NEWS
letter

Centre International
pour le Crédit Communal

November 2006, Number 5

The Newsletter contains important information about the affiliated institutions. Among other items, Newsletter contains articles on interesting developments, new products, cooperative ventures and summaries of annual reports. Contributions to the Newsletter are very welcome and should be submitted on disk (preferably in Word for Windows), by e-mail or by fax. Please direct questions and comments regarding the Newsletter to the secretariat.

Tel.: +31 70 3 750 814 or 3 750 820.
E-mail: centre@bng.nl

Contents

XXXVth ICLC conference inspired by Kondratieff

Autumnal Paris is the scenery of the XXXVth conference of the International Centre for Local Credit, hosted by Dexia, celebrating its 10-year jubilee.

On November 16, participants will discuss the changing environment in which local governments are doing their jobs and the changing role of the public sector as well. And as a consequence of this, developments in the way of financing, by government and by institutions is a logical topic to discuss at the end of the day. On November 17, participants are invited to join a working session on decentralisation and politics in France. This meeting is chaired by mr. Pierre Richard. Mr. Jean-François Copé, vice minister of Finance will be one of the participants in the debate.

We all are familiar with short- and medium term fluctuations of the economy. But in the market economy also long-term fluctuations can be discovered, with a period of 40-60 years. These so-called Kondratieff cycles are triggered by landmark inventions, referred to as basic innovations. Since the 18th century, five cycles have come and gone. The first one, starting about 1780, saw the invention of the steam engine and its use in the textile industry. The second cycle, in the mid-nineteenth century was the great age of steel and the rise of railway transport. The third (last quarter of the 19th century) was triggered by electrical engineering and chemicals industries. Petrochemicals and automotive industry were responsible for the fourth cycle, starting in the roaring twenties. The fifth cycle is marked by the development and exploitation of information technology, starting in the fifties/sixties of the 20th century. Is the sixth wave coming now?

Mr. Leo Nefiodow, the main speaker on the first theme of the conference, sees clear signs of the sixth wave already having begun. This time, the health sector will be the bearer of the long-term cycle, he points out in his book.* Its basic innovations will be psycosocial health and modern biotechnology. That seems a little bit surprising, as medical expenditures are seen as a negative, as a cost factor that people want to minimize, and while the triggers of the previous cycles were 'hard' technologies.

Mr. Nefiodow points out that the main source of modern growth is growth in productivity. This third factor beyond labour and capital is determined by new or improved skills. In the fifth cycle, cognitive skills, like logical-systematic thinking and good solid training played a key role.

The coming cycle will see a radical change in competencies and competitive factors that determine productivity, according to Mr. Nefiodow. Technology is available world wide. Access to capital is no factor anymore, as stockmarkets are accesible for every company above a certain size.

Research, development, expert knowledge and organization are declining as decisive factors in competition, because they are becoming more and more equal as part of globalization. So, what will set economies apart in the future competition is the healt of the people and the quality of their health system, seen as a whole: bodily and mental; psychological, social and ecological.

To make the health sector the bearer of the sixth wave, however, a radical change in approach is necessary. Conventional health care is focused on using the natural sciences, mechanics and technology to research, diagnose, treat and manage disease. It is concerned primarily with treating the symptoms, and not the underlying causes. Economically spoken, this concentration on diseases is expensive and damaging for the society as a whole. It is cynical, so states Mr. Nefiodow, but growth in our current health care system can only happen if there are even more patients and diseases.

The greatest reserves of productivity lie in the restructuring of health care, in a focus on illness, or rather on health. Mr. Nefiodow states that new concepts, strategies and approaches are necessary to tap these resources, that are designed not to repair deseases, but to produce and maintain health and well-being, and take seriously the concept of humans as whole beings. A interesting challenge for the public sector as they are deeply involved in providing an adequate health care system now and in the future.

* Leo A. Nefiodow, Der sechste Kondratieff. Wege zur Produktivität und Vollbeschäftigung im Zeitalter der Information, Rhein-Sieg Verlag, 2001.

Personnel management in Local Authorities: towards a European standard?

By Dominique HOORENS and Judith LEVITAN, Direction des Etudes de Dexia Crédit Local

Most European countries have experienced over the past twenty years substantial reforms of the public sector and a move towards greater local autonomy which have led to the reorganisation of their civil services, both at central and local levels. The notion of 'New Public Management', initially designed in the United Kingdom, took over the continent in the wake of a greater European integration and because of the implementation of EU regulations, such as the principle of free mobility for workers. But does this widespread move towards a greater flexibility and a preference for contractual systems, which is now shared more or less all over Europe, mean that we are seeing the birth of *one standard model of public management*?

* * *

We may roughly classify the various modes of public management in Europe into two theoretical types: one based on the notion of 'career', the other based on the notion of 'employment'.

The career-type system is based on the recruitment of statutory civil servants, organized in 'corps' according to their professional fields. They benefit from a specific status under public law, and the terms of their employment fall within a distinct jurisdiction clearly distinguished from common labour laws. Civil servants may occupy a variety of hierarchical positions within their 'corps', as specified by their 'grade'. Once they have been recruited through competitive exams, it is their 'grade', unilaterally defined by their administration, which determines their employment, and not a specific task or assignment. Their working conditions, together with guarantees as to their income and their career track, are defined either by the Constitution or by law. They benefit from life-employment terms.

In the employment-type system, employees are hired under common labour laws, which is why they are referred to as 'contractual personnel' and not statutory personnel. Their terms of employment are usually defined by some form of collective agreement. The agent is recruited to perform a specific assignment, based on his personal qualifications. He or she may enter public service at any given level of seniority. His or her career is defined by a succession of various assignments and not how he or she climbs the hierarchical ladder of grades.

New Public Management prompted a deregulation of career-based systems

'New Public Management' was born in the United Kingdom, at the beginning of the Thatcher era. It stemmed from a radical questioning by the neo-liberals of the 'bureaucratic' model of public management and the will to rationalise – indeed to curb down – public spending, which was seen as failing to create wealth. At the core of this reform, lay the idea that public management needed to copy private management, in its focus on efficiency and the fostering of commercial or contractual relationships with citizens turned into 'consumers' of public services. It led to a new managerial culture, based on five key concepts: *flexibility, objectives, evaluation, competition* and above all *contract.*

Quite naturally, the British experiment first raised interest in countries whose public sector was already organized as an employment-type system, and whose culture of management was based on the notions of contract and negotiation. These would be countries from Northern Europe such as Sweden, Finland, The Netherlands or Denmark, where public employment gradually fell within common labour laws and where the income of civil servants came to depend on result-based individual performances.

We may add to this list the newcomers from the East. Indeed, throughout the Soviet period, the status of public sector personnel in Central and Eastern Europe countries was not different from that of ordinary workers, subject to common labour laws. This may explain why, during their democratic transition, these countries chose to build their new public sector according to the 'employment-type' system. Two other factors may have contributed to this choice: the fact that private law was easier to understand in their legal culture than western public law, and the influence of the United States, through its considerable financial assistance.

But the principles of 'New Public Management' also had an impact on systems of public management that were traditionally based on 'career'. A number of countries from Southern Europe, such as Spain, Portugal and Italy, were also inspired by the British example. Although personnel management in the public sector remains largely based on the career-type in most of those countries, it is increasingly incorporating elements from the employment-type. Recruitment for instance relies on a growing number of private sector contracts and not only the appointment of statutory civil servants; one may also cite the development of personnel management policies focused on the operational monitoring of tasks, professions and assignments rather than on the formal architecture of corps and grades.

A trend reinforced by European integration

The gradual shift from the career-type system to the employment-type, under the influence of New Public Management, has been spurred on by the legal choices made by European institutions. The Court of Justice of the European Communities interprets the principle of free mobility for workers in a literal way, thereby restricting the special status of public sector employment to those positions which imply the enforcement of public authority or the preservation of the general interests, either at central or local levels. The principle of free mobility should apply regardless of the legal status of civil servants or their mode of recruitment. Undeniably free mobility is best achieved in a country that privileges the more flexible contractual approach rather than a statutory organisation.

The European Commission's long term commitment towards a gradual liberalisation of certain public networks, the disappearance of public monopolies and the introduction of competition and performance within the public sector, also stands in favour of the employment-type system.

A trend also bearing upon Local Authorities

This general shift from 'career' to 'employment' is particularly clear at a local level. Indeed the principle of 'home rule', when applied, generally means that Local Authorities may adapt their working conditions, for instance in terms of recruitment policies and personnel management. The culture of 'employment' may therefore be more present in the management of local public service personnel than in central administrations. This explains why contractualisation, which offers a greater flexibility, is more often found at a local than a central level.

In France for example, 20% of Local Authorities personnel is employed under contract, compared to 13 % for the rest of the public sector; that distinction is even more striking in Germany, where contractual agents represent near 90% of Local Authorities personnel (not counting the *Länder*) and only 35% of the Federal State personnel.

But the local and the central public sector usually tend to be organised along the same lines. The predominant model of public management at a national level, be it 'career' or 'employment', usually prevails at a local level. The exception would be Belgium, where one finds a (narrow) majority of contractual employees at the local level, and a minority at the federal level. In Germany, although there are few statutory civil servants in the local public sector, they constitute the majority in the *Länder*. On the whole, the local public sector in Germany falls therefore within the 'career-type', together with the federal public sector.

However the existence of specific public statuses or the proportion of contractual employees are not the only criteria to take into account before we classify countries as 'career-oriented' or 'employment-oriented'. The management of individual career tracks, the terms for progression, promotion or mobility are usually more flexible at a local level than in the central administrations. Indeed, Local Authorities constitute as many employers whereas the central State, as a unique employer, is bound to apply the same rules of management to all its employees and across all its various departments. Local Authorities benefit from a certain leeway and the variety of modes of management it enables gradually bear upon the public sector managerial culture in their country. In France, for example, the State public sector, divided into no less than 900 'corps', strictly separated one from another, suffers from a form of rigidity and tends to look up to the local public sector for inspiration: the latter is structured in 60 'cadres d'emploi' (employment frameworks), a system which offers more flexibility in the management of individual career tracks.

The general shift toward the employment-type model of personnel management in the public sector, largely sustained by Local Authorities, is thus reinforced by the generalisation of greater local autonomy in most countries of the European Union (with the exception of very small States).

Towards a standard European model of civil service?

The modernisation of the public sector in Europe brought about a number of changes in statutory systems of public management, notably through a tendency to contractualise employment for public sector personnel. But is the employment-type system becoming the standard in terms of public sector architecture and management throughout Europe?

Even in such countries that have adopted New Public Management and where the terms of employment of public sector agents are close to common labour laws, there remains some specificity to the public sector. Each country keeps a 'hard core' of statutory civil servants in charge of State prerogatives such as defence and law or at senior levels of management. This is the case for instance in Italy, Denmark, or even the United Kingdom.

Moreover, there is a great variety in the way the various member States of the European Union organise their public sectors, especially if one considers the precise conditions under which public agents are employed. No trace here of a uniform system of personnel management. The two theoretical models of 'career' versus 'employment' rather appear as the two opposite

> There are 32 million public sector employees in the 25 member States, which amounts to 16 % of global employment in the EU. Local Authorities (which includes federate States) employ 18 millions workers (56 % of public sector employment).
> In most States of the former 15, greater local autonomy meant public employment was shifted from the central to the local levels, except in the Netherlands and Ireland due to the considerable increase of their teaching staff. The case of Spain is remarkable: the Autonomous Communities have almost doubled their staff in ten years and their personnel now represents half of all public sector employment. In the same period, the central level in Spain lost almost 40 % of its workforce and now employs no more than a quarter of public sector personnel, compared to 43 % ten years ago. In Finland, Local Authorities now employ more than 75% of all public personnel, compared to 68 % at the beginning of the 90s. In Austria, Local Authorities (including the Länder) employs 60 % of all public workforce, compared to only half at the beginning of the 90s. In Belgium, the proportion of federal civil servants fell by 5 % in favour of Local Authorities. France and Italy have known a similar decrease, by 2 to 3 %.

poles of a continuous spectrum, in which we may identify a variety of hybrid systems that borrow their concrete rules and regulations from one or another of those poles. For example, contractual public employees in Germany benefit after 15 years from the guarantee of 'life-employment', which was considered to be the sole province of statutory civil servants. Competitive entrance exams, also a characteristic of the career-type system, is widely recognised throughout Europe as the most efficient and fair mode of recruitment, even for employees hired under common labour laws.

Finally, there are limitations to reforms of public sector inspired by New Public Management. The relative failure of the Copernicus reforms in Belgium illustrates the resistance to a possible 'commercialisatio' of the public sector. The 'Bassanini' reform in Italy apparently failed to provide the expected results in terms of increased efficiency of the public sector, since common labour laws did not prove as flexible as anticipated and also resulted in some rigidity on the labour market. Lastly the relevance of New Public Management has been lately called into question in Central and Eastern European countries, even though they had massively opted for the employment-type during the restructuring of their public sector during the 90s. Faced with the – sometimes complete – disintegration of their administrations, they have come back to systems mostly statutory, in both legal and regulatory respects. Not only do statutory systems offer public employees more interesting career tracks (more professional and more regular) but they also impose upon them stricter obligations.

The position of the joint institutions also appears to have changed. The objective of a unique model of public management based on 'employment', entailing a gradual harmonization of the legal status of civil servants, has been abandoned. The Commis-sion now recognizes the specificity of certain services of 'general interest', which justifies in part the recourse to statutory systems.

* * *

We have not witnessed the birth of a standard European model of public sector management but rather that of a hybrid system, maintaining the statutory model albeit within the frame of a new managerial culture, together with a number of contracts framed by collective agreements, themselves often inspired by the regulatory dispositions of civil servant status. As it turns out, the common European standard may be that of a culture of negotiated contractualisation, able to guarantee both satisfying career tracks for public employees and the impartiality of government bodies, while ensuring greater efficiency and flexibility in the management of public services. And Local Authorities stand at the forefront of this modernisation.

* Further information may be found in *Les fonctions publiques locales dans les 25 pays de l'Union européenne*, Dexia Editions, Paris, juin 2006, 228 pages - Foreword by Michel Senimon, general secretary of the association Europa. A joint publication from Dexia Crédit Local and the Centre National de la Fonction Publique Territoriale, with the help of the association Europa.

Bank Nederlandse Gemeenten: profit first half year 2006 slightly higher

Bank Nederlandse Gemeenten reported a profit before tax of EUR 134 million for the first half year of 2006, an increase of EUR 4 million compared with the first half year 2005. Net profit after tax amounted to 104 million. The increase of the pre-tax profit was mainly due to lower operating expenses.

Long term lending by the bank in the first half of 2006 was mainly in line with the first half of 2005. Total turnover was EUR 5.1 billion. The housing associations sector in particular made a substantial contribution to turnover. BNG retained a high market share in its most important markets.

Profit before tax exceeded expectations of BNG. This was attributable to income from early repayments and lower-than-expected operating expenses. These items compensate the decrease in the result financial transactions as a consequence of the application of hedge accounting under IFRS. This and the revaluation of derivatives were mainly responsible for the decrease in total assets, as compared with 2005.

The interest margin is under structural pressure, however, owing to the maturation of loans and advances with a relatively high margin, and the low long term interest rates in absolute terms. The aforementioned early repayments also exert additional pressure on the interest result, because they involve loans and margins with a relatively high margin. The operating expenses for the whole year 2006 are expected to be lower than last year, particularly due to structurally lower staff costs.

BNG expects that the profit before tax for 2006 will be lower than for 2005, barring unforeseen circumstances.

At an extraordinary general meeting in August, shareholders agreed with a proposal of BNG to distribute an extra dividend of EUR 500 million in 2006 from the Reserve Retained Profit.

Key figures first half year 2006

	30-06-2006	*30-06-2005*
Total assets	89,057	94,962
Total income	160	160
Total expenses	26	30
Profit before tax	134	130
Profit after tax	104	89

First Nations Finance Authority

Submitted by the Municipal Finance Authority of British Columbia, Canada
Steve Berna, Executive Director
July 13, 2006

After 10 years of hard work and political discussions, a new co-operative borrowing authority has been born – the First Nations Finance Authority (FNFA). This project started with discussions between the Municipal Finance Authority of BC (MFABC) and staff from the Westbank First Nation, with the objective of creating a borrowing co-operative solely for the aboriginal people of Canada.

This co-operative idea focused upon the operational and ideological workings of the MFABC and the members of the Credit Communal.

This co-operative will be Canada-wide in scope, but membership will be earned, not automatic. Since members of the FNFA will guarantee each other's debt, in an attempt to maximize their initial credit rating this Fall, aboriginal groups across Canada will have to achieve certain financial targets – audited financial statements, transparency of revenue and expenditures, openness regarding sharing of statistics and other required information. The initial number of members in the FNFA is expected to be small, totaling only 25 to 30, and expand as aboriginal bands apply for membership.

History:

In 1995, First Nations Finance Authority Inc. received Federal incorporation. After many long years, and determination by many dedicated individuals, the legislation establishing the FNFA as a statutory body finally became law in 2005 (Bill-C20, The First Nations Fiscal and Statistical Management Act 'the Act'), and the Act itself allowing operations to commence came into force April 1, 2006.

What is the FNFA?

The FNFA is a non-profit finance authority that serves First Nation governments across Canada. The main objective of the FNFA will be securing of capital through the issuance of debentures, but will later expand into creating its own programs around pooled investing, and pooled short term borrowing.

Members of the FNFA

First Nations people are considered the aboriginal people in Canada. There are hundreds of Aboriginal Bands throughout Canada which could apply for membership once they have achieved the financial targets established by the FNFA's Board of Directors.

Why was it established?

Unlike the federal, provincial and municipal governments, it was illegal under law for First Nations to enter into long term loans (that is, loans that exceed one-year in length) to cover the cost of basic infrastructure, such as water and sewer systems. This inability to access affordable capital affected the ability of First Nation governments to undertake proper planning so that infrastructure could be built to meet the current and future anticipated needs.

Without proper planning, and access to affordable capital, the costs were too excessive and projects are not undertaken. The ability to borrow through debentures will allow debt repayment to occur over many years, thereby making viable engineering projects.

Going forward

The FNFA will receive access to capital by using pooled borrowing, creating the advantage of debenture liquidity. For investors, risk will be diminished by the members guaranteeing each other's debt repayments, which creates investor access to many revenue streams. By pooling, the costs associated with borrowing (rating agencies, travel, legal, etc.) will be shared by the members allowing economies of scale to be realized.

The strength of the FNFA will be based upon its size of membership, and on the geographical expansiveness across Canada that ties into the various micro economic regions – Pacific Ocean, Prairies, U.S. border proximity and Atlantic Region.

The strength of the FNFA will also be maintained by the independent quality assessment of certain Federal Government review boards which are responsible for overseeing participation and creditworthiness.

Municipal Finance Authority of BC ties

The Municipal Finance Authority of British Columbia will serve as a 'back office' for the FNFA until they achieve certain logistical levels of debt and investments under administration. The MFABC staff will provide these administration functions, but will not be part of the decision making processes around debenture timing, selection of banking syndicate, rating agency presentations, etc. At a time of FNFA's choosing, the MFABC will cease providing services, and the FNFA will be tasked with securing its own employees, at which time it will become truly self sufficient. The MFABC, and other members of the Credit Communal, were the models that the FNFA reviewed when developing its business plan.

Municipal Finance Authority of British Columbia
Steve Berna, Executive Director
737 Fort Street
Victoria, British Columbia
V8W 2V1 Canada

Phone: 1-250-383-1181
Fax: 1-250-384-3000
Email: mfa@mfa.bc.ca
Web: www.mfa.bc.ca

In the newsletter, we pay attention to the economic forecasts from member institutions. In this issue we publish the forecast of Bank Nederlandse Gemeenten. If you are interested to publish your forecast in the next newsletter, please have contact with the ICLC secretariat for deadlines etc.

Bank Nederlandse Gemeenten, *October 2006*

Recent developments on financial markets

In September and the first half of October, fluctuations in interest rates were limited. The stock markets were slightly higher.

The *credit spreads* barely changed. The spread between U.S. corporate bonds with a rating BBB and Treasury bonds narrowed with 5 basispoints to 128 basispoints. In the eurozone the spread was almost stable at 112 basispoints.

The European Central Bank raised the refinancing interest rate as expected with 25 basispoints to 3.25%. As a consequence, the *short term interest* rates in Eurozone rose, and the yieldcurve flattened.

The *euro* depreciated somewhat to the US dollar.

The price of *crude oil* fell. Op 12 October, the price to be paid for a barrel crude oil was USD 57.30, USD 7 lower than in the beginning of September. Lower demands and favourable weather conditions in the United States were partly responsible for this. The Opec has meanwhile decided to decrease production with 1 mln. barrels a day (3 per cent of the total production). Prices of other commodities were slightly lower.

Interest rate forecasts

Forecasts are based on the following presumptions with regard to the economic developments:

- Expansion of world economy in 2007 will flatten under the influence of tightening monetary policy and high energy proces.
- Economic growth in the eurozone will slow down somewhat.
- Inflation remained moderate.

After the most recent decision we expect the *Federal Reserve* to leave the interest rates unchanged for a longer period. During the course of 2007, we expect a gradual easing of monetary policy. Aan the end of 2007 we expect a Fed fundsrate at app. 4.75% (current level 5.25%). The *Bank of Japan* will continue its gradual increase of interest rates.

As can be deducted from the explanation on the most recent interest rate decisions of the European Central Bank, some further tightening of monetary policy is the most probable scenario. Growth of M3 is still higher than the targets of ECB. We expect that the refinancing facility will be raised this year with 0.25%, resulting in a rate of 3.5%. In 2007 we expect the rate to be raised to a level of 3.75 - 4.0%. As a result of this, three month interest rate will rise to a level of 3.9 - 4.3%.

Capital markets already anticipated on the monetairy tightening of the ECB. Long term interest rates will not rise much from the present levels. We expect the 10 year swap rate at a level of 4.2-4.6% at the end of 2007. Long term interest rates will remain at a low level, seen from post-war perspective. The expectation that inflation will be low and the official demand of Asian Central Banks of western treasury bonds contribute to this expectation. At the end of 2007, we expect that USD 1.30 -USD 1.35 has to be paid for the euro. At the end of this year, we foresee a level of USD 1.23 - USD 1.28.

Main economic developments

We foresee a favourable economic development in 2007, albeit the growth percentage will be slightly lower than in 2006. Due to the monetairy tightening, interest rate levels are somewhat higher, with a slight negative impact om domestic consumption. Oil consumption will rise, so that the fall of oil prices will not continue. Our forecast for the oil price in 2007 is USD 70 per barrel (2006: USD 65/barrel).

Emerging economies will show a strong growth Expansion of the *Chinese* economy will continue. When the acceleration in the second quarter is taken into consideration, a growth rate of 11 % is not unlikely. We have to take into account, that the insight in the Chinese economy is hampered by imperfect statistics. Economic growth will slow down somewhat in 2007 to a level of 9%. Due to the favourable development of China and other surrounding countries, the Japanese economy wille develop well. The growth estimate for 2006 is 2.8%, but will slowdown somewhat in 2007 to 2.5%. Inflation will rise slowly.

In the *United States*, that are at the forefront of the monetary cycle, the effects of the interest rate hikes already can be noticed. The housing market has cooled down considerably. The development of the consumption will be less exuberant than in 2006, due to high energy prices and low savings. Foreign demand will counterbalance these effects somewhat, as the weak dollar has a positive impact on the competitive position. Economic growth will be around 2.5% in 2007, as to 3.5 % in 2006. Inflation will fall as a consequence of the more moderate rise of energy prices from 3.7% in 2006 to app. 3.0% in 2007. Core inflation (excl. food and energy) will remain at the same level.

Expansion of the *eurozone* becomes a broader base, gradually. Export shows a favourable development, but could decelerate somewhat as a consequence of an expected appreciation of the euro. Investments will grow in a relative easy monetary climate.

Employment will therefore grow. Consumption will grow moderately, partly due to government policies in Italy and Germany. Economic growth in 2007 will slowdown somewhat to 2.1%, as German growth will be lower. The monthly IFO-research indicates that industrial managers are very positive about the present situation, but very negative about the things to come. One of the reasons is the rise of the value added tax (VAT) from January 2007 on. Consumers will anticipate to this, by spending their money in the last months of 2006. Surveys under purchasing managers in the eurozone suggest a continuing growth, although the sentiment in the services sector is less positive than a few months ago.

Inflation will remain stable in 2007, despite a moderate development in energy proces at a level of 2.2% (2006: 2.3 procent). The aforementioned rise of VAT in Germany is one of the reasons for this. Dutch economy will grow considerably above eurozone average. We expect a growth percentage of 3.0%. Favourable development of the export in combination with a rise of consumption will contribute to this. Inflation will be at a slightly higher level, but remains low at 1.8%.

Risks

- The deficit on the US curent account will remain high. Financing this deficit might be a problem, for example when the economic growth would suddenly cool down strongly. In case of a crisis in confidence in the dollar, the long tem US interest rates will rise, but will fall for euoloans.
- Labour productivity in the United States has grown considerably in the past years. Continuation of this trend is not likely. In our view we have assumed that employment will grow and the increase in productivity will slow down. A stronger drop in productivity can not be excluded. In that case, labour costs and as a consequence of that, inflation will rise stronger. Labour costs determine about two thirds of the development of the CPI.

Investments will grow in a relative easy monetary climate

International Accounting Standards for financial instruments in practice

By Michiel van der Lof, partner of the IFRS desk at Ernst & Young Global Financial Services (Michiel.van.der.lof@nl.ey.com) and John van Leeuwen, director at Ernst & Young Financial Services Risk Management (John.g.van.leeuwen@nl.ey.com)

The international accounting standards regarding financial instruments (IAS 32 and 39) are controversial for many bankers. In the financial industry, IAS 39 is contemplated as a standard written by academics. Now the first financial statements prepared based on international accounting standards or international financial reporting standards (IFRS) have been issued, we can consider the practical application of this controversial theory.

In this article, we will discuss some of our observations regarding the implications of IAS 39 to the banking books (investment-, steering- and funding portfolios used for the purpose of asset and liability management). Furthermore, we present some highlights of a study performed of the 2005 IFRS financial statements of 24 European banks by Ernst & Young.

Introduction

Since 2005, listed companies have been required to prepare their financial statements based on IFRS. The accounting of the activities of the traditional banking business and asset and liability management (ALM) was done based on the cost principle before the implementation of IFRS. The cost principle had always provided a fair view of the financial position of banks which were using financial instruments in realising interest income. Derivatives and innovative products and financial structures have become more and more part of the ALM- and banking books.

The controversy mainly regards the fact that IAS 39 requires that effectively all financial instruments, in particular derivatives, be held on the balance sheet at fair value, with the changes in fair value of those instruments being recognised in the profit and loss statement. Where banks are using derivatives to hedge exposures accounted for on an accruals basis they face the prospect of having to take changes in the fair value of the hedge instrument to the profit and loss statement without being able to recognise the associated changes in the underlying hedge instrument unless some complex and restrictive rules for hedge accounting are followed. Furthermore, fair value movements of the available-for-sale portfolios cause movements in the capital. Banks have to accept some degree of volatility in both their profit and loss statement and capital as a result of their use of derivative instruments and maintaining available-for-sale portfolios.

As part of ALM, banks would like to reduce volatility of results and capital based on economics rather than accounting implications. With the current low interest rate environment under the expectations of increasing rates, one would maintain duration at low levels to limit the interest rate sensitivity of the banking books. However, conflicting interests could rise if the accounting volatility of income and capital has to be managed. Rather than entering into effective derivative transactions, banks can sell bonds with a high coupon of the investment portfolio as these bonds have a high duration in most circumstances. In the latter case, not only the duration is steered, but also income is positively affected following the release of the associated revaluation reserve.

Observed developments in the ALM world

It is interesting to see what strategies are used by banks to prevent the accounting volatility caused by IAS 39 and how the ALM activities have been affected.

Banking books have been managed more on a fair value basis rather than managing the interest rate positions only since the introduction of IAS 39. Therefore, the unrealised fair value movements captured in the revaluation reserve (special component of equity) are now in scope of ALM and the ALM function is more risk-oriented. A task part of risk management which is monitoring market risks regarding movements of prices, rates, yield curves and other market variables. As ALM has started managing its books also on fair value, risk management has got more interest in these portfolios as well. It can be concluded that the ALM and risk management have become closer to each other.

Driven by corporate governance codes and legislation like the Sarbanes-Oxley Act, the preparation and publication of financial information require precise internal procedures. As a consequence, financial reporting processes are subject to stringent procedures and controls and documentation requirements. The fair value principle and hedge accounting have been part of daily life of the managers of ALM and banking books since the application of IAS 39. Due to the digital conditions regarding the application of hedge accounting and the fair value measurement considerations as laid down in IAS 39, the processes of managing ALM and banking books need to comply to the current requirements of financial reporting processes. On top of that, the external auditor has been attracted as well.

This tendency will strongly be expanded when the IFRS 7 ‘Financial Instruments: Disclosures’ is implemented. ALM and risk management processes will then even more qualify as financial reporting processes.

Responses of the IASB

The IASB acknowledged the volatility issue raised by preparers of financial statements and issued two facilitating solutions: (i) hedge accounting, and (ii) the fair value option.

Hedge accounting

In general, there are four types of hedge accounting:

1. micro fair value hedging
2. *macro fair value hedging*
3. micro cash flow hedging
4. macro cash flow hedging

When micro hedging is applied, a specific transaction or position is hedged by one derivative; a one-to-one relation. In most circumstances, with ALM not specific transactions or positions are hedged but net (risk) positions. As a result, we have not experienced numerous micro hedges in banking books in practice.

Marco hedging has been introduced by the IASB in 2000 (cash flow) and in 2004 (fair value). Macro hedging was a response of the IASB to complaints by the financial services industry. It is more relaxed than micro hedging – the original only hedge accounting facility – and allows that projected or modelled risk positions are hedged by multiple derivatives; the one-to-one relation can be abandoned.

As mentioned before, hedge accounting can only be applied under rigid conditions and brings administrative burdens. Obstacles experienced were: hedge documentation, periodic hedge effectiveness testing, the usage of internal derivatives and the initial hedge designation. Banks have put in great efforts to comply with the conditions of IAS 39 and to deal with the obstacles. Hedge accounting has been proved itself being an effective solution to the earnings volatility issue.

The fair value option

Like as it was for the embedded derivatives issue, in certain cases, the fair value option appeared to be an effective escape of the hedge accounting requirements. This fair value option allows – under certain conditions – financial instruments be carried at fair value with fair value movements through the profit and loss statement. If the respective financial instrument is effectively hedged by a derivative, than both fair value movements net each other in the profit and loss. The accounting treatment of both the hedged financial instrument and the hedge instrument, the derivative, are similar. In particular in (structured) funding books, including both liabilities and steering derivatives, the fair value option has been applied by banks.

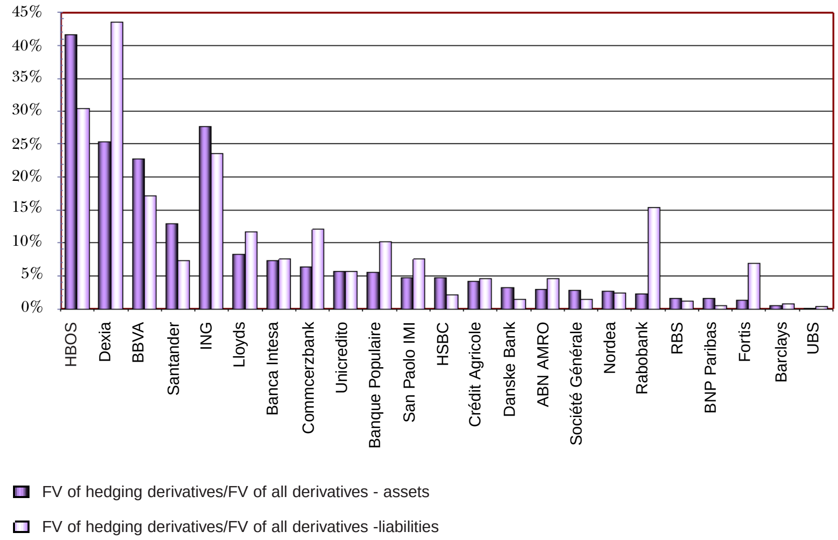
IFRS FINANCIAL STATEMENTS

Following our experiences with IFRS implementation projects, we were very interested in first full sets of IFRS financial statements issued by the banking industry. In this regard, we have studied the 2005 IFRS financial statements of 24 banks. In this article, we address only our observations regarding hedge accounting and the fair value option.*

Hedge accounting

Despite of the administrative burden, we concluded that hedge accounting has been accepted with open arms by banks to control earnings volatility. The *chart above* analyses the relation of the hedge derivatives versus trading derivatives for the assets as well as the liability side of the balance sheet.

From the chart can be derived that HBOS, Dexia, ING and BBVA have included derivatives in a hedge relationship above average. Almost all banks in the scope of our study indicate that they apply fair value hedging on hedged interest rate and currency risks. Contrary, nearly no bank disclose the application of hedge accounting regarding credit or commodity risks.



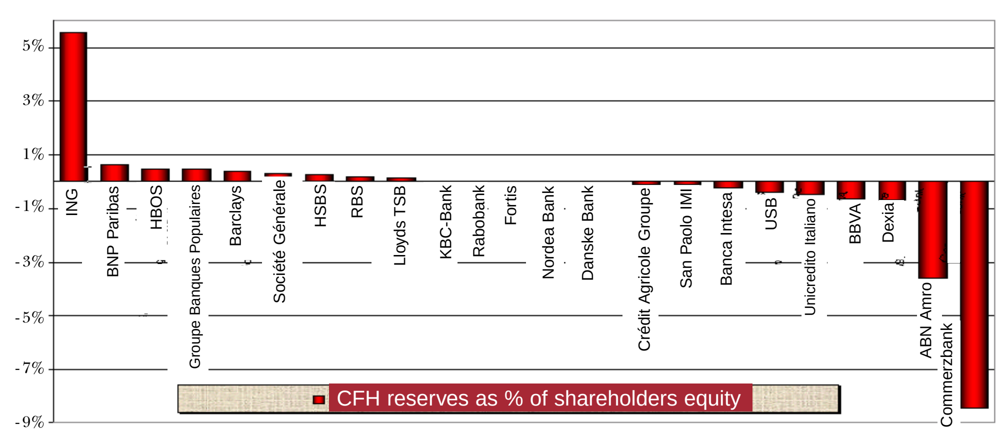
Whereas the application of fair value hedging is hard to assess from financial statements, the extent of cash flow hedging can be measured by looking to the level of the cash flow hedge reserves (CFH reserve). Fair value movements of cash flow hedge derivatives are carried in such reserves until the hedged cash flow occurs. *The table below* summarises the relative proportion of the CFH reserve of total equity.

The overall trend is that CFH reserves constitute only a limited part of total capital; in general below 1%. This may imply that fair value is applied in a greater extent than cash flow hedging. Furthermore, the extent of the CFH reserves underpins the conclusion that cash flow hedging has not caused undesired volatility of capital yet.

The fair value option

The *figure (p. 8)* shows financial assets and financial liabilities designated at fair value through profit and loss ('FVTPL') using the Fair Value Option ('FVO'), as a percentage of the total assets or liabilities recorded as FVTPL.

Out of the banks reviewed, where information was available, 17 of the banks stated that they used the FVO as amended in June 2005, five do not specify which version they used and



two banks stated that the fair value option was not used.

There are some common themes in the use of the FVO:

- designated assets are mainly those used to hedge unit linked insurance contracts;
- designated liabilities correspond either to unit-linked contracts or to structured debt containing significant embedded derivatives; and
- a number of banks use the FVO where hedge accounting would not otherwise be achievable.

Conclusion

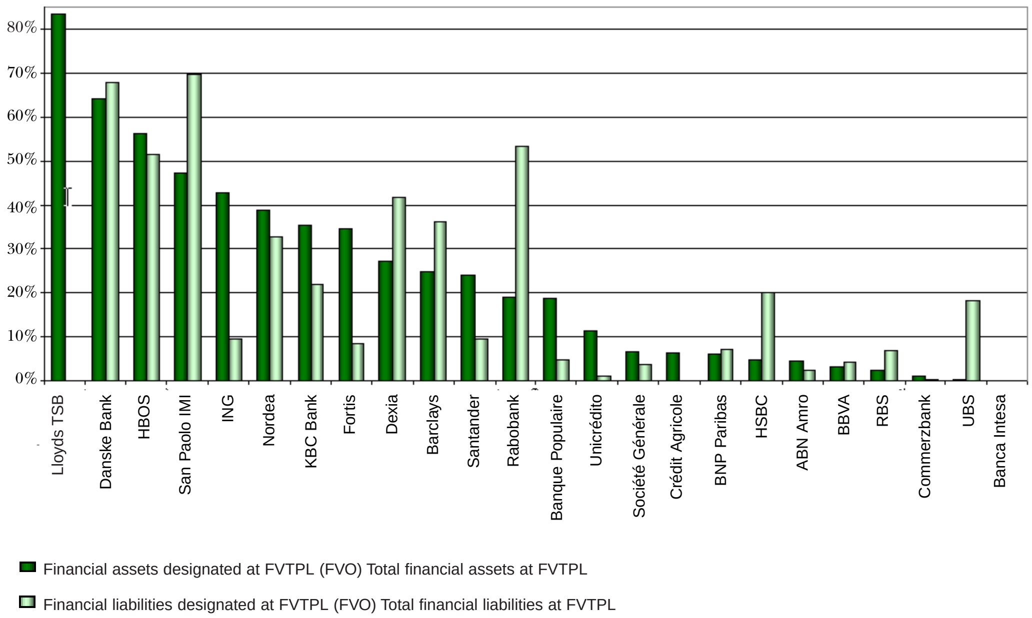
In this article we aimed to give insight of our observations in practice regarding the implementation of IAS 39 with banking books, specifically ALM. In particular, in the part of the banking business, IAS 39 was not warmly welcomed. The industry was afraid that it could adversely affect the economics of solid ALM due to the management of accounting volatility.

Our experience is that banks have effectively coped with the IAS 39 challenges. The main solutions have been: hedge accounting and the fair value option. This has been confirmed by our study of the 2005 IFRS financial statements of 24 European banks.

Main implications for the ALM business are that ALM (and risk management) processes qualify as financial reporting processes, which brings in the strict policies and procedures associated with such processes. Furthermore, the ALM and risk management functions have become closer to each other. ALM is more risk- and fair value oriented after the introduction of IAS 39. As a result of this reorientation, risk management got more interest in the banking books.

Concluding, IAS 39 is working in practice and appeared to be less academic and controversial than expected.

* A comprehensive publication of our study is available on request.



Public Sector Financing in Ireland – August 2006

The public sector financing market in Ireland includes central & local government and infrastructure financing. DEPFA Bank, headquartered in Dublin, Ireland, is active in all areas of the Irish market.

The Irish market is characterised by three key features;

1 Local government in Ireland is highly centralised in comparison to other European countries.
2 Given Ireland's healthy surpluses, there is limited capital markets financing activity at the Central Government level.
3 Significant infrastructure investment is underway in Ireland and will be procured using the PPP model.

Central Government Debt

Ireland, a AAA rated country, has a population of 4.13m, unemployment rate of 4.3%, GDP of €160bn and a forecast GDP growth rate of 4.8% in 2006 as compared to 1.9% in the Euro area. Although the extraordinary growth rates of the late 1990s (average of 10% p.a.) have come to an end, the Irish economy continues to expand strongly driven by buoyant consumer spending, high employment, strong earnings growth and favourable interest rates.

In 1990 Ireland's debt was one of the highest in Europe. It is now, proportionally, one of the lowest with a debt to GDP ratio of 27.8%. It is expected to remain at that level over the next few years. In the seven years since the introduction of the euro on 1 January 1999, the ratio has declined by 25 percentage points.

The National Debt of Ireland is managed by a central government agency, The National Treasury Management Agency

(NTMA) which was established in 1990 when the borrowing and debt management functions of the Minister of Finance were delegated to the NTMA. The National Debt was € 38bn at end December 2005 with a gross issuance requirement of only € 3bn in 2006. Ireland has 5 major benchmark bonds with maturities across the yield curve from 2 to 14 years. The bonds are traded on EuroMTS.

The NTMA also makes advances to designated non-commercial State bodies such as local authorities and the Heath Service Executive. If the commercial banking market does not provide competitive financing to the lower levels of government in Ireland, the NTMA lends the funds itself.

Local Government Financing

Irish local government is just over 100 years old. It commenced in 1898 following the end of the landlord class when County Councils and District Councils were created. Ireland became an independent State in 1922 and at that time the local government system was centralised.

Irish City and County Councils constitute the middle tier of local government and they are the main provider of local government services in the country. There are 29 County Councils and 5 City Councils in Ireland together with 80 sub-county authorities with an average population of 45,000 each. They have a narrow range of responsibilities including housing, planning, non-national roads, water supply and sewerage, recreation and amenities and environmental protection but excluding education, healthcare and social transfers which are central government functions in Ireland. Local government in Ireland today is characterised by vertical imbalance (i.e. the extent to which local authorities depend on their resources on transfers from higher levels of government) with a high degree of centralisation in funding provision. The majority of their revenue comes from Central Government grants and subsidies and they have limited revenue generating capacity. They have no fiscal independence. Local taxes only account for c.2.3% of total taxes in Ireland whereas the European average is almost 10% and taxes by local government as a percentage of GDP were 0.6% in Ireland compared to an EU average of 3.9%.

The Irish local authorities mainly borrow for projects relating to the EU 'Polluter Pays' Directive. They are not permitted to avail of government grants/ funds for the commercial element of 'Polluter Pays' projects and must raise funds in the market. Loan financing is the most common form of financing at local authority level. Borrowing volumes in the Irish market are low in comparison to European peers.

There is a high level of direct and indirect Central Government support for the borrowings of the Irish local authorities given the centralised nature of the system. The local authorities require the approval of Central Government for all borrowing. The Government also decides on the amount that the local authorities are permitted to borrow on an annual basis and allocate it to individual local authorities based on applications.

The Irish local authorities are not rated by the credit rating agencies.

In addition to the involvement of the NTMA in the market, a new government entity, the National Development Finance Agency (NDFA) was established in 2003 to provide advice to local authorities on the optimal means of financing public investment projects. The local authorities are obliged to seek the advice of the NDFA on all borrowing greater than € 20m.

The EIB are active in the provision of financing to Irish local authorities and they also provide financing via the local banks in the form of Global Loan Facilities for smaller projects.

Infrastructure Finance

Infrastructure Financing is a strong growth area in the Irish market and there is a significant pipeline of projects due to a historical infrastructure deficit in Ireland, particularly in transport infrastructure.

The Irish Government recently announced the introduction of a rolling five year multi-annual programme for capital spending. Total investment under the programme over the next 5 years will be € 45bn (equivalent to 5% of GNP p.a.). The investment will be allocated to transport infrastructure, social housing construction, prisons, courts and waste disposal.

The Government stepped up its commitment to the use of PPP procurement with the extension of the functions of the NDFA in 2005 to act as a procuring agency for PPP projects in the Central Government areas of Health, Education and Justice. The NDFA will be responsible for all aspects of delivering the procurement of the projects. The NDFA is not responsible for the roads or rail sectors where a PPP deal flow is established and existing procurement arrangements in place with the National Roads Authority and the Railway Procurement Agency will continue.

In summary the Irish market for public sector financing is influenced by a strong economy, a centralised system with significant Central Government control and significant new infrastructure investment over the medium term.

Nederlandse Waterschapsbank reports profit of € 47.8 million over first six months of 2006

New loans granted by Nederlandse Waterschapsbank during the first half of 2006 amounted to € 2.2 billion, the same as in the first half of 2005. NWB's lending concentrated mostly on housing corporations, municipalities, water boards and organisations in the healthcare sector.

The results were satisfying. Profit before income tax for the first half of 2006 came to € 67.8 million, an increase of € 5.9 million (9.5%) on the same period of 2005. Profit for the period amounted to € 47.8 million, 12.7% above the comparable figure for 2005 of € 42.4 million.

Total operating expenses climbed by 6.2% to € 4.6 million, the main causes being the increase in consultancy fees and the updating and outsourcing of funds transfers.

Equity amounted to € 1.271 billion at 30 June 2006, representing a slight increase on the figure at year-end 2005. Of the profit for 2005 of € 197 million (including a non-recurring tax credit due to the liability for income tax introduced on 1 January 2005), € 157 million has been added to the general reserve this year. The BIS ratio on Tier I capital was 104% at 30 June 2006 (31 December 2005: 110%).

Total assets amounted to € 33.9 billion at 30 June 2006 (31 December 2005: € 33.2 billion).

Despite the satisfactory results for the first half of 2006, NWB is standing by its expectation expressed earlier for the full year 2006 that, barring unforeseen circumstances, the profit will be below that for 2005 adjusted for non-recurring tax income. The reason is that in the second half of 2005, in connection with the application of IFRS to the reclassification of portfolios, a non-recurring accounting item of approximately € 20 million was recognised.

Key figures NWB
(in millions of euros)

	First half 2006	*First half 2005*
Total operating income	72.4	66.2
Total operating expenses	4.6	4.3
Profit before tax	67.8	61.9
Income tax	20.0	19.5
Profit for the period	47.8	42.4
	June 30, 2006	*December 31 , 2005*
Total assets	33,899	33,156
Shareholders' equity	1,271	1,224

Waterboards are among others responsible for dike maintenance

Address
Centre International pour
le Crédit Communal
P.O. Box 30305
2500 GH The Hague
The Netherlands
tel.: +31 70 3750 814/820
fax: +31 70 3750 406
www.centre-international.com
e-mail: Centre@bng.nl