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Improving performance of VAT systems

Jeffrey Owens, Director, Centre for Tax Policy and Administration at the OECD, on how improving performance of VAT systems is a priority in the context of the economic crisis

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These are the 'ALL HITS' Super 7 key reasons that make Durban attractive to both residents and visitors alike.

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Is the world doomed to suffer another Depression?

The west is staring into an economic abyss deepened by political paralysis in the US and EU. Europe is in disarray, the banking crisis is back in full swing, and both the eurozone and US are slipping back towards recession or very low growth. Not since the Lehman's collapse of 2008 have things looked quite so bad.

The spectre of a second credit crunch was raised when central banks were forced to intervene to stop the international financial system from freezing up again. This short-term measure will not change the fundamental problems in the eurozone and elsewhere. There is little or no consensus about what needs to be done. In Europe, governments are miles away from either of the two remedies likely to resolve the crisis: break-up of the euro or the establishment of political and fiscal union. The recent coordination by central banks to protect the euro does not address this problem.

So what is the biggest problem for the eurozone right now? It's that politicians, regulators and bankers say everything is okay, and no one really believes them. Trust has evaporated. If the EU wants to avoid debt crises in the future, it has to devise a system of governance so that those who ultimately pay the taxes have control rights over fiscal policy. The democratic deficit needs to be fixed if steps towards closer fiscal union are to work. Southern Europeans facing wage and social spending cuts might even consider that conceding a certain amount of "sovereignty" might be worth the price. Fixing the current governance structure and creating a fiscal-transfer mechanism are yesterday's lost opportunities and tomorrow's necessity. The eurozone would be safe, at least temporarily, and leaders could resume their glacial trudge toward fiscal and political union.

Mervyn King, Governor of the Bank of England, warned in his Mansion House speech last June "Failure to tackle the imbalances (in trade and credit flows) during the seven years of plenty before 2007 threatens seven lean years thereafter... After a deep-seated banking crisis, now transmuted into a sovereign debt crisis, the need to reduce debt as the world adjusts to a new equilibrium pattern of spending and trade will mean only a gradual recovery in many advanced economies."

So far we have had only four of the seven lean years. It took Europe decades of economic and political turmoil to recover from the extreme over-indebtedness it imposed on itself in the folly of the First World War. Leaders have failed to understand the scale and nature of the crisis, and have played to the gallery of public opinion. However, there is a concern that the current state of the political institutions in the US and Europe won't make it possible for the politicians to take the tough steps that the IMF and the markets amongst others are asking them to take.

There is still a large gap between what the politicians are able to provide and what the markets say is needed. The political class need to step up to the plate and learn from past mistakes, or the doom mongers will be proved correct. ■

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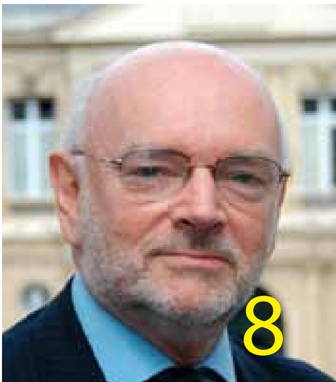

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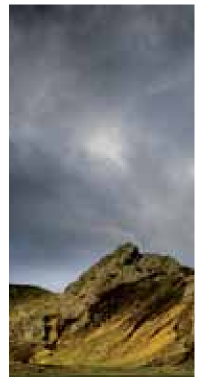

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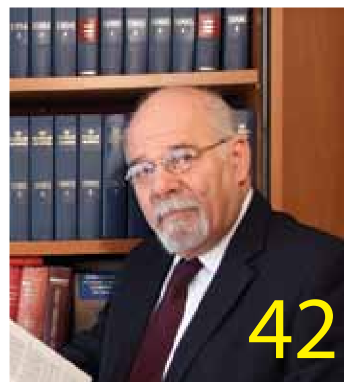

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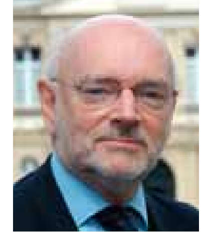
Improving performance of VAT systems is a priority in the context of the economic crisis



Jeffrey Owens is the Director, Centre for Tax Policy and Administration at the Organisation for Economic Co-operation and Development[1]

The global spread of Value Added Taxes (sometimes referred to as Goods and Services Taxes) has been the most remarkable development in taxation over the last 50 years. Operated in less than 10 countries in the late 1960s, VAT now raises one fifth of the world's tax revenue and still more countries are adopting it. The increasing importance of VAT as a source of government revenue is likely to continue as countries deal with fiscal consolidation pressures in the wake of the economic crisis while seeking to restore growth.

The key role of VAT in a post-crisis environment is generally recognized by governments and tax policy makers. In June 2009, OECD ministers declared that *"Growth-oriented tax reforms would generally involve shifting revenue from corporate and personal income taxation or social security contributions onto consumption and property taxes, including housing taxation."* Recent OECD analysis of growth-oriented tax reforms concluded that *"A revenue-neutral tax reform that shifts the balance of taxation more toward consumption and recurrent residential property taxes could [...] strengthen the growth of output over the medium term."* as *"... corporate taxes are the most harmful type of tax for economic growth, followed by personal income taxes and then consumption taxes, with recurrent taxes on immovable residential property being the least harmful."* (OECD (2010), Tax Policy Reform and Economic Growth, OECD Publishing).

A growing number of countries that operate a VAT are considering fundamental reform to increase their revenue raising capacity and to address inefficiencies of the current system. It is a key priority for the OECD to actively support countries in this exercise, as well as ensuring that this interaction between VAT systems does not act as a barrier to world trade. This article highlights the key areas of attention.

Definition and spread of VAT

VAT is essentially a tax that is charged on a broad range of transactions with a tax deduction mechanism allowing businesses to offset VAT paid on inputs against VAT paid on outputs. It is a tax on final consumption by households that is collected by businesses in a staged payment process: each taxable business pays VAT to its providers on its inputs and receives VAT from its customers on its outputs. Input VAT incurred by each business is offset against output VAT so that tax paid by businesses along the value chain does not bear on them but ultimately on final consumers only. VAT thus remains neutral for businesses. It does not distort the prices that they face in buying and selling from one another. In an international context, VAT neutrality is achieved through the application of the "destination principle" according to which exports are exempt and imports are taxed on the same basis and under the same rates as local supplies.

The capacity of VAT to raise revenue in a neutral and transparent manner has drawn all OECD member countries to adopt this broad-based consumption tax, except the United States, which continues to employ retail sales taxes at the state level (and below) rather than apply a federal consumption tax. Its neutrality principle towards international trade has also made VAT the preferred alternative to customs duties in the context of trade liberalisation. VAT it has now been implemented by more than 150 countries with several more considering implementation.

OECD member countries have relied increasingly on VAT as a source of revenues. Over the last twenty years, the share of VAT as a percentage of total taxation has grown by more than 65% passing from 11.2% on average in 1985 to 18.7% in 2008, this share remaining stable since 2000. This source of revenue is globally third in importance behind personal income taxes (26%) and social security contributions (25%) but far above corporate income tax (10%), specific consumption taxes (10%) and property taxes (5%) (see table above). These ratios vary considerably between countries, but in 28 of the 33 OECD countries with VAT, the tax accounts for more than 15 percent of total taxation.

Tax structures in the OECD area[2]

	1965	1975	1985	1995	2000	2008
Personal income tax	26	30	30	27	25	26
Corporate income tax	9	8	8	8	10	10
Social security contributions[3]	18	22	22	25	24	25
(employee)	*(6)*	*(7)*	*(7)*	*(9)*	*(9)*	*(9)*
(employer)	*(10)*	*(14)*	*(13)*	*(14)*	*(14)*	*(14)*
Payroll taxes	1	1	1	1	1	1
Property taxes	8	6	5	6	6	5
General consumption taxes	12	13	16	19	19	20
(of which VAT)	*(2)*	*(9)*	*(11)*	*(17)*	*(19)*	*(19)*
Specific consumption taxes	24	18	16	13	12	10
Other taxes[4]	2	2	2	3	3	3
Total	**100**	**100**	**100**	**100**	**100**	**100**

Source: OECD(2011), Consumption Tax Trends 2010, OECD Publishing

The average standard rate of VAT/GST within the OECD has remained relatively stable at 18% on 1 January 2010 up from 17.8% in 2000. In Europe, the average standard rate of VAT rose from a little over 19% in 2000 to more than 20% in 2010. However, the OECD average is bound to increase significantly as a rising number of member countries have introduced rate increases or have announced plans to do so in response to financial consolidation pressures. In parallel, many countries have started to take base broadening measures. Between 1 January 2010 and mid 2011, not less than 10 OECD governments have increased rates or have announced plans to do so.

Improving the performance of VAT

Raising the standard VAT rate has often been considered as the easiest way to increase revenues from the tax, particularly at a time when many governments are seeking ways to address large fiscal deficits. Some countries have even explicitly linked rate increases to the objective of fiscal consolidation. For instance the Slovak Republic has temporarily increased its VAT rate until the deficit will be reduced to below 3% and in Poland the VAT rates will automatically increase if the public debt to GDP ratio increases above a certain level.

However, raising the standard VAT rate has its own limits particularly in countries where the rate is already relatively high. In addition, when the standard VAT rate is increased (other things remaining equal) the amount of revenue forgone due to the application of reduced rates and exemptions also increases. It may be a better option for governments to consider reform to improve the performance of the VAT systems without having to increase the standard rate. This could include broadening the tax base, limiting the use of reduced rates and exemptions, more efficient tax administration and better compliance.

Research at the OECD of the VAT performance in OECD countries suggests such reform may be a significant option to improve the revenue raising capacity of VAT. The OECD uses the "VAT Revenue Ratio" as an indicator of VAT performance. This ratio expresses the VAT that is actually collected in a country as a proportion of the revenue that

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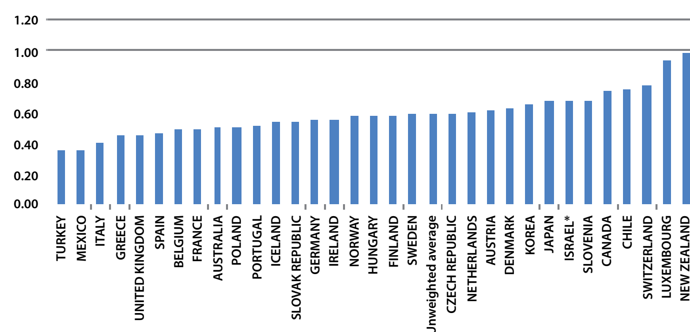
would be raised if the standard rate were applied to all consumption. Across the OECD, the unweighted average ratio appears to be just 0.58, meaning that 42% of the potential VAT revenue is not collected.

VAT Revenue Ratio in OECD countries (2008)



Source: OECD (2011), Consumption Tax Trends 2010, OECD Publishing.

Although the VAT Revenue Ratio has to be interpreted with care and erosion of the tax base may be caused by a variety of factors, it suggests that there is significant potential for raising additional revenues by improving the performance of VAT systems without having to increase the standard rate.

One way of increasing the ratio would be to broaden the tax base such that goods and services that are now subject to zero and reduced rates would gradually be taxed at the standard rate. A reduction of standard rates may even be considered in certain cases as the tax base would be broadened. VAT preferential treatments are still widely used in OECD countries, mainly for equity or social objectives (basic essentials, health, education...). However, studies generally indicate that reduced rates are not an effective way of achieving such distributional objectives. The benefits for better off households in absolute terms will be greater, as their consumption of the tax-favoured goods and services will most likely by greater than that of poorer households. Thus poorer households may benefit from reduced rates but better off households even more. A more effective policy may be to broaden the tax base and to use measures that are directly targeted at increasing the real incomes of poorer households to achieve distributional objectives.

"A growing number of countries that operate a VAT are considering fundamental reform to increase their revenue raising capacity and to address inefficiencies of the current system"

Closing the VAT gap

At a time when many OECD governments are facing deficits of an average of almost 9% of GDP and recalling that VAT/GST accounts on average for almost 20% of tax revenues, it is increasingly unacceptable that the revenue loss from VAT fraud and avoidance is running at 10% or more of potential VAT revenues (as is suggested by a study conducted for the European Commission in 2009; see below). This is not just caused by criminal activities but also by tax evasion and aggressive tax planning.

The EU Commission published a study in 2009 which set out to quantify and analyse the so-called VAT gap for each member state. This is the gap between what is collected in VAT and the estimated amount that full compliance should deliver. The VAT gap includes fraud and other factors such as legal avoidance and unpaid VAT from insolvencies. The study estimated the gap at €106.7 billion in 2006 within the EU-25. This represents an average of 12% of the net theoretical liability, although several member states are above 20%.

The most common type of VAT/GST fraud is the "missing trader" or "carousel" fraud. It arises when a business makes a purchase without paying VAT (typically a transaction for which tax self- assessment applies), then collects VAT on an onward supply and disappears without remitting the VAT collected. It is common with high-value goods sold across borders, such as computer chips and cell phones. But the fraud has more recently moved into services that are bought and sold like goods. In Europe, fraud with CO^2 emission allowances caused more than €5 billion losses in tax revenues in 2009. In addition, new technology assisted types of fraud create new challenges for tax administrations. This includes the use of "zappers," or automated sales suppression devices that are used for skimming cash sales that pass through point of sale systems and electronic cash registers and that have caused significant loss of tax revenue notably in Canada and the US.

Governments have introduced series of measures, incl. new mechanisms for self-assessment, increased cross-border information exchange, international enforcement agreements and additional reporting requirements for businesses. These do not appear to have brought a satisfactory solution. The EU Commission has indicated that it is prepared to consider more radical measures, notably in the method for VAT-collection.

The OECD supports governments in their combat against VAT fraud notably by bringing together officials dealing with VAT fraud in OECD countries and non-OECD economies and by providing a platform for tax administrations to exchange information on fraud on avoidance and aggressive tax planning schemes.

Addressing VAT obstacles in international trade

At a major tax policy conference held earlier this year in Washington, addressing the new challenges arising out of the ongoing economic crisis, OECD Secretary General Angel Gurría indicated that the development of internationally agreed principles for the application a VAT on international trade is a key priority, particularly in the area of services and intangibles. He pointed out that *"The current international environment for consumption taxes, especially with respect to trade in services and intangibles, is creating obstacles to business activity, hindering economic growth and distorting competition".*

The current globalisation process is spreading more widely and includes a growing number of countries. China in particular and the other BRIICS countries (Brazil, Russia, India, Indonesia and South Africa) have become major trading partners for most OECD countries. Within international trade, services trade has grown strongly in recent years. A significant feature of globalisation has been the growth of multinational enterprises (MNEs). Intra-firm trade, ie. cross-border trade between MNEs and their affiliates, accounts for an increasing share of international trade (see (OECD 2010), *OECD Economic Globalisation Indicators*, OECD Publishing).

Combined with the spread of VAT globally, the growth of cross-border economic activities has increased the interaction between VAT systems leading to an increased risk of double or multiple taxation or, in the inverse case, double or multiple non-taxation.

The most common reasons for double taxation and unintentional non-taxation are the use of different rules to determine the place of taxation and different interpretation of similar rules, different characterization of transactions and non-recoverability of tax. As explained above, VAT in principle aims to tax consumption of goods and services within the jurisdiction where the consumption takes place. According to this principle, exports should be zero-rated and VAT should be charged at import in the country of destination. This principle is generally easily applicable for international trade in goods. However, the application of the destination principle for international trade in services is more difficult and differs across jurisdictions and may lead to double taxation or unintentional non-taxation. The strong growth of international trade in services and the spread of VAT globally created an urgent need for internationally agreed principles on the application of consumption taxes to the cross-border supply of services and intangibles.

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The need for international co-ordination first became apparent following the emergence and strong growth of e-commerce. OECD ministers agreed in 1998 on an international common approach for taxing e-commerce, which has become known as the *"Ottawa Taxation Framework"*. In 2001, the OECD issued guidance on place of taxation for VAT, including definitions of place of consumption and on methods for verifying jurisdiction and status of customers and on effective administration and collection of tax. This framework has received almost unanimous international support, and has been endorsed notably by the G8, the World Trade Organization (WTO) and the Asia Pacific Economic Cooperation (APEC).

This work laid down the foundations for the first international norms, outside the European Union, in the field of VAT. Further to the development of globalisation and cross-border trade, it became clear that many of the problems surrounding the application of VAT to e-commerce actually had their roots in the wider area of services and intangibles and that the remaining differences of approaches amongst jurisdictions still had potential for double taxation and unintended non-taxation.

These issues were significant enough to require remedies and the OECD therefore launched a project for the development of the OECD International VAT/GST Guidelines aimed at providing guidance to governments on applying VAT to cross-border trade.

Further guidance on the application of the destination principle was adopted in 2010 and a set of Guidelines on Neutrality was adopted earlier this year, providing guidance for governments to ensure VAT neutrality for businesses in an international context. The relevance of this work was notably confirmed by a survey conducted by the OECD in 2010 among more than 300 businesses around the world. Businesses appeared to incur significant amounts of irreversible foreign VAT: over 80% incur more than US$10,000 per year and over 25% incur more than US$1 million annually. VAT relief procedures are frequently reported to be complex. 72% of the businesses surveyed said that they found these procedures "difficult". More than 20% are unable to recover any foreign VAT/GST. Many businesses said that they recover less than 25% of the VAT incurred in foreign countries and one third said that these difficulties influence investment decisions.

The OECD is now developing further guidance for the implementation of the Guidelines on Neutrality in practice. It is also developing guidance on the application of the destination principle to supplies to businesses that operate on the basis of a branch structure. This includes work on the VAT-treatment of cross-border branch-to-branch transactions, notably on timing and valuation of these transactions. Finalizing the OECD International VAT/GST Guidelines as an internationally agreed framework for the application of VAT to international trade, is an absolute priority for the OECD's work in the area of VAT.

Work in progress...

The rise of VAT across the globe has been a major success story in taxation over the last half century, but VAT is still very much work in progress. It is more important than ever for governments to maximize the performance of their VAT systems by removing VAT obstacles to international business activity. The OECD is in the forefront of developing the policies and standards needed to achieve these goals.■

1. The views expressed should not be taken to represent those of the OECD or its member countries.
2. Percentage share of major tax categories in total tax revenue.
3. Including social security contributions paid by the self-employed and benefit recipients that are not shown in the employee/employer breakdown.
4. Including certain taxes on goods and services and stamp taxes

Investment: a strategic factor for Brazil

Robson Braga de Andrade is the President of the National Confederation of Industries, Brazil

Brazil, the biggest country in Latin America with over 190 million inhabitants with a territory of more than 8.5 million km², ranked the world's eighth largest economy in 2010.

As a high-potential emerging new market, Brazil offers a broad set of conditions to be among the most important economies of the world, aspiring to be recognized as a relevant global player.

Besides territorial dimension and large population, the country has good grounds for such purpose: abundant natural resources, diverse sources of energy production, competitive supply chains and an expanding domestic market.

"Investment is, therefore, a key factor for the Brazilian high economic performance"

However, there is a strategic failure that requires correction: the increase in the relationship between investment and Gross Domestic Product (GDP), so that the nation can keep pace with other emerging countries.

Over the past twenty years, there have been considerable changes in the world economy as well as in advanced and emerging nations. Developing economies have grown significantly, increasing from 18.3% to 37.8% its share in the top 50 countries, according to their GDPs, during the period 1991 to 2010.

The group of emerging nations expanded, in nominal terms, accumulated over five years, 285.3% or 7.4% per year, while the group of advanced countries grew 87.5% or 3.4% annually. These numbers are not only attributable to the remarkable expansion and weight of the Chinese economy. In general, the nominal rates of economic growth are, in almost all countries of the emerging group, higher than those of advanced nations.

The increasing expression of emerging countries is associated with a key variable in the process of economic growth: the relationship between productive investment and GDP.

Differences and trends in investment/GDP ratio among advanced and emerging countries can be identified as the fundamental cause for the reconfiguration of the global economy of the last two decades.

The magnitude of investments, especially when they expand in relation to other macroeconomic indicators, is the most important foundation of promoting rapid economic and sustainable growth for an entire set of changes that lead to socio-economic development.

The relevance of productive investment in the processes of acceleration of growth stems from its multiplier effects on

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employment, production, income and expenditure. There is no other variable of equal importance. When periods of rapid growth are attributed to other variables, there is a risk that they become ephemeral and will eventually require tough corrective measures.

The change of the economic scenario, however, is not transient. The 25 largest emerging countries recorded high and rising rates of investment relative to GDP in the last two decades: a weighted average in nominal terms. During this period, annual growth of investments in emerging nations was 11.47% per year, significantly higher than the 3.08% of the top 25 leading countries.

When comparing the 2010 figures with the ones of 1991, the per capita changes were also significant. In emerging nations, even with population growth higher than that of the advanced countries, per capita investments substantially grew. In advanced nations, investment rose 5.26% per year while in emerging countries the increase was 10.06% annually.

Investment is, therefore, a key factor for the Brazilian high economic performance.

Among favourable conditions that promote productive investment in Brazil, the country's geopolitical importance and the size of its economy stand out associated with the democratic system established and consolidated since the mid 1980's.

These structural conditions are complemented by good economic situation and one of the hallmarks of the national economic performance: the speed in finding ways to overcome adversity. The latest confirmation of this factor was the recovery from the effects of the last 2008 world economic crisis.

Finally, Brazil's position has been consolidated with a favourable international reputation that includes a growing global demand for commodities of its export basket, making the country one of the most attractive to receive foreign investments? ■

EU-Brazil business relations: the opportunities for growth are enormous

Jürgen R Thumann is the President of BUSINESSEUROPE

On 4 October 2011 business leaders from Brazil and the EU will meet in Brussels for the fifth EU-Brazil Business Summit. The Business Summit is organised in parallel to the Political Summit, where the political leaders of the EU and Brazil gather yearly, since 2007, alternating between Brazil and EU member states.

BUSINESSEUROPE and CNI, the National Confederation of Industry - Brazil have organised these yearly Business Summits, bringing together top level business leaders to discuss the opportunities as well as the challenges in, amongst others, the areas of infrastructure developments, the energy sector, trade in goods and services and investments, customs and logistics, and public procurement.

EU-Brazil relations and the EU's trade relations with the MERCOSUR customs union in general of which Brazil is the largest member have been developing strongly over the past decades. Trade and investment has grown tremendously between the EU and Brazil and businesses in both regions have benefited greatly from the close cooperation – with total FDI stock growing from €148.9 to €188.5 billion between 2007 and 2009. Closer cooperation in the future will generate even more business opportunities between the EU and Brazil.

"Brazil is by far the largest trading partner of the EU in Latin America – representing 40% of all trade in goods with Central and South American countries"

EU-Brazil trade

Brazil is by far the largest trading partner of the EU in Latin America – representing 40% of all trade in goods with Central and South American countries. The EU, in turn, is one of Brazil's biggest trading partners, accounting for around 20% of its total trade. Despite a reduction in trade and investment during the financial crisis there has been a strong rebound in 2010 and 2011 and significant growth is expected in 2012.

In 2008 EU imports of goods from Brazil were €35.9 billion with exports at €26.3 billion. Exports and imports plummeted to €25.7 and €21.6 billion respectively in 2009 but have since recovered in 2010 to €32.3 and €31.3 billion respectively. Trade in goods is expected to surpass 2008 levels in 2011 and continue a healthy historic growth in the double digits.

The majority of Brazilian exports in goods to the EU are in the agriculture and raw materials sector, though chemicals, machinery & transport and other sectors represent a significant share of the total (at approximately 30%). In addition, Brazil has a significant stock of FDI with the EU growing from €41.2 to €56.3 billion from 2007 to 2009. EU-Brazil trade in services lags behind trade in goods in terms of total EU figures; especially EU import of services from Brazil, which has declined from 1.4% in 2008 to 1.2% in 2010 in comparison to trade in goods which has remained steady between 2.0 and 2.3% over the three years.

Exports in goods from EU to Brazil are predominantly in chemicals and machinery & transport equipment (at approximately 70%). EU's FDI stock in Brazil has raced up, seemingly little affected by the crisis, from €107.7 billion to €132.2 billion between 2007 and 2009.

EU-Brazil Strategic Partnership

EU-Brazil relations got a huge boost in May 2007 with the launch of the EU-Brazil Strategic Partnership. The main objectives of the partnership were to strengthen political and sector policy dialogues, address global challenges, expand and deepen trade and economic relations and improve cultural ties. In a recent document sent to the EU and Brazilian governments, the Brazilian and EU business communities outlined the challenges that need to be addressed to improve the Strategic Partnership.

A creation of a higher profile mechanism with active and centralised cabinet-level leadership to advance the Strategic Partnership, in close cooperation with business representatives, would be a boost to continued dialogue between both regions. Additionally there should be improvement of mechanisms of coordination, monitoring and transparency of the several economic initiatives incorporated in the Joint Action Plan (JAP). This Joint Action Plan should also be updated to take into account the evolution of the international economic environment and its impacts on Brazil and the EU.

Political leaders should pursue sector or issue-specific agreements and review the sectors selected for the bilateral dialogues such as

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textiles and clothing, forest-based products, steel, non-ferrous metals, and minerals. New sectors should be added including chemicals, automobiles and pharmaceuticals. Problems with technical barriers to trade and sanitary and phytosanitary measures should be addressed through bilateral dialogue.

Finally, leaders should focus on improving tax regulation to reduce the burden on investments and should strengthen bilateral dialogues on regulatory issues in the areas particularly subject to regulations such as energy, telecommunications, infrastructure and raw materials.

EU-MERCOSUR Association Agreement

The MERCOSUR customs union, launched in 1991, has served to bring its four member countries (Brazil, Argentina, Paraguay and Uruguay) closer together and to facilitate trade between them and with third parties. Although EU trade with Brazil dwarfs trade with Paraguay, Uruguay and Argentina, these three countries are rapidly developing markets for EU trade and investment.

As a result, European and Brazilian businesses have both been vocal and highly supportive of the EU-MERCOSUR Association Agreement under negotiations. The free trade agreement will create thousands of jobs over the next few years in the two regions and billions of euros in additional trade and investment. It will stimulate much needed growth in EU countries and ensure fast growth in MERCOSUR countries. It will buffer the cost of raw materials and improve access of supply to Europe while providing a reliable export market for MERCOSUR countries.

The agreement will also allow the EU to regain lost market share in the region. For example, the EU has been losing market share to China in Brazil in the last two years. China is rapidly consolidating its presence in Latin America, focusing specifically on raw materials. Additionally, China's low currency is causing problems for MERCOSUR governments who see their currency rapidly appreciating – making it more difficult for them to export and tempting them to take protectionist measures. The EU, Brazil and MERCOSUR stand to gain from the signing of the Association Agreement. We call on political leaders to ensure a rapid balanced and ambitious conclusion of the negotiations.

EU-Brazil relations 2012 and beyond

In the longer term the EU must ensure that it remains a key partner with Brazil and Latin America in general. The opportunities for growth are enormous and the EU risks rapidly losing market share to the US, a natural partner to South America, but also new economic giants in Asia, China and, in the longer term, India. The EU should ensure, through current strong ties, cultural affinity with Brazil and shared support for free and open markets that a lasting economic and political relationship is established with Brazil.

The Brazilian and European business community calls on the EU institutions and the Brazilian government to encourage more business development, trade and investment between the two regions and to improve the mechanisms of dialogue between the intergovernmental process and business. BUSINESSEUROPE remains committed to giving its full support to developing ever closer ties between the EU and Brazil to benefit businesses and consumers alike. ■

The EU-Brazil strategic partnership: everything but trade?

Susanne Gratius is a senior researcher at FRIDE, a European think-tank based in Madrid

Brazil is one of the European Union's "special ten" strategic partners. In 2007, the country's status was up-graded to that of strategic partner, together with traditional European allies such as Canada, Japan and the US, and other six emerging powers. Trade is the real strategic element in Brazil-EU relations. Accounting for more than half of total imports and exports, Brazil is Europe's largest trading partner in Latin America, while the EU has a total share of 22 percent in Brazil's exports and imports. Traditionally, Sao Paulo is famous for being the most industrialised "German city" and, before the crisis, Spanish-based companies and banks have been the main European investors in Brazil.

Despite these interests, however, until very recently the EU perceived Brazil as a MERCOSUR country. Both shared correct but not particularly close relations based on political affinities but foremost on a solid trade exchange and considerable investment flows. One of Brussels' reasons for recognising Brazil as a strategic partner is the failure to conclude an EU-MERCOSUR free trade agreement, which both parties began to negotiate in 1999. When the EU-MERCOSUR process started, following the first Euro-Latin American Summit in Rio de Janeiro, prospects for success looked bright. The EU held a large trade surplus with MERCOSUR, its major trading bloc in Latin America and, at that time, the most promising integration mechanism in the hemisphere. Spanish and other European based companies actively participated in the opening of the economies and the privatisation of state enterprises in Argentina and, to a lesser extent, in Brazil. The financial crisis in Argentina was still years ahead and the bloc had made substantial progress on integration, inspired by the European model.

> **"Europe needs to open up new markets, especially in such times of crisis. Brazil's economy is stable and growing, its democracy is consolidated and its internal market continues to increase"**

Two year later, the situation changed completely. In 2001, Argentina suffered its most severe financial crisis in decades, MERCOSUR suffered its first serious crisis as a trading bloc, and relations between Argentina and Brazil became tense and conflictive. As the differences among MERCOSUR partners increased, a free trade agreement with the EU became less likely. Although the parties were able to present their proposals for trade liberalisation as a bloc, negotiations finally failed in 2004, when the parties agreed to continue negotiations at the global level, in the framework of the WTO Doha round. In a different format, the zero-sum game continued: MERCOSUR asking for substantial concessions on agriculture (45 percent of its exports to the EU) that Europe assumed as its main loss, and the EU demanding major reductions of industrial tariffs and access to services perceived as a no win by Brazil. In 2010, when the WTO Doha round was paralysed, the EU and its MERCOSUR partners decided to return to the initial bloc-to-bloc format and to conclude an agreement until the end of 2011.

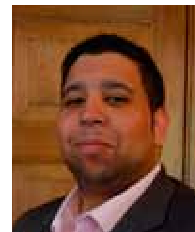
In the meantime, Brazil became a strategic partner of the EU, partly due to the stalemate in EU-MERCOSUR negotiations and partly due to Brazil's rise as a global economic power. The paradox of this new quality of relations is that trade is not included in the bilateral agenda. Annual summits concentrate on mutual energy interests and, given Brazil's UN votes (Iran, Libya), a somewhat doubtful political partnership at the global

stage. The year 2011 is the last window of opportunity for signing an EU-MERCOSUR deal. Little or no progress has been made in the first semester, presidential elections in Argentina in October represent a further obstacle for concluding an agreement, and the European Parliament made it very clear that it does not want an agreement with MERCOSUR.

If nothing comes out of these negotiations, trade should become a key topic in bilateral relations between Brazil and the European Union. For different reasons: other strategic partners of the EU have already signed (Mexico, South Korea or South Africa) or negotiated free trade agreements (India); Brazil is the eighth economy in the world; China is the main destiny of Brazilian exports; and Asia accounts for 20 percent of its trade and could soon replace the EU's privileged economic position in Brazil.

Europe needs to open up new markets, especially in such times of crisis. Brazil's economy is stable and growing, its democracy is consolidated and its internal market continues to increase. Why not use traditional close relations to conclude a free trade deal with Brazil, if an EU-MERCOSUR agreement is no longer realistic? Are European agricultural interests, which represent less than 5 percent of its labour force but still account for the bulk of Brussels' budget, really worth losing the Brazilian market? Economists and politicians should carefully calculate the economic and political costs of what could be another missed opportunity. ■

The shadow bank lending in the eurozone



Raoul Ruparel is the Chief Economist at Open Europe

The actions of central banks are often, even at the best of times, far from clear and explicit - nowhere is this truer than in the eurozone, under the European Central Bank (ECB). We covered the risk of the standard ECB liquidity provision and its bond buying programme in our recent paper *'A house built on sand.'*[1] However, there is an even more opaque and less documented lending tool within the eurozone – the Emergency Liquidity Assistance (ELA). Interest in the ELA has kicked off again, with the announcement by Greek Central Bank Governor George Provopoulos that it was activated in Greece during August.[2] Not only does this mark another worrying turn for the banking sector during this crisis, but could also signify a further substantial transfer of risk away from the private sector towards taxpayer backed institutions.

An ELA refresher

The ELA is the last call for banks which have run out of suitable collateral to use for the standard ECB lending operations. Unlike nearly all other central banking operations the ELA is enacted mostly at the discretion of the National Central Banks (NCBs), rather than the ECB, although it does require initial approval from the ECB and implicit acceptance (the ECB governing council has the ability to vote to terminate any ELA operations if it so wished). As such, any risks taken on through the ELA are the sole responsibility of the NCB, backed up by the state, not the eurozone (at least in theory, more on this later). The ELA is designed to provide temporary assistance to illiquid but solvent institutions, according to the ECB, unfortunately this is also rarely the truth.[3]

> **"The biggest concern with the ELA is its opacity and secrecy, in fact the central banks don't even have to announce its existence"**

Where else has the ELA been implemented?

During the financial crisis it was put to use by both Belgium and Germany to tide troubled lenders over in the lead up to a break-up or restructuring (Fortis and Hypo Real Estate respectively).[4] In these cases, the ELA was fortunately temporary, but only because it was already clear to all that the banks in question were completely insolvent and, as such, restructuring plans had already been put into motion. Worryingly though, the ELA has been extensively used in Ireland since October 2010. It currently accounts for €57bn in lending to Irish banks, and topped €70bn back in February – clearly it is neither temporary nor insignificant.

In recent weeks it has been revealed that Greek banks have begun tapping the ELA and, although the extent is still unknown, this is undoubtedly a troubling development. Evidence from Ireland suggests that, without a credible restructuring or consolidation plan for the banks involved, these lenders could quickly become addicted to the so-called emergency lending.[5]

What do we know about the processes of the ELA?

Unfortunately, not much. The biggest concern with the ELA is its opacity and secrecy, in fact the central banks don't even have to announce its existence (although they usually do for fear of an uncontrolled leak creating market panic). The details on the lending are sparse, with the interest and collateral taken on remaining secret.

The lending rates should in theory be set at painful levels, to penalise banks for entering this 'last chance saloon' and to push them into alternative funding sources as soon as possible. Clearly, this has not been the case in Ireland – it seems highly unlikely that the stricken Irish banks could have afforded to continually role over tens of billions in short term lending at high rates. Given the complete lack of alternatives for Greek banks (they've been reliant on ECB lending for as long as anyone) it's probable the Greek Central Bank will limit the rate as much as possible and help facilitate another huge transfer of risk from the private sector to the public sector at minimal cost.[6] Besides, the reluctance to impose costs on the banking sector has already been demonstrated across Europe with the staunch opposition to a debt restructuring and the heavily incentivised private sector involvement in the second Greek bailout.

The collateral taken on paints an even more depressing picture. As mentioned, the only reason to enact this program is if the banking sector has run out of eligible collateral for the ECB (whose standards are, let's be honest, not exactly sky high these days – see reversals on accepting lower rated government bonds). Likely culprits include: government guaranteed bank bonds, promissory notes and low quality asset backed securities, to which unknown haircuts are applied and unknown valuations are given, often at the central bank's discretion since no effective market exists for many of these instruments (a problematic paradox as almost by definition that is why they are being used for the ELA).

A quick glance back at Ireland gives us an interesting snapshot of this problem, in that Irish banks were issuing themselves state backed bank bonds and then using these as collateral for ELA (and if possible

ECB) loans – insolvent banks backed by an insolvent state creating more debt to gain liquidity of unknown levels at unknown rates. This can in no way be healthy for the long term stability of the Irish and possibly European economy.

Doesn't this amount to money printing?
Not quite (for the most part). In reality, it's not clear where the money for the ELA actually comes from, a point which has been subject to much debate (well as much as there can be surrounding a fairly secretive and technical aspect of financial markets). Since the ELA is the NCBs responsibility, the money should come from the NCBs balance sheet. This could involve using existing financial assets or taking on, or even creating, more short term deposits.[7] There is also the fact that there is some collateral given in exchange, but its value may turn out to be far lower than estimated and it is still essentially monetising otherwise unsellable assets. However, you can, obviously, never conclusively prove that the monetary base has increased further than it would in another state of the world.

That said, evidence suggests that it is difficult for the ECB to fully account for these purchases through sterilisation (removing liquidity from European financial markets to offset any increase from the ELA) and the low quality of the collateral means the programme stands apart from the ECB's pledge of unlimited liquidity. Therefore, although it is not directly money creation or quantitative easing, there could be close similarities depending on the actual structure of the ELA.

Whose risk is it anyway?
As mentioned above, the ELA normally comes with an explicit state guarantee, meaning the state will cover any losses on the ELA loans, a likely scenario given that the collateral is usually highly illiquid.[8] The issue here is that, in cases such as Ireland and Greece, it is very unlikely that the State would be able to afford to cover any ELA losses, especially if they reach into the tens of billions. Both Greece and Ireland have strict deficit targets to meet, failure to do so would likely be poorly regarded by financial markets but also the ECB and IMF and my result in difficulties in receiving tranches of bailout aid.

In any case, since these countries are already reliant on eurozone and ECB funding (via their banking sector and the SMP) it seems obvious that the ultimate risk would be transferred to other eurozone member states or the eurosystem. This could either be through increased ECB bond buying, requests for additional financial aid or simply using current aid to cover losses, all highly undesirable outcomes for eurozone taxpayers. This is not to mention the uncertainty surrounding the process of accounting for any losses, which would itself have knock on effects in jittery financial markets.

It's a sad, if not slightly ironic state of affairs. The eurozone governments created the risk with too much debt (in many cases) which was bought up by banks and helped facilitate the sovereign-debt and banking crisis in Europe, the banks then shifted this debt to the ECB through its liquidity provision, while the ECB shifted the worst of this debt back to the NCBs and states with the ELA, but given the continuing bailout programme propping up these states the risk is transferred back across the eurozone. Obviously, a simplified chain of events but it helps emphasise the continual recycling of risk and debt around the eurozone, as opposed to finding a long term solution – a process of which the ELA is becoming an increasingly integral part.

Is this just a transfer of risk then?
It is undoubtedly another stage in the transfer of risk away from the private banking sector towards taxpayers backed institutions and possible even across national boundaries, but it is also more than that. It has been claimed that the ELA simply replaces other costs, for example by stopping the collapse of the banking sector and preventing another bank bailout or by making sure that these banks can still purchase government debt, helping to keep governments afloat. That is true to some extent but in doing so it also detracts from the necessary steps which need to be taken to ensure the long term health of the banking sector and the eurozone economy, helping to cement and restore the failed practices which placed the banks in their current position in the first place.

Many of these banks need to deleverage and recapitalise significantly and in many cases there needs to be a consolidation of the banking sector, especially in Greece and Ireland, and some parts of the banks need to be wound down. Propping them up with cheap liquidity may stop some short term pain but will not help in the long term and could be incredibly costly given the massive uncertainty which these banks are exposed to in the eurozone crisis.

Failures elsewhere, such as in the second Greek bailout deal, the Italian austerity package or the ratification of the EFSF in Parliaments across Europe could have knock on effects which would threaten fragile banking sectors – something we are already seeing with the recent punishment of European bank shares.

This argument also forgets that it has been made explicitly clear by the ECB that the ELA should only be used for temporary liquidity problems and should not be extended to insolvent institutions – how Irish and Greek banks, backed up by insolvent states, satisfy this criteria remains an unanswered question.[9]

Indicative of the eurozone crisis
The ELA is, on its own, still only a small part of the eurozone crisis, although the worse things get, the bigger it is likely to become in both Greece and Ireland. More importantly, it throws up another opaque and technical barrier to reform in the eurozone and any attempts to fully understand the risk involved in the crisis – indicative of the ECB's and eurozone leader's actions throughout the crisis.

At best it is a stop gap measure, which has its uses when providing emergency liquidity during the transition of a financial institution, but has been abused to suit the needs of the crisis, deflecting from more effective and lasting measures. Its on-going usage and expansion to Greece highlights the massive failure of the bailout policy and of throwing increasing liquidity at what is, and debatably always has been, a solvency issue.

Mechanisms such as the ELA and the bailouts should be wound down as soon as possible and replaced by a widespread recapitalisation of the banking sector, a debt restructuring of insolvent states (Greece, Portugal and probably Ireland) and a series of reforms aimed at restoring competitiveness and growth in these newly burden free economies. These three factors are almost impossible to avoid if the eurozone has any chance of long term survival, better to get on with them than to continue to recycle and shift debt around the eurozone in ever more secretive ways. ■

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8. There is also the side issue here that under a state guarantee, the ELA should be added to the gross government debt calculations. Since it should even out on the NCB balance sheet it may not have a massive impact but should still be taken account of to make the risks clear.
9. ECB speeches, 'Remarks by T Padoa-Schioppa, Member of the Executive Board EUROPEAN CENTRAL BANK', Jakarta, 7 July 2003, available at: http://www.ecb.int/press/key/date/2003/html/sp030707.en.html

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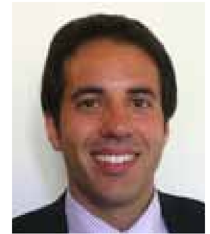

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The eurozone debt crisis has now reached a turning point. This article argues for a more organised intervention by the European Central Bank (ECB) to stop contagion through the creation of a quantitative easing programme, coupled with a political agreement among member states on a more federalist budget for the eurozone.

This paper examines the roots of this crisis and how institutions have repeated some of the mistakes of the Argentine crisis, both in 1998 and 2010. It analyses the reasons why the ECB should start a quantitative easing (QE) programme to contain government bond yields, and shows that it can be done with limited impact on inflation-targeting policies. The importance of reinforcing the new policy announced by the ECB, which has lain rather dormant during the eurozone crisis, is also highlighted as a pre-condition for a broader political agreement on more harmonised fiscal policies and to stabilise market conditions. Responses must be organised on three levels: institutional competences, monetary policy support and fiscal policy coordination.

As the eurozone crisis unfolds, uncertainty about debt sustainability is sparking high volatility on European and global markets. The fear that a political deadlock will induce member states to withdraw the implicit guarantees that hold the monetary union together is high. Political compromises around the creation of ad hoc monetary funds and selective defaults with private sector involvement have not been able to stop contagion effects, and even large countries like Italy and Spain have been put under severe stress with spreads over German bund reaching unprecedented peaks.

The risk that the crisis will persist and impinge growth for years in Europe is fairly high. Caution should guide the action of European institutions in implementing exit strategies, bearing in mind that, in a general downward economic trend, the risk of 'fire sales' of assets and public finance deterioration may undermine any commendable privatisation and liberalisation effort. In these conditions, liquidity problems may easily turn into solvency issues.

Policy-makers have repeated certain past mistakes. In particular, as in the Argentine crisis, they have been over-confident in hard pegging exchange rates with no mechanisms to minimise the costs of such a choice. The general belief that the sovereign crisis was a mere short-term liquidity problem has triggered a political 'end game' among member states and responses have not been able to stop the contagion and address underlying solvency issues caused by a lack of competitiveness and growth. 'Kicking the can down the road' has contributed to the widespread belief that the crisis is somehow a temporary problem unconnected to the broader political project of the eurozone.

In fact, by adhering to a monetary union, member states have implicitly decided to drop the monetary tool of currency devaluation, in favour of boosting financial integration in the eurozone by fiscal adjustments that would fill the competitiveness gap through wealthier European countries. This situation is perhaps sustainable when economies are performing well, but is not necessarily so when market conditions worsen, as they are now.

More competitive member states, such as Germany, Finland and the Netherlands have enjoyed high current account surpluses thanks to the euro, which has allowed them to exploit their long-term advantage in competitiveness over southern European countries. With no mechanisms to redistribute trade balances, however, countries with structural issues and no long-term adjustment plans rapidly experienced liquidity and then insolvency issues when the crisis worsened.

The only way to stop contagion, at this late hour, is to restore market confidence that eurozone member states are doing everything in their power to bring member states' public finances back onto the track of sustainability and growth. Actions should be pursued on three levels: institutional competences, monetary support, and fiscal policies coordination.

On the institutional side, the lesson from the Argentine crisis was that the International Monetary Fund should only intervene when the three conditions below are met:

1. A short-term liquidity problem, rather than a long-term solvency issue;

2. The country's 'lender of last resort' (central bank) does not have enough resources to tackle the liquidity crisis; and

3. A change on the monetary policy of the beneficiary must be pursued.

The idea of being able to solve a long-term structural political problem with a short-term funding tool, such as the IMF or similar tools (eg. the European Financial Stability Fund) linked to austerity fiscal measures, is questionable. Long-term fiscal problems and competitiveness issues should be the prerogative of other supra-national institutions - such as the World Bank and the European Commission (for the EU) - with the support of central banks.

On the monetary policy side, the European Central Bank has finally decided to seek political support to increase the capacity of its Securities Markets Programme, which will purchase government bonds on secondary markets. The ECB has so far been defending supposed inflation targeting (in) action at the cost of breaking up the eurozone and creating intolerable social conflict and economic disparities. The existence of the eurozone itself should certainly come before price stability. The ECB would then not have intervened to save a political project but to support countries that have clearly been hit by a loss of control over monetary policies.

The two classical objections to a Quantitative Easing (QE) by the ECB are the risk of moral hazard by member states, and the risk of deviation from the price stability mission set out in the ECB statute and the European Treaty (TFEU, Art. 121.1).

The moral hazard problem, as with financial institutions, is a problem of supervision and monitoring costs. In an institutional setting such as the eurozone, formal control over member states' new issuances can be carried out jointly by the European Commission and the European Central Bank. Procedures must be designed to impose – on countries benefiting from a QE programme – a formal approval for new emissions by the ECB and Commission in case no austerity

measures have been implemented. Additional sanctioning measures can be imposed through cutting resources pumped into the economy of the troubled country to support austerity measures. In this way, European institutions would also exercise a stricter indirect control over national fiscal budgets.

In terms of price stability, the impact of a QE should be assessed from a legal and economic/financial point of view. From a legal standpoint, looking closely to the Treaty (Art. 121), the purchase of government bonds in secondary markets would not infringe the rules assigning competences to the European central bank and its price stability mission, especially if the programme is backed up by greater contributions of NCBs to the capital of the ECB.

From an economic and financial standpoint, the eurosystem can certainly carry on the QE through several tools available on its balance sheet. Total assets of the eurosystem are 3.4 times gold and FX reserves, while securities held in portfolio represent only 25.76% of total assets in comparison to over 90% for the BoE and over 80% for the FED. In addition, the eurosystem consolidated balance sheet holds only 5.45% of total outstanding government securities, and just 1.29% purchased in the last year for monetary policy purposes. The BoE and FED have proportionally more than 3 and 2 times this amount. The eurosystem purchased, by July 2011, government bonds of Greece, Portugal and Ireland for roughly €74 billion, plus circa €33 billion by the ECB directly.

"The only way to stop contagion...is to restore market confidence that eurozone member states are doing everything in their power to bring member states' public finances back onto the track of sustainability and growth"

As a result, the ECB can both increase the size of the balance sheet and adjust the assets side with very limited impact (if any) on inflation targeting policies. Expanding the assets side can be achieved with two sets of operations. Firstly, by tightening repo transactions policies (removing discretion in the application of requirements such as the minimum rating) and dismissing most liquid financial instruments - such as most of the €60.87 billion purchased under the Securities Markets Programme (SMP) – thereby trying to exploit up to €316.66 billion that are currently booked on the balance sheet as revaluation accounts.

Additional contributions to a QE programme can also come from national central banks, which can fuel additional available resources into the capital of the eurosystem, which is today roughly €81 billion (including past reserves), or directly into the capital of the ECB (roughly €10 billion). Tightening repo transactions policies, dismissing most liquid financial instruments, and increasing the capital contribution of NCBs' actions would certainly have no impact on price stability mechanisms.

Moreover, there are also other available tools that may have indirect but still limited impact on inflation targeting policies. For instance, the Federal Reserve buys Treasuries on secondary markets (through public auctions) and typically wires funds into current accounts held by clearing house banks at the central bank. Financial institutions receiving these funds use very limited amounts because the FED gives an interest on excess reserves that is higher than the federal funds rate and roughly the same as term deposit facilities. The payment of these interests may require liquidity injections in the system, but - assuming that governments will sooner or later be back on track – transactions may be sterilised by selling those securities when markets recover.

For its part the ECB does not offer any interest on excess reserves but only on fixed-term deposits and because the main interbank rate is consistently higher than the US one, the use of the same tool should be coupled with actions in the interbank money market by acting on discount rates and reserves requirements. In addition, the ECB should disclose details of the QE, in particular the total amount of expected purchases and how these securities will be bought (preferably through public auctions). Finally, the ECB may always use, as a 'last resort' tool, the possibility to act on nominal interest rates and expand the monetary base.

However, even this more radical action will not reassure the markets if the eurozone does not implement the third pillar of this exit strategy.

The decision of the ECB to approve a broader purchase programme to support eurozone member states would stimulate member states and other European institutions to follow up this decision with more harmonised and federalist fiscal policies. The QE, in effect, provides the missing link between a common monetary policy and more coordinated fiscal policies. Member states would not be able to bargain their burden to sustain the euro area (as was done indirectly and independently by the intervention of the ECB, with its implications for nominal and relative prices), so they would be forced to try to exercise greater control by promoting adjustments, structural reforms and austerity measures through a eurozone budget.

Bail-out programmes have so far been simply short-term measures in which wealthier countries have contributed with a minimal part of their budget to strengthen the system that allowed them to become stronger. It is also unquestionable that the eurozone has supported uncompetitive countries, bringing their debt burdens into the area of apparent sustainability. In effect, this situation has created, on the one hand, moral hazard by myopic governments and leaders that used the possibility to borrow at a lower cost to finance public expenditures, rather than as an opportunity to reinforce fiscal positions and promote less popular structural reforms to fill the competitiveness gap. On the other hand, structural reforms may take years and cannot be carried out only through cheaper access to markets, without the support of long-term investment programmes.

Bolder and a more long-term-oriented proposal for a eurozone fiscal budget must be brought to the table. Contributions to a more federalist eurozone budget can be supported by eurobonds issuances, and should also be indexed to the level of surplus that countries enjoy, primarily thanks to the common currency. A more federal budget should provide fiscal support, in particular to those countries carrying out painful fiscal adjustments and long-term economic reforms, which will always lag behind in a competitive (and non-federalist) regional area. Proposals must be supported by stronger intervention powers with effective sanctioning systems. Reforms cannot be implemented through austerity alone, but need to be softened by investments, which will minimise the probability of the country falling into loss aversion.

More specifically, loss aversion means that if the public opinion of the country under stress perceives the situation as the choice between two losses - fiscal austerity measures (loss with high probability but 'low' impact) versus the risk of being caught for tax evasion (loss with low probability but much higher impact) - they may become risk-seekers and thus push the country to fail fiscal adjustments and leave the eurozone, thereby returning to a floating nominal exchange rate.

Alternatives to this two-tier long-term exit strategy (quantitative easing and a more federal budget) seem so far unable to confront the structural regional imbalances that lie behind the origins of the monetary union. The role of European monetary funds and the IMF cannot be elevated to a panacea for this crisis, as they are tools to help countries in very specific and limited circumstances. The time for endless political compromises has passed. Now is the time to push our leaders to take their responsibilities and raise the stakes for a more federal and coordinated solution that would avoid a painful and otherwise inevitable decline. ■

Europe should look East to balance the books

Richard Heald is the Chief Executive of the UK India Business Council (UKIBC)

In today's competitive world, firms have to constantly look for new strategies and markets to generate revenue and grow business. We all know that entering new markets is never an easy option. There are many challenges for European businesses in deciding whether to enter any overseas market - let alone one as complex as India. However, for one simple reason alone they should look to India: India is growing at almost ten per cent whist Europe is growing at less than one per cent.

Europe needs to find quick solutions out of the current economic crisis but I also believe that Europe should have greater urgency about scaling up its trade and investment links with India. In the end Europe can only keep tightening its belt for so long. Eventually there will need to be fresh growth and India is able to provide it.

France has successfully sold high-end brands like L'Oréal and Dior into the Indian market, Germany has sold vehicle parts to Indian auto giants whilst the UK is helping to design new Indian airports. But the European footprint in India is a fraction of what it could be. This financial crisis teaches us that European countries need to look beyond just trading and investing with each other and India is an opportunity we can no longer afford to miss.

"Europe should have greater urgency about scaling up its trade and investment links with India"

Dynamic and complex India

We all know that India has a dynamic workforce and a domestic economy which occupies 87 per cent of its overall activity. It has developed financial, professional, legal and corporate services sector which, while should be liberalised further, has sustained and nurtured an impressive economic development to date. It is a vibrant, multicultural society and is famously the world's largest democracy. It is widely accepted that India will evolve into the world's second largest economy by the year 2050.

Given its size, however, India should not be seen as one market but a series of interconnected regional markets where the legislative and investment climate may change from one state to another. Gujurat and West Bengal sit on opposite ends of the political spectrum while Noida and New Delhi, although only a few miles apart operate in different states. When choosing a location, investors must compare local laws, government incentives, the local infrastructure and workforce. Often it is also crucial to find the right partner for your product or service.

Trade barriers

It is often believed that trade barriers in India remain the main obstacle for businesses. In fact, India has come a long way since 1991 when their finance reforms began. Today, 100 per cent FDI is permitted in most sectors. In addition, the Government-to Government deliberations between Indian and many European countries are working all the time to create a beneficial investment climate.

In the UK, we help companies both understand and do business with India. We do this by providing information on specific industries and by developing themes and opportunities around which companies can congregate/participate. Last year we spoke to some 1500 companies in the UK. This year the number will be higher.

Opportunities for different size companies

We need to remember that it is not just Vodafone and Daimler Chrysler which are entering the India market. Companies of different sizes and from different sectors have found success in India.

Delcom, headquartered in Birmingham, offers software solutions to sectors ranging from aerospace and automotive to jewellery and sporting equipment. They now have 135 employees in India in 14 offices based in cities such as Bangalore and Chennai as well as Delhi and Mumbai.

Manchester based HMG Paints joined Indian partner Titan in June 2008 to create Titan HMG Paints India Limited. They now have a manufacturing facility in Coimbatore which sells to Indian customers.

Interactive Ideas is a value-added software distributor based in the UK with activities across Europe. They partnered with Indian company Interfinet based in Bhubaneswar Orissa which delivers services to Interactive Ideas' customers remotely

Opportunities in tier 2 cities

Almost 50 percent of British businesses looking to grow their operations in India are now doing business in emerging cites such as Pune and Chandigarh and not just the metros such as Delhi and Mumbai.

A survey by us of 40 British businesses already established in India shows that 34 per cent do business in both the metros and emerging cities whilst another 13 per cent do business in just the emerging cities. Some of the reasons cited by businesses in the survey include fewer competitors, good standard of living, less pollution, less

Business leaders addressing UKIBC Annual Summit 2011

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traffic, new investment in facilities and roads as well as greater access to Government decision makers. A recent report by McKinsey Global Institute estimates that India will have 68 cities with a population the size of Birmingham in by 2030.

Key sectors

Infrastructure is a sector that India is rapidly scaling up in order to sustain its growth. The Indian Government is projected to invest £350 billion in infrastructure projects in the next few years alone – from roads and railways to the urban built environment. India's manufacturing sector is also developing fast, with world-class companies such as Bharat Forge, Tata Motors, and Mahindra.

India's healthcare industry is already worth around £25-30 billion and will grow to over £40 billion in the next three years. European businesses specializing in pharma, advanced healthcare delivery, diagnostics and medical equipment are filling the demand. Further opportunities are emerging in e-healthcare, clinical research, R&D and education and training.

Top tips

1. European brands are valued
2. Due diligence is very important
3. Tie up with the correct partner
4. Understand your proposition and what makes you different from your competitors
5. Adapt to the local market to succeed.
6. Price point is crucial
7. Talent retention is a challenge. Attrition rate is high
8. Tier 2 cities are less competitive and cheaper to do business in

With the world's largest young population to educate, India aims to train 500 million people and provide an additional 40 million university places by 2022. This opens up a market for European skills providers. And, fuelled by rising income levels among India's youth, the entertainment and media sector is also expected to be worth £15 billion by 2014 – creating a lucrative market for technology businesses selling smart IP.

Conclusion

India may not suit all companies. However, the opportunities presented by India are too great to ignore it completely. It is not sufficient merely to put India in the "too difficult" or "too risky" box or ignore its potential going forward. Indeed, I would argue that the real risk, now, is not being aware of the opportunities presented by India and indeed by Indian capital. Moreover, many UK companies have benefitted from Indian capital investment such as such as Jaguar Land Rover, which is now significantly adding to their workforce here in the UK. ■

E-business - taking advantage of technology

In a series of special features WCR will be examining the best e-jurisdictions and digital locations globally. The use of state-of-the-art telecommunications and e-commerce facilities, coupled with a highly-motivated and well-educated workforce can offset the current economic difficulties.

Increasingly companies engaging in e-business are looking to established, well-regulated offshore jurisdictions for complete e-business solutions. By establishing in and conducting e-business from carefully selected e-business companies are able to gain an enormous advantage over their onshore-based competitors. This advantage extends further than just significant tax savings for the company. A number of offshore jurisdictions have adopted very favourable regulatory frameworks, designed to allow e-business to develop at its own pace, driven and shaped by the needs and demands of the industry and market itself. In addition tax and regulatory compliance costs are substantially reduced freeing up valuable (and often limited) resources and personnel to focus on developing the company's products and services.

"Offshore e-business is about more than just purchasing an international business company in a distant land"

Offshore e-business is about more than just purchasing an international business company in a distant land. E-commerce is not about one-off transactions through an offshore company, but rather very real companies engaging in international trade and commerce on a daily basis. These businesses require a very carefully planned and structured (often multi jurisdictional) corporate vehicle(s) which is designed to accommodate every facet of the business, from marketing to the hosting of the web-site, from payment solutions to banking, from fulfilment to customer care, and ultimately the distribution and repatriation of profits in the most tax efficient manner.

Critical to any tax and regulatory effective offshore structure is the question of management and control of the company. The e-business company with the costliest, most sophisticated corporate structure will very likely expose itself to corporate and income taxes, in certain high-tax onshore jurisdictions, unless the company is seen not just to be incorporated offshore but also, to a substantial degree, managed and controlled from the desired offshore jurisdiction. This envisages people with the requisite skills and knowledge making very real commercial decisions, on behalf of the company, from offshore. Fortunately, the premier offshore jurisdictions have a wealth of professionals who are able to do just this. With the correct offshore partners, e-business companies can be effectively managed and controlled from offshore.

For any e-company to be regarded as truly offshore, it is necessary for the payment processing and banking solution to take place offshore. This further strengthens the identity of the business offshore and has the added benefits, in many cases, of avoiding compliance with cumbersome onshore exchange controls and other fiscal and revenue regulations. There are now many reputable payment processors and banks offering extremely competitive offshore solutions, with cutting edge features such as multi-currency pricing and same day settlement, reliable online banking and high-security features.

The road to a successful offshore e-business begins with a single step (to paraphrase Confucius). The first step is addressing the issues involved and deciding if an e-commerce business offshore is for you. The next step is to choose where. This is the first in a series of features on e-business offshore. In upcoming instalments we will examine how e-commerce is changing the way that we do business, and at a whole world of opportunity in offshore jurisdictions worldwide. Those slow to adapt could find catching up to be a costly and difficult undertaking. ■

WE'RE eREADY WHEN YOU ARE.

Bermuda is highly regarded as one of the most sophisticated e-Business jurisdictions in the World. According to the Economist Magazine's EIU 2010 Digital Economy Survey for e-readiness, out of the world's leading countries, Bermuda has consistently placed in the Top 25.

This is not by chance! Here in Bermuda we have built and customised the talent, the environment and the infrastructure for your global business.

We are here and eReady to help your business maximise its potential.

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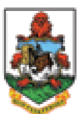


GOVERNMENT OF BERMUDA
The Ministry of Business Development and Tourism
The Department of E-Commerce

Bermuda - ideally positioned for e-business

The Hon Patrice K Minors, JP, MP, Bermuda's Minister of Business Development and Tourism, in a Q&A with World Commerce Review, discusses Bermuda's strength as an offshore location for e-business

The Hon Patrice K Minors, JP, MP is Bermuda's Minister of Business Development and Tourism. Minister Minors was one of the first Progressive Labour Party (PLP) Government Senators. She became a Member of Parliament in the 2003 General Election. After her election she was appointed Minister of Health and Family Services, a position which she held until October 2006. Minister Minors brings a wealth of knowledge of and experience in the International Business sector with her most recent being that of Assistant Vice President of Trust Services at Butterfield Bank.

Minister Minors was educated in Bermuda at Berkeley Institute and Howard University in Washington, DC, where she earned her undergraduate and graduate degrees in Business Administration.

What are the geographical benefits of locating an e-business in Bermuda?

Globalisation has crystallised supply and distribution channels around the concept of business hubs, operating virtually in much the same way as the major US airlines operate physically. Bermuda is ideally positioned to be of service in such a capacity, standing at the crossroads of North and South America and Europe, with a time zone one hour ahead of New York City and four hours behind London and excellent air links to the east and west. Physically separate, yet only one click away in a secure network, Bermuda offers the world the perfect data security mix. Bermuda is also a comfortable and efficient place in which to hold business meetings.

Domiciling corporate headquarters and intellectual property rights in Bermuda, business continuity and disaster recovery has been a growing area for Bermuda's e-commerce companies. Both the public and private sectors on the island have been for quite some time ahead of the curve on data security.

The legal and fiscal framework is an important factor in the location of an e-business. How is Bermuda situated?

Legal framework: Bermuda is a self-governing Dependent Overseas Territory of the United Kingdom, the largest of the remaining territories. Her Majesty Queen Elizabeth II is Head of State and is represented on the island by a Governor, appointed by London.

Bermuda is self-governing in all areas other than international security. It has enjoyed stable government throughout its 400 years of continuous settlement.

In the 100 years during which international business and tourism have been encouraged in Bermuda, the emphasis has always been on quality, rather than quantity. Lately, the Government of Bermuda has executed reciprocal Tax Information Exchange Agreements with 28 other countries. Bermuda is a member of many international public sector agencies. 'Know Your Customer' practices have been in force since the island's earliest days.

Businesses in Bermuda are licensed, regulated and monitored to international standards by the island's independent financial regulator, the Bermuda Monetary Authority (BMA). Bermuda has particularly strong insurance, trust and banking industries and the BMA's depth of experience in these areas has resulted in its representation worldwide on many regulatory bodies and agencies in each discipline.

The Hon Patrice K Minors JP MP, Minister of Business Development and Tourism

About 15,000 companies and partnerships are domiciled in Bermuda, including both locally and internationally-owned businesses. Prospective business owners are subject to rigid vetting and must satisfy the BMA in a number of areas before being permitted to do business on the island. New companies may be formed quickly once all the BMA's requirements are met. Bermuda passed the Electronic Transactions Act in 1999, which ensured the legal enforceability of contracts entered into electronically. It also provided a framework for other aspects of electronic transactions.

How sophisticated is the Bermuda telecommunications infrastructure?

A first-class telecommunications network links Bermuda directly with other countries around the world. The network comprises four diverse bandwidth routes through fibre optic and satellite networks, the highest quality hosting facilities with maximum security and full redundancy, as well as sophisticated telephone, facsimile and satellite services. Web-designers, software and hardware vendors, ISPs and mobile operators are as active in Bermuda as anywhere in the world. Bermuda also has one of the highest penetrations of mobile phones in the world.

Bermuda ranks in the top 22 countries in the world for e-readiness and digital economy, according to the Economist Intelligence Unit's annual listing. The rating covers more than 100 separate criteria, both qualitative and quantitative, which are evaluated by EIU analysts. Bermuda ranks above many developed nations that are considerably larger but less advanced in the area of e-readiness.

It is essential for international businesses to have the necessary professional support services (banking, trust, accounting, custodial and legal services); how does Bermuda ensure that it has the right levels of support?
In short, the market dictates the level of services that Bermuda's support community provides and the Bermuda Government and the BMA ensure that the services provided are of the highest international standard.

More than three-quarters of the Fortune 500 largest US companies and their European equivalents have operations in Bermuda, and they expect to find equivalent levels of banking, trust, accounting, custodial and legal service in Bermuda to those they are used to in their operations around the world.

Bermuda's service providers are supplemented by local management, financial and corporate service companies. The island has an intelligent, well-educated and talented labour pool to assist in the day-to-day operation of business affairs. The ICT industry supporting local and international business provides first class expertise in financial services and customised software solutions. Two Bermuda global IT success stories service customers around the world in the areas of security and payment processing.

How should e-businesses plan their tax structure?
An organisation's tax structure will depend on any number of factors external to Bermuda. No single answer to the question is therefore possible.

Bermuda is tax-neutral. No income taxes, withholding tax, capital gains tax, capital transfer tax, estate duty or inheritance taxes are payable on the Island. A Bermuda "exempted" company may, under current policy, apply to the Bermuda Government for an exemption from paying any taxes until 2035, should taxes be imposed on corporate activities after the company is incorporated.

As a result, companies with operations around the world have found Bermuda to be a sensible place in which to locate an element of their international corporate architecture. The nature of their Bermuda operations obviously varies, depending on external factors.

"Bermuda is committed to maintaining its integrity as an international offshore financial centre, and to maintaining its reputation of providing an environment based on exceptionally high standards where international business can thrive"

Political stability is an important factor in setting up of an offshore e-business. Please describe the benefits Bermuda offers.
Bermuda is politically, economically and socially stable, ensuring a favourable environment in which to conduct business. The island's constitution was established in 1968, with the agreement of all political parties operating under the Westminster system. Since that time, general elections have been held at regular intervals and governments have been formed by both major political parties. Voter turnout at general elections usually exceeds 70 percent.

Bermuda is committed to maintaining its integrity as an international offshore financial centre, and to maintaining its reputation of providing an environment based on exceptionally high standards where international business can thrive. ■

Dialogue with industry will delivers results

Michael Steen is the Chairman of The International Air Cargo Association (TIACA)

In December, members of the World Trade Organization will try to agree a new package of multilateral trade negotiations. If WTO Director General Pascal Lamy gets his way, the agenda will contain the vital issue of trade facilitation.

The International Air Cargo Association (TIACA) strongly supports the inclusion of trade facilitation in the December package. Modern and efficient customs procedures are critical for international airfreight shipments and with 35% of all trade by value being transported using air cargo, businesses and consumers alike have much to gain if air cargo can further capitalize on its inherent advantage of speed.

Trade facilitation initiatives and negotiations, which aim to facilitate trade by addressing border-related impediments to the flow of goods, are of paramount importance to the air cargo industry and its customers. The benefits are far reaching and affect governments, business and consumers. Border delays are particularly costly for exports and imports and, therefore, expedited border clearance is critical to the competitiveness of industry.

Also, the average value of goods shipped by air tends to be higher than for other modes. Therefore, border delays for air cargo tie up high value assets, which can be particularly problematic for importers. Reducing border impediments and implementing facilitative measures will go a long way towards addressing this.

Trade facilitation promotes economic growth. Thanks to the role of aviation and air cargo as a key facilitator of international trade, businesses of all sizes can compete in the global marketplace, generating employment and prosperity for companies and their workers. It encourages inward investment and helps to satisfy consumer demand for a whole spectrum of every day commodities.

Inefficient trade procedures lose revenue for governments as well as for importers and exporters. This is particularly costly for developing countries. The negative impact of inefficient trade procedures further manifests itself by impeding competition and therefore undermining investment in developing economies, and by limiting the efficiencies of domestic producers.

As an association representing every sector of the air cargo supply chain, TIACA commends WTO President Lamy for recognizing the importance of improving and stimulating the way trade is conducted. TIACA urges all negotiating parties in the WTO to dedicate the necessary resources to make this happen.

The Doha Development Agenda (DDA), the formal name of the ongoing multilateral trade negotiations being conducted under the auspices of the World Trade Organization, has set a simple objective; to lower trade barriers globally which will then serve to increase

global trade. If successful, these negotiations could produce the first separate set of trade facilitation provisions subject to WTO disciplines, further elaborating on prior GATT provisions.

Easing the movement of trade would be a positive step forward for the air cargo industry at a time when it faces a series of unprecedented challenges. Only now slowly recovering from the effects of the global economic downturn, it continues to be strongly impacted by high oil prices, while the growing regulations that accompany aviation and air cargo security also bring additional costs for administration and enforcement.

"Trade facilitation initiatives and negotiations, which aim to facilitate trade by addressing border-related impediments to the flow of goods, are of paramount importance to the air cargo industry and its customers"

The environment is another area of pressure – and often unfair pressure. Aviation is a popular target for attack when the subject of emissions and environmental harm are debated but, in fact, the industry has done and continues to do a great deal of measurable work in this area. Indeed, it is economically prudent to do so.

Aviation is one of the fastest improving technological sectors in human history. Since the beginning of the jet age nearly 40 years ago, technological advances have enabled the industry to dramatically reduce the environmental impact of airplanes, resulting in a 70% reduction in fuel consumption and therefore carbon dioxide emissions (which are directly proportional to the amount of aviation fuel consumed). In addition, today's airplanes are 30 decibels quieter – or a 90% reduction in the noise footprint when compared to original commercial jets.

With this in mind, TIACA has called on the European Union to suspend implementation of its controversial Emissions Trading Scheme (ETS) for aviation and to instead pursue a global agreement of aviation carbon emissions through the International Civil Aviation Organization (ICAO).

In a letter to EU Climate Action Commissioner, Connie Hedegaard, TIACA's Industry Affairs Committee stated four main concerns over the upcoming legislation, which from January 1st 2012 would require any airline landing or taking off inside the EU to take part in the regional bloc's emissions trading scheme:

- EU ETS is a violation of international law and treaties: by directly regulating conduct outside of EU airspace, the EU ETS encroaches upon the sovereign authority of each state over its own airspace. The Chicago Convention also prohibits any levies on international flights except on a cost basis *"related to the provision of facilities and services for civil aviation."*

- EU ETS will impose massive new taxes on aviation: according to IATA, the cost to airlines of purchasing the necessary carbon allowances will rise from $1.3 billion in 2012 to $3.5 billion in 2020. There is no requirement that EU member states must use these revenues to reduce carbon emissions, either from aviation or any other sector – nor that they dedicate the money to any environmental effort at all.

- EU ETS is unlikely to improve the environment: ironically, the EU ETS will cripple the industry's ability to continue investing on its own in greener technologies. In recent years, the industry has made impressive progress in reducing emissions, largely through utilization of more efficient aircraft and operating procedures. Furthermore, the industry has actively supported development of sustainable alternative aviation fuels and implementation of next-generation, more efficient air traffic management systems. The cost of EU ETS emissions allowances will divert crucial monies away from investment in such initiatives.

  In addition, the EU ETS may lead to some unintended consequences such as encouraging carriers to fly less direct routing that could increase aviation carbon emissions. For example, a direct flight from Hong Kong to Amsterdam has 5% lower emissions than the same flight with a stopover in Moscow. However, the stopover would sharply reduce the airline's emissions charges – thereby benefiting the airline's bottom line, but not the environment.

- EU ETS ignores the essential global nature of aviation: aviation is intrinsically an international industry. It is the transportation mode that ties together the globe most expeditiously, and many airlines and aircraft operate across borders. The EU has seemingly ignored this reality in taking a regional approach to the issue.

A better way forward is to take a global approach. TIACA strongly supports ongoing efforts by the aviation sector to improve carbon efficiencies. Furthermore, TIACA endorses the industry-wide emissions goals articulated by the Air Transport Action Group (ATAG), including carbon neutral growth from 2020 and a 50% net reduction in carbon emissions by 2050 relative to 2005. TIACA also supports the "four pillar" approach of the International Air Transport Association (IATA) for achieving these goals, focused on technological development, operational improvements, infrastructure upgrades, and economic incentives.

Our Association has made it clear to the EU that we firmly believe that aviation emissions must be addressed through a global framework and that the appropriate body for developing such an approach is the International Civil Aviation Organization (ICAO). The Kyoto Protocol designated ICAO as the body with authority to set international aviation's greenhouse gas policy and we have urged all ICAO members to expedite negotiations to expand on, complete and implement such a global framework to address aviation carbon emissions.

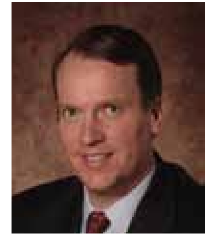
As an industry we have much to do in order to remain competitive and to satisfy the huge global demand for the vital services air cargo companies deliver. Our hope is that industry regulators will work with us and take advantage of our knowledge and expertise so that when they present changes to us in the future they are based on close industry dialogue and are practical, viable and do not impair the competitive advantage of our sector. ■

HKG-AMS vs HKG-SVO-AMS, 747-400F

Route	Origination	Destination	Fuel burn (in tonnes)	CO^2 emissions (in tonnes)	Fuel cost (USD)	Emissions cost (USD)	IATA airport landing charges (USD)	Total (landing + fuel + emissions)
Direct	HKG	AMS	127	399	83,958	16,779	4,961	105,698
Stopover	HKG	SVO	103	324	68,105	0	5,596	73,701
	SVO	AMS	30	95	20,040	4,005	4,961	29,006
	Total		133	419	88,145	4,005	10,557	102,707
Savings (-)/additional costs (+) by flying route with stopover				**20**	**4,186**	**-12,774**	**5,596**	**-2,991**
				5%	**5%**	**-76%**	**113%**	**-3%**

Assumptions: Fuel price 2.00 USD/gallon, Emissions cost 30 EUR/tonne, XRate 1.40 USD = EUR 1, Flight plans at minimum fuel track and 85% annual winds
Source: Frederic Horst presentation at CATS 2009 Conference

Rise in G20 protectionism denounced



Jonathan Huneke is Vice President, Communications and Public Affairs at the United States Council for International Business

In May, following the release of a worrying report indicating that major economies are turning increasingly protectionist, global business urged G20 leaders to keep markets open to trade.

The joint report by the World Trade Organization (WTO), the Organization for Economic Cooperation and Development (OECD) and UN Conference on Trade and Development (UNCTAD) on G20 trade and investment measures found that more new trade-restrictive measures have been implemented in the previous six months than in any previously reported period. From October 2010 to April 2011 alone, G20 members implemented 30 new export restrictions.

This occurred despite the G20's reaffirmation at the 2010 Seoul Summit to resist protectionism. G20 leaders had agreed at their earlier Toronto Summit to withdraw any protectionist measures in the pipeline, including export restrictions and WTO–inconsistent measures for stimulating exports. The WTO-OECD-UNCTAD report reveals that the exact opposite is taking place.

"Concerns in the global business community about this protectionist trend have prompted ICC to put into place its own indicator to monitor market openness"

The joint report reinforces the findings of a 2010 study by the Peterson Institute for International Economics, commissioned by the International Chamber of Commerce (ICC), the world business organization, which noted that all G20 countries had implemented protectionist trade measures since 2008.

Concerns in the global business community about this protectionist trend have prompted ICC to put into place its own indicator to monitor market openness. The Open Market Index will provide an annual ranking of the 50 top-trading countries by order of their openness to trade and investment. This private-sector indicator to monitor protectionism will be launched ahead of this year's G20 Summit – to be held November 3-4 in Cannes, France.

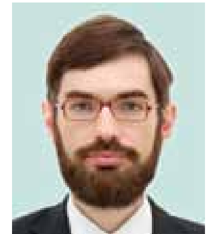
Business groups are gearing up, under the ICC umbrella, to provide input to G20 leaders in the lead-up to the Cannes summit. In June, at ICC's World Chambers Congress in Mexico City, the recently launched ICC G20 Advisory Group consulted with global companies to consolidate business positions on a host of issues. Participants at the meeting included ICC Vice Chairman Harold McGraw III, CEO of The McGraw-Hill Companies (who also serves as chairman of my organization), and Mexican Undersecretary of Foreign Affairs Maria de Lourdes Aranda Bezaury, along with other CEOs and chambers of commerce leaders representing businesses large and small.

Policy position papers on six key themes for the G20 process are to be reviewed, drawing on feedback from CEOs in the advisory group, as well as experts and ICC national committees. Once finalized, ICC and its network will deliver the positions to G20 governments, and unveil them in the media. In parallel to these efforts, the advisory group is working with the World Economic Forum and the French employers' body MEDEF, which is organizing this year's G20 Business Summit, in order to ensure delivery of consistent messages on behalf of global business. ■

To learn more about how business interacts with the G20, visit www.iccwbo.org/G20.

Participants at the G20 Business Summit last year in Seoul. Business is gearing up for a similar gathering in France prior to this fall's G20 Summit in France.

Trends and solutions in Islamic finance today



Muhammad Abdullah Al-Harith Sinclair is a Partner and Head of Islamic Finance at Pinsent Masons LLP

Islamic finance is an area that displays a curious pairing of characteristics - it receives a huge amount of media coverage but it is still a developing area. Why is this?

It is true that Islamic banking and finance allows strict Muslims to earn a return (termed a profit) on their bank savings, which was not previously possible (with the result that many Arab Muslims, prior to the advent of Islamic banking, had all their bank savings in non-interest bearing accounts at large conventional banks), or to buy houses or cars with Islamic bank financing. Furthermore, Islamic banking and finance enables so inclined Muslims to demonstrate their religious sentiments in the exercise their consumer vote by choosing banking and financial services of an Islamic flavour.

However, Islamic finance has probably gained the greatest amount of international financial press coverage because it provides a modus for the governments of conservative Arabian Gulf (and certain other) Muslim countries to demonstrate to their citizens that they are keeping to the Muslim faith in their financial dealings. Following from this, and of equal importance to the momentum that Islamic finance has gained, is the recognition by the largest Western financial institutions and their associated professional advisors that offering expertise in Islamic finance structures will increase their chances of being appointed on lucrative deals in the petroleum capital-rich Arabian Gulf.

While these factors explain why Islamic finance has risen to mainstream public awareness in the past decade, the question arises of why Islamic banking and finance is it taking so long to take off as a mainstream rather than niche form of finance? The answer can be found by looking carefully at whether Islamic finance is yet fully fulfilling its raison d'etre which is to be different from conventional finance in a way that is compliant with the Islamic Shariah code.

The key issue here is that Islamic finance is in principle of most interest to those Muslims who take the strictest view of which activities are prohibited by the Islamic Shariah code and who consider conventional finance involving interest to be so prohibited. The problem for Islamic finance is that these same individuals are also often inclined, unsurprisingly, to take the strictest view as to what types of transactions are truly different from the prohibited types of transactions. This would not be a problem for Islamic finance if it were not for the fact that many of its key financing structures have come in for criticism, often from participants in the Islamic finance industry itself, for being, to a greater or lesser extent, mere re-workings of conventional financing structures.

It is interesting to note the impact of this equation on the majority of Muslims who are more middle-of-the-road in their views and observances: they are somewhat bemused to see strict Muslim scholars being critical of certain aspects of so-called Islamic finance. This phenomenon certainly does not contribute to the widespread up-take of Islamic finance by the majority of Muslims.

A further factor, which it may be hard for those who are not Muslim to understand, is that Islam is in many ways a religion that encompasses a wide range of viewpoints. This is particularly so within Sunni Islam, which does not recognise any one living individual religious leader as having ultimate authority over all other in relation to questions of interpretation of the Islamic Shariah code. This has hindered the development of a coherent view, within the caucus of Islamic Shariah scholars (which is actually a broader caucus than simply those few scholars who happen to focus on and make a living in the field of Islamic finance), as to both the narrow specifics of what is permissible in each circumstance and the perhaps even more important issues of the direction of the Islamic finance industry as a whole.

In this context it is worth noting that many transactions are viewed as permissible by Islamic finance scholars today under the Shariah doctrine of "necessity". The view is taken that if Islamic finance is to take-off in terms of becoming a wide-spread and dominant trend in finance, as opposed to being a niche area, then there is a necessity to accept a degree of compromise.

"...if Islamic finance is to take-off in terms of becoming a wide-spread and dominant trend in finance, as opposed to being a niche area, then there is a necessity to accept a degree of compromise"

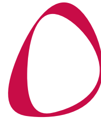
The question which is asked by those Islamic scholars who are critical of aspects of Islamic finance structures is whether the compromises in question negate the very point of Islamic finance, namely that it be meaningfully more Islamic than conventional finance.

Let us now look for the root reasons as to why Islamic finance has to compromise and which are holding it back from engaging the world of commerce on the scale that conventional finance does, but in an uncontrovertibly Shariah compliant manner.

The playing field is not level for conventional banks and Islamic banks in terms of the amounts of money at their disposal. This is due to both commercial and regulatory reasons. The common factor across both the commercial and regulatory factors is that Islamic banks operate very different business models from conventional banks – so much so that at the beginning of 2011, the Qatari Central Bank decided to prohibit its conventional banks from offering Islamic banking at the same time. This was a startling move and caused much debate globally, as many of the leading brands of Islamic banking are offered as 'windows' by conventional banks.

Starting with the commercial factors that have hampered the growth of Islamic finance, there is firstly the competition from the largest conventional banks, which are veritable capital raising machines – borrowing from everyone and paying whatever exact rate of return is needed to get the target customer to lend to them. This is not the case with Islamic banks. This is because an Islamic bank is itself a bit of a misnomer since all the money which it takes in is from 'investors' rather than 'depositors' (it only has depositors in those limited situations where depositors are willing to place funds with it on a non-return-bearing basis).

This is because, where a return is offered to Islamic banking customers, the money is accepted by the bank on the basis that it is an investment by the customer putting its cash with the bank (either as



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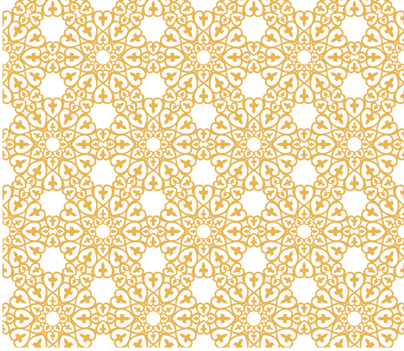
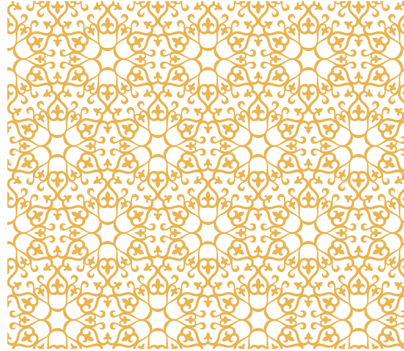
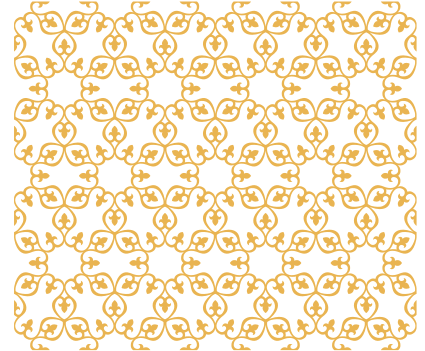
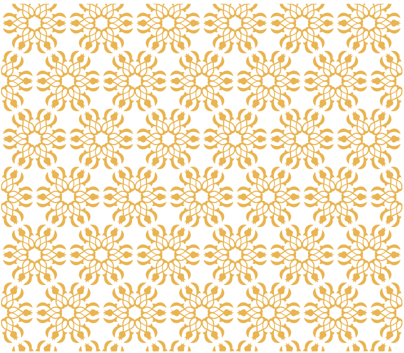
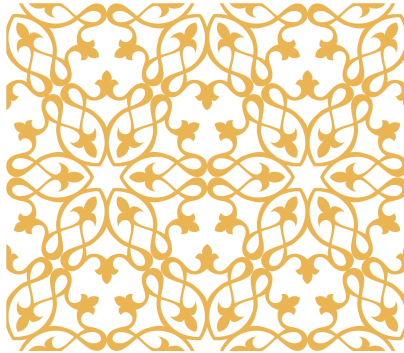
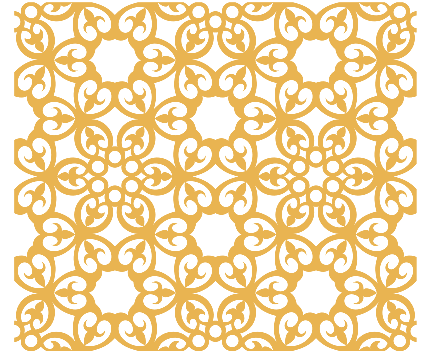
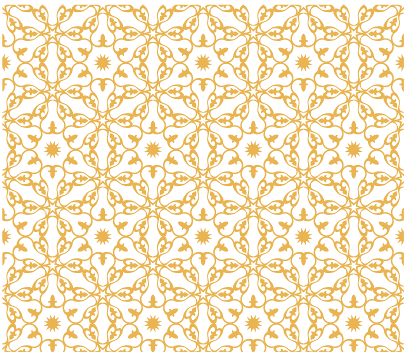
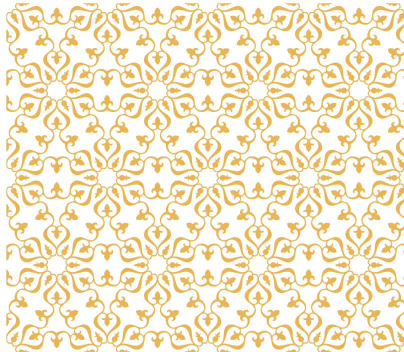
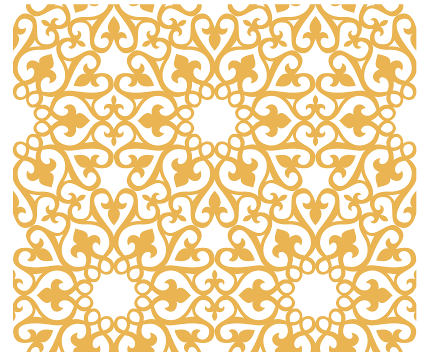

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Talk to the experts in Islamic Finance: Pinsent Masons

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an investment into a specific fund run by the bank or as an investment into the business of the bank itself (both variations are called 'investment accounts')). This is because it would not be permissible for the money to generate a return for the investor if the money were to be accepted on a debtor-creditor basis as in conventional banking. Most such investment accounts are structured as investments by the investor into the business of the Islamic bank itself. Because they are investments into a business subject to market fluctuations they do not naturally have a guaranteed return - but various smoothing mechanisms are used to try and ensure that investors get a minimum and predictable rate of return – these smoothing mechanisms are controversial because they shield the investor from true exposure to both the upside potential and the downside risks. Furthermore, the way in which the proportion of the profit due to the investment account holders is calculated vis-a-vis the proportion due to the Islamic bank's shareholders has proved an often grey area.

The newness of the Islamic banking sector and the consequently relatively small size of Islamic banks' customer bases, coupled with the different nature of the relationship between the Islamic investor and the Islamic bank as compared with the conventional depositor creditor–bank debtor relationship, and the lack of clarity on how profits are shared, are limiting factors on the fund raising capability of Islamic banks from their customer base.

"The newness of the Islamic banking sector and the consequently relatively small size of Islamic banks' customer bases... are limiting factors on the fund raising capability of Islamic banks from their customer base"

One of the biggest problems for the credibility of Islamic finance comes, indirectly, from this difficulty in raising large amounts of capital from Islamic investors (as compared to the balance sheet sizes of the world's larger conventional financial institutions). This problem is that much large scale finance done by Islamic banks relies on them sourcing funds from conventional banks in order to engage in large transactions.

Conventional banks are understandably unwilling to lend at normal lending rates unless they have the same levels of certainty of the Islamic banks' obligations to return the money, with returns, as they would if lending under a conventional structure. Consequently, the use of a particular, highly convenient structure which enables an Islamic bank to borrow money from a conventional bank through a technical sale of goods with delayed payment (with ownership vesting for a few seconds or less) is almost ubiquitous in this context.

The trade is often of metals on the London Metal Exchange, which the conventional bank sells to an Islamic bank which then on-sells the metals immediately, leaving the Islamic bank with cash and a delayed payment obligation of the price (which includes a mark-up designed to take the place of interest for the conventional bank). The cost of the obtaining of money in this way is very competitive as the terms and documentation for the transaction do not raise any problems or worries for the conventional bank. The documentation is usually based on a tweaked version of the standard Loan Market Association loan documentation and references whatever LIBOR+ rate and rollover periods are agreed. The reference to LIBOR is treated as acceptable by Islamic finance Shariah scholars as they treat it as a "mark-up" rate of profit on the sale of the metal rather than as an interest rate.

However, even the same Islamic finance Shariah scholars who agree to approve these metal trade structures for obtaining funds from conventional banks will usually also agree that the structure is somewhat undesirable as it both delivers exactly the same practical results as a conventional loan and also at the same time has a strong smell of being if not a sham transaction then at least a very artificial one.

The other problem for the scalability of Islamic banks and their operations stems from a absence of fit between Islamic banks' capital structures and the still obtaining international regime for the regulation of banking capital which was designed with conventional banks in mind. All banks are required to keep regulatory capital in accordance with the evolving Basle Accord standards. In the current regulatory environment, regulatory capital requirements are expanding and exceeding banks' own proprietary economic capital models, as regulators strive to anticipate and ensure adequate capital buffers to protect against not only the temporal economic trends but also the potential of contagion between zones.

This has repercussions for all banks. However, under the Basle standards currently obtaining, conventional banks are allowed to treat subordinated debt issued by them as validly counting towards part of their regulatory capital requirements. This is not permissible for Islamic banks as they are prevented by Shariah rules from issuing subordinated (or any other type of) debt which would pay out interest. Consequently Islamic banks are required to fund their regulatory capital requirements with equity – which is much more expensive to raise than debt. In fact, only very large financial institutions freely access the cheapest capital flows and as such act as costly gatekeepers for smaller conventional banks and Islamic banks.

The fact that this cheaper source of regulatory capital under the current Basle rules is available to the largest conventional banks, but not to Islamic banks, has been a major factor in restricting the growth of Islamic banks (and, in fact, of smaller conventional banks as well). However there is a solution to this problem, developed by FinaXiom, a leading international regulatory capital structuring firm. FinaXiom has developed a new type of regulatory capital in the form of standby capital. FinaXiom standby capital is completely distinct from the contingent convertible bond structure (which is not allowed to Islamic banks in any event as they cannot issue interest bearing bonds).

The new FinaXiom structure allows Islamic banks (or conventional banks of whatever size) to ask regulators for Tier 1 regulatory capital treatment for the standby capital for which they put arrangements in place. Given Basle III's stringent new requirements for much more capital, and for standby capital, this new type of capital is likely to be of interest not only to Islamic banks but to conventional financial institutions as well.

In an interesting and helpful turn of fate, the 2007 banking crisis and its fallout has led to the new Basle III regime being designed in a way that disqualifies subordinated debt from making up part of a bank's Tier 1 regulatory capital. This will create a level playing field where both conventional and Islamic institutions will be expected to fulfil their Tier 1 regulatory requirements through equity and standby equity structures.

While the regulatory capital position of Islamic finance may be on the road to resolution in a manner favourable to Islamic banks, this will not overnight solve the deeper existential questions for Islamic finance which, as noted above, relate to whether it truly is yet sufficiently different from conventional finance as to deserve the adjective Islamic. However, it is to be hoped that with a level playing field in terms of the regulatory capital requirements and thus greater parity of regulatory capital costs, Islamic banks' balance sheets will grow more quickly. This will put the ball in the court of the Islamic banks to strike out with new business methods and products that are more convincingly in line with Islamic principles. ■

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Placement of shares on foreign stock exchanges by Ukrainian issuers

Mykola Stetsenko is the Managing Partner, and Glib Bondar is a Partner at Avellum Partners

Despite the fact that Ukrainian legislation on securities has changed substantially in recent years, share placement by Ukrainian issuer ("Issuer") on foreign stock exchanges remains poorly regulated. This article is a short comparative summary of advantages and disadvantages of alternative structures of initial offerings of either shares or global depositary receipts ("GDRs") by the Issuer on an international stock exchange ("IPO"). The following structures may be used: (a) direct placement of shares in the Issuer on a foreign stock exchange; (b) placement of GDRs of the Issuer (on the basis of Ukrainian shares); (c) placement of GDRs of a foreign holding company ("Foreign Holding Company")[1] that owns majority of Ukrainian shares in the Issuer; (d) placement of shares in the Foreign Holding Company on a foreign stock exchange.

1. Direct placement of Ukrainian shares in the Issuer on a foreign stock exchange

According to laws of Ukraine the procedure of direct placement of shares in the Issuer on a foreign stock exchange (unlike GDRs) is rather problematic and has to comply with the following requirements:

- obtaining by the Issuer of the approval from State Commission on Securities and the Stock Market ("SCSSM") for share placement abroad
- only shares not exceeding 25% of the total share capital of the Issuer are allowed to be placed on a foreign stock exchange
- registration with the SCSSM of shares issue that will be placed on the foreign stock exchange is required
- registration is conducted by the SCSSM within 45 days and the SSMSC does not have substantial experience in commenting and approving prospectuses prepared according to European standards
- shares in the Issuer may be denominated only in hryvnia
- mandatory requirement of listing of shares in the Issuer on at least one stock exchange in Ukraine
- other technicalities determined by laws of Ukraine

Taking all of this into consideration, we do not consider this option as realistic until laws of Ukraine will improve.

2. Placement of GDRs on a foreign stock exchange

GDRs are issued by a depositary bank (Bank of New York Mellon, Citi, Deutsche Bank or JPMorgan Chase) that issues such GDRs on the basis of securities deposited with a custodian or a depositary bank itself. Since GDRs are not Ukrainian securities and are not intended to be circulated on the Ukrainian securities market, their issuance and circulation are generally beyond the scope of Ukrainian legislation.

Shares in Ukrainian issuers, as well as shares in foreign issuers may be deposited. In case Ukrainian shares in the issuer are deposited, they would be deposited with an authorized Ukrainian custodian (with, eg. ING Bank Ukraine) on the securities account of the depositary bank opened with such Ukrainian custodian. The depository bank, in its turn, will issue a corresponding number of GDRs, which may be sold to international investors and listed on foreign stock exchanges. GDRs may be issued in different proportions to deposited shares, for instance, 1:1, 1:2 or 2:1, etc.

The issuance of GDRs may be conducted either with participation of the issuer (the so-called sponsored issuance program) or without its participation (the so-called unsponsored issuance program). In this summary we focus only on the sponsored programs, which involve additional capital-raising for the issuer, as opposed to mere increase in liquidity of existing shares in the issuer.

IPO experience of most of Ukrainian companies demonstrates that Ukrainian issuers prefer issuance of GDRs (or shares) by the Foreign Holding Company. Please find below a comparison of advantages and disadvantages of the direct (onshore) GDR issuance as opposed to the indirect (offshore) GDR issuance through the Foreign Holding Company.

(a) Placement of GDRs of the Issuer (issued on the basis of Ukrainian shares) on a foreign stock exchange

Advantages

1. No corporate reorganization of shareholding structure is required and there are no accompanying difficulties related to the Law of Ukraine *"On Joint Stock Companies"* (mandatory buy-out (ie. tender offer) of shares of minority shareholders (if they exist) due to acquisition of more than 50% shares in the Issuer by the Foreign Holding Company (Article 65 of the Law of Ukraine *"On Joint Stock Companies"*).

2. No incorporation of the Foreign Holding Company and development of a vertical holding structure are needed.

3. No approval by the SCSSM as in case with placement of shares directly is required.

Disadvantages

1. It is not possible to issue new shares, which will be underlying GDRs, without the full prepayment of such shares and full registration of such issuance with the SCSSM.

2. There is a substantial risk that the depository bank will not have possibility to cast different votes at the general shareholders' meetings of the Issuer in case it receives different instructions from the GDR-holders (so-called split voting).

3. There is a theoretical risk that if GDRs are issued based on 25% of shares or more, prior approval (or waiver) for concentration from the Antimonopoly Committee of Ukraine ("AMC") may be required for the depository bank.

4. If the Issuer is a Ukrainian bank according to the Law of Ukraine *"On Banks and Banking Activities"* the depository bank will need to obtain a prior consent of the National Bank of Ukraine ("NBU") for the acquisition of a substantial stake (required if 10% or more of shares of the Issuer are formally acquired).

5. If the Issuer is a Ukrainian bank according to the Law of Ukraine *"On Banks and Banking Activities"* the depository bank will need to obtain a prior consent of the NBU for granting to the Issuer the status of the "bank with foreign capital" (required if 10% and more of shares of the Issuer are formally acquired by a non-Ukrainian person). This requirement will be abolished starting from 17 June 2011.

6. In case the Issuer decides to issue additional shares there may be risk that the Issuer will become obliged to buy-out shares owned by shareholders that are opposing such issue (Articles 68-69 of the Law of Ukraine *"On Joint Stock Companies"*).

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Until recently there was a problem of insufficient development of corporate governance system in Ukraine. However with the enactment and improvement of the new Law of Ukraine *"On Joint Stock Companies"* this problem is in most aspects resolved. On the other hand, certain time is required to test new provisions in practice.

Among the positive changes in corporate governance, introduced by the Law of Ukraine *"On Joint Stock Companies"*, there are the following:

- election of governing bodies of the Issuer by cumulative voting
- possibility to elect independent directors to the Supervisory Board of the Issuer
- possibility to form committees within the Supervisory Board and, at the same time, formation of the Audit Committee by the Issuer became discretionary
- special procedures for approval of material transactions and transactions with connected entities were introduced
- the law established regulation of reporting by the Issuer to its shareholders on its activities

(b)Issuance of GDRs by the Foreign Holding Company

Advantages

1. No shares prepayment is required during the issue of new shares.

2. The depository bank will have possibility to vote at shareholders' meetings of the Foreign Holding Company in accordance with any voting instructions given by the holders of GDRs (ie. split voting may be possible), as well as the holders of GDRs will be able to vote directly if they wish so.

3. Approval from the SCSSM is not required as in structure involving direct issue of shares.

Disadvantages

1. Corporate reorganization of the shareholding structure of the Issuer will be required (if not already done), in particular:

a. it is necessary to establish the Foreign Holding Company and to transfer shares in the Issuer to it (in case of sale it has to be done for price not less than nominal value);
b. since more than 50% of shares will be acquired by the Foreign Holding Company, such Foreign Holding Company will be obliged to offer the minority shareholders (if they exist) of the Issuer to buy-out their shares;
c. there may be a need to obtain individual license of the NBU if beneficiary – Ukrainian resident will be official shareholder of the Foreign Holding Company or sub-holding companies;
d. if the Issuer is a Ukrainian bank the consent of the NBU for replacement of existing shareholders in the Issuer for the Foreign Holding Company (ie. approval of acquisition of substantial stake in the Issuer by the new entity) will be required according to the Law of Ukraine *"On Banks and Banking Activities"*;
e. if the Issuer is a Ukrainian bank it will need to obtain a prior consent of the NBU for granting to it status of the "bank with foreign capital" (required if 10% and more of shares of the Issuer are formally acquired by a non-Ukrainian person).

2. There is a theoretical risk that if GDRs are issued based on 25% of shares or more, a prior approval (or waiver) for concentration from the AMC may be required for the depository bank.

3. If the Issuer is a Ukrainian bank there is a risk that it will be necessary to obtain a prior consent from the NBU for indirect acquisition by the depository bank of 10% and more shares of the Issuer according to the Law of Ukraine *"On Banks and Banking Activities"*.

3. Issuance of shares in the Foreign Holding Company on a foreign stock exchange

The Foreign Holding Company can place its shares on a foreign stock exchange directly without placement of GDRs. Advantages of this option will vary depending on specific stock exchange and jurisdiction of the Foreign Holding Company. For example, on Warsaw Stock Exchange traditionally shares and not GDRs are in circulation. Advantages and disadvantages of issuance of foreign shares by the Foreign Holding Company from are listed below.

Advantages

1. Voting by owners of shares does not create problems.

2. Additional shares issue of the Foreign Holding Company does not require their prepayment prior to placement among investors.

3. Prior consent by the SCSSM is not required unlike in case of direct shares issue.

4. There are no risks connected to depository bank's acquisition of prior consents from the AMC and the NBU due to the fact that shares will be disbursed among large number of investors and not single depository bank.

Disadvantages

1. Corporate reorganization of the shareholding structure of the Issuer will be required (if not already done), in particular:

a. it is necessary to establish the Foreign Holding Company and to transfer shares in the Issuer to it (in case of sale it has to be done for price not less than nominal value);
b. since more than 50% of shares will be acquired by the Foreign Holding Company, such Foreign Holding Company will be obliged to offer the minority shareholders (if they exist) of the Issuer to buy-out their shares;
c. there may be a need to obtain individual license of the NBU if beneficiary – Ukrainian resident will be official shareholder of the Foreign Holding Company or sub-holding companies;
d. if the Issuer is a Ukrainian bank the consent of the NBU for replacement of existing shareholders in the Issuer for the Foreign Holding Company (ie. approval of acquisition of substantial stake in the Issuer by the new entity) will be required according to the Law of Ukraine *"On Banks and Banking Activities"*;
e. if the Issuer is a Ukrainian bank it will need to obtain a prior consent of the NBU for granting to it status of the "bank with foreign capital" (required if 10% and more of shares of the Issuer are formally acquired by a non-Ukrainian person).

To conclude we would like to stress that, although each structure has a number of advantages and disadvantages, placement of GDRs (issued on the basis of Ukrainian shares) becomes realistic possibility that can be implemented in practice. Placement of shares in the Foreign Holding Company on a foreign stock exchange remains effective and the most widespread structure. ■

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1. In this article we assumed that the Foreign Holding Company will be established in one of the commonly used for these purposes jurisdictions (the Netherlands, Luxembourg, and Cyprus).

Iceland – looking back 3 years later

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The collapse of the financial sector in Iceland

6th of October 2011 will mark the 3rd anniversary from the day the prime minister of Iceland appeared on the television screens of the Icelandic people and asked God to bless Iceland since the major collapse in the financial markets would lead to a struggle for the Icelandic nation in the (following) years ahead. He announced that a new law would hopefully be agreed upon in the Icelandic Parliament that same day which would grant the Icelandic treasury authority to take unusual actions due to the situation. Now, three years since the collapse of the Icelandic financial sector due to the global financial crisis, it is interesting to take a quick look back and review how the next steps were taken, and how things have progressed since then.

The law the prime minister mentioned in his speech was approved by the Parliament on the 6th of October 2008 and took force immediately. It became Act no. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc, which have been referred to in Iceland as "the Emergency Act." By the Emergency Act, the Minister of Finance was granted authority to disburse money to establish new financial institutions, or to take over the existing financial institutions or their bankrupt estates. The Emergency Act also granted the FSA broad authorisations to intervene in the operation of Icelandic banks in crisis under those unusual circumstances.

> **"Due to the uncertainty of so many important issues, it has been difficult for everyone, whether they be banks, companies or individuals, to figure out the exact amounts of their assets and liabilities"**

The provisions of the new Act were put into force right away. On the 7th of October the FSA took over the operation of Glitnir Bank and Landsbanki, and on the 9th of October Kaupthing Bank was taken over as well. These three major banks in Iceland had collapsed. The FSA established three new banks owned by the Icelandic state in October 2008 to secure ongoing operations of the banking system and to secure all deposits on bank accounts in Iceland.

These new banks took in all major respect over the operations of the three major banks in Iceland. Arion Bank took over the assets of Kaupthing Bank, Íslandsbanki took over the assets of Glitnir Bank and Landsbankinn took over the assets of Landsbanki Íslands. Bank accounts in the banks' branches in Iceland were transferred to these new banks, including deposits and overdrafts. For the average Icelandic customer who had a bank account in any of those banks, the transfer was barely noticeable. The bank accounts held the same account numbers, and all credit and debit cards kept working as they used to. Other loan portfolios of the Icelandic branches were also transferred as well as the real estates and other assets and equipment needed for the continuing operation of the banks in Iceland.

The rest was left in the old banks, including operations of the foreign branches and subsidiaries, which were mainly financed by bond issuances and foreign deposits, but the three banks had all been operating branches and subsidiaries abroad, mainly in Europe. All derivatives were also left within the old banks. The new banks paid the old banks for the assets they had received from the old banks and a certain time limit was given for the new banks to obtain an assessment from independent parties on the value of the assets transferred. The new banks were, according to the decisions of the FSA on the takeover, to issue bonds as payment to the old banks for the assets.

The owner of the three new banks, the Icelandic state, appointed a board of directors for each of them, who then hired the CEOs of each bank. The FSA appointed Resolution Committees to take control of the old banks' estates and to take over all the authority of the estates' previous boards of directors.

The estates were put into moratorium when the Emergency Act was set in October 2008. Now they are in a winding-up proceedings under Act No. 44/2009. The Resolution Committees requested appointments of winding-up committees in the fall of 2009, in accordance with the provisions of the Act. The role of the winding-up committees is to take care of the tasks that the Resolution Committees have not specifically been assigned under Act no. 44/2009, but their most important task is to handle the claim process. In short, it could be said that the Resolution Committees are responsible for the assets of the banks' estates and their daily operations, but the winding-up committees administer the formal claiming process, handle all the claims against the estates and make decisions regarding their validity.

The winding-up committees invited creditors to lodge claims towards the old banks and the deadline to lodge claims was by the end of the year 2009 for all three banks. The winding-up committees have prepared lists of claims lodged and currently disputes regarding eg. the validity, amounts and status of the claims are being solved in the Icelandic courts. It is clear that it will take substantial time to have all these cases finalized, so the process will probably continue for a few more years.

At the same time, the Resolution Committees are mainly focusing on maximizing the value of the estates' assets, putting them into sale process when applicable and so on. If any of the creditors of the estates, or other parties that have interests in the estates, are not satisfied with the arrangements of the Resolution Committees and find their interests are not being guarded as they should, the dispute in question can be taken to the Icelandic courts to be resolved.

Ownership of the three major banks today

Today, the new three banks, Arion Bank, Íslandsbanki and Landsbankinn are owned by the creditors of the old banks and the Icelandic state. Landsbankinn is currently owned 81% by the Icelandic state and 19% by the creditors of the old Landsbanki through a company called Landsskil. The current owners of Íslandsbanki are the Icelandic state who holds 5% in the bank, and the creditors of old Glitnir bank who hold their 95% share through a company called ISB Holding. The Icelandic state currently holds 13% in Arion Bank and the creditors of old Kaupthing Bank hold 87% through a company called Kaupskil.

Other financial institutions in Iceland

There were not only the aforementioned three major banks in Iceland that collapsed or had severe difficulties as a result of the international financial crisis. Other banks also became victims of the crises in the financial sector. Just to mention few of them, we can start with ALMC, formerly known as Straumur-Burdaras Investment Bank. ALMC was an investment bank which went into moratorium in March 2009 following the collapse of the Icelandic financial sector. The

moratorium period lasted until August 2010. Over 99% of the bank's creditors approved on a composition proposal in July 2010. The composition became effective in August that same year after being approved by the Icelandic courts. Consequently, the existing share capital was cancelled and the bank's unsecured creditors converted their claims to zero-coupon bonds and shares. The bank's plan now is to maximise returns for the bank's creditors and shareholders.

Other investment banks have also been struggling, for example Frjálsi fjárfestingabankinn which was taken over by the FSA in early 2011 and is now in winding-up proceedings.

The savings banks in Iceland have also gone through serious difficulties, with many of them being taken over by the FSA which has appointed winding-up committees over them. The operations of some of them have been transferred to the new banks to handle their portfolios and clients until the winding-up process is finalised.

The operation of the new banks today and current major issues

Many issues have come up that have made it difficult for the new banks to operate in the already very challenging environment. Besides the obvious, which are the financial difficulties most of their customers are facing whether it be companies or individuals who have had to suffer from immensely increasing debts due to rising indexes and the collapse of the Icelandic currency, some very complex and big issues have emerged such as the question of the legality of currency based index in loan agreements.

In June 2010 the first two judgements were obtained from the Supreme Court in this respect. The decision of the Supreme Court was that a large part of the loans that had been granted to both individuals and companies and were linked to the rates of foreign currencies, were not legally valid, that is, it was regarded illegal to link the nominal amounts of the loans to a foreign currency and let the amounts change in accordance with the fluctuations in the rates of the relevant currencies. This is a big issue that still has not been totally resolved, eg. as how to calculate the loan amounts in Icelandic kronas, how to decide upon what the interest rate on the loans should be, etc. This was very important for the customers of the banks when the Icelandic krona collapsed as much as it did. So many individuals had taken their mortgages and car loans in foreign currencies, and those people suddenly faced a tremendous increase of their outstanding loan amounts and repayments multiplied.

Due to the uncertainty of so many important issues, it has been difficult for everyone, whether they be banks, companies or individuals, to figure out the exact amounts of their assets and liabilities. For that reason the economy has suffered for the past three years and there is still too much uncertainty. While individuals and companies do not know the exact amount of their debts, they cannot invest, sell or manage their operations safely. It is essential that these matters be concluded as soon as possible, but we must wait for the courts to handle the disputes that have arisen over these issues. The abolition of indexation in Iceland is now a polemic subject of debate. The new banks have recently begun to offer new non-indexed mortgages and only time can tell where that trend will lead. No assumptions can be made as to how this debate will be resolved.

It should also be mentioned that the provisions of the Emergency Act have also been debatable. The creditors of the old Landsbanki estate have claimed that the provisions of the Act are discriminating and unlawful and have brought the argument before the Icelandic courts. The district court of Reykjavík ruled in favour of the defendant, and the Supreme Court in Iceland is to render its judgment later in 2011.

In addition, rules on foreign exchange transactions were adopted in November 2008, but their main purpose is to restrict certain types of cross-border capital movements in order to ensure monetary and exchange rate stability in Iceland. The rules have been revised several times and in the current situation the abolishment of these restrictions is expected to come up for revision in 2015. These rules inevitably discourage foreign individuals and companies from participating in investments in Iceland, as many are unwilling to risk bringing their capital into the country when it is uncertain that they can retrieve their money without difficulties.

However, it must be borne in mind that exemptions from the provisions of the rules on foreign exchange can be requested, and they have been granted in several cases. The fact of the matter is that Iceland has valuable natural and human resources, as well as many exciting investment opportunities. It is clear that the country will work its way out of these difficulties. The only question is how long it will take us. The government plays a fundamental role and each decision taken in this regard is of the upmost importance. But the Icelandic people are resilient and resourceful and they have overcome serious challenges before, and therefore the question is not whether the Icelandic economy will recover, but when. ■

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Eastern Caribbean Court of Appeal considers enforcement issues in Alfa v Cukurova

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On 20 July 2011 the Eastern Caribbean Court of Appeal ("ECCA") handed down the latest decision in the long running case of Alfa Telecom Turkey Limited v Cukurova Finance International Limited and Cukurova Holdings AS.

At the trial of the substantive action, the trial judge held decisively in favour of Cukurova, finding that no event of default had occurred and that accordingly, it was not open to Alfa to enforce its security. Alfa appealed the decision and the ECCA subsequently ruled in its favour and set aside the judgment of the trial judge.

The case itself raises several matters of law but there are two main points of note for commercial lawyers in the British Virgin Islands.

Firstly, Justice Gordon held that the trial judge erred in concluding that an acceleration letter served on Cukurova by Alfa on 16 April 2007 was vitiated because its reliance on invalid acts of default constituted a fundamental breach of contract. Justice Gordon stated: *"Service by a lender of a demand letter relying on acts of default which are disputed by the borrower and subsequently not made out cannot constitute a breach of contract unless there is an express or implied duty to rely on valid acts of default in the relevant lending agreement.[1] While there may have been an implied duty for the appellant to assert acts of default in good faith, there is no justification for construing the Facilities Agreement as containing an implied term that the lender would only assert such acts of default which might, if disputed by the borrower, be either agreed to be valid, or determined by a competent court to be valid".*

This finding clearly fits with the common sense approach that a lender cannot be expected to refrain from instituting enforcement proceedings against a borrower purely on the basis that, despite the fact that it feels that an event of default has taken place under the relevant facility agreement, it has niggling concerns that the borrower or a court may disagree and that the lender may find the tables turned and that it may itself be deemed to be in breach of contract.

The ECCA found that Cukurova had committed various acts of default under the Facilities Agreement, and that the English share charges were enforced by a valid appropriation of shares, as referred to in a letter from Alfa's BVI counsel to Cukurova on 27 April 2007.

"The case itself raises several matters of law but there are two main points of note for commercial lawyers in the British Virgin Islands"

This is not to say that a lender can seek to accelerate a loan for breach of contract on the basis of frivolous claims; which brings us on to the second issue of a lender's obligation to act in good faith and/or not in bad faith.

The ECCA upheld the trial judge's findings that Cukurova's extensive submissions to the effect that Alfa had from the outset been acting for an improper purpose and with ulterior motives (ie. to appropriate the collateral pledged, rather than receive repayment of the loan), were largely irrelevant, and that the court was less concerned about people's motives than about legal rights. The ECCA stressed that those rights were freely given at arm's length in a negotiated commercial transaction. Justice Gordon stated: *"...the appellant and the respondent were large companies playing in a cut-throat world of high finance. It would be naïve for a court to expect, or indeed insist, that sympathy rather than reliance on strict legal rights would or ought to rule the day."*

Cukurova had also asserted, along the same bad faith argument, that despite Alfa being well aware that Cukurova was making efforts to progress a refinancing of its loan, Alfa had not proffered its intention to accelerate the loan as it wished to proceed with the acceleration at a time that suit Alfa, notwithstanding that this may affect Cukurova's opportunity to obtain a re-financing deal. Justice Gordon responded to this assertion by stating that he found *"...no evidence of 'bad faith' where a mortgagee or lender awaits the optimum time to exercise its rights, rights fully negotiated between the parties, who the trial judge found, were well advised by professionals."*

A lender is not obligated to take pains to ensure that the timing of an enforcement action suits both parties. Ultimately a lender is entitled to act in what is its own best commercial interest, and doing so will not automatically amount to the lender acting in bad faith.

A final appeal to the Privy Council is likely. ■

Further information

The foregoing is for general information purposes only and not intended to be relied upon for legal advice in any specific or individual situation.

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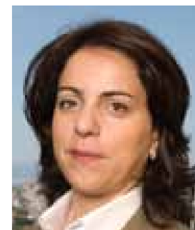
1. *Concord Trust v The Law Debenture Corpn plc [2005] 1 W.L.R. 1591 quoted*

The legal system in Portuguese-speaking countries



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The existence of a "lusophone legal system" is not a specific theme. Some authors recognize its existence. Others deny it, although recognizing the similarities between the several legal systems of Portuguese-speaking countries. Some of the arguments used to deny the existence of a lusophone legal system are the application, in African countries, of a customary law instead of the official law or the existence of strengths that prevent the inclusion of all Portuguese-speaking countries in a same legal system, like the EU, Mercosul or the several African organizations.

Without entering into this discussion, there is a reality that cannot be denied: nowadays the similitude between legal systems in Portuguese-speaking countries (PsC) is evident. That is why it is not difficult for someone legally qualified in one of those countries to act in any of the others. A common history, legal conception and language allow to state that the lusophone legal system has particularities that prevent us from saying it is just one more among the several legal systems included within the Romano-Germanic group, and that, obviously allow it to be distinguished from common law systems.

There is a common history that cannot be denied and the influence of Portuguese law is still obvious nowadays - PsC have assimilated significant legal principles through its own codification. That assimilation occurred not only by direct application of Portuguese law – as happened in Brazil after the independence declaration in 1822 and until 1917, or more recently in Macau -, but also through the creation of their own laws highly inspired by Portuguese rules.

Notwithstanding the importance of the past, looking to the present situation of those legal systems we reach the same conclusion.

In what concerns civil law, we shall highlight the importance of the Portuguese Civil Code of 1966, still in force in Portuguese-speaking African countries. Even some parts of the Portuguese Civil Code of 1867 – family and inheritance law – are presently applicable in Goa, Damão and Dio, ancient Portuguese territories in India.

It is a fact that in order to modernize and adapt the Portuguese law to local reality, several PsC are refreshing their laws, approving new rules. Even so, new laws still follow the recent evolution of Portuguese legislation. That occurred, for instance, in Republic of Guinea-Bissau, with the arbitration law of 2000, or in Republic of Angola which adopted, in 2004, a new companies' law. Also in Mozambique we can find a clear influence of Portuguese law in the Commercial Code of 2005.

A very different way took the law of East-Timor. Since the country was occupied by Indonesia, that imposed its own legal system, in 1975, and until 1999, Portuguese law was set aside. Even though, the influence of Portuguese law was so strong that since the independence of East-

Timor the laws that have been created reflect a reborn of Portuguese influence. That may be confirmed by the Constitution of 2002 or the Civil Code's project of 2008.

Contrary to what one may expect, this continuous process of influence does not work only in one way - we just need to look at the relations between Portugal and Brazil. The recent Brazilian Civil Code of 2002, contrary to what has happened in mid XX century, has emphasized the connexion between the countries as it is very close to Portuguese Civil Code of 1966. This connexion is confirmed, for instance, by the protection given to personality rights and to legal transactions. On the other hand, Portuguese law has received some influences from the Brazilian law such as the rules regarding consumer's protection.

"There is a common history that cannot be denied and the influence of Portuguese law is still obvious nowadays"

One may ask if these similarities between the legal systems of PsC bring any sort of advantages. The answer is obviously positive. It is easy to realise the enormous advantages of having a group of such important countries sharing the main legal values, and, above all, a common language, even from a strictly economic point of view - there is around 240 million Portuguese-speaking people!

Considering our perspective as law professionals working in Portugal and in several PsC, namely lusophone Africa, the advantages are easily identified. The intensification of international trade brought the need to deal with the globalization phenomenon. The latest years have been especially remarkable in what concerns European investment in Africa. The African market has been recognized as having a high potential - most of the countries are living in a development stage which means that there is a huge range of services to be provided, many public works to be executed and natural resources to be explored. The development of all these tasks is being mainly supported by foreign investment, sometimes in a close collaboration with local entrepreneurs.

The safety of knowing how those countries work in legal and economic terms and the familiarity with these legal systems allow us to provide our clients a stronger and solid legal advice based on the deep knowledge we have reached through our experience. In fact, the fear that investors may have - perfectly reasonable considering the high amounts usually involved - is mitigated by the knowledge of the legal system which allows them to anticipate the risks and take, from the beginning, all the suitable measures to prevent future problems and unexpected circumstances.

The same potential recognized in the African market is also recognized in the Brazilian market. We may, for instance, underline the recent Portuguese investment in Brazil, focused in strategic areas such as telecommunications and energy with the same demand for a high quality legal support.

The similarities between these legal systems bring other advantages from our point of view as law professionals: knowing well the evolution of Portuguese law and the several changes that have been introduced in the existing rules through the years, allow us to quickly identify the main problems that have arisen from practice and to successfully assist the process of law revision that several PsC are facing, as stated above.

For the same reasons and considering the intensification of international trade between these countries, the submission of possible conflicts arising from international contracts to arbitration courts in Portugal is a solution to explore.

The existence, at least, of a common language and background in what concerns the main legal principles makes it easier to acquire a deep knowledge of PsC legal systems. Whenever there is the will and it is done, it becomes easy to maximize the connexion between lusophone countries and to provide an efficient legal support to clients who want to expand their business all over those territories. For us, this deep knowledge of PsC legal systems is as essential as the deep knowledge of Portuguese Law - that is what has been allowing us to provide a high quality legal support in several operations, through our local offices in all lusophone Africa and through strategic partnerships with the best law firms in Brazil. ■

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Intellectual property protection in Germany and the EU

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German intellectual property law mainly consists of the Copyright Act (UrhG), Patent Act (PatG), Trademark Act (MarkenG), Utility Model Act (GebrMG) and Design Rights Act (GeschMG), flanked by some provisions of the Civil Code (BGB) and the Act Against Unfair Competition (UWG). All of these bodies of law have histories dating back to before German membership in the European Union (EU) but have since been revised and amended several times to implement European Directives and Guidelines or treaties. In particular, patent law and trademark law are harmonized to a large extent pursuant to the European Patent Convention (EPÜ) and efforts to harmonize trademark law. On a European Union level, national trademark laws are complemented by the option to apply for and register Community Trademarks.

Copyright

German copyright law is based on a natural law or "sweat of the brow" approach, ie. only natural persons can be "authors" within the meaning of the Copyright Act, and there are strong protections for personal rights of the author. Copyright protection arises automatically upon creation of a work that is an individual original creation in a form that is perceptible to humans; registration is neither necessary nor possible. The duration of copyrights is the life of the author plus seventy years. A German copyright as a whole is not transferrable except by inheritance. Authors can, however, grant licenses of any scope.

License provisions should be drafted in great detail since the UrhG provides that a license is, in principle, only granted to the extent necessary for the purpose of the underlying agreement even if the

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wording of a license is general and appears to be unlimited. German copyright law does not feature a "work for hire"-doctrine, wherefore employment agreements and service contracts should address the issue of licensing. An exception is made for certain software works created by employees. In such cases, while the employee author retains the personal rights to the work, the employer is granted a statutory license to exploit the work commercially.

There is no unified EU copyright but copyright in the EU is harmonized by various Guidelines.

Design rights

Design rights in Germany are similar to copyrights in that they offer protection for creative works. The threshold for protection is slightly lower than for copyrights and in contrast to copyrights, design rights are registered with the German Patent and Trademark Office (DPMA) and protection only arises with registration. Design Rights can be transferred and licensed. The term of protection is 25 years from registration.

"EU law offers the possibility to register a unified EU design right"

EU law offers the possibility to register a unified EU design right and there is also a unregistered design right available.

Patents

German patent law requires, in order for a technical invention to be patented, that the invention be new in the respective technical field, inventive, properly disclosed in the application and commercially viable. Applications may be filed with the DPMA and the office examines the application for the above factors before deciding on whether to grant a patent. In Germany, the application process usually takes two to three years. Once granted, the patent grants the holder the right to exclude others from any use (including importation) of the invention for a term of 20 years from filing the application. Patents can be freely assigned and transferred and licenses of any scope can be granted.

On a European level, there is no "community patent" offering protection in more than one member state as a Community Trademark does. However, a patent application may be filed with the European Patent Office (EPO) which was established in implementation of the European Patent Convention to which 38 countries, including all EU member states, are members. Such a European Patent Application results in a centralized process but then produces a "bundle" of national patents in those member states of the EPÜ that were named in the application.

A unified Community Patent, including a single European Patent Jurisdiction, has been under discussion for years but is still not in free; recently some core countries of the EU have agreed on an a attempt to establish a unified patent at least for their territories.

Utility models

Utility models in Germany require originality and inventiveness, just as patents do. Utility models also must be commercially viable. The major difference to a patent lies in the fact that the DPMA will not examine a utility model application for these factors. Also, the term of a registered utility model is three years and can be extended to ten years.

Utility models are not available at EU level.

Trademarks

Trademarks offer protection against the use of identical or confusingly similar marks by third parties. On a European level, trademarks can be registered with the Office for Harmonization of the Internal Market (OHIM) in Alicante, Spain. Such Community Trademarks offer protection in all EU member states. National German trademarks are registered with the DPMA. In both cases, in order to be registered, a trademark must be distinctive for the relevant goods and services.

In the registration process, the OHIM or DPMA, as the case may be, examines the application for registration under these standards. During (EU) or after (Germany) registration, third parties may file an opposition to the registration for three months if the trademark is identical or confusingly similar to a prior trademark. Trademark protection may last for an unlimited amount of time, provided that the owner continues to pay renewal fees after each ten year term and, no later than five years after registration, actually uses the trademark as such for the goods and services for which it is registered. Community Trademarks and national German trademarks can be freely assigned and transferred and it should be noted that the register may not correctly reflect ownership since entry in the register does not affect the substantive legal ownership of a trademark. ■

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International commercial arbitration in Cyprus

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Introduction

For many years the variety of services rendered internationally to business people has placed Cyprus on the map. Cyprus, of course, is not only known for the variety of services offered but, together with the variety, is well known for the highest quality of such services. It was therefore expected that Cyprus will not luck behind in the requirement felt amongst the commercial community worldwide for a quick way to justice.

In all civilised countries recourse to judicial institutions has become such a time consuming process and in effect delays were defeating the object of recourse to justice. As a result of such delays the commercial world had to find alternative solutions and time proved that the best possible alternative as at present is the reference of commercial disputes to either arbitration or mediation.

Arbitration is a process by which a settlement of the dispute is imposed on the parties to the dispute by an independent arbitrator or a panel of arbitrators as the case may be agreed upon by the parties,

whereas mediation has a completely different approach to that of arbitration. There is no imposition of any outside settlement. The mediator is guiding the parties involved for themselves to come to an amicable settlement or shall we say an amicable compromise of their differences.

Though the Republic of Cyprus realised early enough the need to lay the foundations of such out of court settlements there was a lot of conservative thinking amongst the business world of Cyprus for such alternative methods to be used. Over and above the Arbitration Law, Cap.4 which existed before the Independence of Cyprus, the House of Representatives voted into law the well known International Commercial Arbitration Law (L. 101/87) to encourage reference to arbitration of commercial differences not only amongst the business people of Cyprus but also amongst non-residents of Cyprus either in between themselves only or between themselves and Cyprus residents.

"Cyprus has earned an excellent name as a centre for services due to many factors, including its geographical position; it is in the middle of three continents, Europe, Asia and Africa, has a good technology infrastructure..."

After nearly twenty years of reluctance the business and commercial world of Cyprus looked at this alternative method of dispute resolution in a positive manner and we are now witnessing the formation of a number of centres specialising in arbitration and mediation.

It is important at the outset to emphasize that all these arbitration centres have one thing in common. The persons whose names appear on the roll of arbitrators of each and every one of them are highly qualified arbitrators selected from a substantial number of professions to cover every possible requirement. One could see on such rolls the names of lawyers, auditors and accountants, quantity surveyors, civil engineers, architects, assessors, and many others.

Cyprus has earned an excellent name as a centre for services due to many factors, including its geographical position; is in the middle of three continents, Europe, Asia and Africa, has a good technology infrastructure and the weather conditions which are ideal for people who come to Cyprus to do business and resolve their differences.

What matters are left for people to examine before they decide to refer any of their differences to arbitration in Cyprus is the quality of this particular service (arbitration) and the effect of any pronouncement by the arbitral authority. The litigant is not only interested to have his dispute resolved in the earliest possible time but such litigant is also keen to know how effective such arbitral award can be both in Cyprus as well as outside Cyprus.

What is the attitude of the judiciary to arbitration proceedings? Are arbitral awards recognised and enforced by the Courts of Cyprus and abroad? Before we can reach any conclusion in the matter it may be useful to study the provisions of the relevant enactments and any authorities available on the matter.

The International Commercial Arbitration Law (L. 101/87)

The International Commercial Arbitration Law (L. 101/87) applies to disputes which are 'international' in nature and which are of a 'commercial' nature.

Pursuant to section 2 of L. 101/87 'international' is the arbitration which:

a. At the time of the arbitration agreement the parties to the agreement had their place of business in different countries or

b. One of the following places is situated outside the country where the parties have their place of business:

(i) The place where the arbitration will take place if such a place was stipulated in the arbitration agreement or in accordance with the terms of the arbitration agreement
(ii) The place of performance of a significant part of the obligations that derive from the commercial relationship that is the subject of the dispute or the place which has the closest connection with the subject of the dispute

c. If by agreement the parties have stated that the subject of dispute is related with more than one country.

d. In the event that a party has more than one places of business, the place of business for the purpose of the law is considered the place which has the closest connection with the arbitration agreement, and in the event that there is no place of business, then the place of business is considered the place of habitual residence.

'Commercial' is the arbitration if it refers to matters that derive from relationships of a commercial nature, either contractual or not.

The term 'relationships of commercial nature' includes, but not restrictively, commercial transactions for the supply of goods and services, distribution agreements, commercial agencies, leasing, construction works, supply of advisory services, mechanical constructions, licensing, investments, financing, banking and insurance operations, agreements or licenses for exploitation, joint ventures and other relationships of industrial or business co-operation and the transport of goods or passengers by air, sea, rail or road.

It is evident from the above definitions that the intention of the legislature was to give the parties a significant amount of freedom in bringing their dispute under the provisions of the law.

The definition of 'international' and especially (c) above indicates that the intention of the legislature was to enable the parties themselves to decide whether an arbitration is considered international and therefore come under the scope of law 101/87.

In addition the definition of 'commercial' provides an extensive list of potential relationships but does not restrict the definition to that list. The fact that the list is non-exhaustive once again shows the intention of the legislature to have as wide a definition as possible in order to enable the parties to bring their disputes under the provisions of law 101/87.

An agreement to refer a dispute to arbitration must be in writing and may be entered either at the stage of entering into the commercial agreement as a clause to that agreement or by a separate agreement when the dispute arises. Both options are binding on the parties and enforceable by the Courts.

If a party to an arbitration agreement brings an action in Court, the Court, on the application of the defendant/respondent may stay the proceedings and refer the dispute to arbitration.

Attitude of the Cyprus courts towards arbitration agreements

The general attitude of the Courts towards arbitration agreements may be summarised as follows:-

- Constitution of the Republic of Cyprus safeguards access to Courts.
- The Courts do not have power to stay proceedings on the ground that there is an arbitration clause binding on the parties before it, unless the defendant or one of the defendants applies for stay. Such an application presupposes an action in breach of the arbitration clause.
- The defendant/applicant has the onus of satisfying the Court that the action concerns a dispute within the arbitration clause.
- The precise nature of the dispute should be explained to the satisfaction of the Court.

- If the defendant/applicant satisfies the Court that the dispute falls under the provisions of the arbitration agreement the Court has to stay the proceedings and refer the dispute to arbitration.

Interim protective measures pending determination by the arbitrator

One of the most significant factors that a potential plaintiff has to consider when referring a dispute to arbitration is whether he can obtain interim protective measures pending the determination of the dispute by the arbitrator.

Section 9 of law 101/087 provides that the Court has power, after application by one of the parties, to issue interim injunctions any time before the beginning of the arbitration or during the arbitration proceedings.

The attitude of the Courts in Cyprus is very liberal in this respect provided the conditions for the issuing of such injunctions are met. The test that the Courts have to apply in deciding whether to grant such interim relief is set out in section 32 of Courts Law14/1960. The Court must be satisfied that:

a. There is a serious issue to be tried and

b. That the Applicant has a good chance to be entitled to relief and

c. That unless the injunction is issued it will be difficult or impossible for justice to be made at a later stage.

Finally the Court should consider the balance of convenience between the parties when deciding whether to issue the interim injunction or not.

It is possible and is indeed very usual for the interim injunction to be issued on an ex-parte basis. This is done when the applicant convinces the Court that it is very urgent to issue the injunction and that if the other party is informed he may take steps to avoid the possible injunction. In such an event the Court issues the injunction and makes the order returnable within about one week in order to give the chance to the Respondent to challenge the issue of the injunction.

The Cyprus Courts, recognising the importance and urgency in this kind of applications are usually very efficient in disposing of such applications in a very short period of time. In addition, recent case law has shown that the Cyprus Courts are adapting with the modern needs of the business world and the nature of the injunctions issued now varies to accommodate the needs of modern justice.

One example of this trend of the Cyprus Courts is shown by the case of Seamark Consultancy Services Limited v Joseph P Lasala and others 2007 1A A.A.D. 162 where the Supreme Court has extended the power of the Cyprus Courts to issue world-wide mareva injunctions in light of the modern way of doing business and new transaction practices and the need to protect the interests of Plaintiff pending the final outcome of the dispute.

Execution of the arbitrator's judgment

Finally, one other important factor that the parties should consider when referring a dispute to arbitration is the ability to execute an arbitrator's judgment in the various jurisdictions where a defendant may have assets.

Section 35 of law 101/87 clearly stipulates that the arbitration judgment is recognised as binding. The Court, pursuant to an application by any of the parties to the arbitration, issues an order for execution of the arbitration judgment.

Pursuant to section 36 of law 101/87 the only grounds for the Court to refuse an order of execution are:

1. One of the parties to the arbitration agreement had no legal capacity to inter into the arbitration agreement or that arbitration agreement is not valid pursuant to the law which the parties subjected the agreement, or if there is no such agreement, pursuant to the law of the Country under which the arbitration judgments was issued or

2. There was no proper notification of the appointment of the arbitrator or the arbitration proceedings or he was deprived of the opportunity to appear and defend his case or

3. The award deals with a dispute not contemplated by or not falling within the terms of submission to arbitration, or it contains decisions on matters beyond the scope of the submission to arbitration; provided that, if the decisions on matters submitted to arbitration can be separated from those not so submitted, that part of the award which contains decisions on matters submitted to arbitration may be recognised and enforced or

4. The composition of the arbitral tribunal or the arbitral procedure was not in accordance with the law of the country where the arbitration took place or

5. The award has not yet become binding on the parties or has been set aside or suspended by a Court of the country in which, or under the law of which that ward was made or

6. If the Court finds that:

(i) The subject matter of the dispute is not capable of settlement by arbitration under the law of Cyprus or,

(ii) The recognition or enforcement of the award would be contrary to provisions relating to public order of Cyprus

Both section 35 and 36 apply to arbitration judgments issued in Cyprus pursuant to law 101/87 or to arbitration which took place out of Cyprus and their enforcement is sought in Cyprus. It is evident from the provisions summarised above that the only grounds of objection to a recognition and enforcement of an arbitration judgment are technical grounds. The Court has no authority to revisit the matters already discussed and decided upon during arbitration.

Recognition and enforcement

Cyprus is a member of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards - the "New York Convention" of 1958.

Pursuant to the New York Convention, all countries who are parties to this convention should recognise and enforce arbitral awards issued in other contracting states. The list of countries which have ratified the Convention is extensive.

A list of the countries which have ratified that convention and therefore a Cyprus arbitration award issued pursuant to law 101/87 can be enforced and executed can be found at the following web address http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_status.html

The grounds for refusing the recognition of an arbitral award pursuant to the New York Convention are almost identical to the grounds found in law 101/87 so a repetition is unnecessary.

Law 101/87 allows plenty of freedom to the parties to arbitration to set the rules of their arbitration either by setting them out in the arbitration agreement or by implication by referring the arbitration to an arbitration centre such as the Cyprus Arbitration and Mediation Centre with its own set of rules.

Conclusion

In conclusion Cyprus poses many advantages in international commercial arbitration. Potential litigants can find high quality of service both from the lawyers, arbitrators as well as the judiciary and the Cyprus legal system in general.

Cyprus arbitral awards are recognised and enforced both in Cyprus and abroad thus making Cyprus an important jurisdiction in the arbitration sector. ■

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COSTAS TSIRIDES & CO LLC was founded in 1970 and since then it has been established as one of the most reputable and respected law firms in Cyprus.

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