October 2018

High Court confirms no negative interest payable under standard form 1995 ISDA Credit Support Annex

In The State of The Netherlands v Deutsche Bank AG [2018] EWHC 1935 (Comm), the High Court ruled that the Transferor of cash collateral under a standard form 1995 ISDA Credit Support Annex was not obliged to pay, or otherwise account for, interest to the Transferee where the contractually stipulated rate was negative. The decision provides certainty to an issue that the market has sought to deal with contractually by way of ISDA's 2014 Collateral Agreement Negative Interest Protocol.

Background - Current Market Practice

For some time market consensus has been that the terms of the 1995 ISDA Credit Support Annex (the "**1995 CSA**") (commonly used if collateralised derivatives transactions are to be entered into under an English-law governed ISDA Master Agreement) do not oblige a collateral-poster (the "**Transferor**") to pay interest to a collateral-receiver (the "**Transferee**") if the reference rate for interest in respect of cash collateral is negative.

The Facts of the Case

On 14 March 2001, the State of the Netherlands (the "**State**") and Deutsche Bank AG ("**DB**") entered into an ISDA Master Agreement with a 1995 CSA. The parties agreed to a "one-way" credit support under the 1995 CSA, whereby DB would provide credit support to the State where the State had a net credit exposure to DB under the various derivative transactions entered into between the parties, but not *vice versa*.

Throughout the period relevant to the dispute, the State had a net credit exposure to DB and, in accordance with its obligations under the 1995 CSA, DB provided cash collateral as credit support.

The 1995 CSA required the Transferee (i.e. the State) to pay interest on that cash collateral to the Transferor (i.e., DB). However, the agreed rate of interest, EONIA minus 0.04%, had been less than zero for the larger part of the time since 13 June 2014.

Therefore, an important question arose as to whether the standard 1995 CSA required DB, as the Transferor of the cash collateral, to pay negative interest, to the State, the Transferee. (The parties had not signed up to ISDA's 2014 Collateral Agreement Negative Interest Protocol.)

Given the persistence of ultra-low interest rates, by historical standards, and therefore the general importance for the derivatives market of the question raised in the dispute, the case proceeded on the Financial List, a specialist English Court List set up to handle claims related to the financial markets.

The parties' submissions

DB's position was straightforward: the express wording of paragraph 5(c)(ii) of the 1995 CSA provided *only* for the Transferee, and not the Transferor, to transfer Interest Amounts. Had the parties intended negative interest to be payable, so argued DB, the agreement would have expressly provided for the transfer of Interest Amounts from the Transferor to the Transferee, which it did not.

DB also referred to the following passage in the ISDA User's Guide in support of its contention that the focus of the agreement was on what the Transferee was to do in return for holding cash collateral, rather than the other way round:

> "*Paragraph 5(c)* [of the 1995 CSA] *provides that the Transferee will pass through to the Transferor any distributions of assets or rights it receives in relation to transferred securities and will pay interest on any cash collateral at the rate (which may be zero if the parties do not want to provide for interest), and in accordance with the method, specified in Paragraph 11*."

Whilst broadly accepting the force of that point, the State relied on the definition of Credit Support Balance in the 1995 CSA (essentially, the aggregate of all credit support received by the Transferee), which included the following words:

> "*Any Equivalent Distributions or Interest Amounts (or portion of either) not transferred pursuant to Paragraph 5(c)(i) or (ii) will form part of the Credit Support Balance*."

The State argued that this required the Transferor to "account" for negative interest by reducing the Credit Support Balance by the absolute amount of such negative interest. Since the Transferor was obliged from time to time to ensure that the Credit Support Balance was sufficient to cover the Transferee's credit exposure, the Transferee would thereby effectively receive the benefit of negative interest indirectly by way of additional credit support from the Transferor.

The State also argued that the commercial purpose of the interest provisions in the 1995 CSA was "equivalence"; that is, to bring about a situation in which neither the Transferor nor the Transferee suffers or benefits from the fact that the Transferee holds collateral (in addition to the fact that such collateral is to be available to the Transferee in the event of termination for default).

The State also relied on ISDA's 2013 Statement of Best Practice for the OTC Derivatives Collateral Process (the "**2013 Statement of Best Practice**") (which suggested that negative rate should be used in the Interest Rate and Interest Amount calculations and therefore negative Interest Amounts may be computed) and ISDA's 2014 Collateral Agreement Negative Interest Protocol (to which the parties had not adhered).

THE ISDA 2014 COLLATERAL AGREEMENT NEGATIVE INTEREST PROTOCOL

In 2014 ISDA sought to address a perceived deficiency in the 1995 CSA, namely that the terms do not oblige a Transferor to pay interest to a Transferee if the reference rate for interest in respect of cash collateral is negative, by way of the ISDA 2014 Collateral Agreement Negative Interest Rate Protocol (the "**Protocol**"). The Protocol amends the terms of the 1995 CSA to ensure, if the reference rate for interest in respect of cash collateral is negative, that interest payments will be made by the Transferor to the Transferee.

Under the Protocol, negative interest can be accounted for in one of two ways: (i) by way of a physical transfer of cash from the Transferor to the Transferee; or (ii) by way of a deduction by the Transferee from the balance of cash collateral held by it of an amount equal to the negative interest amount that the Transferor would otherwise be required to transfer to the Transferee. Economically, the two methods are intended to achieve the same result.

Adoption of the Protocol has not, however, been universal, with the uptake having been more widespread among certain market participants than others. This may be because the payment of negative interest amounts is less problematic for deposit-taking institutions and other financial institutions active in the money markets (because they are more likely to be able to act as pass-through entities that both receive and pay negative interest amounts) than for certain end-users, such as corporates, alternative investment funds and pension schemes, being entities that are less likely to receive negative interest amounts and so must fund negative interest payments from other sources (such as borrowing).

More prosaically, market participants who have not adhered to the Protocol (which, if adhered to, would have had the effect of amending all of that market participant's existing ISDA documentation) may only consider reviewing the terms of their ISDA documentation periodically and so the opportunity to amend the interest provisions of their 1995 CSAs simply may not have arisen in the ordinary course.

The decision

The Court rejected the State's arguments and ruled in favour of DB.

As a starting point, Knowles J emphasised the importance of the well-established principles of interpretation of the ISDA standard form master agreement, which aimed to promote clarity, certainty and predictability (Lomas and others v JFB Firth Rixson Inc and others [2010] EWHC 3372 (Ch)). The Judge considered that the position should not be any different in relation to a 1995 CSA. In addition, in interpreting such agreements, evidence of the particular factual background or matrix in question had a much more limited, if any, part to play as an aid to construction (In Re Lehman Brothers International (Europe) (in administration) (No 8) [2016] EWHC 2417 (Ch)).

With those principles in mind, Knowles J held that the State failed to show that there was any "obligation" on part of the Transferor in respect of negative interest.

Although as a matter of language, the definition of Interest Amount was capable of being a negative figure, this was only a starting point and it was necessary to look at the documentation as a whole to see if there was any obligation as such in relation to it.

Having done so, he found no express obligation on the part of the Transferor to pay or otherwise account for negative interest. Paragraph 5(c)(ii) clearly placed an obligation on the Transferee, but *not* on the Transferor, to pay the Interest Amount. Furthermore, that paragraph expressly allowed the parties to specify the obligations to be otherwise than that stated in the standard form, for example, where that figure would be negative, but they had failed to do so.

As for the definition of Credit Support Balance, "*Interest Amounts (or portion of either) not transferred pursuant to paragraph 5(c)…(ii)*" simply referred to the Interest Amounts that the *Transferee* was obliged to transfer (pay) under paragraph 5(c)(ii) where that figure was positive, but had not yet done so, rather than any negative interest.

The broad implications of the State's case was that positive interest was to be dealt with through the mechanism set out in paragraph 5(c)(ii) of the 1995 CSA, whereas negative interest was to be dealt with through a wholly different mechanism under the definition of Credit Support Balance. In Knowles J's view, there was no credible commercial rationale for the parties to have made such a choice and if they *did* want to deal with negative interest, then bringing it into paragraph 5(c)(ii) would have been the obvious course.

As for the commercial rationale of "equivalence", there were other considerations which would instead support DB's case. For example, there was simplicity in accounting only for positive interest. Furthermore, it did not necessarily follow from the fact that where cash held could be expected to *make* money, some reflection of that benefit should be received by the Transferor, that where it was expected to *lose* money, that some reflection of that burden should be shouldered by the Transferor; they were separate matters.

Finally, as for the 2013 Statement of Best Practice and the Protocol, they were not available to the parties when they made their agreement, and so were neither part of their agreement nor could they assist as part of the context of their agreement. Moreover, the Protocol envisaged extensive amendments to achieve its stated aim of making negative interest accountable, and the parties in this case had not signed up to it.

Conclusions

Although the commercial rationale of "equivalence" put forward by the State in support of negative interest being payable had some force, the result is not surprising, given the wide usage of the ISDA standard documentation for the finance and derivatives market as a whole and the importance of certainty in interpreting its terms. The Judge placed particular emphasis on the literal wording of the contract in arriving at its conclusion. Moreover, the Judge's remarks implied that the existence of the Protocol, with its "major amendment" to paragraph 5(c)(ii) of the 1995 CSA, rather pointed to the existing wording of the 1995 CSA *excluding* an obligation to account for negative interest.

To the extent that there are any ongoing disputes between counterparties in relation to the treatment of negative interest under existing 1995 CSAs, this decision offers a clear answer. To the extent that parties intend that negative interest should be accounted for, they should adopt the Protocol (or otherwise amend the standard form 1995 CSA) to ensure that their documentation reflects their commercial intention.

A FINAL NOTE ON THE 2016 ISDA CREDIT SUPPORT ANNEX FOR VARIATION MARGIN

In 2016 ISDA introduced the 2016 ISDA Credit Support Annex for Variation Margin (the "2016 CSA"), to assist market participants in complying with certain of the mandatory collateralisation requirements of the European Markets Infrastructure Regulation ("**EMIR**").

Despite purporting to update only the terms of the 1995 CSA that require amendment as a result of EMIR (and not pick up other known issues with the 1995 CSA) the 2016 CSA includes a new provision that, in effect, elects for the Protocol to apply (despite this not being an EMIR requirement).

This remains an election in the 2016 CSA (rather than a mandatory provision) allowing market participants to determine whether, commercially, they accept the principle that a Transferor should pay interest to a Transferee if the reference rate for interest payments is negative.

The full text of the judgment in The State of The Netherlands v Deutsche Bank AG [2018] EWHC 1935 (Comm) is available **here**.

FOR FURTHER INFORMATION, PLEASE CONTACT

10 Snow Hill
London EC1A 2AL
T: +44 (0)20 7295 3000
F: +44 (0)20 7295 3500
www.traverssmith.com

Jonathan Gilmour
Partner, Derivatives & Structured Products

E: jonathan.gilmour@traverssmith.com
T: +44 (0)20 7295 3425

Joseph Wren
Senior Associate, Derivatives & Structured Products

E: joseph.wren@traverssmith.com
T: +44 (0)20 7295 3401

Jan-Jaap Baer
Partner, Dispute Resolution

E: jan-jaap.baer@traverssmith.com
T: +44 (0)20 7295 3449

John Lee
Associate, Dispute Resolution

E: john.lee@traverssmith.com
T: +44 (0)20 7295 3744