KEY POINTS
- The prudential regulatory question is whether the contingent exposure to the borrower created by the Designated Entity Clause follows through to an off-balance sheet contingent position, which requires a Capital Requirements Regulation calculation as to its quantum.
- Banking groups should consider balance sheet effects so as to ensure that deployment of the right to transfer obligations to a Lender Affiliate does not trigger undue balance sheet pressure in the transferee.
- Parties will need to satisfy themselves that any Lending Affiliate will fall within the definition of "Qualifying Lender" in relation to a particular borrower in the tax gross-up provisions, as that Lending Affiliate will not be able to rely on any "Qualifying Lender" status of the Lender that appointed it.

Feature

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The LMA's designated entity clause: a regulatory and tax perspective

This article highlights key tax and regulatory considerations for lenders when seeking to deploy the Loan Market Association's designated entity clause.

Historically, the documentation of the Loan Market Association (LMA) has provided sufficient flexibility to lenders to transfer or assign their rights under a facility to affiliates without borrower consent. Furthermore, lenders were entitled to be repaid and their commitments cancelled if it became unlawful for them to continue to participate in a facility. While in relation to unknown events, these provisions were arguably rational and equitable, in the context of a long drawn event such as Brexit, concerns were raised as to whether the existing provisions achieved the right result. To address these concerns, the LMA recently published a recommended form of Designated Entity Clause. The accompanying User Guide focuses on the utility of the Designated Entity Clause to address issues that might arise following a "hard" Brexit in circumstances where: (a) there is no agreement regarding the continued availability of a passport for UK established lending entities; and (b) there are concerns about the lawfulness of continuing to carry a loan on a UK based balance sheet in respect of loans to borrowers in other jurisdictions.

There has been widespread commentary and analysis of the "Brexit Effectiveness" of the Designated Entity Clause, (including [2017] 7 JIBFL 440 "The LMA's Designated Entity Clause: truly Brexit-proof?"). There has, however, been minimal discussion of some of the key tax and regulatory issues to which use of the Designated Entity Clause may give rise and, in this context, as with most things tax and regulatory, the cautionary note in paragraph 2.4 of the User Guide says it all – 'users should satisfy themselves on the relevant regulatory and taxation implications of the Designated Entity Clause in the context of the relevant transaction'.

At the outset, it is worth noting that while the LMA formulation is undoubtedly a useful addition to the armoury for banks' operational planning for Brexit, it should not be viewed as a "one size fits all" solution.

REGULATORY PERSPECTIVE

Some of the regulatory issues to be considered can be divided into (at least) two categories:

(1) prudential regulatory issues for both the Original Lender or Lender (each as defined in the LMA's recommended forms of facility agreements) and the Original Lending Affiliates or New Lending Affiliates (each as defined in the Designated Entity Clause); and

(2) operational and control framework issues for both the Original Lender or Lender and the Original Lending Affiliates or New Lending Affiliates.

First, a few prudential regulatory issues need to be considered (and for some of these issues, accounting input will be required).

The first issue for any lending bank subject to the Capital Requirements Directive (2013/36/EU) (CRD IV), entering into a facility agreement either at the outset as a Lender or later as a Lending Affiliate, is how both its initial exposure and subsequent exposures will be treated under the Capital Requirements Regulation (575/2013) (CRR). The Designated Entity Clause specifies that the definition of Original Lender or Lender includes Original Lending Affiliates and Lending Affiliates, respectively. Lending Affiliates have certain rights arising upon being formally joined to the facility agreement. The prudential regulatory question then is whether the contingent exposure to the borrower created by the Designated Entity Clause follows through to an off-balance sheet contingent position, which requires a CRR calculation as to its quantum. Accountancy advice on this will be necessary. The overarching legal thinking behind this process also needs to be followed through – if the Lender does decide to procure a Lending Affiliate to participate in a loan or commitment in its stead, the operation of the Designated Entity Clause is such that the Lending Affiliate steps into the shoes of the Lender for all purposes with respect to that quantum of the available commitment and any outstanding participations. Accordingly, the contingent exposure of the Lending Affiliate (if any) will be converted into an actual exposure, with a value calculable under CRR at an entity level for the Lending Affiliate and will fall out of the basket of exposures of the Lender.

This throws up a number of immediate regulatory questions which a Lending Affiliate will need to be able to address. Some of these questions will be particularly pertinent in the context of Brexit planning, where banks are establishing or planning on using Eurozone affiliates as Eurozone hubs for business, after loss of passporting rights. Generally banks will be trying to optimise their balance sheets and keep the amounts of regulatory capital in their affiliates to as low levels as possible. If they are currently booking material exposures to the entities with the largest balance sheets, that makes sense in terms of management of, for example, large exposures and the aggregate sectoral exposures created by certain categories of business. Triggering the right to shift an exposure to a Lending Affiliate will remove that exposure from the balance sheet of the entity that assumed it in the first place (and which, presumably, had the balance sheet capacity to absorb it efficiently). It will then locate that exposure onto the balance sheet of a bank which may well also be subject to CRR. Will it, though, have the same balance sheet capacity, or may the transfer trigger balance sheet issues at the level of the Lending Affiliate?

Banking groups considering using the Designated Entity Clause should therefore consider balance sheet effects not only from the perspective of the Lender, but also more widely, so as to ensure that deployment of the right to transfer obligations to a Lending Affiliate does not trigger undue balance sheet pressure in the transferee or, on the other hand, require holding excessive or inefficient amounts of regulatory capital in an entity against a contingent need.

Two other related regulatory questions also should be considered in the context of processes and controls; namely for lenders to be sure that they have risk and control frameworks which will operate not only at the level of the Lender but also for the purposes of any Lending Affiliate.

The first is to ensure that, if and to the extent that a Lending Affiliate is subject to the European Central Bank's (ECB) Guidance on Leveraged Transactions, May 2017, that it will be able to rely upon the transaction approval processes of the Lender (with any of its own particular constraints and risk management requirements being taken into account) to demonstrate its compliance with the new control requirements of the ECB. (We have not considered the potential mismatches between US and EU leveraged finance control environments for the purposes of this article but note they should be reviewed). A second, and possibly more arcane, point is to ensure that the identity and classification of the borrower is clearly mapped out for the purposes of establishing whether it is an entity in the shadow banking sector, so as to enable any Lending Affiliate (if it is subject to the individual and aggregate exposure limits to the shadow banking sector determined by the European Banking Authority) to show what that Lending Affiliate's and any relevant group's exposure is to the sector.

Second, it is necessary to look at some other process issues, already touched on in the Users' Guide – AML (Anti-Money Laundering) and KYC (Know Your Customer). The User Guide looks at AML and KYC from the perspective of the Agent, and the necessity of ensuring that a Lending Affiliate can satisfy the Agent's AML and KYC due diligence and sign off processes. This is only one half of the AML/KYC piece. A Lending Affiliate will need to ensure that they themselves comply with the local jurisdictional AML/KYC requirements appropriate to the borrower. AML and KYC are in that category of regulatory issues which are generally regarded as being "process" – ie not really substantive, but capable of being solved swiftly, particularly if there is material front office pressure. This view needs careful consideration, particularly given the coming into force of the Fourth Money Laundering Directive, and its increased raising of group standards and the need to have in place robust auditable trails supporting AML and KYC decisions. There is a presumption that if, for example, a Lender has performed its AML and KYC on an original borrower, that its Lending Affiliates will be able automatically to rely upon those checks for their own purposes. This can, indeed, in some groups be taken as a given, in that those groups have well-established group wide AML/KYC processes, driven off "highest common denominator" compliance standards, and with a common risk appetite and a well-established framework within which one affiliate can reasonably demonstrate its ability to rely on the AML checks done by another affiliate. Such standards are not, however, universal and there can frequently be a material delta between one lending entity's AML and KYC checks as required by its local regulator and those of its affiliates. Considering whether these gaps exist and how they can most effectively be bridged should be part of initial deal due diligence if the Designated Entity Clause is to be deployed.

A TAX PERSPECTIVE

As mentioned at the outset, under the LMA recommended forms lenders have significant flexibility to restructure their participations. For example, lenders are permitted to transfer their participations to Affiliates without consulting or getting the consent of the borrower. Lenders can also transfer their participation to another Facility Office subject to meeting some procedural conditions. These provisions should not unduly prejudice the borrower in itself from a tax perspective – for example, the LMA terms provide in the non-leveraged syndicated facility agreements that the borrower, in such circumstances, has no higher obligation or liability under the tax gross-up or increased costs/indemnity provisions than it would have had, had no such transfer taken place.

When viewed from a tax perspective, in substantive terms, the Designated Entity Clause is an extension of the existing mechanics. This is because, irrespective of which mechanics are used, the impact on any withholding tax analysis of an affiliate's performance of lending obligations, or on a borrower's corresponding obligation to repay that affiliate, will be a function of each relevant jurisdiction's tax regime. Each must be considered on a case-by-case basis – particularly so, given that borrowers will not expect to be under any greater liability under the tax gross-up provisions as a result of an affiliate's performance of lending obligations than they would have been under if the loan had been made by the lender that novated to them or appointed them.

Nevertheless, the Designated Entity Clause provides a framework for the tax rights and obligations of each Designated Entity and each borrower in relation to that Designated Entity (albeit one that must be tailored to each commercial deal and the relevant tax jurisdictions of each particular transaction).

Biog box

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Under the Designated Entity Clause, the term "Lender" is expanded to include "Lending Affiliates". As a result, Lending Affiliates are, from the date of their appointment, entitled to the same generic rights (which include the tax gross-up provisions (including protection against changes of law occurring after that date)) and subject to the same generic obligations (such as confirming tax status) which apply to Lenders generally. In most cases these provisions will apply to a Lending Affiliate in its own right, independently of the application of those provisions to the Lender that appointed it.

As a result, parties will need to satisfy themselves that any Lending Affiliate will fall within the definition of "Qualifying Lender" in relation to a particular borrower in the tax gross-up provisions, as that Lending Affiliate will not be able to rely on any "Qualifying Lender" status of the Lender that appointed it. A "Qualifying Lender" in relation to a borrower is, generally speaking, defined as a lender that is entitled under the domestic law of the borrower's tax jurisdiction or under the terms of a relevant double tax treaty to receive payments of interest from that borrower without deduction of tax (generally subject to completion of any necessary procedural formalities). The normal commercial position is that a borrower will expect a Lender to be a Qualifying Lender on the date of a facility agreement, but accepts that if withholding tax later arises as a result of a change of law after that date then it may be required to gross-up.

The practical implication of this is that Lenders will need to select Lending Affiliates that are resident in jurisdictions where they may receive interest payments from the relevant borrowers without deduction of tax (under the terms of a double tax treaty with the borrower's jurisdiction or otherwise); as noted previously, borrowers will not expect to be under any greater liability under the tax gross-up provisions as a result of a Lending Affiliate's performance of lending obligations than they would have been under if the loan had been made by the Lender that appointed them. The definition of "Qualifying Lender" must be tailored accordingly.

The Designated Entity Clause contains provisions requiring Lending Affiliates to provide confirmations as to whether or not they wish the HMRC DT Treaty Passport scheme to apply to the loan and to provide the standard LMA "Tax Confirmation" where that Lending Affiliate is a UK Non-Bank Lender. Again, these provisions may need to be tailored for each relevant tax jurisdiction.

CONCLUSION

Although Designated Entity Clauses have (in some form or another) been in existence historically, the LMA Designated Entity Clause has come under the spotlight as being an appropriate device to deal with the consequences of a "hard" Brexit on existing loan facility arrangements involving lenders that lose passporting rights when (and if) the UK leaves the EU. It is not anyone's suggestion (including the LMA's) that the Designated Entity Clause is a magic bullet which applies satisfactorily to each and every circumstance. However, this provides a good starting point and, with careful consideration of precise facts and circumstances, it should be able to be effectively employed to deal with a loss of passporting rights. ■

Further Reading:

- Brexit and Basel III: an invitation for more or for less? [2016] 8 JIBFL 478.
- The LMA's Designated Entity Clause: truly Brexit-proof? [2017] 7 JIBFL 440.
- LexisNexis Loan Ranger blog: Brexit – how does it impact LMA facility documentation?