Investment Management and Real Estate

European IMRE News

Insights on developments in the European landscape*

02 Treating customers fairly in times of crisis

04 Challenges for money market funds in an illiquid market

05 Insurance investments gain popularity

06 Risk management moves on

08 Transparency gathers momentum in Europe

10 Fair value proves a difficult journey for some

12 Withholding tax proposals likely to impact cross-border and UCITS funds

13 An update on UCITS IV

14 Key IFRS issues for Russian real estate

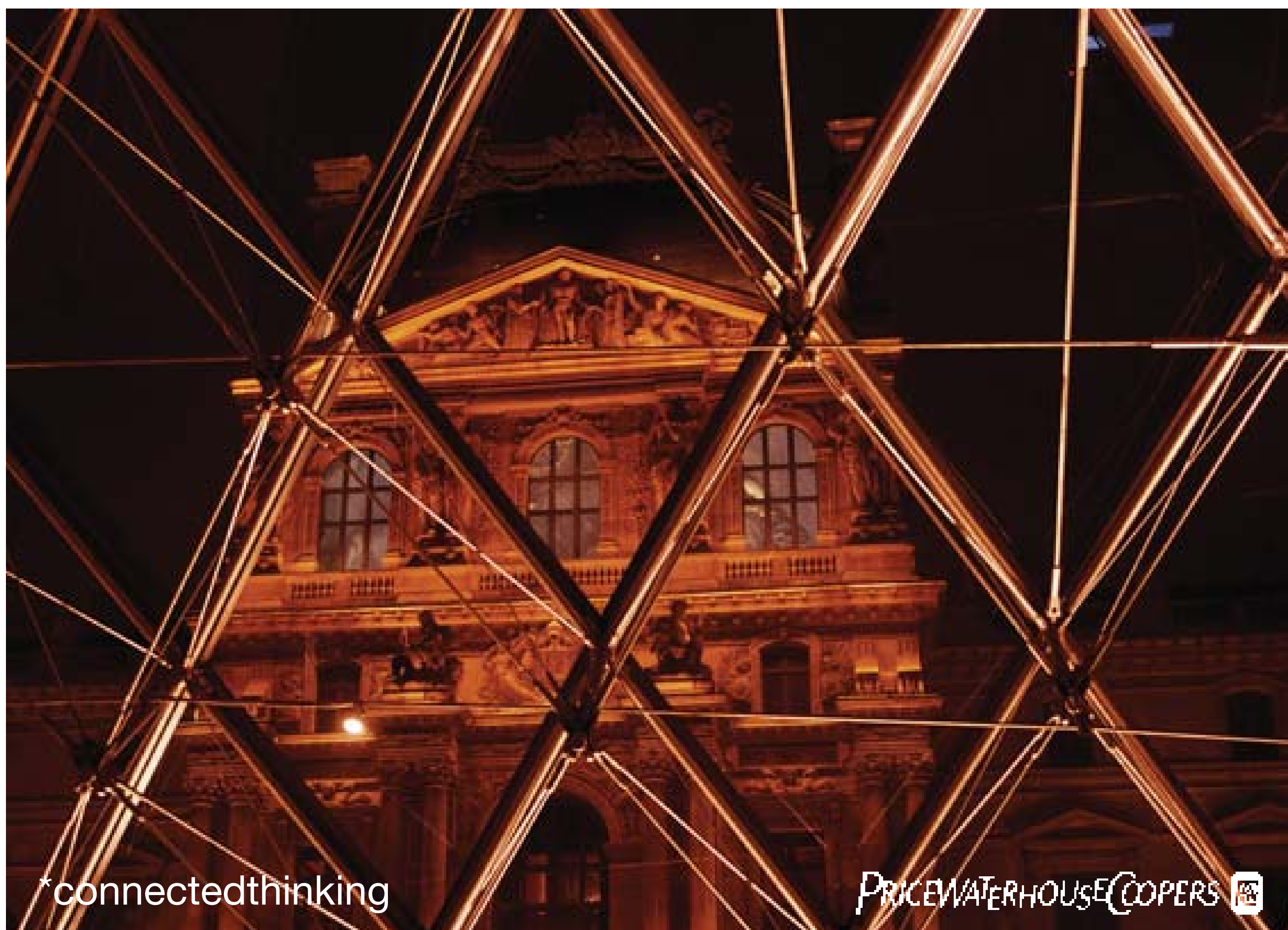
16 The substance issue

18 Taking the opportunity to simplify corporates

20 The exceptional expansion of Islamic finance

21 Important changes to the UK VAT exemption

September 2008



Treating customers fairly in times of crisis

Substantial falls in investment values are placing the regulatory principle that investment firms treat customers fairly under the spotlight – creating challenges not only in the UK but also across Europe.

Roger Turner
PricewaterhouseCoopers (UK)
+44 20 7804 3249
roger.turner@uk.pwc.com

In times of crisis, investment managers should be especially aware of the regulatory requirement that all customers be treated fairly. Market volatility has created conditions in which it is not always clear what is 'fair'. Managers that face such dilemmas should make their decision-making transparent, backed up by proper documentation, so that they can demonstrate their logic if questioned by regulators at a later date.

This is particularly important in the UK, where Treating Customers Fairly (TCF) is being introduced as a specific regulatory principle. But it is also relevant across Europe, as the contents of Markets in Financial Instruments Directive (MiFID) effectively require that investment firms treat their customers equally.

As an example of the challenges that arise, the chaos in the credit markets is making valuation of certain securities extremely difficult. Notwithstanding the debate as to whether 'fair value' accounting is making the situation worse, the disparity between forced sale prices and 'true' underlying value within funds means that the interests of investors remaining within a fund inevitably differ from those leaving. A similar issue exists when firms suspend a fund, impose a lock-in of investors or, indeed, invest their own capital in order to extract securities that are significantly impairing liquidity.

Documenting decisions

If, as seems likely, many of the securities caught up in the credit crunch bounce back, one can see regulators potentially questioning the actions of management. Only by showing that they have taken steps to address investors' competing interests can management be considered to have complied with the new principle. Compliance with the principle of TCF necessitates detailed records of the firm's approach to handling this conflict.

For organisations operating in the UK, the new TCF principle of business is central to the Financial Services Authority (FSA) policy. After several false starts, the FSA requires firms, by the end of 2008, to have necessary systems and infrastructure to achieve active consideration of customers' interests, recorded with management information. The industry's reaction has been, to

put it mildly, mixed. At a stroke, the UK regulator seemingly moved the goalposts, such that notwithstanding the enormity of the existing detailed rules and associated 'noncompulsory' guidance, all organisations needed to undertake a root and branch review of how they interacted with customers.

It is tempting to think that the TCF principle is restricted to organisations falling under the FSA's regulatory net. In fact, MiFID points to the same end goals, even if they are not as precisely articulated as the UK TCF model. Consequently, a non-UK regulator might well look at what the FSA is requesting and ask their local organisations to 'prove' the same result.

Taking the long view

One of the challenges with TCF is that management and staff action can be scrutinised after the event. For example, a firm may have launched a fund or product, or provided advice to a customer group, which with the benefit of hindsight or following dramatic market movements or changes could appear unsuitable today. What should the firm do? Is it expected to contact the customer group (assuming it even knows who they are) and 'advise' them to switch into another product or service? This seems fraught with difficulties, not least of which the 'advice' could be spectacularly wrong, such as selling at the bottom of the market.

In consequence, TCF means management should look less at the rules per se, but spend more time considering what the impact of their products and services might be if market conditions change. The tricky bit is showing that the often-competing interests of customers, shareholders and the regulators have been debated sufficiently robustly, such that any ex post review by an informed outsider would reach a similar conclusion. In times of uncertainty, rapid market change and potential structural shifts in the marketplace, this is no easy task.

A firm may have launched a fund or product, or provided advice to a customer group, which with the benefit of hindsight or following dramatic market movements or changes could appear unsuitable today.

Challenges for market funds in an illiquid market

Liquidity issues in the money markets have created difficulties in determining fair value, making it imperative that fund managers and administrators focus on first principles when assessing basic economic value.

Andy O'Callaghan
PricewaterhouseCoopers (Ireland)
+353 1 7926247
andy.ocallaghan@ie.pwc.com

A money market fund is permitted to use amortised cost as a method of valuation for its assets, provided it approximates the market value of the underlying securities. This means that fund administrators value the fund every day and compare it weekly with the market value. This is the method that is internationally accepted for the valuation of money market funds, and has been for the last few years.

At all times, transparency is paramount. Valuations may include a number of assumptions that could significantly affect the reported value. In such cases, it is imperative that the assumptions are seen to take full account of market information. Where write-down is deemed necessary, market participants need assurance that the markdown reflects current information.

In the case of constant net asset value (NAV) funds, a write-down may trigger a 'break-the-buck' event. In such cases, the fund manager may seek to make a cash infusion to maintain a constant NAV. From an accounting perspective, such an infusion must be disclosed as a related party transaction and cannot be repayable to the manager. Depending on the domicile of the fund, there are legal, regulatory and taxation issues that need to be addressed before any such action is taken.

Difficulties with illiquid securities and lessons learned

The credit crisis of the past 12 months has brought a level of uncertainty into the money markets not previously witnessed in recent years. The primary impact of the crisis on money market funds has been a tightening of liquidity at underlying security level. This in turn has brought uncertainty to the fair value basis of valuation of certain securities. In simple terms, how can one be confident that amortised cost approximates market value if the market value itself is uncertain?

In the daily priced environment under which most money market funds operate, the ability to determine whether a market (that is, a willing buyer) exists for a security is paramount. If no market exists, then is it difficult to avoid the conclusion that a write-down in value is necessary. The biggest lesson of the past 12 months for money market funds has probably been that daily priced, constant NAV funds are not immune to liquidity issues and the only guarantee of liquidity is a willing buyer.

Ongoing uncertainty in the market

Given ongoing issues in money markets in general, there is no doubt that it is becoming increasingly difficult to determine fair value for certain money market fund instruments. It is imperative, therefore, that fund administrators and fund managers focus on first principles in terms of the underlying economic value of all securities. Pricing committees should be very diligent in obtaining clear and concise data regarding market price movements, earnings information, rating information and other securities price movements in determining whether prices offered by brokers or market markers are in fact fair value. At all times, vigilance is paramount.

Insurance investments gain popularity

As demand for uncorrelated investments grows, insurance-linked securities are becoming more than a niche investment area

The current bear market in equities and bonds has increased the demand for investments not correlated to capital market risks in general, and credit risks in particular. Infrastructure and commodity investments, for example, are experiencing increased allocations. It is also, however, increasing the attention given to the less established investment area of (re-)insurance risks, which are wrapped in investment vehicles commonly known as insurance-linked securities (ILSs).

Growing market for public securitisations

More and more investment managers are setting up funds holding traded ILS. ILSs transfer insurance risks insurance companies' balance sheets to capital market investors using securitisation techniques. Such risks may be related to natural catastrophes, mortality, longevity, health or motor and a number of other insurable perils. While the traded catastrophe (cat) bond market has continuously developed since inception in 1990, the potential volume has not yet been reached.

Last year (2007), total new issues exceeded US$30 billion,[1] a level that is thought likely to grow as demand for uncorrelated assets increases and the Solvency II Directive encourages insurance companies to transfer balance sheet risks. Indeed, the market's potential size is estimated at US$7,100 billion for life transactions (by 2010) and US$895 billion for non-life (by 2016).[2]

Private transactions increase too

A smaller number of asset managers have taken the next step and started building expertise in securitising insurance risks themselves, in order to act as direct counterparties in private transactions. Depending on the risk in question, this requires deal-specific knowledge as in the underwriting of life or non-life transactions.

Not many managers have such experience, considerably raising the entry barrier for smaller and start-up firms. Depending on the regulatory framework, managers applying for an insurance licence must have considerable liquidity and reserve requirements, which have limited the actors on the ILS stage so far.

Valuing illiquid ILS transactions

These managers act as counterparties in the securitisation, receiving premiums from the insurance companies for taking the risk from their balance sheets. As such, these transactions are highly specific and in most cases not transferable to other parties, which raises questions about the valuation of such direct or illiquid investments.

Not only is specific underwriting knowledge required, but also the actuarial assumptions used are of particular importance to the valuation. Further, as every transaction is unique, comparative methods are virtually nonexistent. Clearly, only a sound and robust valuation methodology, developed by experienced and savvy pundits, ensures appropriate valuation in accordance with the fair value principle.

Despite these challenges, the market has considerable potential and more managers seem likely to develop ILS investment opportunities. As long as the capital markets continue to be challenging, negative correlation seems to be the magic concept that everybody is looking for.

Marcel Meyer
PricewaterhouseCoopers (Switzerland)
+41 58 792 23 46
marcel.meyer@ch.pwc.com

[1] Sigma Swiss Re publication (life and non-life transactions) – 07.06.

[2] Sigma Swiss Re publication – 07.06.

Risk management moves on

Realising the limitations of traditional value-at-risk (VaR) frameworks, investment managers are considering risk at the security level and adopting more timely, even predictive, forms of risk management.

Jay A. Burstell
PricewaterhouseCoopers (US)
+1 646 471 4293
jamie.a.burstell@us.pwc.com

It is a fair observation to say that during the past 15 years, the practice of financial risk management has evolved significantly. Many important challenges have been overcome in the areas of data aggregation, data normalisation, calculation appropriateness and standardisation and production of statistics that allow multiple risks to be incorporated in common analytical frameworks, such as value at risk (VaR). Also of note has been the emergence of independent risk oversight functions and the governance and formalisation of these functions under the oversight of a chief risk officer (CRO).

All of the above represent truly laudable achievements, yet one might still suggest that opportunities remain, both to enhance and extend risk management practices. This is particularly understandable in the aftermath of significant market events like the recent credit crisis. As such, it is an encouraging sign when firms step back, re-evaluate their current risk management practices and seek advancements.

While there is consensus that current 'VaR-centric' risk management frameworks have produced a far greater understanding of risks across the financial enterprise, two key aspects of such frameworks continue to be scrutinised:

1. Whether they are appropriate for the capture of financial risks associated with newer investment vehicles and products such as hedge funds and derivatives;
2. Whether they improve the organisational ability to proactively identify risks and take pre-emptive, remedial actions in a sufficiently timely manner.

Some drawbacks of traditional approaches

With respect to the first concern, given the latitude that hedge fund managers have in the pursuit of alpha, the consequences of liquidity risks, event risk, specific and general credit risk and risk factor exposures may be significantly greater for them than for traditional asset managers. Also, hedge fund managers often deploy dynamic strategies that are not well described by

unconditional (for example, 'point-in-time') risk measures like VaR. In fact, the dynamic nature of hedge fund strategies is often an important justification used by the managers for the fees charged to their investors.

It has also been observed that hedge fund returns are not normally distributed – a key underlying assumption of VaR – and derivatives in particular often have nonlinear payoff profiles. Lastly, VaR can also be based on correlations that may not be stable during periods of extreme market stress. As one hedge fund manager observed, 'When markets melt-down, all the correlations go to one…that is, everything goes down together.' All of these factors argue for risk management to occur more dynamically, closer to the point of risk origin and at a more granular level.

Regarding the second concern, which is the latency with which risk management is practiced, there is also room for improvement. Given the inherent volatility of financial markets and their risk factors, the velocity of trading and the uneven flow of market and securities descriptive data (upon which trading decisions may be based), firms are learning that they do not have the luxury of large time windows with which to respond to risks.

Evaluation of standard risk outputs (many of which may only be available T+1), consultation with the risk officer, convening risk committees, structuring and final enactment of remedial actions (for example, flattening positions and/or establishing effective hedges) cannot be so protracted a process as to lose more immediate position and risk management opportunities. For firms managing through the recent credit crisis this was all too clear. Liquidity was present in the market – until it was not. Consequently, firms that did not act early and decisively to manage their risk were left holding ultimately undesirable securities positions.

A more dynamic approach implies risk management occurring within trading timeframes, generally associated with the underlying strategies themselves, many of which are real-time. For example, significant latency gaps are obvious if we contrast typical risk management response times to algorithmic trading, where multiple market opportunities are routinely exploited in real-time throughout the trading day.

A resulting challenge, therefore, is to contemplate certain market scenarios and/or impacts on existing strategies, scan the market for them in real-time and be poised to respond with execution of potential remedial actions, again in real-time. A related challenge is to supplement this with 'predictive analysis'. This means further identifying potential risks before they become evident in actual valuations and price movements, or as the aforementioned hedge fund manager also said, 'What I really need is a crystal ball to help me avoid the next credit crisis, not a deadly accurate rear-view mirror for my risks.'

What might newer risk management capabilities resemble?

Since no risk management crystal ball exists, firms have been forced to be more creative in order to address these needs. In evidence of this, several leading securities firms are working actively to adapt real-time trading tools to this purpose. For example, if algorithmic trading tools can scan the markets, evaluate multiple risk factors and securities relationships and execute spread-capturing transactions – all in real-time – then why cannot risk managers automatically calculate and monitor exposures, and create and execute hedges, in such a timeframe? Similarly, if markets can be scanned for trading opportunities, can they also be scanned for data that might foreshadow a credit event…a reputation risk event? Is calculating aggregate statistics like VaR sufficient to understand and manage specific sources of risk such as individual positions, security concentrations, credits and strategies present in the trading portfolio – or is a more specific security and strategy-level monitoring required beyond what is performed on the trading desk?

Recent market events have underscored the need to engage in active risk management at a more granular level and with a much lower latency than has been historically observed. These events have also taught us that predictive analysis can help risk managers develop opinions as to possible sources and magnitudes of exposure, before they become fully reflected in market valuations. In a sense, predictive analysis is not unlike what highly regarded securities analysts do when they attempt to 'go beyond the numbers'. As such, this activity can be thought of as an extension of the research function. It is also not surprising, therefore, that in addition to VaR, many hedge fund managers incorporate predictive analysis in their overall risk management programs, as many have core competencies in such fundamental research.

This trend is certainly not limited to hedge fund managers, however, as these additional capabilities would support the risk management of all asset classes. As a case in point, asset-backed commercial paper was historically sold as a risk-less cash alternative, which turned out not to be the case.

Given the extraordinarily high stakes associated with potential market events like the ongoing credit crisis, both securities firms and their investors have an equal interest in ensuring that risk management practices are re-evaluated, enhanced and extended to provide these new capabilities. As such, these risk management 'growing pains' are a positive sign. It also stands to reason, therefore, that further investment in predictive analytics and more anticipatory and real-time risk management is to be expected.

Transparency gathers momentum in Europe

Just as individual countries introduce voluntary codes of conduct, the European Parliament is pursuing legislation that goes beyond transparency.

Ashley Coups
PricewaterhouseCoopers (UK)
+44 20 7804 4062
ashley.coups@uk.pwc.com

Prashant Babu
PricewaterhouseCoopers (UK)
+44 20 7212 7957
prashant.r.babu@uk.pwc.com

Private equity firms found themselves under fire from all sides in early 2007 in the wake of mega-deals involving well-known and iconic UK businesses and the focus of a Treasury Select Committee. With one UK union official saying they were less transparent than the mafia, only the credit crunch could divert attention from the snowballing coverage of the apparent 'dark side' of private equity.

While the debate about the behaviour of buyout firms has been fiercest in the UK, the sector has also faced sharp criticism in other European countries, such as Germany, where a leading politician branded them 'locusts'.

Voluntary frameworks

The UK private equity industry has agreed a new voluntary code of conduct (published in November 2007 and commonly referred to as the Walker Guidelines) on disclosure and transparency in response to last year's heated political debate, when it was attacked by unions and politicians for job-cutting, asset stripping and tax-avoidance. We are now witnessing a fundamental shift of focus by the European legislative base on private equity over the past year, calling for more transparency and enhanced capital requirements.

Sir David Walker's proposed code of conduct for private equity firms in the UK was said to be able to greatly increase the supply of information to employees, customers and other stakeholders about the portfolio companies they have acquired and about the private equity firms themselves. Following this, many firms have published detailed reports over the last six months about their activities and many portfolio companies have provided significantly enhanced disclosure on their activities in a more accessible form, such as on their websites.

The approach in the UK has focused on private equity volunteering to become more open as a result of enlightened self-interest and that fully engaging with the voluntary framework is preferable to primary legislation and regulation that would come with it. Sweden and Denmark have also followed suit and issued guidelines consistent with those established by Walker and aligned with local statutory requirements.

Legislative proposals

On 26 June the European Parliament's Committee on Legal Affairs adopted the report by Klaus-Heiner Lehne, which calls on the European Commission to submit legislative proposals aimed at making private equity (and hedge funds) more transparent.

The report's proposals are set to have far-reaching implications for the private equity industry across Europe.

Transparency on investment policies: The committee proposes to oblige private equity funds to disclose and explain their investment policy and the associated risks.

Contract terms and risk management: The committee seeks to investigate application of contract terms allowing for a clear limitation of risk and measures to be taken if thresholds are exceeded.

Encouraging transparency for payouts to managers: The committee urges much more light to be shed on pay and bonus packages for fund managers, including the use of stock options. In addition, it calls for the establishment of a code of best-practice limiting remuneration encouraging excessive risk-taking and irresponsible behaviour in investment.

Money laundering: The committee calls for legislation around money laundering in general.

'Asset strippers not welcome': The committee proposes development of standards to prevent 'asset stripping' of companies targeted by private equity funds and to make banks responsible for the use of funds that they lend to private equity funds.

With many countries either having issued guidelines or planning their own rules, establishing a unified pan-European set of rules that are effective will be a challenge. However, with leading MEPs such as Poul Nyrup Rasmussen, a former Danish premier, pushing these recommendations through the European Parliament at rapid speed, European legislation could become a reality within two years.

Beyond transparency

The report raises a number of questions for the private equity industry in Europe. The European Private Equity & Venture Capital Association's (EVCA) new chairman, Jonathan Russell (head of buyouts at 3i), has said that by lumping private equity together with hedge funds, the lawmakers are creating 'a real potential for unintended consequences because you are trying to lump two very different types of finance together within a single pool of legislation'. The report's proposals around risk management and forbidding 'asset stripping' take it far beyond 'transparency'.

It is hard to envisage wide-ranging acceptance of some of the above areas considering the energy many member states have committed to putting in place well-thought-out proposals for greater transparency in private equity. Given the cross-border nature of the industry, private equity firms will be watching developments in this space more closely than ever before.

Fair value proves a difficult journey for some

Fair value accounting means private equity-type investments can no longer simply be valued at cost. While most relevant to private equity, this also creates issues for many hedge, infrastructure and real estate funds.

Nick Rea
PricewaterhouseCoopers (UK)
+44 20 7212 3711
nick.rea@uk.pwc.com

Fair value is one of the hottest topics facing the alternative investment industry today. The ever-increasing pressure from investors, regulators and auditors for companies to focus more on valuation has collided with the credit crunch and the most difficult economic conditions in years. This has made the valuation process particularly difficult at a time when most attention is on maximising returns to attract and retain clients. This is likely to create much more volatility in fair values in financial reports.

The old principle of keeping investments at cost (less any diminution) provided far fewer challenges, especially in a rising market. Now, fair value is increasingly required, due to the accounting requirements of International Financial Reporting Standards (IFRS) and the US generally accepted accounting principles (GAAP), and the increased application of the International Private Equity and Venture Capital Guidelines (IPEVCG or 'the Guidelines') and US Private Equity and Investment Guidelines Group (PEIGG).

The IPEVCG provide an overall framework for the valuation process, but also suggest that valuers apply 'a degree of caution', but 'not excessive caution'. This sets a context within which a valuer should seek neither to understate nor overstate the value of the investments within a portfolio.

We have observed some companies responding well to this challenge, while many are finding the move to fair value to be a difficult journey. As a result of this and other industry issues, the alternative investment industry has reviewed its practices via private equity's Walker Report, the Hedge Fund Working Group and the development of the International Organisation of Securities Commissions (IOSCO) and the Alternative Investment Management Association (AIMA) guidelines – all of which highlight the need to improve valuation.

Suggestions for improvement

Resolving these issues is work in progress (WIP) as the move towards fair value reporting is not complete yet. There are a number of areas where short-term improvements are however possible:

- **Involve the investment manager** – Do not leave the valuation in the hands of a member of the finance team alone, as they may not be involved in the management of the investment.
- **Document your thoughts** – All valuations are underpinned by judgement – ensure the thoughts and drivers are clearly documented and cover all key points.
- **Be consistent** – Should use the same valuation methodology from one period to the next and avoid changing approaches unnecessarily. This will help identify real value movement.
- **Sense check results** – Think about and document how the proposed value compares to the original acquisition, previous years and recent transactions. Does it make sense?
- **Consult** – Developing a robust approach can be time-consuming. Be sure you have consulted appropriately before developing the valuation process.

Conclusion

Fair values are reported in financial statements to their investors, annual meetings or in letters to investors. Approaches adopted for the different forms of communication vary from a lower of cost or market approach, or may state that 'our valuation policy is to carry investments at cost until a significant event dictates otherwise'.

These approaches are generally no longer consistent with GAAP for an investment fund and are coming under increasing scrutiny and interest from investors, regulators and auditors. Therefore, PricewaterhouseCoopers recommend that the available guidance, principally the IPEVCG and PEIGG, should be followed carefully and used to help prepare robust valuations.

Further, these valuations should be prepared, in our view, by a combination of those closest to the investment and the back office or finance function, and should be clearly documented.

A key positive outcome from an improved process would appear to be that this optimises the potential for client retention, which is clearly a key issue for any private equity company operating in the increasingly uncertain and volatile markets. This is surely a sufficient reason to improve the valuation process and to be seen to be operating at a 'top of peer group' level.

This article is an extract from the PricewaterhouseCoopers paper: 'Fair value reporting in private equity' (published in September, 2008).

Withholding tax proposals likely to impact cross-border and UCITS funds

While the Organisation for Economic Co-operation and Development (OECD) and European Union (EU) proposals are likely to clarify withholding tax treaty benefits, this may come at a cost to funds distributed in several countries.

Pat Wall
PricewaterhouseCoopers (Ireland)
+353 1 7928602
patrick.wall@ie.pwc.com

New proposals emerging from the OECD and the EU will have a major impact on international funds. If implemented, they will lead to a streamlining of procedures and clarification of treaty benefit entitlements. But these benefits may well come at a cost. It is very likely that new reporting procedures will accompany any improvement in treaty benefits and funds currently in receipt of benefits might lose out. Funds domiciled in locations such as Dublin and Luxembourg will be especially impacted.

Withholding taxes on cross-border investment flows can be a major cost to investors. Tax treaties and other procedures are designed to mitigate these costs by eliminating double taxation. Tax treaties often do not operate as they should, particularly when the investments are held through a chain of intermediaries, and especially when held through the medium of a collective investment fund. Procedures for obtaining tax reliefs are often cumbersome, paper-driven and can differ widely between jurisdictions. All of this results in significant cost to investors, either as a result of tax reliefs foregone or costs of compliance. Very important proposals to alleviate these problems will emerge in the next 12–18 months.

Within OECD and the EU, groups consisting of government and industry representatives have been meeting to examine the problems and make recommendations for solutions.

Divergent views

The OECD consultive group has held a series of meetings over the last two years, most recently in April 2008. Substantial agreement exists between the governments and industry on what the major problems are. This is likely to result in important clarification on how treaties should operate in the context of investment funds and recommendations for improvements to cross-border

The OECD and EU have joined forces to ensure that internationally agreed measures conform to the recommendations of the EU-sponsored group of experts (known as FISCO), who issued a report in November 2007 recommending a new streamlined withholding tax regime operating across all Member States.

withholding tax procedures. However, there are divergent views on how treaties should operate. Should funds be entitled to treaty benefits and, if so, what are the safeguards against treaty shopping? Should funds distributed in more than one country be entitled to so-called derivative benefits, or should treaty relief only apply to the extent that residents of the same country own the fund? Without derivative benefits, funds distributed in a single country could have a significant advantage over funds distributed in many countries. This would have major implications for UCITS.

The OECD and EU have joined forces to ensure that internationally agreed measures conform to the recommendations of the EU-sponsored group of experts (known as FISCO), who issued a report in November 2007 recommending a new streamlined withholding tax regime operating across all Member States.

Critical phase approaching

The work of the groups is likely to get renewed impetus from recent concerns about perceived deficiencies in the EU Savings Directive. It is very likely that governments will want to link improvements in withholding tax recovery with improved information exchange and anti-evasion measures.

The consultation process is now reaching a critical phase. The OECD report will probably be published this year and the FISCO group has already published its report.

An update on UCITS IV

Odile Renner
PricewaterhouseCoopers (Luxembourg)
+352 49 48 48 3053
odile.renner@lu.pwc.com

On 16 July 2008, the European Commission finally published its proposal recasting the (UCITS) Directive 85/611/EEC. As anticipated, the proposal does not cover the ‘management company passport’ (MCP), that is, the possibility for funds authorised in one Member State to be managed remotely by a management company established in another Member State. This was explained by a series of potential supervisory and investor protection concerns, which would have to be tackled before the introduction of this passport.

This whole MCP topic continues to be vehemently discussed by the industry and regulators, with a remaining gap between large asset management countries and smaller ones. Strong concerns regarding the possibility to enact a functioning management passport have been expressed. Some even fear that a UCITS recast without the MCP would not be accepted, notably by the French who hold the EU Presidency until next December.

The Commission has mandated the Committee of European Securities Regulators (CESR) to assist it in developing an acceptable MCP regulation. CESR immediately submitted a call for evidence to the industry, asking it for assistance on various questions surrounding the impacts of the passport. CESR’s advice is due on 1 November, with the Commission then having little time left to amend the current proposal to include, if at all, the MCP.

For the time being, no one can predict the future development of UCITS IV.

Key IFRS issues for Russian real estate

The Russian real estate market has been riding a wave of success – what are some of the key IFRS reporting challenges for this dynamic sector?

Richard Gregson
PricewaterhouseCoopers (Russia)
+7 495 967 6327
richard.j.gregson@ru.pwc.com

As a comparatively young industry the Russian real estate sector grapples with a myriad of International Financial Reporting Standards (IFRS) challenges. The following issues are, of course, not unique to enterprises operating in the Russian market, but the stage of evolution of the market is such that they are particularly topical, and often challenging.

Business combinations versus asset acquisitions

There are hundreds of developers and investors in the Russian market. Many of these have been established recently or restructured from loosely held asset holdings, as shareholders seek to form consolidating structures to facilitate planned debt or equity raising initiatives.

As developers and investors jostle for their share of the market's pickings, one of the key tendencies is for old residential, commercial, industrial or mixed-use sites to be repackaged for development or resale – and they may often pass through the hands of a speculative investor before they end off with the ultimate investor or developer. Tax-optimised structures will typically imply one asset and one entity. There will usually be investment contracts or other development rights associated with these properties, a limited number of employees, and perhaps some element of revenue streams associated with activities present on the site at the time of acquisition.

By comparison, a business combination represents the bringing together of separate entities into one reporting entity. A business will generally be associated with inputs, processes and revenues, rather than merely being a collection of assets. Sounds simple, but in practice the determination of what represents a business combination as opposed to an asset acquisition can often be quite a subjective process; and the results can differ dramatically, depending on what the conclusion is.

In cases when the determination is that the transaction represents a business combination, this will result in the application of the purchase method of accounting as required by IFRS 3. The difference between the cost of the acquisition and the fair valued assets, liabilities and contingent liabilities will

represent either goodwill or negative goodwill, which is where the next challenge comes into play.

Valuation of property holdings

Valuation approaches will be relevant in the context of fair value considerations when applying purchase accounting, and in the context of the application of valuation principles under either IAS 16 (Property, Plant and Equipment) or IAS 40 (Investment Property). The Russian property market is characterised by a relative lack of transparency, complex permitting processes, legal challenges, spiralling construction costs and a lack of publicly available information on comparable sales prices. All of this can make valuations a challenging business.

The most commonly applied valuation techniques in the market are:

- Market Comparison;
- The Income Capitalisation Method;
- The Residual Method.

In the case of development properties, often the absence of comparable sales prices for similar properties is such that a commonly applied approach is the Residual Method. Under the Residual Method, the value of the development property is defined as the difference between the value the property will reach after the planned investment is implemented and the value of the costs relating to the project implementation (costs of construction, design and monitoring, costs of securing the financing and the anticipated developer's profit). The remainder is the value of the property in its present condition, on the day of the appraisal.

While in an ideal market there should be little difference between the results determined under the Market Comparison approach and the Residual Method, in the Russian market the reality is that very few developers can successfully access and develop prime sites. This fact, combined with the presence of a number of subjectivities associated with the methodology, means that resultant outputs of valuations may vary considerably, depending on what assumptions are used.

There have been a number of cases where property acquisitions have been deemed to be business combinations and the valuations applied as part of the purchase accounting have resulted in the recognition of significant negative goodwill at the time of acquisition. This negative goodwill is recognised directly to the income statement in the period in which the acquisition occurred and can have a dramatic impact on the reported results of the developer/investor.

Revenue recognition for residential sales

Residential developments – both high-rise and freestanding single occupancy dwellings in compounds – are mushrooming throughout much of the country. Developers will typically transfer control, and the significant risks and rewards of ownership of the property, at a single point of time and the revenue should be recognised at that point. Developers will usually receive the majority of the sales proceeds well in advance of the completion of the development, but transfer of property title in Russia is by no means a routine process. This generally means that developers will recognise significant amounts of deferred revenue for extended periods of time, until such time as the risks and rewards of ownership have passed, which will typically be when the State Commission Act is signed between the developer/investor and the State Construction Authorities.

To compound this IFRS real estate experience is in short supply in Russia

Although there has been some reduction in activity as the effects of the global credit crunch make themselves felt in Russia, there are still numerous developers positioning themselves to access domestic and international debt and equity markets. Consequently, the demand for audit and consulting services in the real estate sector and the demand for competent IFRS accountants is equally strong – a real challenge here is that the supply source for these services and resources is often the same.

The substance issue

Growing concern about the use of special purpose vehicles for tax structuring is causing investment companies to consider whether they meet tax administrations' requirements for real substance.

Laurent de La Mettrie
PricewaterhouseCoopers (Luxembourg)
+352 494848 3007
laurent.de.la.mettrie@lu.pwc.com

Due to the particular tax-exempt status of most investment funds, and the potential tax costs arising from their investments, there is often a need to consider appropriate tax structuring by using special purpose vehicles (SPVs). Such vehicles can claim particular tax benefits (for example, tax treaty eligibility, application of parent subsidiary directive, etc.) that can significantly mitigate tax costs arising from the investments and, as a consequence, improve the return of the fund.

However, there is a growing concern regarding the use of such structures, which is the requirement by foreign tax administrations for real substance. This issue has taken on greater significance, following the introduction of FIN 48,[1] which requires the board to undertake a robust assessment of any tax positions taken by the fund.

Differing requirements

The difficulty is that these substance requirements are determined primarily by the countries where the assets are located, rather than by the territory where the entity is established. This makes it difficult to provide a universally accepted definition of substance as the requirements vary from country to country.

There are, nevertheless, certain common features. Apart from regular board of directors meetings held in the country where these entities are supposed to be resident, these entities must be provided with sufficient 'business substance' in terms of purpose of the business or economic presence, and sufficient 'material substance', that is, office premises, equipment, staff, etc. A meaningful level of profits being effectively taxed or a significant level of capitalisation with equity are also indicators that an entity has the appropriate level of substance.

[1] Financial Accounting Standards Board rule governing Accounting for Uncertainty in Income Taxes.

When the substance test is not met, this could lead a foreign tax administration to conclude that a specific entity is purely artificial and should be disregarded from a tax standpoint as being only a conduit vehicle.

Substance in practice

It is interesting to see how this substance requirement has been translated into practice. In a recent internal survey conducted on 35 different funds, covering the private equity, real estate and hedge fund sectors, having legal structures in Luxembourg, it appears that a significant majority (29) of the funds had Luxembourg employees and had their own offices. A further 22 of the funds had senior decision-makers among their local employees.

While only a small proportion – eight of the funds – had five or more Luxembourg employees, it can be expected that this number will increase significantly in the future as boards of the funds have realised the operational benefits attached to having local employees, and are, therefore, actively recruiting.

It is also important to point out that the substance requirement impacts not simply a particular location, but, potentially, all locations. In this respect the human resources potential existing in a given jurisdiction and its connection facilities (for example, in order to facilitate board of directors meetings) are, among others, critical factors to be considered when assessing the substance requirement and the practicalities of satisfying this in a particular country.

Note: This article originally appeared in PricewaterhouseCooper's Rain or shine?* alternative investment funds newsletter – GAIM Special Edition, published in June 2008.

However, there is a growing concern regarding the use of such structures, which is the requirement by foreign tax administrations for real substance.

Taking the opportunity to simplify corporates

Now is the time to take advantage of less stretched human resources to review corporate structures to reduce costs and complexity, while increasing transparency.

Laura Waters
PricewaterhouseCoopers (UK)
+44 20 7212 6173
laura.m.waters@uk.pwc.com

As Europe's economies slow, many financial services groups are finding this an opportune time to review their corporate structures and to eliminate unnecessary complexity. This applies equally to corporate groups and redundant fund structures, such as limited partnerships. Doing so not only reduces cost, but also increases transparency and accountability.

Why now? Because resource freed up by diminishing transactional work has time to review the corporate structure and challenge the need for each entity. Wait until the bear market is in full swing and the resource may be gone – reduced through cost-cutting.

Past bull markets have fostered more and more acquisitions. In the search for investment performance, investment managers have become more complex, moving into multi-jurisdictions and diverse fund structures. All eyes have been on the business, the operations and performance, with less attention paid to the accumulating corporate entities. There has been sparse resource, or appetite, to review redundant and legacy entities before the next transaction or fund launch. Complex webs of entities have quickly built up, with the rationale forgotten. General unease about where to start simplifying has led to the problem being archived.

Pressures to simplify

Operationally, such a 'head-in-the-sand' approach causes challenges. Risk management and corporate governance burdens are relentlessly increasing – coupled with rising costs for professional services in audit and tax, for directors' and officers' (D&O) insurance and employee insurance premiums, including run-off cover. Added to this, pension, environmental, employee and regulatory laws are changing apace – and never to the corporate's advantage. Failing to simplify now will be costly in the long run: the longer an entity exists, the harder and more expensive it is to liquidate, strike off and/or dissolve.

The challenge to date has been how to move this issue up the corporate agenda. Naturally, the next transaction is always more interesting than the last 10 years' housekeeping. Creating entities faster than they are being eliminated is proven from the statistics for 2006/2007. In the UK, the number of companies incorporated rose almost 21%. By comparison, strike-off applications increased 7% and solvent liquidations rose 17%.[1] Data from Ireland, the Channel Islands and France shows similar patterns.

Simplification gathers momentum

Now is the time to return to basics and reduce the cost of complexity. Simplification is gathering momentum across all industries as costs come under the spotlight and questions are asked about rationalisation of operations, businesses and jurisdictions – all tested against the immutable principle of value for money.

Operational simplification involves reviewing business and operational flows, which may lead to offshoring and/or outsourcing. This inevitably reveals a number of redundant entities. Importantly, though, a 'big bang' approach should be avoided. Moving from a 100-company structure to one company at once is a tall order. Instead, splitting the project into phases and planning a reduction over several years makes corporate simplification part of the regular housekeeping.

What is the real value of this activity? There are cost savings, but the main goal is to respond to market pressure for greater transparency and accountability. The CEO's task is to nurture constructive complexity, yet to reduce complexity that destroys value and exposes the organisation to unnecessary risk. We anticipate that 'corporate housekeeping' will become a regular item on the board's agenda, embedded in the group's annual budget.

Operational simplification involves reviewing business and operational flows, which may lead to offshoring and/or outsourcing.

[1] Source: Companies House.

The exceptional expansion of Islamic finance

High oil prices are one of the factors driving growth in Islamic finance, which is now facing the difficulties of a maturing sector.

Suzanne Senior
PricewaterhouseCoopers (Ireland)
+353 1 792 8547
suzanne.senior@ie.pwc.com

The Islamic finance industry, although still relatively young, has grown into a sizeable constituent of the global financial services industry. There is now more than 800 Islamic funds worldwide, with an annual growth rate of 22% over the last five years.

Drivers of success

One of the main driving factors for the growth of the Islamic finance industry is the strong demand from a large number of Muslims for Shariah-compliant financial services and transactions. Islam is followed by 1 billion to 1.8 billion Muslims, making it the second-largest religion in the world. Shariah-compliant products, with their avoidance of forbidden investments and the prohibition of interest in line with Islamic beliefs, have a distinct appeal for this sizeable Muslim population.

A second driving factor is rising oil wealth, which is lifting Islamic finance into the financial mainstream. The Middle East is looking for ways to protect its new-found 'petrodollars', long after all the oil dries up. Asset managers' stampede into Islamic finance is mostly an effort to get a slice of the estimated US$1.5 trillion of funds available in the Middle East. Islamic finance is no longer just a matter of personal belief; this abundance of wealth has attracted the interest of governments, corporates and global financial institutions.

Thirdly, the competitiveness of many of the products is attracting both Muslim and non-Muslim investors. This can be observed in the strong growth in the sukuk market. Sukuks are innovative Shariah-compliant debt instruments that can be traded in secondary markets. The sukuk market is fast emerging as the most significant form of Islamic financing and has been gaining momentum, increasing at an average annual rate of 40% over the last couple of years.

And, last but not least, the recent credit crunch is also a driving factor in this growing interest in Islamic finance, as investors look for ways to limit their exposure to tightening interest rates. Islamic finance products tend not to be sensitive to interest rates, since Islam bans charging interest, making Islamic bonds (sukuks) immune to the credit crisis and a welcome alternative in the current market.

Growth pains

In the midst of high growth figures in this industry, on a global basis, there are challenges that must be addressed, such as transparency, accounting and ratings, with very different standards being used.

Another issue is disagreements among scholars, as Shariah is not a set of codified laws, but a set of interpretations based on the Quran. So we sometimes see a divergence of views and opinions among Shariah boards and scholars regarding the interpretation of Shariah law, relating to products and structures.

There is also a shortage of Shariah scholars with experience in the financial services industry, due to the huge growth in the Islamic finance industry in recent years. And those scholars need to look at evermore sophisticated products that are starting to emerge.

Into the future

Although Islamic finance has been growing rapidly over the last few decades, there remains a number of hurdles, as mentioned above, to overcome in order to achieve its future growth potential.

The challenge then for Islamic finance globally is to step up its efforts in terms of product development, harmonisation of Shariah's views and establishment of a global Islamic financial system framework.

Important changes to the UK VAT exemption

Changes to the VAT exemption rules for investment management, due to be introduced in October, require careful consideration by managers and their administrators.

In the 2008 Budget, HM Revenue & Customs announced changes to the VAT exemption for investment management resulting in:

- The inclusion of investment trust companies (ITCs), and Venture Capital Trusts (VCTs);
- The inclusion of overseas funds that are authorised for distribution to UK retail investors under the Financial Services and Markets Act 2000; and
- The exclusion of 'trust-based schemes' from the scope of the exemption.

The amendments are due to come into force from 1 October 2008, pursuant to the Value Added Tax (Finance) Order 2008 (the 'Order').

The Order amends Item 9 of Group 5, Schedule 9 of VATA 1994 to include the management of:

- An authorised open-ended investment company;
- Authorised unit trust schemes;
- A Gibraltar collective investment scheme (CIS);
- An individually recognised overseas scheme;
- A recognised CIS authorised in designated countries and territories; and
- A recognised CIS constituted in another European Economic Area (EEA) State.

Item 10 of Group 5, Schedule 9 of VATA 1994 is also amended to include the following within the exemption:

- Listed closed-ended investment undertakings.

Understanding unanticipated changes

While the majority of the changes were inevitable, following the decision of the European Court of Justice (ECJ) in JP Morgan Claverhouse in June 2007, which found that the exemption was too narrowly defined, the extension of the exemption to VCTs may not have been so widely expected, although it would appear to be consistent with the ECJ judgment in the JP Morgan Claverhouse case.

The more significant, and unanticipated, change for the fund industry is the extension of VAT exemption to the management of funds established outside the UK. While we understand the legislation is intended to include the management of those sub-funds that are intended for UK retail distribution within the exemption, the drafting is not as straightforward as anticipated.

On the strict interpretation of the Order, it would be reasonable to conclude that it is the 'umbrella' fund that falls within the exemption and not solely the sub-funds, and, furthermore, the deregistration of the sub-fund may not successfully remove that sub-fund from the remit of the exemption.

As a result, the Order restricts the right to input VAT recovery, enjoyed by UK fund managers, on certain cross-border fund management activities. Investment managers, and to some extent, fund administrators, will need to consider the impact these changes will have on their partial exemption methods, particularly as the VAT exemption for fund management is not a 'specified supply' for input tax recovery purposes. Therefore, the blockage on input VAT recovery will also apply on the management of funds falling within the remit of the Order.

Opportunities exist to minimise the impact of the legislative changes, including the areas of restructuring funds, updating partial exemption methods and listing funds on alternative exchanges.

Nick Skerrett
PricewaterhouseCoopers (UK)
+44 20 7804 2054
nick.skerrett@uk.pwc.com

Shima Heydari
PricewaterhouseCoopers (UK)
+44 20 7213 3631
shima.heydari@uk.pwc.com

Investment Management and Real Estate contacts

European IMRE News is produced by experts in their particular field at PricewaterhouseCoopers, to address important issues affecting the investment management industry. If you would like to discuss any aspect of this document, please speak to your usual contact at PricewaterhouseCoopers or one of those listed below:

Global Investment Management and Real Estate Leadership Team

Marc Saluzzi
PricewaterhouseCoopers (Luxembourg)
Global Investment Management and Real Estate Industry Leader
+352 49 48 48 2511
marc.saluzzi@lu.pwc.com

David Newton
PricewaterhouseCoopers (UK)
Global Investment Management Tax Leader
+44 20 7804 2069
david.newton@uk.pwc.com

Tony Artabane
PricewaterhouseCoopers (US)
Global Hedge Funds Leader
+1 646 471 7830
anthony.artabane@us.pwc.com

Brendan McMahon
PricewaterhouseCoopers (Channel Islands)
Global Private Equity Investment Management Real Estate Leader
+44 1534 838234
brendan.mcmahon@je.pwc.com

Henrik Steinbrecher
PricewaterhouseCoopers (Sweden)
Global Real Estate Industry Leader
+46 8 555 330 97
henrik.steinbrecher@se.pwc.com

Barry Benjamin
PricewaterhouseCoopers (US)
Americas Investment Management and Real Estate Industry Leader
+1 410 783 7623
barry.p.benjamin@us.pwc.com

Robert Grome
PricewaterhouseCoopers (Hong Kong)
Asia Pacific Investment Management and Real Estate Industry Leader
+852 2289 1133
robert.grome@hk.pwc.com

Kees Hage
PricewaterhouseCoopers (Luxembourg)
European Investment Management and Real Estate Industry Leader
+352 49 48 48 2059
kees.hage@lu.pwc.com

Pars Purewal
PricewaterhouseCoopers (UK)
UK Investment Management and Real Estate Leader
+44 20 7212 4738
pars.s.purewal@uk.pwc.com

Territory Leaders

Andrea Cerne-Stark
PricewaterhouseCoopers (Austria)
+43 1 501 88 1720

Emmanuele Attout
PricewaterhouseCoopers (Belgium)
+32 2 710 40 21

Brendan McMahon
PricewaterhouseCoopers (Channel Islands)
+44 1534 838234

Costas Mavrocordatos
PricewaterhouseCoopers (Cyprus)
+357 22 555 202

Petr Kriz
PricewaterhouseCoopers (Czech Republic)
+420 2 5115 2045

Mikael Sørensen
PricewaterhouseCoopers (Denmark)
+45 3945 9102

Urmas Kaarlep
PricewaterhouseCoopers (Estonia)
+372 614 1801

Tuukka Lahkela
PricewaterhouseCoopers (Finland)
+358 9 2280 1333

Jean-Pierre Bouchart
PricewaterhouseCoopers (France)
+33 1 5657 1702

Arno Kempf
PricewaterhouseCoopers (Germany)
+49 69 9585 2367

Edgar C Lavarello
PricewaterhouseCoopers (Gibraltar)
+350 782 6724

Nicos Komodromos
PricewaterhouseCoopers (Greece)
+30 210 6874 671

David Wake
PricewaterhouseCoopers (Hungary)
+36 1 461 9514

Hjalti Schiöth
PricewaterhouseCoopers (Iceland)
+354 550 5337

Damian Neylin
PricewaterhouseCoopers (Ireland)
+353 1 792 6551

Mike Simpson
PricewaterhouseCoopers (Isle of Man)
+44 1 624 689 689

Joseph Fellus
PricewaterhouseCoopers (Israel)
+972 3 795 4683

Elisabetta Caldirola
PricewaterhouseCoopers (Italy)
+39 02 7785 380

Juris Lapshe
PricewaterhouseCoopers (Latvia)
+371 6709 4505

Chris Butler
PricewaterhouseCoopers (Lithuania)
+370 5 239 2303

John Parkhouse
PricewaterhouseCoopers (Luxembourg)
+352 49 48 48 2133

Joseph Camilleri
PricewaterhouseCoopers (Malta)
+356 25 647 603

Fred Gertsen
PricewaterhouseCoopers (The Netherlands)
+31 10 407 6622

Geir Julsvoll
PricewaterhouseCoopers (Norway)
+47 23 16 0540

Antoni F Reczek
PricewaterhouseCoopers (Poland)
+48 22 5234 339

António Assis
PricewaterhouseCoopers (Portugal)
+351 213 197 013

Vasile Iuga
PricewaterhouseCoopers (Romania)
+40 21 202 8800

Richard Gregson
PricewaterhouseCoopers (Russia)
+7 095 967 6327

Peter Vazan
PricewaterhouseCoopers (Slovak Republic)
+421 259 350 472

Pierre de Villiers
PricewaterhouseCoopers (South Africa)
+27 11 797 5368

Antonio Greño
PricewaterhouseCoopers (Spain)
+34 91 568 4636

Sussanne Sundvall
PricewaterhouseCoopers (Sweden)
+46 8 555 33 273

Thomas Huber
PricewaterhouseCoopers (Switzerland)
+41 58 792 2436

Pars Purewal
PricewaterhouseCoopers (UK)
+44 20 7212 4738

If you would like to receive copies of this newsletter or would like further information about PricewaterhouseCoopers Investment Management and Real Estate publications, please contact Denise Cook at denise.cook@uk.pwc.com

Editor: Rupert Bruce

The member firms of the PricewaterhouseCoopers network provide industry-focused assurance, tax and advisory services to build public trust and enhance value for its clients and their stakeholders. More than 146,000 people in 150 countries across our network share their thinking, experience and solutions to develop fresh perspectives and practical advice.

This report is produced by experts in their particular field at PricewaterhouseCoopers, to review important issues affecting the financial services industry. It has been prepared for general guidance on matters of interest only, and is not intended to provide specific advice on any matter, nor is it intended to be comprehensive. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers firms do not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

pwc.com

© 2008 PricewaterhouseCoopers. All rights reserved. PricewaterhouseCoopers refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.