

Quarterly Quiz

Autumn 2008

Question 1

Earlier this year the ASB proposed changes to the way in which the present value of future pension liabilities are reported. Given the financial turmoil of recent times, valuation methodology has again been in the spotlight.

Regarding the present value of defined benefit pension liabilities, which of the following is most true?

- (a) "True value" has increased but "reported value" has reduced
- (b) "True value" has increased and "reported value" has increased
- (c) "True value" has reduced and "reported value" has reduced
- (d) "True value" has reduced but "reported value" has increased
- (e) Don't know

Answer

The right answer is (a) "True value" has increased but "accounting value" has reduced

Under current accounting rules the future pension liabilities are discounted at the AA band rate. Wider credit spread have increased yields on AA bonds (recently to 2.5% above gilts) which has the effect of reducing accounting values for liabilities. The increase in yield is due to the extra perceived risk associated of bonds in this category, many of whose issuers are financial institutions.

Earlier in 2008 the ASB proposed that the risk free rate on gilts be used as a discount rate rather than the current requirement to use the rate for AA corporate bonds. This proposal was roundly rejected at the time, partly due to the impact it would have of increasing pension deficits.

What of the "true value"? Is it realistic to suppose that the likelihood of having to meet these liabilities in the future has changed, or that their value is likely to be more eroded by inflation? In reality the value of future pensions has little to do with the situation that arises when many AA bond issuers are seen as riskier. As the market value of future certainty is rising, surely the real value of pension liabilities is also rising.

This has been pointed out by the Chairman of the Pension Regulator, Mr David Norgrove.

FT October 29: Regulator slams pension rules as bizarre, by Norma Cohen

Question 2

Due to the uncertainty surrounding the interbank markets, particularly the lack of liquidity, it has been suggested that some banks may be invoking the 'market disruption' clause often found in corporate loan agreements.

In the LMA syndicated credit facility documentation for investment grade borrowers, and many other loan agreements, what constitutes 'market disruption'?

- (a) a significant fall in the volume of deposits traded in the interbank market at the specified maturity
- (b) absence of a LIBOR screen rate
- (c) a significant proportion of lenders say their cost of funding is greater than LIBOR
- (d) the credit spread of LIBOR over gilts reaches 100 basis points
- (e) don't know

Answer

The right answer is (c) a significant proportion of lenders say their cost of funding is greater than LIBOR

The screen rate may not be available for a variety of reasons, including technological reasons. In this case the Agent contacts Reference Banks and calculates an average from their quotes: in itself this does not trigger a market disruption event. That trigger is either the combination of no screen rate **and** no average from the Reference Banks or a significant proportion of lenders saying that their cost of funding is greater than LIBOR. Of course, under normal conditions banks would be reluctant to admit a difficulty in raising funds at LIBOR.

Loan Agreement Market Disruption Clauses to be Invoked only as a Last Resort; ACT website
<http://www.treasurers.org/marketdisruption/pressrelease>

A Guide to the Loan Market Association Documentation for Investment-Grade Borrowers; ACT website: <http://www.treasurers.org/loandocumentation/investmentgrade>

Question 3

As corporate borrowers are concerned to maintain their access to funding and simultaneously lenders are concerned to limit their exposure to credit risk the potential for break down of lending syndicates to is high. The new Borrower's Guide to LMA Facilities Agreement for Leveraged Transactions incorporates reference to various clauses in which syndicates might be modified to deal with troublesome minority lenders. These are 'yank the bank', 'snooze and lose' and 'delay and it's OK'.

Which is the correct order for these clauses, putting the most aggressive first and the most gentle last?

- (a) 'snooze and lose', 'yank the bank', 'delay and it's OK'
- (b) 'delay and it's OK', 'yank the bank', 'snooze and lose'
- (c) 'delay and it's OK', 'snooze and lose', 'yank the bank'
- (d) 'yank the bank', 'delay and it's OK', 'snooze and lose'
- (e) Don't know

Answer

The right answer is (d) 'yank the bank', 'delay and it's OK', 'snooze and lose'

'Yank the bank' gives the right to remove uncooperative banks from the syndicate, and therefore is the most aggressive clause. Next in order of aggression is 'delay and it's OK' where any lender who does not respond within a given time period is assumed to have given consent. The least aggressive, or most gentle is 'snooze you lose' where lenders who fail to respond are disregarded from the perspective of determining whether a majority of lenders has been obtained.

How Borrowers Can Protect their Funding Availability; ACT website,
<http://www.treasurers.org/loandocumentationleveraged/pressrelease>

The ACT Borrower's Guide to the LMA Facilities Agreement for Leveraged Transactions;
ACT website, <http://www.treasurers.org/loandocumentation/leveraged>

The Guide is also referenced in The Treasurer, October 2008, Drawing from Leveraged Lending by Philip Snell and Kathrine Meloni of Slaughter & May, <http://www.treasurers.org/node/4047>

Question 4

The demise of Lehman Brothers has lead to many problems for both financial institution and corporate counterparties of the failed bank.

Imagine that you are treasurer of a company for whom the lenders included a non-UK Lehman entity acting through a UK branch. There were no provisions in the loan agreement covering this situation, nor was there any reference to withholding tax. The Lehman entity has now ceased to trade.

Which of the following reflects the action that should have been taken?

- (a) No action at all should have been taken
- (b) The withholding tax exemption no longer applies and you should now be withholding tax from tax from interest payments.
- (c) The withholding tax exemption no longer applies and you should be grossing up your interest payments for withholding tax
- (d) You should have ceased all payments under the agreement.
- (e) Don't know

Answer

The right answer is (b) The withholding tax exemption no longer applies and you should now be withholding tax from tax from interest payments.

If the non-UK Lehman entity has ceased to trade then the usual withholding tax exemption will no longer be available. If there were specific provisions to cover this situation then these provisions may require grossing-up of the tax, otherwise tax should be withheld.

Lehman Brothers Situation, general comments re tax situations, by LMA and Clifford Chance;
ACT website, <http://www.treasurers.org/node/4061>

Question 5

HM Treasury has announced plans for a special resolution regime for failing banks. The aim is to reduce the potential for any threat to financial stability. Any necessary legislation is expected later this year.

The regime involves action and responsibility by the Financial Services Authority (FSA), the Bank of England (BoE) and HM Treasury (HMT).

Which of the following reflects the plans announced?

- (a) The FSA will trigger the special resolution regime, the BoE will decide what measures to employ, HMT will determine whether public funds may be used
- (b) HMT will trigger the special resolution regime in consultation with the BoE and the FSA will decide what measures to employ.

- (c) The BoE will trigger the special resolution regime, the FSA will decide what measures to employ, HMT will determine whether public funds may be used
- (d) The FSA will trigger the special resolution regime and decide what measures to employ, HMT will determine whether public funds should be used
- (e) Don't know

Answer

The right answer is (a) The FSA will trigger the special resolution regime, the BoE will decide what measures to employ, HMT will determine whether public funds may be used.

The special resolution regime will be governed by the Financial Stability Committee (FSC) of the Court of the Bank of England. One of the details that are yet to be resolved is the governor of the Bank being accountable to the FSC, which he chairs.

The Treasurer, September 2008, Technical Update by Martin O'Donovan,
<http://www.treasurers.org/node/3981>

Question 6

Earlier this year the EU made proposals regarding credit rating agencies. Very soon after the end of the consultation period the Commissioner said that he intends to propose binding registration and an external oversight regime with European regulators supervising the agencies' policies and procedures.

Among those warning against the proposals was the European Associations of Corporate Treasurers (EACT). What were the main objections of EACT?

- (a) the proposals threaten competition and innovation and may result in higher costs
- (b) the proposals major on inappropriate and fruitless detail
- (c) the proposals concern traditional sovereign and corporate ratings rather than the structured finance instrument ratings at the heart of recent problems
- (d) all of the above
- (e) don't know

Answer

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

It is surprising that the Commissioner has indicated that he intends to press ahead so soon after the close of consultation – some say before the results of the consultation can have been analysed. It has been said that the need to be seen to be doing something is of major importance to politicians at the present time.

The Treasurer, October 2008, Technical Update by Martin O'Donovan,
<http://www.treasurers.org/node/4065>