BoE interest rate hike demands intra-group review

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The biggest hike in 33 years has prompted multinationals to review the TP risks associated with financial market instability

Companies must ensure intra-group arrangements continue to reflect the Bank of England's interest rate increase on November 3 – the biggest hike in 33 years – or risk facing transfer pricing issues.

"For most companies, it will be bad news," says Ben Henton, global head of transfer pricing (TP) at IT management company Computershare in Bristol.

"Unless your profits are increasing as much as interest rates are, your ability to borrow will decrease, and that also applies when you're borrowing within your group," he adds.

The bank raised the interest rate by 0.75% points in early November, pushing the base rate to 3%, in a bid to curb inflation. The current inflation rate in the UK is 10.1%.

This monetary policy change is bound to affect TP policies that multinational enterprises (MNEs) apply in financial arrangements. When the cost of debt increases, the TP risk related to the intra-group debt also rises.

It could become a significant issue for companies with a low capacity to borrow, particularly if the borrowing entity was already stretched, according to Henton. Higher rates mean less ability to borrow.

If MNEs' balance sheets aren't growing to support the additional cost of borrowing, TP rules could limit interest payments.

"The deductibility for your debt starts to be called into question. When companies make decisions around borrowing, you assume they will have a tax deduction to their debt," explains Henton.

As rules around deductibility on interest have become stricter over the years, securing the interest deduction could be more difficult.

"The rules weren't as bad in the previous financial crisis. Now we are facing an inflation crisis," says Henton.

Spillover effect

Existing loans with variable interest rates, and new loans with either fixed or variable rates, will be affected by the interest rate increase. This includes short-term and long-term loans, financing activities, cash pooling, as well as hedging and guarantee transactions.

Andrius Tamosiunas, TP manager at professional services firm TMF Group in Luxembourg, says the increased interest expenses for loans in pound also reduces the debt service coverage ratio for fixed earnings before interest, taxes, depreciation and amortisation.

“This could lead to a spillover effect whereby a deteriorating implied credit rating of the borrowers may indirectly result in higher interest rates to be applied for intra-group loans in the future,” he says.

“The base rate hike will increase the UK risk-free rate, therefore increasing the required return on capital to be realised by entities performing intra-group on-lending activities that are pound-denominated or are financing UK-based investments,” adds Tamosiunas.

These multiple risks that MNEs are exposed to following the BoE’s interest rate increase will require long-term robust corporate treasury policies and clear risk management strategies.

“The way currencies are moving quite dramatically, companies should get stability around that risk caused by the pound collapsing and interest rate hike,” says Henton.

Compliance is key

Tom Heal, a TP manager at a gambling company in the UK, says his biggest concern is that corporations will need to remain compliant with TP rules when it comes to company funding.

“There may be an appetite to try and get lower or higher interest rates. Tax authorities will be thinking along similar lines and look to scrutinise company lending a bit more coming forward.

“I’ve seen more TP in debt than earlier on in my career,” he explains.

Multinationals will have to ensure their benchmarking is up to date with the new debt while complying with local rules and best practices. They risk falling under scrutiny from tax authorities if they fail to do so.

With multiple base rate increases, MNEs will have to keep a close eye on their TP arrangements.

Phil Roper, TP partner and technical lead at ‘big four’ firm KPMG in the UK, says the qualitative aspect and lender appetite within a TP analysis, where the arm’s length is determined, is often easily forgotten.

“We talk to our debt specialists at KPMG to see what they are seeing in the market, and they are seeing significant changes in lending appetite, not necessarily in high street banks,” he says.

“We’re going to see shifting trends in the debt market, and as TP specialists we need to stay connected as much as we can now. Old data is quite risky,” adds Roper.

Document changes

The current market volatility makes an even bigger case for MNEs to document their inter-company loan agreements as clearly as possible.

The term or maturity dates, currency, the relevant interest rates – fixed or floating – and how they are calculated, as well as the repayment and prepayment terms will need to be outlined, according to Ivan Hanna, partner at law firm LCN Legal in London.

“The analysis in some circumstance will be similar to a domestic mortgage: if you’re a borrower on a five-year fixed interest rate mortgage, you would not agree to a higher interest rate just because base rates have increased,” he says.

“This was the message of the 2016 Swedish case involving Nobel Biocare, where the taxpayer purported to adjust interest rates with a fixed term, without any clear explanation, commercial rationale or adequate documentation,” he adds.

Moving markets

Tamosiunas says related parties will have to verify that their intra-group arrangements represent or continue to represent market conditions following the monetary policy shift.

Gaspar Lopes Dias, partner at advisory firm Taxand in London, says the revision of intra-group arrangements is the main concern.

“This could affect more than bonds and loans. If you have intra-group loans, all the assets that are being valued and transferred would have pressure on their transactions because the discount rate would be higher," he explains.

The BoE chief economist Huw Pill announced on Wednesday, November 8, that interest rates will be raised again shortly; JP Morgan is rumoured to have predicted a base rate rise of almost 6% in 2024.

Businesses are finding it hard to juggle the current economic environment and day-to-day operations. Future inter-company arrangements and loans under floating rates are bound to be affected by the bank's decisions.

TP directors remain confident that inter-company debt continues to be an attractive borrowing tool. In the meantime, MNEs will need to stay on top of market trends.