CLIFFORD CHANCE

Briefing note

May 2016

Corporate Treasury Update – May 2016

Brexit – Practical Questions For Corporate Treasurers

In this update, we explore some of the key questions that treasurers should be asking themselves in the run-up to Britain's referendum on EU membership on 23 June 2016.

Much has already been written on the long-term legal, constitutional and macro-economic repercussions of a UK exit from the EU. Any such analysis is necessarily speculative given that the shape of the UK's future relationship with the EU post-Brexit will be largely determined by the outcome of negotiations in the period following the referendum (this period can be up to two years without an extension, which would require unanimous agreement among the EU's members).

However, a Leave vote may have 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.

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

A Leave vote may cause a devaluation in sterling and could also have a negative effect on the value of the euro and other European currencies, at least in the short term. This, in turn, 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.

Market turmoil in the period immediately following a Leave vote has the potential to affect liquidity in the UK and EU financial 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 could have consequences for the availability of existing uncommitted facilities and also for the pricing of new facilities. Indeed, we are seeing pricing differentials between sterling and foreign currency tranches included in some new facilities.

The sterling bond market is likely to suffer an immediate reaction to a Leave vote and the first half of 2016 has seen very limited sterling issuance as investors struggle to value and price the risks of exit.

It is unclear what support the European Central Bank will give EU banks but the ECB is currently looking at Brexit issues.

What is our exposure if FX rates are volatile?

The anticipated volatility in the foreign exchange markets following a 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, a 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 corresponding negative effect on a company's cash flows or reserves.

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

Brexit is "the biggest risk to financial stability."

Mr Carney, BOE Governor

to increase credit lines to allow them to enter into new hedging transactions.

Companies may wish to consider additional hedging – if only for the short term. However, additional demand has pushed up the price of protection. Of course, if the result of the referendum is a Remain vote, then many predict a bounce back for sterling.

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 just 7 days after the referendum. Volatility in the FX markets following a 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. 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?

As already discussed, the immediate concern on a Leave vote is whether in practice it could be difficult for some lenders (particularly non-bank lenders) to make some loans.

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 if the UK withdraws from the EU.

If there is a Leave vote, 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 lenders and other financial service providers as to whether they can continue to provide their services. 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 in order to cater for the possibility of a Leave vote, although additional prospectus disclosure may be appropriate for some businesses. We have seen a few Brexit-specific provisions creep into recent deals but these are by no means the norm. These include:

- a 'Flexit' provision which allows lenders to flex the margin of the loan during syndication in the event of a Leave vote. 'Flexit' provisions have so far only been seen in leveraged transactions and even then very rarely;
- a MAC clarification: there has been some discussion as to whether it is useful to include language confirming that neither a vote to leave the EU nor leaving the EU will constitute a material adverse change or a default; and
- some generic Brexit risk factors have been included in certain bond prospectuses, particularly for UK issuers; although other European

issuers are drawing attention to the broader macroeconomic risks that a Leave vote may entail. At present however these risk factors provide few specific details as to the likely impact on individual businesses.

Will withholding tax change?

The tax effect of withdrawal, in due course, by the UK will be that the European Directives providing exemption from withholding tax on intra-group dividends, royalties and interest payments will cease to apply to UK companies. The most significant effect of this will be on UK headquartered groups. Dividends UK companies receive from subsidiaries in Germany, Italy, Luxembourg, Ireland and ten other member states would become subject to local withholding taxes. Similarly, interest UK companies receive from their Greek, Italian and Portuguese subsidiaries will become subject to withholding tax. It is possible, but we think unlikely, that the terms of the UK's exit could preserve access to the European directives in question. More likely, the UK would need to renegotiate its double tax treaties with the fourteen affected countries to provide for a dividend/interest withholding tax exemption – this would not be straightforward.

In comparison, there is not expected to be a significant change to withholding tax on interest paid to lenders or bondholders in the short term with the exception of loans to Italian borrowers, which could become subject to withholding at the point the UK leaves the EU. In the medium to long term things may change if EU member states (or the UK) introduce tax changes which discriminate between local and UK entities.

Where withholding taxes are imposed by member states then contractual gross-up provisions in loans would usually require borrowers to gross-up interest payments and any related provisions such as the obligation to mitigate the risk or the ability to change lenders would be relevant.

Conclusion

In light of the issues highlighted above, it is important for companies to plan for the consequences of a Leave vote. Market volatility is likely to be an issue, at least in the short term. Contingency planning for the medium to long term is more difficult given the widely different alternatives for withdrawal from the EU. If Britain chooses to leave, companies should monitor developments as the negotiations progress.

For a more detailed consideration of the potential legal implications of Brexit, please refer to our briefing note on the topic: The day after Brexit: what will happen if Britain votes to leave the EU?

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.

This update is intended to consider the legal and business implications of the UK voting to leaving the EU. It does not address the question of whether the UK should leave or remain in the EU.

"If the ECB were called upon to take measures to manage turbulence …we would do so."

Mr Villeroy de Galhau, French ECB governing council member

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