially after all we have learned from the experience of the financial crisis. Moving this core piece of the global financial system to a firm and durable foundation is essential and worth the cost.

This task is admittedly hard, but I am optimistic given our past successes. We have demonstrated that effective collective action can provide solutions to longstanding structural vulnerabilities in the financial system. A key lesson from the crisis is that structural vulnerabilities must be addressed continually. If they are ignored, larger problems eventually will result. For example, through collective action over the past decade, we have successfully addressed structural weaknesses in the tri-party repo market, the over-the-counter derivatives market, and money market mutual funds.

Each of these challenges required a tailored solution that relied on different tools—including a diverse mix of market, regulatory and supervisory measures—to get the job done. Everything isn't a nail, and the best tool is not always a hammer. You have to identify the problem that needs fixing and select the right tool for the job. This is likely to require both official sector engagement and private sector initiative.

In the case of LIBOR, the official sector has taken a multi-pronged approach: strengthening the LIBOR regime, developing reference rate principles, using its convening authority to marshal private sector participation, supplying robust alternative reference rates, and using the bully pulpit to educate and spur action. International coordination has featured strongly in these efforts, and should continue to do so. This approach has achieved a great deal to date, but, in light of the risks and potential implications, will it be sufficient?

The transition away from LIBOR represents a significant risk event for firms of all sizes, and they should actively manage this transition through their existing frameworks for identification, management, and mitigation of risk. Supervisors should continue to support this objective by ensuring that all firms are aware of the transition and that LIBOR-related issues are being addressed in a way that is commensurate with a firm's exposures and risks. More broadly, the official sector will continue to push market participants to take all necessary steps to mitigate the risks to financial stability from a disorderly transition.

In closing, the LIBOR scandal certainly was one low point among many during the financial crisis and its aftermath. It highlighted the need for reform of a critical area of the global financial system. We have made considerable progress since then, but reform still has a long way to go. The remaining work, by necessity, will involve purposeful collective action and engagement across the financial industry to address market-wide issues. It also will require firm-specific action to manage individual risks. The challenge is that the window for action is narrowing.

Therefore, we must redouble our efforts to ensure a successful transition from LIBOR to a more sound and durable regime.

Thank you for your kind attention. I would be happy to take a few questions.

NOW IS THE TIME FOR BANKING CULTURE REFORM

REMARKS BY MR **JOHN C. WILLIAMS**, PRESIDENT AND CHIEF EXECUTIVE OFFICER OF THE FEDERAL RESERVE BANK OF NEW YORK, AT THE GOVERNANCE AND CULTURE REFORM CONFERENCE, FEDERAL RESERVE BANK OF NEW YORK, NEW YORK CITY, 18 JUNE 2018.

Introduction

It’s a pleasure to speak at today’s conference on this critically important issue, one that Bill Dudley and his colleagues have done tremendous work bringing to the forefront over the past few years. It’s also an honor to be sharing a stage with Bill today, and I’d like to thank him for his outstanding leadership of the New York Fed.

I’ve learned a great deal from this conference, especially hearing the diverse perspectives and experiences of regulators from across the globe, industry leaders, and academic experts. The speakers and discussions have already covered a lot of ground, so I’ll keep my remarks brief.

This afternoon I’m going to talk about the urgent need to focus our attention on banking culture in supervision and what that means in practice. Before I go any further, I have to give the usual Fed disclaimer that the views I express are my own, and not necessarily those of anyone else in the Federal Reserve System.

The Good Times Are When to Get Your House in Order

In the wake of the financial crisis and ensuing economic downturn, the world’s attention was trained on financial services. The crisis severely eroded people’s trust in the industry, both here and abroad.

Governments and regulators quickly got to work fixing the main deficiencies in the existing regulatory framework. These included requiring much stronger loss-absorbing capital to weather severe economic downturns, demanding greater liquidity cushions to withstand market and funding disruptions, and creating a robust resolution framework to protect both the economy and the taxpayer in the event of a failure of a systemically important firm.

These changes were appropriate and necessary. We must not lose sight of their importance in safeguarding the soundness of the financial system and in ensuring that future generations do not have to suffer the economic trauma that we lived through this past decade.

Bringing us to the present day, we are in a much, much better place, in terms of both the financial sector and the overall economy. We have a more robust regulatory regime in place, and banks are well positioned to survive future storms.

Furthermore, our economy's in great shape; we're in the second-longest expansion in history, and economic data from both the United States and countries around the world continue to trend upwards. As a policymaker, solid growth, a strong labor market, and inflation near our target are all exactly what I want to see.

Paradoxically, it's precisely this sense that things have gotten so much better that worries me most. Although we have seen marked improvements in the critical areas of capital, liquidity, and resolution, we have not yet fully addressed the root causes of many of the problems that have plagued the financial sector. I am thinking of not only the excessive risk-taking and leverage in the run-up to the crisis, but also the repeated scandals related to LIBOR, FX, money laundering, sales practices; unfortunately, the list goes on and on. Underlying these scandals is often an inadequate corporate culture, where accountability and ethical conduct have fallen by the wayside.

The good times we're in can exacerbate these problems in three ways. First, there's a risk of complacency setting in—an "if it ain't broke, don't fix it" mentality. Second, in a strong economy, the hard numbers that we tend to focus on when examining profits, losses, capital, and liquidity can look like everything's coming up roses, even when an uncomfortable reality lies beneath. And, finally, culture is a long-run investment that takes many years to develop and requires constant reinforcement to preserve. If you let it erode, you can't go to the market and obtain a new "culture" overnight.

As I mentioned, establishing a more robust regulatory framework was absolutely necessary for a healthier, more resilient financial system. But, it is far from sufficient. The danger we face today is that people may conclude that the hardened defenses are enough, and other supervisory activities around culture, conduct, and governance are superfluous.

This feeling that we've built a strong fortress able to withstand any onslaught may create a mood of complacency and detract attention from the dangers that could be growing within the walls of financial institutions.

This problem is aggravated by the fact that the hard numbers studied by regulators and supervisors should look great when the economy's doing well. Profits are high and loan losses low when the economy is humming along. But, strong numbers in a strong economy don't give you the full picture. They can't always tell you whether people are cutting corners, taking excessive risks, or violating rules and regulations. Even worse, they can distract you from digging into the truth and unearthing unethical business practices and misconduct that may hide below the surface.

The well-known challenge with culture is that, in contrast with things like capital and liquidity, culture feels "softer" and, therefore, more difficult to measure. And often in finance there's a tendency to disregard what can't be quantified. But just because it's hard to measure doesn't mean we should ignore it or downplay its importance. As we heard throughout today's conference, culture shapes every conversation, every decision, and every action; it is at the root of whether an organization performs in a manner consistent with its mission, or not.

How to Achieve a Better Banking Culture

This brings me back to the issue of culture as a long-term investment that can't be "fixed" overnight. Several years ago, Rich Lyons, Dean at Berkeley's Haas School of Business, spoke at the San Francisco Fed and talked about culture in a way that has stuck with me ever since. Transforming a culture is a five- to ten-year project; keeping it that way is an ongoing mission that requires strong leadership and consistent action.

As a leader of a large organization, I've taken that message to heart. I've found that a culture based on the principle of open and authentic dialogue, that embraces our diverse backgrounds and perspectives delivers better results. I've found that well-defined collective values and direction lead to greater collaboration and innovation. Finally, I've found that this work is never a finished project, but an ongoing one that constantly evolves.

I started by saying that I feel a sense of urgency in addressing banking culture. So where do I see the priorities for supervision?

As supervisors, we need to ensure that bank management and boards are exerting strong and effective leadership with robust governance. That means holding management and boards of directors to high standards in terms of culture and conduct, even when the numbers look rosy. It means ensuring corporate values are clearly articulated and incentives are squarely align with a bank's strategic goals. It means identifying, communicating, and mitigating risks in a timely and effective manner. It means that employees feel empowered to raise their hands if they see wrongdoing, and that comprehensive fixes are implemented when something goes wrong.

Conclusion

In conclusion, when times are good, we rarely feel an urgency to make changes. And these are certainly good times. But numbers can have a funny way of not revealing the whole truth. A sound spreadsheet may mask unethical behavior, a well-capitalized bank may be on the road to ruin, and a neglected corporate culture can turn toxic.

We must stay vigilant around the "softer" side of supervision. Strong culture and robust corporate governance are our first lines of defense. They're a critical part of the tool kit when it comes to protecting people, banks, and the economy from risk, scandal, and harm.

Press, Journal Article

CHART OF THE WEEK

Payden&Rygel
Investment Management

Too Loose...Kick Off The Bearish Shoes

3-Month Treasury Bill Yield Minus Core PCE Inflation

For The Week Ending 07/13/18

Source: Bureau of Economic Analysis, Federal Reserve Bank of St. Louis, Payden Calculations

The yield curve—the difference in yield between a 10-year U.S. Treasury Note and a 3-month U.S. Treasury Bill—has become the favorite cocktail conversation among economists and investors alike. Why? Historically, it has been a harbinger of recession. But why is the curve such a potent prognosticator? The key part is the message sent by short-term rates: when they rise too far, too fast, a recession ensues. Are we there yet? Based on history, probably not. Using real, 3-month T-Bill yields (to remove the effects of inflation), we see that before the last seven recessions, real short-term rates rose, on average, 530 basis points from their cycle lows before the next recession. In this cycle, real short-rates have jumped just 197 basis points from their lows. We think the economy can withstand more tightening from the Fed before recession signals start flashing red.

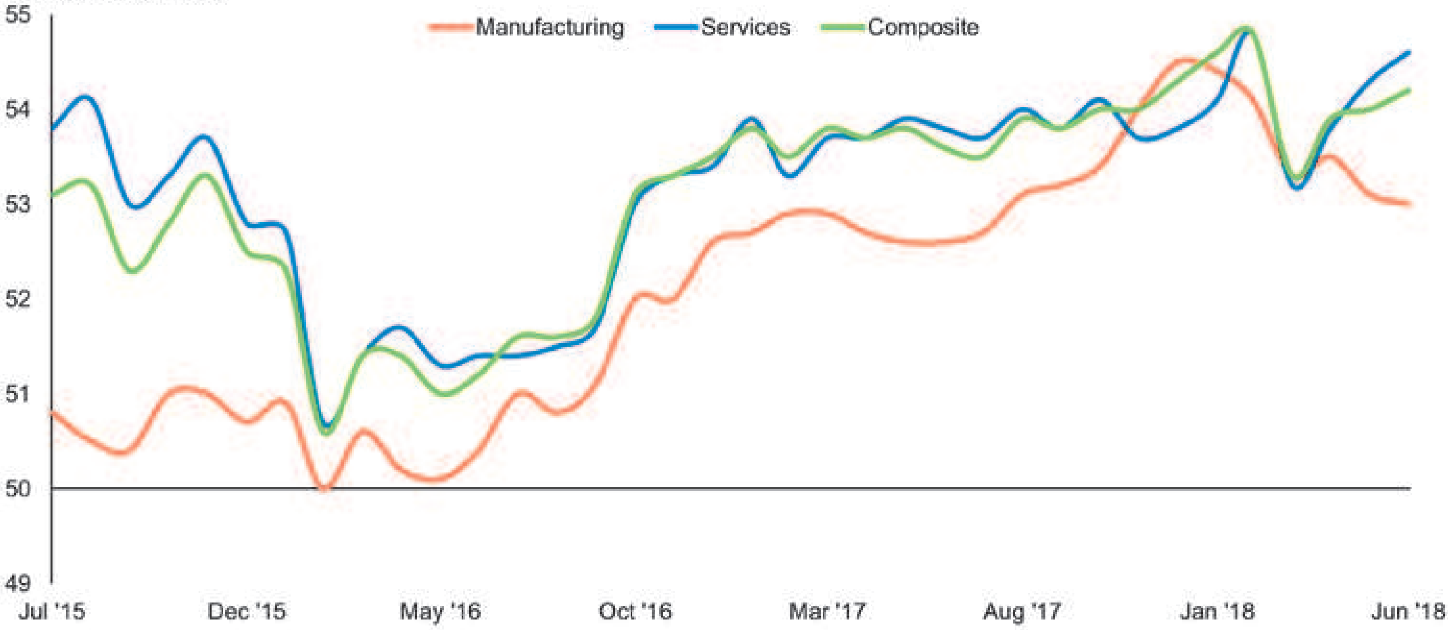
CHART OF THE WEEK

Payden&Rygel
Investment Management

Unfair to Compare

J.P. Morgan Global Purchasing Managers' Index (PMI) By Component

For The Week Ending 07/06/18



Source: J.P. Morgan

**Value above 50 indicates expansion*

Weaker global economic data. A strengthening U.S. dollar. Chinese currency devaluation. Equity market wobbles. Wider credit spreads. Is it 2015/2016 all over again? While investors love to draw historical analogs, comparing 2018 with 2015/16 still seems like a bit of a stretch to us. For one thing, the U.S. economy is in much better shape now. GDP growth for the just-completed second quarter looks set to top 3% at an annual rate. By contrast, the U.S. economy slowed throughout 2015 and notched just 1.2% year-over-year growth in Q1 2016. This week's global economic data also paint a prettier picture at present. While JPMorgan's Global Composite PMI bottomed in March (at 53.3), the index of global economic activity appears to have picked up some springtime steam: it registered at 54.2 in June, led by a rebound in the services component. The Global Manufacturing PMI slowed through June, but at 53 is still signaling expansion. A 2015 repeat? We don't see it.

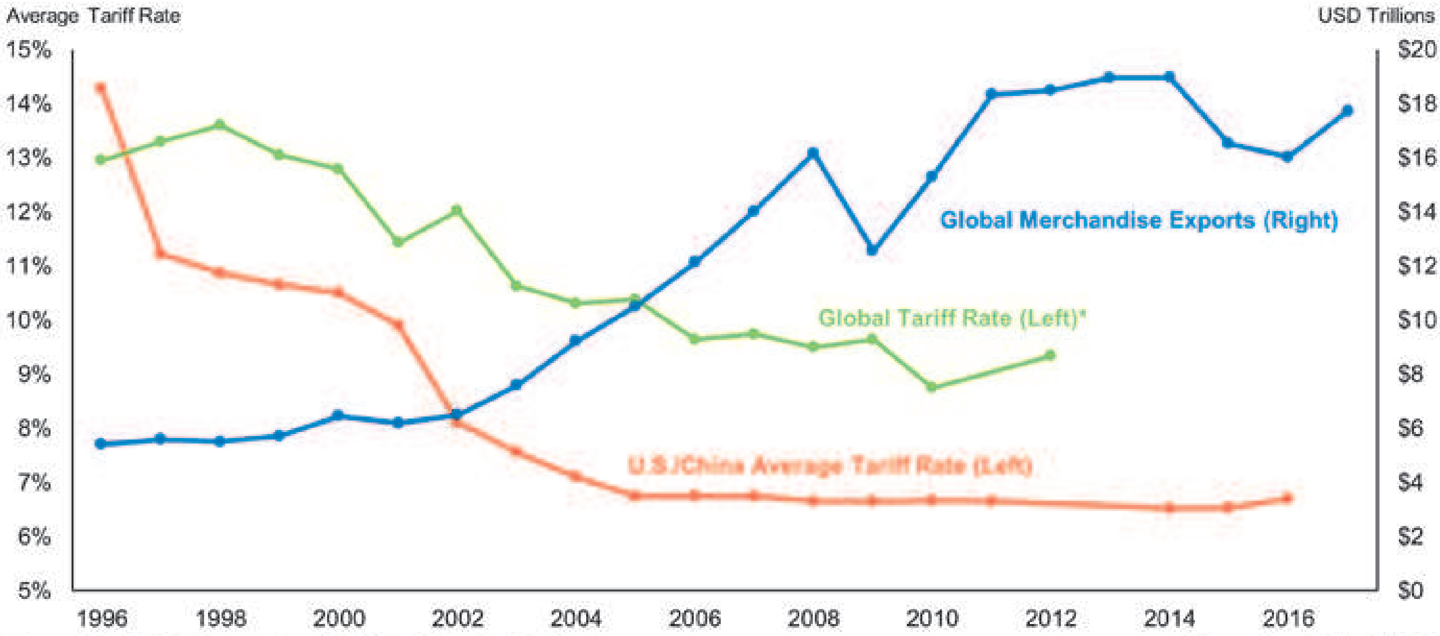
CHART OF THE WEEK

Payden&Rygel
Investment Management

Don't Be "Tariffied"

Average Tariffs on All Products and Value of Merchandise Trade Over Time

For The Week Ending 06/22/18



Source: World Trade Organization, World Bank, Payden Calculations

**Data only available till 2012*

In light of the latest tariff-related threats flying out of the White House, we wanted to put global trade and tariffs in perspective. Last week the White House published a revised list of Chinese imports subject to tariffs. More recently, President Trump threatened to apply additional tariffs on at least $200 billion worth of imports if China retaliates again, presumably at a 10% tax rate. However, since 1996, the world has become less protectionist and average tariff rates are near the lowest levels they have ever been. The average global tariff on all products fell from 13% in 1996 to a little above 9% in 2012. Average tariff rates in the U.S. and China have plunged over the last two decades from 15% to under 7%. Meanwhile, world trade has almost tripled. So before you become terrified of the "trade war" headlines, remember that the world remains more interconnected than ever before. While tariffs may rise on the margin, we are unlikely to see a reversal of two decades' worth of progress. A "trade war" tipping the global economy into a recession remains a low probability.

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IAFEI SECRETARIAT Corso Genova, 6 20123 Milan - Italy
Email: secretariat@iafei.org | Phone: +39 02 83242288 | Fax: +39 02 58118093