INTRODUCTION

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If you take just the financial sector, there are scores of professional bodies, trade and industry associations, discussion groups, research bodies and lobby organisations.

So can the voice of the Association of Corporate Treasurers (ACT) be heard among all of these? Given its modest size and resources the answer is that the ACT is influential, and when we are able to come to a common position with others, the answer is yes.

Three reports in this month's Technical Update all tell of changes for the better that are to come about in regulation, accounting and law following successful persuasion from the ACT.

In addition, we have heard that the Inland Revenue has taken heed of our representations and will be adjusting the tax treatment of discounts on convertible bond issues. It is not easy to spot all the developments that may affect treasurers, intentionally or otherwise, but if we can all get involved at the earliest opportunity it can only be for the better.

In this month's Technical Update, the world of payments and business-to-business messaging is examined and we compare some of the main standards organisations.

Many of these standards are still developing so corporates should make their reactions known here.

ACT queries IAS 39 changes

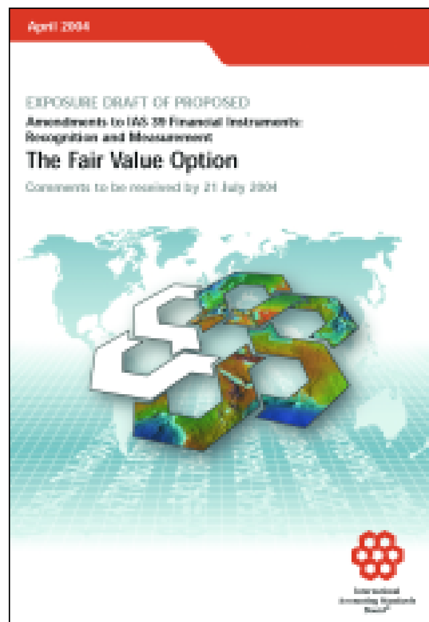
For a standard that was fully revised in December 2003, the subsequent amendments to IAS 39 are still coming in thick and fast, but perhaps this was only to be expected. The ACT has now responded to the April 2004 Exposure Draft (ED) on the fair value option.

In the original standard, the fair value option gave entities the option to fair value, through their profit and loss (P&L) accounts, any financial asset or liability that would otherwise not normally be required to be fair-valued.

This was deliberately included to simplify the application of IAS 39 by mitigating anomalies resulting from the different measurement attributes in the standard. For example, it eliminates the need for formal hedge designation and effectiveness testing where there is a 'natural offset'. It means that, instead of going through the complex process of separately valuing an embedded derivative, you can value the instrument including the embedded derivative as one. It also eliminates problems arising from a mixed measurement model where financial assets are measured at fair value and related liabilities are measured at amortised cost.

The ED was issued to address concerns, raised largely by financial regulators and supervisors, that the fair value option might be used inappropriately where fair values are not verifiable, and that volatility in the P&L may, as a result, be increased.

Restrictions on the availability of the fair value through P&L option were proposed so that this technique can only be used in restricted circumstances. Such cases include where the financial asset or liability contains an embedded derivative; where the cashflows of the liability are contractually linked to the performance of assets



that are fair-valued; and where changes in the fair value of the asset or liability are 'substantially offset' by the exposure to fair value changes in other financial liabilities or assets.

The ACT has not supported the proposed changes and has argued that if changes are required by financial regulators then they should apply only to the financial sector and not to corporates. The ACT believes that the changes introduce confusing new tests such as 'verifiability' and the need for 'substantial offsets' and that they negate the original intention of allowing natural offsets that do not meet formal hedge criteria.

The ACT has also gone back to the original wording and taken issue with the limitation that the fair value option can only be applied upon 'initial recognition', and is irrevocable for the asset or liability concerned. While recognising the need to avoid abuses, there should be the ability to start and end the option as assets and liabilities come and go from the balance sheet. The full ACT response is available on the ACT website.

FORECAST INTRA-GROUP TRANSACTIONS. Three very thin new EDs about IAS 39 were issued in July covering financial guarantees; transition and initial recognition; and hedging forecast intra-group transactions. This latter ED is welcome in that it addresses a point that the ACT had alerted the International Accounting Standards Board (IASB) to – namely, that a change in guidance notes had removed the ability to hedge forecast intra-group transactions. A solution is being put forward that does allow hedge accounting for intra-group forecast cashflows, but only at the consolidated level and not at the entity level.

At a consolidated level it will be possible to designate a highly probable forecast external transaction denominated in the functional currency of a subsidiary as a hedged item. In other words, the external transaction is being used as a sort of proxy for the intra-group transaction that is related to it, and that is really the place where the exposure arises.

Surprisingly the IASB is allowing a forecast dollar sale, say, being made by a dollar-based subsidiary as a hedged item. Indirectly the IASB seems to have opened the door to the possibility of doing a hedge at the top level of consolidated overseas earnings.

The ACT intends to respond to this ED and comments from readers will be welcomed. ■

Insurance regulation clarified

The threat of regulation falling with its full rigour on the normal activities of a central insurance function looking after group risk management appears to be receding.

The Association of Insurance and Risk Managers (AIRMIC), has been spearheading a campaign to clarify the scope of the Insurance Mediation Directive (IMD), and the ACT has been happy to lend its support by writing to the Financial Services Authority (FSA) and Treasury.

The IMD brings anyone involved as an intermediary dealing with insurance into the scope of financial regulation with all the costs, admin, training, compliance and reporting that these can entail.

While aimed at organisations selling insurance to the public, such as travel agents, finance lenders and car-hire companies, the perimeter guidance from the FSA appeared to bring group risk management under the same regulation.

This is notwithstanding the fact that insurance is not being offered to external parties.

Initial suggestions from AIRMIC, the ACT and later from the Confederation of British Industries, had hoped that there could be a get-out if the group activities were not being done for remuneration and by way of business. Progress on this was not encouraging.

Then in early July, John Tiner, Chief Executive of the FSA, delighted all concerned by announcing his agreement that group insurance arrangements should not fall within regulation if funded solely by group members, even if this was on a cost-plus basis.

Furthermore, the FSA will consider ways to ensure that arrangements, with or on behalf of joint ventures, can also be excluded.

A crucial factor influencing this move was a legal opinion, obtained by AIRMIC, which found that the UK had not properly incorporated the EU Directive into English law.

Various formal processes still need to happen but with support from the top there is reason to be optimistic. ■

JOHN TINER, FSA CHIEF EXECUTIVE, SAID THAT GROUP INSURANCE SHOULD NOT FALL WITHIN THE SCOPE OF THE INSURANCE MEDIATION DIRECTIVE.

Solvency tests proposed for payment of dividends

A new report proposes that the rules on maintenance of capital should be changed so that the ability to pay dividends will depend on a solvency test rather than the existing concepts of 'profits available for the purpose' and 'realised profits'.

This was the recommendation of the British Institute for International and Comparative Law report based on a joint initiative of the Accounting Standards Board (ASB) and the Company Law Centre.

A two-part solvency test is proposed – that, having regard to the company's annual report and accounts, the company will, in the directors' opinion, immediately after any distribution, remain able to pay its debts and secondly, have sufficient resources as a going concern to be able to meet its liabilities as they fall due for the following year.

Where the latest audited balance sheet does not show a surplus sufficient to justify this view, the directors should state that fact and explain why they nevertheless regard the distribution as within the test.

It is proposed that the directors should provide and publish a certificate giving an assurance that, in their opinion, immediately after the payment there would be no grounds on which a court could find their company was unable to pay its debts, taking into account prospective and contingent liabilities.

A requirement should be added to certify that, having regard to their intentions and '*the resources in their view likely to be available'* for the year immediately following, the company will be able, in the ordinary course of business, to meet all its debts as they fall due as a going concern. The italicised words are helpful in that a company will not need to line up replacement finance months ahead of any refinancing need as is currently often deemed the case for a prospectus style working capital statement. A mandatory auditors' certificate is considered inappropriate.

Changes to the law in this area will take a long while to come about – and probably be part of EU level standardisation, but this is one to watch. ■

Support for Listing Rules

In its January 2004 response to a general consultation by the FSA on the Listing Rules, the ACT supported changes to require shareholder approval should an issuer want to delist its shares.

The backing for such a change was so overwhelming that the FSA has accelerated its specific proposals for shareholder approvals. The ACT has responded by supporting this. In the same recent consultation the FSA has been considering the extent to which various elements of the Combined Code should be audited and what that audit should involve. The Listing Rule requirements are catching up with the move from the 1998 Combined Code to the 2003 version.

The ACT has supported the need for a degree of audit over the disclosures and the processes in making the Comply or Explain statements, but without wishing the auditors to question the judgements of the directors.

The concept of directors making 'due and careful enquiry' may be incorporated here, but the ACT suggested holding off going that far until the same question has been debated in the context of auditing the Operating and Financial Review, which is in consultation.

The Combined Code can be found at **www.fsa.gov.uk/pubs/ukla/lr_comcode2003.pdf**. ■

ABI stirs up bond terms debate

The Association of British Insurers is leading an initiative to safeguard investors in the sterling and euro bond markets, with a July paper published to get investors, issuers and their representatives talking.

The Association of British Insurers (ABI) is leading a new initiative to improve standards in the sterling and euro bond markets and to provide more protection to investors.

A position paper was published in July, with the aim of starting a dialogue between investors, issuers and their representatives.

There is a wish list for terms more favourable to investors, which inevitably will not be attractive to issuers, but the ABI is at pains to explain that: "Specific views expressed in the paper are not intended as rigid requirements. It is concerned with principles and best practice rather than with prescription."

High among the priorities is the very reasonable desire for higher standards of transparency. This means timely access to information and clear labelling with regard to the seniority status of individual issues, which avoids misleading use of language.

Fine print

Covenants which look attractive in headline terms, but which in reality are bogged down in so much legal fine print that they are worthless, do not help.

For the moment this is a UK-based initiative, but the ABI is keen to work with like-minded groups and spread its message across Europe.

The full document (four pages) can be found online at **www.treasurers.org**. ■

Extracts from the ABI document

- High standards of disclosure are paramount. Investors would expect a draft prospectus or red herring to be made available to investors in a timely manner before the start of the roadshow, to assist them in making the judgements necessary to invest. A final prospectus should be sent to all investors.
- To be meaningful, a commitment to disclosure requires a covenant committing the borrower to continuing disclosure if it is taken over, taken private or merged with another entity – for example, through an annual bondholder meeting.
- Transparency of terms, as well as clear labelling of seniority status, will help avoid confusion and damage to the issuer's reputation and protect investors from abuses. Once bonds are labelled 'senior unsecured' as a result of such limits, investors are entitled to expect that this status will not change.
- Investors recognise that each credit is unique and the formulation of covenants will reflect the individual circumstances of the issuer. However, they note that real value is delivered by clear wording which sets out the precise nature of the commitment made by the borrower and demonstrates that the commitment will be observed. Clarity of meaning and hence improved transparency will be reflected over time in the market by keener differentiated pricing and market access between issues and issuers.
- Bond investors can suffer a material fall in the value of their investments through a change of control. Unlike credit risk, this adverse event risk potential is rarely priced in the bond at the time of issue. Whilst equity holders can exercise voting rights and bank lenders are frequently protected through tight covenant wording, bond investors typically are caught without any mechanism for mitigating this risk – investors should have the opportunity to redeem the debt on terms that reflect the original loan agreement.
- Investors will favour a negative pledge clause which clearly sets out what an instrument's legal and structural position will be, relative to any current or potential future indebtedness (on, or off balance sheet, regardless of maturity and currency). A negative pledge clause that effectively permits bonds to be subordinated through the accumulation of bank borrowings will command less value from the market.
- Whilst investors do not wish unduly to restrict financial flexibility, the negative pledge clause should clearly safeguard the position of the current debt holders.
- A general disposal of assets clause should spell out the way in which investors are to be protected. Investors should be able to understand the degree to which the status of their investments would be affected by disposal of assets by the issuer.
- Investors do not wish to restrain the flexibility of issuers to manage their affairs but they would place little value on a disposal of assets clause that allowed companies to dispose freely of assets 'in the normal course of business' as such clauses are so general as to render other protection worthless.
- Investors are prepared to consider call options which provide the issuer with flexibility to redeem and refinance the debt at a fair and reasonable level.
- Proper consideration should be given to ensure that the trustee chosen will be able to fulfil all their duties in a conscientious and impartial manner. The importance of the trustee's role can easily be underestimated, particularly for complex instruments.
- Higher standards of documentation and disclosure will give confidence to investors and benefit issuers by making their securities more marketable. A best practice approach is preferable to prescription or regulation. Further development of best practice will improve the functioning of the market for issuers and investors alike. ■

Will TWIST set the standard?

Last month saw the launch of TWIST – a new set of harmonised standards which can be used by treasurers for electronic payment communications with banks and other corporates. But TWIST is only one of a number of standard-setting initiatives being worked on today, as *The Treasurer* finds out.

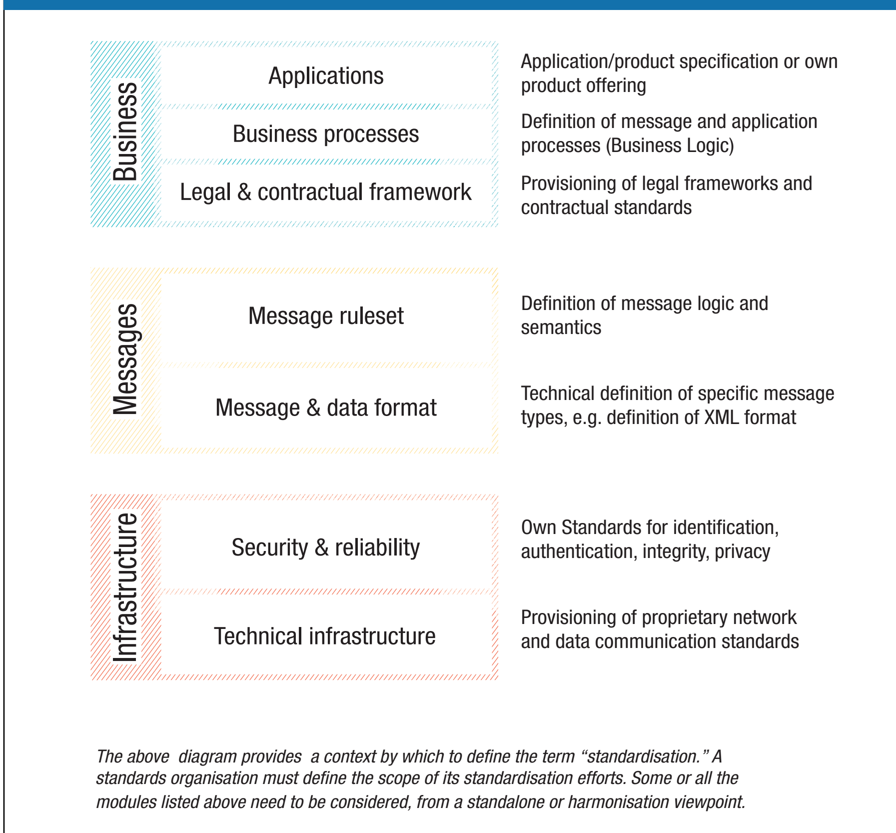
It may sound like a contradiction in terms, but there are a number of different organisations involved in various initiatives around payment and processing standardisation. They have different intentions for the electronic market and have developed key alliances, dependencies and co-operations amongst themselves and with other organisations.

For example, the Society for Worldwide Interbank Financial Telecommunications (SWIFT) develops and maintains the payment initiation message standard, while also providing assistance for RosettaNet's corporate-to-bank, end-to-end payment services. Treasury Workstation Integration Team (TWIST), meanwhile, has collaborated with RosettaNet and SWIFT on a standard design for payments, while Identrus and RosettaNet are actively working together on solutions to prove identity online.

Only SWIFT provides a messaging platform, in addition to its standardisation work. The other initiatives also have to rely on corporates, banks and vendors to implement and apply their messaging services. All initiatives tend to be platform-independent, using the internet as the messaging network; proprietary networks are thus unlikely to play an important role in the future of electronic messaging.

All the initiatives also require the participation of financial institutions, either as supporters or active members of the standards proposed.

Figure 1. Definition and scope of standardisation



The above diagram provides a context by which to define the term "standardisation." A standards organisation must define the scope of its standardisation efforts. Some or all the modules listed above need to be considered, from a standalone or harmonisation viewpoint.

INTERNATIONAL STANDARDS TEAM. One of the best-known initiatives is the Standards Harmonisation team, set up between TWIST, SWIFT, Interactive Financial Exchange Forum (IFX) and Open Applications Group (OAGi), along with nine international banks, to develop a single payment kernel for commercial payments.

The International Standards Team (IST), as it came to be known, has now published its core payments kernel – an agreed set of key financial data components required for a payment message in any currency. All four participants are committed to including it in their own sets of standards as and when they are developed. Banks, corporates and system vendors can now start using the core payments kernel to streamline payments applications and take advantage of the straight-through processing (STP) benefits it offers.

TWIST. This global, non-profit group was founded in 2001 and its members include investment banks, treasury industry bodies, software services firms, professional services firms and market infrastructure providers. TWIST, which was set up – and continues to be actively run by – the Royal Dutch/Shell treasury function, has recently announced its set of XML-based standards for inter-corporate and corporate-to-bank electronic communications for payment-related transactions.

The standards, which were launched last month (see *TWIST is launched*, News/page 7, July/August, *The Treasurer*) are based on the basic payment kernel standard developed by the IST. TWIST offers extensions to this kernel which, it claims, will help corporate treasurers and fund management operations communicate with their banks, brokers and electronic trading platforms for foreign exchange and other financial instruments. The result will be business process improvements for the global trade lifecycle from trade origination to negotiation, execution and confirmation and settlement and reporting.

TWIST provides standards for the processing of invoices and invoice dispute management, as well as the reconciliation of payments. The payment types supported include electronic fund transfers, automated clearing house payments, direct debits, cheques and card payments.

"These standards unlock significant efficiency gains for corporates and their banks. By harmonising the core payment kernel of these standards with SWIFT, IFX and OAGi, we have ensured not just their universal applicability but also broad support for these XML standards," said Steven Hartjes, a Partner at Ernst & Young, who is responsible for co-ordination of the payments initiative within TWIST.

Organisation similarities and differences

	TWIST	SWIFT	FIX	IDENTRUS	ELEANOR	ROSETTANET
Functional standardisation						
Identity management		X		X		
Business processes	X	X				X
Foreign exchange (FX)	X	X				
Payments	X	X			X	X
Trade	X	X				X
Derivatives	X	X	X			
Fixed income		X	X			
Functional standardisation						
Productive/live implementation	X (FX)	X	X	X		
Test/pilot stage	X (Payments)	X (epayments)			X	X

SWIFT. SWIFT is a co-operative society, founded in 1973, under Belgian law which is owned and controlled by its shareholder members. It has established itself as a de-facto standard for messaging services in the financial services industry. The standard covers payments, FX and treasury, securities and trade.

It supplies highly secure and reliable messaging standards and services, including a global messaging platform, which is used by all of its 7,500 financial institution members. New services are based on SWIFTNet, an internet protocol(IP)-based messaging platform.

Any financial services organisation, either directly or indirectly involved in the exchange of financial services messaging can be a SWIFT client, although corporate users are also being introduced to SWIFT through the Member Administered-Closed User Group (MA-CUG) arrangements.

SWIFT is actively engaged in the convergence of all standardisation initiatives and is using a single standardisation approach in co-operation with the International Standards Organisation (ISO) and the United Nations Economic Commission for Europe (UN/CEFACT).

FIX. The Financial Information Exchange (FIX) protocol is a message standard for real-time electronic exchange of securities transactions. The protocol enables electronic communication of pre-trade and trade messages between financial institutions – primarily investment managers, brokers/dealers, electronic communication networks and stock exchanges. The aim is to achieve Straight-through processing across regions for multiple products, thereby simplifying global trading.

The FIX protocol itself defines the format of messages and session level interaction between two FIX applications.

The owner of the FIX property rights – FPL – is a privately-owned, non-profit organisation, founded in 1993, which is run by committee and has an open membership. Members represent buy and sell-side financial institutions, vendors, stock exchanges, brokers and other securities industry participants.

IDENTRUS. Identrus – one of the world's largest electronic security initiatives – was set up in October 1998 to provide the identity and trust required for secure business-to-business e-commerce. The initiative was launched by a consortium of banks, including eight of the largest global ones, to provide corporate clients with the electronic identity required for secure e-business with each other – regardless of whether they know each other or not.

In order to achieve this, Identrus has set up an international infrastructure, based on Public Key Infrastructure – a very highly-advanced electronic security technology. This provides not only the encryption needed to ensure online privacy and confidentiality, but also allows the online authentication of persons involved in an e-transaction.

Such high levels of security are achieved using a pair of converse cryptographic keys – the private key, which is unique to the owner/user, and the public key which is made available to everyone via a public directory.

When sending an electronic message, the sender encrypts it with the recipient's public key to ensure its confidentiality – only the recipient's private key will be able to open it. Conversely, if a sender wants to authenticate his/her identity in an e-message, he/she can sign it using his/her own private digital key. As only the sender's public key can open this message, the recipient, on opening the message, is provided with verification that the sender really is who he/she claims to be.

Like other advanced PKI authentication systems, Identrus also issues digital certificates to the potential users of a PKI-based infrastructure. It signs each certificate using its own private key, and this then serves as a rubber-stamping of that corporate's identity, providing the authentication required for electronic transactions between two parties who do not know each other. Effectively, both parties take the word of the trusted party in relation to the authenticity of their e-commerce counterpart.

ELEANOR. Project Eleanor is an Identrus initiative which aims to introduce secure, direct business-to-business payments over the internet between trading partners. The idea centres on the use of traditional bank systems, but with straight-through-processing capabilities.

The different types of payment messages covered include payment order, payment obligation, certified payment obligation and conditional payment obligation. An Identrus certificate is a basic requirement for using Eleanor.

A reference implementation has already been successfully tested, but a full solution is not yet available via any of the banks. Eleanor is targeted at financial institutions who may offer the payment services to any business or governmental organisation.

ROSETTANET. RosettaNet is a self-funded, non-profit organisation, which has a global focus, although its core member participants are primarily in the Asian market. It is an electronic messaging standard and covers supply chain-related electronic transactions and payment services between participant corporates and banks. It targets itself at supply chain partners in the respective industries which it represents – companies in the information technology, electronic components, semi-conductor manufacturing and telecommunications industries.

In October 2003, Microsoft announced that it is participating in a RosettaNet payment milestone programme. It has since launched a RosettaNet payments toolkit, a package designed to support the initiative and provide financial institutions and their corporate customers with automated payments for supply chain transactions.

SWIFT is co-operating with RosettaNet on the creation of a commercial payments solution for end-to-end payment initiation. TWIST has also contributed to the payments standard's design.

This article includes extracts from a report by specialist electronic services and IT security consulting company eConsilium.
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