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Legal Update
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Is a party obliged to pay negative interest on collateral provided under an English-law ISDA CSA?

Parties to an ISDA Master Agreement may choose to enter into a Credit Support Annex whereby one or both parties are obliged to post collateral. Commonly, there will be an obligation for the party receiving the collateral to pay interest on it, with the aim of making the provision of collateral reasonably economically neutral for both parties.

But what happens if the relevant reference interest rate is in effect negative? Does the party that posts collateral also have to pay interest on it to the receiving party? That is the question at the heart of a case recently considered by the English Court.

The High Court handed down its judgment on 25 July 2018 (*The State of the Netherlands v Deutsche Bank AG* [2018] EWHC 1935 (Comm)), finding that in this case if the parties had envisaged that the State might be entitled to receive negative interest, it would have been spelled out in the Agreement.

The background

The State of the Netherlands ("the State") and Deutsche Bank AG ("the Bank") entered into a number of derivative transactions pursuant to an ISDA Master Agreement ("the Agreement") and Credit Support Annex ("CSA") dated 14 March 2001, both governed by English law; the Agreement was the 1992 version of the ISDA Master Agreement and the CSA was the 1995 version though it had been amended in 2010, deleting and replacing paragraph 11 (which contains information about the credit support to be provided, including eligible collateral and interest rate. This meant that the Agreement and CSA predated the ISDA 2014 Collateral Agreement Negative Interest Protocol (the "Protocol"), and the parties had not amended them in light of that Protocol.

The State and the Bank entered into various derivative transactions on the terms of the Agreement and CSA. If there was a net credit exposure of the State to the Bank, then the CSA required the Bank to provide credit support to the State – in this case, this was cash collateral. The CSA provided for interest to be paid on that cash collateral credit support at the rate of EONIA minus 0.04% (where EONIA is the Euro OverNight Index Average).

However the interest rate had been less than zero for the "larger part of the time since 13 June 2014"[1]. The question before the Court was therefore "whether the parties' agreement, as made using the ISDA documentation concerned, requires the Bank to pay 'negative interest', i.e. interest from the party who provides a principal sum for a period of time, rather than from the party who receives it and has the use of it for a period of time."[2]

The terms of the CSA

The CSA defined the Credit Support Balance, i.e. the credit support the Bank provided to the State, as:

"the aggregate of all Eligible Credit Support that has been transferred to or received by the Transferee under [the CSA] ... Any Equivalent Distributions or Interest Amount (or portion of either) not transferred pursuant to Paragraph 5(c)(i) or (ii) will form part of the Credit Support Balance."

Pursuant to Paragraph 11 of the CSA, "Eligible Credit Support" for the Bank included cash.

1 [2018] EWHC 1935 (Comm), paragraph 4.
2 [2018] EWHC 1935 (Comm), paragraph 4.

The key provision of the CSA relating to interest is Paragraph 5(c)(ii):

"***Interest Amount.*** Unless otherwise specified in Paragraph 11(f)(iii), the Transferee will transfer to the Transferor at the times specified in Paragraph 11(f)(ii) the relevant Interest Amount to the extent that a Delivery Amount would not be created or increased by the transfer, as calculated by the Valuation Agent (and the date of calculation will be deemed a Valuation Date for this purpose)."

Paragraph 11 of the CSA provided that "Transferee" was to be read as a reference to the State and "Transferor" as a reference to the Bank.

Paragraph 10 of the CSA defined Interest Amount as being calculated for each day as follows:

"(x) the amount of cash in such [relevant] currency on that day; multiplied by

(y) the relevant Interest Rate in effect for that day; divided by

(z) 360 (or, in the case of pounds sterling, 365)."

Paragraph 11(f) of the CSA stated that (as we have already seen) the relevant Interest Rate was "EONIA minus four (4) basispoints", i.e. EONIA minus 0.04%.

The issues and the Court's ruling

The Court held that the State had not succeeded in meeting "the central point": to show that there was an obligation in the CSA in respect of negative interest. The Court accepted that the definition of "Interest Amount" was in principle capable of allowing a negative interest figure. However, it held this was simply "a starting point" and that the Agreement needed to be looked at as a whole.

The State recognised that paragraph 5(c)(ii) of the CSA provided only for the State to transfer Interest Amounts to the Bank, and not vice versa. However it argued that negative interest rates should be taken into account in the calculation of the Credit Support Balance.

In support, the State emphasised the final sentence of the definition of "Credit Support Balance", which envisaged the situation where "Interest Amounts" may not be transferred from the State to the Bank. As the CSA provided that interest accrued from day to day, the State argued, the "Credit Support Balance increases by the amount of positive accrued interest and decreases by the amount of negative accrued interest".[3]

The Court disagreed, finding that this sentence merely reflected the fact that the CSA (specifically Paragraph 5(c)(ii)) envisaged a situation where the Transferee – the State – was obliged to pay interest but had not yet transferred it. It did not of itself recognise an obligation in relation to negative interest.

The Court pointed out that if the State's arguments were correct, the effect was that negative interest had to be paid via a mechanism other than that set out in Paragraph 5(c)(ii) of the CSA – and it did not believe that there was any "credible commercial rationale for the parties to have made such a choice". The Court noted that, in contrast, the parties had modified the CSA such that if the Bank paid the credit support in to the wrong bank account, the interest rate on those funds would be zero.

The State argued further that the commercial purpose of the interest provisions of the CSA was "equivalence" – they were intended "to bring about a situation in which neither the [Bank] nor the [State] suffers or benefits from the fact that the [State] holds collateral, over and above the fact that such collateral is to be available in the event of termination for default."[4] The Court was not persuaded by this argument, noting that it is not necessarily the case that the State would incur loss by holding cash where interest rates were negative (i.e. that the cash collateral would actually diminish): the parties had agreed that the State remained free to use the cash to earn interest elsewhere.

The State also sought to rely, amongst other materials, on the Protocol. However, whilst this was introduced so that negative interest rates should "flow through ISDA collateral agreements under certain circumstances", the Court noted that the Protocol "contemplated the parties would amend paragraph 5(c)" of the CSA to achieve this[5] – which had not occurred in this case.

3 [2018] EWHC 1935 (Comm), paragraph 18.
4 [2018] EWHC 1935 (Comm), paragraph 20.
5 [2018] EWHC 1935 (Comm), paragraph 23.

It was therefore clear it had been open to the parties to determine what was to occur in the event of negative interest rates. Why they had not done so was between them, but one answer may have been that they wanted simplicity. The Court found that if there were any obligation in the CSA in relation to negative interest, it would be spelled out.

Comment

The decision is of course confined to the particular terms agreed between the parties. However an important general lesson that can be drawn – especially in light of the Protocol – is that if the parties would like negative interest to be dealt with in any ISDA arrangements, including existing arrangements, they will need to state expressly how it should be dealt with.

This would require the parties to consider whether they would prefer this be treated by way of the amendments to Paragraph 5(c)(ii) envisaged by the Protocol, or by way of the more bespoke option of introducing some other mechanism.

More broadly, the same principle may be taken to apply in other financial contracts which reference an interest rate, such that the Courts will need to be persuaded that the contract expressly contemplates the payment of negative interest.

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