

# International Finance & Treasury

Weekly Report for International Finance Executives

## Cash Flow-at-Risk

March 26, 2001

A model for assessing cash flow volatility and a valuable analogue to VaR for non-financial companies.

Allan Ripp, Lela Moore and Peter Cohn

**Is your company prepared to withstand the impact of possible future cash flow shortfalls? Indeed, do most corporations even know how to calculate the odds of a “torpedo shock” to their cash flow?**

Now, for the first time, non-financial companies can better plan for their worst-case downside risk by using a new analytic model that may become the standard for measuring volatility to expected cash flow.

Cash Flow-at-Risk (*c-far*) is being introduced by NERA, a leading economic consulting firm. The model was designed by a group of NERA economists as a new method of measuring, with a high degree of probability, the risk of cash flow shocks for non-financial companies. It comes to market in what is turning out to be a big season for unanticipated earnings shortfalls at some of the country's largest companies.

Accurately forecasting expected cash flow is a cornerstone for determining shareholder value. However, measuring expected earnings takes one only so far. How would shareholder value be affected by unexpected future shocks that may rock a company? Until now, executives charged with making investment, capital policy and hedging decisions have been forced to rely on “rule-of-thumb” assessments to make this determination.

For this reason, *c-far* may become a necessity within such volatile

See *c-far*, Page 11

## FAS 133 Fallout

The new standard could produce some disparities between fiscal and financial reporting; a case for Congress.

Ira Kawaller and John Ensminger

**Last June, the private Financial Accounting Standards Board (FASB) implemented a new accounting standard that could significantly affect U.S. tax law. The new standard, FAS 133, changes how accountants handle derivatives, which are agreements that derive value from some underlying price or variable, a notional amount or payment provision.**

FAS 133 requires accountants who compile balance sheets to show changes in a derivative's value as an asset or liability, even if the derivative remains in an open position. This is a sharp departure from past accounting procedures, which allowed many types of derivatives, such as forward contracts and swaps, to be omitted from balance sheets.

The change may not seem important to those who are not accountants, but it could have a significant effect in the business world. Some industry experts fear that the new practice could exacerbate income volatility and give the appearance that companies are operating irresponsibly or taking unnecessary risks.

The change may also accelerate the push for more pervasive fair value

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## A Dutch Onshore Alternative

The foundation, or *stichting*, provides the attributes of a special purpose vehicle, or other “pass-through” application, without the need for an offshore structure.

Dr. Cor P.M. van Houte

**Domestic taxation of an onshore special purpose vehicle (SPV) is a constant threat to securitization transactions. The Dutch legal system has a legal form, the foundation (stichting), that combines considerable tax advantages with limited liability.**

Last year in The Netherlands, there was a lot of concern about pending corporate income tax legislation. At that time, it was proposed that interest on so-called “hybrid loans” should no longer be deductible from the taxpayer’s taxable profit.

Abolition of this tax deduction, should it occur, would cause an increase in costs for Dutch onshore securitization deals. As a consequence of the new proposals, such onshore

transactions, it is therefore not impossible that future legislation will cause new tax obstacles for securitization transactions involving an onshore Dutch SPV.

Regardless of eventual new proposals, if a Dutch foundation does not carry on business or compete with enterprises, it is not liable for corporate income tax (*vennootschapsbelasting*). Therefore a Dutch foundation has a limited tax liability. Absent such liability, it becomes a matter of indifference as to whether interest paid out to the note holders is deductible or not.

Interest deduction or interest spreads do not apply to a SPV that is operating in the form of a non-business foundation.

**If a Dutch foundation does not carry on business or compete with enterprises, it is not liable for corporate income tax (*vennootschapsbelasting*).**

### Characteristics of a Dutch Foundation

Before describing the tax implications of a Dutch foundation it would be helpful to provide a brief description of the characteristics of the Dutch foundation.

A Dutch foundation is a legal entity with a limited legal liability; it has no members. Furthermore, a Dutch foundation does not have any “pay up in full” obligation with regard to its capital subscription. No minimum capital is required, which means that no thin capitalization problems will arise regarding a foundation. Finally, organization and documentation of a foundation is easy to accomplish, and the process does not take a long period of time.

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transactions were placed on the rating agencies’ watch lists.

After criticism from Parliament, the Secretary of State for Finance canceled his bill affecting the tax status of hybrid loans. Peace among the various branches of government has been restored, for the time being.

The Secretary of State has installed a Commission that will investigate the international tax implications of hybrid loans. Pending the determinations of the Commis-

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## A Deeper Dive

There is increasingly substantial evidence that the current U.S. slowdown will be around for a while; the Fed needs to respond.

Scott E. Pardee

**The Federal Reserve is still moving step-by-step, when it should be taking big strides to lower interest rates in the face of a deteriorating economic picture. Consumer confidence is falling sharply, new orders for durable goods are down, and industrial production is slipping.**

Many big-name private-sector economists are saying that prospects for the economy look weaker than they thought just a few weeks ago. Instead of debating whether the recovery will be “V”-shaped or “U”-shaped, economists are considering whether it will be “U”-shape or “L”-shaped, as in the case of Japan.

Our elected officials in Washington aren't helping much either. President *George W. Bush* is so intent on pushing his 10-year tax cut that he is stressing the current weakness of the economy to get it passed. Thus, for expedient purposes, he is confirming the

impression that the economy is in distress.

The stock market is dropping, erasing billions of dollars of wealth that Americans thought they had accumulated. A number of commentators have tried to stand *Alan Greenspan's* “irrational exuberance” on its head, coining terms like “irrational pessimism” and the like, but we will have to wait for Greenspan himself to craft the term that most aptly describes the collapsed bubble in the stock market.

When he does, Professor *Robert Schiller* of Yale, who wrote the best-selling book *Irrational Exuberance*, can use the new term to write his next book. Hopefully, that one will explain why so many people fled the stock market in such a hurry, leaving those who held on with no one to blame but themselves. Now that the bears have the attention of the media, it is hard to turn on the television at

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## Exchange Strategies

The case for Cavallo and an Argentine rebound. Also, what it might take to actually get the euro off the ropes.

Brendan Murphy

**Foreign exchange market price action, and the equivocal response from financial markets—particularly regarding the Federal Reserve's third 50 basis point rate cut in as many months—raise serious questions for us as to whether the euro can ever make more of its window of opportunity versus the dollar.**

The single currency managed to push as high as US\$0.9125 last week, but was pushed back under the US\$0.90 level to finish at US\$0.8825, representing a 0.45 percent decline on the week.

The reaction across financial markets to the 50 basis point cut that was delivered by the *Federal Reserve Board's Open Market Committee* was ambiguous, to say the least. U.S. equity markets were disappointed not to get the 75 basis point cut for which investors had hoped,

even though further easing is clearly in the pipeline. Indeed a 4 percent funds rate is anticipated by *J. P. Morgan-Chase* (Morgan-Chase) economists by the end of the first half of 2001, while the broader market is pricing in about 75 basis points of further Fed easing.

Despite these portents, Treasuries failed to get much of a pop, either, and the long end of the curve backed up slightly on the February rise in the core consumer price index. This escalated to a 2.7 percent year-on-year rate, compared with 2.5 percent through the end of last year.

Nevertheless, the dollar rallied handily, picking up about 3 percent on a trade-weighted basis over the past two weeks, according to Morgan-Chase, putting it up 6 percent for the year to date.

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### Also in This Issue...

**Scott Pardee**

believes the Fed's pump priming to date will not be enough to put out the fire.

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Two extraordinarily durable situations—a depressed euro and a lackluster Argentine economy—draw **Brendan Murphy's** attention this week.

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Rates, trends and forecasts for major currency pairs.

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# U.S. Outlook/Exchange Strategies

## Deeper, from Page 3

breakfast without hearing that you that you will be poorer by dinnertime.

The Fed of course has not been idle. Chairman Greenspan and his colleagues have reduced the Federal funds rate from 6.5 percent to 5 percent in less than three months, and have indicated that further reductions are possible.

The monetary policy makers certainly have further scope to cut interest rates. Inflation is not dead, as the latest consumer price index figures show, but at worst it is running 3 percent per annum and likely to slow over the months ahead.

In the last recession and recovery period, in 1990-93, the Fed cut the Fed funds rate to 3 percent right on top of the then 3 percent inflation rate, providing a zero real interest rate. Monetary policy works with a lag of 6-18 months, depending on the industry you are in, so the sooner the Fed gets to a Federal funds rate of 3 percent this time, the more likely it will be that we will have an early recovery.

For all the negative hype, the economy has plenty of strength.

Despite the drop in confidence, many consumption indices have held up surprisingly well, including the demand for motor vehicles. Inventories are up, but not enough to cause firms to engage in major and extended cutbacks in production; many com-

panies have already cleared away recent inventory buildups.

Credit aggregates, of course, have grown along with the rest of the economy. Despite this, the banking system is not over-extended and many banks are prepared to lend to qualified borrowers. Indeed, now that the relatively easy access to capital markets has collapsed, firms will have to turn more to banks for credit, something many of them should have done in the first place.

Finally, most of the people still have jobs—the labor market is less tight than it was, but unemployment is still at a historically low 4.2 percent.

As in previous slowdowns, consumption will pull us out of this one as well, but it will now be a matter of six-months to a year, rather than a few months. □

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## Strategies, from Page 3

“With this move, the dollar now stands 22.4 percent above its 1990s average level and is approaching the heady territory it reached in 1985, Morgan-Chase’s *Bruce Kasman* observes. Kasman notes, in addition, that “the latest round of dollar appreciation has been particularly broad based, incorporating gains of 3 percent or more against the Japanese yen, euro, pound sterling, Australian dollar and Korean won.”

Given the fall in U.S. equities, Kasman attributes this to disappointment on European and Japanese prospects.

### Dollar Correction—or Upside?

However, it could be difficult for the dollar to sustain these levels, Kasman continues. One problem would be the risk of a U.S. recession, to which Morgan-Chase assigns a 45 percent probability. The other would be the drag on exports from dollar strength, which

handicaps U.S. producers. Further dollar strength would increase strains on corporate profit margins and, by indirection, on the massive U.S. external deficit.

However, such analyses do not reckon with the global market’s capacity for ignoring fundamentals when sentiment is primarily driven by risk and fear, sending capital into the safe haven greenback. A further dollar surge cannot be ruled out given the considerable volatility in world markets.

Certainly the *Bank of Japan’s* reluctant shift to quantitative easing could clear the way for a leg higher in dollar-yen as a driver of dollar strength. For now the market seems content to trade the cross in a ¥120 to ¥125 range. Authorities on both sides of the equation surely must consider a breakout towards ¥140 to be a potentially destabilizing, therefore undesirable, scenario.

However, we would not be surprised to see a battle of wills between bilateral mon-

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The sooner the Fed gets to a Federal funds rate of 3 percent this time, the more likely it will be that we will have an early recovery.

“The latest round of dollar appreciation has been particularly broad based, incorporating gains of 3 percent or more against the yen, euro, pound sterling, Australian dollar and Korean won.”

## Bank of America's World Value of the Dollar as of March 23rd

The table below gives the rates of exchange for the U.S. dollar against various currencies as of Friday, March 23rd, 2001. The exchange rates are middle rates between the buying and selling rates as quoted between banks, unless otherwise indicated. All currencies are quoted in foreign currency units per U.S. dollar except in certain specified areas. All rates quoted are not intended to be used as a basis for particular transactions. *Bank of America* does not undertake to trade in all listed foreign currencies, neither does *Bank of America* assume responsibility for errors.

EUR=\$0.88744      SDR=\$1.26530      3-month LIBOR 4.78      3-month SIBOR 4.85      6-month LIBOR 4.60      6-month SIBOR 4.65

Country	Currency	Value of U.S. Dollar	Country	Currency	Value of U.S. Dollar	Country	Currency	Value of U.S. Dollar
Afghanistan	Afghani (c)	4750.00	Georgia	Lari	1.975	Pakistan	Rupee	60.55
Albania	Lek	145.75	Germany	Mark	2.2039	Panama	Balboa	1.00
Algeria	Dinar	77.04	Ghana	Cedi	7425.00	Papua N.G.	Kina	3.2841
American Samoa	US\$	1.00	Gibraltar	Pound *	1.4273	Paraguay	Guarani (d)	3759.00
Andorra	Peseta	187.4899	Greece	Drachma	383.9696	Peru	Nuevo Sol (d)	3.5258
Andorra	Franc	7.3916	Greenland	Krone	8.3623	Philippines	Peso	49.15
Angola	Kwanza (4)	18.2458	Grenada	E. Car. \$	2.70	Pitcairn Island	NZ Dollar	2.4076
Antigua	E. Car. \$	2.70	Guadeloupe	Franc	7.3916	Poland	Zloty (o)	4.1305
Argentina	Peso	1.00	Guam	US\$	1.00	Portugal	Escudo	225.9105
Armenia	Dram	554.29	Guatemala	Quetzal	7.7815	Puerto Rico	US\$	1.00
Aruba	Florin	1.79	Guinea Rep.	Franc	1885.00	Qatar	Riyal	3.6408
Australia	Dollar	2.0188	Guinea Bissau	Franc	739.1565	Rep. Macedonia	Dinar	64.045
Austria	Schilling	15.5056	Guyana	Dollar	180.50	Rep. Yemen	Rial (a)	161.458
Azerbaijan	Manat	4565.00	Haiti	Gourde	24.00	Ile de la Reunion	Franc	7.3916
Bahamas	Dollar	1.00	Honduras	Lempira (d)	15.24	Romania	Leu	27440.50
Bahrain	Dinar	0.377	Hong Kong	Dollar	7.7997	Russia	Ruble	28.7725
Bangladesh	Taka	54.05	Hungary	Forint	298.62	Rwanda	Franc	428.35
Barbados	Dollar	2.00	Iceland	Krona	88.71	San Marino	Lira	2181.8602
Belarus	Ruble	1210.00	India	Rupee (m)	46.66	Sao Tome/Principe	Dobra	8203.50
Belgium	Franc	45.4565	Indonesia	Rupiah	10385.00	Saudi Arabia	Riyal	3.7506
Belize	Dollar	2.00	Iran	Rial (o)	1752.50	Senegal	CFA Franc	739.1565
Benin	CFA Franc	739.1565	Iraq	Dinar (o)	0.3124	Seychelles	Rupee	6.455
Bermuda	Dollar	1.00	Ireland	Punt *	1.1268	Sierra Leone	Leone	1899.065
Bhutan	Ngultrum	46.66	Israel	New Shekel	4.2175	Singapore	Dollar	1.785
Bolivia	Boliviano (f)	6.43	Italy	Lira	2181.8602	Slovakia	Koruna	48.869
Bolivia	Boliviano (o)	6.07	Jamaica	Dollar (o)	45.50	Slovenia	Tolar	242.005
Bosnia Herz.	Konv. Marka	2.2039	Japan	Yen	122.995	Solomon Is.	Solomon \$	5.1493
Botswana	Pula	5.5991	Jordan	Dinar	0.71	Somali Rep.	Shilling (d)	2620.00
Bouvet Island	Krone	9.0585	Kazakhstan	Tenga	145.10	South Africa	Rand (c)	7.9725
Brazil	Real	2.1615	Kenya	Shilling	77.50	Spain	Peseta	187.4899
Brunei	Dollar	1.785	Kiribati	Aus. Dollar	2.0188	Sri Lanka	Rupee	85.60
Bulgaria	Lev	2.181	Korea, North	Won	2.20	St. Christopher	E. Car. \$	2.70
Burkina Faso	CFA Franc	739.1565	Korea, South	Won	1309.00	St. Helena	Pound *	1.4273
Burundi	Franc	751.00	Kuwait	Dinar	0.3081	St. Lucia	E. Car. \$	2.70
Cameroun	CFA Franc	739.1565	Kyrgyzstan	Som	48.989	St. Pierre/Miq'lon	Franc	7.3916
Canada	Dollar	1.5707	Laos	Kip	7600.00	St. Vincent	E. Car. \$	2.70
Cape Verde Is.	Escudo	122.447	Latvia	Lat	0.6299	State Cambodia	Riel	3835.00
Cayman Is.	Dollar	0.82	Lebanon	Pound	1510.00	Sudan	Pound (c)	2560.00
Cent. Af. Rep.	CFA Franc	739.1565	Lesotho	Maloti	7.9725	Sudan	Dinar	256.00
Chad	CFA Franc	739.1565	Liberia	Dollar	1.00	Suriname	Guilder	981.00
Chile	Peso (m)	591.95	Libya	Dinar	0.5357	Swaziland	Lilangeni	7.9725
Chile	Peso (o)	518.37	Liechtenstein	Franc	1.7161	Sweden	Krona	10.323
China	Renminbi	8.2773	Lithuania	Litas	3.999	Switzerland	Franc	1.7161
Colombia	Peso (o) (1)	2294.50	Luxembourg	Franc	45.4565	Syria	Pound	52.50
CIS	Ruble (m)	28.7725	Macao	Pataca	8.0571	Taiwan	Dollar (o)	32.775
Comoros Rep.	Franc	554.3673	Madagascar	Franc	6400.00	Tanzania	Shilling	846.00
Congo Rep.	CFA Franc	739.1565	Malawi	Kwacha	79.35	Thailand	Baht	44.195
Congo Dem. Rep.	Franc (3)	4.4999	Malaysia	Ringgit	3.80	Togo Rep.	CFA Franc	739.1565
Costa Rica	Colon	323.15	Maldives Is.	Rufiyani	11.77	Tonga Is.	Pa'anga	2.07
Cote d'Ivoire	CFA Franc	739.1565	Mali Republic	CFA Franc	739.1565	Trinidad/Tobago	Dollar	6.24
Croatia	Kuna	8.6102	Malta	Lira *	2.2139	Tunisia	Dinar	1.4273
Cuba	Peso	1.00	Martinique	Franc	7.3916	Turkey	Lira (7)	983500.00
Cyprus	Pound *	1.5436	Mauretania	Ouguiya	253.95	Turks & Caicos	US\$	1.00
Czech Republic	Koruna	38.529	Mauritius	Rupee	28.245	Tuvalu	Aus. Dollar	2.0188
Denmark	Krone	8.3623	Mexico	New Peso	9.62	Uganda	Shilling	1785.00
Djibouti	Franc	175.00	Moldova	Lei	12.3833	Ukraine	Hryvnia	5.4183
Dominica	E. Car. \$	2.70	Monaco	Franc	7.3916	United Kingdom	Pound *	1.4273
Domi. Rep.	Peso	15.65	Mongolia	Tugrik (m)	1099.00	Uruguay	Peso (m)	11.3925
Ecuador	Sucre (o) (2)	25000.00	Montserrat	E. Car. \$	2.70	U.A.E.	Dirhan	3.673
Egypt	Pound	3.8855	Morocco	Dirham	10.906	Uzbekistan	Sum	775.00
El Salvador	Colon (d)	8.752	Mozambique	Metical	18412.50	Vanuatu	Vatu	141.80
Eq'tl. Guinea	CFA Franc	739.1565	Myanmar	Kyat	6.7245	Vatican City	Lira	2181.8602
Estonia	Kroon	17.5263	Namibia	Dollar	7.965	Venezuela	Bolivar (d)	705.355
Ethiopia	Birr (o)	8.25	Nauru Is.	Aus. Dollar	2.0188	Vietnam	Dong (o)	14571.00
European EMU	Euro*	0.8874	Nepal	Rupee	74.6598	Virgin Island BR	US\$	1.00
Faeroe Is.	Krone	8.3623	Neth. Antilles	Guilder	1.79	Virgin Island US	US\$	1.00
Falkland Is.	Pound *	1.4273	Neth. Antilles	Florin	1.79	West. Samoa	Tala	3.5199
Fiji	Dollar	2.3175	Netherlands	Guilder	2.4832	Yugoslavia	New Dinar (6)	66.0422
Finland	Markka	6.6999	New Zealand	Dollar	2.4076	Zambia	Kwacha	3400.00
Fr. Pacific Is.	Franc	134.392	Nicaragua	Gold Cordoba	13.10	Zimbabwe	Dollar (5)	55.05
France	Franc	7.3916	Niger Rep.	CFA Franc	739.1565			
French Guinea	Franc	7.3916	Nigeria	Naira (m)	111.50			
Gabon	CFA Franc	739.1565	Norway	Krone	9.0585			
Gambia	Dalasi	15.25	Oman Sultanate	Rial	0.385			

(n/a) Not Available. \* U.S. Dollar per national currency unit. (a) Parallel. (c) Commercial. (d) Free market. (f) Financial. (m) Market. (o) Official. (1) Colombian peso allowed to float freely on 9/27/99. (2) Ecuador introduces dollarization, 25,000 sucres to the dollar. (3) Congo Democratic Republic, formerly Zaire Democratic Republic, Congolese franc is new currency. (4) Angolan kwanza revalued on 12/13/99. (5) Zimbabwe dollar delvalued by approximately 24 percent on 2/8/00. (6) Yugoslavian new dinar is now "managed float," linked to euro/mark. (8) Turkish lira allowed to float freely on 2/22/01.

# Exchange Strategies

## Strategies, from Page 4

etary authorities and the currency markets on this, such that dollar-yen could be propelled into a ¥125 to ¥130 range on a not-too-distant horizon. If the euro is unable to keep pace, then dollar-yen strength could be an even more broad-based phenomenon.

With respect to the euro, the danger we see is that European growth prospects start to fade more dramatically, just as U.S. indicators suggest that the business cycle has bottomed out.

Looking at what is perhaps the highest-impact European indicator, the *Ifo* German business climate survey, corporate sentiment

**If the euro is unable to keep pace, then dollar-yen strength could be an even more broad-based phenomenon.**

in the European industrial heartland deteriorated sharply last month to 94.9, from 97.5 in January—the largest monthly decline since the index peaked in May, 2000.

Market participants are increasingly expectant of a cut in the *European Central Bank's* (ECB) 4.75 percent repo rate on March 29<sup>th</sup>, most likely by a cautious 25 basis points given ECB caution on easing thus far.

## Euro-Fundamentals More Critical Here

Market response to this could go either way. On the one hand, ECB easing at this point would be positive for the euro, at least based on the lift it received from comments from *Otmar Issing*, the ECB's chief economist, suggesting that growth was becoming more of a concern than inflation.

The ECB's announcement of the anticipated rate cut must strike the right balance, though, and this central bank has not distinguished itself in communications with the markets. Moreover, a run of discouraging activity reports from around the economic and monetary union could put the burden of proof right back on the ECB, to show it has not fallen behind the curve on rates. Markets have shown an inclination to put the most negative interpretation on such issues.

The most advantageous outcome for the euro would be for the ECB to ease, and to do so in such a way as to convince financial markets that European growth will continue at a higher level than U.S. growth. A corollary would be that European assets stand to outperform their U.S. counterparts at least for a few quarters. But again, if markets conclude that Europe is headed into the same trough as the U.S., then the U.S. stands to emerge ahead of it and all

**Actual and Forecast FX Ranges, F&T Outlook for Major Currency Pairs**  
(Exchange Rates from Thomson Financial/IFR, Boston)

Currency Pair	Prior Range	Forecast Range	Last Week	Last Seen	Change (%)	Two-Week Outlook
USD/Euro	0.8825–0.9125	0.8775–0.9225	0.8960	0.8920	–0.45%	Neutral
DEM/USD	2.1434–2.2162	2.1201–2.2289	2.1828	2.1926	+0.45%	Neutral
JPY/USD	121.95–124.30	120.25–124.75	122.70	122.55	+0.12%	Neutral
JPY/Euro	108.90–112.40	108.25–113.75	109.95	109.25	+0.64%	Neutral
JPY/DEM	55.68–57.47	55.35–58.16	56.22	55.86	+0.64%	Neutral
USD/GBP	1.4175–1.4395	1.4125–1.4475	1.4290	1.4270	+0.14%	Positive
GBP/Euro	0.6215–0.6345	0.6200–0.6350	0.6270	0.6250	+0.32%	Neutral
DEM/GBP	3.0825–3.1470	3.0800–3.1546	3.1193	3.1293	–0.32%	Neutral
CHF/USD	1.6835–1.7310	1.6750–1.7250	1.7100	1.7165	–0.38%	Cautious
CHF/Euro	1.5265–1.5375	1.5250–1.5400	1.5330	1.5320	+0.07%	Neutral
SEK/Euro	9.1210–9.2730	9.1000–9.2500	9.1445	9.1680	–0.26%	Cautious
CAD/USD	1.5580–1.5770	1.5475–1.5775	1.5650	1.5655	–0.03%	Positive
USD/AUD	0.4885–0.5045	0.4875–0.5125	0.4950	0.4985	–0.71%	Positive
MXN/USD	9.4870–9.6700	9.5000–9.7500	9.6000	9.5980	+0.02%	Cautious
BRL/USD	2.0770–2.1770	2.0750–2.1750	2.1270	2.1560	–1.36%	Neutral

Foreign exchange pairs given per U.S. convention. Percent change refers to numerator in respective currency pair; positive change means that the denominator, or base currency, has gained. Outlook refers to base currencies, with the exception of the Canadian dollar, Mexican peso and Brazilian Real; in those cases it refers to the two-week outlook for the CAD, MXN or BRL against the USD.

bets are off for euro-dollar.

We are not quite as gloomy on U.S. prospects as the consensus, expecting a “just-in-time” recovery from the “just-in-time” recession, but sentiment will mend slowly after the hit from equities declines, and the recovery will have to build gradually through the housing-investment-demand cycle.

Japan will continue tottering along, as it has for so many years, albeit with significant downside risks should the *Liberal Democratic Party* manage to set new lows in competency and new highs in self-serving obfuscation. This would not preclude a surge in dollar-yen, but that surge would, in itself, hammer U.S. competitiveness across the Pacific Basin and corporate profits at home. So a Japanese recovery is very much in the U.S. interest, and quite relevant to euro-dollar rates, too.

Pursuing this line of argument, were the U.S. economy to take a hit from a Japanese collapse—a surge in corporate bankruptcies triggering another round of financial institution bankruptcies and still weaker corporate investment and consumer demand amplifying deflationary forces—Europe would feel the least impact of the three major blocs by virtue of its relatively self-contained trade profile.

Assuming that foreign exchange market participants and investors were willing to accept a significantly repriced euro, euro-dollar could rally through parity and euro-yen would explode. But such a dire scenario is still fairly remote, so this is not an argument for buying euros here.

### Cavallo Steps up in Argentina

It was a short run of just two weeks for *Ricardo López-Murphy* in the Economics Ministry, as *Domingo Cavallo* came off the sidelines to restore a semblance of calm in the markets (and to reinforce the sagging credibility of President *Fernando de la Rúa*'s fledgling government). The question remains whether Cavallo's clout and resourcefulness are sufficient to push through a fiscal package tough enough not only to satisfy the *International Monetary Fund*, but convince investors that the peso is going to remain pegged to the dollar and that Argentine debt will remain manageable.

Cavallo vowed that his Convertibility Plan would remain in place. If any man can

save the Cavallo plan, it's plain that it is Cavallo himself. Longer-term, however, it is hard to see how convertibility can continue in the event that U.S. and global economies subside much further.

The Argentine economy is, to put it bluntly, hamstrung by the currency board arrangement, and whatever the macroeconomic models may suggest as to the efficacy of fiscal consolidation in enhancing competitiveness, benefits will be slow to come but the pain will be felt immediately. Cavallo's installation gave de la Rúa a breathing space, but the combination of market and political pressures will whittle away at Cavallo's reserves of good will. The best that can be hoped for is a painful grind.

Meanwhile, peso devaluation will be standing in the wings. If Cavallo is lucky and skillful, he may be able to stall it until such time as the external environment allows him to ease out of the straitjacket he crafted without a calamitous devaluation that devastates external accounts and pushes Argentina into a restructuring of its \$120 billion in debt.

The population is apparently supportive of convertibility, but the Peronist opposition has fiercely resisted fiscal tightening which impacts on its trade union base—the reason for López-Murphy's ouster and Cavallo's proposals for more palatable financial transaction taxes as the basis for fiscal progress.

Devaluation will be staved off until there is no other option, so convertibility is safe for now. However, Argentina's problems will remain a thorn in the side of Latin markets, spilling over into Brazilian markets and, we anticipate, eventually Mexican assets as well.

The Mexican peso continues to ride high on capital inflows, oil revenues and credible monetary management—but managers of Latin liquidity centers should continue to shun exposure in this linchpin currency. Anticipate a correction in the Mexican peso towards MXN9.75 in the weeks ahead as investors book gains on arbitrage plays against the Brazilian real, with potential for a more serious short-term slide. □

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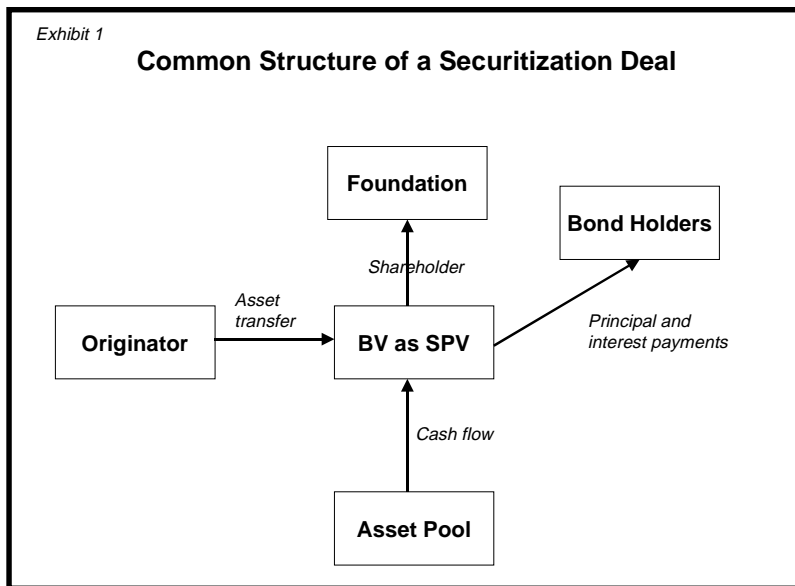
*Foreign exchange analysis and recommendations by Brendan Murphy, Curragh Publishing, New York. Market News International, New York, and Thomson Financial-IFR, Boston, have provided information and data for this report.*

We are not quite as gloomy on U.S. prospects as the consensus, expecting a “just-in-time” recovery from the “just-in-time” recession.

Argentina's problems will remain a thorn in the side of Latin markets, spilling over into Brazilian markets and, we anticipate, eventually Mexican assets as well.

# International Organization

Dutch, from Page 2



If a foundation is purely a pass-through vehicle, there is no corporate income tax liability. This position has been confirmed twice in recent decrees of the Supreme Court.

Compared with a *besloten vennootschap met beperkte aansprakelijkheid* (BV), the usual business vehicle for conducting a business, the foundation offers several strategic legal advantages.

In case of a BV, the minimum time for establishment is 3 to 4 weeks. Unlike the requirements for a BV, there is no preliminary investigation necessary before establishing a Dutch foundation. As mentioned, the foundation requires no minimum capital, while the minimum required capital for a BV is €18,000 (€1:\$0.90).

Compared with the BV, the Dutch foundation is not yet very popular as a business vehicle. The main reason for this state of affairs is the requirement for a foundation to pay out voluntarily (i.e., without any legal obligation) any profit reserves (*Article 285, Paragraph 3, Book 2 Civil Code*). Only the voluntary payout of profit reserves for social or idealistic causes is permitted.

In my opinion, this requirement does not constitute an obstacle that would prevent use of a Dutch foundation as a pass-through SPV. Profit reserves which accrue in the SPV after debt service and issue expenses have to be eventually paid out to the Originator. This payment is based on a contractual obligation of the SPV and can therefore not be considered as a “non-obligatory payment” under the provisions of the Civil Code.

Of course, redemption and interest payments to the bondholders are also obliged.

Thus, a Dutch foundation contains all the legal necessities to form a SPV.

### Limited Corporate Income Tax Liability for the Dutch Foundation

Whether a Dutch foundation is considered as an enterprise (or a business competitor) depends on the facts. The question whether it is an enterprise or not is not always easy to answer.

There is a lot of jurisprudence on this matter. In general, however, the following rules of thumb apply.

The intention to earn profits, or not, is not decisive. If a foundation states in its deed that it shall not act with the intention of making any profit, this statement alone is an insufficient condition for being considered as a business foundation. What matters to the authorities are the facts.

If there is an accumulation of profits as a result of business activities, the foundation is considered as a “business” within the meaning of the *Dutch Corporate Income Tax Act 1969 (Wet op de vennootschapsbelasting 1969)* and therefore liable for corporate income tax purposes. However, if a foundation is purely a pass-through vehicle, there is no corporate income tax liability.

This position has been confirmed twice in recent decrees of the Supreme Court. In my opinion, a pass through SPV meets all the criteria of this jurisprudence and is therefore not submitted to corporate income tax in The Netherlands.

### Common Structure of a Securitization Deal

Until now, the role of a Dutch foundation as a SPV in a securitization structure has been limited. Usually the standard securitization structure under Dutch law is as shown in the accompanying *Exhibit 1*.

In this structure, the BV plays a role as SPV, while the foundation is a 100 percent shareholder of the BV. Because the foundation has no members, nor a capital participation, it is possible to disconnect any relation between the Originator and the SPV. In this way, consolidation of the SPV assets with the Originator is prevented.

If the Originator wants to hold control over the SPV, which is often the case, the directors of the SPV are recruited from the management of the Originator (personal union).

In the usual transaction structure, the BV plays a role as SPV, while the foundation is a 100 percent shareholder of the BV.

From a purely legal perspective it is needless to create such structure, because it does not create any extra advantages compared with a structure using only a foundation, as described in the following section. In addition, a structure incorporating both a BV and a foundation can cause extra tax complications, e.g., corporate income tax, capital duty, thin capitalization exposure, and no deductibility of interest.

Unlike a foundation, a BV does not have a limited corporate income tax liability. Any economic advantage that it gains becomes part of its taxable profit. In case of an asymmetry between the input cash flow (payments out of the asset pool) and the output cash flow (redemption and interest payments towards the bondholders) through the BV, it is necessary to find a way to avoid taxation.

In general, it is possible to avoid taxation on the basis of the matching principle. If assets and obligations are interdependent it is, under Dutch tax law, permitted in principle to avoid taxation on appreciation of the assets.

In any event, it would be preferable to avoid any discussion with the tax authorities regarding the interdependency of assets and obligations, because there is no up-front guarantee that the tax authorities will agree upon applying the matching principle in a certain case.

Another point of possible disagreement with the tax authorities could be the taxable minimum spread that may be required between the input and output cash flows in the event of an advance tax ruling. Even if this spread is only 0.125 percent, it is still a considerable amount of money on the average securitization deal.

In case of a foundation, with no tax liability whatsoever, the complications mentioned before will be avoided.

### Alternative Securitization Structure

For these reasons, I prefer a Dutch securitization structure as shown in the accompanying *Exhibit 2*.

It is easy to see that this structure will reduce associated costs and result in fewer tax and legal complications. The possible tax implications of a BV have disappeared.

Remember from the previous review of its characteristics, a Dutch foundation has no

capital duty and no corporate income tax liability (if it does not conduct an enterprise or compete with enterprises), so no discussions about any spreads will arise.

### International Taxation

If the cash flow from the asset pool originates from a foreign jurisdiction (i.e., outside The Netherlands), international taxation rules are applicable. International taxation is also applicable in case of non-resident bondholders who hold notes of a Dutch SPV.

The Netherlands does not have withholding taxes on interest payments to non-residents, so interest paid out by a Dutch SPV to non-resident bondholders leaves The Netherlands tax-free.

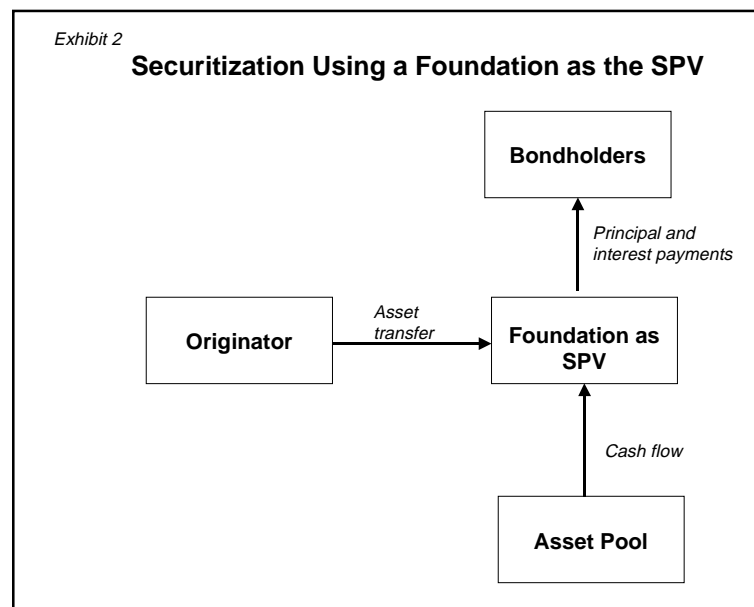
In case of a tax treaty between The Netherlands and the foreign jurisdiction, a question that has to be answered is whether or not the Dutch pass through SPV (in the form of a foundation) as recipient of the interest can be considered as a “beneficial owner” for treaty purposes. That characterization would allow the foundation to benefit from the provisions of the treaty.

Since, neither interest nor capital accumulates in a pass through SPV, the question arises if such a SPV can be considered as “fiscally transparent.” In case of fiscal transparency, the foundation can not be considered as the beneficial owner of the received interest, despite a true sale of the assets according to the Civil Code.

In Dutch jurisprudence there are several

**It would be preferable to avoid any discussion with the tax authorities regarding the interdependency of assets and obligations.**

**Since, neither interest nor capital accumulates in a pass through SPV, the question arises if it can be considered as “fiscally transparent.”**



See Dutch, Page 10

# International Organization

*Dutch, from Page 9*

criteria designed to test whether a legal entity is fiscally transparent or not. In general, the following rule applies: there is no fiscal transparency if the entity (e.g., the SPV in the form of a foundation) has the right of free disposal regarding its assets and the benefits of these assets (Dutch Supreme Court, July 22nd, 1981, no. 20.657).

In order to avoid fiscal transparency of the foundation, any (legal) dependence of third parties—whether they are the Originator, the Bondholder(s) or other persons—must be avoided. If the effective management of the SPV has the legal ability to act with absolutely independence, the concept of fis-

**If the SPV is legal owner of the assets and is entitled to dispose freely of the interest, it qualifies under Dutch tax law as “beneficial owner.”**

cal transparency can not be applied.

Furthermore, the Dutch Supreme Court (HR April 6th, 1994, no. 28.638) has determined that the term “beneficial owner” must be interpreted on a very restricted basis. Recently, the Supreme Court (HR February 21, 2001, no. 35.415) has decided that, in case of dividend stripping, any tax avoidance reasons were subordinate to commercial reasons, and therefore the principle of *fraus legis* was not applicable.

In my opinion, this latter decision corroborates that the term “beneficial ownership” is interpreted in a strict legal sense.

In conclusion, if—in a securitization structure—the SPV is the legal owner of the

assets and it is entitled to dispose freely of the interest (i.e., it is not an agent of a third party), the SPV qualifies under Dutch tax law as “beneficial owner” of the assets for treaty purposes, and can therefore benefit from the treaty’s advantages.

Although The Netherlands has a broad and favorable treaty network, in some cases withholding taxes from other countries (e.g., developing countries) on interest income are levied. Under Dutch tax law there are several possibilities to reduce the tax burden on pass through interest flows.

One possibility to achieve such a reduction would be to obtain fiscal transparency of the Dutch SPV, in order to trigger the application of a possible favorable tax treaty between the state in which the recipients of the interest (the beneficial owners) are resident and the state in which the interest arises.

Another possibility under these circumstances would be to place a legal entity in the organizational structure, between the SPV and the non-resident debtor(s). Such structures are valid under Dutch law and can result in interesting advantages (e.g., the application of a tax sparing credit).

To conclude, the Dutch foundation is an ideal on-shore legal entity for SPVs in international securitization set-ups. □

*Dr. Cor van Houte is a Dutch tax lawyer, specializing in securitization. Readers wishing to obtain further information about the applications of the stichting, or other Dutch tax matters relating to securitization, may contact him by e-mail at [cor.vanhoute@planetinternet.be](mailto:cor.vanhoute@planetinternet.be) directly.*

## Foreign Exchange Market Options Data

Provided by *Bank of America*

	3/23/01	Year Ago	% Chg. \$ Value	Implied Volatility for At-the-Money Options						Implied Volatilities
				1 Week	1 Month	2 Month	3 Month	6 Month	1 Year	
EUR/USD	0.8937	0.9712	7.98%	13.4/14.4	13.1/13.4	13.1/13.4	13.1/13.4	13.1/13.4	13.1/13.4	<p>The pullback in USD/JPY vols, although expected with the retracement in spot, was quite severe overnight. Expect some flattening of the curve ahead of expectations that we are re-entering a period of consolidation in the spot market.</p> <p>We continue to see bullish euro interest from Europe, offset by U.S. interests hedging long euro exposures. Ultimately, vols have not changed much in the last 24 hours.</p> <p>LATAM vols jumped higher yesterday. In AUD/USD, there is some interest around to sell implied volatility.</p>
USD/JPY	122.80	107.06	14.70%	11.0/12.5	12.0/12.3	12.2/12.5	12.2/12.5	12.4/12.8	12.6/12.9	
GBP/USD	1.4267	1.5870	10.10%	9.8/10.8	9.6/10.0	9.6/9.9	9.6/9.9	9.6/9.9	9.6/9.9	
USD/CAD	1.5650	1.4666	6.78%	6.5/7.5	6.6/7.0	6.4/6.7	6.3/6.6	6.0/6.3	6.0/6.3	
AUD/USD	0.4936	0.6067	18.65%	15.0/16.0	14.1/14.5	14.1/14.4	13.9/14.2	13.3/13.6	13.1/13.5	
USD/CHF	1.7140	1.6410	4.45%	12.0/13.0	12.1/12.4	12.3/12.6	12.3/12.6	12.5/12.8	12.6/12.9	
USD/MXN	9.5760	9.1450	4.69%		8.9/10.1	10.1/10.9	10.9/11.7	11.6/12.4	13.1/13.9	
USD/BRL	2.1650	1.7090	26.68%		14.9/16.2	13.5/14.6	12.5/13.5	12.0/13.0	12.0/13.0	
USD/HKD	7.7992	7.7841	0.19%		0.1/0.6	0.1/0.6	0.2/0.6	0.6/0.9	1.6/2.0	
EUR/JPY	109.69	103.98	-5.49%	15.3/17.3	16.4/16.8	16.2/16.6	15.9/16.2	15.7/16.0	15.4/16.0	
EUR/CHF	1.5323	1.5930	3.81%	3.8/4.8	4.0/4.3	4.0/4.3	4.0/4.3	4.1/4.3	4.0/4.4	
EUR/GBP	0.6261	0.6113	-2.42%	8.5/9.5	9.2/9.5	9.3/9.6	9.4/9.7	9.5/9.8	9.6/9.9	

## *c-far*, from Page 1

industries as energy and high technology, but its applications are considerably wider. Lawyers can use the model as a way to clarify reported risk in securities litigation and disclosure documents. Investment bankers and venture capitalists will find it a useful method for analyzing investment opportunities.

### Similarities to Value At Risk

Banks, insurers, investment firms and other financial companies have long had a tool for portfolio risk management, known as *Value-at-Risk* (VaR). VaR measures how much the value of financial assets—foreign currencies, equities, commodities, and bonds—will drop in a day or a week if they're walloped in a market reversal. An example would be the impact of an interest rate "spike" on a bond portfolio.

"VaR has become the standard for understanding and managing risk of a portfolio meltdown at financial institutions," says *Dr. Jeremy Stein*, one of the architects of *c-far* and Professor of Economics at *Harvard University*.

*c-far* is a non-financial analogue to VaR, encompassing the full spectrum of operating risks faced by a company and their potential effects on earnings. NERA's *c-far* model could be construed as a VaR-like tool for measuring aggregate risk against a company's cash flow.

Whereas VaR methodology takes a "bottom-up" approach to quantify the risks caused by individual financial assets, *c-far* looks directly at cash flow on the assumption that all risks to a corporation are manifest in shocks to expected earnings.

"The failing of previous attempts to assess cash flow risk is that they've followed the 'bottom-up' school of modeling individual risks and adding them together to arrive at a probable earnings distribution, when they should have been taking a 'top-down' view of cash flow that leads them back to what creates risk in the first place," said Dr. Stein, named one of the country's leading economic theorists by "CFO" magazine.

### A Strategic Risk Management Tool

*c-far* addresses the question, "What is the probability that this year's realized cash flow will be inadequate to fund our strategic investments?" It considers every risk exposure encountered by a company and produces a comprehensive profile that answers this critical question accurately and confidently.

The *c-far* model creates forward-looking probability distributions for a company's cash flow, whether a single quarter or an entire year. It therefore provides a uniquely accurate view of the

likelihood of extraordinary negative events that could induce a significant drop in earnings.

*c-far* may enhance financial strategy and long-term investment planning, but the NERA model could also be used to help companies assess their capital structure and creditworthiness. *c-far* can establish whether a company has adequate cash reserves to service its debt in the event of an earnings jolt. It should also have applications for purchasing insurance and other hedging strategies.

*c-far* derives from a broad statistical analysis of earnings results and other factors for the entire universe of publicly held non-financial companies. As such, it has the potential to become a widely used benchmark for corporate risk management.

### A CFO Comments

*John Faraci*, Executive Vice President and CFO of *International Paper Co.*, recently explained how *c-far* could be applicable to Fortune 500 companies.

"Historically, the forest products industry has experienced significant volatility in earnings and cash flow because of the wide fluctuations in product prices through a cycle," said Mr. Faraci. "Increased leverage from mergers and acquisitions and greater emphasis on controlling capital spending have high-lighted the risks of sudden, rapid downturns in cash flow.

"A tool such as *c-far* that helps to quantify cash flow volatility can help us better understand 'downside' and 'worst case' scenarios and develop strategies to enhance or preserve shareholder value under a variety of alternative business environments."

### Industry Comparables: The Dell Example

NERA's *c-far* is based on a proprietary "comparables" model that generates a company's cash-flow-at-risk profile based on historical results for its industry peers. NERA has amassed an extensive database of industry-specific economic and historical information, to develop probability distributions of a company's operating cash flow over an extended timeline. *c-far* can forecast where cash flow jolts could occur during that period.

"Every company faces a huge universe of strategic and business risks," Dr. Stein remarks. "It's difficult for any business to identify and model these risks, but *c-far* draws from a large sample of comparable companies both inside and outside its industry to create a comprehensive risk profile."

*c-far*'s comparables modeling parallels a common approach to corporate valuations: looking at multiples (e.g., market to book, price to earnings, price to cash flow).

"For any single company, there may not be

*c-far* is a non-financial analogue to VaR, encompassing the full spectrum of operating risks faced by a company and their potential effects on earnings.

"A tool such as *c-far* can help us... develop strategies to enhance or preserve shareholder value under a variety of alternative business environments."

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*c-far*, from Page 11

enough data on corporate cash flow over time to make precise statements about the likelihood of rare events,” said Dr. Stephen Usher, a NERA consulting economist and co-developer of *c-far*, who was formerly with the **Federal Reserve Bank of New York**.

“Even with 10 years of quarterly data, you’d have only 40 observations—not nearly enough to base accurate projections on rare events,” Dr. Usher said. “We’ve developed a methodology to identify companies whose cash flow risks, scaled for assets, are similar.

“By using a large number of comparable companies, you avoid the need to use older data—critical for industries facing regulatory or other structural change brought about by mergers, acquisitions and convergence.”

For example, in plotting a NERA *c-far* model for **Dell Computer Corp.**, NERA economists naturally drew data from other large computer marketers such as **Compaq**, **Gateway** and **Micron**. The model also included large direct retailers such as **Williams-Sonoma** and **Bed, Bath & Beyond** as among Dell’s peers, because of their resemblance in terms of market capitalization, profitability and stock-price volatility.

“Even though these companies are in a different industry, they have historically demonstrated cash flow volatility comparable to Dell and other tech marketers,” Dr. Usher noted.

### Identifying Key Risk Factors

The *c-far* model works something like a corporate actuarial table. As the table shows the health risk faced by an individual, *c-far* indicates earnings risks faced by a company. In both cases, prospective risks are derived from real world results.

*c-far* creates a universe of corporate risk based on four key measurements: market capitalization, earnings to assets, standard industry risk, and stock price volatility (bounce rate). NERA economists identified 81 separate corporate peer groups, each one reflecting a different combination of the key corporate risk determinants.

The initial benchmark universe was constructed by analyzing eleven years of corporate data from firms in all non-financial industries. The firm identified 85,000 separate instances in which actual cash flow came in at a different level than forecast, using regression analysis based upon public disclosure filings. The matrix of earnings outcome probabilities flows from these calculations.

### Preparing for the Worst—and Best

“We’re not interested in making more accurate predictions about quarter-ahead or year-

ahead cash flow than could be produced by industry experts or well-informed company insiders,” Dr. Stein explained. “We wanted to develop a more precise method for measuring the probability of shocks to cash flow, particularly the “one-in-a-hundred” or “five-in-a-hundred” earnings disasters.

“Because bad things can happen to good companies, *c-far* is a diagnostic for assessing risk and better managing the impact of risk to a company’s strategic planning and, as a result, to shareholder value.”

The *c-far* model attaches probabilities to a complete range of future earnings. It not only generates a probability for an earnings “train wreck,” but also the probability for a positive earnings surprise, as well as probabilities for results between the two extremes. The economists calculated *c-far* for both quarterly earnings and full-year earnings. The calculations are based on earnings before interest, taxes, depreciation and amortization (EBITDA), and amounts are expressed in earnings per \$100 in assets, allowing for easy comparability among companies of different sizes.

“It’s important to note that *c-far* cuts both ways,” Dr. Usher said. “It tells you what the chances are that you may have trouble making an interest payment, and also alerts you when you may be sitting on too much cash.”

### Application of *c-far*

*c-far* can lend an added degree of accuracy and reliability to the following important financial analyses and responsibilities:

- planning for new investments, such as research and development, plant, equipment and product development;
- testing adequacy of credit lines, cash reserves and capital structure in the event of earnings shock;
- improving shareholder disclosure and providing against litigation in the event of an unanticipated down-turn;
- evaluating existing hedging techniques and insurance strategies; and
- managing investor expectations in both bear and bull markets.

Under tightening economic conditions, with tougher scrutiny from analysts and investors, *c-far* brings a beneficial “reality check” to long-term corporate planning. Management can assert that it has looked at worst-case eventualities and planned for adversity.

Though it is geared to large, non-financial companies, *c-far* is a versatile financial tool. It can assist in the use of derivatives and other

“By using a large number of comparable companies, you avoid the need to use older data—critical for industries facing regulatory or other structural change brought about by mergers, acquisitions and convergence.”

“(c-far) tells you what the chances are that you may have trouble making an interest payment, and also alerts you when you may be sitting on too much cash.”

hedging strategies and help set targets for new debt and equity issuance. It can even help calculate the merits of pursuing legal action, including shareholder litigation.

## An Example at Dell Computer

*c-far* data for Dell Computers illustrates the applications for the NERA model. The analysis projected that this PC direct marketer faced significantly higher risks than would have been predicted a year ago, based on Dell's history.

Using a *c-far* analysis based on data available at the start of fiscal 1999, NERA found that a worst-case scenario (i.e., a precipitous drop in earnings with a probability of 1 in 20) would have led to a cash flow short-fall of \$28.50 per \$100 of assets. Given the level of Dell's operating assets at the time, this translates into a cash flow hit of roughly \$1 billion relative to expectations.

In the event, Dell's 2000 performance has indeed fallen short of the company's targeted expectations a year ago, by approximately \$800 million. While Dell didn't quite hit the worst-case threshold, the company has taken what most observers agree represents a substantial hit to projected earnings growth.

## *c-far* and Electric Utilities

NERA used *c-far* to analyze the utilities industry, producing provocative results.

The firm compared utilities in the early 1990s to the current state of the industry and found that deregulation and sharply increased competition have brought a considerably higher risk of cash flow shocks. At the same time, it found that utilities have not adjusted their capital structures to fully compensate for the increased risks.

"It seems likely that utilities don't have the information they need to develop strategies to overcome their increased cash flow risk exposure," Dr. Stein said. "The *c-far* model can help them proactively address questions about their capital structure with greater certainty, and can help them more accurately assess the probability of a big shock and low interest coverage which could lead to default."

Looking at about 100 U.S. utilities, NERA found that the cash flow risks came close to doubling during the 1990s. Utilities with low profitability and high stock price volatility showed a risk profile that was twice as high as their industry peers. The companies' interest coverage held almost steady over the decade. But, with the increase in the risk of a cash flow shock by 1999, utilities had a significantly lower capital cushion available to cover a worst-case scenario.

"The risk of financial distress in the electricity industry may not be as high as other sectors, but it's become significantly greater amidst rapid deregulation," Dr. Stein said. "We're not saying utilities have a capital structure that is 'right' or 'wrong' in an absolute sense. Our findings do show that *c-far* can be used to help formulate debt-equity tradeoffs in a more quantifiable manner, thereby reducing the overall cost capital and increasing shareholder value."

## Risk Management: Hedging and Insurance

*c-far* can help companies develop more effective risk management policies, whether in using derivatives to hedge operating exposures or buying insurance to protect against other losses. A more precise understanding of non-financial risk can lead to a more precise hedging strategy. With the *c-far* model, companies can have a higher degree of assurance that risks are covered. Equally important, companies can also make sure they are not overspending on insurance or derivatives.

"Current research shows that risk management is an important tool for creating shareholder value," Dr. Stein said. "But the need for risk management is clearly greater when there's a bigger chance that cash flows may fail to support strategic investments. *c-far* gives a company a very clear picture of just how likely that downside is."

Dr. Usher adds, "Acknowledging existence of a *c-far* analysis provides a measure of assurance to executives and shareholders that all risks have been appropriately identified. When you have an understanding of where risk can interfere with strategic execution, you can put plans in place to avert a potential corporate disaster."

## Managing Investor Expectations vs. Earnings Volatility

As Wall Street continues to shudder with corporate downgrades and layoffs, investors grow ever more concerned about earnings surprises, placing management under greater pressure to meet earnings forecasts.

A company that provides a *c-far* analysis in its disclosure material stays ahead of the game if an earnings shock takes place. "Disclosing a *c-far* analysis to investors or securities analysts can put an earnings shock into a credible, objective, peer-benchmark context," Dr. Usher said. □

*NERA, a multinational economic consulting group, operates in thirteen countries. It is part of Marsh & McLennan Companies, Inc. Readers wishing to learn more about the capacities and availability of c-far should visit the firm's Web site at [www.nera.com](http://www.nera.com).*

*c-far can help companies develop more effective risk management policies, whether in using derivatives to hedge operating exposures or buying insurance to protect against other losses.*

*"Acknowledging existence of a c-far analysis provides a measure of assurance to executives and shareholders that all risks have been appropriately identified."*

# Taxation and Accounting

## Fallout, from Page 1

accounting requirements. Indeed, a recent FASB "Preliminary Views" report advocated measuring all financial instruments at fair value.

If financial reporting does move to fair value accounting, this change would radically conflict with U.S. tax law.

Accountants preparing taxes generally ignore derivative values and focus on income received and gains realized on the sale of property. However, when they prepare FASB-compliant financial statements, they must include derivatives in their reporting. Given this difference, lawmakers may now wonder if they should change tax law to require reporting derivatives and other fair value financial assessments.

Some financial observers would favor this change, because it would establish a consistent set of accounting procedures. As columnist Lee Sheppard recently wrote, "Congress should sweep away the various definitions and accounting methods for derivatives that have been installed piecemeal [in tax law] over the last two decades, and replace them with a tax law analogue of FAS 133."

Other observers argue that basing tax calculations on fair value accounting would radically depart from the current structure and thus be practically and politically unfeasible.

Despite the difficulties of altering tax law, showing a derivative's value on tax returns could simplify the law and unify accounting practices. It would also close a number of tax loopholes that accountants may use to shelter clients' assets.

## Fiscal vs. Financial Reporting

Many countries require conformity between tax and financial accounting, but the U.S. allows a number of differences. For example, accountants show capital depreciation over much shorter time periods on tax returns than on financial reports. Also, accountants who fill out tax returns usually do not deduct the cost of stock options granted to employees until the options are exercised. Despite this, financial accounting requires such options be included in the disclosure of pro forma net income and earnings per share even though a deduction for stock based compensation has not been taken.

The differences between tax and financial reporting reflect the different purposes of the two systems. The government established tax regulations to produce accurate descriptions of taxable cash flows. The FASB created rules for financial reporting to produce an accurate depiction of a firm's economic health, so investors, creditors and company directors can make informed business decisions.

Despite this, the two systems differ significantly in only a few relatively specific sets of cal-

culations. However, these disparities open the way for "creative accounting" that may, in extreme instances, amount to tax fraud. They also prove costly for companies that now must conduct two distinct sets of accounting calculations. Given these problems, many commentators advocate conformity between tax accounting standards and financial reporting standards.

## Why FASB Adopted Standard 133

The FASB favors accounting standards that handle various financial instruments consistently, as much as possible. It enacted FAS 133 to establish one set of guidelines for handling different types of derivatives. The Internal Revenue Code, conversely, has a separate tax system for almost every type of financial instrument.

For instance, tax law requires taxing stock dividends when they are received, but there is no tax for increases in share values until the shares are sold. Over-the-counter options are taxed under traditional property principles that often view them as down payments. Exchange-traded options and futures contracts are valued ("marked-to-market" under §1256 of the Code) at the end of the taxpayer's tax year and any change in value is recognized as a capital gain or capital loss.

Unlike stock, which produces a lower capital gain rate if held for more than one year, capital gains or losses on §1256 contracts are automatically 60 percent long-term capital gain and 40 percent short-term capital gain (or loss in either case), regardless of the holding period.

Because the tax code uses such a complex and confusing system, it opens the way for irregular and questionable tax accounting methods. Over time, lawyers and financial engineers have exploited the tax system by developing new, more sophisticated instruments and strategies that produce savings for those who can afford such planning.

To the extent such efforts are successful, they effectively shift tax burdens in a way that differs from the government's original intent for the tax system. A more consistent tax accounting system would limit the opportunity for these tactics.

## FAS 133 and Structured Notes

One example of a particularly problematic category of instruments is that of "structured notes." These securities include such common debt issues as *Participating Hybrid Option Note Exchangeable Securities* (PHONES), *Debt Exchangeable for Common Stock* (DECS), *equity-linked notes* (ELKS) and an number of other structures, each with its peculiar acronym.

Investment banks market such instruments to corporations that hold stock in other firms for

"Congress should sweep away the various definitions and accounting methods for derivatives that have been installed piecemeal [in tax law] over the last two decades."

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various purposes. Holding companies often want a more immediate return on their stock than long-range plans may allow. Investment banks provide a means of obtaining capital for such stock holdings, in a move known as “monetization,” that corporations prefer when they receive little or no dividends from the stock. Most high-tech stocks fall into this category.

PHONES illustrate the kind of creative engineering that has become a part of the financial landscape. Marketed by *Merrill Lynch*, **Comcast** became the first company to issue these instruments in mid-1999, when it monetized its **AT&T** stock. The Comcast notes were to mature in 30 years and had a number of embedded derivative features, as described in the following paragraphs.

If, at maturity, AT&T shares were worth more than 150 percent of AT&T’s share value at the issue date (allowing for certain adjustments like stock splits, etc.), the maturity of the security was to be extended for another 30 years.

The periodic interest payments were determined by formula to be 1.75 percent of par, plus the amount of the cash dividend paid on AT&T shares.

A holder could exchange his PHONES after one year from the date of issue for cash equal to 95 percent of the value of AT&T shares. This percentage rose to 100 percent if Comcast elected to defer quarterly interest payments on the notes. At maturity, the holder would receive the greater of the issue price (as adjusted) or the value of an AT&T share.

In addition to receiving cash, Comcast also obtained interest deductions on its debt.

Because PHONES are, from a tax perspective, contingent payment debt instruments, tax accountants determine interest payments and deductions from the comparable yield. The actual interest payments Comcast made amounted to 1.75 percent of the principal amount each year, but the comparable yield was determined to be 9.3 percent. The latter percentage determined Comcast’s deductions.

Comcast managed to orchestrate three benefits with PHONES:

- it received higher deductions than payments it actually made to holders of the debt;
- it monetized its AT&T stock holdings without adverse tax consequence; and
- it was able to arrange financing on a tax-advantaged basis.

This highlights another problem with the current tax law.

Some experts believe the 9.3 percent interest deduction should not be allowed, because accountants will correlate the final payment on the PHONES with the position Comcast holds in the

AT&T stock. These experts argue the correlation triggers application of the complex “straddle” rules that preclude deductions where one position offsets another.

Beyond the question of the size of the deduction, the tax system treats PHONES debt as a single debt instrument even though the debt includes derivative features. However, if a company issues PHONES as two independent instruments, debt and derivative, the tax system could apply tax rules to each of them separately or, depending on certain factors, could integrate them into a single “synthetic” instrument.

As long as the derivative features are not clearly and closely related to the host contract, the financial accounting system treats the embedded derivatives as “stand alone” derivatives. Thus, the tax system may respond in different ways to PHONES depending on whether the deal is structured as a single transaction or as a combination of more than one trade.

Given the diversity of financial instruments and the ways they can be combined and separated, a system based on fair market value would provide a consistent approach to valuing them. Implementing it may be easier said than done, however. Valuing instruments with embedded derivatives will require a significant level of financial engineering skill; those with greater facility with valuation methodologies will be better able to conduct the required tax calculations.

Another factor to consider is that the government wants the tax system to collect taxes as efficiently and quickly as possible. However, the IRS is concerned that some companies will use the current system to defer tax liabilities indefinitely. A tax system based on fair value would limit companies’ ability to use delaying tactics.

The next installment of this article will deal with differing perspectives on other embedded derivatives and financial structures. □

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## Ground-Breaking Reinsurance Deal for Multilateral Guarantee Program

In mid-March, **Sovereign Risk Insurance Ltd.** (Sovereign) announced the signing, by Sovereign and the **Inter-American Development Bank** (IDB), of the first contract providing reinsurance for a private sector guarantee issued by IDB.

Sovereign's \$50 million reinsurance policy supports the IDB's first private sector convertibility/transferenceability guarantee for Brazil, issued for a \$100 million loan to **VBC Energia S.A.** (VBC). The loan to VBC, provided by a syndicate of commercial banks, was made to finance expansion and modernization of two of Brazil's electricity distribution companies, **Companhia Paulista de Forca e Luz, S.A.** and **Rio Grande Energia, S.A.** The \$100 million IDB guarantee of that loan covers risks associated with currency inconvertibility, transferability and funds expropriation. Under the reinsurance policy, Sovereign assumes a portion of the guarantee risk.

Use of reinsurance is one way in which IDB seeks to leverage its resources and enhance its capabilities to guarantee private sector transactions in its member countries. The reinsurance contract for this project will be a model for other similar reinsurance contracts between the IDB and private sector insurers.

**Hiroshi Toyoda**, Manager of IDB's Private Sector Department, noted that this is a groundbreaking transaction that will allow the IDB to better support private sector operations in the IDB's member countries throughout Latin America and the Caribbean.

**Price Lowenstein**, President and Chief Executive Officer of Sovereign, commented he was "extremely pleased about the opportunity to support the IDB's private sector operations. Sovereign works with financial institutions and bilateral and multilateral agencies on a global basis, and we are very proud to be the first private sector underwriter to reinsure the IDB."

## Spanish Banking Giant Confronts Regulators on Regional Mergers

**BBVA**, Spain's largest bank by market capitalization, has launched a bitter attack on Europe's central banks for blocking cross-border mergers in the financial sector. BBVA executives are angry that the bank's ambitions to forge an alliance with a European partner have been blocked by central bankers. **Francisco González**, BBVA co-chairman, told the bank's annual meeting earlier this month that he wanted the group to be at the forefront of Europe's financial consolidation.

The "Financial Times" reports that BBVA executives are frustrated by the intransigence of Europe's central bank governors—notably in Italy and France. At the meeting in Bilbao, one executive said that Europe's central bank governors were "the biggest obstacle against the free movement of capital within the European Union."

BBVA's market capitalization, at €52 billion (\$0.90:€1), is second only to **Deutsche Bank** in continental Europe. The bank believes it would be able to use its shares in acquisitions, were it not for opposition by central bank governors.

Negotiations with Italy's **Unicredito** in 1999 came to nothing when **Antonio Fazio**, governor of the central bank of Italy, blocked the merger. Now BBVA is displeased at the prospect of seeing its 10 percent stake in **Banca Nazionale del Lavoro** (BNL) diluted, owing to BNL's interest in acquiring **Cardine**, a combination of Italian banks.

BBVA has turned its attention to Europe after completing expansion in Latin America, where it controls about 10 percent of the financial sector. Its position in Europe is comparatively weak. As well as its 10 percent stake in BNL, it has a small Portuguese presence and owns about 4 percent of **Crédit Lyonnais**. □

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