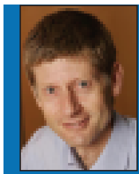
IN BRIEF

The UK Listing Authority has provided further **guidance on prospectuses** in its September newsletter List! The "relevant period" during which a supplementary prospectus can be required, in certain circumstances, should end on whichever is later: the close of the offer or when trading begins. Among many other matters is the recommendation that where the cashflow statements required for retail debt issues are onerous to produce because they are not required under the applicable local Generally Accepted Accounting Principles (GAAP), then a derogation should be sought from them.

The International Accounting Standards Board (IASB) is progressing the **Technical Correction to IAS 21 *The Effects of Changes in Foreign Exchange Rates*** so that foreign exchange (FX) differences on loans forming part of an entity's net investment in a foreign operation may be reclassified to equity, irrespective of currency of the loan. The comment period ended on 31 October and it is hoped that the Technical Correction will be issued promptly to become immediately effective and applied retrospectively. EU endorsement will then follow. The IASB is unfortunately not addressing the wider problem of FX differences on shorter term monetary items that do not form part of the net investment.

The **London Stock Exchange** has issued a reminder that new three-month lag index-linked gilts will be traded on a 'real clean' price (RCP) basis with the effect of inflation stripped out of the price but included in the settlement consideration. Existing eight-month lag index-linked gilts will continue to be traded with an inflation-adjusted price. The new style three-month lag issues are called Index Linked Treasury Gilts to distinguish them from old-style eight-month lag issues which are called Index Linked Treasury Stock.

Further draft clauses have been published for the imminent **Company Law Reform Bill** covering poll results, statutory auditors and information on interests in shares. Following strong representations by the Confederation of British Industry (CBI) the proposals for a seven-year prison sentence for filing defective accounts are to be dropped, as well as the extension of criminal sanctions to senior executives for non-compliance with companies legislation.



INTRODUCTION

By **MARTIN O'DONOVAN**
ACT Technical Officer

When the various financial rules and regulations change do you ever wish you could have had a chance to tailor the changes to be more sensible? Fortunately, in this era of open government, many changes do go through a process of consultation so your voice can be heard. Doing just that the ACT has responded robustly to the risk based levy on defined pension schemes being proposed by the Pension Protection Fund (PPF) and highlighted some of the more significant unfair elements, but even at this late stage do consider sending in you own views to the PPF. It can only help in reaching a more rational system in the long run.

Likewise do please feed in thoughts on bond price transparency. The relevant section below flags a good opportunity to get views taken into account long before the official position becomes entrenched, in that the Financial Services Authority (FSA) is pre-empting a European Union review that is only scheduled to start in a year's time.

Secondary bond market pricing

The FSA is investigating whether the secondary bond market is sufficiently transparent as regards pricing. Is there sufficient price information available pre-trade along with firm price quotes and is there sufficient post-trade data available so that market participants can assess market levels and activity?

Most corporates are not actively following the prices of bonds in the secondary market save in the run-up to pricing a new issue, or if their policies allow for active debt management in the sense of buying back debt in the market when a refinancing or new issue can be done at lower rates.

Arguably, treasurers should take a strong interest in encouraging a healthy market and liquidity since the secondary market provides guidance as to new issue rates.

But then again is the credit derivative market more important now? Do treasurers in fact want to be able to take advantage of arbitrage opportunities in markets which are less than perfect?

Some market makers will argue that the bond market is unlike the equity or currency markets in that most bonds are held to maturity with very little secondary trading occurring. If a dealer has to report post-trade volumes and prices in thin markets they will find it more difficult to manage their own positions. If conditions become too difficult for them, or not profitable enough, they will simply withdraw from the market and liquidity will be worsened – the exact opposite of the intention of better transparency.

Transparency is not an end in itself but it can be viewed as a facilitator of market efficiency and investor protection. It can stimulate more competitively priced quotes, improve the price discovery process and reduce transaction costs.

On the other hand it can be argued that bond price transparency is less essential than in the case of equities because there is more information available to assess the intrinsic value of bonds.

The EC is due to consider bond pricing transparency in 2006 as a requirement of the MiFID, but before it or the FSA act they will need to demonstrate a market failure.

The FSA is clearly concerned that those closest to the market have superior information from which they can profit, but yet there exist many electronic trading systems and to a lesser extent post-trade information services which go a long way to ensure reasonable transparency. Perhaps the market will develop its own solution before regulation is needed.

The FSA's discussion paper on trading transparency in the UK secondary bond markets is available on the FSA website and provides a useful explanation of how the markets currently work and the huge number of information providers that already exist. The ACT would welcome feedback from readers which can inform the response it intends to submit. Contact modonovan@treasurers.co.uk ■

ACT technical manifesto

The ACT has published a technical committee manifesto on its website with the objective of explaining the aims and scope of its technical work and the general stance that will be taken by the ACT in formulating and publishing any official views on technical matters. The core premises which will be used as the basis for any submissions to government, regulators and standard setters are laid out. These are:

- Open, liquid, transparent and honest markets are in the interests of all companies involved in those markets in any way and of society at large.
- Regulation commonly represents a barrier to entry, restricts competition and innovation and increases costs. It should thus normally only be used as a last resort.
- Where regulation is to be applied it should be with a bias towards light-touch regulation and principles-based regulation to lower costs and preserve as much flexibility as possible.

The ACT's membership includes many persons who work in the financial services sector which already has a number of trade bodies which strongly represent it. The ACT's orientation is towards the non-financial corporate and it will therefore seek to represent that viewpoint.

Advice on loan agreements updated

Any loan negotiations are likely to fare better if you start well prepared, knowing the position the other side is coming from and the arguments they will be putting forward. With the help of the ACT Guide to the Loan Market Association Documentation for Borrowers you can do just that, using the expert advice of Slaughter and May, its authors. The Guide explains each clause in the Loan Market Association's (LMA) investment grade syndicated loan facility document and explains where it might be worth seeking more favourable terms, what one should aim for and the likely counter arguments from the lenders. The guidance is just as valid for a bilateral or non-LMA form agreements since most loan agreements will have a substantial core that is covering similar matters where similar principles apply. (See also *The Treasurer* July/August 2004 p41.)

The Guide was completely revised and reissued last year and a further supplement added in August 2005. The supplement explains recent changes to cater for major operational disruption, for example terrorism, which allow for an extra grace period for payments and for the Agent to have the authority to respond pragmatically at the immediate time of a Disruption Event. Disruption Event is defined as being 'of a technical or systems related nature', so borrowers may like to debate if this should be extended to disruption affecting the human element, for example if the office is evacuated by the police. There is also the reminder that the extra grace period does not apply to the cross default so a non-payment under another loan agreement could still cause a problem. If the borrower cannot convince the banks to include a grace period on the cross default clause the remedy is to get Disruption Events allowed for in all the other agreements to match.

Also new is some wording to cater for additional costs arising from Basel II. Basel II will be different from the current set up in that the capital cost attributable to a loan will no longer remain constant over the life of the loan but will vary as the borrower's credit worthiness changes and may be affected by the bank's own assessment methodologies. Under the normal increased cost clause the introduction of Basel II will be a change of law or regulation and potentially give rise to increased costs on pre-existing agreements. For facilities signed after the implementation of Basel II there could still be increased costs arising from a 'change in administration or application' of the regime as when the borrowers credit standing changes. The LMA standard agreement provides an alternative increased costs clause which excludes Basel II-related costs. The argument for this approach is that the consequences of Basel II can be predicted now and are effectively built into the setting of margins on any facilities likely to extend beyond its start date. The Guide also covers some further refinements that could be considered and negotiated.

For the full ACT Guide and supplement see www.treasurers.org/technical/lmaguide.cfm. ■

IN BRIEF

The findings of the group reviewing the **Turnbull Guidance on Internal Control** have been supported by the ACT. The wide-ranging scope of the matter addressed, which goes beyond just financial controls, is preserved and the minor proposals for change generally avoid prescription of how the guidance is to be applied. The trap of seeking to eliminate risk rather than to look to its identification and management has been avoided.

The **IFRS Tax Disregard Regulations** continue to be revised so that the 1 October deadline for elections has been extended to end 31 December 2005 in respect of regulation 9, which covers currency and interest rate swaps. Unfortunately, the corresponding deadline for electing that regulations 7 and 8, which deal primarily with currency and commodity forward contracts, should not apply was not extended. The disregard regulations are designed so that the taxpayer is not disadvantaged by the move to International Financial Reporting Standards (IFRS) and is not taxed on fair value gains and losses which are taken to reserves.

The ACT has provided feedback on **client categorisation in the Markets in Financial Instruments Directive (MiFID)** to the European Commission (EC). It argues for a clear distinction to be drawn between retail, professional and eligible counterparties so that larger and more experienced organisations can opt into a higher category with less protections but more freedom and speed of execution. Any reduction in the three-tier arrangement would reduce flexibility.

Following the EC's consultation on **shareholder rights** Commissioner Charlie McCreevy is proposing light-touch regulation which would abolish share blocking and instead mean companies would use a record date to determine those shareholders who would have access rights to general meetings; a simple means to vote *in absentia*; and timely and easy access to complete General Meeting information and documents.

The European Parliament has approved certain amendments to the **4th and 7th Company Law Directives concerning statutory audits.** The key audit partner must rotate after seven years as opposed to the five years proposed earlier and member states will have discretion to exempt certain bodies from the obligation to have an audit committee.

ACT warns on PPF levy methodology

Figure 1. Risk-based levy per £1m of Pension Protection Fund liability

	Insolvency risk band									
	1	2	3	4	5	6	7	8	9	10
approx rating	aaa to a-	bbb+ to bbb-	bb+ to bb	bb-		b+		b	b-	ccc
funding level										
50%	572	2,640	5,500	7,480	10,340	14,960	20,900	29,040	30,000	30,000
55%	520	2,400	5,000	6,800	9,400	13,600	19,000	26,400	30,000	30,000
60%	468	2,160	4,500	6,120	8,460	12,240	17,100	23,760	30,000	30,000
65%	416	1,920	4,000	5,440	7,520	10,880	15,200	21,120	30,000	30,000
70%	364	1,680	3,500	4,760	6,580	9,520	13,300	18,480	27,300	30,000
75%	312	1,440	3,000	4,080	5,640	8,160	11,400	15,840	23,400	30,000
80%	260	1,200	2,500	3,400	4,700	6,800	9,500	13,200	19,500	30,000
85%	208	960	2,000	2,720	3,760	5,440	7,600	10,560	15,600	24,000
90%	156	720	1,500	2,040	2,820	4,080	5,700	7,920	11,700	18,000
95%	104	480	1,000	1,360	1,880	2,720	3,800	5,280	7,800	12,000
100%	52	240	500	680	940	1,360	1,900	2,640	3,900	6,000
105%	10	48	100	136	188	272	380	528	780	1,200
110%	10	48	100	136	188	272	380	528	780	1,200
115%	10	48	100	136	188	272	380	528	780	1,200
120%	10	48	100	136	188	272	380	528	780	1,200

Source: Board of the Pension Protection Fund

The Pension Protection Fund's (PPF) proposals for assessing a risk-based levy on defined benefit schemes in deficit are generating widespread protest, and the ACT has registered its own concerns in its response to the public consultation.

The PPF scheme has been set up to pay compensation to pensioners who lose out when their scheme is in deficit and the sponsoring employer can no longer support it because of an insolvency. For those already drawing their pensions there will be 100% compensation for the amounts in payment and for people below pensionable age there will be 90% compensation for accrued benefits, with some limited indexation in both cases.

The PPF is funded by charges levied on pension schemes and from 2006/7 those charges are to be largely risk-based.

The proposed scale of charges is to be set as a function of the scheme's level of deficit, and the likelihood of the scheme sponsor's insolvency viewed over a 12-month horizon, with the insolvency probability determined by the PPF's appointed service provider, Dun & Bradstreet.

The proposed fees are shown in *Figure 1*. The conventional scale of credit ratings is shown but this is only an approximation since it will be the Dun & Bradstreet score that is actually used. The fees are charged on the scheme liabilities not the amount of the deficit. Thus for a BBB credit in band 2 that is 75%-funded, the fee is £1,440 per £million or 14bp. Expressing this as 56bp on the 25% deficit makes it more apparent that it is the cost the sponsor incurs for effectively 'borrowing' from the fund.

The ACT has made a submission to the PPF which is strongly in favour of moving to a risk-based levy and recognises that in the interests of introducing this approach quickly there are bound to be some rough edges that should be sorted out over time. However, it still feels that a good deal more could, and should, be done to make the proposals more equitable.

- In classifying the risk for the sponsor the PPF needs to recognise fully the implications if the sponsor is part of a larger group, and benefits from the strengths of that group. The PPF proposed that in multi-sponsor schemes the risk is assessed from the sponsor that has the largest number of employees. Taking an entity in isolation may significantly overstate the true risks.

- The Dun & Bradstreet analysis produces a probability of insolvency. The PPF should in addition take into account any risk mitigation such as external credit support arrangements. By recognising them the PPF would encourage sponsors to put such arrangements in place, which would ultimately help secure the pensions due.

- The PPF should be immediately responsive to any favourable moves taken by sponsors, such as lump-sum or enhanced contributions, or a material improvement in credit standing or credit support. This would encourage the behaviours and actions that are beneficial.

Other deficiencies that need changing include:

- The levy is pro-cyclical and will hit weak companies especially hard at just the time when they are most vulnerable, which is not helpful for overall public policy.

- The various capped elements create a cross subsidy from the stronger to the weaker schemes and sponsors. The government should bear this cost.

- The approach of the PPF-contracted provider of credit information is largely mechanistic, so an appeals process is essential.

Shortly after the consultation closed, the PPF issued an update to its levy proposals which accepted some of the points made by the ACT and others. The PPF intends to take some account of scheme structures where sponsors would be unfairly hit by levies if the "largest employer" rule were applied to them. Where special contributions have been made since the last valuation, the PPF will allow a rolled forward valuation. It will also take account of contingent assets of the scheme, although not of the sponsor.

These changes represent a good start but still do not fully remedy the many deficiencies of the PPF's current levy proposals. ■

A copy of the ACT's full response to the PPF is available on www.treasurers.org/technical/papers/actresponse_pplevy.pdf

See feature, page 22.