IN BRIEF

In August 2010 the IASB and FASB accounting standards boards jointly published **exposure draft ED/2010/9 on lease accounting**, with its proposed amendments to IAS 17. Among the proposals are that operating leases should be recorded on the balance sheet (currently only finance leases are), which will ensure one accounting model for all leases. Also proposed is for accounting for lessors to be based on whether there has been a transfer of significant risks or benefits of the underlying asset. The exposure draft also proposes basing the accounting for leases on the expected lease term, which includes options to extend or terminate, rather than the current minimum lease term (for finance leases only).

The ACT is in general agreement with the overall approach to a "right to use" accounting model, with both lessees and lessors recording assets and liabilities arising from lease contracts. However, in our response to the IASB consultation we noted that conceptually it is difficult to understand why one accounting model covers all lease situations from the lessee's perspective while the same lease contracts require two different accounting models for the lessor. The performance obligation approach results in the asset being capitalised onto the balance sheet of two different parties, the lessee and the lessor. We also highlighted the practical difficulties for treasurers of implementing some of the proposals – e.g. assessing and making judgement calls on the lease term.

See A New Lease of Life, p40

The government has published its **final legislation on the bank levy** first announced in the June Budget. This will introduce a levy based on banks' balance sheets from 1 January 2011, and is intended to encourage banks to move to less risky funding profiles.

The final legislation revises the rate of the levy and introduces an allowance rather than a threshold. The levy is estimated to generate £2.5bn of annual revenues and has been introduced with two aims: to ensure banks make a fair contribution that recognises the potential risks they pose to the UK financial system as a whole and to the wider economy; and to encourage banks to make greater use of more stable sources of funding, such as long-term debt and equity.

INTRODUCTION

By Michelle Price
ACT technical officer, policy and technical

A new face on the Technical Update pages! I joined the policy and technical team just over three months ago and have been busy not only drafting consultation responses but also attending government and financial association meetings to keep ahead of the knowledge curve. I can now say I've been into the Bank of England building twice (it's well worth a look for its glorious architecture and Roman-style mosaics).

What has surprised (and impressed) me is the huge amount of work the ACT does behind the scenes, which as a member I wasn't aware of. ACT policy and technical director John Grout and assistant policy and technical director Martin O'Donovan are constantly reviewing ideas put forward by banks, regulators, government bodies, etc, and responding as the voice of the treasurer. Some of these proposals never make the press – I guess because they were so absurd in the first place.

Companies fall down on strategy disclosure

Given the stress that investors place on understanding a management's business strategy, the narrative reporting in the annual report and accounts is of real importance as it is one of the few occasions when management can make public disclosures.

However, in its recent consultation, the Department for Business Innovation and Skills found that investors regarded company statements on forward-looking strategy and principal risks and opportunities as "patchy and often unsuitable for forecasting future performance. Strategy was generally focused on the past rather than the future and tended to be too broad."

Companies, on the other hand, thought that they were providing useful and relevant information.

For investors, the worry was that "risks were not linked clearly to company strategy and it was not always clear how those risks were being managed".

Meanwhile in December 2010 the IASB published an IFRS practice statement (Management Commentary: A Framework for Presentation) – a form of non-binding guidance that outlines the key elements of management commentary. This is the culmination of an IASB project that started in 2002, with a discussion paper in 2005 leading to a 2009 exposure draft. Much of it is highly relevant to treasurers drafting sections of their company's reports. The IASB recommends that management should do the following:

- disclose its objectives and strategies in a way that enables users of the financial reports to understand the priorities for action as well as to identify the resources that must be managed to deliver results;
- disclose an entity's principal risk exposures and changes in those risks, together with its plans and strategies for bearing or mitigating those risks, as well as disclosure of the effectiveness of its risk management strategies;
- distinguish the principal risks and uncertainties facing the entity, rather than listing all possible risks and uncertainties;
- provide discussion and analysis of significant changes in financial position, liquidity and performance compared with previous periods;
- include forward-looking information when it is aware of trends, uncertainties or other factors that could affect liquidity, capital resources, revenues and the results of operations; and
- avoid presenting an over-optimistic picture – forward-looking information must be neutral.

The intent is to move closer to the US approach, where the MD&A (Management Discussion and Analysis) aims to offer narrative explanations as seen through the eyes of management. In the UK, the ASB Reporting Statement 1: The Operating and Financial Review provides more detailed guidance covering much the same ground and taking into account the Companies Act 2006 requirements for an enhanced Business Review for listed companies. ■

Super-pensioners get Lehman preference

The Lehman Brothers bankruptcy has been throwing up some contentious judgements in the UK courts with implications that will flow back into the legal situation of certain treasury transactions. In December 2010 the High Court ruled against the creditors of Lehman Brothers International Europe and gave certain pension liabilities super-priority over other creditors.

Generally debts incurred after the start of an administration do not have a claim on the company in administration unless they are expenses of administration (i.e. those liabilities essential to the conduct of the administration), in which case they have priority. In this case, where the Lehman pension scheme was in deficit, the Pensions Regulator extended the pension obligation to connected companies through a financial support direction, and when that support was not forthcoming, issued a contribution notice. However, the contribution notice was issued after the firm had entered administration and by a quirk of the drafting of the Pensions Act 2004 the judge found that this liability had to be treated as an administration expense.

The judge recognised that his judgement would "hang like an enormous sword of Damocles above the administration, paralysing it in all relevant respects" and that the outcome was "likely to prove unfair to the creditors of an insolvent target".

Super-priority means that the contribution notice ranks ahead of floating charges but behind liabilities with fixed charges. Even so, it is likely to complicate any restructurings if the banks have to look at potential liabilities for a group pension deficit and distributions to creditors are frozen until this liability is ascertained and resolved.

A further finding in the case of the Lehman administrators concerned outstanding swaps. The ISDA terms meant that the non-defaulting party could withhold payments to the party in default or potentially in default, as was the case with Lehman. The non-defaulting party had the right not to terminate; had it opted to terminate, then, since Lehman was in the money on the deals, it would have had to make payment to the administrators. This case seemed unfair to Lehman but the judge found that it did not contravene the anti-deprivation principle. ■

Banking sector counts the costs of Basel III impact

McKinsey has assessed the potential impact of Basel III on the European banking sector in a report issued in November 2010. Assuming full implementation by 2019 and before any mitigating actions by banks, McKinsey estimates that banks' pretax return on equity would decrease by between 3.7 and 4.3 percentage points from the pre-crisis level of 15%, mainly because of the impact on capital and funding requirements.

Basel III will require banks to put aside more capital to cover counterparty risk on derivatives with both banks and corporates. Smaller banks will have fewer offsetting positions and will therefore require greater hedging. This may result in higher costs due to their hedging activity. McKinsey estimates that the cost of over-the-counter (OTC) derivatives to banks will increase by up to 85 basis points on the market value of unnetted, uncollateralised positions on average. OTC derivative activities will require banks to hold more capital for both market risk and counterparty credit risk

Uncommitted credit lines to corporates are estimated to have a cost increase of 45bps (30bps for higher liquidity requirements plus 15bps for higher capital requirements). Both short-term and long-term corporate loans are estimated to increase costs by between 45bps and 50bps.

While the magnitude of cost increases is debatable, the direction appears to be clear. What remains to be seen is to what extent corporates will bear the brunt in higher fees and margin. For a copy of the McKinsey report, go to **http://bit.ly/hLLJvm**

See Piecing B3 Together, p34

IN BRIEF

The market position of credit rating agencies has been the subject of a European Commission consultation. The official concern is over mechanistic reliance on external ratings and a lack of competition in ratings. The ACT response is as follows:

- We agree that excessive hard coding of ratings within regulation can have a destabilising herding effect but would not want excessive prescriptions around this. We view the alternative of using credit default swaps or bond spreads as inappropriate in regulation.
- We see no need to change the charging model for sovereign ratings, nor to force free disclosure of the full sovereign rating reports.
- We would view special central bank rating bodies as anti-competitive especially if their ratings were mandated in regulation; nor would a subsidised European Rating Agency help.
- Civil liability would create a major barrier to new competition in the industry and would turn credit rating agencies into credit insurers, with huge cost implications for issuers.
- In most cases the current "issuer pays" model does not really cause a conflict of interests.

A new-style **increased cost clause** is being built into recent loan agreements in the US. Increased cost clauses normally let lenders pass on costs from new laws and regulation arising after signing, but with the uncertainty on the cost implications of the Dodd-Frank Act some loans have been signed with the increased cost clause applying "regardless of the date" when the cost-triggering change occurs. There are no similar moves in Europe but we may yet see pressure from the US banks.

The government is to tackle **tax avoidance** and is implementing two proposals with immediate effect:

- preventing a group using intra-group loans or derivatives to reduce the group's tax bill; and
- addressing schemes where a company does not fully recognise certain amounts in its accounts involving loans and derivatives.

A further measure relevant to treasurers is stopping investment companies retrospectively changing the currency they prepare their accounts in for tax purposes.

In addition to the above a study on a General Anti Avoidance Rule (GAAR) will be undertaken to consider whether a GAAR could deter and counter tax avoidance, while retaining a tax regime that is attractive to businesses.

IN BRIEF

A proposed new **EU regulation on energy market** integrity and transparency is designed to prevent market manipulation and insider trading. It would remove the anomaly that energy derivatives traded on energy exchanges are covered by MiFID and the Market Abuse Directive while the large physical energy market is not.

The Markets in Financial Instruments Directive or MiFID came into force in 2007 and is now up for review by the European Commission. Under consideration is an extension of the transparency rules to new markets such as bonds and even OTC derivatives. This could mandate disclosure of pre and post trading prices and data. Another section covers underwriting and placing and the conduct of business around allotment processes. The ACT would be concerned were any new rules to remove the flexibility an issuer has to allocate bonds as it and the lead managers feel fit.

The Rights Issue Fees Group set up by the Institutional Investor Council released its findings in early December. While the risks borne by the lead underwriters have generally fallen in the last decade, fees have not come down accordingly. The group found investors concerned about the high underwriting fees that banks charge and the lack of transparency around them. The report concluded that because most non-financial companies are not regular users of the capital markets they negotiate fees from a less well-informed position than their bank advisers. Their perception of the "cost of getting it wrong" may also be an inhibiting factor in attempting to negotiate lower fees.The inquiry has made a number of recommendations. The full report is available at **http://bit.ly/fcyUVE**

The International Chamber of Commerce (ICC) launched new Incoterms 2010 rules in Paris last September that took effect from 1 January 2011. The Incoterms rules are widely used in international sales and govern the costs, risks and practical arrangements on the sale and movement of goods. There are significant changes in the 2010 rules: four have been removed and two new ones developed. There are also changes to deal with cargo security and insurance. The rules have been generally updated to make them more user-friendly and to mirror the modern language of international trade.

OTC derivative update

The European Market Infrastructure Regulation (EMIR for short) has passed on from the European Commission and is working its way through redrafting in the EU Parliament and the Council of Ministers.

Although nothing is set in stone, a great deal is taking shape, with a presidency compromise proposal released in mid-December.

The scope is extended to cover not just over-the-counter (OTC) derivatives but also those traded on a multilateral trading facility or a regulated exchange. A pension funds exclusion is no longer mentioned in EMIR but is still on the table for discussion.

The concept of a threshold size beyond which trades must be reported has also been removed and the reporting obligation now applies to all counterparties to swaps, not just the financial counterparty. However, a non-financial counterparty may delegate this reporting obligation to the financial party.

The all-important clearing threshold still exists beyond which deals must be passed through a central counterparty and therefore margined, but the draft regulation now makes clear that only deals done after the threshold has been crossed must be cleared. The exact threshold is not specified but hedging transactions are not included in its calculation. The ACT is pressing HM Treasury to make representations in the Council to ensure that the hedging definitions cover group exposures, and not just the single dealing entity's exposures. There remains a risk that further changes may mean that once the threshold is crossed all old deals will have to be margined, creating a looming cliff-edge requirement for vast reserves of liquidity for companies approaching the threshold.

Under the equivalent US legislation, central clearing is required of major swap participants (defined as those holding a "substantial position" in swaps). Two alternative definitions of the term have now been provided by the Commodity Futures Trading Commission (CFTC) and the SEC. Crossing either would bring a company within the clearing obligation.

The first test for a "substantial position" would be a daily average mark-to-market exposure (after netting) of $1bn for each of the three categories of swap (equity, commodity and credit), but $3bn for the fourth major category (rate and foreign exchange swaps). Exposures arising from "hedging or mitigating commercial risk" are excluded.

The second test doubles the exposure limits but in calculating the exposures the potential future exposure is added to the current exposure using a complex methodology. ■

EU sets SEPA deadline

In December the European Commission proposed setting EU-wide end-dates for migrating the old national credit transfers and direct debits to Single Euro Payments Area (SEPA) instruments. With only one in 11 credit transfers in the euro area currently executed using a pan-European payment instrument, the Commission has decided that self-regulation simply isn't driving the migration to SEPA fast enough.

Internal market and services commissioner Michel Barnier said: "The proposal fixes end-dates to make this pan-European system a reality, hopefully as early as 2012."

The deadline has been welcomed enthusiastically by most market participants and should allow banks, corporations, small and medium-size enterprises and individuals to prepare properly for the change-over. However, there are still many issues surrounding SEPA, and progress will be governed not so much by corporations as by individual consumers, many of whom do not yet understand SEPA or its benefits.

To ensure interoperability, the use of common standards such as international bank account numbers (IBANs) and bank identifier codes (BICs) will be mandatory for all payments in euros in the EU, and financial messaging standard ISO 20022 XML for all bulk payment files.

At the annual SEPA conference held in Brussels in December 2010, much of the talk was of technology, with mobile payments, e-invoicing and real-time payments at the forefront. There is a groundswell of support emerging for real-time payments, with certainty of payment important for retailers and corporations with rapidly moving credit risk issues. Treasurers would also like real-time liquidity information and many do not appreciate why payments take so long. Forget D+1 – H+0 seems to be the new objective.