Loan Market Association
The Mandatory Costs Schedule

It has been brought to the LMA's attention that agent banks are experiencing operational difficulties in managing the way mandatory costs are calculated pursuant to the formula set out in the form of Mandatory Costs Schedule recommended for use in LMA Facility Agreements (the **"Mandatory Costs Schedule"**).

The LMA has been informed that the loan systems in use by agent banks may be insufficiently flexible to deal with syndicates comprised of lenders with different levels of mandatory cost. We understand this means that any allocation of non pro rata payments is time consuming and therefore costly to administer particularly for deals where there are very large syndicates. The Mandatory Costs Schedule was formulated at a time when the loan syndicates were typically much smaller and were comprised of a less diverse community of financial institutions.

The purpose of this note is to:

(i) confirm how the Mandatory Costs Schedule currently works; and

(ii) to set out options for LMA members to consider how they may wish to treat mandatory costs going forward as a result of the issues that have been identified.

Background to the Mandatory Costs Schedule

Broadly speaking, when considering mandatory costs under an LMA Facility Agreement we are referring to Bank of England and FSA costs for a lender with a facility office in the UK and European Central Bank ("**ECB**") costs for a lender with a facility office in any member state of the European Union that has adopted the euro as its lawful currency (a "**Participating Member State**"). The Mandatory Costs Schedule does not contemplate mandatory costs for any lender who is not lending out of the UK or a Participating Member State.

As the LMA explains in the Mandatory Costs Schedule published each year, financial contributions made by banks to the running costs of the Bank of England and the FSA have, from 1 June 1998, been made in two ways which relate directly to a bank's Eligible Liabilities (as defined by the Bank of England):

(a) *Bank of England Costs*: The Bank of England has the right to require each bank to place a non interest bearing deposit with it in respect of that bank's sterling Eligible Liabilities. The percentage of Eligible Liabilities required to be provided as cash ratio deposits has been significantly reduced over time and is now 0.11% (0% percent on the first £500,000,000 of a bank's sterling Eligible Liabilities). The Bank of England also has the right to require special deposits, although it has not done so.

(b) *FSA Fee*: A fee was introduced in 1998 to pay for the FSA's costs. Under the FSA fees regime, the FSA fee is charged by reference to a bank's tariff base which, for the financial year from 1 April 2012 to 31 March 2013, roughly corresponds to the bank's Modified Eligible Liabilities ("**MEL**") for December 2011 in the case of a bank which reports quarterly, and averaged for October, November and December 2011 in the case of a bank which reports monthly. See the Schedule attached to this paper for the current FSA fee tariffs, an example of how the FSA Fee is calculated and the amounts involved.

(c) *ECB costs*: Following the introduction of the euro, "ECB costs" were introduced into the Mandatory Costs Schedule in relation to those lenders lending from any Participating Member State to compensate those lenders for the costs of complying with the requirements of the European Central Bank.

The Mandatory Costs Schedule requires the agent to calculate the percentage rate known in LMA Facility Agreements as the **"Additional Cost Rate"** that is aimed at covering these costs.

How does the Mandatory Costs Schedule Work?

The agent is required to calculate the Additional Cost Rate for each lender on the first day of each interest period for each loan as follows:

(a) *Bank of England Costs*: (Ignoring Special Deposits which, to date, the Bank of England has not required) the Bank of England element of the Additional Costs Rate is the actual cost suffered by each relevant lender. It is only applicable to lenders lending out of a UK facility office and it is calculated by reference to the percentage of Eligible Liabilities a particular lender is **required** to place with the Bank of England. There may be lenders in any syndicate who will not be required to place such deposits eg. funds. The Bank of England fee element of the Additional Costs Rate is charged on sterling loans only.

(b) *FSA Fees*: When the Mandatory Costs Schedule was formulated it was considered necessary to simplify the methodology for calculating the FSA fees element as a single lender can be subject to up to three different rates of charge depending on the size of its MEL. As noted in the Schedule, the FSA Fee will be different for banks which have a branch in the UK but are incorporated in another jurisdiction. The Mandatory Costs Schedule requires that FSA costs are charged on the basis of rates supplied by a group of reference banks agreed by the borrower and the lenders and specified in the facility agreement. Each reference bank is required to supply the agent with its average fee tariff rate (ignoring any minimum fee or zero rated bands) and the average of each of those rates will be the rate of charge applied to each relevant lender. FSA costs are only applicable to lenders lending out of a UK Facility

Office and apply whether or not they actually incur those costs. The FSA fee element of the Additional Costs Rate is charged on both sterling and non-sterling loans.

(c) *ECB Costs*: There is no formula for how such costs are calculated, it is based off the rate notified by the relevant lender. This is only applicable to lenders lending out of a facility office in a Participating Member State. We understand these costs are not routinely charged.

On entering the syndicate (and on any change of facility office), each lender should be requested to notify the agent of the location of its facility office. Each reference bank is asked to supply the agent with details of its average rate of FSA charge. This information enables the agent to make the necessary calculations of each lender's Additional Cost Rate in accordance with the above methodology. The Mandatory Cost Schedule provides that the Agent only has to use the information actually supplied to it and makes it clear the Agent has no liability to any person if its determination on the basis of the mechanics set out therein results in an Additional Cost Rate that over or under compensates any lender.

The overall mandatory cost for each loan is the weighted average of all those different Additional Cost Rates and forms part of the interest rate applying to each loan. This should be calculated for each interest period and advised to the borrower at the time of rate fixing for each loan. When received the agent should distribute the amount of mandatory cost on the basis of each of the individual Additional Cost Rates.

Non Pro Rata Payments

Therefore under the current Mandatory Costs Schedule, the agent should calculate in respect of each interest period and loan, using the relevant formulae, a mandatory cost according to the currency of the relevant loan, the location of each lender's facility office, the type of institution the lender is (i.e. whether it is required to place cash ratio deposits with the Bank of England) and the average of the rates of charge supplied by the reference banks. It is clear from the number of variables that this means it is unlikely there will be a pro rata payment of the mandatory cost to all lenders on all deals.

Members to decide the way forward

The LMA Facility Agreements are recommended forms that have to be tailored to the requirements of the parties on any particular transaction. The Mandatory Costs Schedule is a standalone document that can be included in a Facility Agreement either in its current form or as parties may wish to amend it or it can be omitted on any given deal. Although it is probably true to say this is a provision that over time has been thought of as "boilerplate" not requiring discussion or amendment, given the operational difficulties that have been identified the LMA recommends that its members consider how they want to treat mandatory costs on their deals going forward. To this end if members decide that changes are required we set out below thoughts on possible options for consideration although these are suggestions only and are by no means exhaustive:

1. *Amend the Mandatory Costs Schedule to change the methodology* – there are 2 potentially simpler methods:

   (a) Agent's Own Rate – this would be calculated using the agent's Additional Cost Rate applied to all lenders subject to the Bank of England and FSA charges and the percentage determined by the Agent to reflect ECB costs for a lender from a Participating Member State; or

   (b) Reference Bank Rate – this would be calculated using the reference banks Additional Costs Rate applied to all lenders subject to the Bank of England and FSA charges and the percentage determined by the Agent to reflect ECB costs for a lender from a Participating Member State.

Neither option necessarily gives rise to pro rata payments depending on the formulation but both options have fewer variables than the current Mandatory Costs Schedule.

Other variables that may merit consideration under each of the above options are:

(i) *Lenders from Participating Member States* – a decision could be taken to remove the distinction in the way these lenders are treated and to pay them the same amounts as UK lenders;

(ii) *Non Bank Lenders* – currently under the Mandatory Costs Schedule the FSA element is charged in respect of all lenders (whether or not they are a bank) but the Bank of England element is only charged in relation to those institutions who are "**required**" to place cash ratio deposits with the Bank of England. A decision could be taken to include non bank lenders in all elements;

(iii) *Currency* – as the costs for non sterling liabilities are lower (no Bank of England element and the FSA element is one-third for non sterling eligible liabilities), members could think about retaining mandatory costs for sterling loans only.

2. *Remove the Mandatory Costs Schedule from the LMA Facility Agreements* – clearly this requires a view to be taken on how material the costs to be claimed are now or could potentially be in future in comparison with the costs of administering the processing of mandatory costs by agents. It may be that assumed costs could be built into pricing rather than appearing as a separate item.

Obviously any changes proposed by lenders will require the consent of the borrower community.

Loan Market Association
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The Schedule

The fee tariffs for the deposit accepting activity of banks [1] for the period 1 April 2012 to 31 March 2013 are as follows:

Minimum Fee	£1000[2]
£million of MEL's	**£/£m or part £m of MEL's**
>10-140	40.30
>140-630	40.30
>630-1580	40.30
>1580-13,400	50.37
>13,400	66.49

The FSA has indicated that any consultation by the PRA / FCA on fees for 2013/14 will be on the basis that the PRA / FCA will adopt the FSA's fees methodology with minimal changes. The FSA has indicated that it intends to publish details of such changes in October 2012.

An example of how the FSA fee would be calculated in relation to a bank's deposit accepting activity is as follows:-

Sterling eligible liabilities of £1,800,000,000

£million of MEL's	Calculation of Fee	£fee
	Minimum fee	£1,000.00
10 - 140	£130m x 40.30£/£m	£5,239.00
140-630	£490m x 40.30£/£m	£19,747.00
630-1,580	£950m x 40.30£/£m	£38,285.00
1,580-1,800	£220m x 50.37£/£m	£11,081.40
Total fee payable for deposit accepting activity		**£75,352.40**

The FSA fee is therefore calculated by adding together the relevant minimum fee and the additional fees calculated by multiplying the bank's MEL by the appropriate tariff rates applying to each tranche of MEL.

[1] The fee tariffs for the deposit taking activity of banks are subject to a 30% discount if the bank's permission is to accept deposits from "wholesale depositors" only [FSA Fees Manual - Fees 4 Annex 2R Part 1].

[2] FSA Fees Manual – Fees 4 Annex 2R Part 1A

FSA fees for banks which have a branch in the UK but are incorporated in another part of the European economic area are charged at 50%[3].

FSA fees continue to be weighted at one-third for non sterling eligible liabilities[4].

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[3] FSA Fees Manual - Fees 4 Annex 2R, Part 3.

[4] FSA Fees Manual – Fees 4 Annex 1R, Part 2.