

ISDA CREDIT SUPPORT ANNEX: COURT OF APPEAL RE-AFFIRMS NO OBLIGATION TO PAY "NEGATIVE INTEREST"

The English Court of Appeal has ruled on whether the standard form ISDA 1995 Credit Support Annex contains an obligation to pay negative interest. The Court's judgment re-affirms 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 (the "State") and Deutsche Bank AG (the "Bank") 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* [2019] EWCA Civ 771 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

- Court of Appeal re-affirms no obligation on a party transferring eligible collateral in the form of cash in respect of negative interest on that cash
- On its true interpretation and considered as a whole, the CSA does not provide for the payment of negative, as opposed to positive, interest
- Five primary reasons given to support the Court's conclusion
- The relevant CSA had not been amended in light of the ISDA 2014 Collateral Agreement Negative Interest Protocol

THE APPEAL

The Court of Appeal was critical of certain aspects of Knowles J's judgment at first instance. Nevertheless the appeal by the Netherlands was dismissed.

Submissions by the Netherlands

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 appellant 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).

In essence, the Netherlands submitted that the defined term "Interest Amount" can include negative interest, and the definition of "Credit Support Balance" requires that that negative interest should "form part of" that Credit Support Balance.

Submissions by the Bank

The respondent Bank submitted that the sole interest obligation was in paragraph 5(c)(ii) of the CSA and that provision simply did not require payment of negative interest. There was no credible reason why negative interest would have been dealt with otherwise than in paragraph 5(c)(ii) and if negative interest had been intended, it would have said so in paragraph 5(c)(ii).

With respect to the final sentence of the definition of Credit Support Balance (see text box), the Bank submitted that an "Interest Amount" had to be a positive amount transferable by the State to the Bank. In that final sentence, the words "not transferred" meant "transferable but not yet transferred under paragraph 5(c)(ii)". Moreover, the whole purpose of the words "not transferred pursuant to Paragraph 5(c)(ii)" was to make clear that the qualification in the last sentence of the definition of Credit Support Balance was only referring to an Interest Amount that fell within paragraph 5(c)(ii).

The judgment of the Court of Appeal

The Court held that, on its true interpretation, the CSA could not be taken as providing for the payment of negative, as opposed to positive, interest.

In support of this conclusion the Court listed five grounds.

Firstly, the 1999 User's Guide to ISDA Credit Support Documents and background materials published by ISDA did not show that ISDA thought that negative interest was intended to be payable.

Secondly, as was common ground between the parties, paragraph 5(c)(ii) covers positive, but not negative, interest. That paragraph is certainly the most obvious place to find a reference to negative interest if it were intended.

Thirdly, the Court held that certain of the asymmetries created by the State's interpretation and identified by the Bank, relating to rounding and minimum

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."

transfer amounts, had force and would create an "inexplicable disparity" when comparing the treatment of positive and negative interest.

Fourthly, under paragraph 11(f)(iv) of the CSA, any transfer to the wrong account reduces interest to zero, whereas if the parties had negative interest in mind, then they would have provided in that paragraph 11(f)(iv) for transfers to the wrong account to be penalised by reduction of interest to the lower of zero or a negative rate.

The Court's fifth, and overarching, reason was that it saw nothing in the CSA read as a whole that suggested that negative interest was contemplated or intended.

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 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 of the Court of Appeal re-confirms 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.

CONTACTS

Tim Cleary
Partner

T +44 207006 1449
E timothy.cleary
@cliffordchance.com

Andrew Coats
Partner

T +44 207006 2574
E andrew.coats
@cliffordchance.com

Paget Dare Bryan
Partner

T +44 207006 2461
E paget.darebryan
@cliffordchance.com

Anne Drakeford
Partner

T +44 207006 8568
E anne.drakeford
@cliffordchance.com

Jeremy Elliott
Knowledge Director

T +44 207006 3442
E jeremy.elliott
@cliffordchance.com

Matthew Grigg
Partner

T +44 207006 1746
E matthew.grigg
@cliffordchance.com

Simon James
Partner

T +44 207006 8405
E simon.james
@cliffordchance.com

Jessica Littlewood
Partner

T +44 207006 2692
E jessica.littlewood
@cliffordchance.com

Caroline Meinertz
Partner

T +44 207006 4253
E caroline.meinertz
@cliffordchance.com

Jeremy Walter
Partner

T +44 207006 8892
E jeremy.walter
@cliffordchance.com

Will Winterton
Partner

T +44 207006 4386
E will.winterton
@cliffordchance.com

Deborah Zandstra
Partner

T +44 207006 8234
E deborah.zandstra
@cliffordchance.com

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www.cliffordchance.com

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London, E14 5JJ

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