IN BRIEF

Liquidity facilities provided by banks to non-financial companies will be deemed by Basel III to be fully drawn in the stressed scenario tested under the liquidity coverage ratio. Banks therefore have to hold 100% liquid assets to cover such undrawn liquidity commitments as compared with 10% for general credit facilities. There was some concern that because most credit facilities can be drawn immediately and so could generate backup funding they might be treated as needing 100% liquidity cover.

Reacting to concerns voiced by the Loan Market Association (LMA), the Basel Committee clarified its definitions in the following statement: "A liquidity facility is defined as any committed, undrawn backup facility put in place expressly for the purpose of refinancing the debt of a customer in situations where such a customer is unable to obtain its ordinary course of business funding requirements (e.g. pursuant to a commercial paper programme) in the financial markets. General working capital facilities for corporate entities (e.g. revolving credit facilities in place for general corporate and/or working capital purposes) will not be classified as liquidity facilities, but as credit facilities."

A good result.

S&P is reviewing bank riskiness with a consultation on proposed changes to its bank ratings methodology. S&P's new approach places greater emphasis on country, economic and industry risk, and looks at the extent of government support throughout the cycle. The entire industry is seen as volatile, therefore it will be generally more cautious, with probably no AAA or AA+ banks, and 36% of banks likely to see a downgrade. In outline the new process will work as follows.

First, a bank's standalone credit profile will be calculated using economic and industry risk to set an anchor level incorporating BICRAs (banking industry country risk assessments). The rating will then adjust from that anchor for bank-specific risks of business position, capital and earnings, risk position and liquidity.

Second, there will be consideration of the support framework, which consists of the relationship/extraordinary support from parent or government.

And third, the first two steps will be combined to give a potential issuer credit rating, which will be notched up or down based on relative creditworthiness in its peer group.

INTRODUCTION

By Martin O'Donovan
ACT assistant director, policy and technical

In selecting news items or commentaries for these pages there is normally no special agenda or theme: it just depends on what issues have come to light or are in progress at the time of writing. However, a scan through this month's pieces soon reveals that Basel III is a recurring theme, which is telling. Basel III must be the single biggest subject that will influence finance and the markets in the years ahead, assuming the smouldering volcano of the sovereign debt crisis does not erupt. The exact impact and cost of Basel III is hard to be sure of just yet, and in any case a theoretical cost increase of a product for a bank may well be absorbed, or further loaded, by the cross-subsidies and pricing strategies adopted. What is sure is that some what-if planning is in order for customers of the banking community.

Hedge accounting rules start lining up with risk

The International Accounting Standards Board (IASB) seems to be heading in a helpful direction with its hedge accounting proposals, issued in December. The board has sensibly aimed at aligning hedge accounting more closely with corporate risk management activities. The result would be a more objective-based approach to hedge accounting, with inconsistencies and weaknesses in the current IAS 39 hedge accounting standard addressed.

The ACT agrees with the IASB's approach of moving from a heavily rules-based standard to a more principles-based approach. However, the IASB has still not gone far enough, having included rules to patch up issues that exist in specific industries or sectors under IAS 39 that are not fit for all.

A summary of the IASB's key proposals for IFRS 9:

- effectiveness testing – 80-125% bright line has now been removed;
- hedging with options – time value can be deferred in Other Comprehensive Income, so less profit and loss volatility;
- a layer of an item or group can now be hedged (this could only be done previously for cashflow hedges);
- derivatives can now be hedged items when combined with a non-derivative;
- hedging a net position is now permitted, although as all items must affect profit and loss in the same period the hedge accounting of net cashflows from sales and purchases typically will not be allowed;
- rebalancing of hedge relationships is required and is an adjustment to a continuing hedge relationship, rather than a dedesignation and new hedge relationship under IAS 39;
- voluntary dedesignation of hedge relationships is not permitted if risk management objectives have not changed;
- fair value hedge accounting adjustment is presented as a separate line item in the balance sheet;
- presentation of net hedges is shown as a separate line item in the profit and loss;
- all fair value movements on hedged items and hedging instruments are taken to Other Comprehensive Income (previously only the case for cashflow hedges); and
- basis adjustments (e.g. from Other Comprehensive Income to stock) were a policy choice but are now mandatory.

The ACT is currently drafting a response to the IASB's proposals and would welcome treasurers' comments via **technical@treasurers.org**.

We would particularly like feedback on the following areas of concern:

- disclosure of commercially sensitive information;
- mandatory rebalancing; and
- prohibition on the dedesignation of hedging relationships.

More information on these issues is available at www.treasurers.org/node/6720

Basel III threatens payments squeeze

Increasing the stability and robustness of the financial system makes sense, but politicians need to weigh up the benefits versus the negative impacts for the real economy. Treasurers in particular will want to assess the latter.

The Bank for International Settlements (BIS) has reported that the new Basel III capital standards are likely to have a modest effect on aggregate output. The bank estimates that, if higher requirements are phased in over eight years, this would result in a maximum decline in the level of GDP of 0.22% from baseline forecasts, with annual growth 0.03% below forecasts. A faster implementation would lead to a slightly larger deviation from the baseline path with a somewhat greater impact on annual growth rates.

No additional work on the impact of stronger liquidity requirements has been done to that published in the interim report in August 2010 as the liquidity requirements are still subject to an observation period.

But the impact could be greater than this if, for example, banks attempt to meet the stronger requirements ahead of the timetable that has been set out by the Basel Committee and/or choose to hold an additional voluntary buffer of common equity capital above the amounts set out in the new framework.

And these impacts do not take into account the consequences of the liquidity requirements, which, as noted above, are still subject to an observation period.

The tendency is to consider the impact of Basel III on the cost and availability of borrowing and derivatives, but its effects will be marked on trade finance instruments and even on day-to-day payments and transaction banking. In making payment services available, a bank will normally be providing some daylight or short-term liquidity, allowing payments out prior to cash coming in.

Under Basel II this sort of uncommitted or immediately cancellable facility is normally zero risk-weighted. This provision continues for risk-weighted capital limits under Basel III but such liquidity provision will be treated as 10% drawn for purposes of the 3% leverage ratio test.

The liquidity coverage ratio (LCR) in Basel III requires a bank to be able to survive a modelled risk scenario whereby no new funding is available for 30 days and during that time cash deposits with the bank are withdrawn and loan commitments drawn down according to various assumptions. The modelled cash outflows will have to be adequately covered by holdings of top-quality liquid assets. It will be up to local supervisors to set the assumptions as to the cash outflows from these sorts of liquidity lines.

The second strand of the Basel III liquidity requirements, the set stable funding requirement, looks at the availability of stable funding over 12 months to cover the asset book. This funding will include uncommitted transaction lines to an extent determined by the local supervisors.

One way or another these new Basel metrics will discourage the provision of daylight limits, upping the cost or forcing the banks to require cash in prior to paying away.

On the other hand, any cash available to banks from balances held for cash management purposes counts as reasonably stable for LCR purposes (only 25% is assumed to be withdrawn during the 30-day test period compared with 75% outflow of non-financial wholesale deposits) and so is attractive for the banks.

As payments flow through the interbank systems, exposures arise between financial institutions. Under the Basel regulations, these are deemed particularly at risk for capital and liquidity purposes, generating a much increased overhead for banks in maintaining interbank connections and correspondent positions. That constitutes a further negative for payments and transaction activities. ■

Basel III

The website of law firm Clifford Chance hosts a readable yet thorough and authoritative summary of the specific requirements of Basel III which is very welcome and worth noting as a work of reference.

http://bit.ly/h6mmnh

IN BRIEF

▸ **The London stock exchange order book for retail bonds (ORB)** has reached its one-year anniversary. The stock exchange has been steadily expanding the number of bonds listed and quoted on its information and dealing platform; a significant proportion are from well-known non-financial company names, alongside banks and government gilts.

▸ Rather than implement an entirely new **MMF ratings scale**, ratings agency Moody's has decided to use the conventional ratings symbols but with an "mf" modifier for managed fund ratings – Aaa-mf, Aa-mf, etc. The methodology will also be redesigned so that strong sponsorship will not enhance a fund's rating but it will still have regard to risk stemming from the sponsor's own operational, market or funding challenges. The ACT had questioned whether sponsor support was being given disproportionate weighting in Moody's original proposals. The final methodology should be published in Q1 2011, and applied to funds in Q2.

▸ **A trade white paper** has been published by the Department for Business, Innovation and Skills (BIS), entitled Investment for Growth. It sets out a strategy for securing the benefits of greater openness for the UK economy, British business, the global economy and, in particular, the world's poorest people. It also sets out the government's commitment to addressing the barriers that hold businesses back from trading and investing, and to ensuring that the UK is one of the most attractive places in the world to invest and do business.

▸ **A study on equity underwriting** has been published by the Office of Fair Trading (OFT), hot on the heels of the report on rights issues by the Institutional Investors Council that came out in December 2010. This OFT report found that the fees paid to investment banks had risen significantly but that a market investigation reference to the Competition Commission was not warranted. Instead companies and institutional shareholders could work to introduce more competitive tendering into the underwriting process, and push for better transparency and justification for fee levels. The OFT did alert issuers to some inherent conflicts of interest affecting underwriters and advisers.

See Are Underwriting Fees Excessive?, p14

Businesses botch financial capital disclosures

Many companies manage their capital management disclosures poorly, with many making no disclosures whatsoever and others relying entirely on uninformative boilerplate statements or providing scant information, according to a recent study of financial capital management disclosures by the Accounting Standards Board (ASB).

Of the 65 companies reviewed by the ASB, 25 offered no IAS 1 capital management disclosures at all. And over a quarter of the remaining companies' disclosures contained nothing more than boilerplate statements, while others provided little more information than a comment on short-term corporate dividend plans.

A number of treasurers were interviewed as part of the study. Given current debt market conditions it is no surprise that they said that capital matters had risen significantly in importance in recent years. They also noted there was no common definition of financial capital, with some viewing it in terms of pure equity while others included longer-term debt.

Interviews were held with selected investors to understand the market need for information about capital and how it is managed. Although investors take a keen interest in capital, they do not make much use of current disclosures about capital in annual reports and accounts. The study suggested that this might be because the disclosures were not always presented in an informative way.

Capital structure and therefore capital management is one of the key aspects of treasury management and getting it right probably has a far more significant impact on a company than much of the other normal treasury activity.

Given that capital management and financial strategy is so core to the business, shareholders should be made aware of the company's policy towards it. Possible disclosures include:

- gearing policy expressed as a target range over time or over a business cycle;
- the company's policy on dividends, share buybacks or new issues to maintain target ratios; and
- key performance indicators such as debt/equity ratios and return on capital.

Export credit widens support for trade

At a time when boosting economic activity is the objective it seems perverse that Basel III looks likely to have a disproportionate impact on the cost to banks of providing various trade finance instruments, a point that the ACT has recently raised with the business minister. It is therefore good news that the Export Credits Guarantee Department (ECGD) has announced four initiatives to support exporters both large and small. The government department will:

- set up a bond support scheme to help exporters raise tender and contract bonds by sharing risks with banks that issue bonds or counter-indemnities for export contracts. ECGD will provide a guarantee to the issuing bank for between 50% and 80% of the exporter's credit risk;
- extend its existing short-term credit insurance (which currently applies to capital goods) to cover a broader range of exports;
- launch an export working capital scheme to facilitate exporters' access to working capital finance for specific export contracts by providing guarantees to banks making working capital loans over £1m to the exporter; and
- develop a foreign exchange credit support scheme to share credit risk on FX deals provided to exporters by the banks, where exporters have taken out another ECGD product. Discussions with the banks on this product have yet to be completed.

In addition, the Department for Business will set up an export enterprise finance guarantee scheme to offer export finance to SMEs for contracts under £1m.

With the exception of the extended insurance scheme, which is available directly from ECGD, the schemes will be made available from participating banks. Whether the banks will market these schemes more to SMEs or to large companies has yet to be seen, but the message for treasurers must be to press their banks to provide access to this very welcome support. ■

ACT issues warning over latest MiFID proposals

The European Commission is reviewing the Markets in Financial Instruments Directive (MiFID) with the aim of extending some existing equity market structures and practices into other non-equity markets such as bonds and derivatives.

The ACT has submitted a response expressing serious concerns about the proposals to force all over-the-counter (OTC) derivatives capable of being put through central clearing to be dealt on an exchange, thus removing the flexibility of dealing OTC and requiring a cash collateral (margin) to be put up. In the context of the draft regulation of OTC derivatives (the European Markets and Infrastructures Regulation) the Commission has already accepted that mandatory margining would impose an unwarranted liquidity burden on users, so it would be perverse if it backtracked on those principles for MiFID.

Nor does the ACT support some of the other proposals for pre and post-trade transparency in the bond and derivative markets. These markets are far less standardised than the equity markets, and have minimal liquidity, so that availability of such data would not necessarily generate increased competitiveness and price discovery.

On the proposals to extend investor protection and supervision, the ACT is concerned by loss of flexibility for customers to choose their client categorisation, which in turn determines the extent of various investor protections and costs.

The Commission also considers processes around underwriting and placing of securities. While there are some obvious conflicts of interest here for underwriting and arranging banks, the ACT does not wish to see issuer flexibility constrained by excessive rules.