

PARENTAL BACKING



Letters of comfort can be used to secure vital bank funding for group subsidiaries. Sarah Boyce explains

> We all think of funding in terms of debt or equity, but one responsibility of a treasurer is to ensure that each part of the organisation is funded in the most efficient way. Traditionally, the cheapest source of funds for large groups was to borrow centrally and lend intercompany to operations. But one effect of the 2008 financial crisis has been banks refocusing on domestic lending, leading to an increase in local borrowing by subsidiaries. This, in turn, has resulted in increased demand by banks for some form of parental support (ranging from general awareness provided by a letter of comfort (LOC) to a full parental guarantee).

An LOC is a form of parental support generally issued by a parent or sometimes by another group company (the issuer) in support of a subsidiary or fellow group member (the borrower), which is borrowing money or using other bank services, in favour of the provider of credit (bank).

The LOC sets out the relationship between the issuer and the borrower. It is *never* intended to give rise to legally enforceable obligations, but rather to create a moral responsibility on the part of the issuer, which may have reputational issues if not fulfilled.

> Although not legally enforceable, from the bank's perspective an LOC confirms:

- ◆ That the borrower is, in practice, controlled by another company. This will influence the credit relationship (and the decisions made by the bank on the amount of credit that can be extended).
- ◆ That the issuer is aware of the credit arrangement. This may influence the broader bank relationship with the organisation.

From the issuer's perspective, an LOC avoids having to issue a guarantee. There are many reasons why this might be desirable:

- ◆ The parent is prohibited by constitution (memorandum or articles of association) from issuing guarantees;
- ◆ Existing undertakings are in place with other credit providers not to issue third-party guarantees;
- ◆ The borrower is a joint venture or project finance structure (with minimal group ownership) and therefore needs to 'stand alone';
- ◆ Taxation, transfer pricing and other costs may be incurred if a guarantee is put in place; and
- ◆ Reporting requirements – guarantees are contingent liabilities and so must be disclosed.

> An LOC generally includes the following terms:

- ◆ Names the subsidiary (the borrower) and confirms that it is a group member (or what the relationship is);
- ◆ Confirmation that the issuer knows of the provision of the precise service being provided by the bank (a statement of awareness); and
- ◆ A disclaimer along the lines of 'nothing in this letter (express or implied) is intended to create legal relations between the parties'.

A draft *pro forma* that can be replicated for each bank requiring comfort is an effective way of ensuring that only agreed commitments are made, that all letters are consistent across the group and so all banks in receipt of such a letter are treated equally (this is often a key concern for banks).

While carrying no legal obligation, LOCs do impose a moral obligation and are not to be issued lightly. So it is important to get legal advice on the

precise drafting if the company has no experience of using LOCs.

With respect to the issue and control of LOCs, the treasurer needs to ensure that:

- ◆ Anybody with authority to issue LOCs understands the importance and risks associated with providing support and is aware of the process that needs to be followed when issuing such letters;
- ◆ Group treasury (or head office) is aware of all LOCs issued across the organisation;
- ◆ The likely effect of an LOC on the relationship with the bank and with other providers of credit is understood;
- ◆ The impact on any minority shareholders, associates or joint venture partners if an LOC is provided is clear;
- ◆ Such letters do not create unexpected tax consequences either for the issuer or the borrower; and
- ◆ All statements made in the LOC are factually accurate and expressions of opinion are made in good faith.

Conclusion

Many organisations have a policy of never giving parent company guarantees unless unavoidable, but may issue LOCs, which evidence the *moral* obligation to support the subsidiary, without accepting a *legal* obligation to do so.

But the high reputational risk in the event of failing to support a borrower for whom an LOC has been issued must always be kept in mind.

The ACT has recently reissued a briefing note on LOCs that makes valuable reading for anyone tasked with the drafting, issuance or development of a policy around providing this type of support. It can be found at www.treasurers.org/lettersofcomfort ♦

Sarah Boyce is associate director of education at the ACT