Quarterly Quiz

2010 Quarter Two

Question 1

In recent years the issue of corporate governance has been under close inspection. The US stance, embodied by the Sarbanes-Oxley Act, has been more legalistic than the European response to the increasing problem that is perceived. In the UK the FRC has revisited the Combined Code; the standard for corporate governance. In December 2009 the FRC published proposals for changing the Code and responses were due in March 2010. A final report is due in May 2010, but the main changes have been widely anticipated.

Which of the following contains the thrust of the change expected?

(a) a change to the more legalistic approach of Sarbanes-Oxley
(b) incorporation of a Europe-wide governance directive rather than a UK specific Code
(c) encouragement to make greater use of the flexibility within the 'comply or explain' provision of the Code
(d) to remove the 'comply or explain' provision and replace it with a requirement to comply.
(e) Don't know

Answer
The right answer is (c) encouragement to make greater use of the flexibility within the 'comply or explain' provision of the Code

The 'comply or explain' provision has been thought to be too prescriptive approach, so that where the recommendations of the Code seem to the Directors to be inappropriate for their business, they should feel freer to choose the appropriate course of action and explain why they believe that this is more appropriate in their circumstances.

The Treasurer, February 2010, Technical Update by Martin O'Donovan
The Existing Code in the Listing Rules: http://www.fsa.gov.uk/pubs/ukla/lr_comcode2003.pdf
FRC Website: the December 2009 Proposals:
http://www.frc.org.uk/images/uploaded/documents/2009%20Review%20of%20the%20Combined%20Code%20Final%20Report1.pdf

Question 2

The ACT and the Loan Market Association have worked together to update the investment grade borrowing facility incorporating the amendments since the dramatic changes to the financial environment over the last two years. One of the main changes is the incorporation of provisions to cover the potential for a defaulting lender.

While the definition of default by a lender can be the subject of negotiation, the core issues will normally be:

failing to provide funds as specified in the agreement

rescinding a finance document
suffering an insolvency event

But what should the borrower's position be in these circumstances?

The points at issue are:
payment of any fees
prepayment rights
participation rights in a syndicate
commitment to lend and commitment to borrow

Prior to this new financial environment, the main issues when considering risks associated with lending banks were which of the following?

(a) whether they maintained a high credit rating
(b) whether they were qualifying lenders
(c) whether they would be accommodating in difficult times
(d) whether they provided ancillary services
(e) don't know

Answer
The right answer is (b) whether they were qualifying lenders

While all of the above are legitimate concerns when selecting a lending bank, the only issue important enough to be included in loan documentation was the potential for grossing up payments to lenders when withholding tax applies. In most documentation the concern is that borrowers may have to accept higher charges either due to a change in the law or the transfer of a participation to a new lender.

The Treasurer, March 2010, 'Borrower, be aware' by Andrew Balfour and Jane Hands
ACT website for the revised guide: A Guide To The Loan Market Association Documentation For Borrowers *http://www.treasurers.org/loandocumentation/investmentgrade*

Question 3

What is the Corporate Funding Association?

(a) An association of funding managers formed as a sub-category of the Association of Corporate Treasurers
(b) An association of banks coming together to share their expertise in lending to corporates, as well as their losses from lending to corporate customers.
(c) An association of companies intending to establish their own bank whose only activity would be lending to corporate members of the association.
(d) An association of private equity managers who are establishing a new vehicle to invest in corporate debt rather than equity during these difficult times.
(e) Don't know

Answer
The right answer is (c) An association of companies intending to establish their own bank whose only activity would be lending to corporate members of the association.

The intention is to establish the CFA with around 100 members and to run a low cost lending operation. Costs could be low because there would be minimal marketing or infrastructure costs.

This would leave the potential for either very low cost lending or very high returns for the equity owners. If lending is only to members, who may also be owners, the benefits accrue to the same people.

The Treasurer, March 2010 'Let there be credit' by Philippe Rocca, Arnaud Chambriard and Hugues Delafon. www.corp-funding.com

Question 4

As banks are reputed to be less willing to lend, more and more emphasis has been placed on trying to reduce the need for external finance. One of the consequences of this is the extra attention paid to the investment in working capital.
ABC is a profitable manufacturing business paying more attention to its working capital. The company is very fortunate in experiencing a high demand for its products, so much so that sales are expected to grow by 25% in its next financial year.
Given the information below and this growth expectation, how much cash is likely to be generated or consumed next year?

This year

Sales	100

All Inventory	25
Trade-related Debtors	15
Trade-related Creditors	13

These are expected to remain at similar proportions next year

Next Year (expected)

Sales	125
Direct costs	105
Depreciation	10
PBIT	10
Interest	4
PBT	6
Tax	2
PAT	4

What is the cash generation or consumption before incurring any capital expenditure?

(a) £7.25 generation
(b) £2.75 consumption
(c) £11.25 generation
(d) £19.75 consumption
(e) Don't know

Answer
The right answer is (a) £7.25 generation

If sales next year is £125, then the working capital investment is expected to be £33.75, the same proportion as this year, i.e. 27 increased by 25% sales growth. Cash available is PBIT (£10) plus depreciation (£10) less interest and tax (£4 and £2) = £14
Cash available will be £14, cash required will be £6.75 increase in the absolute level of working capital – resulting in cash generation of £7.25.

Question 5

Since the economic chaos that followed the virtual seizing up of the financial markets, there have been calls for more regulation of financial products, particularly the worst culprits of all … derivatives!

Now the European Commission has is working on draft legislation to reform the OTC derivative markets. Not to be left behind, the EU's Committee on Economic Affairs has also published a report on its own initiative, by a German MEP, Werner Langen.

Which of the following is closest to the findings of the EU's Committee on Economic Affairs?

(a) All EU derivative transactions should be traded on regulated exchanges with appropriate daily margins
(b) The EU should, in principle, regulate its financial transactions more closely than the free-market approaches adopted in the US
(c) All corporates quoted on EU exchanges should be prohibited from using financial derivatives entirely
(d) EU firms need to be able to manage their risks efficiently: derivatives that hedge corporate risks pose no systemic risk and require no additional regulation.
(e) Don't know

Answer
The right answer is (d) EU firms need to be able to manage their risks efficiently: derivatives that hedge corporate risks pose no systemic risk and require no additional regulation.

For many in the UK this statement from the EU that further regulation is NOT needed will be surprising and encouraging. Following the ACT response to initial proposals for margining on all derivative transactions, there has been significant progress in the argument. The above report from within the EU, as well as a letter from ISDA and a group of major market participants to the New York Fed offering voluntary undertakings about increased transparency are very encouraging developments.

The Treasurer, April 2010, Technical Update by Martin O'Donovan.

Question 6

Over the last decade pension deficits have been causing significant concern ….
Issues causing the problem have included falling interest rates, the performance of the equity market, changing accounting standards, increasing life expectancy as well as other factors.

As a result of the fall of the equity market in the early years of this decade there was a general trend to de-risk pension fund assets, replacing 'risky' equity assets with 'less risky' bond assets. The logic underpinning that trend was the desire to match the value of assets with the value of pension liabilities. These liabilities are valued using the present value of expected future pension payments – in other words the liabilities exhibit value sensitivity very much like debt instruments. This trend was termed Liability Driven Investment (LDI) although, strictly, LDI involves rather more sophisticated investment structures. So, pension schemes became immunised from the variability of the equity market so that the deficit could not become even worse. Unfortunately, as the equity

market recovered some ground over the next several years, the assets did not benefit from this 'risk' so the deficit was not reduced.

The Pension Regulator has become more aggressive in these circumstances and made clear the expectation that companies will take as much action as is reasonably practical to clear remaining deficits – estimated in December 2009 to be £103bn for the UK's biggest 200 schemes.

If the top 200 companies can eliminate their deficits, is the problem of defined benefit pension underfunding removed from the corporate treasurer's desk?

- (a) Yes, all that is necessary is to invest cautiously
- (b) Yes, the regulatory environment removes need for treasury input; it is only an administrative problem
- (c) No, we can immunise the asset portfolio against known cash flows but not against changes in life expectancy
- (d) No, if interest rates rise again – reducing the deficit – there will be pressure to reduce contributions, rates will fall again, deficits will rise and the cycle will repeat
- (e) Don't know

Answer

The right answer is (c) No, we can immunise the asset portfolio against known cash flows but not against changes in life expectancy.

It is very tempting to argue that the problem really will go away when deficits have been eliminated, but the issue of longevity is still, largely, an 'unknown'. Although some forms of longevity hedging is possible it is difficult to immunise against the risk – as with inflation. Theoretically it is possible to hedge against inflation risk – but at price! In practical terms there is nowhere near enough supply of index-linked bonds to provide an adequate hedge for UK pension assets.

The Treasurer, April 2010, Bite the bullet by Graham Buck.