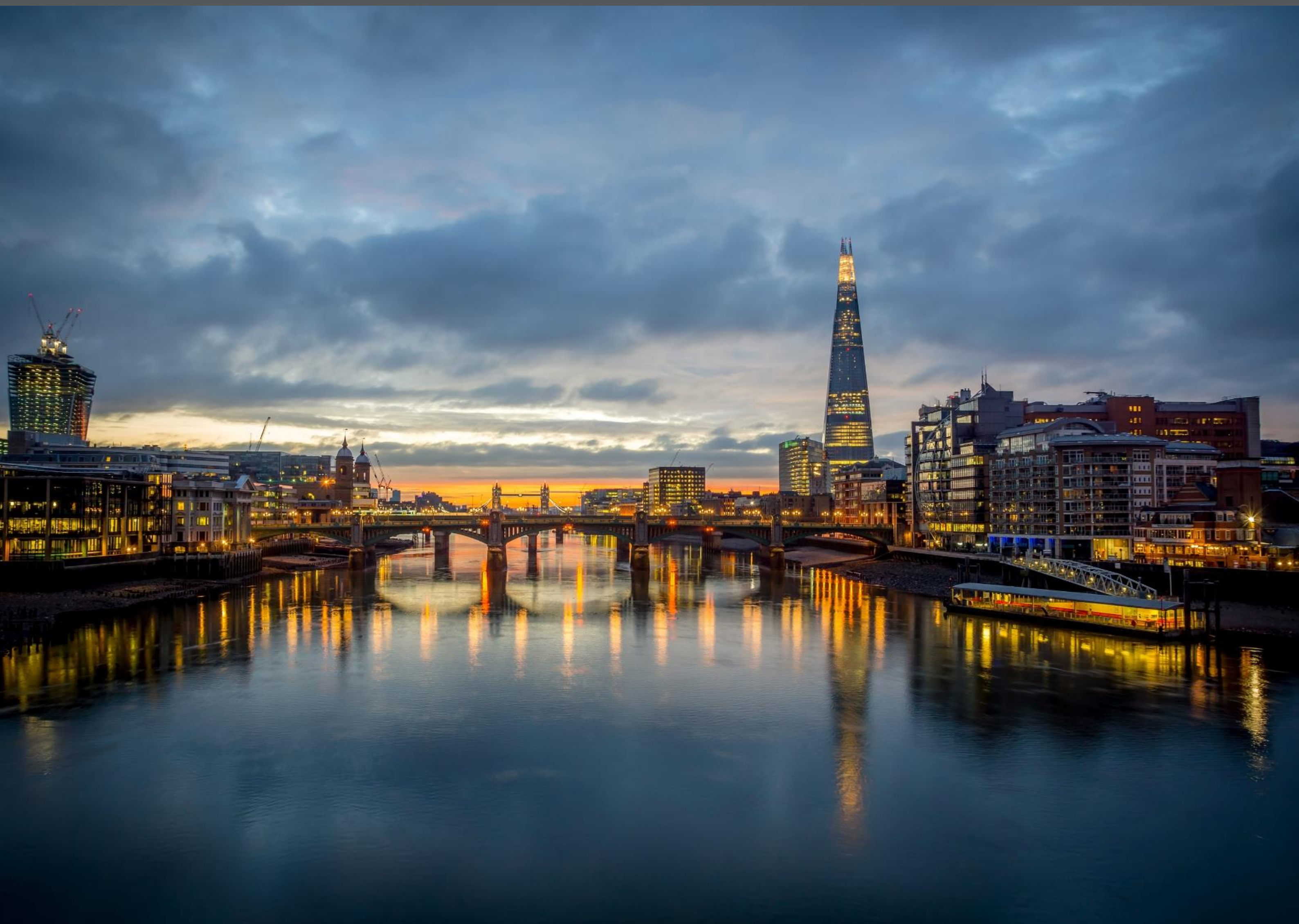
ADDLESHAW GODDARD

November 2018

Q4 CORPORATE BORROWER UPDATE



INTRODUCTION

Welcome to the November 2018 edition of the Addleshaw Goddard Corporate Borrower Update.

It's been a busy summer for our corporate banking team, with Q4 2018 also showing a great deal of corporate activity which is supported by the continued high levels of available liquidity. With the Brexit date fast approaching, there will doubtless be some reticence around transactions, although opportunities should continue to arise.

In this issue of the Corporate Borrower Update, on page 1 we take a look at 'green finance', considering the LMA's launch of the 'Green Loan Principles' and the potential benefits to borrowers in entering into socially and environmentally responsible activities.

August 2018 saw the EU respond to the Trump Administration's reinstatement of sanctions against Iran by introducing the 'Blocking Regulation' which operates to nullify the application of those sanctions on EU persons. On page 3 we consider the impact of the EU's Blocking Regulation on borrowers in the context of high standards imposed by banks' on borrowers in respect of sanctions.

Finally, on page 4 we summarise the current position regarding the replacement of LIBOR as a benchmark funding rate following scandals around rate-setting. Bloomberg has called LIBOR 'the world's most important number' – it underpins such a vast number of financial transactions that its replacement and the related transitional arrangements are both systemically important and technically challenging.

We do hope these articles are of interest – do not hesitate to contact any of the team if you would like to discuss (see page 6 onwards) or if there are topics which you would like us to address in future editions.

We look forward to working with you over the coming months.

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GREEN FINANCING

The Growth of Green Finance

Social awareness of environmental issues has gathered pace in recent years. The transition to a low carbon economy is high on the UK Government's agenda, as demonstrated by the launch of the City of London's Green Finance Initiative in January 2016 in partnership with the Government. This initiative's objectives are to promote the UK as a global centre for green finance and to work towards boosting the economy through green investment. This initiative, the establishment of working groups on sustainable finance (e.g. the EU High-Level Expert Group on Sustainable Finance) and the issuance of voluntary principles and guidelines on green financing by industry bodies has contributed to the increased pressure on corporates, investors and lenders alike to demonstrate environmentally sound behaviour.

So what is green finance?

"Green finance" is an umbrella term used to describe any kind of financing (whether that be bonds, equity or debt) that supports or encourages environmentally sustainable behaviour.

The green bond market has been busy for some time and is currently worth approximately $160 billion annually, consequently, it is evident that green bonds have played an important role in encouraging investment into green projects. The Green Bond Principles (**GBPs**) were introduced in 2014 (updated in 2017) by the International Capital Market Association as voluntary guidance for bond market participants in the issuance of green bonds. The key element of a green bond is that the proceeds will be invested into projects, activities or assets that have a specified environmental benefit. The use of the proceeds will be detailed appropriately in the legal documentation and will often be used as a marketing tool to expand the investor base for the bond issue.

Green loans are a relatively new development but have been on the increase during 2018 and further significant growth in this market is expected over the next 12 months. The term 'green loan' is used to describe a loan which is made available for a specified green purpose, similar to a green bond (such as investment into a wind farm or the acquisition of a target which has demonstrable environmentally sustainable qualities). Until very recently there were no agreed guidelines setting out what makes a loan "green", and parties to such a loan would often look to the GBPs for direction. However, on 21 March 2018, the LMA published its Green Loan Principles (**GLPs**), which build on and refer to the GBP with a view to promoting consistency across financial markets. The GLPs seek to provide a framework of voluntary recommended market guidelines and include an appendix that provide a non-exhaustive list of eligible green projects to assist the industry in identifying environmentally friendly lending, with the aim of promoting and supporting environmentally sustainable economic activity. The GLPs will be reviewed and, where necessary updated, on a regular basis to ensure that they evolve with the developing and growing global green loan market.

In addition, outside of the scope of the GLPs and the focus on use of proceeds, the market has seen the emergence of a new type of 'green loan', which instead of specifying that the loan must be utilised for a green purpose provides a financial incentive for the borrower to engage in environmentally responsible behaviour. The loan documentation includes 'green' covenants that set out certain sustainability criteria (e.g. relating to CO2 emissions, water usage, energy performance certification and/or certification that an agreed annual amount has been invested into achieving energy efficiency) that are tied to a reducing margin ratchet. Compliance with these covenants will most likely be tested by an independent party, although certification by the directors may be acceptable in some deals. The covenants are genuinely being used as an incentive and not a stick i.e. failure to meet criteria will not result in a breach or trigger an event of default. This type of 'green loan' naturally opens up the door to green financing to a much wider group of corporate borrowers than the use of proceeds approach might otherwise do.

The benefits to the lender of providing any form of 'green loan' are that (i) they are associated with the sustainable financing that is being widely promoted by the Government and industry bodies; (ii) corporates that engage in sustainability and are environmentally conscious are viewed as a better credit risk; and (iii) encouraging sustainability can often result in an increase in the value of a lender's security (for example improving the energy efficiency of a real estate asset).

How can corporate borrowers take advantage of this?

As is evident from the 'noise' in the market around green financing (e.g. the overriding focus of this year's LMA Syndicated loans Conference was 'building a sustainable future') there is clearly an appetite for improved environmental performance from both lenders and corporates. This coupled with lenders' internal corporate and social responsibility requirements means corporate borrowers can use the opportunity to obtain beneficial pricing. Public expectation of brands acting in an environmentally conscious manner is growing, and positive sustainable behaviour is a useful selling point to both stakeholders and customers.

AG has experience advising on both green bond issuance and green loan documentation. Please do not hesitate to contact our team if you wish to discuss this further.

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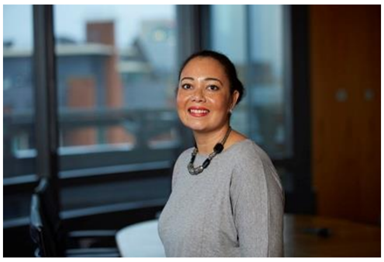

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SANCTIONS: NAVIGATING THE DIVERGENCE BETWEEN US AND EU POLICY

The Background

In May, President Trump announced the US's withdrawal from the Joint Comprehensive Plan of Action 2015 (JCPOA), thereby re-imposing sanctions against Iran (the Sanctions), including secondary sanctions which target non-US companies engaging in non-US business. Whilst they do not prohibit conduct or impose mandatory compliance, the secondary sanctions pressurise third parties to cease activity in Iran. US persons can enforce these by suspending or prohibiting transactions with third parties engaged in activity in Iran.

The EU responded in August by expanding the scope of the EU Blocking Regulation (the Regulation) to reaffirm its commitment to JCPOA and preserve the interests of European companies investing in Iran. The Regulation was originally enacted in 1996 and to date has mainly applied in relation to US Sanctions against Cuba.

The Divergence

The Regulation intends to counteract the extraterritorial effect of the Sanctions by:

1. forbidding EU persons from complying with the Sanctions, whether directly or indirectly, through a subsidiary or intermediary, actively or by omission;
2. nullifying the effect in the EU of any foreign court judgments relating to the Sanctions;
3. allowing EU persons to recover damages for loss arising from the application of the Sanctions; and
4. allowing EU persons to apply for authorisation to comply with the Sanctions.

EU persons is broadly defined to include EU incorporated companies, EU nationals, and non-EU nationals resident within the EU acting in a professional capacity. Non-compliance risks civil or criminal liability at the discretion of the relevant EU member state – a criminal offence in the UK, with the possibility of an unlimited fine.

The Impact

It is important to be aware of the differing approaches to sanctions and the possible need to balance obligations under both regimes. Although the Regulation is intended to protect EU persons engaging in business with Iran, rather than compel continued investment, a risk of conflict exists in that the US may take enforcement action against EU persons engaged in activity in Iran whilst EU member states simultaneously take enforcement action against those complying with the Sanctions.

In practice, corporate borrowers should consider their exposure to business caught by both the Sanctions and the Regulation. Borrowers should have in mind the zero-risk policies usually adopted by banks in relation to sanctions compliance and check the wording of sanctions-related representations, warranties and covenants in existing loan agreements, which could contravene the Regulation.

Borrowers should also be mindful of the risks of litigation. Under the Regulation, EU persons can claim damages from a person/entity that has caused the EU person loss as a result of their compliance with the Sanctions. It remains to be seen how this will play out in practice.

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THE FUTURE OF LIBOR

What is the key concern?

After 2021 the Financial Conduct Authority will no longer persuade or compel panel banks to submit the rates required for the calculation of LIBOR.

What is LIBOR?

The London Interbank Offered Rate (LIBOR) is set with reference to the rate at which certain large and financially sound panel banks indicate that they can borrow short-term wholesale funds from one another on an unsecured basis in the interbank market. LIBOR serves as the benchmark rate and relative performance measure that can be used to calculate funding costs, investment returns or for signalling changes in the financial environment.

What has brought about the concern and need for change?

Following the financial crisis and various fixing scandals, there were increasing calls to regulate and reform LIBOR. The Wheatley Review (2012) made recommendations for the reform of LIBOR which resulted in the ICE Benchmark Administration being appointed as an independent regulator and the requirement for market participants to play a significant role in LIBOR production and oversight.

One core goal of regulators has been to anchor LIBOR rates to actual transactions to ensure that the rate is truly representative of market conditions. At the same time, banks have become increasingly unwilling to participate as submitting banks for LIBOR due to legal and compliance risks in light of the scandals that emerged from the financial crisis. Consequently, there has been a significant reduction in transactional data available to determine LIBOR rates and increasingly the rate is based on expert judgement rather than actual data. This was highlighted in July 2017 when Andrew Bailey, Chief Executive of the Financial Conduct Authority (FCA) gave a speech setting out the limitations of LIBOR and deeming the benchmark to be an unsustainable and unreliable basis for financial contracts.

The FCA have confirmed that LIBOR panel banks have agreed to continue submitting to LIBOR until the end of 2021, but this does not mean that we can ignore the impending changes until then. A transitional period is required and working groups have been established to look at alternative benchmark rates to replace LIBOR.

What is the alternative?

The Bank of England has identified the Sterling Overnight Index Average (SONIA), which is already used in the sterling Overnight Index Swaps market, as the preferred alternative 'risk-free reference rate' (RFR) to replace LIBOR. SONIA is based on actual transaction data (i.e. it is supported by an average of 370 transactions per day) and, consequently, does not need to rely on expert judgement.

Concerns with SONIA and further development required

Although SONIA has been identified as the preferred RFR, the significant differences in its calculation compared to LIBOR mean there are concerns regarding its use in the loan market, including:

- Credit risk – SONIA is a reflection of the wholesale cost of funds, whereas LIBOR can include lenders' perceived credit risk, the absence of which could result in increased margins being charged.

- Term – SONIA is an overnight rate. LIBOR is a term rate that can be used for various tenors (typically 1, 3, 6 or 12 months), which takes account of the increased risk for lending over longer periods. As noted above, the absence of this from RFRs could result in increased cost.

- Backwards looking – LIBOR can be set at the beginning of a forward looking credit period, giving certainty of cash flow, whereas SONIA can only give a retrospective rate, which would not provide borrowers with certainty of cost.

It is clear that these issues still need to be addressed before SONIA (or any other alternative rate) can be adopted into documentation. The Bank of England has set up a working group to develop a term SONIA reference rate (TSRR) and documentary proposals, amongst other things. In July 2018, the working group anticipated that a TSRR would be available for use by the second half of 2019.

What does this mean for borrowers?

Until the preferred form of RFR is settled, it is of course not possible to incorporate alternative RFR provisions into financial contracts. The Loan Market Association's suggested facility documentation does include 'fallback' provisions, but these are only designed to address a temporary unavailability of LIBOR; and in October 2018 the LMA published a revised version of its suggested Replacement of Screen Rate provisions that facilitate further flexibility by permitting amendments with a lower consent threshold than may otherwise be required upon certain events relating to LIBOR. This revised wording was agreed with borrower representatives and, to the extent possible, is mindful of the then current draft of the ISDA Benchmark Supplement.

Borrowers can also engage with this issue by considering:

1. their arrangements that refer to LIBOR and determining whether there is any fallback language and amendment flexibility;

2. the range of financial products they are currently using and try to ensure consistency between them – for example, by ensuring ISDA documentation and term loan documentation can be determined by the same reference rate;

3. whether amendments should be sought to documentation to require longer and more flexible consultation periods with relevant counterparties to accommodate alternative reference rates (for example the LMA's Replacement of Screen Rate provisions noted above);

4. whether lower consent thresholds should apply to changes to reference rate selection.

Conclusion

It is impossible to definitively state whether LIBOR will cease to exist after the end of 2021 but in the meantime the number of financial contracts based on LIBOR which will mature beyond 2021 continues to grow and the possibilities for change should be considered. Much still depends on the development and adoption of an alternative RFR as noted above. Once an appropriate RFR has been developed and broadly accepted by the market then appropriate changes to documentation can be implemented. The same working groups are also looking at appropriate 'fallback' language to fit with the any new rate. Until then it would be wise to keep the issue in mind, take any protective steps available and consider it in any financial planning to help ensure stability beyond 2021.

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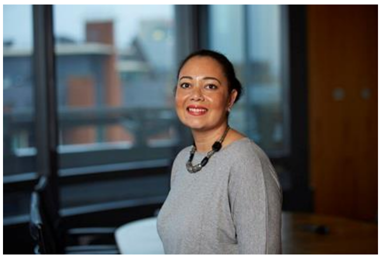

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