

ATOZ NEWS

High inflation and increasing interest rates – What is the impact on intragroup financing?

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When we speak about intragroup financing transactions involving a Luxembourg company, there are **two angles** to it. The first angle, like in every other country, consists of benchmarking the interest rate, and the second angle, that is specific to Luxembourg, consists of determining an arm's length remuneration for a Luxembourg company performing intragroup financing activities. That remuneration is a margin and is supposed to be the difference between the interest perceived and the interest paid.

In essence, that margin aims to remunerate the **equity put at risk** by the company and to cover its operating costs.

The equity at risk is the equity that a financing company needs to have to cover the **expected loss** on the financing granted if one of its borrowers is in default.

That equity at risk is therefore strongly linked to the **credit risk** of the borrower and is materialised through a **credit rating**.

It is important to monitor the risks through an **annual review of the credit risk borne** by a financing company in order to demonstrate that an active risk management is done by the company's board of directors.

Two outcomes can result from this review:

- Either there are no changes in the credit risk borne by the financing company and no action other than to **document that finding in the board minutes** needs to be taken;
- Or there are changes in the credit risk profile of the financing company (for example a new loan has been granted or the credit risk of a borrower has worsened or improved), in which case the **equity at risk and the related margin needs to be adjusted**.

So irrespective of whether the macroeconomic environment is more or less volatile, an annual credit risk review needs to, nonetheless, be carried out, as well as the potential adjustments to the equity at risk resulting from this review.

As for potentially adjusting the interest rates on intragroup financing to current market conditions, one should distinguish agreements that have **already been signed** and those that **will be signed** in the future.

For existing agreements, from a lender perspective, mostly **fixed interest rates** have been determined as, in the low interest rate environment that we have had until recently, it was the **only way to have the highest possible interest rate**.

In principle, that interest rate is expected to be applied until maturity and it is questionable whether a tax authority would accept that an interest rate be increased **only based on macroeconomic evolutions**. The interest rate could be revised only if there is breach of covenants, if any, in the financing agreement.

Common debt covenants in financing agreements between third parties typically include **positive covenants** (for example a certain level of LTV or interest rate coverage ratio that a borrower must achieve) or **negative covenants** that are actions a borrower cannot do (for example the issuance of more senior debt).

If there is a breach of one or multiple covenants, that could be a reason to terminate the existing agreement and refinance at current market conditions or increase the interest rate.

As for new agreements, again from a lender perspective, there are two possibilities. If one believes that interest rates will continue to increase and will remain high in the long term, it makes sense to apply a floating rate. However, if one believes that the increase is only of a short-term nature and that a quantitative easing, for example, will be necessary to fight a potential recession, one should probably take benefit of the current environment to secure a relatively high interest rate for the long-term.

Do you have further questions?



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