In search of firm ground

BREXIT, NOW A REALITY, CONSTITUTES A POLITICAL SHOCK, BUT THE REPERCUSSIONS HAVE YET TO PLAY OUT. NARESH AGGARWAL AND STEPHEN POWELL DISCUSS THE IMPLICATIONS

We've seen an immediate impact following the UK popular vote to leave the EU in the form of a flight from riskier assets like sterling and equity to safer asset classes such as government bonds, gold and even US bonds. But greater certainty is some way off and dependent on the withdrawal negotiations and eventual agreement.

Questions around the volatility businesses already face and the regulatory issues that the UK government will need to address were the focus of a well-attended ACT webinar, 'Brexit: what now?'

The first discussion point was the legal process for an exit. The UK government will serve a notice under Article 50 of the Lisbon Treaty on the European Commission. Then there is a negotiation and waiting period while a withdrawal agreement is drawn up. That period will last either until the agreement is concluded or for a period of two years or, if everyone agrees, for some stipulated time beyond two years.

From a technical point of view, once the waiting period is over, EU law is effectively dead for UK banks and corporates. "Any direct effect EU law has on the UK will cease," said Stephen Powell, partner at Slaughter and May, and member of the ACT's policy and technical team. "However, there will be many, many cases relevant to corporate treasurers where the UK will want to adopt something similar to EU law."

Deregulation

The big questions around deregulation are: when and in what respects will UK-based treasurers start to see deregulation in terms of their EU-generated obligations? And the picture is a mixed one.

"Coming back to areas corporate treasurers are focused on, so many of the decisions we see coming from the EU were actually taken at G20 level and so the UK government will want to comply with those. An example is European Market Infrastructure Regulation [EMIR]. The ability to have a derivative transacted through a third party on an exchange would be something that the UK government will likely continue. Indeed, if you want to operate across borders you will need EMIR, because other people want equivalence with their regime," said Powell.

A recent ACT poll found the number one concern for treasurers to be FX volatility and the weakness in exchange rates. Naresh Aggarwal, senior manager at PwC and a member of the firm's Brexit consultancy team, pointed out that in the immediate aftermath of the vote, spreads widened in some instances to 10 times their typical size. And while that volatility has abated to around two

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SHUTTERSTOCK

to three times (at the time of publication), the market is not as liquid as formerly. “You also get a sense that some of the smaller banking players are withdrawing from the market and not providing as much pricing. You’re seeing more activity concentrated around larger global banks and banks not domiciled in the UK,” he said.

From a funding perspective, Aggarwal sketched out two sets of issues. “For regular issuers, we’ve seen good response. One issuer was three times oversubscribed,” he said. “You get the sense that with interest rates and long-term rates lower than they have been for a very long time, this is a good time for an issue providing that it is part of a regular programme,” he said. Irregular issuers may struggle from a reputation and perception point of view, however, as an issue may be considered a genuine need for additional funding.

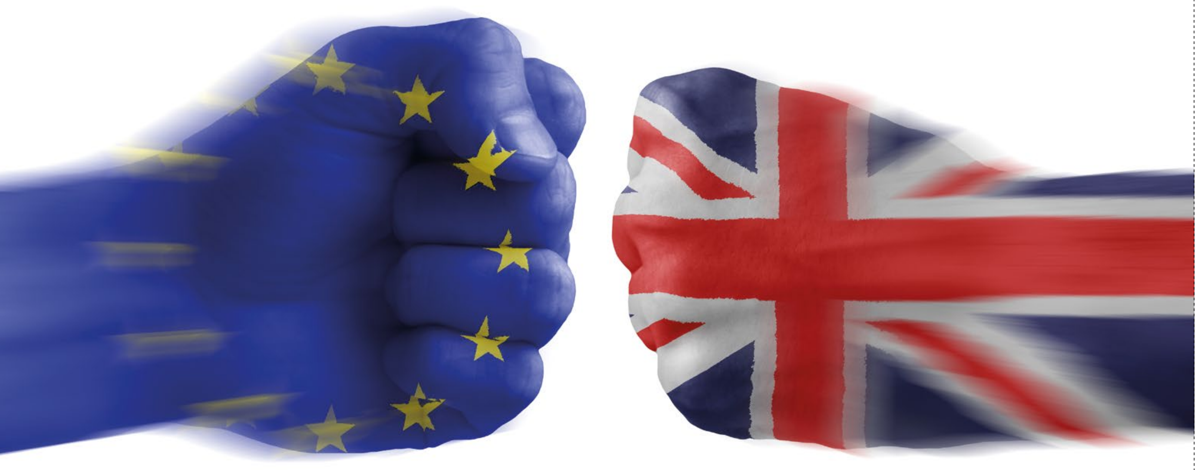
From an FX perspective, the issue becomes how robust their planning has been. Well-organised corporates that had run aggressive stress tests and one in 200 event planning will have found 24 June to be business as usual, Aggarwal said. “However, there were certainly a lot of challenges for those who weren’t properly prepared.”

Many are looking at hedging strategies to see if they are still appropriate, he continued. “Some smaller risks are becoming more prevalent and regulators are already asking how well businesses could support another 15% movement in sterling based on today’s exchange rate,” he went on.

The cash and liquidity issue is a little harder to read at this early stage, Aggarwal

WHAT SHOULD TREASURERS DO NOW?

- Keep a close eye on counterparties, not just in terms of their credit ratings, but across a wider set of measures.
- Keep a close eye on your documentation.
- Do the things treasurers do so well, which is providing that bedrock of confidence for your colleagues across your business.
- Support the business to take advantage of new levels of exchange rates and explore new markets.
- Take time to ensure your governance is still fit for purpose; that your risk appetite is still relevant and appropriate; and that contingency plans are robust.
- Demonstrate your unique skills and expertise to aggregate new risks from across the organisation, and provide it in a clear and coherent way to senior management.



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argued. "We know a lot of organisations have hoarded cash. It may be that over the coming months that starts to leak out," he said. "We're seeing a renewed focus on cash forecasting and we're back to producing a lot of daily information to senior management. Medium term it will definitely be prudent to review assumptions around cash forecasting and working capital, and ask what stress you could withstand if suppliers start asking for payment upfront or customers start to delay payments."

Counterparty risk

With the UK's recent downgrades and some banks on negative outlook, counterparty risk will be front of mind for many. Aggarwal suggested treasurers are looking at counterparties more closely. "There is greater interest in looking at a variety of measures such as banks' size, where they are located, share price volatility. Organisations are building more complex models to get a better understanding of their key banking partners."

In the lead-up to the UK referendum, treasurers will have done a great deal of work scrutinising their funding documentation. Powell advised that they continue to do so. "The key is to look for anything you might trip over. If you have a covenant with a balance-sheet item measured against a profit and loss item, check whether FX volatility has an impact," he said. "There are things people have written into the documentation that overcome that. Check whether your covenants going forward are affected by Brexit. Look at flexibility: might your business want to make some disposals going forward? Does your banking documentation allow you to do that? The same point applies to acquisitions," he said.

"On default events, check your documents," Powell advised. "The vote itself is unlikely to prompt a material adverse change [MAC] clause. Going forward, assess the impact Brexit has on your business – might that be a MAC? In debt capital markets, corporates are already focusing on risk factors – again watch continuously."

Aggarwal also reinforced the need for continuous review. "A lot of organisations will want to ensure the risk framework remains robust and coherent. Again, it comes down to planning. Do you have the right people on your task force, asking the right questions, identifying the right management information?"

Continuing to provide sound evidence-based advice is key: "Making sure that boards have the right information to make the right judgements is really important. The markets have moved, but fundamentally, the legislative framework hasn't changed. But make sure the risk framework around fraud risk, dealer risk, dealer controls and cyber risk is just as robust today as it was before the vote," he said.

PASSPORTING AND EQUIVALENCE

Passporting

Under existing regulations a bank authorised to carry out a particular line of business, for example, corporate lending, in one member state can carry that authorisation to another. However, not all bank activities require a passport, and banks are looking at what they offer across the EU. UK corporate treasurers will need to keep this under review. "Look closely at your bank and understand what it is doing against that background. Make sure you have clear communication channels so that it doesn't come as a surprise if they say 'we're withdrawing or changing'," Powell advised.

Equivalence

The equivalence concept is an important one, because the UK, post-Brexit, will be a different jurisdiction from the rest of the EU for many purposes. Often banks may operate and serve customers based in a different jurisdiction, providing the two jurisdictions have regulatory regimes that are equivalent. That ability to operate across broadly similar regulatory regimes is the reason the UK is likely to maintain similar regulatory provisions after the two-year negotiation period.

This article is based on the ACT webinar – 'Brexit: what now?' (See www.treasurers.org/webinars/brexit)

Naresh Aggarwal is a senior manager at PwC and a member of the firm's Brexit consultancy team

Stephen Powell is a partner at Slaughter and May, and a member of the ACT's policy and technical team