Quarterly CPD Quiz

Winter 2008/09

Question 1

The current state of the financial markets have caused significant reappraisal of the terms in many loan agreements. Which of the following is likely to be an outcome of the current situation?

(a) banks will require clearly specified redress when a borrower fails to perform
(b) borrowers will require clearly specified redress when banks fail to perform
(c) borrowers will determine when ‘market disruption’ is sufficient to permit departure from the agreed LIBOR.
(d) lenders will try to impose loan margins based on CDS prices
(e) don’t know

Answer
The right answer is (b) borrowers will require clearly specified redress when banks fail to perform
Answer (a) is already fairly well covered in existing loan agreements. Answer (c) might be attractive to borrowers but is pretty unlikely! Answer (d) is a possibility, but should be the subject of careful thought beforehand – see the ACT’s Briefing Note (December 08) “Credit Default Swap based loan pricing”, http://www.treasurers.org/cdsloanpricing.

Borrowers brace themselves for lender dialogue, Martin O’Donovan
http://www.treasurers.org/node/4548

Question 2
Some borrowers have agreed to incorporate the CDS price into the loan margin to be charged by their lender. Which of the following is NOT a reason to be wary of agreeing this incorporation?

(a) CDS process are volatile as the market has minimal liquidity
(b) in principle the CDS price is uncapped
(c) a thin CDS market may be susceptible to manipulation
(d) theoretically the CDS price reflects the firm’s probability of default
(e) don’t know

Answer
The right answer is (d) theoretically the CDS price reflects the firm’s probability of default

In theory the loan margin should reflect the risk to the lender and, in theory, the CDS price reflects that risk. However the practicalities of the illiquid thin market mean that the actual CDS price may not be a fair reflection of that risk.

Briefing note: Credit default swap based loan pricing, http://www.treasurers.org/cdsloanpricing

Question 3
Provisions of the Companies Act 2006 concerning the process known as 'whitewashing' came into effect on 1st October 2008.
Which of the following describes the change in the law on 1st October 2008?

(a) private companies may now grant financial assistance towards the acquisition of their own shares
(b) public companies may now grant financial assistance towards the acquisition of their own shares
(c) the provision of any assistance must be in the "best interests" of the company
(d) company directors have a duty to consider "best interests" of the company and "financial success" before agreeing to provide assistance
(e) don't know

Answer
The right answer is (a) private companies may now grant financial assistance towards the acquisition of their own shares
Answers (c) and (d) have always been the case in common law – and continue to be the case.

The Treasurer, November 2008, A Change in Focus by Tony Anderson, Pinsent Masons

Question 4
A longevity swap allows the treasurer acting for a pension scheme to remove any risk associated with increasing longevity of the scheme members. A pension scheme values its liabilities on the basis of an expected liability so that the risk is that members live longer than expected and the scheme has to fund pensions for longer than expected.
Which of the following structures for entering a longevity swap is BOTH true AND the gives the lowest risk for the pension scheme?

(a) the product can be written as an insurance contract covered by the Financial Services Compensation Scheme which meets all of the provider's obligations in the event of default
(b) the product can be written as an insurance contract covered by the Financial Services Compensation Scheme which meets 90% of the providers obligations in the event of default
(c) the product can be written as a derivative in which case collateral could be required to be posted by either party equal to the present value of expected future payments
(d) the product can be written as a derivative without the need for collateral with a "sound" financial institution
(e) don't know

Answer
The right answer is (b) the product can be written as an insurance contract covered by the Financial Services Compensation Scheme which meets 90% of the provider's obligations in the event of default.

Answer (a) would be a lower risk alternative than (b) if it existed. Unfortunately the Financial Services Compensation Scheme does not take on 100% of the providers' obligations. Answer (c) is certainly available, but the present value of expected payments at the start of the life of the swap must be equal for both parties, otherwise there would be a large fee to cover the disparity. The risk being managed is that the actual payments extend for longer than the current expectation. So any departure of actual payments from those expected are only likely to become significant in the later years of the swap; in other words the risk on the counterparty in the swap is heavily skewed to the later years. Any commercial counterparty is likely to be of a lower credit status than the Financial Services Compensation Scheme, and therefore this choice carries a higher risk for the scheme.

The Treasurer, December 2008/January 2009. Costing the Span of Life, by Andrew Reid, Credit Suisse,

Question 5
In November 2008 CRUF (Corporate Reporting Users' Forum) wrote to Finance Directors and CFOs of major companies explaining their concerns over cashflow reporting and suggesting a voluntary best practice. This letter followed a previous letter to the Editor of the Financial Times on the same topic. The ACT has endorsed the CRUF proposals. One of their main concerns was that it is no longer required for companies to show the reconciliation between cash flow and net debt.
Despite the absence of a 'requirement', a proportion of UK companies do provide such reconciliation.

What proportion of non-financial FTSE 100 companies is estimated to provide this reconciliation in their latest annual report and accounts?

(a) 30%
(b) 40%
(c) 50%
(d) 60%
(e) Don't know

Answer
The right answer is (c) 50%

Given the group making the estimate it is likely to be reasonably accurate. They also estimate that the proportion of companies in continental Europe providing the reconciliation is substantially less.

ACT Website: http://www.treasurers.org/crufrecommendations

Question 6

On 23rd December 2008 the IASB published an exposure draft that proposes to amend IFRS 7 "Financial instruments: Disclosures" to require additional disclosures about debt investments. The exposure draft requires these disclosures for all debt investments (other than those classified at fair value through profit and loss) not just those that are impaired or those that are available for sale investments.

If approved, when would these proposals take effect?

(a) Year ending December 2008
(b) Year ending March 2009
(c) Year ending September 2009
(d) Year ending December 2009
(e) Don't know

Answer
The right answer is (a) Year ending December 2008

If the proposals are approved, the collection of relevant information is extremely urgent!

ACT Website: http://www.treasurers.org/node/4559