SLAUGHTER AND MAY

FINANCING BRIEFING
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Negative benchmarks in Europe: considerations for borrowers

INTRODUCTION

Certain benchmarks in common usage in European debt financing transactions, for example, CHF LIBOR, STIBOR, CIBOR and EONIA have been in negative territory for some time. More recently the impact of negative rates has become more significant and widespread as Euribor and euro LIBOR rates (sub-three month maturities) have dipped below zero and pre-existing negative rates have fallen further.

In the absence of clear language there is some uncertainty as to the impact of negative rates under loan, bond and swap terms. As a result, the topic is being raised in many current documentation discussions. This Financing Briefing summarises how negative benchmark rates might affect payments under typical LMA, floating rate note and ISDA terms. It also considers the steps borrowers and issuers are currently taking to retain the economic benefit of negative rates.

LOANS

The effect of negative rates on a borrower's payment obligations under its loan agreements will depend on the terms of the relevant agreement. The interest clause in the LMA's recommended forms of facility agreement provides for the calculation of interest as follows:

> "*The rate of interest on each Loan for each Interest Period is the percentage rate per annum which is the aggregate of the applicable:*
>
> (a) *Margin; and*
>
> (b) *LIBOR or, in relation to any Loan in euro, EURIBOR.*"

It goes on to provide that that the borrower to which the loan has been made shall pay accrued interest on that loan at the specified times (generally, at the end of the applicable interest period).

How would that clause operate if the applicable benchmark is negative?

An English law contract is construed by reference to the intention of the parties entering into the contract, as deduced by the court largely from the natural meaning of the words used by them but also giving some weight to the background matrix within which those words are used. Thus a court would focus on the words used, in the context of the contract as a whole.

Looking solely at the words of the LMA interest clause quoted above, there is no indication that in determining the interest rate, negative rates should be disregarded. Further, if a zero floor is to apply to LIBOR, it is market practice to state that expressly. The LMA's benchmark definitions (for example, "LIBOR" and "EURIBOR") contain optional zero floor wording which provides that in the event the relevant rate is below zero, the rate is deemed to be zero for the purposes of the agreement. This express zero floor language has been quite widely adopted since its introduction in 2011 (see further below), which would suggest its omission to be deliberate in LMA-based agreements concluded subsequently and in particular, more recently. In other words, its absence could be taken as indicative of the parties' intention that negative rates should be taken into account in the interest calculation.

If the word "aggregate" is given its ordinary meaning, the interest rate is the sum of the margin and the relevant benchmark. Thus if an express zero floor is not included in the relevant definitions and the relevant benchmark is negative, it seems probable, based on the LMA's wording, that a court would conclude that the margin will be reduced to the extent of that negative amount.

For example, the rate of interest on a loan in euro drawn on 1 June with a three month interest period and a 0.5% margin would be the aggregate of 0.5% and -0.013% (3 month Euribor on that date), 0.487%.

The construction process is potentially more challenging if the negative amount (the benchmark) exceeds the positive amount (the margin) in the interest rate calculation. Are lenders required to reimburse the borrower the amount of the negative rate (in other words, pay the borrower for borrowing money) under LMA terms?

For example, the rate of interest on a loan in Swiss francs drawn on 1 June with a three month interest period and a 0.5% margin would be the aggregate of 0.5% and -0.788% (3 month CHF LIBOR on that date), -0.288%.

The LMA agreements (and indeed most loan agreements) place no express payment obligation on the lenders in these circumstances. The payment mechanics make provision for payments by the lenders via the agent, but (it may be argued) for the purposes of discharging the lenders' specific payment obligations under the agreement, in other words, their obligations to advance funds to the borrower and to make indemnity payments and sharing payments among themselves.

Where a contract makes no provision for a particular event, the court must determine whether a term should be implied. The absence of an express term often means that nothing is intended to happen in relation to that event. In general, courts are slow to imply terms and will do so only where it is necessary to do so (in broad terms, where the contract will not operate without the implied term or its absence would lead to consequences at odds with what a reasonable person would understand the contract to mean).

Accordingly, the correct interpretation of a loan agreement on LMA terms in circumstances where the overall interest rate is negative is uncertain. It is arguable that a court may be reluctant to find a lender to be indebted to the borrower in the absence of clear words that provide for how that debt is to be discharged (for example, by a reduction in the principal amount of the loan). However, the precise wording used, and the commercial context, will be crucial and may be sufficient to rebut that argument. For example, it is possible that an agreement entered into when rates were positive may be interpreted differently to an agreement entered into when rates were negative.

FLOATING RATE NOTES

As for loans, the impact of negative rates on FRNs depends on the terms of the bond and the general principles of contractual construction outlined above apply.

A typical FRN indenture or trust deed might provide that the coupon on the notes is a rate equal to the sum of the relevant benchmark and a margin (for example, 3 month Euribor plus 5%). Unlike in the loan market express zero floor wording is unusual, but a floor on the overall interest rate is used in some FRNs where the parties wish to make their intentions clear.

Such customary FRN interest provisions, like the LMA interest clause quoted above, do not indicate that in determining the interest rate, negative rates should be disregarded. Therefore if the word “sum” is given its ordinary meaning, the negative rate should be taken into account for the purposes of the interest rate calculation. A negative benchmark rate therefore seems likely to erode the coupon payable to the noteholders.

What if the overall coupon (the sum of the benchmark and the margin) is negative? There is in English law, by contrast to certain jurisdictions in continental Europe, no legal principle standing in the way of an obligation to make payments being imposed on bondholders, but the bond terms must be sufficient to evidence that obligation.

A typical FRN does not make any provision for payment obligations of the noteholder to the issuer. Further, the clearing systems are not set up to process payments by noteholders to the issuer. These factors combined may point to the conclusion that an implied zero floor applies to the overall coupon, in the absence of clear words to the contrary and an agreement as to how the payment mechanics might operate. In the case of bonds this conclusion is arguably strengthened by the practical difficulties in enforcing a payment obligation against bondholders, particularly where bonds are held in a clearing system. As with loans, however, the practical difficulties may not dispose of the question (there is the possibility of netting negative interest obligations against principal repayments). The precise wording used, and the commercial context, will be crucial.

INTEREST RATE SWAPS

Interest rate swap confirmations on ISDA terms generally define the floating rate payer’s obligations by reference to the relevant benchmark rates (eg Euribor). Express wording is required to place a zero floor on the benchmark and such wording is not incorporated in vanilla swaps.

This raises an obvious point for borrowers; if a zero floor applies to the benchmark rates payable on its floating rate debt, there will be a mismatch between the amounts it pays on its debt and the amount it receives (often from syndicate banks) under its interest rate hedging. This may strike borrowers as particularly unfair, given that the hedging may be a requirement of the same syndicate banks and is imposed to require the borrower to protect itself against high floating interest rates; there is no justification for benefiting hedging banks who are also syndicate members where floating rates are extraordinarily low.

WHAT ARE BORROWERS DOING TO MITIGATE THE IMPACT OF NEGATIVE RATES?

Loans

As mentioned above, since its introduction some years ago, the LMA's zero floor language has been quite widely used. However, the language is not included in all agreements and has been deliberately omitted from a number of more recent facilities with the intention that negative benchmark rates should reduce the margin on loans in the relevant currencies. This tends to be after some negotiation and borrowers should anticipate resistance from lenders.

Borrowers should also be mindful that the LMA agreements provide lenders with a means to replace the agreed benchmark with their actual cost of funds. Although rarely invoked in practice in the European market, the LMA "market disruption" clause permits lenders who are unable to fund themselves at the agreed benchmark rate (whether positive or negative) to notify the agent to that effect. If lenders whose participations represent the requisite percentage of a particular loan notify the agent (usually somewhere between 30% and 50%), pending agreement on an alternative, each lender is entitled to charge the borrower its actual cost of funds (usually from whatever source it may reasonably select) in place of the agreed benchmark. This clause makes no specific provision for the consequences of negative rates, but its potential application in this context may provide a further reason for borrowers to negotiate the terms of the market disruption clause in new transactions[1].

We are not yet aware of a borrower that has negotiated express provisions obliging lenders to reimburse the amount by which the negative rate exceeds the margin, should that occur. However, according to reports, there are borrowers seeking to raise that argument.

FRNs

Only a minority of English law FRNs currently contain a floor on the overall interest rate. We have not noted any particular trend (yet) towards the inclusion of floors or other specific language to address negative rates in new transactions.

Market practice continues to be mixed but given recent press coverage this may change. Issuers and lead managers may resolve to specify a minimum overall interest rate of zero given the relatively minor documentation changes required should investors demand them to do so[2].

Interest rate swaps

Borrowers and issuers with zero floors in their floating rate debt obligations are now alive to the potential for mismatch between their interest payment obligations and associated hedging. Some have attempted to address this by matching the floor on their payment obligations in their hedging arrangements.

The difficulty is that the additional cost of a structured swap incorporating a zero floor may outweigh the burden of the zero floor (ie the loss of the benefit of the negative rate under the related debt instrument). We are aware of instances of borrowers having abandoned plans to incorporate zero floors into their interest rate swaps for this reason.

[1] For a fuller discussion of the market disruption provisions for borrowers, see the ACT Guide to LMA Loan Documentation for Investment Grade Borrowers Benchmarks Supplement (November 2014).

[2] In standalone bonds, this would involve a small adjustment to the terms. For programme issues, the ICMA pro forma final terms (if used) contemplate the insertion of a floor on the coupon, which could be set at zero.

COMMENT

Euro benchmark rates are negative but to date, negative rates have been discussed largely in transactions in Swiss francs and the Nordic currencies where negative rates are deeper. The issue is of most immediate significance to the investment grade market, such borrowers being able to access funds at lower margins. The extent to which borrowers and issuers are willing to fight to maintain the upside of negative rates will obviously depend on how seriously they are affected going forward.

Treasurers must form their own views on how low rates will go. However, if more rates become negative and/or negative rates continue to fall, the inclusion of zero floors in loan and FRN documentation (or the cost of matching swaps) will become a significantly more contentious and widespread issue and in the loan market at least, a relationship point.

Negative deposit rates will be on the minds of most treasurers operating in Europe in any event, but their potential implications for debt financing transactions should also be borne in mind. For example, cash collateral arrangements may be used in loan finance transactions to secure letter of credit exposures, mandatory prepayment obligations or the borrower's obligations to its lenders generally. In relevant cases, in addition to the impact of negative benchmarks on the facility pricing, it may be necessary to think about the potential for those deposits to be eroded, how to mitigate that and whether leakage is permitted under the terms of the finance documentation.

For further information on the issues raised in this briefing, please contact any of the lawyers below or your usual adviser at Slaughter and May.

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