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October 2016

Corporate Treasury – key considerations and a review of market developments

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This year has been a volatile one for corporate treasurers and their advisors and Brexit added yet another element of uncertainty. Here, Clifford Chance experts explore some of the major market developments and how they impact treasury functions.

Corporate Bond Purchase Scheme

The Bank of England announced a stimulus package in the wake of the Brexit vote that included a Corporate Bond Purchase Scheme (CBPS) for sterling bonds which are EU listed, investment grade rated and issued by high quality non-financial issuers meeting the eligibility criteria (see below).

In the short term, sterling bond issuances have risen since the announcement. Though it remains to be seen what the longer term impact of CBPS will be. The current low interest environment and liquid markets already give companies a range of financing options – should they wish to borrow. However the uncertain economic backdrop may discourage companies with cash rich balance sheets or no immediate investment plans from borrowing.

Eligible issuers: issuers which 'make a material contribution to the economic activity in the UK', whether through significant employment, generating significant revenues, serving a large number of customers, having a number of operating sites, or by being headquartered in the UK.

CPBS stimulus: CPBS aims at providing monetary stimulus by lowering the yields on corporate bonds, thereby reducing the costs of borrowing for companies, triggering portfolio rebalancing into riskier assets by sellers, and stimulating new issuance. The programme will involve up to £10 billion of sterling corporate bonds, and will run for 18 months from 27 September 2016.

EU Market Abuse Regulation

In July the EU Market Abuse Regulation (MAR) came into force, replacing the Market Abuse Directive (MAD). Companies have already taken steps to accommodate the changes it brings but the approach to the practical application of the rules and the regulators' interpretation of them continues to evolve.

Michael Dakin, a Clifford Chance finance and capital markets partner, says:

"There are some real challenges here. MAR is not just a new version of MAD but extends the rules quite considerably."

Michael Dakin, Partner, London

In particular, it now applies to securities and derivatives trading on a broader range of European markets and trading platforms including not only the London Main Market and other major exchanges but also multilateral trading facilities, such as AIM or the Luxembourg Euro MTF, and (from 2018) "organised trading facilities" operated by investment firms. It also applies to securities and derivatives that are admitted to trading outside the EU (or are not available for public trading anywhere) but which have an effect on the price or value of securities or derivatives trading on markets within the EU.

From a corporate treasury perspective, some of the challenges include:

- **inside information**
  what constitutes inside information is substantively unchanged but MAR imposes increased obligations in terms of identifying when inside information comes into existence and more onerous requirements for maintaining insider lists, requiring more personal information (such as maiden names, mobile numbers and home addresses) and changes to the on-boarding process to get the necessary written acknowledgements;
- **market soundings**
  soundings to gauge interest in equity or debt issuances are permitted but there are enhanced record keeping and procedural requirements; and
- **internal share dealing policies for directors and other PDMRs (persons discharging managerial responsibility) and persons closely associated with them**
  policies have had to be updated-eg to reflect the shorter notification period for transactions, the €5000 minimum threshold (if companies choose to adopt this – most haven't done so) and the new closed periods when PDMRs cannot trade shares or debt securities. Helpfully, the FCA and ESMA recently confirmed that the UK practice of closed periods ending on the issue of preliminary statements can continue.

BEPS and withholding tax

The OECD's base erosion and profit shifting (BEPS) programme aims to address tax avoidance strategies that exploit gaps in tax rules by artificially shifting profits to low or no-tax locations. However it is not necessary for a company to be engaged in tax avoidance to be impacted by BEPS.

BEPS is an enormous undertaking, and includes a couple of elements that directly impact corporate treasurers. These include the treaty abuse and interest deductibility rules.

BEPS Action 6 aims to combat treaty abuse, which is about withholding tax on interest payments. In common tax planning structures, one of the main ways that withholding tax can be reduced, and often eliminated, is under the terms of double tax treaties entered into with other countries. Luxembourg companies are often put into UK structures, for example, because there is no withholding tax under Luxembourg domestic law, and no withholding tax under the Luxembourg/UK tax treaty.

Action 6 is intended to make such structures ineffective where they are abusive and is considering two possible approaches. The first is a 'limitation on benefits' article, which means that treaty benefits are limited to entities that pass the economic benefit on to persons that would themselves qualify for treaty relief, thereby removing classic treaty shopping.

The second is a 'principal purpose' test, tackling arrangements or transactions where obtaining the benefit of the treaty is the principal purpose.

Nick Mace, a Clifford Chance tax partner, says: "The issue is that borrower jurisdictions may deny non-bank lenders the usual exemptions from withholding tax unless they can show that their investors are themselves exempt from withholding tax. There is unlikely to be any grandfathering, so historic facilities with non-bank lenders may face significant withholding tax, and this will be a borrower cost under most loan documents."

It remains to be seen which jurisdictions will adopt Action 6.

BEPS and interest deductibility

The second BEPS issue concerns BEPS Action 4 about interest deductibility. The purpose here is to limit interest deductions by reference to a company or country's EBITDA, and the UK has already announced plans to introduce an interest barrier of 30%. The OECD recommends a 'group ratio rule', which requires the external debt of a company to be allocated pro-rata to local EBITDA to benefit fully, and this rule is included as part of the UK proposals due to commence from April 2017.

Mace says: "One issue is that if you're a multinational company, the group ratio rule only helps fully if you have allocated the debt proportionally to local EBITDA."

Developments in cash management

One factor shaping the cash management industry in recent years has been new bank capital requirements post-Basel III, meaning banks require more and better capital to support their businesses. In addition to facing higher capital charges, banks must meet additional legal and operational requirements, and where banks are seeking regulatory capital relief, or relying on any sort of credit risk mitigation, such as on-balance sheet netting, they have to submit legal opinions to regulators.

This has impacted corporate treasurers via increased costs, and also in the negotiation of documentation.

Caroline Meinertz, a finance and regulatory partner with Clifford Chance in London, says: "Five or 10 years ago, all documentation in the context of cash management products was pretty standard, and banks were pretty flexible in accommodating requests for changes from their corporate customers. Now banks have very little latitude to change their documentation, for fear of potentially falling outside the coverage of this web of legal opinions."

Also threatening to disrupt the cash management landscape is the introduction of the leverage ratio. Though not yet in force as a regulatory requirement, banks now have to report to their regulators on their leverage status.

The leverage ratio seeks to cut down the size of bank balance sheets by putting an absolute limit on the amount of leverage that each institution can have, expressed as a ratio of bank capital divided by gross asset value, which must exceed 3%. The key word here is gross – banks have to consider the full value of any lending exposure, without taking account of any benefit they might have thanks to credit risk mitigation techniques.

"Treasurers will need a good handle on EBITDA in each jurisdiction, so as to allocate accordingly, and will need to be flexible to move debt around."

Nick Mace, Partner, London

"For corporate treasurers who are making use of cash management techniques, such as notional cash pooling products, it is sensible to discuss alternatives with their bank service providers, such as virtual accounts or target balancing."

Caroline Meinertz, Partner, London

"Ultimately the leverage ratio doesn't prohibit banks from providing these notional pooling services," says Meinertz, "but it actually makes providing those services prohibitively expensive from a balance sheet perspective."

Euroclearing post Brexit

There has been much discussion about the potential location of Euro-denominated cash accounts post Brexit, centring around whether companies can continue to have Euro-denominated cash accounts in London, or whether they might have to move onto the continent. Payment systems Target2 and Euro1 limit membership to EU banks, or EU branches of non-EU banks, and so corporate treasurers may be forced to consider fragmentation of currency accounts across different treasury centres. The alternative for those that wish to keep their accounts in London is to shift treasury business in to an EU bank that operates a branch in London. In any event, there is a need for a new emphasis on transferability in documentation.

The other impact of Brexit arises in the context of derivatives clearing, because a significant proportion of Euro-denominated swaps are currently cleared in London. In 2011 the European Central Bank tried to argue Euro-denominated swaps should be cleared in the Eurozone, but failed in the EU courts. However, post Brexit, another challenge might result in a different outcome, since the UK would no longer be protected by EU anti-discrimination principles. This will not have a significant impact on corporate treasurers unless they are subject to the mandatory clearing threshold under the European Market Infrastructure Regulation, or are engaging in voluntary derivatives clearing.

Negative interest rates

Negative interest rates are not new. The European Central Bank cut its interest rate below zero in 2014 and charged banks to deposit cash with it. Other central banks have also set negative interest rates – including Japan this year. What is new is the willingness of banks to pass on negative interest rates to their customers. This has a range of implications including for loans, hedging and cash management.

Lenders may protect margins in a negative scenario by imposing a floor below which interest rates cannot fall. For example, LMA loan documentation has an option to impose a zero floor on the benchmark rate – so even if the LIBOR or EURIBOR benchmark rate falls below zero, the loan interest will be calculated on the basis of a zero benchmark rate plus margin.

If loan interest is floored, then borrowers may find themselves with imperfect hedging arrangements as floors are not usual in interest rate swaps (although they can be obtained – at a price).

If banks do charge corporate customers for cash deposits then companies may think again about what they do with their cash. Companies could choose to diversify their bank deposits or store cash (with related insurance solutions). Alternatively they might choose to redeploy cash through repaying debt early or bringing forward M&A or investment plans or self-fund supply chains. "Cash equivalents" (such as top rated bonds) might be provided as collateral instead of cash. Corporate treasurers may also mitigate the impact by shifting cash from negative interest rate jurisdictions or into certain currencies.

Choosing English law post Brexit

There have been some questions about the use of English law as the governing law in documentation post Brexit. English law has, historically, been a popular choice of governing law. The benefits of English law, such as freedom of contract and emphasising the importance of parties' commercial bargains, will be unaffected by Brexit.

Furthermore, as a result of the Rome I Regulation, courts in EU member states will be obliged to continue to give effect to parties' choice of law, whether that choice is of an EU member state's law or a third country's. And what about courts in England? Given that English courts upheld the parties' express choice of governing law before Rome I Regulation's predecessor, the Rome convention, came into force, there is no reason to doubt that they will do so after Brexit.

"We do not expect to see a material shift away from English law" says Peter Dahlen, a partner in the finance and banking practice at Clifford Chance. Parties should continue to choose the law most appropriate for their transaction.

The historical reasons for finding English courts attractive (expertise, commerciality and being relatively quick) will also not change with Brexit.

"What might change is your ability to take an English court judgement and enforce it in Europe," says Dahlen. At present, English judgements are enforceable in EU member states under the Brussels I Regulation. Following Brexit, it may be that this regulation would no longer apply to English judgements. There are a range of possible alternatives. It is possible that there could be automatic recognition of judgements (for example if the UK accedes to the Hague convention or other arrangements are agreed). In the worst case scenario, English judgements could be in a similar position to that of, say, the judgements of New York courts, whose enforceability in EU member states depends on the local law in each of those states.

For now parties are not changing their approach and where they have chosen English law, they continue with usual practice (ie opt for the non-exclusive or exclusive jurisdiction of the English courts). That said, parties should, as always, consider the circumstances of their particular transaction.

Loan markets update

For corporate treasurers accessing the loan markets, there continue to be strong levels of liquidity and pricing remains very attractive for borrowers.

The investment grade refinancing cycle in recent years has seen banks fighting for a share of corporate treasury wallets which has put pressure on loan pricing. It will be interesting to see whether in the future, this pressure will continue or whether increasing regulatory costs will make ancillary corporate treasury business less attractive and loans will be priced more on their own merits.

There remains reasonably strong activity in the M&A markets and fears of a Brexit-related tightening are yet to materialise.

There is a potential need for corporate treasurers to start looking at their relationship bank group for regulatory reasons, BEPS reasons and other reasons (including possible loss of passporting rights as a result of Brexit), and it makes sense to consider diversification of funding sources.

The switch of long-term funding from the bank market to the bond market continues, while the private placement market in Europe has yet to really take off thanks to price pressures. Alternative debt providers are becoming serious competitors to banks in certain parts of the market, such as senior secured lending in certain situations, and so should be part of the mix of options.

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Peter Dahlen, Partner, London

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J20161310161929