WHITE & CASE

Insight: Bank Finance

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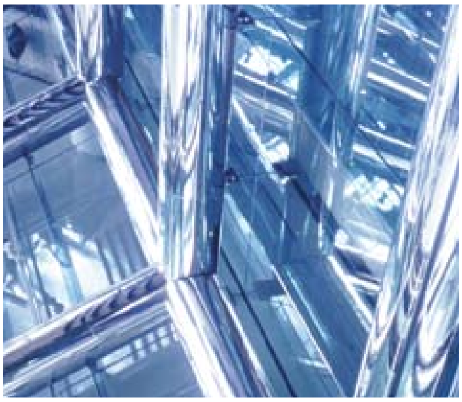
Increased costs – the great debate

The introduction of Basel III and the Bank Levy has brought the increased costs provision in facilities agreements into sharp focus once more. Whether, and to what extent, lenders will seek to pass any costs arising from the introduction of either of these measures on to borrowers remains the subject of some debate in the market. In this alert we consider such changes in light of the increased costs and financial covenant provisions in facilities agreements.



Regulatory changes

Basel III reforms

The majority of the Basel III measures are to be phased in gradually from 1 January 2013. For a summary of the Basel III proposals please click here.

Bank Levy

In June 2010 the British Government announced its intent to introduce a Bank Levy (jointly with the French and German Governments each announcing equivalent measures) which has, as one of its primary aims, the reduction in both the level of risk taking in the banking industry and the use of wholesale finance by the banks. The Bank Levy is to be introduced by the *Finance Bill 2011*, which will likely receive royal assent by July 2011 and will have retrospective effect from 1 January 2011. The Bank Levy will be imposed on all UK banks, including UK subsidiaries and branches of non-UK banks that conduct their banking and finance activities in the UK, where the financial institution's chargeable equity and liability base is £20 billion or more. "Chargeable equity and liabilities" are determined as reported from relevant (consolidated) balance sheets, adjusted to exclude certain categories (including Tier 1 Capital, segregated client monies, tax liabilities, insured client deposits) and adjusted for the off-set of highly liquid assets in certain circumstances.

Other jurisdictions in the EU (including France and Germany) have confirmed that a similar bank levy regime will be introduced in their relevant jurisdictions in the next 12-18 months.

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Increased costs - implications for lenders and borrowers

The increased costs clause is one of a number of clauses in a facilities agreement intended to protect the lenders 'cost plus' approach to lending i.e., any cost associated with the making of a particular loan which would otherwise erode the lenders rate of return should be for the account of the borrower. The clause generally allows lenders to recover any increased costs incurred as a result of compliance with a change in law or regulation which occurs after the date of the facilities agreement. An increase in capital required as a result of the Basel III reform, or the payment of the Bank Levy, will likely fall within the scope of such provisions.

Historically, the purpose of the increased costs clause has been to protect lenders against costs arising from changes in law or regulation which are unforeseen. Once the nature of any change becomes clear there is therefore an argument for any such costs to be excluded from the protection afforded to lenders by the increased costs provision on the basis that such changes could be factored into the pricing of the loan facilities. Although the LMA acknowledged this concept prior to the implementation of Basel II by the provision of optional language excluding costs arising from Basel II from the increased costs provision, they have not done so as regards Basel III or the Bank Levy - on the contrary they have advised parties that Basel III may inadvertently be excluded by the previous carve out relating specifically to Basel II. This premise has been reflected in several recent transactions where lenders have requested the inclusion of language to clarify that any Basel III costs will be recoverable from the borrower pursuant to the increased costs clause.

There has been some debate in transactions in non-European markets as to whether the Bank Levy (and its French, German and United States equivalents) should be excluded from the increased costs clause, however such debate has not yet occurred with respect to UK market deals, which may perhaps reflect the domestic UK political sensitivity surrounding this issue.

Borrowers will be sensitive to any costs associated with the regulatory changes being passed on to them. If such costs are for the account of the borrower there may be a significant impact on their cash flow position in the short to medium term and possible consequential effects on the ability of the borrower to meet its financial covenant obligations, specifically, interest cover to the extent that any such costs fall within any definition of 'finance charges' and cash flow cover to the extent not specifically excluded.

In order to alleviate these concerns, borrowers may request that the payment of increased costs be amortised to reduce the impact on their cash flow. Further, borrowers may suggest that the period during which the increased costs clause can be invoked be limited to, for example, six months from the date the cost is incurred. In recent deals variants of all of the above have been seen, specifically with respect to potential increased costs from Basel III.

Where a lender seeks to invoke the increased costs provision, borrowers may, as a last resort, replace such lender from the syndicate under the terms of the finance document. However, such action would not necessarily be an easy solution as the borrower would have to find a new lender willing to replace the lender seeking increased costs payment and the borrower would be responsible for any shortfall to the extent that such new lender was not willing to buy in at par.

Given the series of regulatory changes expected from various authorities in the UK, EU and internationally, the increased costs provision will come under further scrutiny from lenders and borrowers alike and we expect this to be a heavily negotiated topic until a market approach is established both with respect to documentation and lenders actual use of the increased costs provision.

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