CPD
2011 Quarter Two

Question 1
In March 2011 it became known that four banks (two European and two US) were being investigated regarding the possible manipulation of LIBOR. With an estimated $350,000bn of rate sensitive assets it is clear that the major banks have an incentive to try to ‘manage’ the rate. Further, a Viennese asset manager has launched a legal case in the New York against 12 banks accusing them of conspiring to manipulate the LIBOR rate between 2006 and 2009.

The FX and MM committee of the British Bankers Association is responsible for the determination of LIBOR. Strictly speaking it should be known as ‘bbalibor’ to distinguish it from other reference rates. The calculation is performed for ten currencies, each for 15 periods from overnight to twelve months. There is a panel of banks for each currency, the panel being selected by reference to their activity within that currency’s market.
While the actual calculations are undertaken on BBA’s behalf by Thomson Reuters, the BBA takes responsibility for the design of the calculation, which is detailed on their website www.bbalibor.com.

Which of the following is the question to which the panel of banks responds to generate the data for the determination of BBA LIBOR?

(a) At what rate have you lent funds of a reasonable market size in interbank trading today just prior to 11.00am?
(b) At what rate could you borrow funds were you to do so by asking for and accepting interbank offers in reasonable market size just prior to 11.00am today?
(c) At what rate do you think interbank term deposits will be offered by one prime bank to another prime bank for a reasonable market size today at 11.00am?
(d) What is your interbank offer rate for a reasonable market size for prime banks at 11.00am today?
(e) Don’t know

Answer
The right answer is (b) At what rate could you borrow funds were you to do so by asking for and accepting interbank offers in reasonable market size just prior to 11.00am today?

What is being sought is the offer rate rather than the bid rate, so borrowing rates of banks is at issue rather than lending rates, as in (a). Answer (c) was the question being asked until 1998, when the change was made to the current question as in (b). Answer (d) might be seen to be encouraging banks to produce “11 o’clock” rates that might sway the determination of LIBOR.

EURIBOR is not determined by the BBA, that is the responsibility of the European Banking Federation. Thomson Reuters also crunch these numbers.

The LIBOR calculation takes quotes from a number of banks and eliminates the highest and lowest quartile of quotes. This leaves half of the quotes, which are then averaged to produce LIBOR. Statistical testing is done to reduce the potential for banks to manipulate the calculation: the BBA is confident that its procedures are robust, but certainty is always elusive.

Detailed methodology for determination of LIBOR can be found on the BBA LIBOR website: *www.bbalibor.com*

FT.com: Crisis probe puts LIBOR in spotlight, March 15 2011 by David Oakley
http://www.ft.com/cms/s/0/780dc306-4f34-11e0-9038-00144feab49a.html#ixzz1JtQcuyum

FT.com: Stakes are high in setting Libor, March 25 2011by Megan Murphy
http://www.ft.com/cms/s/0/ad9c146e-5718-11e0-9035-00144feab49a.html#ixzz1JtRNZRpa

Twelve banks worldwide sued for manipulating LIBOR:
http://uk.reuters.com/article/2011/04/19/uk-libor-lawsuit-idUKTRE73I40T20110419

Question 2
At the start of the credit crunch UK dividends, in fact dividends all over the world, were scaled back. This was because companies were unsure about future funding and so conservation of cash seemed the right thing to do. As we reach the end of the recession those funding concerns are fading as some degree of confidence regarding corporate profitability returns. Many eyebrows will be raised at that comment as the return to modest growth appears very patchy. Even more eyebrows might be raised at the news in April that UK dividends rose in the first quarter of 2011 by 10% over the same quarter of 2010. The special payout from International Power, following its takeover of GDF Suez in February, and the return of BP's dividend have made a major contribution to this figure. Even so, the overall level of growth of UK dividends in 2011 is anticipated to be 8% - a total of £64.2bn over 2010's £56.5bn.

In today's financial environment, where the return on 10 year gilts is around 3.5% and the equity risk premium is around 6%, that would mean that the average UK equity cost should be around 9.5% - let's say 10% to keep the numbers easy.

If long-term dividend growth before 2011 had been 3%, and this figure of 8% can be maintained for the future, what *increase* in value does that represent for the UK stock market in 2011 over 2010?

(a) 50% increase in value from 2010 to 2011
(b) 150% increase in value from 2010 to 2011
(c) 350% increase in value from 2010 to 2011
(d) 750% increase in value from 2010 to 2011
(e) Don't know

Answer
The right answer is (c) 350% increase in value from 2010 to 2011

The basis of the valuation that requires just cost of equity and the dividend growth rate is the Dividend Valuation Model. This is derived from two propositions: the idea that dividends can be valued as a growing perpetuity; and the idea that all returns from the company will – over the life of the company – be paid out as dividends. The phrase 'over the life of the company is particularly important here: retaining cash rather than paying out dividends increases present growth and therefore increases future dividends.
The formula is:

*Value now = dividend next year / (cost of equity – **perpetuity** dividend growth rate)*

If we assume that dividend next year is '1' in either case, then under the previous assumption of 3% growth in dividends, Value = 1/(10% - 3%) = 14.28.
If we revise our growth assumption in dividends to 8% p.a. then the value becomes 1/(10%-8%) = 50.

This is an increase in value of 350%!

The flaw in the argument is the flaw that is often levelled at the Dividend Growth Model – that the growth rate has to be the long-term growth rate of dividends, over the life of the company. While we might think of the long-term as being 5 years, this model requires an assumption for a much longer term.

FT.com: UK dividends set for an 8% rise in 2011 by Alice Ross April 17th 2011
http://www.ft.com/cms/s/0/f89b91b8-6917-11e0-9040-00144feab49a.html#ixzz1JtQ494HD

Question 3
The first quarter of 2011 has seen a dramatic rise in high yield bond issuance. In itself that may not be too surprising because the market fell to such low levels in 2008, 2009 and 2010. So when news broke of a potential new 'bubble' in high yield bonds there was considerable surprise tempered by the thought that dramatic growth from a low base is probably more of a statistical quirk than anything too concerning.

Then in April more evidence emerged that the market was overheating with 12 new issues in a single week and experienced managers quoted as saying they had never seen 'anything like it' and figures showing that junk-bond issuance had doubled on year-to-date over the same period last year.

Perhaps the best indication for concern might be the re-emergence of Payment In Kind bonds rated CCC. These are risky bonds. Finance theory would argue that there will always be a price for risk, so there will always be a market for risky investments, but that high risk must generate a high return. Markets exist to price that risk return trade-off. Naturally, in practice as risk increases the number of potential investors reduces. The surprise has been the number of investors lining up to invest.

What is a Payment In Kind Bond?

(a) It is a bond where capital and coupon are paid as discounts on the issuing company's products
(b) It is a bond where coupons are paid as discounts on the issuing company's products but capital is returned in cash
(c) It is a bond where coupons and/or capital repayment is made by issuing new bonds to the investor
(d) It is a bond where the issuer doesn't have to repay at all, just issue further paper ad infinitum
(e) Don't know

Answer
The right answer is (c) It is a bond where coupons and/or capital repayment is made by issuing new bonds to the investor.

Answer (d) is obviously not a sensible description of a PIK bond!

FT.com: High Yield Bonds February 10th 2011
http://www.ft.com/cms/s/3/78465eb2-3528-11e0-9810-00144feabdc0.html#ixzz1JtSVtAkI

Investment Week: High-yield managers concerned on record junk-bond issuance, April 18th 2011 by Emma Dunkley *http://www.investmentweek.co.uk/investment-week/news/2044007/-yield-managers-concerned-record-junk-bond-issuance#ixzz1JtT0j28x*

DJ UPDATE: Dometic Plans EUR200M 2019 Payment-In-Kind Bond by Serena Ruffoni , Dow Jones Newswires
http://www.morningstar.co.uk/uk/markets/newsfeeditem.aspx?id=138501957995012

Question 4
Islamic financing did not suffer the major setbacks experienced by much of the world over the last few years. This was partly due to the fact that Islamic banks were much less involved (if at all) in the more extreme activities of many major western banks. Being relatively unscathed, the Islamic banks were, and still are, in a position to continue their activities. Over the past year they have achieved enormous growth and the 'Islamic finance market' has become of international interest so that Standard and Poor's have produced a report arguing that global standards are needed to maintain and develop the market from current levels.

From small beginnings around the turn of the millennium, sukuk (Islamic bond) issuance rose to just under $40bn in 2007. The levels did fall in 2008 and 2009, but 2010 saw a record issuance of just over $50bn. The figures from February of 2011 suggest that this year will see even more growth above that figure. Much of the issuance is focussed on Malaysia but the Gulf region is becoming more significant.

Three forms of Islamic finance dominate overall sukuk issuance. These are ijara, murabaha and musharaka.

Using simple western terms rather than precise definitions, what are ijara, murabaha and musharaka?

(a) Ijara is lease financing, murabaha is cost-plus financing and musharaka is equity financing
(b) Ijara is construction/project financing, murabaha is equity financing and musharaka is cost-plus financing
(c) Ijara is cost-plus financing, murabaha is payment for future delivery and musharaka is interest-bearing financing
(d) Ijara is cost-plus financing, murabaha is not-for-profit financing and musharaka is lease financing
(e) don't know

Answer
The right answer is (a) Ijara is lease financing, murabaha is cost-plus financing and musharaka is equity financing.

Answer (c) cannot be right because the principle of Islamic finance is that interest is not permitted, so there can be no interest-bearing finance.

The Treasurer April 2011: Resurgent sukuk market smashes all the records, page 06
http://www.treasurers.org/node/6823

Standard and Poor's Global Standards Needed To Give Breadth And Depth To Growing Sukuk Market, 1st March 2011
http://www.standardandpoors.com/prot/ratings/articles/en/eu/?assetID=1245296473664#ID3129

ACT Qualification Certificate in Corporate Finance and Funding: Study Unit 5, section 4.6 Islamic Finance.

Question 5

The principles involved in deciding the corporate structure of international groups are largely about risk management and tax management. International taxation is a specialist area and companies have to be very careful to structure their operations in a tax efficient manner and to observe the regulations that govern their tax liabilities. Overlaid on this tax environment though, is the broader issue of risk management. The regulatory authorities comprise more than just tax. Liability for a range of activities can be managed using the legal structure of the group. For example, lenders are wary of the credit implications of structural subordination, whereby their loan may become subordinated to other creditors.

In the UK the Pensions Regulator has power to override the strict legalities inherent in corporate structure, as has been shown recently by their issue of Financial Support Directions.

The Pensions Regulator was established by the Pensions Act of 2004. The regulator has powers to issue either a contribution notice or a financial support direction to prevent companies from avoiding pension obligations . These powers are referred to as "moral hazard powers". They are issued through the 'determinations panel' of the pensions regulator. In 2010 a contribution notice was issued against Bonas Group and two financial support directions against Nortel and Lehman Brothers. In each case, the regulator – or more precisely its determinations panel – took the view that the companies' actions had the effect of avoiding their pension obligations.

In the case of Bonas Group, the order was issued against the Belgian company VDW, the parent company. VDW arranged for Bonas to go into administration; the administrators then sold the company to another VDW subsidiary. In the regulator's view, VDW has used this technique to retain the business of Bonas while avoiding the pension liability.

In the case of Lehman Brothers, most UK employees were employed by Lehman Brothers Ltd but seconded to their operating companies. The regulator took the view that despite the strict legality, the operating companies had benefitted from the service of the employees and that the operating companies were the employer for all practical purposes. The regulator therefore issued a financial support direction against the three main operating companies in the UK and three of the holding companies of the main employer, Lehman Brothers Ltd.

These examples demonstrate the issue of contribution notices (CN) and financial support directions (FSD). What is a contribution notice (CN) and a financial support direction (FSD)?

(a) A CN is an instruction to make a specified contribution into the pension scheme, a FSD is an instruction to support a pension scheme as necessary
(b) A CN is a request to make a contribution to a pension scheme up to a maximum amount, a FSD is a request to support a pension scheme if possible.
(c) A CN is an instruction to make an unspecified contribution to a pension scheme, a FSD is an instruction to make an immediate payment of a specified amount to a pension scheme

(d) A CN is an instruction to make a specified contribution into a pensions scheme, an FSD is an instruction to support a pension scheme – and both are indisputable and unchallengable in the courts.
(e) Don't know

Answer
The right answer is (a) A CN is an instruction to make a specified contribution into the pension scheme, a FSD is an instruction to support a pension scheme as necessary.

The CN and FSD are most certainly not requests, they are instructions. Contributions are specified and it is not permissible to make a reduced payment; an FSD is made against "sufficiently resourced connected or associated party" to support a scheme, and full support is required.

Both a CN and an FSD can be challenged, as Nortel did in 2010. However the panel concluded that it would be reasonable to impose the FSD. Lehman Brothers also took the matter to the High Court. For more information see The Treasurer, April 2011.

The pensions Regulator website:
Bonas Contribution Notice: http://www.thepensionsregulator.gov.uk/press/pn10-11.aspx
Nortel FSD: http://www.thepensionsregulator.gov.uk/press/pn10-13.aspx
Lehman FSD: http://www.thepensionsregulator.gov.uk/press/pn10-26.aspx

Question 6
Before the financial crisis the advent of Basel II was hailed as creating a stable and robust framework to control the way in which banks were managed. Although some national authorities were still resisting the limitations when the crisis hit, clearly the constraints of Basel II were insufficient. The constraints of Basel II have now been extended by Basel III.

The core architecture remains the same but the capital that banks are required to hold is increased and more closely defined, there is an increased capital charge for derivatives and there is an increased risk charge for exposure to financial institutions.

New to Basel III is the emphasis on liquidity. This is covered by the liquidity coverage ratio and the net stable funding requirement.

What is measured by the liquidity coverage ratio (LCR) and the net stable funding requirement (NSFR)?

(a) LCR compares short term assets with deposits; NSFR compares internally generated retained equity with bonus payments to staff
(b) LCR compares retail deposits with market-sourced deposits; NSFR compares internal funds with externally-sourced funds
(c) LCR compares total liabilities with short (less than 7 days maturity) liabilities ; NSFR compares pure equity funds with subordinated debt
(d) LCR investigates increased withdrawals at the same time as no new funding for a period; NSFR compares the asset book with funds over 12 months maturity
(e) Don't know

Answer

The right answer is (d) LCR investigates increased withdrawals at the same time as no new funding for a period; NSFR compares the asset book with funds over 12 months maturity.

The revisions represented by Basel III have been reported in the Treasurer, most recently in March 2011 Technical Update. In addition a most readable summary of the new framework is provided by Clifford Chance, available to download from the web address below.

The Treasurer, Technical Update March 2011, page 11
http://www.treasurers.org/node/6824

Clifford Chance website:
http://www.cliffordchance.com/publicationviews/publications/2010/10/basel_iii_the_shapeofbankstocome0.html *or* *http://bit.ly/h6mmnh*