IN BRIEF

▸ The ACT has raised concerns with the FSA over its proposals for a **special resolution regime for banks**.

As originally drafted, the proposed powers to cater for rescuing a failing bank could override contractual provisions and potentially split a bank into a good part for onward sale and a "bad bank" rump. There would be no certainty into which portion its wholesale dealings with a corporate would fall. The resulting uncertainties could mean that clean legal opinions on bank contracts would be impossible and, if taken to the extreme, would destroy the ability of the financial services sector to do business in London.

The Banking Bill is currently before parliament and it is hoped that flexibility will be created to tailor the special resolution regime by subsequent secondary legislation. The Banking Bill also covers other areas of bank insolvency and administration, and the Financial Services Compensation Scheme, as well as formalising the Bank of England's role in the oversight of payment systems.

▸ Controls over the **credit default swap (CDS)** markets are in the offing. The New York State Insurance Department is thinking of regulating a CDS as an insurance contract if the buyer holds the underlying security, whereas the SEC is focused on naked CDS because of the potential for market manipulation. Within the markets, support is growing for a central clearing house to reduce counterparty risk and enforce margin requirements.

▸ The European Commission is set to **regulate the credit rating agencies** despite its recent consultation uncovering widespread market sentiment that such a move would be unhelpful. Even the Committee of European Securities Regulators responded negatively to the form of the proposals in the earlier consultation. Likewise, the International Organization of Securities Commissions has argued for an internationally co-ordinated approach rather than Europe introducing independent rules.

▸ The ACT has responded to the IASB's discussion paper proposals on **reducing complexity in reporting financial instruments**. Moves to reduce complexity in IAS 39 are welcome, but the ACT believes that it is essential to preserve the concept of hedge accounting and to make it more generally applicable to all true economic hedges.

INTRODUCTION

By Martin O'Donovan
ACT Assistant Director, Policy and Technical

In normal times the policy work of the ACT and its influencing role run on extended timescales. New rules and regulations from the authorities flow from discussion papers, followed by draft proposals, and then the final rules. At each stage, there is at least three months for consultation, with time for processing and feedback.

But in today's markets a week is a long time. Adjusting to this, we have been pleased to be able to feed the corporate viewpoint into the topics of the moment and under review at official levels, or indirectly via the press.

Among all the problems within the financial services sector it is important to ensure that the customers which depend on those services are not forgotten.

Fair value in question

Some commentators have blamed much of the financial crisis on accountants because it is their rules that have led to the write-downs of all manner of complex financial instruments. Shooting the messenger does not address the underlying problem of toxic assets, but it is valid to ask whether the use of accounting fair values presents a true picture of financial institutions.

US regulator the SEC and standards organisation the FASB have jointly provided guidance on the FASB's fair value measurements in the form of Statement 157. Under Statement 157, when an active market for a security does not exist, the use of management estimates that incorporate current market participant expectations of future cashflows and include appropriate risk premiums is acceptable. It even says that "in some cases using unobservable inputs (level 3) might be more appropriate than using observable inputs (level 2)".

Broker quotes may be an input in measuring fair value but are not necessarily determinative if an active market does not exist for the security. The broker quotes may themselves be based on a model rather than on actual trades.

The FASB seems to be giving ample opportunity for accounts preparers to move away from apparent market prices, saying that the results of disorderly transactions are not determinative when measuring fair value. The concept of a fair value measurement assumes an orderly transaction, and distressed or forced liquidation sales are not orderly transactions.

Once again judgement is required in deciding the approach to valuations and whether an investment is temporarily impaired. In general, the greater the value of the decline and the longer it continues and is expected to continue, then the greater the level of evidence necessary to conclude the decline is temporary.

On 2 October standards-setter the IASB said it considered Statement 157 consistent with its financial instruments standard IAS 39. Then mid-month, it provided an update on its work to consider the application of fair value when markets become inactive. In essence, the IASB said that IAS 39 already catered adequately for the abnormal markets.

Following on from this, the IASB issued a new exposure draft of proposed amendments to its disclosure standard IAS 7. IASB chairman Sir David Tweedie said: "The credit crisis has heightened concerns about liquidity risk and pointed to the need for entities to explain more clearly to the outside world how they determine the fair value of financial instruments, especially those that are particularly complex."

The Committee of European Securities Regulators has also stressed that the starting point for measuring financial instruments is the assessment of whether they are being traded on an active or a non-active market. If quoted market prices are not used, then the related disclosures become ever more important. ■

ePolitix is the place to go for all the detailed news about Westminster politics, with news, analysis and comment. The site can also provide the inside track for those who need to keep an eye on the sort of legislation that fails to make it to the national press, such as the Protection of Bats and Newts Bill, the Bank Holiday (Contribution of Polish Citizens) Bill, or briefings on more substantive proposals, such as the Planning Bill. Go to: **www.epolitix.com**

Corporate reports up to scratch

After examining 300 sets of accounts, the Financial Reporting Review Panel has concluded in its annual activity report that the current standard of corporate reporting in the UK is good, although 88 companies have had to undertake to make changes to their future reporting.

The areas of reporting that prompted most questions were those dealing with more complex accounting issues, or where the exercise of judgement by management was most critical.

The business review came under scrutiny for the first time and within this there is a requirement for a description of the principal risks and uncertainties facing the company. Some companies provided a long list of risks and uncertainties, which fell short of the requirements in two respects. First, the principal risks and uncertainties were not identified, and second, there was no proper description of them.

Listed companies were reminded that the business review should extend to a discussion of the main trends and factors likely to affect the future development, performance and position of the company.

On a related area, the panel also noted a number of instances where companies had not provided any reference to their use of financial instruments. If material, companies are required to describe their financial risk management objectives and policies, including hedging policy and the company's exposure to price, credit, liquidity and cashflow risk. In a number of cases where such disclosures were expected, none was provided.

The disclosure of principal risks and uncertainties is likely to warrant greater attention during the forthcoming reporting season given the current financial and economic crisis. ■

Problems in bank lending markets

Loan market conditions have been extraordinary since 13-14 September, the weekend of the Lehman collapse. Treasurers, bankers and lawyers have all had to undertake a speedy relearning of how the strict legal agreements for bank lending work. Amid news that lenders triggered the market disruption clause in their agreements with a large Taiwanese electronics company, Hon Hai, the ACT has issued advice on this point.

Most borrowing agreements, particularly if based on the Loan Market Association documentation, have a market disruption clause allowing the lenders to replace the Libor reference rate with their own cost of funds if more than a certain percentage of lenders (typically 33%) certify that they are unable to fund themselves at Libor. The ACT recommended that this clause be invoked only as a last resort and that for the time being it was inappropriate to trigger it. The British Bankers' Association came to the same conclusion.

Given that a significant element of the market problem was the lack of liquidity in periods of one month or longer, borrowers and their lenders might find it mutually beneficial to consider shorter draw-down and interest periods.

The ACT website includes briefings from Clifford Chance and the Loan Market Association covering some of the consequences of the Lehman administration, which can also serve as a timely reminder on what happens to contracts when a bank fails. Often there will be no express contractual termination provisions in the event of the insolvency/administration of a lender, but the borrower can claim for damages if the lender fails to lend on request. None of the other lenders will be responsible for the filed lender's obligations, but the borrower can gross up the draw-down request to top up for any missing amounts.

On a loan rollover, the borrower is normally obliged to make a repayment to the failed bank but will then find it impossible to redraw from that bank since agreements usually do not provide for rollover loans to be effected by way of netting. The briefing explains how to create a netting right in the hands of the agent through making the request for a new borrowing to be offset against the cash held to repay the previous drawing.

A second briefing covers some taxation implications where the lender is a non-UK Lehman entity acting through a UK branch. It is likely the Lehman entity will have ceased to carry on a trade for UK tax purposes; if this is the case, the usual withholding tax exemption on interest a UK borrower would have relied on may not be available. Where a US Lehman entity is not acting through a UK branch it may have ceased, as a technical matter, to qualify for the benefit of the UK/US double-tax treaty. If so, any treaty clearances to pay interest gross would be invalid.

Latest updates from the ACT technical team can be found at: www.treasurers.org/technical or via the ACT homepage

IN BRIEF

▸ **The first auction of carbon trading allowances** under phase II of the EU emissions trading scheme will be held on 19 November 2008, conducted by the UK Debt Management Office. The UK will be the first member state to hold such an auction.

▸ Significant changes to the **Capital Requirements Directive** have been proposed by the European Commission:

- Banks will be subject to limits on their inter-bank funding: 25% of their own funds or €150m, whichever is higher;
- Originators of securitised transactions will have to retain a material share of the risks and in any case not less than 5% of the issue, with firms investing in the securities subject to heavy capital penalties if they fail to conduct comprehensive due diligence before making their decisions; and
- Colleges of supervisors will oversee banking groups that operate across the EU's internal borders.

▸ **The rules on insider trading** may be relaxed. The Financial Services Authority is planning to allow persons discharging managerial responsibilities in listed companies to enter into trading plans that would let them deal in prohibited periods. This would cover trading plans set up with independent third parties provided the plans meet key criteria.

▸ The **US Internal Revenue Service (IRS)** is to relax the rules for US corporations taking tax-free loans from their foreign subsidiaries. US corporations that receive loans from foreign subsidiaries typically need to pay a tax of 35% on such loans, but under the new IRS notice (2008-91) will get 60 days in which they can repay the loan tax-free, subject to certain restrictions. This notice will apply from taxable years ending up to 31 December 2009.

▸ Companies Act 2006 changes for private companies, effective from 1 October 2008, have removed many of the previous complications around **unlawful financial assistance for the acquisition of own shares**, and will allow a capital reduction using a solvency statement rather than court approval. For groups that have inherited complex group structures there may now be an opportunity to revisit whether there are new possibilities to reorganise and create savings and efficiencies.

See page 40, A Change in Focus