ACT LEADING TREASURY PROFESSIONALS

GIVING DIRECTION

BRIEFING NOTE:

BREXIT 2019

A UK TREASURER'S CHECKLIST

NOVEMBER 2018

Briefing note

BEXIT 2019
Plan for the worst, hope for the best…
A UK Treasurer's Checklist

The Association of Corporate Treasurers
The Association of Corporate Treasurers (ACT) is the only professional treasury body with a Royal charter. We set the global benchmark for treasury excellence and we lead the profession through our internationally recognised treasury qualifications, by defining standards and by championing continuing professional development. We are the authentic voice of the treasury profession representing the interests of the real economy and educating, supporting and leading the treasurers of today and tomorrow.

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INTRODUCTION

This briefing note forms part of the regular Brexit updates the ACT provides to its members and should be read in conjunction with the Q&A[1] (which itself will be updated on a regular basis).

Two weeks after the Ides of March 2019, the UK will leave the EU. Although there remain many uncertainties including what we're leaving and when we will have departed, with less than 150 days before 29 March 2019, treasurers need to make sure they're ready.

At a minimum this requires assessing your current treasury landscape, understanding what the business needs and learning how your banks are adapting.

Many large organisations have already developed comprehensive Brexit plans with detailed scenario analyses to cover a range of outcomes and the effects on all major parts of their business – including Treasury. However, if you're still formulating your plans, waiting for clearer decisions or wanting to benchmark your efforts, we hope you find this Briefing Note useful.

Having seen an initial shock to the financial markets following the referendum, sentiment towards a successful Brexit outcome will continue to fluctuate over the coming months and the risk of a disruptive Brexit is currently high. As such we recommend planning for a worse-case scenario.

This Briefing Note focuses on the short-term effects of Brexit and what organisations should consider as they build their impact assessments and mitigating plans in a number 0f key areas. After all, it's better to plan for the worst and hope for the best.

1 https://www.treasurers.org/brexit/question-and-answers

1. MAINTAINING SUFFICIENT LIQUIDITY

Many corporates could experience a drain in working capital caused by a variety of factors including:

a. Delays to trade receivables as shipments are interrupted by changes to customs rules
b. Delays to payments by customers as cash is hoarded
c. Accelerated payments to suppliers (through changes to payment terms or to access goods in short supply)

Companies will need to understand how significant these changes may be and review the assumptions in their cashflow forecasts. It may be prudent to build a contingency buffer into these forecasts to accommodate any unforeseen cashflow implications. Setting tolerances and Early Warning Indicators will help in identifying any low points.

In assessing liquidity requirements there will need to be consideration of how long any disruption may last – from a few days to several months and have strategies developed for those scenarios most likely in your organisation. It may be useful to adopt some of the stress techniques used by banks in setting their Liquidity Coverage Ratio (which looks at whether a bank has sufficient liquidity to withstand a market-wide shock). These include:

a. Calculating the worse-case net inflow / outflow by applying a haircut to receipts (perhaps dropping to nil) and that supplier payments are accelerated
b. Deciding whether to apply one month or three months to the period when liquidity could be under stress
c. Reviewing all sources of liquidity and:
   - Assessing how truly liquid all cash and cash equivalents, repos and investment products are and understanding the time it may take to liquidate them and any associated breakage clauses and fees
   - Checking that borrowing facilities can still be drawn on (i.e. that market conditions, force majeure or covenants will not be revoked)
   - Sourcing additional sources of liquidity (such as banks offering short term working capital facilities, government supported loan packages or asset-based financing programmes)

and using the information to calculate either how many months the company can survive or what the percentage of surplus liquidity for a given time period will be. An additional refinement is to undertake reverse-stress testing whereby the calculation is how many months' worth of liquidity is available before the company can no longer pay its suppliers.

2. CONTINUITY OF CONTRACTS

Most treasury departments have large cupboards stacked with legal documents covering ISDA arrangements, loans, investments and derivatives contracts. However, assessing how these legacy contracts will be affected is complicated by the current absence of any agreement between the UK and the EU27.

Assuming you have identified and logged all your treasury agreements, some of the areas that will need to be considered are:

a. Under what conditions can these agreements be terminated early and whether both parties have equal rights to terminate
   - Whether a counterparty is more likely to terminate the agreement if the contract is currently in their favour (e.g. if it is In-The-Money)
   - Whether a counterparty is more likely to terminate the existing agreement if a replacement contract is in their favour (e.g. a higher margin can be applied due to real / perceived increased credit risk)

b. If existing contracts need to be transferred to another entity (such as a subsidiary domiciled in the EU27)
   - The effect of a replacement contract being with a weaker counterparty within the same banking group, increasing credit exposure

c. If assets pledged (for example under an invoice discounting facility) need to be separated between the UK and EU27 countries and potentially excluded from the facility

d. The costs incurred in changing contracts (such as legal costs)

It is therefore important to know exactly what terms and conditions have been agreed to – especially as the documents may have been signed many years ago by a different treasury team.

Insurance

The likely loss of passporting rights will affect how insurance contracts continue to provide appropriate cover. Irrespective of the nature of the contract, without portfolio transfers or grandfathering, (re)insurance firms would be breaking the law if they were to fulfil their contractual obligations unless they chose to cancel and rebook their policies. This will affect all types of insurance and all events including:

a. Handling of existing claims
b. Payment of premia (including instalments)
c. Pay-outs from future claims based on pre-Brexit policies

Key actions to consider include:

a. Understanding current insurance arrangements and which legal entity the policy is with
b. Discussing with the insurer what plans they have in place (such as providing cover via multiple entities that have local authorisation)
c. Deciding if it is better to pay premia before or after 29 March 2019
d. What (if anything) will happen to insurance cover and claims that cross over 29th March 2019?
e. Checking with your insurer to know if any contracts will be transferred to another insurer: e.g. from a UK insurer to an EU insurer

3. FX VOLATILITY

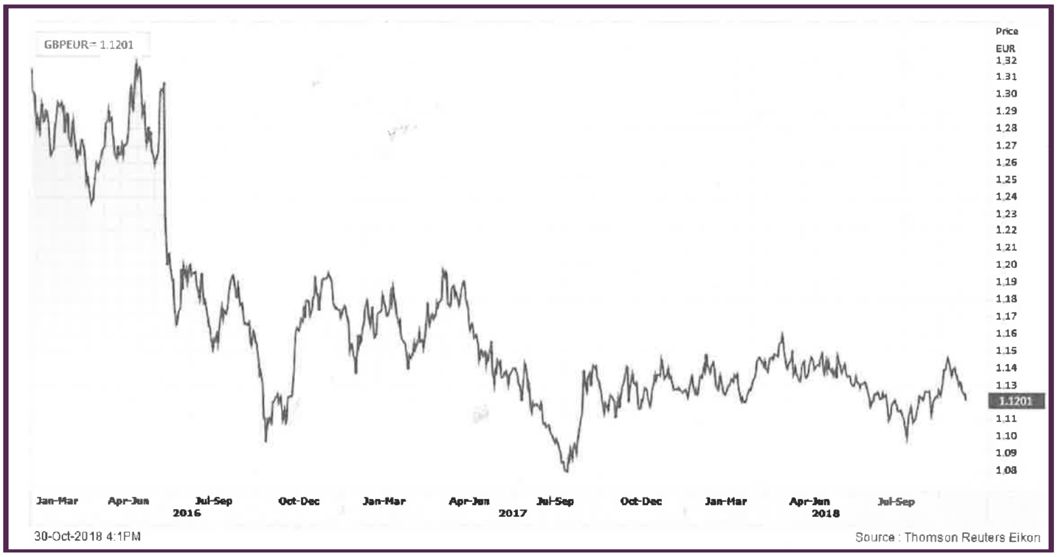
As the chart below shows, sterling has experienced significant volatility against the euro since the initial decision to hold a referendum. Progress (or lack of progress) in the Brexit talks has had a material effect on the currency and however negotiations develop, sterling will continue to be subject to significant movements. We recommend that treasurers with exposure to FX risk take the following steps:

a. Review existing currency risks and ensure they are all being captured (suppliers and customers may have changed recently because of Brexit)
b. Model currency risks to ensure that hedging policies remain fit for purpose (as historic currency volatility increases)
c. Discuss with the Risk Committee/ Board whether hedging policies should be revised (temporarily or permanently) to ensure greater certainty for the business as the risk appetite may have changed
d. Increase reporting of currency exposures to include more scenario planning
e. Consider how unusually high levels of volatility may affect operational hedging activities (such as wider spreads, ability of bank counterparties to provide quotes, thin liquidity, and a reduction in credit lines and FX dealing facilities)
f. Identify how increased volatility has increased their credit exposure to the bank and led to increased credit spreads applied by banks

In addition to managing the ongoing transactional risks, treasurers will need to consider if action is needed specifically to manage the periods around the 29th March and 21st January 2019 when negotiations may take on a greater level of frenzy causing higher levels of volatility in financial markets. Some treasurers we know are looking at:

a. Purchasing options to hedge certain material currency exposures
b. Changing when they take out hedges to avoid a period of increased volatility
c. Reducing their thresholds for when they hedge currency exposures
d. The rates and processes they use to set budget exchange rates for 2019 and beyond given the expected volatility

Movement in GBP EUR exchange rate since January 2016



4. CASH MANAGEMENT

Having spent the last few years centralising payables, receivables and banking activities across Europe, treasurers are now having to look at potentially separating them out again. Many of the changes that treasurers may need to implement will depend on how extensive this centralisation is and how much of it will cross the new virtual borders that will arise post-Brexit. For those thinking beyond the immediate future, such a review offers a **good opportunity to revisit existing cash management arrangements and strategies.**

Cross-border European cash pooling structures may be affected by changes to:

a. The legal entity providing the pooling services
b. The owner of the corporate header account
c. Treatment of interest and the application of withholding taxes

Even if the changes can be managed, there may a short-term disruption to the management of liquidity across the organisation (see Section 1 above).

Banking arrangements across Europe may need to change. Key questions to consider are:

a. Do I need a bank account domiciled in the EU27 area to enable me to make and receive SEPA payments?
b. Will I be able to process credits and debits quicker if I have an account domiciled in the EU27?
c. Do I need new bank accounts for new entities I am setting up in the EU27 or the UK?
d. Does my bank require me to change the legal entity I bank with (with additional administrative burdens from new KYC requirements, and obtaining new Standard Settlement Instructions and Legal Entity Identifiers)?

As noted above Brexit has encouraged many treasurers to further consolidate their banking arrangements with some choosing an EU27 bank and a separate UK bank. (With the increased adoption of ISO20027 we are promised that inter-operability between banks should be seamless!). At the very least treasurers need to be speaking with their banks to understand what (if any) changes the bank is planning for its own service offerings.

5. CREDIT AGENCY RATINGS (CRA)

Credit rating agencies will no longer be governed under a single EU28 body but will need separate authorisation[2]. For treasurers with an external rating, it will be important to:

a. Understand which CRA entity(ies) will be responsible for legacy issues and how debt issued in various markets may be treated differently by the regulators, the listing authorities and the CRAs themselves
b. Understand which entity and teams will be responsible for ratings going forward and if any changes are required to managing the relationship in the future
c. Understand how Brexit is impacting the rating of the company and the overall sector

6. PENSIONS

The current position of UK based employees in overseas schemes is unclear and provision may be required in the event they cannot continue to participate in relevant schemes.

Week commencing 25 March 2019

Other than year-end for many companies, there are no significant UK bank holidays this week. This will allow treasurers to focus on the news cycle and any last-minute Brexit updates (incl. the results of the final Session of the European Parliament for March). Expectations are for significant FX volatility and a possible disruption to payment systems as they struggle to deal with an unusually high volume of activity.

Being prepared and having contingency plans in place will be critical. Taking action (funding, FX, payments) to minimise any treasury disruption over the immediate Brexit period would be prudent.

[2] The CRA Regulation seeks to ensure that credit ratings issued in the EU respect minimum standards of quality, transparency and independence by providing that only companies registered by ESMA as CRAs may lawfully issue credit ratings which can be used for regulatory purposes by credit institutions, investment firms, insurance and reinsurance undertakings, institutions for occupational retirement provision, management companies, investment companies, alternative investment fund managers and central counterparties.

THE ACT WELCOMES COMMENTS ON THIS REPORT

Please send your comments to

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