CPD Quarterly Quiz January 2011

Question 1
Hedge Accounting
Both the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) have published proposals to reform the current situation on hedge accounting and the criteria for qualifying for hedge accounting. The FASB has proposed that hedges should be 'reasonably effective' rather than the previously required 'highly effective' and the IASB, in their Exposure Draft on Hedge Accounting published in December 2010, have proposed reforms to make hedge accounting more accessible for corporates.

The IASB makes it clear that the intention of the reforms is to align hedge accounting with the risk management within the firm by reflecting the risk management objectives and the extent to which any hedging achieves those risk management objectives.

Why have any criteria for hedge accounting?

- **(a) To make sure that all financial activity is fully documented and explained when decisions are undertaken**
- **(b) To make sure that the treatment of an exposure and a hedged item will be similar**
- **(c) To allow profits and losses from dealing derivatives to be kept out of the income statement**
- **(d) There should be no qualifying criteria, companies should take responsibility (and the consequences) for their financial decisions**
- **(e) Don't know**

Answer
The right answer is (b) To make sure that the treatment of an exposure and a hedged item will be similar

Before the advent of IFRS and 'fair value accounting' there was no requirement to qualify for hedge accounting. The concept of, and need for, hedge accounting was created by the classification of assets and liabilities into different categories which would be treated differently regarding profits and losses. This separation was brought about, at least partly, by the major derivative disasters of the late 90s; companies had found ways of keeping derivative losses away from the eyes of their shareholders hoping that the loss would reduce before disclosure was inevitable. So, derivatives were required to be marked to market at regular intervals and gains/losses reported in the income statement. This was not the case for conventional corporate assets and liabilities, so an exposure and a derivative hedge were likely to be treated differently – destroying the effectiveness of the hedge.

To make the continued use of derivatives in hedging work in accounting terms, if it could be proved that the derivative was for the purposes of hedging then it has been permissible to account for the derivative in the same way as for the hedged exposure. Both the hedged exposure and the hedging derivative should still be valued as required – but as long as they receive the same treatment any gains and losses will cancel out, because they are treated the same way, and the hedge will be effective. But this special treatment for derivatives was only allowed when a hedge has been proved to satisfy the criteria.

In trying to prevent future derivative disasters the rules were relatively complex and, in some circumstances, produced outcomes in reported financial statements that did not reflect either the underlying hedging or the risk management objectives of the business. The current reforms are attempting to find the balance between complexity and unintended consequences and the prevention of non-disclosure of derivative losses.
The Treasurer, November 2010 Technical Update, plus The long trek to IFRS 9 Part Two, by Mateusz Lasik, Deloitte.

Question 2
Basel III
After the major financial upheavals of recent years, new regulations for banks have been proposed. Termed Basel III the new regulations were agreed in principle at the G20 summit in Seoul.

The regulations require banks that are internationally active to hold minimum levels of capital to cover for potential losses. Various forms of capital are allowable ranging from 'pure' equity risk capital to forms of debt that is subordinated to liabilities to depositors. Financial engineering inevitably led to grey areas between the tiers of capital so that, although the headline level of capital that banks needed to hold was quoted as 8% of their balance sheet, the most basic ratio of 'core Tier 1' capital to risk-weighted assets was much lower at 2%. Basel III has increased this to a much more conservative 7% - an even bigger increase than that sounds because the eligibility for Tier 1 capital has been tightened as has the definition of risk-weighted assets. The overall impact has been that what qualifies as core capital has been reduced but risk-weighted assets have increased due to the changes in definitions.

In fact the 7% new requirement is made up of 4.5% minimum plus 2.5% capital conservation buffer which can be run down in troubled times. Banks must exceed the 4.5% minimum. If the 2.5% buffer is depleted it triggers restrictions on paying dividends and discretionary bonuses. There is a yet further potential to impose up to 2.5% additional capital requirement called the counter cyclical buffer which would be imposed to cool down an overheating economy.

When are these new requirements to become affective?

- **(a) Immediately**
- **(b) From January 2013**
- **(c) From January 2019**
- **(d) Phased from 2013 through to 2019**
- **(e) Don't know**

Answer
The right answer is (d) phased from 2013 to 2019

The present minimum tier 1 capital ratio of 2% must increase to 3.5% by January 2013. After that the minimum value must rise to 7% by January 2019 if restrictions are not to be imposed.

Surprisingly, US banks are still to accept Basel II.

FT, November 19 2010, Basel III: The impact on bank capital
The Treasurer November 2010 A New Regulatory Landscape by Graham Buck

Question 3
Takeover Panel Review
The takeover of Cadbury by Kraft of the US was the catalyst for a consultation on the Takeover Code. This consultation was undertaken in June and July of 2010 and a review of the outcome was published at the end of October 2010.
The review reinforced the continuing relevance of the underlying purpose of the Code;

> "The Code is designed principally to ensure that shareholders are treated fairly and are not denied an opportunity to decide on the merits of a takeover and that shareholders of the same class are afforded equivalent treatment by an offeror. The Code also provides an orderly framework within which takeovers are conducted. In addition, it is designed to promote, in conjunction with other regulatory regimes, the integrity of the financial markets."

The key concerns raised by the review were that the balance had been weighted in favour of hostile bidders and that the outcome of hostile bids was unduly influenced by short term equity investors. As a result the review gave notice that proposals would be brought forward to redress the balance in favour of the offeree company.

Of particular concern was the issue of a 'virtual bid'.

What is a 'virtual bid'?

- **(a) It is a bid that is made and conducted only in cyberspace**
- **(b) It is a bid for an internet social networking site**
- **(c) It is not a bid; it is a publicised notice of a possible intention to bid**
- **(d) It is not a bid; it is a publicised notice of a firm intention to bid**
- **(e) It is not a bid; it is a publicised notice of an irrevocable intention to bid**
- **(f) Don't know**

Answer
The right answer is (c) It is not a bid; it is a publicised notice of a possible intention to bid

The announcement of a possible intention to bid can destabilise the target company while the offeror is able to bypass the target's board and engage in public discussion of value with target shareholders without the need to commit to making an actual offer. At the same time, the target company is constrained by Rule 21.1in taking any action that might be intended to frustrate the offer. Target companies were found to be reluctant to use the "put up or shut up" arrangements for fear of being branded defensive or self-serving.

The outcome is that this area of the Code will be revised to ensure that the bidder will have a four-week period in which to confirm whether they are proceeding or not.

Also proposed is that deal protection measures and inducement fees will be banned except in exceptional cases; that any offer-related fees should be disclosed; an improved quality of disclosure regarding offeror's intentions and for those intentions to be held for at least one year. Target boards are also confirmed as being able to take any factors they thought fit into account when giving their opinion of the offer.

The Treasurer, December/January 2011 Technical Update

The Takeover Panel website 'response statement to consultations
http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/2010-22.pdf

Question 4
Private Equity Investment
Private Equity has been a high risk/high return activity for investors. Returns have been evident for those willing to accept the high level of risk inherent in the investment; but high risk does mean that spectacular successes will be accompanied by (hopefully fewer) spectacular losses. In recent years there has been a trend of investment in 'fund of funds' private equity investment in an attempt to smooth the uneven flow of returns implied by the risk characteristics.

Private equity businesses seek investment from 'limited partners' who pay fees for the management of their investment to 'general partners' who are the managers of the fund. Needless to say, the limited partners invest in the general partners that they think will generate the best trade off between high returns and low cost.

Confidence has been especially low during the worst of the credit crunch, but the Coller Capital Global Private Equity Barometer for Winter 2010-2011 reports an improvement in confidence of future returns. Now roughly one third of investors expects a net annual return of 16% or more over the next 3-5 years.

In addition to this primary market there is an active secondary market in private equity investments. This was buoyant in 2007, fell slightly in 2008 but was very quiet in 2009 following the collapse of Lehmann Brothers. In 2010 the market rebounded with the banks as major sellers of private equity assets as buyers emerged.

Private Equity managers (general partners) periodically issue requests for re-investment from their limited partners. Limited partners can agree to these requests (called 're-ups') or reject them.

Given the current state of the economy in Europe and the United States, what is the most recent level of limited partners *rejecting* requests for reinvestment from their general partners?

- **(a) 90% of European investors, 70% of Asia-Pacific investors and 85% of North American investors rejecting the request**
- **(b) 45% of European investors, 40% of Asia-Pacific investors and 40% of North American investors rejecting the request**
- **(c) 50% of European investors, 75% of Asia-Pacific investors and 90% of North American investors rejecting the request**
- **(d) 35% of European investors, 25% of Asia-Pacific investors and 40% of North American investors rejecting the request**
- **(e) Don't know**

Answer
The right answer is (a) 90% of European investors, 70% of Asia-Pacific investors and 85% of North American investors rejecting the request

These are the highest levels since the winter of 2008-9, but the first time that European investors have been leading the refusal to reinvest. North American investors have maintained a fairly steady

80%-85% level of rejection. Reasons for rejection quoted a year ago included lack of transparency in reporting, poor performance and 'terms and conditions'. Does this indicate that investors look backwards when considering investments – or the opposite – that they looked forward and saw more risk and less return? It could also mean that fewer investors were willing to continue investing in single fund investments, preferring to spread their investment into a 'fund of funds' manager.

Coller Capital Global Private Equity Barometer Winter 2010-11 www.collercapital.com

Question 5
Credit Rating Agencies
Credit Rating Agencies (CRAs) found themselves in the firing line when culprits for the financial disasters of the last few years needed to be found. Part of the problem for regulators has been the extent to which incorporation of ratings outcomes into risk exposure measures such as Basel II has been encouraged by those same regulators. CRA methodology was investigated and, in some cases, found to be wanting. One consequence of this has been the attention that they are now receiving from regulators trying to ensure that ratings can be relied upon in future.
In November 2010 The Directorate General Internal Market and Services of the European Commission issued its document for public consultation on credit rating agencies. This document proposes improvements to address:

- A perceived over-reliance on external ratings
- Increased disclosure by issuers of structured instruments to facilitate independent analysis
- Improving the transparency, methodology and process of sovereign debt ratings
- Enhancing competition within the sector by introducing new players and lowering the barriers to entry
- Introducing civil liability for ratings agencies
- The conflict of interest inherent in the 'issuer pays' model

The ACT has responded to this consultation with some concern. For example, if the issuer did not pay for rating a debt issue, then agencies would be reluctant to spend time understanding a smaller issue where there would be fewer potential investors, or 'buyers' of their ratings.

On the theme of increasing competition between agencies, it has been suggested that information obtained by any one agency should be made available to all other agencies – or even made publicly available! Clearly if information given to a ratings agency were expected to be made public then only public information would be made available – with consequent effects on the reliability of the resulting ratings. Even if one rating agency had to inform all other agencies of any information it had there would be severe doubts about the security of that information.

Also covered in the ACT's response was the effect on 'herding' behaviour. The consultation was attempting to reduce this behaviour, where many market participants behave in a similar fashion, all trying to buy or trying to sell together with clear effects on the resulting price volatility.
What was the ACT's response regarding 'herding' behaviour?

(a) As long as rating agencies adopt similar methodology herding is inevitable
(b) As long as rating agencies compete with each other they are bound to produce similar ratings because they cannot afford to be out of line
(c) Herding behaviour can be reduced by limiting access to ratings and encouraging investors to compile their own view independently
(d) Incorporating rating thresholds into investment criteria for regulated investing institutions can only reinforce ratings triggers

(e) Don't know

Answer

The right answer is (d) Incorporating rating thresholds into investment criteria for regulated investing institutions can only reinforce ratings triggers

The actual quote for the ACT response is below:
Most investors will tend to see the effect of events on a particular credit as "good" or "bad". So there is a natural level of "herding" of response and regulation can only hope to avoid increasing this. Credit ratings will also tend to respond similarly to such events. And a change in a credit rating or ratings can itself be a secondary "event".
If a significant number of investors for regulatory or for contractual reasons may need to reduce their exposure to an obligor if its credit rating falls or will be able to consider buying if the rating improves, this can make a major herding trigger.
We agree that to reduce herding effects, regulation should avoid specifying ratings thresholds for regulatory consequences and central banks should avoid ratings for setting eligibility for collateral or the types of securities they will buy. Use of ratings should also be avoided in setting required holdings for liquidity purposes.

The Treasurer December/January 2011 Technical Update
The European Commission website: consultation document
http://ec.europa.eu/internal_market/consultations/docs/2010/cra/cpaper_en.pdf
The ACT response: http://www.treasurers.org/node/6674

Question 6
Money Market Funds

Moody's has proposed a revised methodology for determining ratings along with a new rating scale applying solely to money market funds. At the heart of this revised methodology is the combination of analysis on portfolio credit quality and portfolio stability.
Portfolio credit quality is determined by combining assessments of the quality of individual investments and the maturity of those investments. The underlying assumption is that the shorter the remaining maturity the lower the credit risk. In combination then the lowest risk will be the highest credit quality and shortest-term portfolios and the highest risk will be the longer term investments in lower credit quality instruments.
Portfolio stability is determined by reference to the potential for interest rate and liquidity risks that could adversely affect their principal value or ability to meet liquidity drawdowns on demand. Three factors contribute to the overall portfolio stability profile. They are:

- the asset profile, measured with reference to the weighted average maturity and the concentration of the top 3 obligors in the portfolio
- the fund liquidity, measured with reference to the overnight liquidity relative to the top 3 investors and the overnight and seven day liquidity relative to the total assets under management
- exposure to market risk, measured by stressing net asset value for a yield curve shift, a credit spread shift and other stresses.

The two key determinants of Portfolio stability and Portfolio credit quality are then combined to produce an overall rating. The scale used is proposed to be MF1+ at the highest quality through MF1 to MF4 at the lowest quality. Subsequently in a response statement in January 2011 Moody's have

instead decided to stick with the traditional levels of Aaa, Aa etc but with a modifier so as to appear as Aaa-mf, Aa-mf etc.
Not mentioned in the brief outline above, but still a factor in the analysis is the proposed importance to be given to sponsor support – the extent to which a sponsor is able and willing to support the fund in times of uncertainty.

All of the above was published as a 'request for comment' by Moody's.
What was the ACT's response, published on the ACT website in January 2011?

(a) We prefer to continue using the old methodology and the old scales for MMFs
(b) Overall supportive but concern that sponsor support might be given a disproportionate weighting in the overall assessment
(c) Overall supportive but concern that the rating should really be determined only by financial stability because high quality money market funds can only invest in the highest credit quality instruments anyway
(d) Very supportive, the ideas are first rate and should be adopted as they are
(e) Don't know

Answer
The right answer is (b) Overall supportive but concern that sponsor support might be given a disproportionate weighting in the overall assessment
The ACT response was supportive and did raise the concern above, along with another issue that the rating seems to be determined by equal weightings of credit quality and portfolio stability, when it might be better if credit quality be more heavily weighted

In a press release of 18th January 2011 (http://image.exct.net/lib/fefb127575640d/m/2/Update+on+MMF+Ratings+Methodlogy.pdf) Moody's announced the result of their consultation and agreed that sponsor support would not play such a key role in the rating of MMFs. They state "The methodology is re-designed to reflect a fund's own characteristics and thus strong sponsorship will not enhance a fund's rating." This same statement revised the proposals so as to use the Aaa-mf, Aa-mf terminology. Their proposals will be finalised in Q1 2011.

The Treasurer, December / January 2011 Technical Update
For the full Moody's proposals: Moody's website
http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_126642
For the full ACT response: http://www.treasurers.org/node/6445