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CORPORATE TREASURY BULLETIN: KEY TRENDS AND OPPORTUNITIES

In our first corporate treasury bulletin we outline the key economic trends which have emerged recently in the corporate debt markets, provide an update on corporate treasury opportunities and challenges and finally highlight documentation, tax and debt structuring issues which have a Brexit angle.

We would welcome your feedback on this bulletin and would be delighted to discuss any of the matters raised in it with you. Contact details appear below.

DEBT MARKET ECONOMICS

Bank debt pricing

Anecdotal evidence suggests a reversal of the modest rise in bank pricing for loans seen in the first part of 2016. Market volumes for new loans and refinancings are significantly lower when compared to recent years (partially in the light of corporates taking advantage of bank pricing reductions in the last two years through 'amend and extend' exercises) resulting in significant competition to lend to corporate credits.

Pricing for bank loans is at historic lows with investment grade loan capital raisings typified by inter-bank competition to lend.

Pricing arbitrage

The paucity of transactions in the bank loan market is also reflected in other debt markets, for example the US private placement market. The result has been similar to the bank lending market; there has been a general tightening in pricing with some observing a pricing arbitrage benefit of a US private placement compared to a public bond issue. Pricing arbitrage and the desire to ensure that a corporate's debt capital structure is as robust as possible with staggered maturities and diverse funders has led to ongoing diversification of debt sources. Please see our latest corporate debt survey for further information on debt diversification trends.

Negative LIBOR/EURIBOR base rates and overall cost of funding

Recent volatility in EURIBOR has resulted in brief periods of negative rates. Unless LIBOR/EURIBOR floors have been included in facility agreements, that negative rate has operated to reduce the margin payable on loans.

Borrowers without LIBOR/EURIBOR floors in their bank facility documentation are under pressure from lenders to accept those floors (typically set at zero in the investment grade market).

To the extent that floors are accepted or are in place, it will be important for treasurers to assess the net financial impact where interest rates are hedged as finance-linked swaps and other derivatives typically do not include floors (resulting in a mismatch of payment flows between the bank facility and related derivative transactions). In Europe, there has been some discussion as to whether a net negative rate could result in the lenders paying to lend to corporates. It is unlikely that many (if any) vanilla corporate facility agreements will provide for this.

OTHER CORPORATE TREASURY OPPORTUNITIES AND CHALLENGES

Insurance

The Insurance Act 2015 came into force on 12 August 2016. This is the most significant reform of UK insurance law in over 100 years and impacts any business entity taking out a contract of insurance. The Act was prompted by concerns that the current law was outdated and was putting the commercial English insurance market at a competitive disadvantage in the global arena.

The new Act seeks to address this by reforming the law in key areas including:

- the insured's pre-contract duty of disclosure;
- insurance warranties;
- terms in insurance contracts not relevant to the loss; and
- insurers' remedies for fraudulent acts.

Click here to read our article which sets out the practical implications of the Act for clients and contains links to all our useful resources on this topic.

Tax

Implementation of the BEPS initiatives, and in particular those relating to interest deductibility and to hybrid instruments is gathering pace, in the UK and in the EU more generally. Coupled with the introduction of relief for equity investment in some jurisdictions, there is likely to be some recalibration of corporate capital structures: while debt of all forms will no doubt continue to be a key source of funding it is possible that more recourse will be made to equity-based funding.

Incentives

We are seeing many companies revisit funding arrangements in connection with their employee share schemes as a consequence of volatility in the market. Often companies have a choice in how to settle share awards between issuing new shares, using treasury shares and acquiring shares on market through an employee benefit trust. Where an employee benefit trust is being used, historic hedging arrangements may be in place with the trustee making periodic purchases of shares, which it may be appropriate to revisit or even cancel in favour of using newly issued shares.

In order to avoid overspending on hedging arrangements companies should also assess, where share awards are subject to performance conditions, the likely levels of vesting as existing hedging arrangements may no longer be appropriate.

To the extent that there is a trust surplus, it may be possible to recover such amounts if there are outstanding loans to the trust.

BREXIT: DOCUMENTATION AND STRUCTURING CONSIDERATIONS FOR TREASURY TEAMS

Capital markets pricing: structuring considerations

The Eurosystem's rules on what financial securities constitute eligible assets for its collateral framework could impact issuances by, or guaranteed by, UK companies. The place of establishment of an issuer must be an EEA or a G10 country but, in the latter case, only once the Eurosystem has ascertained that its rights would be protected under English law; a guarantor must be established in an EEA state.

There are similar rules for asset-backed securities and certain credit claims.

Issuers of bonds should consider issuing or guaranteeing through an EU entity if the use of a UK entity would prevent the instruments being so eligible and if this would negatively impact pricing of an issue.

Reacting to FX volatility

Volatility in foreign exchange rates is likely to continue (as evidenced following the High Court judgment recently that Parliament must approve the triggering of Article 50) and that has, and will continue to have, a number of consequences for treasury teams, some of which were more foreseeable than others. For example:

Margin calls

Concerns soon after the Brexit vote that we would see across-the-board margin calls in relation to out of the money derivative positions have been misplaced. Whilst the making of a margin call is dependent upon a host of factors (not least the terms of the derivative documentation and the covenant strength of the counterparties) in our experience margin calls have been made sparingly, although the position does vary between sectors. As volatility is expected to continue, treasury teams should assess potential margin call obligations under existing derivatives to ensure that they remain manageable.

Financial covenants

In some leverage covenants a spot rate of exchange is used for calculation purposes (e.g. to convert non-reporting currency debt obligations or cash/cash equivalent assets) at a particular date, which can cause distortions in underlying financial performance depending upon the circumstances at the end of the covenant period. Consideration should be given to reviewing financial covenants to ensure that issues such as this are, or on a refinancing will be, addressed (for example, by using an average exchange rate). In addition, if the drafting of the covenant does not permit, for example, the effect of currency hedging to be taken into account, the resulting calculations can be further distorted from the actual financial position.

Baskets

When documenting a new financing it is worthwhile re-considering baskets generally. This will apply throughout the business-facing covenants and, potentially to a lesser degree, the de minimis thresholds which qualify the events of default. Whilst primarily a treasury matter, input from other business teams (e.g. those responsible for M&A and cap. ex.) should be consulted to ensure that, having regard to macro-economic conditions, the terms of a new financing are sufficiently flexible to allow the company to implement its business plans).

Products

Cash pooling

> **We are aware that a number of banks either have decided not to continue certain cash pooling services or are exploring options to amend them in the light of Brexit and the wider regulatory and business changes which they potentially face.**

Many banks do not rely on an EU passport to provide either domestic or cross-border cash pooling services. As such, at this stage it is not anticipated that Brexit will necessarily impact on those arrangements directly (although that will depend upon the form that they take).

It is also possible that changes will be required to the structure of cash pooling arrangements in order to achieve the desired accounting treatment for borrowers, although those changes may be at odds with the terms required by lenders in order to receive the desired regulatory treatment. As noted above, an ongoing dialogue with relationship banks will be key.

EIB

If EIB funding is important, the EIB's approach and commitment to the UK following its departure from the EU will be crucial. Currently the EIB's approach and commitment to future funding of British businesses is unclear; if you would like to discuss this in more detail please let us know.

Documentary considerations

Withholding tax and increased costs

The EU Parent-Subsidiary Directive allows interest to be paid gross in the context of most intra-group situations, even where exemptions under bilateral double tax treaties are not available. But once the UK leaves the EU the directive will likely cease to have effect, and payments to UK holding companies may give rise to withholding taxes. Structural adjustments and even wider reorganisations may therefore be expected to be required in the case of pan European groups, and these may impact on external/bank debt arrangements as well.

A few domestic law exemptions (for example in Italy) may apply to EU-resident banks only, so would cease to apply to UK banks following a UK exit. Under standard LMA facility documentation, the risk of this would fall on the borrower. Likewise, a change in tax law can result in the counterparty affected by the requirement to gross up being entitled to terminate affected transactions.

It will be important to consider the location of borrowers and lenders in assessing the potential Brexit-related impact.

Lenders are likely to want to seek to pass on to borrowers any increased costs of lending associated with Brexit (either through the margin (to the extent known) or through the increased costs provisions (for unforeseen costs)). Since the increased costs clause in facility agreements is generally widely drafted, borrowers will want to try to limit the ability of lenders to make claims in these circumstances. Whether lenders agree or not will largely depend on the transaction and the jurisdictions involved, and of course the negotiating strength of the parties.

Basel III is currently implemented in the UK via the EU-derived CRD IV regime. The UK would still be required to implement Basel III following Brexit, and while there is a possibility that the regime could differ from CRD IV in the future, any such deviation would be unlikely to affect increased costs claimed in connection with lending.

However, in the current market banks are increasingly willing to limit their ability to recover Basel III and CRD IV costs and this approach is likely to be pushed by borrowers to limit their costs exposure (something to which lenders are likely to respond positively in the medium term, as the post-Brexit costs landscape becomes clearer).

Material adverse change events of default

Whilst this will turn on the terms of the documentation, for typical corporate debt facilities the Brexit vote itself did not have, and was unlikely to constitute, a material adverse change since that event of default is typically directed at the financial health of the borrower/corporate group and the legal effectiveness of the lenders' rights under the documents. Whilst some borrowers have sought to expressly exclude Brexit-related events from 'MAC' events of default these have, given future uncertainty, been resisted by lenders. Whilst this will be a topic of on-going debate, this will become part and parcel of a company's post Brexit financial planning, of which its debt financing plans will form one element, and testing how robust your MAC event of default is will be an important part of that alongside, for example, financial covenant forecasting.

EU as a geographical area

It will be important to ensure that any references to the EU or EEA in any financing documentation, for example in relation to any geographical restrictions on acquisitions or joint ventures or in relation to the definition of cash equivalent investments in bank facilities, also include the UK from now on. In the context of loans, the current LMA recommended form of wording does usually (but not always) already expressly refer to the UK in these examples.

Force majeure

Whilst force majeure is generally not relevant for borrowers in debt financing documentation, these provisions are found in ISDA agreements used for hedging purposes and are also a usual feature of commercial agreements which may fall within a treasury team's remit. Whether Brexit-related events might constitute force majeure will again depend on how the particular clause is drafted. In most clauses, force majeure is defined by reference to a non-exhaustive list of events, together with a general "wrap-up" provision to include other events which are not within a party's reasonable control. The clause may also exclude specific categories of event which the parties agree will not constitute force majeure.

However, it is not enough for an event to fall within the definition of force majeure. The provision will generally be triggered only if the event prevents, hinders or delays a party performing its obligations under that agreement. Typically, if that is the case, that party's obligations are suspended without liability while the impact of the force majeure event continues (subject to obligations to notify the counterparty of the force majeure event and to seek to mitigate its effects). Most force majeure clauses will also give the counterparty (or both parties) the right to terminate the contract if the force majeure event continues for a specified period of time.

A change in economic or market circumstances which makes the contract less profitable or performance more onerous is not generally regarded as sufficient to trigger a force majeure provision. Parties wishing to rely on Brexit-related events as force majeure are therefore likely to have to point to something beyond mere economic hardship.

From a corporate treasury perspective, force majeure clauses are often found in bank ancillary services contracts (for example cash pooling) and custody arrangements (dealing with the custody of cash and securities). Corporates are now beginning to raise with their counterparties what Brexit means for these arrangements more generally (given the inclusion of force majeure clauses as well as reasonably short termination periods) and whilst the answer to date is often that it is too early to say, this is a conversation that should be had periodically leading up to the actual UK exit from the EU so that corporates have as much notice as possible should alternative arrangements need to be made.

Loss of passporting – transfers to affiliates

Loss of passporting rights in relation to the provision of financial services either from the UK or into the UK are likely to be affected by Brexit. The extent of the impact on UK and EU corporates will depend on the current national laws and their continued existence (for instance, the UK has in its national law more cross-border exemptions than continental European States), and on what is eventually agreed between the UK and the EU on provision of financial services. Regardless of the ultimate outcome, many financial institutions are considering taking steps prior to the UK exit to transfer positions or commitments to affiliates or from a UK branch to another branch in the EU. For example, the national laws of some EU and EEA jurisdictions require lenders to have a licence to lend to corporate entities (though the UK does not).

Lenders can currently rely on their passporting rights to lend across the EEA, so in order to deal with potential loss of any necessary passporting rights following a UK exit from the EU those lenders may wish to designate an affiliate, which would meet any relevant regulatory requirements, to lend in their place, and may seek to include appropriate provisions in a facility agreement to permit this.

The LMA has indicated that it intends to suggest drafting to address this. Corporate counterparties to derivatives may also be asked in due course to approve similar provisions in ISDA documentation, and even in the absence of such clauses may face requests to approve novations of hedges to affiliates of their counterparties or changes to the booking office of a trade. In all such cases, comfort that there are no negative tax implications must be sought, and in the case of derivatives, comfort that the netting analysis is not affected by the transfer.

As the position becomes clearer we will circulate a further client e-bulletin on this topic.

Jurisdiction and enforcement of judgments

The result of the UK referendum and a UK exit from the EU itself should not have any effect on the willingness of parties to loan agreements, capital markets transactions and derivatives to choose English law or on the legal advice as to the advantages of doing so. A choice of law clause providing for English law to be the governing law of the contract should remain enforceable across the EU.

It is highly likely that Member States will continue to respect English jurisdiction clauses.

We also envisage that EU Member States would continue to enforce an English judgement. Whether there are any changes to this position would depend on the precise arrangements put in place following the UK's exit from the EU. Arbitral clauses and the enforcement of arbitral awards will remain unaffected, though in certain contexts, such as debt capital markets issues with fiscal agency arrangements, arbitration may be an impractical method of dispute resolution.

It is worth noting that relevant industry bodies in the financial markets are not currently making any changes to standard form documentation but clients wanting to further understand the risks under their transactions and their options (which involve opting for arbitration as the prime or fall back method) should click here.

However, in the unlikely absence of an alternative regime being agreed with the EU, the parties to such transactions involving a submission to the English courts would be in the same position as parties to New York law obligations containing a submission to the New York courts.

EMIR

The burden imposed by EMIR originates from EU law and the relevant EU Regulation is directly effective in the UK. However, the requirements have their basis in a G20 commitment, so it seems likely that the UK would adopt a similar regime post Brexit. Equally, the UK may wish to ensure an equivalent regime to benefit from the advantages equivalence may afford it vis-à-vis the EU.

One way or another, any trades with an EU-based counterparty will still need to comply with the EMIR regime; in addition, issues as to the availability of exemptions from clearing may arise for corporate pension trustees (which are often a wholly owned subsidiary within a corporate group) upon a UK exit from the EU.

For more information on the issues raised in this email please contact your usual HSF contact or one of those appearing below. You can also access our Brexit hub here.

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