Compliance curtain descends mid-Atlantic

Financial institutions believe that extraterritorial regulation has proliferated in the wake of the financial crisis, a report from risk consultancy Protiviti suggests.

The group canvassed executives in more than 40 financial institutions across 19 countries. It found that 53% had either decided against entering an overseas jurisdiction or had pulled out as a direct result of the costs of complying with the country's regulations.

Six in 10 respondents agreed that the growth in extraterritorial regulation – that is, the legal ability of a government to exercise authority beyond its normal boundaries, imposing its rules on businesses based in another jurisdiction – had "escalated significantly" since the financial crisis began.

US laws and regulations such as Sarbanes-Oxley, FATCA and Dodd-Frank were cited as having the greatest impact, particularly by UK respondents, while Solvency II and other European/UK directives were seen as having a lesser impact on US companies.

Just over one in three respondents said that more than 25% of their total compliance budgets were swallowed up by complying with laws and regulations outside of their home country, and 45% said it accounted for between 10% and 25%.

More than half the respondent firms (55%) agreed that a degree of extraterritorial application of regulation was necessary and unavoidable, but 28% said it was unnecessary. However, when asked if they preferred global standards to national regulations, 70% opted for the former.

"With the emphasis in the financial services industry on improving performance and managing costs, extraterritorial laws and regulations are noticeably adding to an already complicated picture," said Bernadine Reese, managing director at Protiviti UK.

"As a consequence, global financial institutions are being forced to re-examine and in many cases significantly change the way they are managing compliance risk. Few observers appear to have any expectations that this trend will abate any time soon. Organisations will need to find a way to manage an increasingly complicated and often conflicting web of regulation."

Write-offs to rise as bank loans shrink

Banks and insurers must brace for more corporate insolvencies this year, while bank lending to business will fall further from its 2008 peak, according to an Ernst & Young Item Club report.

Tyne slide: insolvencies set to surge in NE

Write-offs are expected to rise to 1.9% of all corporate loans compared with 1.6% in 2011, with insolvencies likely to rise most sharply in the North East of England and in Wales.

Neil Blake, senior economic adviser to the club, said: "Although 1.9% doesn't sound big, this will be the highest annual rate of write-offs since the mid-90s; and the more loans banks have to write off, the less money they will have to lend."

The report now predicts that the amount lent to businesses by UK banks this year will contract by 6.8%, against a previous estimate of 5.1%, with the total figure falling to £419bn.

"The contraction expected in 2012 is more acute than the 6.1% contraction last year," added Blake, "and means that the funding squeeze that corporates and SMEs have been experiencing is only set to get worse."

The annual lending figure has steadily declined since its peak four years ago of £575bn. The report predicts that it will not return to this level before 2016 at the earliest.

It warns that financial services face "a worsening outlook as the real effect of sluggish growth continues to impact creditor and consumer behaviour". It also criticises the government's most recent initiative to help SMEs by cutting the cost of credit by 1% as "not unhelpful" but too modest to affect hiring and investment plans. ■

Basel blow for trading books

Financial institutions have been warned that the Basel Committee's recent fundamental review of the trading book poses a further threat to profitability.

Osborne: bowing to inevitable

Regulators want banks to hold greater capital reserves against the risk of major losses caused by market freezes. They are keen to close the loopholes that let banks cut capital requirements by including assets in their trading books.

Patrick Fell, a director at PwC, described the increase in capital that banks must hold for their trading positions as "a further turn of the screw for trading books".

He added: "As capital requirements rise, the return on capital will fall and more banks will question their appetite for trading.

"The rules propose a tighter definition of the banking book and trading book, and will allow less arbitrage between the two."

Similar views were expressed by Michael McKee, partner at law firm DLA Piper, who said: "Now that CRD [Capital Requirements Directive] 4 is moving through the EU legislative process, it is likely that this concept will be incorporated into the thinking for this regulation and could be developed in future as part of the implementation of CRD 4."

EU economic and finance ministers agreed in May to strengthen the regulation of the sector with a new CRD after the UK dropped its initial opposition. McKee said that the UK chancellor, George Osborne, was "bowing to the inevitable".

He added: "Basel III is one of the areas where changes in the voting rules mean that Britain has no realistic prospect of obtaining other countries' support to block the proposals. The chancellor is right to say that in the current context financial stability is vital, so the current situation justifies the change of tack." ■

IBE puts e into ethics

Four in 10 FTSE 250 companies offer no training in business ethics to their staff, according to the Institute of Business Ethics' latest survey.

The IBE said businesses whose staff understood codes of behaviour and acted ethically delivered far better financial performance. The institute's e-learning tool, Understanding Business Ethics, has now been translated into French, German and Spanish, to help employees at all levels and in every type of organisation.

The short course, available as an online download, aims to raise awareness of what business ethics is about and help staff understand why ethical values in the workplace matter. Four interactive modules guide employees in recognising and dealing confidently with day-to-day ethical challenges at work.

IBE director Philippa Foster Back said: "The cost to a business if it fails to support staff to do the right thing can far outweigh the cost of a training budget. Fines from regulators, loss of confidence from investors, loss of reputation among customers, loss of assets through fraud – all of these potential integrity risks could be averted by a small investment."

Further details on how companies can utilise the course for their employees – or those of their suppliers – are available by contacting the IBE at info@ibe.org.uk or going to http://tinyurl.com/csprzdr

Foster Back: a small investment in ethical training can help companies to mitigate integrity risk

OTC market shrinks

The outstanding volume of over-the-counter (OTC) derivatives shrank by nearly 10% in the second half of 2011, reports the Bank for International Settlements (BIS).

Notional amounts outstanding had fallen to $647.76 trillion at the end of December, against $706.88 trillion at the end of June. The fall largely reflected declines in the number of interest rate swaps, credit default swaps and equity-linked contracts. Interest rate swaps accounted for more than 75% of the total notional volumes outstanding.

The actual drop may have been even bigger as, for the first time, the data included reports from Australia and Spain and expands the reporting population to dealers in 13 countries.

However, the fall was offset by a sharp jump in the gross market value of all contracts outstanding, which is a way of measuring what it would cost to replace those contracts. This jumped by more than a third to $27.29bn, the biggest increase since the second half of 2008, when an international credit squeeze intensified in the wake of Lehman Brothers' demise. Over the second half of 2011 the euro zone debt crisis extended to Spain and Italy, which are among the world's largest issuers of bonds.

The BIS said the increase was due largely to the impact on outstanding interest rate contracts of the decline over H2 of last year in long-term euro and US dollar interest rates, which pushed up the value of interest rate contracts.

Pension derisking pulls in employers

Employers are engaging more with pension scheme management and increasingly taking on responsibility for derisking, according to research from MetLife Assurance.

The insurer's study of companies last September found that 61% of those with a £1m+ annual turnover accepted primary responsibility in partnership with trustees or sole responsibility for derisking. When a similar survey was conducted in 2010, the figure was 46%.

In the 2011 survey, 40% said derisking was the employer's primary responsibility in conjunction with trustees, while 21% believed the employer had sole responsibility. The 2010 survey had figures of 24% and 22% respectively.

Of the trustees surveyed, 92% thought that the responsibility was shared.

The pensions industry continues to raise awareness of buy-ins, asset allocation and buy-outs as derisking strategies. Around 37% of employers surveyed were aware of buy-ins, 33% of asset allocation and 28% of buy-outs.

However, 42% were unaware of any derisking strategies. Trustees showed higher levels of awareness of derisking; 66% had plans in place to derisk over the next five years, against 60% of trustees who participated in the 2010 survey.

"The industry can take some comfort from the levels of awareness of buy-ins and buy-outs but clearly more needs to be done to help employers understand the derisking options open to them, said MetLife's chief executive officer Wayne Daniel.

Daniel: derisking options going unnoticed

Trustees alerted to corporate restructures

Porkolab: restructuring threat to pensions

A likely increase in corporate restructurings means that employers and trustees must be more vigilant in managing the employer covenant available to their pension scheme, says Punter Southall Transaction Services (PSTS).

Financial or operational restructures are undertaken to avoid insolvency, financial distress or a deteriorating trading performance. Premier Foods, TUI Travel, JJB, Logica and Punch Taverns are among companies that have recently explored the option.

Lorant Porkolab, head of PSTS's covenant advisory team, said: "Many restructurings affect the legal shape of the business. It is critical for trustees to understand where this leaves the pension scheme and its sponsoring employer. Restructuring can involve moving key assets out of the sponsoring employer and weaken the covenant support available to the pension scheme. This can also happen even if the legal position remains the same.

"Employers and trustees should prepare to work together on mitigation to put the scheme back in the same place as it was before the restructuring. It's important that everyone is pragmatic and commercial throughout the process. Benefits from properly restructuring a business will ultimately bolster the covenant support available for the pension scheme."

Five to watch for with IAS 19

The revised IAS 19 standard will impact the sponsors of defined benefit (DB) pension plans in five main areas, suggests Mercer.

The first area flagged up by the consultancy group's analysis of the international accounting standard for DB pensions, which will be adopted by many companies over the next year, will be better comparability. This will be achieved by removing the subjective "expected return on asset assumption". Companies reliant on bullish assumptions that automatically improve their reported profit – irrespective of actual plan asset performance – can expect major change in key performance indicators (KPIs). This may prompt plan sponsors to review how KPIs are affected by actions to reduce DB plan risk.

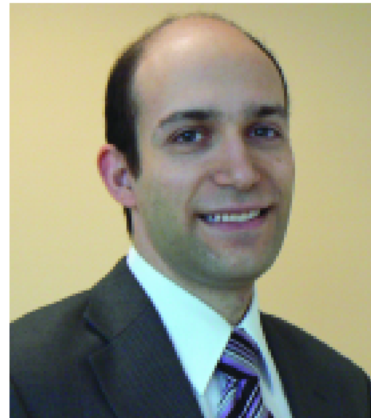
Second, because the option to defer recognition of gains and losses will be removed, companies that have used deferral and have large unrecognised losses face a step-change in their balance sheet position. Offsetting this, however, is that early adoption of IAS 19 could mean an improvement in future reported profits.

Third, there will be a focus on longevity risk management. From a pension accounting perspective, a pension increase exchange is probably the best way of managing longevity risk. It can achieve more certainty in future cashflows and lead to an immediate reduction in the DB plan risk reflected in financial statements.

Fourth, there will be a focus on DB plan liability management. IAS 19 clarifies that routine benefit payments that are part of the terms of the plan do not need to be accounted for as settlements. This may encourage some plan sponsors to consider agreeing long-term enhancements to transfer values so that more DB plan risk is transferred to members without triggering settlement costs in the profit and loss (P&L).

And finally, there will be a focus on DB plan risk transfer. For companies wishing to transfer the risk to an insurer and willing to lock into current bond yields, the accounting implications of a buy-in are generally more attractive to reported P&L than a full transfer via a buy-out.

Warren Singer, Mercer's UK head of pension accounting, said: "Given that reported profits will no longer be automatically rewarded for holding equities rather than bonds, the new IAS 19 and the footnote disclosures may cause plan sponsors to re-evaluate their approach to DB plan risk management.



Singer: explain DB risk or pay the price

"As many companies prepare to adopt new IAS 19 in 2013, a failure to prepare for the footnote disclosures that explain DB risk management may lead to some companies being viewed negatively compared to peers when analysts look at DB plan risk with a renewed focus." ■

SWIFT fashions standards tool

A web-based application to help manage global standards and related market practices across the financial industry has appeared from SWIFT, the provider of secure messaging services to financial institutions.

The bank-owned body has developed MyStandards in partnership with pilot customers and the program will become commercially available later this month.

Aimed at helping financial institutions, market practice groups, market infrastructures and corporations to implement standards, MyStandards is promoted as bridging the gap between business and IT for business analysts, product and project managers and standards implementers.

Karla McKenna, steering committee chairman of the Securities Market Practice Group (SMPG), said: "SMPG supports MyStandards as a tool to streamline market practice for standards in the financial industry.

"We intend to use MyStandards to document market practices currently on the SMPG website and believe it will be a valuable tool for SMPG and individual national market practice groups in the development, publication and distribution of future market practices." ■