Matheson

COVID-19 and the Banking Sector

The situation surrounding COVID-19 has placed extraordinary pressure on business' working capital and liquidity, as can be seen from the widespread media reports of additional funding requests and drawdowns globally. The situation is fast-moving and in Ireland, the five main retail banks have already announced a facility to apply for a "payment break" for business and retail customers affected by COVID-19. We set out below some matters for borrowers and lenders to bear in mind when examining their existing arrangements to determine how to make the best use thereof.

Forecasts and Communication

Businesses should review in detail their projections for the next months and identify what mitigating actions can be taken, including potential sources of capital. If cashflow forecasts suggest that liquidity is or will become an issue, businesses should assess options for raising new funds including drawdowns on their revolving facility, arranging temporarily larger facilities or super-senior facilities, and considering asset-based financing where appropriate.

A borrower's forecasts may indicate in advance a potential breach of covenants. By communicating with lenders, businesses can look to negotiate waivers or amendments and thereby help to prevent any breach. Failing clear communication, lenders can make use of information rights under their loan agreements to try to monitor the situation.

Borrowers should test and challenge all assumptions and run scenarios based on the currently unknown factors to help understand actual and potential financing needs. Options should be kept under review.

Requesting Further Facilities

If a business decides that further facilities should be requested, it should carefully review its current lending documents, in particular as to any headroom or flexibility provided, and anticipate and prepare for other lender questions, including:

- what exactly is being requested: a term loan, a revolving facility, or other? Term, interest rate, repayment?
- what are the borrower's projections as to its ability to service and repay the debt?
- can the borrower offer additional security?
- should reporting obligations be increased?

Notwithstanding the Irish banks' stated willingness to offer additional working capital facilities to businesses affected by COVID-19, we can expect banks to continue to apply sound loan underwriting practices, not least as their lending practices in these crisis times are likely to come under regulatory scrutiny once the crisis has passed.

New Loan Documentation Issues

The provision of new loan facilities will likely require amendments to existing loan agreements, either by letter, agreement or amendment and restatement, depending on the amount of amendments.

Where new collateral is given, new security documentation will be required, and existing guarantees and security may not cover the new debt. Evidence of corporate approvals may be requested, and possibly legal opinions. Irish banks have learned from the experience of earlier crises and are unlikely to engage in widespread relaxation of standard documentation requirements for additional or amended facilities.

Breach and Remedy

In case of breach of financial covenant, lenders will assess how material the breach is and whether it is likely to be repeated. A waiver of the specific breach can be granted, reserving all rights in relation to future breaches. Alternatively, the covenant levels can be amended, or specific breaches carved out. If provided for in the loan agreement, a sponsor or shareholder of the borrower may contribute new capital to cure the breach (an "equity cure"); usually the number of cures in a given period is limited without consent of the lender.

On default, a lender may, if provided for under the loan agreement, prefer to prevent the borrower from drawing down any undrawn commitments. If this could in turn cause a default, the lender should engage with the borrower to manage the situation.

Enforcement

Breach of a payment obligation is usually the most concerning default from a lender's point of view, although the lender may again decide to waive it, exercise forbearance, or amend the documentation to vary the payment obligations. The Irish banks have committed to defer court proceedings against affected borrowers and to exercise forbearance for three months but it remains to be seen what this will mean in practice.

In the current climate, lenders will no doubt think very carefully before electing to call an event of default or take enforcement actions under the loan agreement; clearly this could trigger cross-default provisions in other agreements. The lender should explore with the borrower all available options, including restructuring, equity or subordinated debt contributions and debt rescheduling.

Capital / Liquidity Issues for Lenders

From the lender's perspective, an exposure must be treated as non-performing, based on guidance issued by the European Banking Authority, either where the liability is 90 days "past due" or where the borrower is assessed as being unlikely to pay without enforcement of collateral. It is for this reason that the Irish banks have been able to offer "payment breaks" of up to three months without this automatically resulting in higher capital requirement based on risk-weighted asset (**"RWA"**) calculations. The Central Bank of Ireland has also, as has appeared in the press, released the counter-cyclical capital buffer thereby freeing up an additional €1 billion of capital to support RWAs in the Irish banking sector.

It is likely that the banking regulators will come under pressure in coming weeks, as forbearance levels in the EU banking sector increase, to relax the RWA requirements for COVID-19 affected exposures, but under Article 178 of the Capital Requirements Regulation, the 90 days "past due" limit is set in EU primary legislation for all exposures save for those secured by residential or SME real estate, so there are limits to what the banking regulators can achieve without legislative intervention.

Lenders are also faced with extraordinary demands on their liquidity, with some corporate borrowers drawing down standing facilities in their entirety. The European Central Bank, in its statement of 12 March, said that it would permit Eurozone banks to operate below their Liquidity Coverage Ratio "temporarily" (in addition to operating below certain other buffer requirements). We can expect to see the banking industry continue to lobby in the coming weeks for additional relaxations to permit it to support the real economy both during and after this crisis.

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