Quarterly Quiz
2011 Quarter Three

Operational Risk

Operational risk has been in the news recently with the "best-selling" Sunday newspaper having to close when its name became "toxic" and therefore, presumably, valueless. The issue was, and still is, one of law breaking in an attempt to gain access to news stories. Another variant on the trade-off familiar to all those involved in finance – risk versus return.

Enterprise risk management is about understanding what risks are being taken and what returns are expected as a result. Much of the time we are trying to reduce risk, particularly financial risk because our shareholders invest in our business skills rather than our ability to play financial markets. That is not always the case, though. When the risk that we identify is to do with our core market, or in our core field of expertise then we should be willing to take a position that we think will generate returns in the longer term. So, we design a new product or organise operations differently in order to take advantage from the developments that we expect. If we are right we gain; if we are wrong we lose – but that is exactly the sort of risk that shareholders want us to take. No-one invests in Tesco or Glaxo Smith Kline because they take no risks at all.

Decisions on risk appetite determine the way that the company is managed. But the decisions must be based on full information of the potential risks and returns. Having said that, operational risk is the one area that virtually no company wants any exposure; no-one expects to gain by making sure that there is no law-breaking in the firm, except by avoiding the cost of disaster.

Question 1

Where does responsibility lie for ensuring that *(operational?)* risks within a large enterprise are appropriately managed?

(a) Operational managers within the operating unit
(b) Legal officials within the operation unit
(c) Divisional risk managers
(d) The Group's Board
(e) Don't know

Answer 1

The right answer is (d) the Group's Board.

The answer is that the responsibility lies squarely at the top. It is often said that the CEO's role is to manage the corporate culture. The balance between risk and return is perhaps the most fundamental part of that culture. A CEO cannot take credit for management skill when things go right but deny all knowledge of the risks being run when things go wrong. The role of risk committees from the main board down is to make sure that the right questions have been asked. The "I didn't know" defence is inadequate, unless at the same time it can be demonstrated that the question had been raised and that there were preventive measures in place.

As treasurers, most of the time we are concerned with the financial aspects of risk and return, but ultimately all risks and returns have financial consequences.

Basel III and Bank Regulation

The rush to revise the regulatory environment for banks after the catastrophe of recent years has focused on the determination that 'this must never happen again'. To that end minimum capital levels have been increased and the requirements for the sort of finance that can be accepted as "capital" has been tightened. Of course, having spent over a decade trying to agree Basel II for all internationally active banks, the chances of reaching unanimity on any new stricter regulations look slim.

The direction of travel is clear, though, given pronouncements from every quarter. The division of the universe of all banks into the 'too-big-to-fail' group of systemically important banks and 'the rest' seems to be agreed across the world. In July of 2011, the Basel Committee on Banking Supervision announced that it thought that the 30 systemically important banks should be hold only ordinary equity to cover their proposed surcharge of 1% – 3.5% on their core equity tier one capital. The Chairman of the Financial Stability Board (FSB) has also supported this stance. This gives significant weight because the FSB is a truly international body of regulators and standard setters including European, US and Asian representatives.

This sounds like the end for co-cos, contingent convertibles which appear as a bank's debt while all regulatory requirements are met but convert to loss-absorbing equity when capital ratios are under pressure. They seem to be the ideal instrument to deal with this contingent capital requirement because when extra capital is not required they are lower-cost debt but when extra capital is needed they convert to higher-cost equity. Unfortunately, Credit Suisse had issued $9bn earlier in the year.

Question 2

What is the problem with co-cos that has resulted in their proposed exclusion from this category of bank capital?

(a) There is no reason, this is an over-reaction by the regulators
(b) Conversion triggers may not be applied as required by the instrument documentation
(c) Investors will be more reluctant to invest in such potentially loss-absorbing instruments
(d) The instrument is likely to accelerate a bank's problems when capital constraints are at their worst
(e) Don't know

Answer

The right answer is (d) The instrument is likely to accelerate a bank's problems when capital constraints are at their worst.

The argument put forward to justify the acceleration of the problems, is that rational behaviour for an investor would be as follows. Holding such an investment may be worthwhile depending on the expected likelihood of problems arising coupled with returns expected in the meantime. If problems do arise, and the instrument is likely to be converted, the bank's equity is almost certain to come under pressure. But the rational investor, confronted with this situation, would be encouraged to sell the bank's equity in the anticipation of conversion, before the price drops even further. These extra sales would place further depress the equity value of the bank in question and increase the probability of the bank failing. The instrument is therefore pro-cyclical in nature and is inappropriate for this application.

Regarding answer (c), investors are very likely to be able to distinguish a good investment from a poor investment without the help of the regulator.

FT.com Lex, http://www.ft.com/cms/s/3/60d33d90-b2c8-11e0-bc28-00144feabdc0.html#axzz1SjMOJrbk
FSB http://www.financialstabilityboard.org

Bribery

It was announced in July that Willis, the insurance broker, has been given a record fine for failing to ensure that commisions for overseas business were not used for bribery and corruption. Given the current climate regarding wrongdoing and the potential for the unintentional finance of terrorism, it is worth a reminder that the UK Bribery Act 2010 came into force at the beginning of July 2011.

The Act makes a company liable for the offence of bribery by an employee or someone performing services for the company. We like to think that the potential risk to a UK company doing business in the UK is relatively small, but perhaps some recent events may have changed minds on that. In contrast, we tend to believe that doing business overseas or involving overseas agents may represent greater risk. After all, in Willis' case the offence related to commisions paid regarding Russian and Egyptian business.

Joint ventures are not automatically presumed to be associated with the joint participants, although a risk averse company might be wise to take some precautions on audit rights and other commitments for any ventures they are involved with. Corporate hospitality is excluded from the Act provided that it is proportionate, reasonable and made in good faith.

Question 3

If accused of bribery, what defence might a UK corporate offer that, if successfully argued, would mitigate any potential punitive measures?

(a) We didn't know it was happening
(b) It contravened the employment contract of the individual concerned
(c) Demonstration of adequate procedures in place to prevent bribery occurring.
(d) Firing appropriate employees as soon as the situation becomes known
(e) Don't know

Answer

The right answer is (c) Demonstration of adequate procedures in place to prevent bribery occurring.

Again, looking the other way and then proclaiming lack of knowledge will be no defence whatsoever. If the corporate can successfully argue that it did have adequate procedures in place to prevent bribery or to expose it if it had occurred then the liability may be downgraded to the lesser offence of failing to prevent bribery.

With all risk management, the key is to be aware of what risk exposure the company has and then to establish means of assessing, evaluating and managing that exposure. When it comes down to it, lack of knowledge might, in terms of managerial quality, be an even bigger indictment.

Technical Update by Martin O'Donovan, The Treasurer, May 2011 p06, http://www.treasurers.org/node/6901

Pension Protection Fund Levy

The Pension Protection Fund has announced changes to its framework for determining the pension protection levy. There are four main changes;

- fixing the levy rules for periods of three years to give greater stability,
- incorporating investment risk so that low risk investment will be rewarded and high risk investment will be penalised
- averaging or smoothing funding levels to avoid the impact of volatility in financial markets
- applying 10 rating bands rather than the current 6 bands

The PPF has worked with all stakeholders to try to reform the current framework so that the levy can better reflect the risks inherent in each pension scheme. The new framework will take effect from 2012/13.

Question 4
What are the factors which currently (2011/12)determine the PPF levy?

(a) Size of any deficit plus insolvency risk of the sponsor plus benefit for any asset/liability risk reduction
(b) Proportion of assets relative to liabilities plus insolvency risk of the sponsor
(c) Percentage of assets relative to liabilities plus credit rating of the employer plus benefit for any asset/liability risk reduction
(d) Size of any deficit plus benefit for any asset/liability risk reduction plus a maturity measure determined by number of active and deferred members versus pensioners
(e) Don't know

Answer
The right answer is (b) Proportion of assets relative to liabilities plus insolvency risk of the sponsor

The formula used by the PPF for 2011/2012 is
Risk based levy = underfunding risk × insolvency risk for sponsor × levy scaling factor × % risk-based

Underfunding risk is determined by first finding the funding level as
$$\frac{\text{asset value}}{\text{liability value}} \times 100$$
If this factor is less than 135% then
underfunding risk is U=(1.36×liability value) – asset value

In the unlikely event of the funding level being greater than 135%, then the underfunding risk declines until the funding level reaches 150%, when underfunding risk is deemed to be zero. The means of calculating liabilities is that used in section 179 annual return .

As things stand, there is no benefit in terms of the liability for the levy for taking risk reduction measures.

News and Comment, The Treasurer July/August 2011, p04 http://www.treasurers.org/node/7086
PPF website:
http://www.pensionprotectionfund.org.uk/levy/howthelevyworks/Pages/howthelevyworks.aspx

Hedge Accounting Changes

IFRS9 is the replacement for the existing standard covering derivatives for hedging. It will replace IAS 39 which has been controversial since its inception. The Hedge Accounting exposure draft was published in December 2010 and comments were required by March 2011. It is expected that the final standard will be published in late 2011.

Apart from the inevitable difficulties over wording, particularly in relation to the portfolio hedging of interest rate risk, there is a major stumbling block ahead for adoption of the new standard by UK companies.

Question 5
What is the major stumbling block for adoption of the new standard by UK companies?

(a) The new standard has yet to be endorsed by the EU
(b) The portfolio hedging of interest rate risk will be outlawed
(c) Derivatives can only be used in hedging if they are exchange-traded
(d) All hedging gains and losses must be taken through the Income Statement
(e) Don't know

Answer
The right answer is (a) The new standard has yet to be endorsed by the EU

This is a problem for all companies whose shares are traded on an exchange within the EU. Those companies whose shares are only traded outside the EU will have no problems. Small companies not currently required to use IFRS but using UK GAAP will be unaffected until 2013 when they will be required to use a form of IFRS.

IFRS9 is the only IFRS standard not wholly endorsed by the EU, being subject to some carve-outs.

Tectonic Changes by Johann Kruger, The Treasurer, May 2011 pp28-30,
http://www.treasurers.org/node/6896

Are You Being Reasonable?

Often in loan documentation, as well as other legal doucuments, there is a requirement for 'reasonableness'. In loan agreements this arises particularly in the context of transfers and assignments where the phrase 'such consent not to be unreasonably withheld' is far from unusual.

Cifford Chance have publsihed a briefing covering what this means, and it is available as a download. Because there is little authoritative precedent in this area, they have drawn conclusions on the key principles from other legal cases that have some similarity to the case of a loan document. Some of the conclusions are drawn from the precedent of landlord and tenant judgments.

Question 6
What are the key principles to be applied to determine reasonableness in the transfer of loan assets?

(a) There are no general principles, just the specific context of the case
(b) The burden of proof is on the party seeking approval and the grounds would include the ability of a substitute to perform over the life of the contract

(c) The burden of proof is on the party refusing approval and the grounds would include the ability of a substitute to perform over the life of the contract
(d) The burden of proof is carried by both parties and the grounds would include the ability to perform over the life of the contract plus the right to require a compensation payment or other advantage in return for approval.
(e) Don't know

Answer
The right answer is (b) The burden of proof is on the party seeking approval and the grounds would include the ability of a substitute to perform over the life of the contract.

In the briefing the authors suggest that the landlord tenant relationship has similarities to loan documentation and that the onus of proving that consent has been unreasonably withheld is on the party seeking the approval. Interestingly the argument that lenders were expected to stay for the life of the loan cannot hold water if there are provisions within the contract for assignment or transfer.
A good cause for refusal of consent might be the imposition of adverse withholding tax consequences, as might be expected.
However, the briefing does point out that the details of each case mean that the permutations are endless.

Are Borrowers acting unreasonably when they withhold their consent to Transfers and Assignments by Lenders? Briefing paper by Deborah Neale and Debbie Clark of Clifford Chance
http://www.lma.eu.com/uploads/files/LMA_article_on_borrower_consent_to_transfer.pdf

Technical Update by Martin O'Donovan, The Treasurer, July/August2011 p09
http://www.treasurers.org/node/7091