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Legal update —— July 2015

Banking and Finance Budget effects Q&A

We've now had almost three weeks to digest the Summer Budget. The Banking and Finance team at Trowers & Hamlins thought we'd share some of the questions we've been asked since Mr Osborne stood up at the despatch box and started to speak…

Will compliance with financial covenants be affected?

There is likely to be a significant impact on any covenants linked to (i) asset valuation as stated in accounts and (ii) income. Sensitivity testing should be something your finance team are starting now, if they haven't already.

A lot of the debate over the past weeks has been about asset cover. In the longer run, it's likely that many organisations will find a problem with asset cover easier to "fix" than any effect the changes may have on other financial covenants. In most cases, the other covenants are much harder to fix, even with cost cutting exercises or structural business changes.

What about security cover?

We don't expect MV-T valuations to be affected. Valuers active in the sector are having ongoing discussions as to the extent to which the EUV-SH valuation basis for security purposes will be affected – the answer could change as the bill makes its way through Parliament.

At present the general position as regards the impact on valuations is too uncertain for any lender to expect you to be able to say what the impact will be on your business. It's probably worth waiting a short while to see whether a consensus emerges from the valuers. If no consensus emerges then you need to assume the worst – i.e. lenders will assume that EUV-SH values will be negatively impacted, perhaps by a significant percentage, and will ask for revaluations if they anticipate security covenant breaches.

We've just had a valuation and the next one's not for three years so we're ok – aren't we?

Don't assume your organisation is protected from a revaluation until the next scheduled valuation date. Many loans contain a clause stating that the lenders can call for a valuation of their charged properties at any time if they think a default might have occurred. Generally speaking, if it turns out as a result of the valuation that that there wasn't a breach, then the lender will have to pay for that valuation.

What steps do we need to take now?

Most RPs will already be working to identify cost savings and in some cases this may be sufficient to avoid an interest cover breach. You should also be testing all possible impacts on your accounts and covenants for the financial years ending 31 March 2016 and 31 March 2017 (i.e. the year in which the rent reduction first takes effect), a job which is complicated by the introduction of FRS 102.

Note that there is an obligation to deliver a revised Financial Forecast Return by no later than the end of October in the "Dear Chair" letter sent by the Homes and Communities Agency last week. In addition to this, if at any stage you identify a potential covenant breach or liquidity problem or anticipate you may not be compliant with the viability standard, you need to inform the Regulator straight away.

Will there be a sector wide "Material Adverse Effect"?

A sector wide default on the basis of the changes amounting to a material adverse change/effect event of default seems very unlikely. We think lenders would probably find it difficult to call a default on this ground alone.

On an individual basis a material adverse change default is a possibility for those RPs who cannot demonstrate ongoing financial viability or who are forecasting covenant breaches in the near future. On the other hand, if this is the case there is likely to be another kind of default in play under any given loan

Published by
Trowers & Hamlins

Trowers & Hamlins LLP
3 Bunhill Row
London
EC1Y 8YZ

t +44 (0)20 7423 8000
f +44 (0)20 7423 8001

www.trowers.com

agreement, and a lender is likely to find it easier to use a more specific default.

Should we consider applying to the Regulator for a waiver?

Only if absolutely necessary. This may well come with unpalatable conditions and will only be available if the Regulator is (a) convinced as to lack of financial viability and (b) able to convince the Department for Communities and Local Government to agree. You will need to try very hard to show possible cost savings first.

What should we be saying to our lenders?

In practice, you can expect lenders to be asking the same questions on financial viability as the Regulator. However, there is no need to tell lenders anything until you are reasonably sure that you have an accurate and settled view of the numbers. If you are able to give them comfort on covenant compliance then it's probably in the organisation's interests to communicate this ASAP.

In any event you need to be working on a new business plan to demonstrate compliance as well as working up plans B and C and/or D – waiver, variation of terms, co-operation with another RP? See if the lenders are prepared to amend the covenants so you can comply with them – it's not likely to be in their interests to have a number of borrowers in hot water at the same time – especially if the organisations concerned can continue to demonstrate that they can meet their loan obligations on an ongoing basis.

If variations to terms are required, give your lenders as much time as possible for this – there should be ample time prior to the start of the next financial year to agree variations or waivers. You should also check with your auditors as to when any waiver or variation needs to be completed in order for them to be able to sign off your accounts for this financial year on a going concern basis.

If at any stage you conclude that there will be a loan covenant breach there will in most cases be an obligation to notify the relevant lender of a potential event of default. A prudent assumption is that all your loans will contain some kind of cross default clause, and therefore you would almost certainly have to notify all lenders even if not all loan agreements are affected by the actual covenant breach.

What should I / can I say publicly?

Don't be trapped into making dramatic statements for the press – your lenders aren't going to want to hear about any potential financial problems for the first time via the housing trade press. Speak to lenders and the Regulator first if you think there are any significant concerns.

Can we sign this new loan agreement that's nearly ready to go?

When you sign a new loan agreement it will usually require you to represent that no event of default or potential event of default is outstanding. If this representation can be made and all the other preconditions satisfied, then go ahead.

If there is a question mark over your covenant compliance then you should give serious thought to whether signing a new loan is the right thing to do. In a breach situation you will almost certainly have to notify all lenders because of the operation of cross default clauses.

Source: Fotolia

What about signing off our March 15 and March 16 accounts?

You should be discussing this with your auditors. They will need to be satisfied that the RP remains a going concern – they may need to be satisfied now that projected costs savings are sufficient to demonstrate continued covenant compliance if this is tight. This will be even more of a concern in relation to your March 16 accounts and you need to be talking to your auditors in good time and identifying what you need to do and when in relation to any potential breaches.

What else should I check?

It would be worth checking whether your financial covenants are tested as at a particular point in time or by reference to your latest audited accounts, or whether they can be assessed on a rolling or "at any time" basis. In some cases, the time of testing may impact on whether or not compliance can be demonstrated.

What about bond finance?

Bond documents are generally less restrictive than loan funding documents. If you have existing bond finance then provided that you are continuing to comply with your covenants and pay your interest the bondholders probably won't trouble you.

Investors have indicated that the instability introduced by the change to a previously set rent formula and the new right to buy policy are likely to result in higher spreads and therefore coupon rates – but this will not affect completed deals. There is also likely to be a negative impact on ratings for the sector as a whole and individual issuers.

We expect the capital markets to be quieter until the impact on the sector becomes clearer.

What's the likely impact of "Pay to Stay" on loans?

It's hard to say whether there is any impact at the moment. The information available is nebulous, but at the moment we wouldn't expect this part of the proposals to have a significant impact on funding documents.

Should we do some more charging?

Often, short term security cover breaches can be "cured" by charging cash to funders in place of property – assuming that the cash to do this would be available. It may be worth checking your loan documents to see whether this option is available and whether you have charged accounts set up as an alternative to charging properties.

In most cases it's difficult to know whether extra property security will be needed at the moment. It might be worth starting to dust off titles and work out whether there are assets available for charging in anticipation of any revaluation impact, particularly for organisations with substantial EUV-SH portfolios. You may already have started this kind of work in connection with the preparation of your asset register.

If appropriate, you might consider starting work on a "funder ready" pot of security now. Once any impact on valuations is clearer, affected organisations with available security may well need to do extra charging to comply with security covenants.

For more information please contact

Adrian Carter
Partner - Head of Banking and Finance
t +44 (0)20 7423 8301
e acarter@trowers.com

Sarah Gooden
Partner
t +44 (0)20 7423 8334
e sgooden@trowers.com

Neil Waller
Partner
t +44 (0)161 838 2032
e nwaller@trowers.com

Anna Clark
Partner
t +44 (0)20 7423 8130
e aclark@trowers.com

Naomi Roper
Partner
t +44 (0)20 7423 8127
e nroper@trowers.com