

## ISDA CREDIT SUPPORT ANNEX: HIGH COURT CONFIRMS NO OBLIGATION TO ACCOUNT FOR "NEGATIVE INTEREST"

The English High Court has ruled on whether the standard form ISDA 1995 Credit Support Annex contains an obligation to pay negative interest. The Court's judgment confirms that, where parties have not otherwise agreed how to address negative interest rates, there is no obligation in the CSA on a party transferring eligible collateral in the form of cash to pay or otherwise account for negative interest on that cash.

### BACKGROUND

In 2001, the Netherlands and Deutsche Bank AG entered into a 1992 ISDA Master Agreement, Schedule and a 1995 Credit Support Annex. Pursuant to these agreements, the parties entered into a number of derivatives transactions.

The parties' agreements predated the ISDA 2014 Collateral Agreement Negative Interest Protocol and were not amended in light of that Protocol.

The parties had, however, amended the CSA so that only the Bank was required to provide credit support to the State; there was no requirement for the State to provide credit support to the Bank should there be a net credit exposure of the Bank to the State.

For a large part of the time since June 2014, the rate of interest (EONIA minus 0.04%) to be paid by the Netherlands to the Bank on cash collateral provided by the Bank has been negative.

The central issue for the court in *The State of the Netherlands v Deutsche Bank AG* [2018] EWHC 1935 (Comm) was whether the Bank was required to pay "negative interest", i.e. whether the party which has provided cash collateral is, in addition, required to pay interest on that cash collateral if the interest rate is negative.

### Key issues

- High Court has ruled no obligation under a CSA to account for negative interest
- No obligation on a party transferring eligible collateral in the form of cash in respect of interest on that cash
- The relevant CSA had not been amended in light of the ISDA 2014 Collateral Agreement Negative Interest Protocol

## THE STATE'S CLAIM

Given the wording of para 5(c)(ii) of the CSA (see text box), which provided for the Netherlands, not the Bank, to transfer Interest Amounts, the Netherlands did not contend that the Bank was obliged actually to pay negative interest.

Rather, the Netherlands argued that negative accruals should be taken into account in the calculation of other amounts payable between the parties. More particularly, the Netherlands argued that accrued but unpaid interest (including, where applicable, negative interest) should be included in the calculation of the Credit Support Balance. It emphasised the last sentence of the definition of Credit Support Balance (see text box).

The Interest Amount for an Interest Period was produced, according to the Netherlands, by summing all positive and negative amounts of daily interest. As interest accrues from day to day, the Credit Support Balance increases by the amount of positive accrued interest and decreases by the amount of negative accrued interest.

Where the aggregate of daily accruals over an interest period has been a negative number, the Netherlands accepted that there is no interest for the State to pay under paragraph 5(c)(ii). However, it argued that that did not mean that the daily accruals do not exist or should be ignored in calculating the Credit Support Balance.

## THE COURT'S JUDGMENT

Mr Justice Robin Knowles considered that the Netherlands had to show that there was an obligation on the Bank in respect of negative interest - but the Netherlands had failed to do so.

There is an obligation at paragraph 5(c)(ii) to transfer (pay) interest, but that requires payment by the Transferee (the Netherlands), not by the Transferor (the Bank). Paragraph 5(c)(ii) "contemplates the transfer of interest by the person holding the collateral to the other person who posted it. It does not require the person who posted the collateral to transfer interest to the person holding it."

The judge rejected the Netherlands' argument that while a positive sum by way of interest is dealt with through the machinery of paragraph 5(c)(ii), a negative sum by way of interest should be dealt with through a different machinery, namely by way of adjustment to the Credit Support Balance.

It was open to the parties to deal with negative interest, most obviously by bringing it into paragraph 5(c)(ii), but they did not do so – and there was nothing in the design of the machinery regarding the adjustment to the Credit Support Balance to support the view that this machinery was designed to handle amounts of negative interest.

## CONCLUSION

The importance of the need for clarity over how negative rates, and the payment of interest on posted collateral, should be treated in standard collateral documentation was reflected in the publication of the ISDA 2014 Collateral Agreement Negative Interest Protocol. This Protocol provides one

### CSA provisions

CSA, para 5(c)(ii)

**"Interest Amount.** Unless otherwise specified in Paragraph 11(f)(iii), the [State] will transfer to the [Bank] 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....."

CSA, para 10. Definitions.

**"Credit Support Balance"** means, with respect to a Transferor on a Valuation Date, the aggregate of all Eligible Credit Support that has been transferred to or received by the Transferee under this Annex, together with any Distributions and all proceeds of any such Eligible Credit Support or Distributions, as reduced pursuant to Paragraph 2(b), 3(c)(ii) or 6. 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."

method by which parties to a CSA (or the other specified ISDA collateral standard documents) may address negative interest rates.

However, in circumstances where there is no agreement between the parties on how to address negative interest rates, this judgment provides clarification about how the payment of interest on posted collateral is to be calculated under a CSA in a negative interest environment. In short, unless the parties have expressly addressed negative interest, there is no obligation to pay or otherwise to account for negative interest.

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