Quarterly Quiz

July 2013

1 The Kay Review

In 2011 the Business Secretary, Vince Cable, commissioned Professor John Kay to investigate the state of UK equity markets and their impact on the long-term performance and governance of UK quoted companies. The report was duly published one year ago in July 2012 giving a total of 17 recommendations. At the time the report was criticised by some as being too high-brow and not practical enough. Because of this expectations of change as a result of the report were fairly low.

However, a report in the FT marking one year since the report's publication argues that, of 17 recommendations, only 2 are still to be addressed. For example the Stewardship Code, the FRC's responsibility, is under review, as evidenced by an update to the Code in September 2012 and later. By Baroness Hogg's speech to the NAAPF in December 2012.

Apart from the specific recommendations, two characteristics of the UK equity market were highlighted by the report. These were the extent to which the structure of shareholding had changed – who owns the majority of shares traded on the London Stock Exchange – and the extent to which UK companies are provided with capital by the equity market.

Question 1

The Kay Review quoted Bank of England data on the amount of capital provided by the equity market to British non-financial companies and compared it to the amount of equity capital repurchased by British non-financial companies. The data covered the years 20013 – 2011 inclusive.

In how many of these nine years was the amount of capital provided by the equity market greater than the amount of equity capital repurchased?

(a) 0
(b) 1
(c) 3
(d) 5
(e) 7
(f) 9
(g) Don't know

Answer

The right answer is (b) 1

The equity market has not been an important source of capital for UK companies for many years, but in the nine years before the report the amount of capital provided only exceeded the amount of *equity repurchased in a single year. In the other eight years the amount of repurchases, either share buybacks or share acquisition in takeovers exceeded the amount of capital provided. That single year was 2009, and according to the Bank of England, the primary reason for equity issuance was to reduce leverage rather than to finance new investment.*

The Kay Review, The Department for Business Innovation and Skills website http://www.bis.gov.uk/assets/biscore/business-law/docs/k/12-917-kay-review-of-equity-markets-final-report.pdf
Baroness Hogg's speech to NAAPF on FRC website http://www.frc.org.uk/News-and-Events/FRC-Press/Press/2012/Speeches/Speech-by-Baroness-Hogg-at-the-2012-NAPF-Conferenc.aspx
FT report by David Oakley, FT.com, July 23rd 2013 www.ft.com/cms/s/0/96807136-eec3-11e2-98dd-00144feabdc0.html

2 FATCA

This acronym stands for Foreign Account Tax Compliance Act. It is a piece of US legislation that requires any US-sourced payment to a foreign financial institution (FFI) to be subject to a 30% withholding tax unless the FFI has registered with the US Internal Revenue Service (IRS). This registration obliges the FFI to obtain and report information relating to its US-based account holders. The clear intention is to track down US citizens who are trying to evade US taxes by holding cash outside US jurisdiction.

While this might be a laudable aim, it is possible that non-US companies can be affected by this legislation impacting on any payment originating in the US.

Question 2

The legislation is drawn to include any US-sourced payment to a foreign (i.e. non-US) financial institution.
From the list below, which entities are very likely to be included in the definition of a foreign financial institution?

A. A non-US bank
B. A non-US deposit-taking body
C. A non-US based insurance company
D. A non-US based non-financial group's treasury centre
E. A non-US based non-financial group's holding company

(a) A only
(b) A and B only
(c) A, B and C only
(d) A, B, C and D only
(e) All of them
(f) Don't know

Answer
The right answer is (c) A, B and C only

The definition of a foreign financial institution is drawn widely, probably to anticipate a sudden growth of institutions that are just outside the definition. Banks, brokerage firms and insurance companies are within the definition, as are treasury centres and holding companies – if they are part of a financial group. If the treasury centre or holding company is part of a non-financial group, then they are outside the regulations and therefore will not be exposed to possible withholding tax deduction, but it is not quite clear cut. The term FFI can include entities involved in leasing, factoring captive insurance, taking customer deposits and foreign retirement plans that do not meet the limited exclusions in the FATCA regulations.

The clear implication for companies that do not want to be accidentally caught by this legislation is that they should proactively seek to clarify the status of a treasury centre or other subsidiary and, if necessary, register with the IRS. This should be possible as long as local regulation does not prohibit the transmission of account holder details outside their non-US jurisdiction.

The deadline for implementation has been extended to July 2014, but given the number of companies that may want clarification or registration with the IRS, the process should be under way now!

IRS website: FATCA Information for Foreign Financial Institutions and Entities
http://www.irs.gov/Businesses/Corporations/Information-for-Foreign-Financial-Institutions

3 The 'Too Big to Fail' Banking Problem

The issue of banks that are too big to fail is being addressed by regulators the world over. Capital adequacy appears to be the prime pressure point but regimes that protect depositors while managing an orderly wind-down are also being discussed.
The core problem is that banks are a necessary part of the financial infrastructure; if they fail then depositors lose money, payments cannot be made and the economy may suffer severe shock. Because of this their failure is more disruptive than a non-financial company being allowed to fail. The underlying problem is that banks must be exposed to the risk of failure to enforce some sort of discipline, but without the wider economic effects of failure being felt by the rest of the economy.

Hence the idea of the bail-in. Although the rules are still being debated they are expected to follow the creditor hierarchy that would apply in a liquidation - the equity holders lose their investment first as a way of absorbing losses. After that, the various layers of debt would either be written off or written down dramatically until all of the expected losses have been covered. A key feature of the bail-in is that depositors with deposits of less than €100,000 would be exempt from this, as would be some liabilities related to banks' core functions and short-term interbank loans.

This clearly has implications for treasurers as well as for banks, particularly relating to short term investment of surplus funds. The three golden rules of short term investment for treasury are

1. Safety of invested amount comes first,
2. Liquidity can be considered after safety is assured, and
3. Yield is the least important factor after safety and liquidity are assured.

Question 3

Taking a strict interpretation of the three golden rules to ensure safety of principal and to avoid being caught by a bail-in which of the following should guide the company's short term investment policy?

(a) Prohibit deposits in banks with a credit rating less than AAA
(b) Prohibit deposits greater than €100,000 equivalent in any EU-based bank
(c) Prohibit deposits greater than €100,000 equivalent in any bank that has a credit rating less than AAA
(d) All investments should be in government securities and no funds should be deposited in banks
(e) Don't know

Answer

The right answer is (d) All investments should be in government securities and no funds should be deposited in banks.

Taking a strict interpretation of the short term investment rules the only option is to invest only in short term government securities. There are few AAA banks and the idea of spreading a 'corporate-sized' deposit amount across many banks without exceeding the €100,000 limit seems unrealistic. The threat of a bail-in is a very real risk for many cash rich companies.

One other alternative exists, and that is investment in short term corporate securities- but frequently they are subject to interest rate risk as well as credit risk unless held to maturity- in which case the liquidity requirement may be compromised.

Technical Briefing, The Treasurer, July/August 2013 by Martin O'Donovan
http://www.treasurers.org/node/9216

4 Derivative reporting under EMIR

The process of establishing the reporting framework required under the European Market Infrastructure Regulation is struggling to keep pace. The Regulation is already law but the mechanics for compliance are still being put into place.

Credit and interest rate derivatives were to have been reported to a trade repository starting September 2013 but the European Securities and Markets Authority have deferred that start date to 1 January 2014.

Question 4

A total of seven organisations are believed to have applied for registration as trade repositories by July 2013. How many have been authorised at the end of July 2013?

(a) 0
(b) 1
(c) 3
(d) 5
(e) Don't know

Answer
The right answer is (a) 0

At the end of July there have been no appointments as trade repositories. It is expected that ESMA will announce registrations in early autumn 2013.

Other than the lack of a trade repository with which to register derivatives, companies will also have to apply for a legal entity identifier (LEI) and the system for doing this is only just taking shape. Each derivative trade will also require a unique trade identifier (UTI) and this system also is yet to be agreed.

The concern for companies should be that once the infrastructure is in place, the time for adoption and compliance may be very short.

Technical Briefing, The Treasurer July/August, by Martin O'Donovan
http://www.treasurers.org/node/9216

5 Trade Finance joins the Digital Age
Letters of Credit (LCs) have declined dramatically over the last decade. As a result, more trade is being undertaken on open account, with consequent risks. Perhaps this is a reflection of the trend to globalisation with trading partners being larger and better acquainted with each other. But perhaps it is also a reflection that the speed of business has increased and relying on paper documentation seems from a different, more sedate, age. The Global Credit Manager of BP Chemicals told The Treasurer that BP "could physically move 150,000 cubic metres of liquefied natural gas faster than it could process 500gms of paper".
Enter the Uniform Rues for Bank Payment Obligations (URBPO). This is a system for replicating the risk-avoiding characteristic of an LC in a digital environment. It replaces the documentary nature of LCs with a digital equivalent; matched reporting from the interested parties and subsequent irrevocable payment obligation. This maintains the speed of process expected of digital processing with the certainty that conditions have been satisfied. Risk is mitigated and cost is reduced while reliability and speed are enhanced.

Question 5
Which organisations have originated this URBPO system?

(a) Bank for International Settlements and a consortium of software providers

(b) A consortium of software providers
(c) A consortium of global banks concerned to enhance their service offering
(d) The SWIFT organisation with a consortium of global banks
(e) The SWIFT organisation with the International Chamber of Commerce
(f) Don't know

Answer
The right answer is (e) The SWIFT organisation with the International Chamber of Commerce

It is at first surprising that these two organisations would be the main drivers of such a new product, however, many of the largest banks are likely to see their main clients as the largest international companies, who trade with each other on a global basis and are not so exposed to the trade risks of dealing with an unknown trading partner that this product seeks to mitigate. The International Chamber of commerce has members who are mostly not the major global corporates and who are most exposed to these trading risks – and SWIFT is the international payments body that is most likely to be able to offer help in implementation.

The Payment Pledge, The Treasurer, July/August by Tony Anderson, Banking Partner of Pinsent Masons http://www.treasurers.org/node/9201

6 Payment Safety

Since the financial crisis regulators have been thorough in seeking out previously uncharted risks. One of these concerns the systemic risk inherent in the way that the UK's Clearing House Automated Payment System (CHAPS) works. This is an electronic bank-to-bank same-day-value payment system for sterling transactions. Globally it handles 0.5% of total cleared volumes, but 93% of total cleared sterling values. It generally covers all high value bank-to-bank transactions. It is the UK equivalent of the European TARGET2 system for Euro payments.

It is a real time gross settlement (RTGS) system which means that money being sent in the transaction is moving and being settled between banks within the same timeframe of the payment being made. This reduces the potential risk associated with bank failure during a prolonged transaction period.

Regulators concern has recently focussed on the proportion of direct members of CHAPS versus indirect participants. There are two main risks associated with indirect participants:

1. Large credit lines are extended to indirect participants by the direct members sponsoring their payments, and these can be withdrawn at any time
2. Operational risk posed by the direct member to the indirect participant in the event of an operational outage.

So the systemic risk is real and exacerbated by the split between direct and indirect members.

Question 6
What is the proportion of CHAPS payments that are made on behalf of indirect participants?

(a) Around 20%
(b) Around 30%
(c) Around 50%
(d) Around 70%
(e) Don’t know

Answer
The right answer is (c) Around 50%

As a result of the recognition of this risk CHAPS and the Bank of England have introduced the CHAPS Tiering Criteria which requires indirect participants accounting for specific proportions of payment volume to become direct members of the scheme. This Criteria came into force in April 2012.

In 2008, when the crisis hit, there were 14 direct members of CHAPS. Since the Criteria were introduced the number of direct members has risen to 19 and a further 6 have committed to become direct members by 2015. The greater the proportion of payment volume controlled by direct members the lower the systemic risk and the greater the potential for ensuring the integrity of the CHAPS system.

The Treasurer, June 2013, Safety First by Phil Kenworthy, Managing Director CHAPS.
http://www.treasurers.org/node/9110