

For the avoidance of doubt, the LMA Facility Agreements and the Mandatory Costs Schedule are in a non-binding, recommended form. Their intention is to be used as a starting point for negotiation only. Individual parties are free to depart from their terms and should always satisfy themselves of the regulatory implications of their use.

Loan Market Association

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Withdrawal of the Mandatory Costs Schedule¹

It has been brought to the LMA's attention that agent banks are experiencing operational difficulties in managing the way mandatory costs are calculated pursuant to the formula set out in the form of Mandatory Costs Schedule that was, prior to 1 April 2013, recommended for use in LMA Facility Agreements (the "**Mandatory Costs Schedule**").

The LMA has been informed that the loan systems in use by agent banks may be insufficiently flexible to deal with syndicates comprised of lenders with different levels of mandatory cost. We understand this means that any allocation of non *pro rata* payments is time consuming and therefore costly to administer particularly for deals where there are very large syndicates. The Mandatory Costs Schedule was formulated at a time when the loan syndicates were typically much smaller and were comprised of a less diverse community of financial institutions.

Additionally, and as set out below, one of the constituent elements of the Mandatory Cost Schedule was the periodic fee payable to the FSA. On 1 April 2013 the FSA ceased to exist and its functions were transferred to two new regulatory bodies, the Financial Conduct Authority and the Prudential Regulation Authority. Periodic fees will be payable by banks to both the FCA and the PRA and will be assessed by reference to a bank's Modified Eligible Liabilities. The fee rules for the two new authorities are set out in two new Fee Manuals (the FCA Fees Manual and the PRA Fees Manual) which became effective on 1 April 2013. Members should consult the relevant materials published by the FSA, FCA and PRA for more information.

The LMA will no longer be publishing revised forms of the Mandatory Costs Schedule to take account of the changes to the UK regulatory fee structure. Accordingly, in order to prevent confusion, from 1 April 2013 the Mandatory Costs Schedule was withdrawn from the LMA website. If members wish to continue using a formula for calculation of mandatory

¹ This note consolidates the contents of the previously published LMA notes entitled "*The Mandatory Costs Schedule*" and "*Changes to the UK's regulatory fee structure and withdrawal of the Mandatory Costs Schedule formulated for use in LMA Facility Agreements*".

costs, legal advice should be sought on the changes that need to be made to reflect the revised regulatory fee structure.

The purpose of this note is to:

- (i) confirm how the Mandatory Costs Schedule worked; and
- (ii) to set out options for LMA members to consider how they may wish to treat mandatory costs going forward as a result of the operational issues that have been identified.

It does not address, or take account of, the revised regulatory fee structure referred to above.

Background to the Mandatory Costs Schedule

Broadly speaking, when considering mandatory costs under an LMA Facility Agreement we are referring to Bank of England and FSA (now FCA/PRA) costs for a lender with a facility office in the UK and European Central Bank ("**ECB**") costs for a lender with a facility office in any member state of the European Union that has adopted the euro as its lawful currency (a "**Participating Member State**"). The Mandatory Costs Schedule did not contemplate mandatory costs for any lender who is not lending out of the UK or a Participating Member State.

As the LMA explained in the Mandatory Costs Schedule published each year, financial contributions made by banks to the running costs of the Bank of England and the FSA had, from 1 June 1998, been made in two ways which relate directly to a bank's Eligible Liabilities (as defined by the Bank of England):

- (a) *Bank of England Costs*: The Bank of England has the right to require each bank to place a non interest bearing deposit with it in respect of that bank's sterling Eligible Liabilities. The percentage of Eligible Liabilities required to be provided as cash ratio deposits has been significantly reduced over time and is now 0.11% (0% on the first £500,000,000 of a bank's sterling Eligible Liabilities)². The Bank of England also has the right to require special deposits, although it has not done so.
- (b) *FSA Fee*: A fee was introduced in 1998 to pay for the FSA's costs. Under the FSA fees regime, the FSA fee was charged by reference to a bank's tariff base which, for the financial year from 1 April 2012 to 31 March 2013, roughly corresponded to the bank's Modified Eligible Liabilities ("**MEL**") for December 2011 in the case of a bank which reported quarterly, and averaged for October, November and December 2011 in the case of a bank which reported monthly. By way of illustration, see the

² This percentage is currently expected to change to 0.18% (0% on the first £600,000,000 of a bank's sterling Eligible Liabilities) with effect from 3 June 2013.

Schedule attached to this paper for the 2012-13 FSA fee tariffs, an example of how the FSA Fee was calculated and the amounts involved.

- (c) *ECB costs*: Following the introduction of the euro, "ECB costs" were introduced into the Mandatory Costs Schedule in relation to those lenders lending from any Participating Member State to compensate those lenders for the costs of complying with the requirements of the European Central Bank.

The Mandatory Costs Schedule required the agent to calculate the percentage rate that was known in LMA Facility Agreements as the "**Additional Cost Rate**" that was aimed at covering these costs.

How did the Mandatory Costs Schedule work?

The agent was required to calculate the Additional Cost Rate for each lender on the first day of each interest period for each loan as follows:

- (a) *Bank of England Costs*: (Ignoring Special Deposits which, to date, the Bank of England has not required) the Bank of England element of the Additional Costs Rate was the actual cost suffered by each relevant lender. It was only applicable to lenders lending out of a UK facility office and it was calculated by reference to the percentage of Eligible Liabilities a particular lender was **required** to place with the Bank of England. There may be lenders in any syndicate who will not be required to place such deposits e.g. funds. The Bank of England fee element of the Additional Costs Rate was charged on sterling loans only.
- (b) *FSA Fees*: When the Mandatory Costs Schedule was formulated it was considered necessary to simplify the methodology for calculating the FSA fees element as a single lender could be subject to up to three different rates of charge depending on the size of its MEL. As is noted in the Schedule, the FSA Fee was different for banks which had a branch in the UK but which were incorporated in another jurisdiction. The Mandatory Costs Schedule required that FSA costs were charged on the basis of rates supplied by a group of reference banks agreed by the borrower and the lenders and specified in the facility agreement. Each reference bank was required to supply the agent with its average fee tariff rate (ignoring any minimum fee or zero rated bands) and the average of each of those rates was the rate of charge applied to each relevant lender. FSA costs were only applicable to lenders lending out of a UK Facility Office and applied whether or not they actually incurred those costs. The FSA fee element of the Additional Costs Rate was charged on both sterling and non-sterling loans.
- (c) *ECB Costs*: There was no formula for how such costs were calculated, it was based off the rate notified by the relevant lender. This was only applicable to lenders lending

out of a facility office in a Participating Member State. We understand these costs were not routinely charged.

On entering the syndicate (and on any change of facility office), each lender was to be requested to notify the agent of the location of its facility office. Each reference bank was asked to supply the agent with details of its average rate of FSA charge. This information enabled the agent to make the necessary calculations of each lender's Additional Cost Rate in accordance with the above methodology. The Mandatory Cost Schedule provided that the Agent only had to use the information actually supplied to it and made it clear the Agent had no liability to any person if its determination on the basis of the mechanics set out therein resulted in an Additional Cost Rate that over or under compensated any lender.

The overall mandatory cost for each loan was the weighted average of all those different Additional Cost Rates and formed part of the interest rate applying to each loan. This was to be calculated for each interest period and advised to the borrower at the time of rate fixing for each loan. When received the agent was to distribute the amount of mandatory cost on the basis of each of the individual Additional Cost Rates.

Non Pro Rata Payments

Therefore under the Mandatory Costs Schedule, the agent was to calculate in respect of each interest period and loan, using the relevant formulae, a mandatory cost according to the currency of the relevant loan, the location of each lender's facility office, the type of institution the lender is (i.e. whether it is required to place cash ratio deposits with the Bank of England) and the average of the rates of charge supplied by the reference banks. It is clear from the number of variables that this means it is unlikely there would be a *pro rata* payment of the mandatory cost to all lenders on all deals.

Members to decide the way forward

The LMA Facility Agreements are recommended forms that have to be tailored to the requirements of the parties on any particular transaction. Although it is probably true to say the Mandatory Costs Schedule is a provision that over time has been thought of as "boilerplate" not requiring discussion or amendment, given the operational difficulties that have been identified the LMA recommends that its members consider how they want to treat mandatory costs on their deals going forward. To this end if members decide that other approaches are required we set out below thoughts on possible options for consideration although these are suggestions only and are by no means exhaustive:

1. *Different methodology* - there are 2 potentially simpler methods:
 - (a) Agent's Own Rate - this would be calculated using the agent's Additional Cost Rate applied to all lenders subject to the Bank of England and FSA (now FCA/PRA) charges and the percentage determined by the Agent to reflect ECB costs for a lender from a Participating Member State; or

- (b) Reference Bank Rate - this would be calculated using the reference banks' Additional Costs Rate applied to all lenders subject to the Bank of England and FSA (now FCA/PRA) charges and the percentage determined by the Agent to reflect ECB costs for a lender from a Participating Member State.

Neither option necessarily gives rise to *pro rata* payments depending on the formulation but both options have fewer variables than did the Mandatory Costs Schedule.

Other variables that may merit consideration under each of the above options are:

- (i) *Lenders from Participating Member States* - a decision could be taken not to distinguish the way these lenders are treated and to pay them the same amounts as UK lenders;
 - (ii) *Non Bank Lenders* - under the Mandatory Costs Schedule the FSA element was charged in respect of all lenders (whether or not they were a bank) but the Bank of England element was only charged in relation to those institutions who were "**required**" to place cash ratio deposits with the Bank of England. A decision could be taken to include non bank lenders in all elements;
 - (iii) *Currency* - as the costs for non sterling liabilities are lower (no Bank of England element and the FSA (now FCA/PRA) element is one-third for non sterling eligible liabilities), members could think about retaining mandatory costs for sterling loans only.
2. *Remove the Mandatory Costs concept from the LMA Facility Agreements* - clearly this requires a view to be taken on how material the costs to be claimed are now or could potentially be in future in comparison with the costs of administering the processing of mandatory costs by agents. It may be that assumed costs could be built into pricing rather than appearing as a separate item.

Obviously any changes proposed by lenders will require the consent of the borrower community.

The Schedule

The FSA's fee tariffs for the deposit accepting activity of banks³ for the period 1 April 2012 to 31 March 2013 were as follows:

Minimum Fee	£1000 ⁴
£million of MEL's	£/£m or part £m of MEL's
>10-140	40.30
>140-630	40.30
>630-1580	40.30
>1580-13,400	50.37
>13,400	66.49

An example of how the FSA fee would be calculated in relation to a bank's deposit accepting activity is as follows:

Sterling eligible liabilities of £1,800,000,000

£million of MEL's	Calculation of Fee	£fee
	Minimum fee	£1,000.00
10 - 140	£130m x 40.30£/£m	£5,239.00
140-630	£490m x 40.30£/£m	£19,747.00
630-1,580	£950m x 40.30£/£m	£38,285.00
1,580-1,800	£220m x 50.37£/£m	£11,081.40
Total fee payable for deposit accepting activity		£75,352.40

The FSA fee was therefore calculated by adding together the relevant minimum fee and the additional fees calculated by multiplying the bank's MEL by the appropriate tariff rates applying to each tranche of MEL.

FSA fees for banks which had a branch in the UK but were incorporated in another part of the European economic area were charged at 50%⁵.

FSA fees were weighted at one-third for non sterling eligible liabilities⁶.

³ The fee tariffs for the deposit taking activity of banks were subject to a 30% discount if the bank's permission is to accept deposits from "wholesale depositors" only [FSA Fees Manual for 2012-13 - Fees 4 Annex 2R Part 1].

⁴ FSA Fees Manual for 2012-13 – Fees 4 Annex 2R Part 1A.

⁵ FSA Fees Manual for 2012-13 - Fees 4 Annex 2R, Part 3.

⁶ FSA Fees Manual for 2012-13 – Fees 4 Annex 1R, Part 2.