Figure is put on liquidity premium

How big is the liquidity – or illiquidity – premium in the credit markets?

JPMorgan's analysts recently tackled this question and attempted to gauge its size, employing both a top-down macro-economic and bottom-up credit ratings-based analysis to do so and bringing in default rates and ratings transitions from the Great Depression and the 2001-03 telecoms boom-to-bust to forecast credit spreads.

According to the analysts, current prices for investment-grade bonds do not primarily reflect the credit risk of the bonds. Rather, there is a significant illiquidity premium in the price, which is driven by fear, uncertainty about the future and lack of risk appetite.

JPMorgan's finding is that the current liquidity premium in investment-grade corporate bond spreads could potentially range from 100 basis points to 200bp, but the general economic deterioration and the credit crunch mean that a premium closer to 100bp is more realistic.

"This suggests that if we believe the liquidity premium and funding premium are equivalent, corporates could fund up to 15% cheaper," the analysts said in their report.

Based on the group economists' scenario of a very deep and sharp contraction in growth over the first half of this year, followed by a second-half recovery, the worst case forecast for 2009 speculative-grade default rates is 13%, against a base case of 6%.

Using these inputs, the group's macro-economic model predicts current investment-grade industrial asset swap spreads at a high of 114bp in the first half of 2009. With market spreads at 236bp at the time of calculation, this implies a maximum liquidity premium of 122bp.

Corporates could fund up to 15% cheaper

FSA looks forward to a stricter financial regime

The FSA has published its Financial Risk Outlook 2009, setting out the main risks facing firms, consumers and the regulatory system in the economic downturn.

The Outlook indicates that banks will be subject to new rules on capital adequacy as momentum grows for a new counter-cyclical regime to restrain over-rapid growth.

More intensive regulation and supervision of liquidity can be expected, as can a wider institutional scope to bring in complex investment banks, structured investment vehicles, conduits, mutual funds and hedge funds, which have created risks inadequately covered by current regulation and supervision.

The FSA is targeting OTC derivative risks

On global economic conditions, consensus forecasts suggest the total global economy will be close to zero growth in 2009, with a recovery in 2010 producing global growth at 2.0%. The FSA's scenario planning offers three alternatives:

- policy measures restore confidence and growth;
- recession is more severe than expected; or
- over the longer term, stagflation emerges.

The last option is regarded as least likely.

There is little indication whether the capital markets are expected to play a bigger role in company funding. The FSA is more concerned about the risk to market mechanics, and homes in on the role of the rating agencies and the risks in the over-the-counter derivatives markets: counterparty risk, operational risk, and the risk that limited transparency affects market confidence and effective regulatory oversight.

One of the FSA's roles is to debate the future of financial regulation, although by the end of this month the Turner Review should report on such wide-ranging matters as the role of credit rating agencies, appropriate remuneration approaches, fair value accounting issues and clearing of credit default swap contracts. ■

On the move...

- **Patrick Clarke**, International Affiliate, has joined EMI Music as group treasurer. He was previously manager for treasury consulting at Accenture.
- **Alan Drew**, AMCT, previously assistant treasurer at DSG International, has been appointed group treasurer of Signet.
- **Simon Dunne**, AMCT, has been appointed a director at Savills Capital Advisors. He was previously an executive director at Morgan Stanley.
- **Natalie Eastham**, AMCT, has left her position as executive director at Glitnir.
- **Jonathan Fisher**, AMCT, previously decision support manager at Bear Stearns International, has been appointed director of business risk services at Ernst & Young.
- **Lal Manglani**, AMCT, has been appointed head of IFRS policies at Aegon. He was previously national office director in the Amsterdam office of PricewaterhouseCoopers.
- **Eymon Tsang**, FCT, previously general manager for corporate finance and treasury at Hong Kong & Shanghai Hotels, has been appointed director for corporate finance at Ka Wah International Holdings.

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Members' contact details are updated regularly at **www.treasurers.org**. *Email changes to Matthew Trickey:* **mtrickey@treasurers.org**, *or phone +44 (0)20 7847 2557.*

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Accounting quirk masks deficits

A report on the pension schemes of FTSE 100 companies has warned of misleading basic analyses suggesting that 2008 was a good year rather than the worst on record.

Charles Cowling, managing director of Pensions Capital Strategies, which produced the report, said: "Pension funding positions in company accounts improved in 2008, largely due to deficiencies in the accounting rules, as significant asset losses in pension schemes have been matched by reductions in the accounting value of pension liabilities."

The discrepancy is caused by a "quirk" of the accounting rules that links the value of a company's pension liabilities to the value of AA bonds, which have fallen during the credit crunch and thus have brought down the accounting value of pension liabilities.

Pensions Capital Strategies estimates that if pension liabilities were valued on more normal levels of credit spreads (with AA bond discount rates at gilts+80-100bp), FTSE 100 schemes would show a total deficit of £100bn rather than a $12bn surplus. On average, companies would see a 30% rise in pension liabilities.

Cowling added: "The fact that AA bonds have fallen in value is not a good reason to regard your pension liabilities as being a lot lower. It is just a quirk of the accounting rules that is hiding the problems that many pension schemes currently face."

Moody's takes sanguine view

A separate survey by ratings agency Moody's suggests that pension deficits in 2008 reached levels unplumbed since the depths of the dotcom boom-to-bust of 2003/04 and are likely to further deteriorate this year.

But while the Moody's report found that sponsoring companies' credit metrics worsened last year, it added that the declines were not yet "of a magnitude that would warrant wholesale ratings changes based solely on pension-related issues".

This was partly due to the buffer provided by asset surpluses in 2007. In addition, a fund's average exposure to equities has fallen to 47% from 59% four years ago.

UK-based pension plans were helped by sterling's weakness on their overseas assets. Although US stock market indices declined by nearly 40% in 2008, the fall was "a less damaging 15% when measured in sterling", while overseas government bonds performed relatively well.

Fears mount over pension liabilities

Nine out of 10 UK companies with a defined benefit pension scheme are worried about its effect on their business, PwC's fourth annual pensions survey suggests.

The report, to be published in full early in March, is based on responses from 98 companies, including 29 FTSE 100 businesses.

PwC found that most companies feared that their pension scheme trustees would push for increased cash funding at a time when they could least afford it, driven by trustees' perceptions of the financial health of British businesses and a misinterpretation of the Pension Regulator's stance on scheme funding.

As a result, companies with defined benefit schemes intend to step up their control of pension funding negotiations with trustees and PwC said there would be a "huge increase" in the number seeking to reduce or remove their pension risks. This is despite the serious obstacles to offloading a scheme, such as cost, lack of cash and lack of capacity from insurance providers to whom the risk can be transferred.

Hommel: strong business is best security

The survey shows that companies are reviewing a wide range of risk-reduction strategies for their schemes while a smaller number have already instigated them. The more popular moves include benefits redesign, interest rate hedging, inflation hedging, buy-outs and buy-ins.

Four out of five of the respondent companies said they were worried by the Pension Regulator's stance on scheme funding.

PwC partner and UK pensions leader Marc Hommel said: "The best security for a pension scheme is having a strong sponsoring business – and the regulator has said this repeatedly.

"It has also confirmed that trustees should not make demands on employers that could lead to the demise or weakening of the sponsoring business."

He added: "It's not easy being a trustee right now and employers need to engage trustees openly and early in the funding negotiation process to explain the company's objectives and constraints, including covenant strength and cash availability." ■

Dutch promise for UK funds

A ruling by Dutch tax authorities could pave the way for rebates of over €100m to UK pension funds, according to KPMG.

The ruling results from a successful test claim by KPMG client Strathclyde Pension Fund against a withholding tax levied on dividend payments to tax-exempt bodies (including UK pension funds) located within the EU but outside the Netherlands.

According to KPMG, the implications of the ruling extend beyond the UK to other tax-exempt bodies in EU member states that have paid Dutch withholding taxes in recent years. The total cost to the Dutch Revenue could be as much as €500m.

Chris Morgan, the group's head of international corporate tax practice, described the ruling as "ground breaking and progressive" in recognising the need to remove Europe's barriers to cross-border investment and to support the principle of the free movement of capital within the EU.

"Pension funds which have not filed claims to date should look to do so in the near future before claims potentially become time-barred," he said.

Default rates soar for speculative-grade bonds

Speculative-grade default rates around the world have risen steeply, according to credit rating agency Moody's.

The agency's issuer-weighted speculative-grade default rate quadrupled to 4.8% at the end of January 2009; a year before the rate had been 1.1%.

And default rates among US and European speculative-grade issuers both increased in January, to 5.2% and 2.4% respectively.

At the same point last year, the US default rate stood at 1.4%, while the European rate was half that, at 0.7%.

In all, 22 Moody's-rated corporate issuers defaulted in January: 12 in the US, three in Canada, three in Europe and four in other regions.

Moody's default rate forecasting model also predicts that the global speculative-grade default rate will continue to rise sharply for most of this year. It should reach a peak of 16.4% in November, before easing back to 15.5% by January 2010.

Rapidly deteriorating global economic conditions and the ongoing banking crisis signal a flood of corporate defaulters in 2009.

Moody's now forecasts that around 300 rated corporate issuers will default during the course of this year, compared with 104 in 2008 and just 18 in 2007.

Among US and European speculative-grade issuers, Moody's default rate forecasting model predicts that speculative grade default rates will peak at 16.4% and 19.6% in the fourth quarter, respectively.

In January, Moody's distressed index came in 52.6%, which was slightly lower than the 54.7% level recorded the month before, but still represents the third highest level since the index was launched in 1996.■

Deposit auction site targets SMEs

Alox has launched an online auction market for fixed-rate term deposits that delivers real-time interest rates for depositors' cash.

The auction site, MaxBips.com, offers no-obligation half-hour auctions, with banks and building societies providing term deposit rate quotes. Firms can then evaluate the bids against institutions' credit ratings, financial metrics and deposit protection data.

The site's rate indicator tool gives a guide to the previous day's interest rate spread. Depositors must have a minimum of £30,000 for auction.

Alox added that MaxBips was independent of all financial institutions and dealt only with those that are FSA-regulated.

Managing director Aloysius Fekete said: "The number one concern of small and medium enterprises [SMEs] today is survival. MaxBips can help by streamlining their cash management and improving returns on their surplus cash at the same time."

The International Treasurer's Handbook 2009

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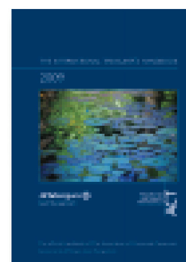

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How to avoid the M&A trap

At a time when the global liquidity crisis is expected to fuel new merger and acquisition (M&A) activity this year, a report has claimed that failure rates remain at a high level despite the growing corporate experience of mergers over the last seven years.

The report, from management consultancy Arthur D Little and entitled Winning the Merger Decathlon, outlines a 10-step approach that companies can take to ensure a merger will boost their productivity and profitability without bringing additional risk to existing business.

According to the report, the three major M&A drivers that will continue fuelling deal activity in 2009 are: continued corporate restructuring; industry consolidation in mature markets; and the desire of established players to exploit growth opportunities in emerging markets.

Based on an analysis of corporate post-merger integration projects across industry, the report identified the 10 most important considerations managers must make to successfully move forward from a corporate merger (see below).

Michael Ungerath, the report's author and a director in Arthur D Little's global strategy and organisation practice, said: "Whether looking to M&A to enter new growth markets, to consolidate services in mature markets or to acquire new technologies, the current recession climate means companies considering merging in 2009 must developing a winning strategy upfront, or else risk losing the value of their investment in a failed merger."

With the credit crunch forcing consolidation as well as providing opportunities to use acquisition as a market entry strategy, businesses may no longer be able to afford the costs of a failed M&A pursuit.

The full report can be accessed at:
www.adl.com/mergerdecathlon

1. Follow a clear strategy
2. Pick the right deal
3. Leverage the pre-closing period
4. Adapt integration approach and speed
5. Take critical governance decisions upfront
6. Invest your best resources
7. Keep your eyes on the ball
8. Capture synergies in the bottom line
9. Communicate
10. Address the cultural differences

Fraud hits 13-year high, with worst still to come

More than £1.1bn of fraud came before the UK courts last year, the second highest level recorded in 21 years and exceeded only in 1995, according to KPMG Forensic.

The group's Fraud Barometer suggested that, at £800m, fraud by professional gangs during 2008 remained at the high levels of previous years, while individual fraud by company managers, employees and customers tripled from 2007 to £300m.

Only government losses to VAT carousel fraud showed a sharp decrease.

However, KPMG warned that the worst was yet to come, as much of the fraud committed since the credit crunch began in August 2007 has yet to come before the public courts. This would replicate the experience of the previous recession of the early 1990s, where court cases peaked in the middle of the decade.

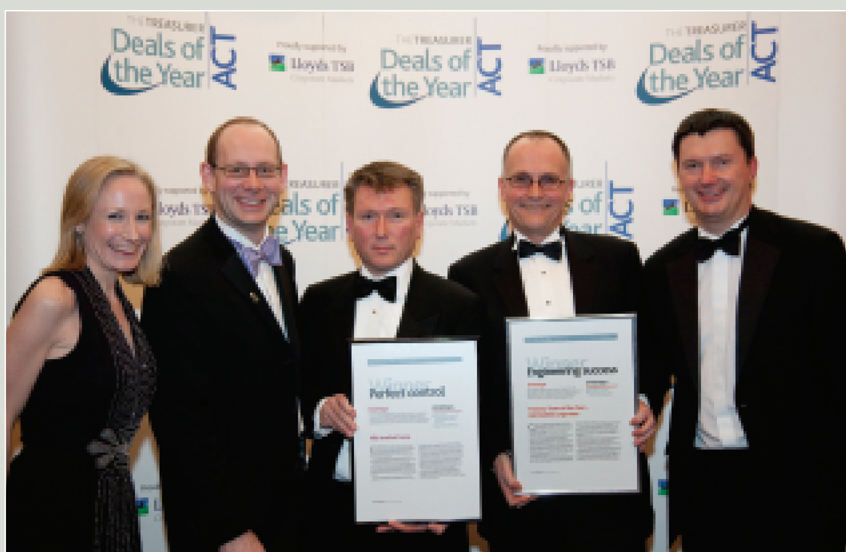
The Fraud Barometer, which measures fraud cases coming to court where charges are for at least £100,000, recorded a total of 239 cases in 2008, of which professional gangs accounted for 111. The financial services sector was hardest hit, with £388m of fraud in 63 cases against £37m from 36 cases in 2007. The sharp increase was partly due to the alleged £220m attempt to hack into Sumitomo Matsui Banking's systems, which came to court last March.

The corporate sector also suffered, with £125m of fraud from 54 cases against £24m from 45 cases in 2007. Managers accounted for £128m (£54m in 2007) of fraud and employees for £100m (£27m), while customers inflicted £65m (£25m).

KPMG Forensic's fraud investigation partner Hitesh Patel said: "Internal frauds are becoming more prevalent and should set alarm bells ringing within organisations. In difficult times, they could even become the tipping point between the survival and demise of an organisation.

"Companies need to be rigorous about re-inforcing their anti-fraud measures. By reviewing their high-risk and key operations, having effective reporting channels and deploying detection mechanisms such as data analytics, they may give themselves a better chance to fight fraud."

Half of the fraud by value in 2008 was committed in London and the South East (£527m), while the amount recorded in the Midlands tripled from a year earlier to £380m. ■



In a ceremony in central London last month, the ACT recognised the winners and the highly commended in Deals of the Year Awards, supported by Lloyds TSB Corporate Markets. For the details, see page 16.