SLAUGHTER AND MAY

# Transforming Interest Rate Benchmarks

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## Negative interest rates in a post-LIBOR world

In an attempt to limit the economic fallout from the COVID-19 pandemic, central banks around the world have slashed bank rates to record lows. In the UK, the Bank of England Bank Rate (the **Base Rate**) sits at an all-time low of just 0.1%, amid speculation of further cuts. The Bank of England is not ruling out taking rates below zero.

At the same time, work continues on the transition from LIBOR. Certain interim milestones have been delayed as a result of COVID-19 (the regulators' initial target of the cessation of new sterling LIBOR business has been moved from Q3 2020 to Q1 2021). However, a joint statement of the FCA, Bank of England and Working Group on Sterling Risk-Free Reference Rates made clear that firms must continue to work on the basis that LIBOR will not be published after the end of 2021.

In this briefing, we consider the implications of falling and potentially negative central bank rates for interest payment obligations that reference either LIBOR or the risk-free rates (**RFRs**) designed to replace it.

## Impact of Base Rate on LIBOR and RFRs

Spreads between the Base Rate and sterling LIBOR widened with the on-set of the pandemic (as they did during the financial crisis), reflecting a perceived increase in credit risk in the inter-bank market. Some LIBOR rates have since fallen, but cuts in central bank rates have not reduced certain interest payments referencing LIBOR to the same extent as those referencing RFRs.

RFRs, which do not measure bank credit risk, fell more immediately and continue to track central bank rates closely. SONIA, the sterling RFR, fell sharply in line with the Base Rate, and is now well below 0.1%. This is positive news for those who are already using RFRs. The authorities have been quick to point out that recent events highlight the importance of transitioning from LIBOR to alternative rates as soon as possible.

## Negative reference rates

Users of LIBOR and RFRs may be affected to different extents by the recent cuts to central bank rates, but the current environment and uncertain outlook bring the topic of negative reference rates, and the extent to which those negative rates operate to reduce borrowers' interest payments, again to the fore.

Negative reference rates, and their implications, have been discussed extensively since CHF LIBOR dipped below zero during 2011, followed by a number of other IBORs over the following years. To protect lenders' yields, "zero floors" were applied to IBOR rates in many loans and other products.

There are some justifications for a zero floor on the reference rate in the context of loans. For example, the prevalence of relationship pricing in the investment grade loan market may not support margins being eroded by negative rates. More generally, lenders will argue that they do not fund themselves at LIBOR whether positive or negative. Nonetheless, LIBOR floors are not entirely satisfactory from the borrower's perspective, for the obvious reason that the full benefit of the negative LIBOR rate is not passed on, exacerbated if the zero floor is not reflected in any related interest rate hedging. There is also a notable difference in how zero floors operate in the loan and floating rate note (**FRN**) markets.

With certain RFRs (including SARON and €STR) already in negative territory and the possibility that other RFRs could follow suit, attention is now turning to the implications of negative RFRs. In the context of loans, there are some additional considerations for borrowers to keep in mind with respect to negative RFRs that are different to those applicable in a LIBOR context. Borrowers will also need to continue to pay attention to the interaction of zero floors with their hedging arrangements.

## Negative rates - loans

"Zero floor" wording features in the LMA's IBOR-linked recommended forms. The agreements provide that if the relevant reference rate (ie LIBOR or EURIBOR) is negative, the rate will be deemed to be zero. Interest is the sum of the applicable IBOR rate and the Margin. The interest payable on the loan is therefore effectively floored at the Margin.

The zero floor provisions are optional and while, as noted above, they are widely used, they are not adopted in all cases. During periods in which the incidence of negative rates has increased, the inclusion of a zero floor has tended to be negotiated more frequently, with some borrowers in currencies affected or likely to be affected by negative rates, successfully resisting such language.

The zero floor provisions have been carried into the LMA's Exposure Draft Compounded RFR Facilities Agreements[1], which provide that if the reference rate is below zero, it shall be deemed to be zero. Borrowers entering into facilities referencing RFRs might resist the zero floor for the same reasons as in a LIBOR deal. Not all will be successful, so will have to think through how the floor will operate in a RFR-linked facility.

Most of the RFR-linked loans completed so far have used a compounded RFR to which a credit spread is added, as an approximation of the bank credit risk element of LIBOR. Interest is the sum of the applicable RFR, the credit spread and the Margin. If the RFR carries a zero floor, the interest payable on the loan is floored at the sum of the credit spread and the Margin – thus putting lenders in a more favourable position than would have been the case in a LIBOR-linked deal.

Borrowers will argue that the zero floor should apply to the sum of the compounded RFR and credit spread rather than the compounded RFR only. In that case, interest is floored at the Margin. This is closer to how zero floors operate in relation to LIBOR and is consistent with the principle that the transition from LIBOR to RFRs should be economically neutral as between lender and borrower.

The potential incompatibility of the methodology used to arrive at the compounded RFR with a zero floor is a second new issue to bear in mind – conceivably a reason for some borrowers to resist zero floors being applied to RFRs if it cannot be resolved. The Bank of England will publish a SONIA compounded index from early August, to simplify the calculation of compounded SONIA and thereby accelerate the adoption of SONIA in sterling markets. It is understood that the index may not be usable if SONIA turns negative yet a zero floor is to be applied. There have been calls for the Bank of England to consider publication of a second index that includes an interest rate floor, but whether such an index will be forthcoming remains to be seen.

As in relation to LIBOR, the application of a zero floor to a RFR-linked deal must also be considered in the context of any related interest rate hedging.

## Negative rates – bonds

The coupon on a FRN is typically the sum of a reference rate plus a margin. This is the case whether the FRN references LIBOR or a RFR. The practice of applying a credit spread to RFR-linked deals is not applicable in the same way as to loans. The bank credit risk element of LIBOR is instead replicated within margins.

Another important distinction between loans and FRNs is that, in FRNs, the issuer typically gets the full benefit of the negative rate until such time as the overall coupon reaches zero. Zero floors operate in a different way, to floor the coupon rather than the reference rate.

[1] See our previous client publication – Transforming Interest Rate Benchmarks: LMA's Compounded Rates Facilities Agreements – Key Points for Borrowers (November 2019).

Some issuers apply an express zero floor to the overall coupon (reference rate plus margin), such that the coupon is floored at zero. There are a number of common formulations. For a standalone issuer the interest provisions in the terms and conditions might state: "*Interest on the notes will accrue on the outstanding note balance of each note at a per annum rate equal to the sum of the Sterling Overnight Interbank Average Rate (SONIA) and a margin of [X]% per annum, provided that if such rate is below zero, the applicable interest rate will be zero.*" For a programme issuer, the ICMA pro forma final terms (contained within the ICMA Primary Market Handbook) include an option for issuers to expressly provide for the minimum rate of interest to be zero and FRN issuers will typically select this option. Other programme issuers may hardwire a zero floor into the programme terms and conditions by including wording along the lines of "*unless stated otherwise in the final terms, the minimum rate of interest shall be zero*".

Even where an express zero floor is not included, it is thought that general principles of contractual construction suggest that a zero floor should be implied in FRNs in normal circumstances, a position endorsed by the ICMA Primary Market Handbook (which has persuasive influence among market participants). This is because bond terms and conditions customarily only provide a "promise to pay" by the issuer, with no corresponding contractual promise by investors to pay anything. Further, the clearing systems generally do not have mechanisms to process payments by noteholders to an issuer.

The introduction of RFRs is not therefore expected to alter the approach to negative rates and zero floors in FRNs.

It is also worth remembering that in bonds, the possibility of negative reference rates and how the negative numbers affect payments may need to be considered other than in the context of coupon calculations. For example, a benchmark (or a related reference rate, such as the yield on a sovereign bond such as a gilt or a bund) may be used to calculate a make-whole amount, in circumstances where an issuer opts to redeem a bond early.

## Negative rates - derivatives

For interest rate and cross currency derivative transactions entered into under the standard terms of the 2006 ISDA Definitions, payment obligations in respect of negative reference rates are dealt with in one of two ways.

The "Negative Interest Rate Method" is the default option under ISDA terms, so will apply unless the parties specify otherwise. The Negative Interest Rate Method provides:

- if the amount payable by the party which would normally be required to pay an amount in respect of the floating leg of the interest rate of a derivative transaction (the **Floating Amount** and **Floating Rate Payer,** respectively) is a negative number at the relevant date (either as a result

of a negative interest rate or due to the addition of a negative spread to a positive interest rate)

- such party will not be liable to pay anything in respect of the floating leg - the Floating Amount is deemed to be zero
- the other party is instead required to pay an amount equal to the absolute value corresponding to the negative amount to the other party.

The effect is to flip the obligation to pay the amount in respect of the floating leg onto the other party. The Negative Interest Rate Method obliges a borrower (paying the fixed rate) to pay the swap counterparty (paying the floating rate) a payment to account for the negative interest rate. This payment would be in addition to the fixed amount owed on the swap. There is, therefore, the potential for mismatch between the obligations under the hedged item (eg a loan or bond) where the hedged item applies a zero floor to the floating benchmark (whether LIBOR or a RFR).

The alternative is the "Zero Interest Rate Method". When this method is switched on:

- if the amount payable in respect of the floating leg would otherwise be negative on the relevant payment date, the Floating Rate Payer has no obligation to pay such amount
- the amount is deemed to be zero and effectively floored such that there is no requirement for the other party to make the reverse payment of the absolute value of the negative amount.

It is important to bear in mind that both the Negative Interest Rate Method and the Zero Interest Rate Method apply in respect of the Floating Amount as a whole - so take into account both the reference rate and any applicable spread on the swap. Therefore, if the reference rate is negative but, due to the addition of a spread, the Floating Amount is positive, then the operation of the Negative Interest Rate Method or Zero Interest Rate Method will not be triggered. (And on the converse, it means that when the reference rate is positive, a negative spread might cause a negative Floating Amount which triggers the operation of the Negative Interest Rate Method or Zero Interest Rate Method.)

The above provisions apply whether the derivative references an IBOR or a RFR. It is expected that the upcoming Supplement to the 2006 ISDA Definitions, to include new IBOR fallbacks, will apply these provisions in the same way if, and once, the IBOR reference rate in a derivative switches to a fallback adjusted RFR. In that context, there might be potential for further mismatch if a reference rate in a derivative switches to a fallback adjusted RFR (which includes a spread adjustment), and the related loan falls back to an adjusted RFR, applying the zero floor provision only to the RFR reference rate and not to any spread adjustment.

The 2020 ISDA Interest Rate Definitions are expected to be published before the end of 2020 for incorporation in transactions entered into after that date. They are expected to deal with negative reference rates more fully than the 2006

Definitions. A particular point to note is that there is expected to be an additional concept of Zero Interest Rate Method (excluding spread) which allows the Zero Interest Rate Method to apply only in respect of the reference rate (as opposed to applying in respect of the sum of the reference rate and the spread).

## Negative rates - collateral arrangements

For those borrowers who have collateral arrangements in place in relation to their derivatives, it is important to consider how negative interest rates are or should be dealt with in those documents. For example, the terms of the 1995 ISDA Credit Support Annex do not expressly provide for how the payment of negative interest amounts should be made and by whom. The 2014 ISDA Collateral Agreement Negative Interest Protocol was introduced to deal with this ambiguity. The protocol deals with negative interest rates in a similar way to the Negative Interest Rate Method in the 2006 ISDA Definitions, such that the transferor, instead of being the party to receive an interest amount, is the party required to pay an amount equal to the absolute value of the negative interest amount to the other party. Parties can amend their collateral documents on a bilateral basis to achieve the same treatment.

It is expected that the transition away from IBOR reference rates to RFRs will not impact the mechanisms for dealing with negative interest rates in the context of collateral obligations as described above.

## Comment

The slashing of central bank rates around the world in response to the COVID-19 pandemic has thrust the issue of negative reference rates back into the spotlight. Negative reference rates, and RFRs in particular, are a reality currently for only a handful of currencies, but remain a possibility for many others. Whilst the transition from LIBOR to RFRs does not change the implications of, or the options for dealing with, negative reference rates in loans, bonds and derivatives, it does throw up some new questions which treasurers will need to consider as they navigate the terms of new RFR-linked products.

*Slaughter and May are monitoring closely developments in relation to transition from LIBOR, EURIBOR, EONIA and other major benchmarks across all of the major financial products. For further information, please contact any of the lawyers listed below or your usual adviser at Slaughter and May.*

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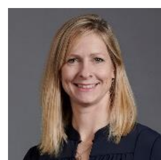

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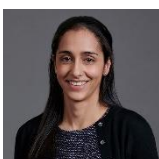

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