CLIFFORD CHANCE

Briefing note

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Brexit: Corporate Treasury Update – July 2016

Practical questions for corporate treasurers post-Referendum

In this update, we explore some of the key questions that treasurers need to ask themselves following the UK's vote to leave the European Union.

Much has already been written on the long-term legal, constitutional and macro-economic repercussions of the UK's exit from the EU. Any such analysis is necessarily speculative given that the shape of the UK's future relationship with the EU is still to be determined by the outcome of negotiations. Recent political developments in the UK indicate that the process itself will take some time to be defined even before negotiations begin.

However the Leave vote has already had an immediate impact on the day-to-day operations of companies both in the UK and in mainland Europe and creates a number of short-term practical considerations for corporate treasurers.

What are the repercussions of the Leave vote for treasury?

Many companies are reviewing their finance arrangements and available lines of credit, the conditions available to draw on those lines of credit, the impact on them of the depreciation of sterling and the euro. The UK has already been downgraded. There is a particular focus on hedging market volatility and any collateral requirements arising from such market volatility on existing hedging contracts.

How does Brexit affect what borrowers do now?

It's largely a process of due diligence. Companies have to consider the following: the implications of ratings downgrades for financing arrangements; collateral requirements for hedging exposure or increasing the cost of borrowing; checking the availability of credit line; ensuring they are committed; examining dependency on uncommitted lines of credit; the need, timing and ability to tap capital markets for needed liquidity; and the long-term implications of movements in exchange rates.

In our experience, a significant number of companies depend on uncommitted bilateral lines of credit. If banks' exposure changes through mark-to-market exposure on derivatives then there is a question over whether those uncommitted lines will be available. Companies dependent on uncommitted lines should consider whether to turn them into committed funding lines if they are critical to the liquidity of the relevant company.

Companies are also considering their dependency on EU funding – if they're reliant on the EIB, if they're reliant on EU grants or subsidies – and what is the impact of Brexit on that. Companies may look to the non-bank funding market. The US private placement market has been around for a very long time and is used extensively by corporates. The more recent development of a European private placement market, largely through the insurers and pensions funds and the workings of the Loan Market Association, has not really been tapped by the corporate market but has been used to fund infrastructure projects and projects with longer tenure. Corporates may look to that as an alternative for bank funding. The availability of these alternative financing options, however, is yet to be seen.

In addition, companies that have historically or were otherwise planning to tap into liquidity in the capital markets need to consider the timing of any such issuance of securities. While markets have stabilised in the immediate wake of the referendum vote, it is yet unknown the extent to which primary deals can clear the market and at what price. And as the markets for sterling denominated securities are narrower, the impact on those markets will take more time to be determined. Accordingly, companies dependent on capital markets liquidity will need to carefully consider the timing and logistics of their financing needs.

Are we prepared for a changing interest rate environment? Could there be liquidity issues?

The vote to leave caused an immediate devaluation in sterling with the pound falling to a 30 year low and the Eurozone hit hard by market turmoil. Uncertainty could lead to a rise in interest rates as central banks look to control inflation and regulate the value of their currency. Rate moves can create significant problems for borrowers who are unprepared for such eventualities, particularly as they have been operating in an era of unprecedentedly low interest rates. Even if central banks do not raise rates, spreads in the market could widen and increase the costs of future financings.

Central banks including the Bank of England, the European Central Bank, the US Federal Reserve and the Indian Central Bank, among others, have all promised to provide necessary liquidity to support markets. The Bank of England has indicated that it will intervene to provide sterling liquidity to UK banks. However, it may be more expensive for non-UK lenders (particularly non-bank lenders) to fund in sterling and there may be a reluctance to lend to UK businesses in currencies other than sterling in the short to medium term.

This potential lending liquidity shortage (many markets have seen significant outflows in funds in the last weeks), could have consequences for the availability of existing uncommitted facilities and also for the pricing of new facilities or securities. Indeed, we are seeing pricing differentials between sterling and foreign currency tranches included in some new facilities and securities.

What is our exposure if FX rates are volatile?

The volatility, or a material re-basing, in the foreign exchange markets following the Leave vote could be problematic, particularly for companies with revenue streams in one currency and foreign currency borrowings or trade liabilities in different currencies. If foreign exchange exposures are hedged by way of foreign exchange or cross currency derivative transactions, the fall in the value of sterling or euro against other currencies will change the mark-to-market value of such transactions. If those transactions are collateralised, this could lead to a requirement to post additional collateral, with a potential corresponding negative effect on a company's liquidity positions.

An increase in exposure may also exhaust the maximum available credit line provided to a company by its hedging provider and parties may need to agree to increase credit lines to allow them to enter into new hedging transactions.

Many companies with a financial year (or financial half-year) ending on 30 June will have to test their financial covenants in their loan agreements against historically low exchange rates. Volatility in the FX markets following the Leave vote could be a concern for those borrowers with borrowings in foreign currencies if they calculate their debt by reference to the spot rate on the testing date. However, many borrowers use an average exchange rate over the relevant period, which should help smooth out fluctuations for the period ended 30 June, but could have implications in future periods. If your loan agreement is silent on the point then the exchange rate that you use is likely to be calculated in accordance with your accounting principles.

Do we need to think about what happens with our relationship lenders?

Currently many financial services firms rely on the EU "passport" regime to provide their services in other member states. Although the UK does not require lenders to be authorised to make corporate loans, some EU countries do impose such a restriction. Therefore, in the longer term, a key question is whether financial service providers can still provide their services across borders.

It will be some time before it is clear what the nature of a post-Brexit UK/EU relationship will look like and therefore what regime(s) will allow cross border access. As things become clearer, companies can begin a dialogue with existing lenders and other financial service providers as to whether they can provide their services on an ongoing basis. This may be through their existing model or under a new model (for example, could a lender book loans through a local facility office?).

Ultimately, if it did become illegal for a lender or financial service provider to continue its activities, illegality protections in contracts would apply and would likely require loans by that lender to be repaid or possibly transferred to another lender.

Are Brexit terms being included in new financings?

In general, our view is that no immediate changes should be required to existing loan or bond documentation following the Leave vote, although additional prospectus disclosure may be appropriate for some businesses and Brexit related risk factors are now being seen.

Could the UK seek to amend our tax treaties with various nations?

In principal the answer is yes, but there are a number of barriers. First those countries that have dividend withholding tax are usually reluctant to give it up in tax treaties. Second it would be a difficult negotiation because the UK has nothing to give in return. We don't impose withholding tax on dividends so diplomatically it may be difficult to achieve and there is also a timing problem as treaties take three or four years to negotiate. The UK negotiates two or three a year, and they take at least one year more to come into effect. In the medium term, international groups need to think of ways of mitigating these costs.

Conclusion

Presently the financing markets are still digesting the implications, process and timing of Brexit and while a key focus in the immediate wake of the referendum has been about liquidity and exchange rate implications, more specific implications will become clear over time. We are working with the Loan Market Association and the Association for Financial Markets in Europe to determine if any changes to market practice will be needed going forward and to shape the look of any such changes and the financing markets themselves. As our work and the markets progress we will provide further updates. In the meantime, if you would like to discuss any of the issues raised in this update in more detail then please contact your usual Clifford Chance contact or any of the people listed below.

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