IN BRIEF

▸ Draft legislation on **over-the-counter derivatives** is expected from the European Commission in June 2010. Little by little the official thinking on various elements is taking shape. It is now almost certain that non-financial companies will not be obliged to clear OTC derivatives through a central counterparty, unless their positions pose a "systemic risk". As a result, businesses should be able to avoid the complications of providing collateral in the form of margin unless their dealings cross certain size thresholds that are yet to be determined. The European Association of Corporate Treasurers (EACT), through its chairman Richard Raeburn, was given the opportunity to give a presentation on the issues to the members of the Commission's ECON Committee. His presentation covered why end-users use derivatives, how derivatives are used, whether there is any evidence that end-users cause systemic risk, and whether SMEs should be treated differently from corporates.

▸ **The Financial Services Act 2010** received royal assent following the "wash-up" before parliament was dissolved in April. The act requires the FSA to force some banks to prepare recovery and resolution plans (living wills) and to lay down remuneration rules, and gives the FSA the power to make rules to ban short-selling in financial instruments. Provisions to allow "collective redress" (class-action lawsuits) against financial organisations involved in "mass failures of practice" have been dropped.

▸ A new **SEPA Direct Debit Fixed Amount (SDD FA)** scheme is out for public consultation. The exact amount and frequency of the direct debit collection is agreed between the payer (debtor) and the biller (creditor). Under SDD FA, as permitted by the Payment Services Directive, the refund right will be excluded for authorised transactions but the 13-month refund period will remain for unauthorised transactions.

▸ The European Payments Council (EPC) customer stakeholder forum, which represents the EPC and user organisations including the EACT, has prepared a questionnaire about the experience of users inputting **IBAN and BIC** (International Bank Account Number and Bank Identifier Code). There have been suggestions that some bank customers may have problems using these two identifiers when initiating SEPA credit transfers. The questionnaire will remain open until the end of June and is at **bit.ly/bGmH8Y**

INTRODUCTION

By Martin O'Donovan
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All corporate treasurers have had to weather the problems of the financial crisis: the lack of liquidity in the various markets, the banks' new attitude to risk and the constraints of their own balance sheets, all of which have occurred despite the banks and financial systems being subject to existing regulation. The regulators are now setting about prescribing a new medicine to remedy failures in the health and stability of the financial system. However, there is a grave risk that while we may indeed end up with a safer system, the Basel III proposals will have the side effect of so limiting the banks that once again loans and bank services at reasonable prices will be in scarce supply. A better balance is needed.

Capital constraints come closer for the banks

In the wake of the financial crisis the banking regulatory authorities have issued proposals to improve the control of liquidity risk exposures in credit institutions along with changes to the requirements for regulatory capital.

The proposals come from the Bank for International Settlements and its Basel Committee on Banking Supervision (Basel III). The European Commission is also consulting on alterations to its Capital Requirements Directive (CRD IV)

In responding to these consultations, the ACT has welcomed moves that address the stability of the financial system but has warned of the importance of leaving that system fit for purpose in serving its customers. Regulation should not make the provision of financial services to non-financial companies excessively difficult or unreasonably costly.

The punitive increases in the capital required against unmargined over-the-counter (OTC) derivative transactions is a case in point. Non-financial companies have been winning the argument on OTC derivatives, with the European Commission agreeing not to impose mandatory central clearing and the provision of margin on them. Having accepted the reasoning for this, the Commission would be acting illogically if it enforced central clearing and collateral by imposing excessive capital charges on banks doing derivatives with companies.

Over and above the need for banks to keep higher amounts of capital against business they write, the proposals attempt to redress the severe shortage of liquidity that occurred during the crisis by requiring banks to hold at all times high-quality liquid assets sufficient to cover all the bank's potential net outflows for 30 days. Were this rule to be imposed, all undrawn committed loan amounts would need to be covered by holdings of liquidity. In basic terms a bank might end up funding itself long term and reinvesting in short-dated government bills with a cost of carry of many percent – a huge cost to be loaded onto the commitment fee.

For banks, any holdings of corporate obligations, whether bonds or loans, are inherently illiquid. The ability to use corporate obligations as collateral, particularly with central banks, is an important alternative source of liquidity. The ACT recommended that at least investment-grade corporate obligations should be eligible with central banks. Assuming this background, it is then appropriate that eligible corporate obligations count, with appropriate limits and haircuts, toward meeting the liquidity obligations of financial institutions.

Delving further into the liquidity obligations of group companies within a bank, the provision of internal credit facilities to a bank subsidiary will not count as a liquidity inflow, adding further to the bank's costs and possibly affecting the bank's ability to offer cost-effective international pooling systems for its customers.

The Basel III proposals are due to be finalised in time for the G20 summit in Seoul, South Korea, this November. ■

Own credit risk could be shunted out of P&L

Last month the International Accounting Standards Board (IASB) launched a consultation on proposed changes to the fair-value option for financial liabilities. Back in November 2009 when IFRS 9 was issued (covering financial instruments, recognition and measurement), only financial assets were covered and the consideration of the treatment of liabilities was deferred.

The consultation aims to address the volatility in the income statement (the profit and loss, or P&L) caused by changes in the credit risk of a financial liability ("own credit"), but only for those entities that choose to apply fair value to their financial liabilities.

Changes in a financial liability's credit risk affect the fair value of that liability. When an entity's creditworthiness deteriorates, the fair value of its issued debt will also decrease (and vice versa). For financial liabilities measured using fair value, this causes a gain (or loss) to be recognised in the P&L. Many investors have found this result counterintuitive and confusing.

The IASB proposes a two-step approach to address the P&L volatility arising from own credit as follows:

- the full fair-value change of liabilities under the fair-value option would be recognised in P&L; and
- the portion of the fair-value change due to own credit would be reversed out of P&L and recognised in other comprehensive income.

The result would be that P&L volatility would no longer result from changes in own credit while information on own credit would still be available for investors. Consistent with investor requests, all liabilities that an entity chose to measure at fair value would continue to be on the balance sheet at fair value and a "new" measurement method would not be introduced.

The proposals would not apply to financial liabilities that are required to be measured at fair value (being derivatives and liabilities held for trading).

The IASB's Fair Value Option for Financial Liabilities exposure draft is open for comment until 16 July 2010. ■

Close the pension corridor to improve visibility

Improvements to the recognition, presentation and disclosure of defined benefit plans have been proposed by the IASB. Measurement is not being covered.

The IASB is consulting on the removal from IAS 19 of the "corridor" options that allow a company not to recognise some gains and losses that arise when it changes its estimate of a defined benefit obligation, or when there are changes in the fair value of its plan assets. The IASB proposes instead that companies should recognise these items immediately.

The IASB has put forward for discussion a new presentation approach to improve the visibility of the different types of gains and losses arising from defined benefit plans. Specifically, it proposes that companies should present:

- service cost, in profit or loss;
- finance cost, as part of finance costs in profit or loss; and
- remeasurement, in other comprehensive income.

The proposal complements more general improvements in the presentation of items of other comprehensive income that the IASB plans to begin consulting on in May 2010.

Risk disclosure requirements would be improved for matters such as:

- the characteristics of a company's defined benefit plans;
- the amounts recognised in the financial statements;
- risks arising from defined benefit plans; and
- participation in multi-employer plans.

The exposure draft Defined Benefit Plans is open for comment until 6 September 2010.

IN BRIEF

Optional "new mandate check" functionality is to be included in the next release of the SEPA Direct Debit scheme rulebooks that will be published in November 2010. The new mandate check provides an extended timeline for the optional verification of mandate information by the payer's bank (debtor bank), thus enhancing its ability to provide additional mandate management services to its customers.

Current SEPA Direct Debit schemes are based on a creditor-driven mandate flow. The payer's bank does not receive the mandate and cannot check it, although this omission is redressed through the Payment Services Directive, which grants payers (debtors) the right to a no-questions-asked refund during the eight weeks following the debiting of the payer's account.

In the event of unauthorised direct debit collections, the payer's right to a refund extends to 13 months as stipulated in the directive. The European Payments Council is considering the introduction of a debtor-driven mandate flow so that the payer's bank receives the mandate and can make suitable checks.

The **IAS 39 replacement exposure draft** on amortised cost and impairment includes a proposal to include the initial credit loss estimates for financial assets in the effective interest rate calculation, considering them over the life of a financial asset, and recognising the effect of changes in those initial credit loss estimates as a catch-up adjustment at the time that the change in estimate occurred. To help users understand the logic behind this change, IASB staff have prepared a short document, an example and an audio recording to make the rationale clear.

A follow-up report on the recommendations that **the Rights Issue Review Group** made in late 2008 has been issued by the FSA. Many of the recommendations made for speeding up the rights issue timetables have already been implemented. Likewise, the concept of compensatory open offers, which are sometimes described as similar to a rights issue without nil-paid dealings, have already become established as a useful additional capital-raising tool. Some of the review group's recommendations remain and are reiterated, including the one that issuers should consider the possible increased use of shelf registration for equity issuance.