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Transfer pricing and financial markets – assessing the impact of COVID-19

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Cash and liquidity management has been a major issue MNEs worldwide have been tackling during the uncertain economic context brought on by COVID-19, which continuously calls for a rethinking of liquidity-preserving measures. The negative economic outlook and significant financial market volatility have created a severe and extensive credit shock across many sectors, regions and markets. The combined credit effect of these developments is unprecedented. This situation continues to put substantial pressure on the treasury function performed within MNEs. This is due to significant growth in the volatility of capital markets, dealing with internal and external financing, and managing liquidity and cash flow across group entities and jurisdictions.

While MNEs are coping with the global economic and financial downturn, they must protect group entities from defaulting on both their internal and external financial obligations. Therefore, new or increased intra-group, cross-border financial support may be either required or already been put in place during the crisis.

From a transfer pricing perspective, these arrangements will need an outcome for the related parties involved that is in alignment with the arm's length principle. Potential tax risk exposures may include withholding tax and breaching the existing EU legal framework (e.g., income-based interest limitation rules). Finally, additional guidance provided by the Organization for Economic Cooperation and Development (OECD) on the transfer pricing analysis of financial transactions has been issued at a crucial time. This should be observed by MNEs, given the highlighted importance of these transactions in the current economic context.

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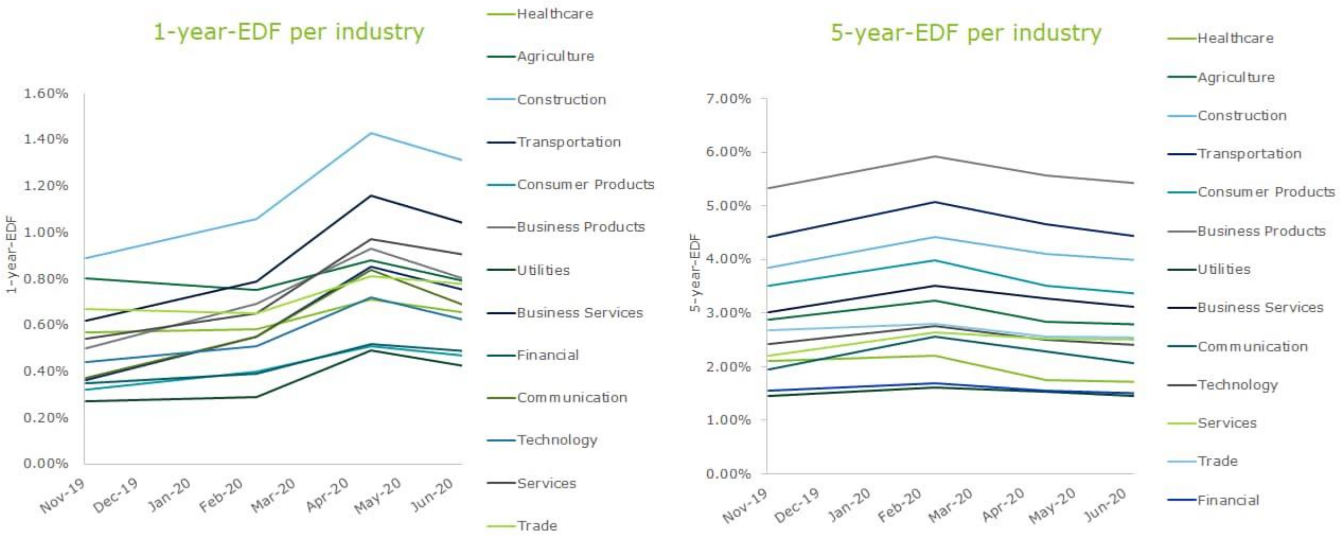
Understanding the impact of COVID-19 on standard elements of the transfer pricing analysis of intra-group financing arrangements

Credit-risk metrics: Moody's Expected Default Frequency (EDF)™ or Probability of Default (PD)

The EDF (or PD) measures the probability that a company will fail to make scheduled principal or interest payments over a specific period. The EDF is, therefore, the primary input to determine a company's credit-risk metrics. There are three key values to determine a company's EDF: (i) the current market value of the company (market value of assets); (ii) the level of the company's obligations (default point); and (iii) the vulnerability of the market value to large changes (asset volatility).



Source: Moody's CreditEdge

Intra-group borrowers are not expected to be immune to these effects; the extent of which will vary by industry and country, depending on the degree of exposure to the COVID-19 pandemic shock and country risk levels before the crisis. Typically, from a transfer pricing perspective, the EDF is analyzed based on the maturity set for the intra-group financing arrangement: creditworthiness of short-term borrowers would be measured through a one-year EDF, while long-term borrowers' creditworthiness through a five-year EDF.

As a result of the crisis, global industry EDFs rose in response to a decline in the market value of assets; that is, a decrease in stock price in many countries since around January this year when the COVID-19 pandemic began to spread internationally. These increased EDFs reached a peak during February and April for the one-year and five-year EDF respectively. However, when assigning an EDF period to the intra-group financing arrangement under analysis, consideration is also given to the arrangement's specific terms and conditions and the degree to which the lender controls the credit-related risks. Ultimately, these elements signal the lender's capabilities to proactively mitigate credit risk before default. Given the effect of the COVID-19 crisis on global industry EDFs, MNEs should proactively review the credit-risk metrics of intra-group borrowers for both short-term and longer-term financing arrangements. Both existing and new intra-group financing arrangements should accurately reflect these metrics, as affected by the crisis, through the arrangement's main terms and conditions, which are: Interest rate, repayment schedule, purpose of the loan, collateral provided, and presence of guarantees.

Any review of existing financing arrangements should be carried out in the context of the parties' actual behavior during the crisis; that is, the actions taken by the lender and the borrower related to the transaction and their overall financing positions. In this regard, there is sufficient financial data available of private companies that service providers have gathered in order to be able to adjust group borrowers' EDFs, based on their existing pre-crisis financials. This is an alternative to group borrowers' financial projections embedding the impact of the crisis and calls for evaluating transfer pricing assessments carried out by relying on historic default rates, as this data would not accurately reflect current circumstances.

Credit ratings

Credit ratings are relied upon to gauge the creditworthiness of debt issuers or individual obligations. Agency-issued credit ratings assign a higher weighting factor to longer-term trends than to cyclical factors, aiming to provide a stable indicator of creditworthiness. This method seeks to avoid volatile signals arising at a given moment that are linked to investors' sentiment or even ongoing macroeconomic trends. One of the effects of the economic developments brought forth by the crisis relates to credit rating downgrades, involving companies having their credit ratings cut or set on a negative outlook; a trend that has been brought to an all-time high due to the pandemic. Fallen Angels - investment grade companies that cross over to speculative grade - have reached a level normally seen over a three-year period in just a few weeks in March and April, with the majority of affected companies belonging to sectors such as energy (oil and gas), automotive and food, and beverage and tobacco.

Credit ratings are a crucial element and a defining comparability factor when assessing the arm's length nature of intra-group financial transactions. This assessment is carried out through a benchmarking process relying either on internal or external comparable arrangements. When relying on external comparables for the transfer pricing assessment of financing transactions, the terms and conditions of third-party instruments bearing a similar credit rating are evaluated. Generally, these instruments refer to corporate bonds, the use of which has been ratified by the latest available OECD guidance. Criteria such as maturity, seniority, and currency complement the analysis and should be factored in by referring to the existing terms and conditions of the intra-group financing arrangement. In this respect, the impact of the crisis on corporate debt issuers, as well as the overall effect on lending markets, should be critically reviewed to assess the degree of reliability of the conditions currently observed in the market to those present in the intra-group arrangement. In the current climate, these conditions may change dramatically in a matter of days or weeks and will likely be very different from the benchmarked conditions observed by MNEs when entering into intra-group borrowings pre-crisis.

Where internal comparable arrangements (i.e., funding granted by external parties to a group subsidiary) are relied upon for transfer pricing assessment, it is understood that the third-party lender assesses the borrower to arrive at its creditworthiness, which is then reflected in the arrangement's terms and conditions. As such, any changes implemented during the crisis as a result of the impact on the borrower's creditworthiness (i.e., in its credit rating) could potentially provide information on third-party behavior that MNEs could leverage to inform potential reassessments of their intra-group arrangements.

Furthermore, room should be given in intra-group financing arrangements for potential adjustments that may be considered reasonable to be applied to the arrangement's terms and conditions. These adjustments may need to be applied if the effect of the crisis on the borrowers' creditworthiness is protracted, or if the period of economic recovery has a positive effect on the group's or stand-alone subsidiary's credit rating.

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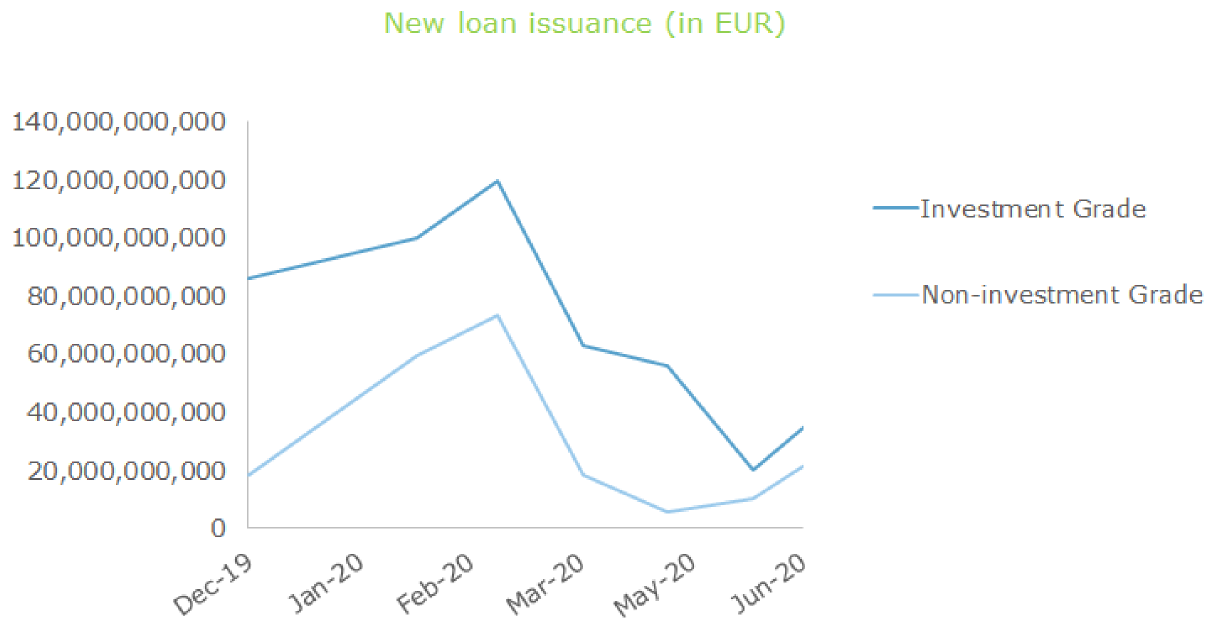
Financial market monitoring – Ongoing impact on transfer pricing assessment

Liquidity in loan markets

The current economic depression led to increased risk aversion in financial markets, which resulted in volatile credit spreads, shifts in reference interest rates, and fewer debt transactions.



Source: Refinitiv Eikon

While lenders were willing to provide additional financing, with a peak of about EUR70 billion of leveraged loans and EUR120 billion of investment-grade loans in February 2020, the uncertain solvency of borrowers saw a decrease in the number of new loan issuances until the end of May.

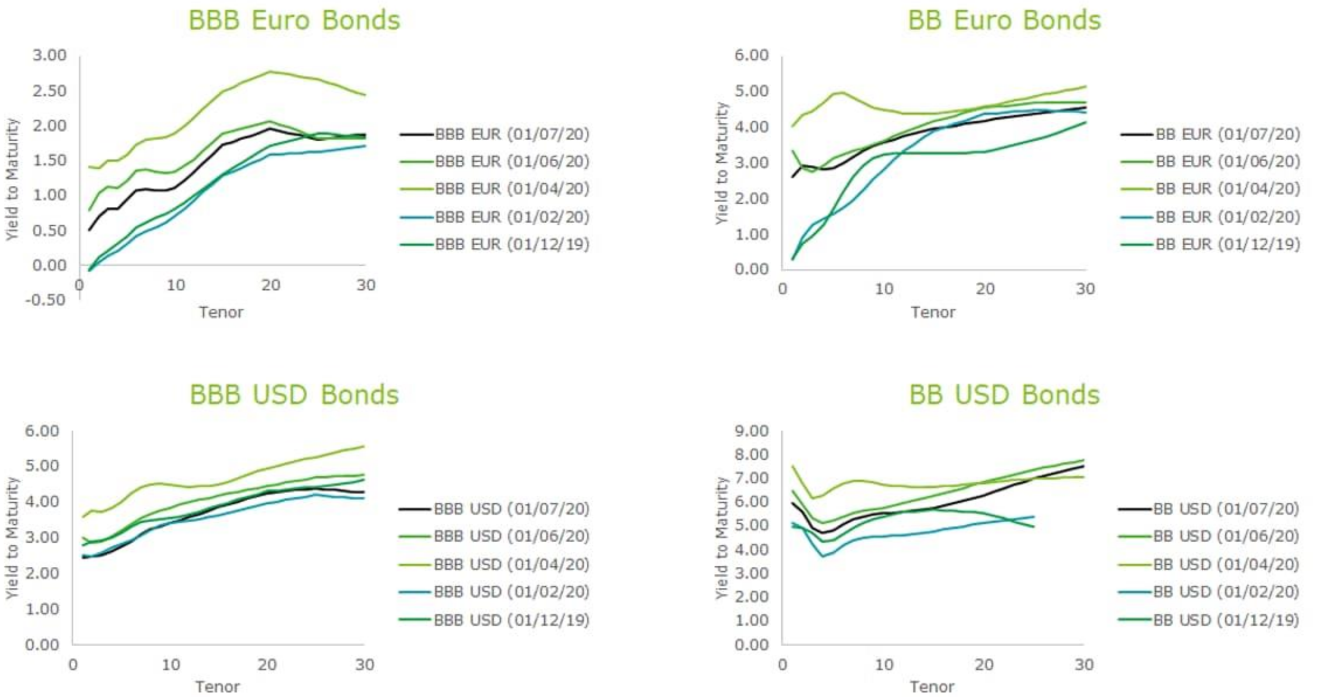
However, the trend at the end of June signals an uptick in debt facilities issued to both investment and speculative grade companies. In this context, governments are taking unprecedented steps to support businesses and compensate companies for their liquidity shortages, which can lead to MNEs seeking to refinance existing debt to take advantage of potentially lower rates. However, this may not crystalize due to the effect of the crisis on group and stand-alone subsidiary credit ratings. Similar to the conditions seen during the 2018 crisis, the above trend may signal that COVID-19 will produce further restrictions on liquidity and, therefore, less available data in the course of interest rate benchmarks for certain credit ratings.

From a transfer pricing perspective, this raises the question as to whether intra-group financing arrangements conditions and, most notably, interest rates, could be established by reference to such an unstable environment with fewer potentially comparable transactions. Companies should then evaluate their existing and envisaged economic analysis to support the arm’s length nature of their financing arrangements, allowing for flexibility of use of different data sources and approaches to establish arm's length interest rates. This consideration is highlighted by the anticipated level of scrutiny by tax authorities worldwide regarding intra-group financing arrangements. Therefore, careful consideration of all current market information will be required for transfer pricing purposes.

Ongoing volatility in the financial markets

While the possibility of receiving external debt seems to be a challenge for companies considering the latest market developments, the current economic conditions and their consequent impact on key terms should be considered. In this respect, this raises the question as to whether the terms and conditions of intra-group transactions concluded before the crisis should be reviewed and changed to reflect the current financial situation. Lenders may need revised terms, which could potentially include guarantees or pledges from affiliated entities, while related parties may consent to restructure debt with less restrictive covenants, although at higher interest rates.

As noted previously, in the absence of internal comparable agreements, corporate bonds are considered as comparable financial instruments for the assessment of intra-group financing arrangements. COVID-19's impact on corporate debt issuers' financial circumstances and the general downturn of financial markets have triggered changes in corporate debt yields, which have been subject to significant volatility. This poses a challenge for timing and documenting the benchmarking of arm's length interest rates.



Source : Refinitiv Eikon

Yields have peaked for both investment and speculative grade bonds in April; however, the trend seems to signal that yields are converging towards pre-crisis levels.

For long-term transactions, yields are similar to those observed in February, while short-term transactions seem to have higher yields than those in February. In other words, investors wish to hold on to notes instead of actively trading, as market participants show confidence in an economic recovery in the long term. Therefore, considering the OECD's latest available guidance, market conditions at the effective date of the transaction and the economic and financial position of the parties involved are of crucial importance, and should be taken into account when performing interest rate benchmarking.

Given the current volatility of financial markets, attention should be drawn to relying on such conditions for policy and price setting of intra-group financial transactions. As proactive monitoring of both borrowers' conditions and market circumstances should be observed in lenders' functions, intra-group arrangements may seek to reflect clauses allowing COVID-19 related adjustments to allow room to review and refresh interest rate benchmarks at a pre-determined point of time in the future.

Summary

- Credit rating assessment is a defining element of the transfer pricing analysis of intra-group financial transactions. The crisis has negatively affected group credit ratings; with the spread of COVID-19 through different continents, this effect can now be observed worldwide and throughout different industries.

- Expected Default Frequencies - an important indicator of a company's financial health - immediately increased with the outbreak of the crisis. While the effect differs from one industry to another, the statistics imply that the probability of companies defaulting in the short run is distinctly more significant than in the long run. When setting up intra-group financing arrangements, multinational entities (MNEs) should consider reviewing the terms and conditions for both short- and long-term investments to mitigate a potential rise in credit risk.

- COVID-19 made investors more risk-averse, as public ambiguity towards borrowers' financial soundness became real. Consequently, a downturn of the provision of additional financing could be observed since the crisis began, while there has been a conspicuously rising trend for loan issuances in June. From a transfer pricing perspective, it is important to consider current market conditions when assessing intra-group financial arrangements and their arm's length nature.

- Elevated uncertainty resulted in a substantial increase in yields on both investment grade and leveraged financial instruments. However, as markets seem to be slowly but gradually recovering, financing costs are tending to converge to pre-crisis levels. Therefore - in line with the latest Organization for Economic Cooperation and Development (OECD) guidance - market conditions and the financial positions of the parties involved should be considered when setting interest rates and pricing policies.

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