IN BRIEF

Practice Note 16 from the Audit Practices Board (APB) has been substantially revised and reissued, this being the protocol agreed between the accountancy profession and the British Bankers' Association (BBA) for auditors to request confirmation of balances and transactions from bankers.

In planning bank circulation, auditors should consider the decision to make a request using a risk-based approach and request extra information on trade finance, derivative and commodity trading only when there is a reasonable expectation that the client uses these facilities. Where practicable, requests should be made so as to reach the bank one month in advance of the period end date and banks will endeavour to provide the information within a calendar month of the period end date although a fast-track option also exists.

The banks have agreed to publish addresses for centres to which requests for audit information are to be addressed on the BBA website and confirmed they do not need a new authority to disclose information every time. The banks request that the main account number and sort code are provided for each legal entity in the request.

The ACT has responded to the ideas of the International Accounting Standards Board (IASB) for **changes to IAS 39** to clarify the circumstances when portions of the cashflow of a financial instrument may be designated as a hedged item, and what risks can be separately hedged in an instrument. Although the ACT welcomed guidance in these areas, our response objected to the restrictions that the proposed drafting creates, particularly through eliminating the use of hypothetical options to demonstrate effectiveness on hedging done with options.

The comment period for the UK's **National Payments Plan** from the Payments Council has now closed. The ACT's view is that although the creation of the plan to facilitate open discussion on the development of payments processes is to be welcomed, our preference is for market-led solutions. Hence we expressed caution on its impact and implementation.

The Financial Reporting Council (FRC) is proposing **changes to the Combined Code** to remove the restriction that an individual should not chair more than one FTSE 100 company and to allow the chairman of a company outside the FTSE 350 to be a member of (but not chair) the audit committee, provided he or she was considered independent on appointment.

INTRODUCTION

By Martin O'Donovan
ACT Assistant Director, Policy and Technical

One of the joys of working in the field of treasury is that there are always new projects to consider or changed market conditions to get used to or even whole new disciplines that could be taken within the treasurer's responsibility. Trendy ideas like sustainability or climate change are going to establish themselves, so even if you are not personally responsible you will still need to be able to explain your group's risks and policies to lenders and credit rating agencies. More ambitious individuals may want to claim the job of carbon/ emissions trading; it's a highly complex area, so as a start we try to explain the basic terminology this month.

2008 Financial Risk Outlook

The FSA has published its 2008 Financial Risk Outlook (FRO), with market participants eager to see what the financial services watchdog is worried about and identifying as the key risk areas.

The FSA's aim is to assess the priority risks that are most likely to affect its ability to meet its strategic goal of promoting efficient, orderly and fair markets. This year it has had the unenviable job of highlighting the risks while trying to avoid triggering a panic that would make the predictions self-fulfilling.

Irrespective of whether the risks are properly identified, the FRO always makes for good reading. It provides a round-up of data on the status and health of all the financial markets and participants. It is, as ever, well written, with information clearly presented.

The priority risks listed this year tend to state the obvious: existing business models of some financial institutions are under strain as a result of adverse market conditions; market participants and consumers may lose confidence in financial institutions and in the authorities' ability to safeguard the financial system; and a significant minority of consumers could experience financial problems because of high levels of borrowing.

In the capital markets, concern centres on the originate and distribute model used by banks and on credit risk transfer mechanisms which can affect the interests and behaviour of stakeholders in a corporate restructuring.

Refinancings have become difficult, the FSA observes, particularly for private equity portfolio firms whose higher leverage accentuates the chance of financial distress or failure. This could then affect the efficiency of the wider market.

Given the turbulence of 2007 it is instructive to look back at the 2007 FRO. Last year the FSA had concerns over the weakness of stress-testing in businesses, particularly company-wide stress events. It warned: "The combination of low volatility, high correlation and a historically low level of risk premia brings with it an inherently high likelihood of a major shock, especially if an event were to occur that triggered a significant deterioration in market sentiment."

The need to stress-test business models is repeated again in the 2008 FRO.

An alternative scenario the FSA considered for 2007 was "the impact of a global reappraisal of risk, which involves a widening in risk premia across all asset classes, but particularly affecting emerging markets and high-yield assets. Volatility across markets could increase for a prolonged period, resulting in a lasting aversion to higher-risk assets and more complex strategies and products. Volatility could quickly spread to other markets and to assets with lower risk premia."

There were astute comments back in early 2007, although others might argue that if enough warnings of doom and gloom are given at least a few are bound to come true. ■

http://www.
WEBSITE WATCH

Web-based financial dictionaries are valuable for providing quick and simple explanations or clarifications of financial terminology. Several banks put glossaries on their sites, but for a good all-round dictionary, – although not one particularly oriented to pure treasury – try Moneyterms. Traditionalists may prefer something similar in paper. An excellent and comprehensive example is *The Handbook of International Financial Terms* by Peter Moles and Nicholas Terry from the Oxford University Press, ISBN 0-19-829481-6.
www.moneyterms.co.uk

The treasurer's guide to climate change instruments

The Department for Environment and Rural Affairs (DEFRA) is consulting on a simplification project to bring the muddle that characterises climate change instruments to an end.

The government is looking into the UK's three main instruments – the EU's emissions trading scheme (ETS), climate change agreements (CCAs) and the proposed carbon reduction commitment (CRC). The aim is to eliminate overlap, simplify regulation and minimise the regulatory burden on the economy, thereby improving the overall efficiency of the measures.

The EU ETS is a cap-and-trade scheme whereby EU member states have agreed target reductions in greenhouse emissions to meet the commitments agreed in the Kyoto Protocol.

Under Kyoto, 39 industrial countries were given targets for reductions in the 2008-12 period which averaged 5% compared with a 1990 baseline. There are significant variations by country and in the case of the UK it was 12.5%.

Member states allocate emissions allowances to operators of carbon-intensive installations, predominately power generators. Initial allocations are free but tradeable and allow the emission of one tonne of CO_2 into the atmosphere. Operators must reduce their emissions to within their allocation; if they cannot do so, they have to buy surplus allocations from operators with excess allowances.

The initial phase of the EU ETS ran to the end of 2007, but the allowances given were relatively generous so there was little market for allowances by the end of the period. The period 2008-12 has far tighter allowances.

Linked to the EU ETS is an international system for generating credits called certified emission reductions (CER), which can be used to offset pollution in excess of a business's allowed levels. Emissions credits can be bought from a project that can verifiably demonstrate a reduction in greenhouse gas emissions. Where this reduction project takes place in a developing country it is certified as a clean development mechanism (CDM); where it is in an industrial country it is strictly speaking a joint implementation project and generates emission reduction units (ERUs).

Climate change agreements are voluntary agreements to meet energy efficiency or emission reduction targets. Achieving these targets entitles businesses to an 80% discount on the climate change levy. The UK ETS enables the buying of allowances to comply with CCA milestones or the selling/banking of any overachievement.

The carbon reduction commitment will be a mandatory UK cap-and-trade scheme targeting carbon emissions – either direct CO_2 or indirect via electricity usage – with a proposed three-year introductory phase from 2010. CRC will cover large power users with an annual consumption in excess of 6,000MWh (equivalent to around £500,000 a year in electricity bills) aggregated across the highest UK parent company and all its UK subsidiaries. There will be no cap on emissions. Each CRC organisation will have to buy enough allowances each year to cover its emissions either in the initial government fixed-price sales or through market trading. Emissions covered by the voluntary CCA would be excluded from the CRC.

Hot topic: a raft of cap-and-trade carbon schemes will affect businesses in the UK

DEFRA's particular concern is the overlap between schemes. For example, the power generators are covered by the EU ETS and to an extent will pass on the cost of their allowance in the price of electricity to businesses facing the double cost of also reducing emissions to meet their own CCA or CRC targets, so the debate revolves round the economic efficiency of the various instruments.

The government also needs to consider the burden for business in having to deal with a frequently changing suite of instruments and mechanisms.

More and more companies will find themselves brought into the mandatory arrangements, so treasurers may need to consider their group's emissions trading arrangements.

Even if the prime responsibility sits in a procurement department, or elsewhere, treasury departments should be used to help create the information systems, the monitoring and controls.

Arrangements for forecasting exposures, trading between group subsidiaries and centralising and netting overall positions will have similarities with treasury foreign exchange management and internal accounting. ■

Climate framework for financial services

A group of banks and financial firms have produced a guide, issued via the British Bankers' Association (BBA), to how financial services companies can meet the challenges presented by climate change.

Much of the advice in the guide is targeted at the internal organisation of these entities, but it also covers the implications from their customer side. Treasurers will need to start planning how to respond to new questions and concerns from their bankers.

The guide explains that some businesses may find that in a low-carbon economy their products have limited prospects (for example, sports utility vehicles, long-distance fruit imports, low-efficiency heating and electronic goods). Banks will want to ensure they have the means to assess and mitigate the increased future default risks inherent in lending to these customers, while still winning new business.

Banks are increasingly held to account for their indirect emissions, including those arising through the activities of their corporate customers. Managing such exposures and balancing the loan portfolio will be increasingly important for public affairs and reputation management as well as for good credit risk practice. Campaign groups and ratings agencies have already begun comparing the carbon exposure of several banks' loan portfolios, identifying and highlighting banks with particularly strong support for, or high exposure to, carbon-intensive industries.

Because of this enhanced degree of scrutiny, the guide advises banks to agree a policy and risk appetite for lending to clients with potentially higher climate change-related risks in the short term (for example, construction projects on flood plains) and the longer term (for example, ski resorts located close to today's snowline, or irrigation/dam projects).

Banks need to develop the tools and resources to enable relationship managers and credit teams to manage climate-related risks. For example, they should generate detailed plans for integrating climate change risk considerations into current credit sanctioning processes, with a supplementary set of procedures to enable relationship managers to assess climate change-related risks in new loan applications and reviews.

Fund and asset management businesses should be able to analyse the effects of climate change on their assets to ensure that their investment decision-making processes include these considerations. ■