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- The Audit Commission has reported on **local authorities and the Icelandic banks**. Its study looked at treasury management within public authorities, the quality of skills and experience of staff and council members, and the use of advisers. In general, the report concluded that the treasury management framework in many local authorities worked well, although in a few cases there were serious deficiencies, with investments still being made after the Icelandic banks had been downgraded to defaulting status. It suggested that certain elements of treasury management guidance of the Chartered Institute of Public Finance and Accountancy (CIPFA) should be tightened in light of the Icelandic banks' collapse, and supported the steps already in train for the ACT to work with CIPFA in providing an appropriate treasury education and qualification.

- The **SEPA direct debit** will be subject initially to an interchange fee, according to the European Commission, to create the right incentives for rolling out the scheme. It will only be permitted for the first three years from 1 November 2009; thereafter there will be no transaction-based multilateral interchange fees at the national or cross-border level for SEPA or national "legacy" direct debits.

- A new standard on **the accounting for income tax** has been proposed by the International Accounting Standards Board (IASB) to replace the existing requirements in IAS 12. The proposed standard retains the basic approach to accounting for income tax, known as the temporary difference approach, which recognises the future tax consequences of past events and transactions rather than waits until the tax is payable. The exposure draft retains the principle, but proposes to remove most of the exceptions in IAS 12 to simplify the accounting.

- **The regulation of credit ratings** has moved closer with the European Parliament's Economic and Monetary Affairs Committee's approval of new rules to enhance the transparency, independence and good governance of credit rating agencies. The move to improve the quality and reliability of credit ratings and boost consumer trust could become law very soon, with a full vote of the parliament expected this month. The committee has also proposed setting up an independent, non-profit-making credit ratings agency to improve the quality of European ratings.

INTRODUCTION

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

During the early stages of the financial crisis I could not help noticing that the regulators and politicians were relatively quiet about casting blame and, although obviously considering increased regulation, surprisingly slow to start putting forward specific new rules and requirements. Clearly they had their hands full attempting to come up with initiatives to help solve the immediate problems, to strengthen the banking sector and get business moving again.

The ACT had warned against knee-jerk reactions. Now, with the passage of time, we seem to have every authority imaginable coming out with their proposals of what needs to change, but at least the ideas come after a sensible review and consideration. This month's piece on the Turner Review (see page 10) and the miscellaneous news briefs pick out a few of the many proposals.

Home truths for investors

Hector Sants, chief executive of the Financial Services Association (FSA), has said that company owners need to engage actively with the senior management and non-executive directors of the company, and even organise themselves more effectively for collective action.

Addressing the National Association of Pension Funds (NAPF) investment conference, Sants said that the lessons of this crisis were that greater interrogation by investors of how well a company was managed, its governance and the adequacy of its risk controls were all material factors in investment management.

Sants said that many of the failures over the last 18 months could be traced back to poor strategies and business models. The responsibility for ensuring effective delivery in this area was primarily management's, but he encouraged investors to challenge management to ensure that their business plans were credible.

Investors, said Sants, had to make sure that boards "understand the circumstances under which their firms will fail and be satisfied with the level of risk mitigation".

Ultimately, institutional investors can exercise their voting rights to influence the company, but the advice from the FSA is for owners to intervene at a far earlier stage, particularly where there are concerns about business strategy, management or performance.

Sants went on to question whether investors really understood what they were buying, or were too reliant and unchallenging of normal channels of information such as annual reports and company announcements.

"Companies have become all too good at framing the information presented – ie. focusing on the information of the companies' choosing," he said. Similarly, there appeared to be an overreliance on credit rating agencies.

The FSA, Sants said, was keen to encourage greater dialogue between the regulator and investors, and was keen to hear when any issues or risks were not being addressed. ■

Bank of England buys up corporate bonds

On 25 March the Bank of England started its bond secondary market purchase scheme, the second phase of its asset purchase programme to help corporate borrowers. The Bank continues to be active in buying new issues of three-month sterling commercial paper (CP) from investment-grade names at highly competitive rates, having already bought over £2bn of CP.

The bond scheme has a more indirect impact on corporate borrowers, boosting secondary market liquidity. By helping market making by banks and dealers, the scheme should reduce the liquidity premiums on high-quality bonds, and so remove obstacles to corporate access to capital markets.

The Bank is offering to buy £2m to £5m tickets of investment-grade bonds via a reverse auction. The Bank has published a list of eligible securities for its scheme on its website and is prepared to update this list at the request of counterparties if they believe they should be eligible. Initially there are four auctions a week and the intention is to include each eligible security in an auction at least once a week. Plans for the third phase, whereby the Bank buys into corporate syndicated loans, are still under development.

Fair values under distress

Fair value and the impairment of financial instruments have long been tricky issues for accountants, but the banking crisis has pushed them into the political and regulatory limelight.

Since last autumn the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) have been trying to co-ordinate their approach to dealing with reporting issues arising from the global financial crisis.

Most recently, FASB staff have put forward ideas on "determining whether a market is not active and a transaction is not distressed for the purposes of fair value calculations". According to FASB's Statement 157, a fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date, ie. not a forced or distressed sale.

The IASB and FASB are now proposing a two-step process to determine whether a market is not active and a transaction is not distressed.

Step 1 provides factors that indicate that a market is not active. They include:

- few recent transactions;
- price quotations varying substantially over time or among market makers;
- abnormal (or significant increases in) liquidity risk premiums or implied yields for quoted prices; and
- abnormally wide bid-ask spread.

If the reporting entity concludes in step 1 that the market for the asset is not active, then it proceeds to step 2. It checks whether for a quoted price there is evidence that:

- there is sufficient time before the measurement date to allow for usual and customary marketing activities for the asset; and
- there are multiple bidders for the asset.

If there is no evidence, then the reporting entity will consider that the quoted price is associated with a distressed transaction and must then use a valuation technique other than one that uses the quoted price without significant adjustment. For example, the reporting entity could use an income approach, such as a present value technique, to estimate fair value.

A second FASB idea being considered by the IASB is the recognition and presentation of other-than-temporary impairments. The key difference here is that international financial reporting standards (IFRS) do not allow management intent and ability to continue holding an instrument to be factors in the assessment. Under the US GAAP approach, the intent and ability of management to retain the investment in the security to allow for any anticipated recovery in fair value can be factored in.

A Fitch Ratings report of 31 March comments: "Because much of both proposals hinges on either the intent and/or estimations provided by management, the proposed qualitative disclosures by themselves may not be sufficient for financial market professionals' understanding of the impairment and fair value conclusions reached by an issuer." Fitch's concern is that, without increased disclosures, investors and analysts may assume the issuer has taken the least conservative approach to valuation and impairment. ■

The tax impact of hedging capital

The government is proposing to extend the disregard regulations to cover the hedging of certain share capital-related transactions.

If a company is making a rights issue where its share capital is denominated in a currency other than its functional currency for accounting purposes, it may wish to fix the value of the share proceeds in its accounting currency. The company could hedge the risk that exists between the announcement and completion by entering into a forward contract to sell the proceeds for value at the final date.

Any exchange gain or loss on the derivative contract would be brought into account for corporation tax purposes as a profit or loss on the derivative contract. By contrast, the opposite exchange position wrapped up in the share proceeds would not be a profit or loss for corporation tax purposes. Under the new rules, any exchange gain or loss on the derivative contract arising between the date of announcement of the rights issue and receipt of the share proceeds will be disregarded to the extent that the derivative is hedging the proceeds.

However, if any exchange gain on the hedging derivative is subsequently distributed to shareholders, the gain will be brought back into account as a derivative contract profit for the accounting period in which the distribution is made.

The changed regulation applies immediately and is backdated to apply to hedging transactions entered into on or after 1 January 2009 and still current on 10 March 2009. ■

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▸ Company law changes on **rights issues and treasury shares** have been drafted by the Department for Business Enterprise and Regulatory Reform. The proposed amending regulations will reduce the minimum pre-emption rights issue subscription period from 21 days to 14, as recommended by the Rights Issue Review Group last November. They also would remove the 10% cap on companies holding shares in treasury and extend the period for which authorisation may be given for the purchase of shares from 18 months to five years. The changes would come into force from 1 October 2009.

▸ Possible changes to the **Capital Requirements Directive** have been published for consultation by the European Commission. The proposals aim to strengthen capital and disclosure requirements for the trading book and complex securitisations. The changes include bolstering capital requirements in the trading book, raising capital charges for resecuritisation exposures such as the collateralised debt obligations (CDOs) of asset-backed securities, and upgrading risk management and disclosure standards for securitisation positions.

▸ **The Basel Committee** has indicated that the level of capital in the banking system needs to be strengthened. Ideas being pursued include measures to build up a capital buffer that can be used in periods of stress, strengthening the quality of bank capital, and improving the risk coverage of the capital framework. The regulatory minimum level of capital under the current Basel II framework will be reviewed in 2010.

▸ **Increased liquidity buffers** are being considered by the Committee of European Banking Supervisors (CEBS), which has published its views on how large and in what form a liquidity buffer should exist to allow banks to weather a period of stress in the market. A survival period of one month has been suggested for conducting stress tests. A consultation paper on CEBS's refined proposals will be published by mid-2009.

▸ **A new guide to securities lending** has been published by the International Securities Lending Association (ISLA) and is available on its website. The guide complements the existing one produced jointly by ISLA, the ACT and others, and which is available at: **http://www.treasurers.org/node/2939**

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- The FSA has been consulting on **stronger liquidity standards** for banks and the instruments that can be treated as providing liquidity. The ACT has made the point that the traditional bankers' acceptances could be included if the Bank of England were again to be a final buyer of these bills, thus providing liquidity to the banks and encouraging the funding of companies' trading activities.

- A discussion paper on leases from the IASB and the US Financial Accounting Standards Board (FASB) proposes that **lease accounting** should be based on the principle that all leases give rise to liabilities for future rental payments and assets (the right to use the leased asset) that should be recognised in an entity's statement of financial position.

  At present IFRS and US GAAP both split leases into finance leases (capital leases under US GAAP) and operating leases. Finance leases are recognised as assets and liabilities in the statement of financial position, whereas operating lease payments can be recognised as an expense over the lease term.

  The standard setters believe that users of accounts often include operating leases as assets and liabilities to give a more realistic picture. They are also concerned that the two accounting treatments allow deals to be structured for different accounting outcomes.

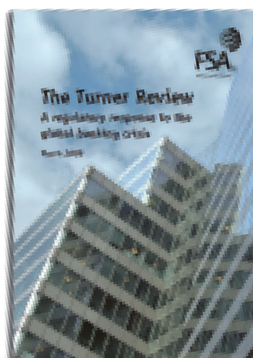
  Treasurers should be alert to the impact on debt covenants of the proposed change.

- A draft **Bribery Bill** has been published to replace a fragmented and complex web of offences under common law and a variety of statutes. The bill seeks to provide a framework that sits better with international obligations and creates a discrete offence of bribery of a foreign public official and a new offence of negligent failure by commercial organisations to prevent bribery. It would make it an offence to request, agree to receive or accept a bribe as well as giving, promising or offering a bribe. The maximum penalty for bribery would increase from seven to 10 years' imprisonment, with an unlimited fine.

- **The Financial Reporting Council (FRC)** is reviewing the effectiveness of the Combined Code on Corporate Governance, which sets standards for UK-listed companies. In particular, it will focus on the composition and effectiveness of the board as whole, and the role of the chairman; risk management; the remuneration committee; and the part played by institutional shareholders.

The Turner Review

Even proponents of light-touch regulation and laisser-faire markets would probably accept that more regulation of the banking and financial sector is inevitable. Pressures are coming from regulatory authorities around the world and here in the UK a major review commissioned by the chancellor has been released: the Turner Review.



This comprehensive report takes a systematic view across the whole field of regulatory reform, starting with an assessment of the main causes of the crisis (macro-economic imbalances, financial innovation of little social value, important deficiencies in key bank capital and liquidity regulations, and a flawed reliance on market forces) and puts forward a raft of responses.

The report concludes that the amount of regulatory capital required by banks should be significantly higher than at present and for systemically important (tier 1) banks should be high-quality capital only. The capital held by banks against their trading book would be massively increased. Any changes would be phased in while the downturn persists and would lead into a set of counter-cyclical capital requirements.

The report proposes either a dynamic provisioning model based on the FSA's discretion and analysis of each bank, or a variable minimum capital ratio ranging perhaps from 4% in bad times to 7% in good times. Capital reserves built up in good times would be allowed to be depleted in the years with higher losses.

During this crisis, fair value accounting has come in for criticism that it is unrealistic and incorporates a counter-cyclical tendency that aggravates any downturn. Turner favours retaining existing accounting rules to value the trading book and banking book, but would also require banks to create a non-distributable economic cycle reserve, setting aside profit in good years to anticipate losses likely to arise in future.

There would be a gross leverage backstop: namely, a cap of the gross assets as a multiple of core capital, the example being the Canadian system, where gross leverage is capped at 20.

The crisis has clearly illustrated the risk from lack of liquidity, and the FSA has already proposed increases in the liquidity held and the quality of that liquidity. The Turner Review is considering a further idea that banks comply with a core funding ratio limit (a maximum permissible ratio of loans to deposits).

Moving on to the wider structural issues for the financial system, Turner rejects the Glass-Steagall concept of prohibiting "utility" banks from engaging in investment banking activities. Instead it would discourage banks from engaging in excessive trading activity by raising the capital required on trading books.

It is proposed that the scope of regulation be extended to take in any firms which behave like a bank. Thus, off-balance-sheet vehicles would be treated for risk purposes as on the balance sheet and some mutual and hedge funds would be subject to prudential regulation. However, many hedge funds are not directly comparable with banks (their leverage is lower, they do not deal with retail and their funds cannot be withdrawn on demand) and so immediate regulation should not be expected.

Cross-border activity complicates regulation. The FSA views the current EU cross-border passporting rights for bank branches as untenable, and that the host state should have a greater ability to oversee capital and liquidity.

However, the whole question of cross-border regulation needs reform. The FSA's view is that there is too much home state control/ responsibility given the current weaknesses in harmonisation of national rules and supervisory practices. Either host states need greater powers (meaning a less open single market) or there needs to be greater European integration.

The review does not identify excessive remuneration as a primary cause of the financial crisis but it expects the measures proposed to have the effect of reducing remuneration for bank traders. The FSA threatens that it will focus strongly on the risk consequences of institutions' remuneration policies. ■

www.treasurers.org/glossary
For a quick reminder or explanation of treasury and financial terminology, go to the ACT's own glossary of terms, which is accessible from the main menu on the homepage. Let us know if any definitions are missing that you think should be included.