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Making Increased Costs Claims Under Basel III — Working with the LMA provisions

Introduction

It is customary in loan agreements to permit lenders to pass on to borrowers increased costs incurred by lenders in performing their obligations following a change in law. Such a provision shifts to a borrower the risk that a change in law (or a change in the application of an existing law) occurring after execution of the loan agreement will impose increased costs on the lender not covered by the loan pricing agreed at completion. Such a provision is often accompanied by a right on the part of the borrower to replace any lender making an increased costs claim.

Following the announcement of the Basel II regime several years ago, it became common to see negotiated provisions relating specifically to increased costs that would be incurred by lenders following the implementation of those rules. In some transactions, a mechanism was included to allow the lender to recover such increased costs through a margin ratchet and/or a step up in commitment fee levels. In other transactions, carve-outs have been negotiated to prevent increased costs claims relating to the implementation of Basel II on the basis that lenders were able to price in the projected increase to their cost of capital caused by the proposed rules. In some structured deals, where increased demands on a borrower's projected cash-flows could impair bond ratings, increased costs claims payable in a senior position in the priority of payments waterfall were capped.

The broad outline of further regulatory capital reform, leading to a new "Basel III" regime, have been announced in recent weeks and will be adopted into law over the coming months. Basel III will meaningfully increase capital charges for most banking activities, including for loans to corporate borrowers. Even though a long adoption period for Basel III is anticipated, now is the time to formulate and adopt internal policies and processes for making increased cost claims, whether under existing loan documentation or under documentation to be entered into during the transition period.

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Documentation Analysis

Although a right to claim increased costs is common to many loan facility agreements, the extent of the rights varies between deal-types and markets. Moreover, rights under documents are only one aspect of allocating the risk and burden of increased costs — the relative negotiating power of the parties is another no less important factor in determining whether claims will be made and if made paid.

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The Loan Market Association (LMA) standard provisions (which are widely used in English law loan documentation, not only in investment grade and leveraged loan transactions but also in project and structured finance facilities) allow for lenders to claim for the following types of costs:

(i) "a reduction in the rate of return from a Facility or on a Finance Party's (or its Affiliate's) overall capital;

(ii) an additional or increased cost; or

(iii) a reduction of any amount due and payable under the Finance Document, which is incurred or suffered by a Finance Party or any of its Affiliates to the extent that it is attributable to that Finance Party having entered into its Commitment or an Ancillary Commitment or funding or performing its obligations under any Finance Document or Letter of Credit."[1]

Under the LMA approach, such costs can be reclaimed to the extent that they are incurred by the lender (or any of its affiliates) as a result of:

(i) "the introduction of or any change in (or in the interpretation, administration or application of) any law or regulation; or

(ii) compliance with any law or regulation made after the date of [the facility agreement]..."[1]

To be recoverable, increased cost claims must have resulted from a change in law, or a change in the "*interpretation, administration or application of*" any law or regulation. In circumstances where a rule change has been announced, or even introduced, but comes into effect later (exactly the situation we face now with Basel III), it seems clear that a "change in application" of the regulatory capital rules will occur as and when the rule change becomes effective. However, in order to avoid any later dispute in such a circumstance the parties may wish to specify whether increased costs resulting from the law becoming effective on a later date are to be included in the loan pricing or are to be claimed separately.

The LMA standard wording does not allow a lender to recover increased costs to the extent incurred solely by reason of a downgrade of the borrower's credit rating. Under existing regulatory capital rules, and under the proposed Basel III regime, a borrower's rating downgrade will usually increase the capital charges to be held against a loan to that borrower. For example, under Basel II, a downgrade of a borrower's external corporate credit rating from BBB- to BB+ would increase the risk weight from 100 per cent to 150 per cent for Standardised banks, and from about 50 per cent to about 100 per cent for IRB banks (depending upon the formula inputs applicable to IRB banks). Risk weights are "banded" for Standardised banks, so some downgrades (BBB+ to BBB-, for example) will not result in any risk weight or capital increase. Risk weights for IRB banks, however, are formula based and thus more risk sensitive and more likely to result in increased capital charges following a ratings downgrade. Similarly, a liquidity provider to a structured finance transaction could be affected by a rating downgrade of the notes supported by the liquidity facility. Accordingly, lenders and borrowers should consider whether to include or exclude a specific provision regarding recovery of increased costs incurred in such circumstances.

Basel III

When effective, Basel III will inevitably increase the capital cost to a bank of acquiring and holding, and of arranging and syndicating, loans to corporate borrowers. Every bank determines its capital requirement on the basis of the following formula: the ratio of a bank's risk-weighted assets (the denominator) to its qualifying regulatory capital (the numerator) must not be less than 8 per cent (the current overall capital requirement). All three elements in this formula will be more burdensome under Basel III, even before including the costs of new leverage and liquidity ratios.

Although much drafting remains, the broad outline of Basel III reform is as follows:

- *Increased overall capital requirement*: Between 2013 and 2019, the common equity component of capital (core Tier 1) will effectively increase from 2 per cent of a bank's risk-weighted assets before certain regulatory deductions to more than 7 per cent after such deductions. This change alone will make all banking activities more expensive. Moreover, the overall capital requirement will increase from 8 per cent to more than 10.5 per cent over the same period.
- *Narrower definition of regulatory capital*: Common equity will continue to qualify as regulatory capital (core Tier 1), but other hybrid capital instruments (upper Tier 1 and Tier 2) will be replaced by instruments that are more loss-absorbing and do not have incentives to redeem. Non-qualifying instruments will be excluded from core Tier 1 capital from 2013, and other non-qualifying instruments will be phased out between 2013 and 2023.
- *Increased capital charges for banking book exposures*: The few changes here, effective from 31 December 2010, will increase capital charges for securitisation exposures and will permit banks to invest in securitisations only if the originator or arranger retains 5 per cent of the risk, unhedged, for the life of the deal. Corporate loans held in the banking book will otherwise not be affected.
- *Increased capital charges for trading book exposures*: From 31 December 2010, capital charges will increase materially for banks across their trading books. Among other changes, banks will be subject to new "stressed" VaR models, increased counterparty risk charges, more restricted netting of offsetting positions, increased charges for exposures to other financial institutions and increased charges for securitisation exposures. Changes to the VaR models alone may double, triple or even quadruple regulatory capital charges for loans and bonds "warehoused" in a bank's trading book pending syndication, depending on the bank's risk management practices and other factors.
- *New leverage ratio*: A minimum overall Tier 1 capital ratio of 3 per cent, measured against a bank's gross (and not risk-weighted) balance sheet, will be trialed until 2018 and adopted in 2019.
- *Two new liquidity ratios*: A "liquidity coverage ratio" requiring high quality liquid assets to equal or exceed highly-stressed one-month cash outflows will be adopted from 2015. A "net stable funding ratio" requiring "available" stable funding to equal or exceed "required" stable funding over a one-year period will be adopted from 2018.

Given that the Basel III reforms must still be incorporated into national law, and given the (in some cases) long transition periods between announcement and final implementation, it will be common over the next several years for loan agreements to be drafted and entered into in the knowledge that subsequent rule changes will increase the capital cost to regulated lenders of providing commitments and loans. As a result, borrowers and lenders could benefit from a more explicit allocation of risks and costs during this period of uncertainty. Here are some preliminary thoughts to get through the next decade until Basel III is fully implemented:

- **Until adoption.** Until the exact scope of Basel III is known in any country, there is little that can reasonably be done by the parties when negotiating new documents other than to insert generic increased costs wording (including kick-out rights), and include "for the avoidance of doubt" language to clarify that future Basel III costs would be treated as increased costs or, if the lenders are comfortable with such an approach, agree to a specific exclusion of such increased costs. Existing loan documentation that already includes LMA standard increased costs provisions should not need to be amended to cover future Basel III costs. The severity of the final rules and the parties' relative negotiating power will determine whether increased costs claims are made once the rule changes are implemented.

- **During transition**. Once the actual Basel III rules have been adopted and the timing of implementation is known (but not yet complete), the parties will be better able to strike a deal (again, based on relative negotiating power) allocating the risks and burdens of increased costs. Solutions could range from fixed pricing and a clause prohibiting further increased cost claims for the known rules on the one end of the spectrum, to full ability to recover increased costs on the other end of the spectrum. This latter approach notably does not guarantee a lender's recovery of its claims, only its right to make them. A middle-ground approach to address this issue would be to prohibit further claims for the known rules but agree pricing step-ups on the effective date(s) on which the most significant rule changes become effective. One difficulty with this approach is that the Basel III rules need not be uniform across jurisdictions, resulting in potential shortfalls for some lenders and windfalls for others (the potential for such windfalls would be increased if any of the lenders receiving such step-up is not regulated under the Basel III regime).
- **Following full adoption and transition**. Once the Basel III rules have been adopted and are fully in effect, lenders will not, under standard wording, be permitted to make increased cost claims because there will be no subsequent "change" in law to trigger the clause. Thus, following full implementation, the associated capital costs should be fully reflected in pricing and nothing more need be done to allocate Basel III risks and costs.

Making Claims

The LMA standard increased costs wording requires lenders to take all reasonable steps to mitigate any circumstances resulting in an increased costs claim, including requiring affected lenders to transfer their commitments to affiliates or other facility offices. Moreover, the standard wording requires a borrower (or its parent) to indemnify the lender for any reasonable costs incurred in connection with any mitigation actions. However, no action is required which might prejudice a lender, and a failure to mitigate will not prevent a lender from bringing an increased costs claim.

The LMA standard wording does not impose any particular claims process or requirement, or time limit, on lenders bringing increased costs claims, other than requiring that the lender should (as soon as practicable after a demand by the facility agent), provide a certificate confirming the amount of its increased costs. It is critical to keep in mind that, although the LMA standard language contains no restrictions in the timing or making of claims, the actual wording in a lender's loan documentation may differ. Actual loan documentation may impose claims processes and deadlines, and require a detailed explanation regarding how the increased costs claim was calculated. From a borrower's perspective, the longer that a lender waits to make a claim, the greater the impact on the borrower's cash-flows, so prompt claims are in the interests of all parties.

In the event that a lender makes an increased costs claim, the borrower will typically have the right to cancel the commitment of the lender in question and repay any outstanding loans by that lender on the next interest payment date (thereby avoiding associated break costs).

In light of all of the foregoing, several practical steps are advisable. First, lenders and borrowers alike should take the time now to check their loan documents and formulate a policy and process for making claims. Second, lenders and borrowers should, to the extent practicable, become familiar with and monitor the scope and timing of regulatory capital reforms in all relevant (lender) jurisdictions. Third, in the event that a claim is to be made, a lender should document the basis for that claim

in reasonable detail and not merely meeting the bare requirements of the relevant loan document. Fourth, claims should be made in as timely a manner as possible, even if the document does not require it. At a minimum a lender should notify the borrower promptly once the lender concludes that it will make a claim. Finally, lenders should follow up until the claim is resolved one way or the other.

Endnotes

[1] LMA form of Senior Multicurrency Term and Revolving Facilities Agreement for Leveraged Acquisition Finance Transactions, September 2010.

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