CPD Quarterly Quiz

July 2008

TREASURY, RISK AND FINANCE PROFESSIONALS ACT

Question 1

The FSA has announced that it will be adopting a policy of 'credible deterrence' on market abuse. This will involve tough measures, more severe sanctions and an increased volume of cases pursued.

What is this policy intending to address?

(a) short selling
(b) insider trading
(c) stock borrowing
(d) bonus payments for inadequate performance
(e) don't know

Answer
The right answer is (b) insider trading

The ACT had again argued that it cannot be right to trade when in the possession of "relevant information not generally available" or RINGA. The EU's definition (in the Market Abuse Directive) is less all embracing than the standards currently used in the UK, requiring information to be precise before the action becomes prohibited.

The Treasurer, June 08, Technical Update..

Question 2

There are at least two embedded options within the 'pension augmented balance sheet' i.e. the combined balance sheet for company plus its pension scheme.

Which of the following describes those two options?

(a) a put on pension scheme investments with an exercise price equal to the value of scheme liabilities, and a put on the potential surplus within the scheme
(b) a put on pension scheme investments with an exercise price equal to the value of scheme liabilities, and a call on the potential surplus within the scheme
(c) a call on pension scheme investments with an exercise price equal to the value of scheme liabilities, and a call on the potential surplus within the scheme
(d) a call on pension scheme investments with an exercise price equal to the value of scheme liabilities, and a put on the potential surplus within the scheme
(e) don't know

Answer
The right answer is (b) a put on pension scheme investments with an exercise price equal to the value of scheme liabilities, and a call on the potential surplus within the scheme

The put option reflects the fact that a sponsor may be required to make up any deficit in the scheme. The call option reflects the potential for a surplus to arise in the pensions scheme assets. This is likely to be shared between the scheme and the sponsor although any deficit can be regarded as wholly belonging to the sponsor.

The Treasurer, June 2008, Transferring the Risk by John Hawkins and Tim Keogh pp26-29. This article was developed in the July issue with a second article.

Question 3

Which is the most likely to be a source of difficulty on full implementation of the Payment Services Directive (PSD)?

- (a) The PSD defines a business day as a day when all jurisdictions to the transaction are open, whereas the FX convention is when the payer is open.
- (b) The PSD defines a business day as a day when all jurisdictions to the transaction are open, whereas the FX convention is when the receiver is open
- (c) FX transactions settle after 1 day whereas PSD requires settlement after 2 days
- (d) FX transactions settle after 2 days whereas PSD requires settlement after 1 day
- (e) don't know

Answer

The right answer is (d) FX transactions settle after 2 days whereas PSD requires settlement after 1 day

The Treasurer, June 08, Prepare for the Payment Services Directive by Dermot Turing and Julia Smithers Excell pp35-37.

Question 4

Loan obligations of syndicated borrowers have been trading significantly below par. This might be regarded as an opportunity to buy back debt at advantageous prices. However there can be problems.

Which of the following gives the real problems to such buy backs?

- (a) If a borrower buys back its own debt from the lender then it is effectively contracting with itself which is not allowed under English law
- (b) If a borrower buys back and extinguishes a debt, this is likely to infringe the prepayment requirements
- (c) If a borrower buys back part of its debt with the intention of extinguishing that part, then it could be infringing a duty to treat all lenders pro rata
- (d) All of the above
- (e) don't know

Answer

The right answer is (d) All of the above.

In addition, if the cash for the buy-back has come from asset disposal then the permitted use of proceeds of disposal may be contravened. The LMA is addressing the problems posed by the above. It hopes to amend the LMA template loan document to permit negotiation on whether buy-backs should be permitted or not.

The Treasurer July/August 08, Technical Update

Question 5

The IASB has issued a discussion paper on ways to reduce the complexity of IAS 39. Specifically it addresses hedge accounting. It recognises that in the longer term a wider application of fair-value accounting would lead to fewer occasions when hedge accounting was required because the hedge and the underlying exposure are more likely to be accounted for at fair value. The paper then discusses three methods for more immediate reduction of complexity in hedge accounting.

Which of the following is NOT one of the three methods discussed?

(a) allow a fair value option for instruments that are not automatically valued at fair value
(b) permit recognition outside earnings of gains and losses on ‘hedging instruments’.
(c) permit recognition of the present value of expected future cashflows as an asset to offset cashflow hedges
(d) permit recognition outside earnings of gains and losses on financial instruments
(e) don’t know

Answer

The right answer is (c) permit recognition of the present value of expected future cashflows as an asset to offset cashflow hedges.

There is no suggestion that cashflow hedges should be amended at all. The incorporation of the present value of expected cashflows might present a natural offset for cashflow hedges – but there might be a few other side effects of introducing expected cashflows into the accounts!

The Treasurer, July/August 2008, Technical Update Extra by Martin O’Donovan.

Question 6

At the end of May 2008, the Pension Protection Fund (PPF) announced an increase to its Pension Levy Scaling Factor.

What is the Pension Levy Scaling Factor?

(a) The extra levy paid by pension schemes with over 60% assets invested in equities
(b) The multiple by which each schemes levy is increased to ensure that the PPF meets its funding requirement
(c) The scaling difference for schemes in deficit
(d) The scaling difference for schemes with a D&B rating below 63
(e) don’t know

Answer

The right answer is (b) The multiple by which each schemes levy is increased to ensure that the PPF meets its funding requirement

Sponsors can attempt to control the ‘internal’ risk of the scheme, i.e. its funding level and its investment risk, as well as their own bankruptcy risk. Unfortunately the third dimension of the PPF levy is the scaling factor – and that is entirely in the gift of the PPF.
The published estimate for the scaling factor last November was 1.6. By the time the final figure was published, it has risen to 3.77!

The Treasurer, July/August 2008, In Search of Stability by Peter Williams and Deborah Cooper