



Client Briefing, May 2019

Negative Interest on Swaps Collateral

On 2 May 2019, the English Court of Appeal ruled in the case of *The State of The Netherlands v Deutsche Bank* on whether negative interest accrued on cash collateral posted under an English law title transfer ISDA Credit Support Annex (the "CSA"). Paragraph 5(c)(ii) of the CSA provides for the transfer of positive interest from the Transferee to the Transferor. The question was whether, in circumstances where rates were negative, the Transferor had an obligation to account for negative interest. The trial judge held that it did not.

Arguments on appeal by the State. The State argued that although paragraph 5(c)(ii) did not create an obligation to transfer a negative amount, it did not mean it did not have to be accounted for. It argued that the definition of "Credit Support Balance" ensures that a running total is kept under the CSA and that positive and negative interest is taken account of on termination. In addition, the commercial purpose of the CSA is to provide credit protection, not to enable the collateral receiver to make money; that was why both positive interest and distributions had to be passed on.

Arguments on appeal by the Bank. The Bank argued that the absence of an express provision in the CSA or the ISDA User's Guide demonstrated that it was not intended that negative interest would be accrued or paid. In response to the State's arguments, the Bank pointed out that this would require a number of asymmetries between how positive and negative interest is accrued and paid under the mechanics of the CSA.

Decision of the Court of Appeal. For the Court of Appeal, an analysis of paragraph 5(c)(ii) was too narrow. Its approach was instead to consider the CSA as a whole. It did not believe that the CSA could be taken as providing for the payment of negative, as opposed to positive, interest. In addition to some fact-specific points, the reasoning of the judges included the following:

1. The ISDA User's Guide and various ISDA statements of best practice on negative interest did not show that ISDA thought that negative interest was intended to be payable under the standard form of CSA.
2. Paragraph 5(c)(ii) covers positive, but not negative, interest.
3. The fact that Interest Amounts were excluded from both the Minimum Transfer Amount and the Rounding provisions created an "inexplicable disparity" between the way in which positive and negative interest would be accounted for.
4. The court saw nothing in the CSA read as a whole that gives the impression that negative interest was contemplated or intended. Interest would, of course, be swept up on a default, but that did not mean that negative interest, which might (as turned out to be the case) be theoretically payable for years, would be likely, if intended to be payable at all, to be excluded from paragraph 5 that deals with Interest Amounts.

Clients will be familiar with ISDA's Negative Interest Protocol, which is incorporated by reference by some dealers in more recent CSAs. Clients may wish to check the position across their CSAs to ensure consistency.

If you wish to discuss this topic in more detail, please contact your relationship partner or Dan Harris at daniel.harris@chanceryadvisors.com.

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