WORKING BEHIND THE SCENES

Seeing the ACT in the press (for the right reasons) is satisfying, but much policy and technical endeavour takes place with less publicity. We maintain good links with other professional bodies, trade associations, government and regulatory authorities. Some positive results remain invisible – such as the Wheatley discussion paper on Libor (see below), which is informed by the British Bankers' Association in-depth review, in which we have actively participated for many months

Martin O'Donovan is ACT deputy policy and technical director @MartinODonovan1

{ IN DEPTH }

IN THE EYE OF THE LIBOR STORM

Restoring confidence in Libor is essential. So the ACT has responded fully to the initial discussion paper from the review of the benchmark interbank lending rate by Martin Wheatley, managing director of the UK Financial Services Authority (FSA). The ACT has been a member of the FX and money market committee that supervises the Libor process of the British Bankers' Association (BBA) since 2009.

Companies must be worried that the current system, where reference banks make voluntary submissions on a daily basis, breaks down and banks cease to participate for fear of legal repercussions.

In the absence of Libor, the fallback might entail reverting to small panels of reference banks for each deal. This would increase costs, be an administrative nightmare and would probably generate inconsistencies between borrowing rates and hedging rates in the swap markets, with consequent problems with hedge accounting.

In future, we propose that an appropriate authority, such as the Bank of England or the FSA, should oversee the Libor process, and a robust legal framework should exist so that contributor banks feel confident that they are not needlessly running high risks. Major market participants should be required to get involved as part of their regulatory obligations.

To a layman, it must seem baffling that data on interbank lending cannot be speedily collected with average rates compiled to produce a reliable and auditable reference rate. But, at present, the problem is that the actual volumes of deals done each day are often small, with the exception of shorter maturities.

The ACT supports Libor being based on the rates at which a bank funds itself in the wider wholesale money markets, not just on interbank deals. But to avoid distortion – or even deliberate manipulation – of the rates, there does need to be an element of judgement, bank by bank. No deals at all might take place for some currencies or maturities, or the deals that are done might reflect the special circumstances of the transaction or relationship between the parties. But any judgement involved does need to be fully justified and documented, and subject to adequate compliance and governance procedures. And the whole process should be governed by regulation.

For the moment, Libor is the main focus of interest and the European interbank lending rate, Euribor, has escaped the storm. Euribor bears some similarities to BBA Libor, but is based on much larger panels of contributor banks. This necessarily means that not all the banks involved are market leaders or of the highest credit standing. To remove the distortion of rates by the participation of smaller or weaker banks, the rates contributed by each bank are supposed to be the rate at which a theoretical, superior-standing bank can expect to fund itself. This theoretical bank approach introduces an additional layer of judgement for Euribor. Similar governance provisions, as discussed above, should apply for all rate contributions involving judgement.

> Euribor bears some similarities to BBA Libor, but is based on much larger panels of contributor banks

YOUR SHOUT

Which regulatory developments concern you most right now? Are important changes approaching that you think treasurers are not sufficiently aware of? Tell the ACT policy and technical team. Email: modonovan@treasurers.org or mprice@treasurers.org

{ INTERNATIONAL }

CENTRAL CLEARING LOOMS

Treasurers of most non-financial companies expect to avoid mandatory central clearing of their derivatives, but market pressures may mean they voluntarily head in that direction. Companies with property funds and pension funds that fall within the Alternative Investment Fund Directive will already have a timetable to mandatory clearing. With the US rules in mind, the International Swaps and Derivatives Association (ISDA) has published a cleared derivatives addendum to its agreements.

The addendum includes representations for each party to make regarding certain clearing-related matters, such as the treatment of customer collateral. It also outlines the close-out methodology for cleared OTC swaps, the triggers for liquidation and provisions for valuing the terminated trades.

ISDA has also published its *August 2012 Dodd-Frank Protocol*. This multilateral contractual amendment mechanism allows swap market participants to amend multiple ISDA master agreements simultaneously to facilitate compliance with Dodd-Frank regulatory requirements, such as the External Business Conduct Rules.

Separately, ISDA published the *ISDA 2012 FATCA Protocol*, designed to offer market participants an efficient way to amend the ISDA master agreement tax provisions to address the effects of the US Foreign Account Tax Compliance Act.

View the following technical updates and policy submissions at www.treasurers.org/technical

Funding for lending webinar with Paul Fisher, Bank of England

ACT response to ESMA consultation on technical standards for OTC derivatives

ACT response to the Wheatley review of Libor

{WATCH THIS SPACE }

IS LIBOR RELEVANT FOR VALUING DERIVATIVES?

Derivative pricing is based on cash flows discounted back to today's value. Historically, BBA's Libor settings have been used at the short end of the curve when building a zero coupon curve to calculate the discount factors. But banks seem to be adopting the overnight index swap (OIS) rate when valuing some of their derivatives. Reval, the treasury and risk management software provider, says it is seeing more European corporate clients who tend to have bilateral credit support annexes in place.

For less risky, collateralised deals, the additional credit spread implicit within Libor is not relevant, so the OIS rate becomes the more appropriate basis. When there is no collateral posted in a derivative contract, then Libor still seems the favoured rate.

Treasurers need to understand that changing the source of rates from Libor to OIS will affect the valuation of their derivative portfolio because the spread between OIS and Libor has increased since Lehman collapsed. Potential hedge accounting issues can arise if Libor is used to calculate the discount factor on the underlying cash flows being hedged, while OIS is used to value the hedging instrument. The resultant basis risk will produce ineffectiveness that is booked to the profit and loss account.

{ TECHNICAL ROUND-UP }

SEC, FX AND FSA

The Securities and Exchange Commission (SEC) has proposed rule changes to allow general solicitation or advertising (GSA) in connection with private placements under Rule 506, as long as issuers take reasonable steps to verify that all purchasers of the securities are accredited investors. GSA will also be allowed for issues under Rule 144A, provided the securities are sold only to persons that the seller reasonably believes are qualified institutional buyers. The current ban on GSA remains until the rule change is formally adopted. Certain state securities laws will continue to prohibit GSA unless subject to state exemptions.

New guidance on managing settlement risk on FX has been proposed by the Basel Committee on Banking Supervision. The guidelines address governance, principal risk, replacement cost risk, liquidity risk, operational risk, legal risk and capital for FX transactions. There is a strong emphasis on settling FX transactions through the use of financial market infrastructures that provide payment-versus-payment arrangements.

The Financial Services Authority (FSA) has warned on the risks of crowdfunding where returns can be slow for start-ups, liquidity is poor and there is no protection if the business or project fails. Crowdfunding involves a business, usually a small one, raising debt or equity from a very large number of individuals, who each contribute small amounts (often just £10-50) using an online platform. The FSA's view is that most crowdfunding should be targeted at sophisticated investors. Nevertheless, the ACT sees crowdfunding as an innovative method for raising finance and has sponsored a report (*Seeds of change: emerging sources of non-bank funding for Britain's SMEs*) into the platforms that already offer the product.

OTC derivative regulation passed into law The EU regulation of OTC derivatives (EMIR) has been published in the *Official Journal* and accordingly entered into force on 16 August 2012. The start dates for the reporting and clearing obligations are set for summer 2013, but may yet be delayed further.