



Finsights
on negative interest rates
—
2019



I hate to be negative, but....”

Loan and swap structuring in a low interest rate environment

Negative interest rates have been an issue in offshore markets for many years, but the focus has sharpened in recent months in Australia with back to back RBA interest rate reductions, and signposting of further reductions to come. It is now a first order issue for corporate treasury teams.

For a number of years, there have been provisions included in facility agreements addressing this scenario – see the APLMA syndicated facility agreement, which provides for the base rate to be deemed to be zero in the event that the actual base rate is negative. (The position in the bond markets is less uniform.)

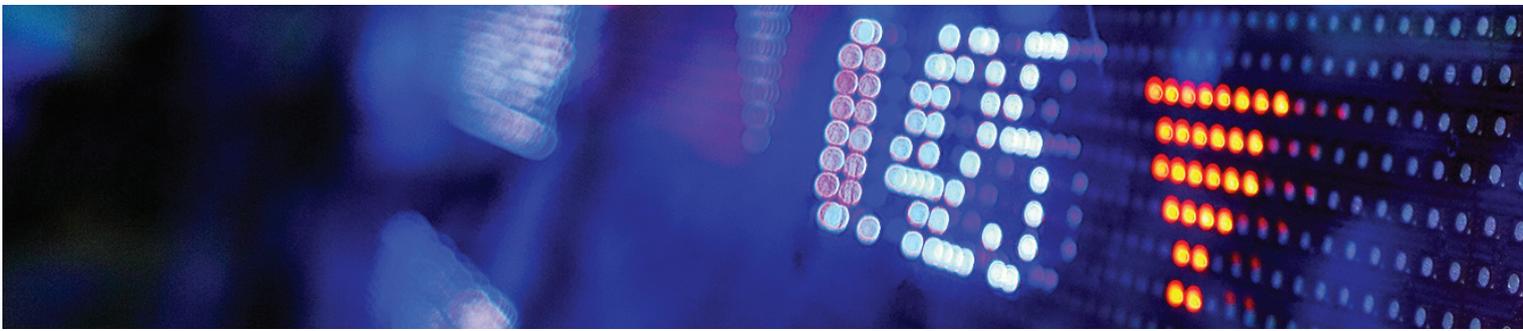
Most financiers will insist on inclusion of this provision (as it protects their margin from erosion) – and it is only a limited number of borrowers that have the bargaining power to resist this request.

But understanding the risk borne under the facility agreement is only half the issue – most corporates will also have interest rate swaps in place to hedge the risk of changes to interest rates, and it is these arrangements which may well contain hidden dangers.

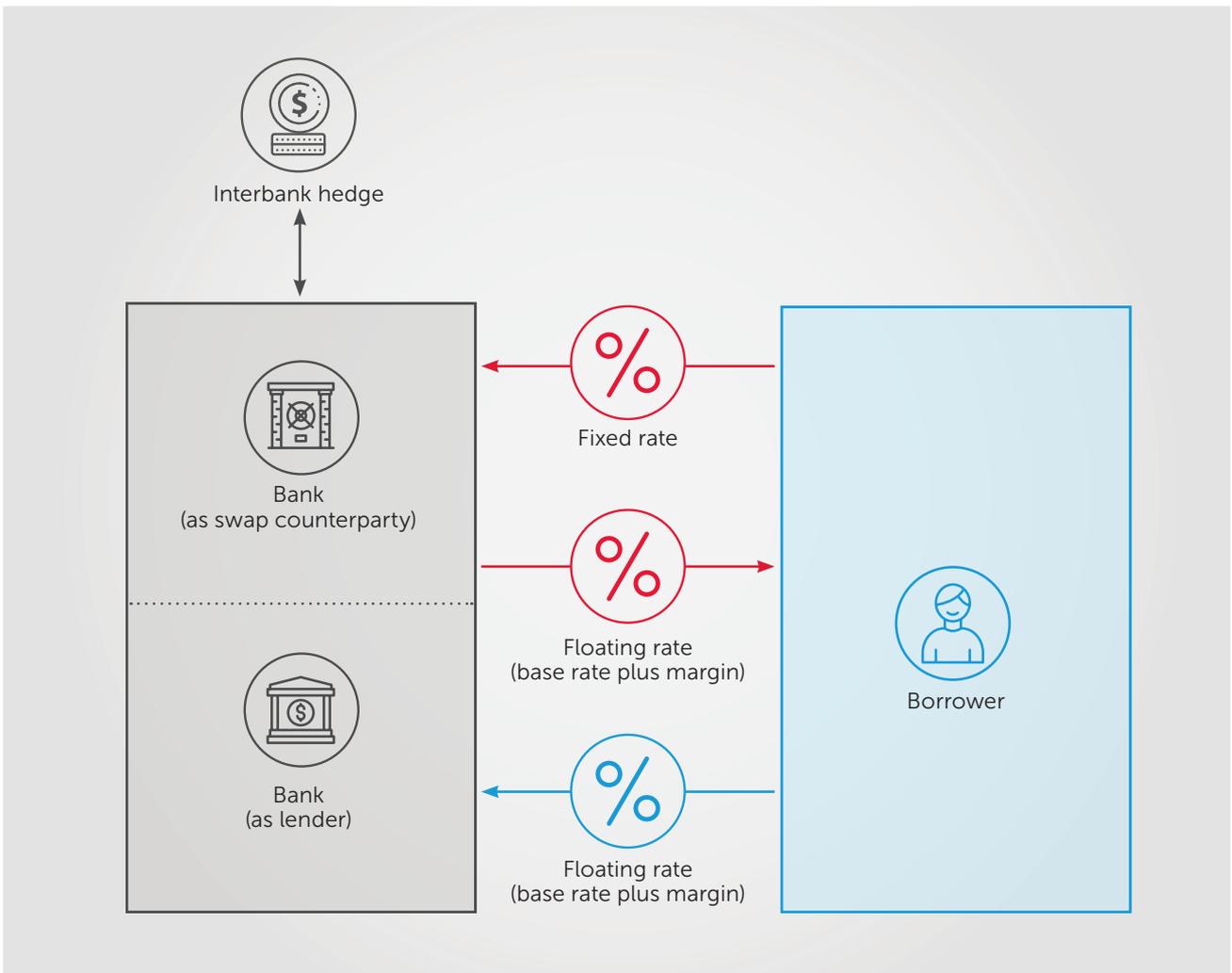
This is of course a fundamental issue for corporates as, by definition, the intention of the swap should be to hedge the risk of interest rate movements – so to end up in a position where such a transaction actually adds additional risk is highly problematic.

This article highlights the risks, sets out a ‘ready reckoner’ to assess the position, and sets out some possible solutions. It also considers what was once thought to be a “doomsday” scenario - where the aggregate of the negative base and the margin results in an overall negative interest rate – which is now considered by many to be a real possibility in Australia.





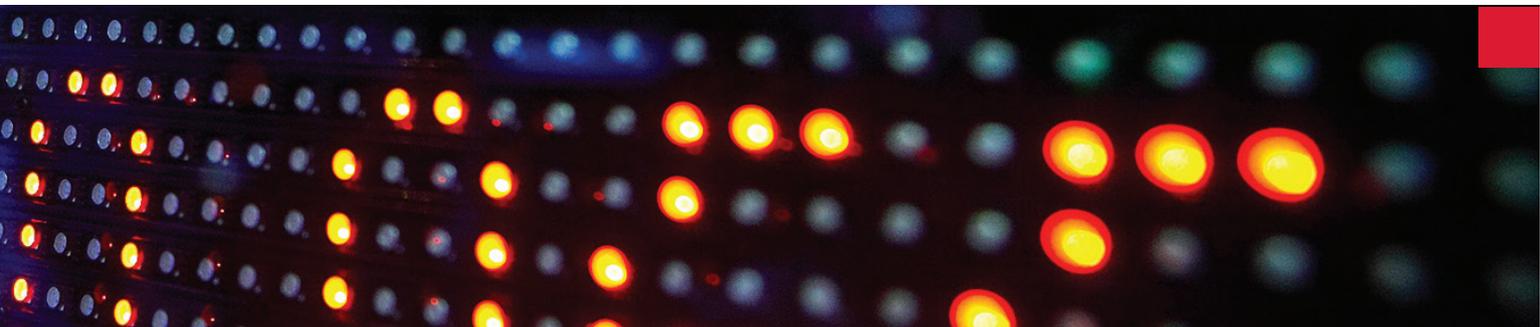
Funding Structure



The interest rate payable by the borrower is the aggregate of the base rate (BBSW, BBSY and the like), and the agreed margin (which represents the financier's return).

The payments under the swap are made purely by reference to the relevant base rate.

The key issue will initially be whether the facility agreement contains a "zero floor" – that is, a provision which provides that, come what may, the base rate under the facility agreement will not be less than zero.



The basic loan dynamics in the context of negative base rates are essentially:

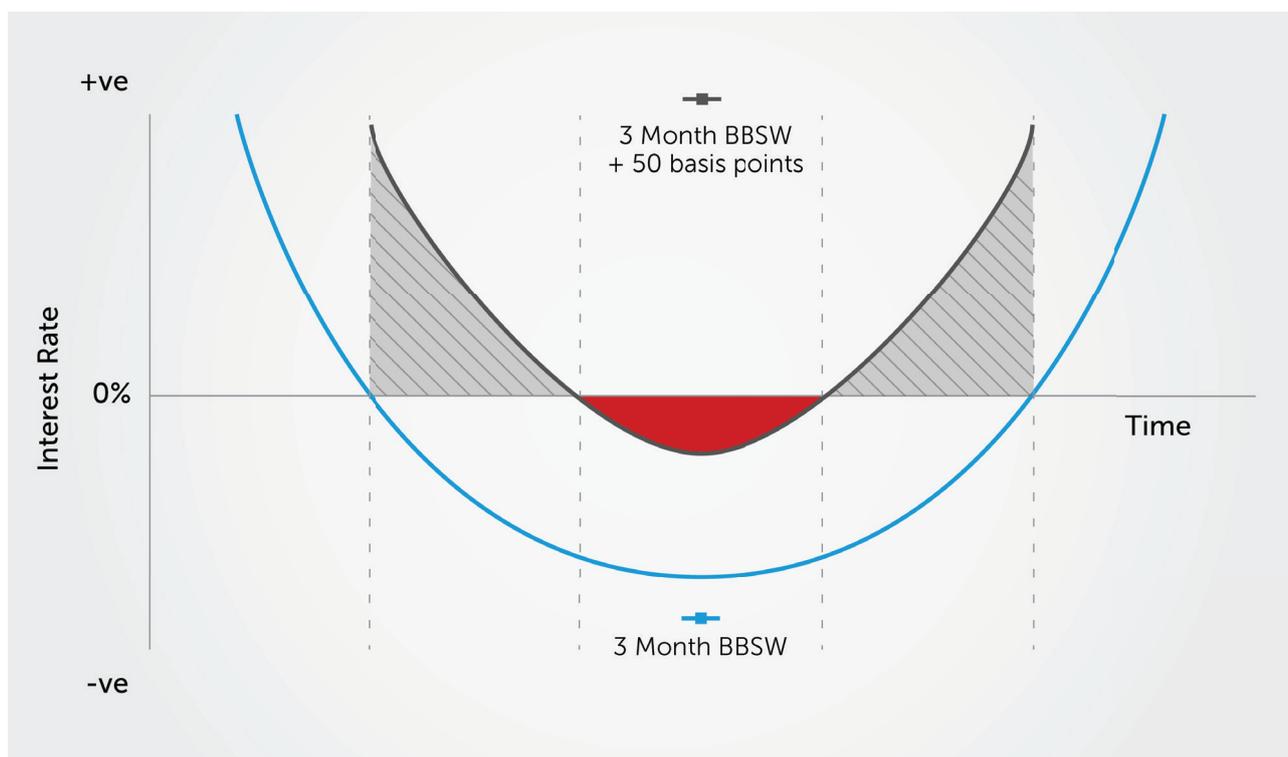
- where the loan facility does contain a “zero floor”, the interest rate payable by the borrower will be the agreed margin (as the base rate will be deemed to be zero). The effect of this is that at all times, lenders will receive their agreed return on the funding.
- where the loan facility does not contain a zero floor, a negative base rate will erode the margin – so the lenders will actually receive less than the agreed return.

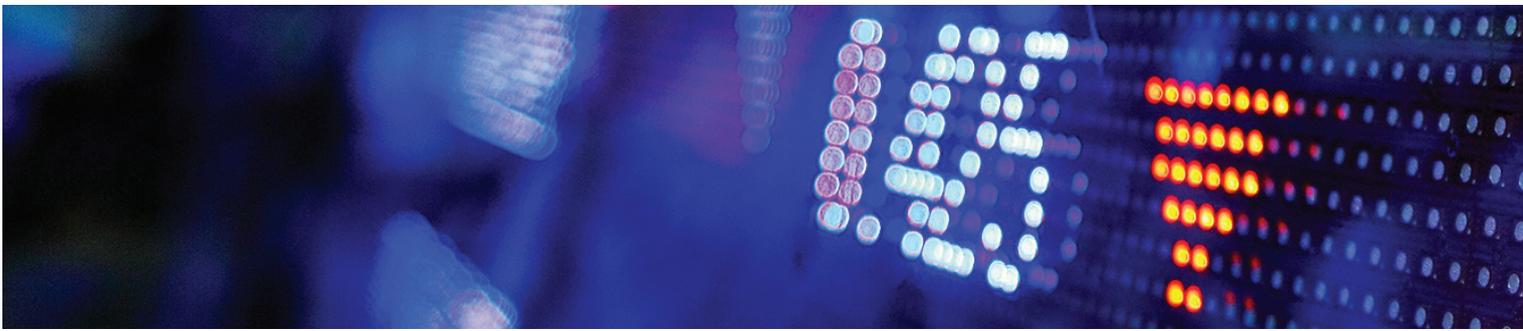
It is this situation which has for some time been in focus.

However the expectation has generally been that even if there are negative base rates in Australia, the aggregate of the base rate and the margin would remain positive.

However, market participants have recently started to consider what had previously thought to have been unthinkable – that is, that the aggregate of the base rate and the margin could itself be negative. If the negative base rate were to exceed the margin, then there would be, in aggregate, a negative interest rate in respect of the facility – requiring the lender to, on its face, make payment to the borrower for the right to lend the borrower money. (For most transactions, this would not lead to an obligation on the lender to pay the borrower – the interest obligations under most facility agreements are expressed solely as an obligation on the borrower to pay.)

In a graphic sense, the difference would be as follows – the grey shaded section is where the base rate is less than zero, but the overall rate is positive, and the red coloured area is where the aggregate interest rate is less than zero:





OK, so what's the issue?

This issue has some complexity, and may not be readily identifiable on the face of the documents, but essentially goes back to whether there is a mismatch between the manner in which the facility agreement and the related derivative arrangements deal with negative rates.

Where both sets of documents deal with the issue in the same manner, then the hedge will be maintained. However, where one set of documents deals with the issue, but the other doesn't (or at least, doesn't deal with it in the same manner), there is an issue.

Most swaps will apply what is known as the "Negative Interest Rate Method". This simply means that there is no deeming of zero as the base rate when the base rate otherwise determined under the swap would be less than zero – simply speaking, the rate "is what it is".

The alternative – which in practice is rarely used in documentation – is the "Zero Interest Rate Method" – which as the name implies, deems a base rate of zero when rates would otherwise be negative. However, this is typically not used, as it is not adopted in the interbank market, so banks will typically not want to introduce a mismatch into their own funding arrangements.

The ready reckoner

With that background, there is an easy three step process to determine if there is an issue:

1. Check the facility agreement – does it have a "zero floor" that applies in circumstances where the base rate would otherwise be zero?
2. Check the swap – if the 2006 ISDA definitions are used (which is typically the case), then the "Negative Interest Rate Method" (rather than the "Zero Interest Rate Method") will usually apply.
3. Apply the below "ready reckoner" to determine if there is a mismatch, and if so, who bears the risk.

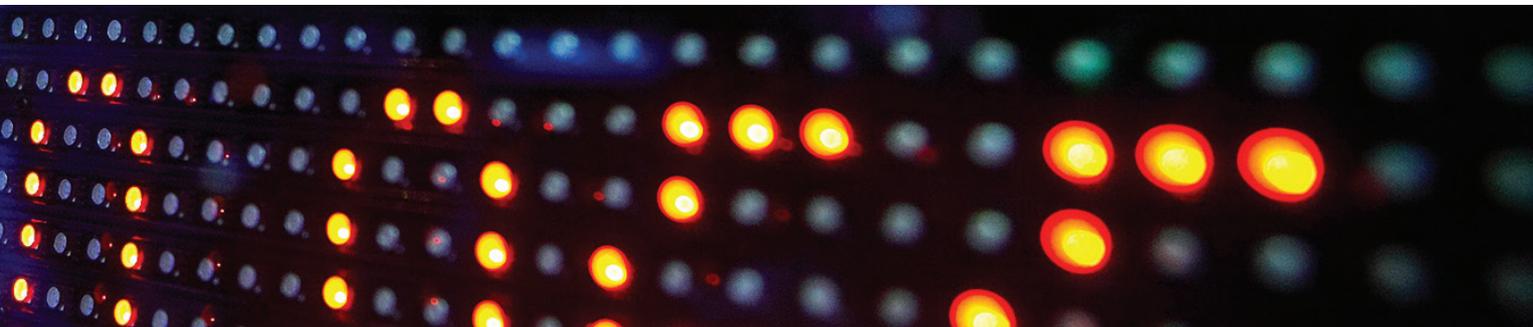
Swap \ Loan base rate	No zero floor	Zero floor
Negative Interest Rate Method	✓ Hedged (if aggregate rate > 0)	✗ Mismatch - Borrower risk
Zero Interest Rate Method	✗ Mismatch - Financier risk (but unlikely to apply commercially)	✓ Hedged

As may be seen, it is the circumstance where there is a "zero floor" in respect of the base rate under the loan facility, and the Negative Interest Rate Method applies under the related interest rate swap, that is particularly of concern.

Most borrowers will be in this situation. Only strong borrowers will have been able to negotiate a different position.

This leaves the borrower with two adverse results – it does not get the benefit of the negative base rate in the loan (which would otherwise reduce the interest rate to below the margin), but it is still required to make payment of an amount equal to the negative base rate under the swap (as an addition to the fixed rate payment it is in any event required to pay).

In short, beware the double negative!



What do you do if you have a mismatch?

If documentation is currently being renegotiated, borrowers should seek to address the issue up front with the financiers. Some of the options that could be considered are as follows:

	Solution	Comment
At loan level	Borrow at a fixed rate	May not be commercially available - loan market is a floating rate market. In addition, borrowers typically prefer floating rate as reflects business better.
	Remove zero floor	Aligns with swap (assuming Negative Interest Rate Method) – but lenders may be reluctant to accept due to margin protection concerns. Borrower/lender dynamics and negotiating power will be the key determinant. Lenders will likely resist this on the basis of the manner in which they are funded. Borrowers will seek to argue that they take the risk on base rate increases, so should get the benefit of decreases – as well as the swap mismatch issue otherwise highlighted above.
	Limit extent of hedging obligation	Some borrowers choose to hedge their interest rate exposure, but some are required by their lender to hedge an agreed percentage of their overall debt position (by way of a covenant included in the facility agreement). If the above risks cannot otherwise be satisfactorily addressed, focus should turn to the extent of the hedging obligation imposed by the lending group (ie limit the percentage of overall debt that must be hedged).
At swap level	Adopt “Zero Interest Rate Method” in swaps	Unlikely to be acceptable to swap counterparty, as they will likely have back to back arrangements in place which use the “Negative Interest Rate Method”, and will not accept risk of mismatch.
	Use other derivatives, such as caps and floors	Provides protection of the upside risk that is of primary concern to the borrower ie increasing rates. Likely to be the simplest option.

Of course, many of the above potential solutions will have incremental costs that will likely be imposed on borrowers, so renewed focus on the fundamentals of zero floors and mismatch as between facility and swap documentation is likely to be the starting point for discussions.

In respect of existing issues, borrowers can of course seek to negotiate amendments to reflect the above positions, but this will likely come at a cost (and is unlikely to be practical in the context of diversified lenders such as large syndicate groups and bond issuance).

At a minimum, borrowers should put this issue on the agenda with their financiers in the context of forthcoming annual reviews and extension requests.

Importantly, it is the “doomsday” scenario contemplated above - where the base rate plus the margin is less than zero – that is of primary focus for many borrowers. In this situation, removal of the zero floor in the funding documentation does not solve the issue for the borrower – as the aggregate interest rate on the facility would still be less than zero. In this case, the options available to the borrower include buying a floor at a rate equal to the negative level of the margin on the facility, so that the sum of the floor and the margin equals zero.

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