THIS MONTH

LIBOR HOGS THE HEADLINES

Will the sun still be shining when this edition of *The Treasurer* is published? At the time of writing, there may be lovely warm weather outside for the masses, but the financial environment remains stormy. The euro crisis has taken a back seat to the Libor scandal. But while Libor has been tarnished, Euribor has remained relatively unscathed. The difference between these two benchmark rates is explained in the In depth article below.

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{ IN DEPTH }

LIBOR: NOW HONEST?

The London Interbank Offered Rate (Libor) is a reference rate approximating the rate at which a leading bank might be able to borrow unsecured in the London interbank market for a given period, in a given currency.

The calculation has become well known: contributed rates from a panel of the largest market-participant banks are ranked in descending order, and the arithmetic mean of the middle two quartiles is used as the British Bankers' Association (BBA) Libor for that currency and maturity. Each panel bank's contributed rates are released with the Libor fixings for market participants to see.

Panel banks are asked: "At what rate could you borrow funds, were you to do so by asking for and then accepting interbank offers in a reasonable market size just prior to 11am?"

Each submission is the lowest rate at which a bank estimates it could fund in the London interbank market, in reasonable market size, in a given maturity and currency. They are not necessarily based on actual transactions. Not all banks will require funds in a marketable size each morning, in each of the currencies and maturities they quote. It would not be feasible to create reliable Libor rates if this were a requirement. But a bank knows its credit and liquidity risk profile from rates at which it has recently dealt, and it has access to a lot of market information. It can use its judgement to provide the required rates, informed by market activity.

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Euro Interbank Offered Rate (Euribor) uses rates submitted by a larger panel of banks, which are asked this question: "At what rate do you think interbank term deposits will be offered by one prime bank to another prime bank within the EMU zone?" (Note that 'prime bank' is not defined.)

The difference between the two is that Euribor allows important smaller and weaker banks to contribute rates and submissions that are not based on their own situation, and which may be lower than they would have to pay. So in several eurozone countries there is a divergence between Euribor and the actual cost of interbank borrowing.

Martin Wheatley, incoming head of the UK Financial Conduct Authority, is reviewing Libor and will publish his final conclusions in September. But Lord Turner, chair of current regulator the Financial Services Authority (FSA), told a Bloomberg News event in July that Libor has been "pretty robust since 2009 and 2010". "People are trying to do it as honestly as they can," he said. The FSA has advised banks on the process for arriving at rates, and banks have had to attest, to the regulator, to the quality of their Libor submission process. "I would be very amazed if, at the moment, there is anything remotely like the problems of the past in terms of deliberate manipulation," said Turner.

The ACT and other non-banks have sat on the Forex and Money Markets Committee that oversees Libor since 2009.

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 }

EXPANSION OF COLLATERAL

The forthcoming European regulation on derivatives will, in certain circumstances, require derivatives that are not put through central clearing to be subject to the exchange of bilateral collateral. Now the International Organization of Securities Commissions (IOSCO) and the Basel Committee have published initial policy proposals debating and recommending more general margin requirements for non-centrally cleared derivatives. Going back to first principles, there is an international consensus to reduce systemic risk posed by derivatives and to limit excessive and opaque risk-taking.

Holding capital buffers and posting margin both mitigate risk, but in very different ways. With margin, the losses are absorbed by the collateral, so the defaulter pays. By contrast, capital adds loss-absorbency to the system, but it is the survivor that pays. Margin is specifically targeted and adjusted over time as the amounts and risk change. On the other hand, capital is shared by all the entity's activities and thus may be more easily depleted at a time of stress and less easily adjusted. Hence the increased emphasis on margin as the preferred protection.

Fortunately, IOSCO and the Basel Committee recognise that additional margin requirements are not needed for non-financial companies unless they are themselves systemically important, but the tone of the discussion is a reminder that the trend is towards more secured and collateralised transactions.

NEW ON THE WEB

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

Contingency planning for a downturn in the economy: a treasurer's checklist

ACT response to HMRC on tax deductions on interest

ACT response to IOSCO on money market funds reform

{ WATCH THIS SPACE }

OTC DERIVATIVE CLEARING THRESHOLDS ARE SET

The ACT has responded to the European Securities and Markets Authority consultation on technical standards for regulating over-the-counter (OTC) derivatives trades under the European market infrastructure regulation (EMIR). EMIR provides that, for non-financial counterparties, OTC derivatives used as hedges – and derivatives that aren't hedges, but which do not exceed specified thresholds – are not subject to the clearing obligation.

Clearing thresholds are to be based on the consolidated group's notional value of OTCs, and will be set for each of five asset classes set out below. When one of the clearing thresholds is reached, the counterparty is subject to clearing for *all* future OTC derivatives, for all the asset classes, whether or not they are hedges. Clearing thresholds of notional values have been set at €1bn each for credit derivatives and equity derivatives, and €3bn each for interest rate derivatives, FX derivatives, and commodity and other OTC derivatives.

The ACT still has two main areas of concern:

- The definition of what sort of derivatives count as hedges (or, strictly speaking, are "objectively measurable as reducing risks...") and are therefore exempt from margining could be interpreted too narrowly. Further clarification is required.
- The requirement to report intragroup OTC derivative transactions would require non-financials to establish extensive new reporting procedures. It is generally anticipated that banks will report on external hedges by non-financial corporates.

{ TECHNICAL ROUND-UP }

LEIs, LEASES AND LONG-TERMISM

A global legal entity identifier (LEI) system that will uniquely identify parties to transactions has been proposed by the Financial Stability Board (FSB). The FSB aims to establish a global LEI system by the end of 2012, with an independently functioning system by March 2013. View the report at www.financialstabilityboard.org/publications/r_120608.pdf

The International Accounting Standards Board and the US Financial Accounting Standards Board have a new ruling on leases. The standard setters previously agreed that leases should be recorded on the balance sheet, but now some lease contracts will be accounted for using a similar approach to that outlined in a 2010 exposure draft, while others will get a treatment similar to a straight-line lease expense. A joint exposure draft is expected in the last quarter of 2012.

A white paper on banking reform, jointly published by HM Treasury and the Department for Business, Innovation and Skills, sets out government proposals to implement the recommendations of the Independent Commission on Banking (ICB). Suggestions include a ring fence to separate retail banking from investment banking activities, but, in a change from the original ICB proposals, they allow a ring-fenced bank to offer simple hedging products and derivatives to customers, subject to safeguards.

A review of the notes that accompany financial statements is being undertaken as a joint project by the European Financial Reporting Advisory Group, the UK Financial Reporting Council and its French counterpart, the Autorité des Normes Comptables. The discussion paper is open for comment until 31 December 2012. See www.bit.ly/OiPH53

The Kay review on the UK equity markets and long-term decision-making was published in July. Professor John Kay concluded that the underlying problem of short-termism is principally caused by a "misalignment of incentives within the investment chain and the displacement of trust relationships by a culture based on transactions and trading". Describing regulation as "largely ineffective", Kay recommended a regulatory focus on structure and incentives rather than rules.