Cassels

A Warning Regarding Negative Interest Rates

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The UK Court of Appeal (Civil Division) (the Court) has confirmed that no negative interest is payable on cash collateral posted under the standard form English law-governed ISDA 1995 Credit Support Annex (the CSA) unless counterparties made a specific election to the contrary under Paragraph 11. The decision further confirms that parties contracting using the CSA or engaged in any commercial finance transaction should expressly address the possibility and legal responsibility for payment of negative interest.

Background

On May 2, 2019, the Court's judgment in The State of the Netherlands v Deutsche Bank AG queried whether interest provisions under the CSA between The State of the Netherlands (the State) and Deutsche Bank AG (the Bank) captured negative interest rates.

In 2010, the Bank and the State entered into a CSA with an established interest rate of the Euro OverNight Index Average minus 0.04%. However, by 2014, due to declining interest rates, the determinative rate in the CSA yielded a negative interest rate. Upon settling the transactions, the State brought a claim against the Bank to recover additional cash compensation in relation to the negative interest rate, and the Bank in turn argued that such payments were never initially contemplated and, as such, that the Bank should not be required to make any payments to the State. In 2017, the English and Welsh High Court (Commercial Court) ruled in favour of the Bank, finding the absence of a specific negative interest mechanism, among other factors as indicative of the parties' intent.

The State appealed to the Court, arguing the trial judge oversimplified the State's position. While the Court agreed with the grounds for the State's appeal, it ultimately held in favour of the Bank. Significantly, in rendering its judgment, the Court took notice of numerous extrinsic factors, including ISDA publications which were issued after the CSA came into force, and were not submitted by either party as evidence to the trial court. The Court accepted these publications notwithstanding these defects on the ground that ISDA publications are: (i) publicly available, and (ii) provide insight into market consensus on how to deal with negative interest rates at the time the CSA came into force.

This decision is significant as it sets a precedent that encourages courts to take notice of ISDA's interpretation of general market trends, notwithstanding such documentation is not presented as evidence.

Market Impact

ISDA updated UK and NY Credit Support Annexes in 2016, which now specifically address negative interest, however counterparties must elect to have negative interest apply in Paragraph 11 (UK) or 13 (NY). Going forward, drafters should:

- to the extent an existing ISDA Master Agreement remains secured by, or a counterparty has elected to use, an ISDA 1995 Credit Support Annex, parties wishing to adopt a negative interest rate should adhere to the ISDA 2014 Collateral Agreement Negative Interest Protocol. Without such amendment or election, this case provides the default rate will likely floor to 0%; and
- pay special attention to ISDA best practice notes and similar guidance, to ensure that, if litigated, such guidance will not impede the parties' intentions.

For more on this topic, please contact Patience Omokhodion, Mike Tallim or any member of the Banking, Lending & Specialty Finance Group.

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