Contemporary Issues in Finance
International financial reporting standards

Martin Upton

To help me explore the issues of financial risk management and, in particular to show how financial risks are managed in the business world, I'm delighted to be joined by Neil Henfry, the Group Treasurer of Boots, the United Kingdom's leading health and beauty retailer and Paul Outridge, the Head of Treasury at De La Rue, the world's largest commercial security printer and paper maker. Managing company risks involves an active relationship with the banking sector... and here to represent that sector I'm pleased to have Hor Chan of the international banking group ABN Amro.

Martin Upton

Neil, can I ask you to talk about the problems which you think exist with pension funds and how they pose a significant additional risk for companies like yourselves.

Neil Henfry

Yes, Martin. Boots, like many companies in the UK has got a defined benefit scheme. It's fairly closed to new members but, nevertheless, it's got liabilities of £3.5 billion at the last count, which is broadly the same as the market capital of the company and therefore it's a very substantial size of liability there. Now, obviously there's assets matching those liabilities to the extent they can, and Boots is in the very fortunate position of having broadly a fully funded scheme. So, it's got about £3.5 billion of assets as well. So, you might say – so what's the problem? Well, the problem is that the size of the liabilities depends on things like long term discount rates, inflation rate, prospective salary increases and, probably the most important of all, actuarial assessment of longevity, mortality of the people in the fund. And so the size of those liabilities moves up and down with the markets, as discount rates moves, and every time actuaries decide that people live an extra five years it adds more to the liabilities. Now, the assets themselves, of course, depending on what they are, might act in a very different way. Boots itself has got 85% of its funds in bonds and 15% of its funds in equities and properties. Now, obviously they don't necessarily move in the same way as the liabilities do, so what you find is that, when you measure both the assets and the liabilities on the market base, which is what you're required to do for accounting purposes these days, you can quote very substantial volatility in the difference between the two. And, let's imagine that you've got a deficit of £200 million, how are you going to make that up – and how quickly are you going to make that up? And so you can find that all of a sudden that you've got a very quick demand from the trustees to make substantial additional contributions to the fund that you weren't expecting. So, it eventually flows through to a funding liquidity issue. However, even despite that, during the whole process of this – because it's a market valuation, it's now on balance sheet, banks look at the deficit, investors look at the deficit, rating agencies look at the deficit and treat the deficit as being debt-like; and so it can impact on you quite substantially in your credit rating, your share price and your relationships with banks, if you've got substantial deficits, which many companies do have.

Paul Outridge

That's right. Adding to what Neil said, I think, one important areas that is now coming through is how treasury departments can help the trustees to manage that deficit and in terms of derivatives, which we're talking about. The problem is the mis-match in the funding gaps. For example, the assets may well be in bonds, but the maturity of the bonds won't necessarily match the profile of the maturity for the pensioners or prospective pensioners in the scheme. And this is one area in which, for example, interest rate swaps are certainly being talked about as one mechanism in which you can help to smooth the difference the exposure between the assets and liabilities.

Martin Upton

We know that with the introduction of international financial reporting standards, IFRS, the position in respect of pension fund liabilities has to be reported , but also I understand, Paul, that IFRS, as we know it, has had an impact on other areas of your risk management business.

Paul Outridge

Certainly for us at De La Rue, yes, that's right. IS32 and 39, for example, which deal with financial derivatives and financial instruments have a significant effect on us in terms of not necessarily the way in which we manage our exposures, but certainly the way in which we're required to report them and also to the level of documentation that we have to provide. The key element of IS39 simply relates to how you can match your forward contracts or your financial derivatives that you've taken out to hedge your underlying currency exposure. Traditionally, providing the level of forward contacts you had in place matched your level of exposure, then that was sufficient within the accounting rules in order to effectively to be able to combine the two and simply effectively, when the forward contracts matured, you would then be able to match those off against your sales or your purchases within the profit and loss account. What has happened now is that, in order to achieve the same treatment under IFRS, there's a whole new regime called 'Hedge Accounting' that has become now part of this exposure document. And, as result of that, to achieve Hedge Accounting there are very strict rules that you have to manage in order to be able to achieve the same result and effectively put to all your forward contract revaluations which now have to be marked to market on a monthly basis, to your reserves rather than taking them to P & L every month. The level of documentation required is quite onerous and, certainly for major international groups, is a key decision in terms of managing your exposure, whether you want to manage that volatility to your P & L or not. For De La Rue the decision was made that we do need to manage that because the potential volatility exposure, or sudden changes in the exchange rates, is such that it could produce a significant effect in our reported results which – not as a result of our actual economic hedging that we've undertaken, but simply as a result of an accounting standard – has created this volatility. And that, to us, was unacceptable.

Martin Upton

So, in effect, you're saying that changes to accounting standards are, in a sense leading to certain business inefficiencies when it comes to your hedging and business activities in treasury?

Paul Outridge

Um… certainly in the sense that we have, as a policy, decided we did not want to change the business rationale for hedging. We still have underlying exposures in currencies, we still wanted to maintain that level of hedging on an economic basis. What it has impinged on, certainly, is the level of administration that now goes into maintaining the level of exposure management that we do currently. And that has put a considerable onus, not just on treasury departments, but also on the subsidiaries throughout the group in order to comply with these, the new accounting standards.

Martin Upton

What impact have all these high profile treasury related disasters had on the way in which large banks undertake business?

Hor Chan

I think it's, for the bank itself, I think it's made us improve our own control systems and made us focus much more on operational risk than perhaps we had previously. When you think that the Allfirst debacle, for example, was really about loss of controls, about a single person who managed to run up large positions which simply we hadn't detected for some time. But within the bank, what it's really meant is that we've undertaken a huge exercise really to identify all our operational risks and also try to construct a database, really, of where we've had operational risks in the past within the bank itself. But, in fact, not just the actual losses but we also need, of course, to try to capture the near misses also which has been more difficult as people don't really like to admit that they almost made a loss. So, that's one area –

certainly it's made us focus much more on operational risks I think, and that's been a great impact. The impact of Enron, for example, one of the impacts certainly is Sarbanes-Oxley which has actually created a lot more work for us. Paul's mentioned the onerous tasks that have to be undertaken for IS39, well Sarbanes-Oxley is also hugely onerous on our control systems, on our auditing, on the reports we have to produce internally to make sure we're complying with it. So I think what's really happened, in a sense, with these disasters is much more regulation and essentially much more work for us on keeping records and showing that we're doing the right thing.

Martin Upton

Paul and Neil, has that been the experience in the corporate world?

Neil Henfry

At Boots we've been very lucky that we've not had to deal with Sarbanes-Oxley because we're not US listed. However even in the UK the introduction of the Operational Financial Review and forward looking risk statements in the annual report and prospectus and things like that means that we've had to introduce a far more formal risk management process across, not just treasury, but the whole of the business operations. And that's been introduced over the last couple of years. So, there's a much more rigorous holistic risk of process nowadays of which treasury is actually a very small part, because many of our risks are quite mitigated away, whereas your core business risks you can't mitigate away, and they're the ones that you actually need to understand on the Board more than many of the treasury risks which we've got rid of.

Paul Outridge

That's right. I think, certainly now, part of the annual account require formal statements on policy in terms of how you address the risk, as we've said and Neil said, not just financial risk but also insurance risk, etc, business operational risk; and certainly the whole corporate governance has moved. Even De La Rue does not have to, I'm pleased to say, report under Sarbanes-Oxley either. But the whole level of reporting under corporate governance is now filling quite a few pages now of everybody's annual reports. And it's an area that, as Hor said, I think more and more, there will be additional requirements in which we need to comply in future, as we go forward, as more accounting standards and, potentially, more disasters happen in which everybody, if you like, needs to make sure and demonstrate that they have the systems in place to mitigate those risks.

Martin Upton

This is also setting a serious educational challenge for executive and non-executive directors who don't necessarily come from a financial background. How are companies dealing with this?

Paul Outridge

Well, certainly from our side, I know we do have formal training courses for directors when they're appointed. They now actually have a series of lectures and informal discussions, so they are actually made fully aware of just what the risk of being a company director for a public quoted company is. Because in circumstances they are liable along with the company and therefore it is a personal liability as well as a corporate liability.

Martin Upton

We would have a similar kind of thing at Boots.

Hor Chan

Well, I think one of the things I can say from the difficulties perhaps that some of the corporates are facing is actually that this is a good opportunity for banks, of course. This is a chance for us to move in, perhaps, and help advise on some of the regulations that are required or to advise on how to manage your hedging systems, so it's more efficient and you comply with IS39 or, indeed as Neil mentioned, on the pension funding side, of course. We are suppliers of the financial instruments that he mentioned – inflation links, swaps and other assets for investment and so on, of course.

Martin Upton

I'd like to finish by focussing on one curious but particular foreign exchange related risk which I was discussing with Paul just before the making of this programme. Now, De La Rue prints banknotes and recently we've seen the emergence of the euro and the eurozone, in recent years, and, who knows, in the future many more countries may be joining the eurozone. And, as a printer of banknotes, I just wondered whether this development in the forex market was good business news or bad business news.

Paul Outridge

Well, in the sense of certainly the spread of the euro market, to a certain extent it is, from a treasury perspective, it's actually quite good because obviously it helps to mitigate the risks in the foreign exchange market. From a business perspective there are both opportunities and, perhaps, disadvantages. With regard to principal western European countries, most countries print their own banknotes. As the largest private printer of banknotes we have about approximately 50% of the private market but 90% of the banknote market is actually printed by state governments. So, therefore, particularly for the eurozone, most countries will actually print their own notes and therefore there isn't an opportunity in that particular area necessarily for us. Although, together with the change, obviously, in the changeover in currency it means that there needs to be new machines both for handling and counting notes, and that is an area of opportunity for us in which, obviously, we make sure we're well placed.

Martin Upton

Would you be well placed when Britain goes into the euro?

Paul Outridge

Yes, I think there's sufficient lead time on that to allow everybody, I think to be able to manage that.