

## UK: Prospect of negative interest rates adds to issues to be considered in LIBOR transition

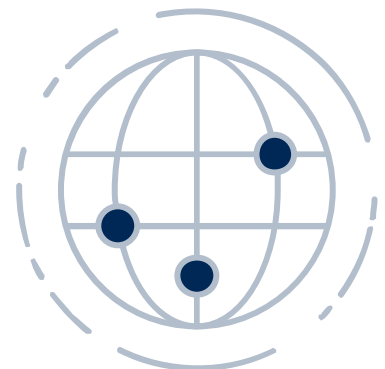
### In brief

On 12 October 2020, the UK Prudential Regulation Authority (PRA) published Dear CEO letters. In the letters, Sam Woods, the Bank of England deputy governor and PRA CEO, commenced his engagement with the largest UK deposit-taking banks over the prospect of zero or negative interest rates. Whilst we are yet to see the Monetary Policy Committee make a move to negative rates, the prospects for this have increased.

As the loan market transitions away from the use of London Interbank Offered Rates (LIBORs) to alternative near risk-free rates (RFRs) by the end of 2021 (or June 2023 in the case of most USD LIBOR tenors), lenders and borrowers should focus on the impact of negative rates in applying those RFRs in practice, including the use of interest rate floors and the interaction with any loan-linked hedging.

### Key takeaways

- The Bank of England has raised the spectre of negative rates for Sterling. This is an added layer of complication for the ongoing reform to LIBOR.
- Near risk-free rates are structurally and economically different from LIBORs. Market solutions developed for negative interest rates for LIBOR-referencing loans require amending for RFR-referencing loans.
- Parties must consider whether an interest rate floor should apply (and the correct level), whether it should be applied to each day's RFR or to the overall compounded RFR at the end of each interest period, and whether it should be applied to the RFRs only or to the aggregate of the RFRs and any credit adjustment spread.



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- The potential for hedging mismatches already exists for LIBOR-referencing loans where loan-linked hedging does not contain a matching interest rate floor but additional mismatches may occur where different RFR calculation methodologies are employed in the two products.

## In more detail

At various times over the last decade or so, central banks in a number of countries have adopted negative interest rate policies. With the UK PRA's 12 October 2020 Dear CEO letters, the Bank of England has now raised the prospects of negative interest rates for Sterling.

Since the inception of LIBORs in the late 1960s, they have become the near-ubiquitous choice for floating-rate financial products. LIBORs are used as a proxy for a lender's cost of funds in making a loan available to a borrower; to reflect the borrower credit risk (and to give the lender its profit) a margin is added and the borrower is required to pay LIBOR plus margin.

Today, as a result of current central bank policies, LIBORs are in negative territory for Swiss Franc, Japanese Yen and Euro and we are now facing the real prospect of the same for Sterling.

For borrowers, negative interest rates may sound like an excellent idea but things are rarely that simple ...

For LIBOR-referencing loans, logic and simple maths mean that a negative LIBOR will eat into the lender's margin. It remains an open question whether a lender could ever be required to pay "interest" to a borrower if a negative LIBOR was greater than the margin. However, the better view is that it should not. Loan agreements do not contain any wording obliging a lender to make such interest payments to a borrower or the payment mechanics for doing so. A similar argument was successfully made in the context of a collateral arrangement used in the derivatives market (*The State of the Netherlands v. Deutsche Bank AG [2019] EWCA Civ 771*).

Over the years, LIBORs have been increasingly divorced from lenders' actual costs of funds. Lenders rightly point out that a negative LIBOR does not equate to negative actual funding costs for them and does not mean the credit risk on the borrower is lowered in such a way that a consequential reduction in margin is justified. To address those concerns, interest rate floors have been a feature of the floating-rate syndicated lending market for a number of years. An interest rate floor simply means that if a LIBOR is lower than a certain level (usually zero, but in certain markets, it may be 50 or 100 basis points or even higher), a borrower will be charged that floor level plus margin.

For LIBOR-referencing loans, the main borrower concern has been handling any mismatch arising from hedging its floating-rate loan with a swap contract that does not also include the same floor. The vast majority of hedging takes place under standard form documents issued by the International Swaps and Derivatives Association, Inc. (ISDA). The default position under the 2006 ISDA Definitions is that for an interest rate swap transaction the Negative Interest Rate Method applies; accordingly where LIBOR is negative, the floating rate hedging counterparty is deemed not to owe anything and instead the borrower is required to pay an amount equivalent to the absolute value of the negative amount to the hedge counterparty. That would result in a double hit for the borrower because it is required to pay a negative amount to the hedge counterparty (in addition to the agreed fixed amount payable under the interest rate swap transaction) but does not gain the benefit of any reduction in LIBOR below zero to reduce the amount payable by it to the lender. For example, if a borrower wishes to cap its interest payments at a maximum of 6% in relation to LIBOR plus 400 bps loan, it may enter into a swap whereby it agrees to pay a fixed rate of 2% to the hedge counterparty (that will be the floating-rate payer). If LIBOR is -0.5%, then, according to the Negative Interest Rate Method, the borrower would be required to pay the hedge counterparty 2.5% (being the fixed rate of 2% plus the negative LIBOR of 0.5%) and the hedge counterparty would not be required to pay anything to the borrower. It would also be required to pay 4% (being LIBOR or zero



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plus 4% margin) to the lender. Its total payment would be 6.5% (rather than the planned maximum of 6%). This is a difficult issue for borrowers because, whilst they may wish to amend the hedging documentation to reflect the zero floor in the related facility agreement, this may not be acceptable to the hedge counterparty and could be a more expensive option. Another option is for the borrower to take out a cap rather than a swap to avoid this problem altogether.

So far so good, but borrowers and lenders now also need to grapple with the much-anticipated cessation of LIBORs (expected around the end of 2021 for most currency and tenor pairs other than the most widely-used US Dollar LIBOR tenors which are expected to be published until 30 June 2023). The move away from LIBORs to alternative RFRs, such as Sterling Overnight Index Average ((SONIA) for Sterling borrowings) adds another layer of complexity to the picture.

RFRs are structurally and economically different to LIBORs. RFRs are daily rates. There are various possibilities for applying RFRs to a longer period; for example, one day's RFR could be chosen and applied to the entire period. However, to even out daily volatility, most financial products are settling on a compounded average of the RFRs over the period. Compare this with LIBORs, forward-looking rates that are known at the start of, and applied for, the relevant period.

The first issue, therefore, is whether any interest rate floor should be applied to the daily RFRs or to the compounded average figure arrived at the end of the period. The latter may appear more favourable for a borrower; if one or two daily RFRs within any period are negative, they receive the benefit in the reduction in the overall compounded average and, unless the compounded average is less than the floor, no adjustment is made. However, calculating compounded RFR averages involves a relatively complicated formula. A number of countries, including the US, Switzerland and the UK, are now producing indices (and, in the case of the US and Switzerland, period compounded averages) for compounded RFRs to assist those tasked with calculating these rates. The indices do not include daily RFR floors and so it is only possible to use those tools if any zero floor is applied at the end of the relevant period. To complicate matters further, the loan product needs to deal with the possibility for intraperiod events, such as prepayments and, in the case of syndicated lending, loan transfers and assignments. The US and the UK regulators have hit upon different recommendations for accommodating this requirement (which you can read about in our article "[In the Know: From one into many — Replacement rates for LIBOR](#)"). However, assuming a compounded average RFR is being used (which is the UK recommendation and an acceptable alternative in the US), a daily noncumulative compounded rate formula needs to be used to allow for interest accruals to be calculated each day. This method lends itself most easily to the application of any floor to the daily rate. If a floor was only applied at the end of the period to the combined daily accruals, this would require retrospective adjustments to those daily accruals that had formed the basis on which loan transfers and prepayments with accrued interest may have been made during the period. Consequently, the official recommendations from both the UK and US regulators are to apply any interest rate floor to the relevant daily RFRs.

Second, RFRs are not a proxy for a lender's cost of funds and are typically always lower than LIBORs. For Sterling, SONIA has historically tracked the Bank of England's base rate very closely, even in times of market stress. The same cannot be said for LIBOR, where volatility and liquidity issues can cause a marked deviation between LIBOR and SONIA. This was seen most recently during the early days of the coronavirus outbreak in the UK, where SONIA tracked downward when the Bank of England cut its base rate to 0.1% but Sterling LIBORs spiked upward. One of the key challenges in LIBOR transition is the extent to which, and how, a lender can reflect that "cost of funds" element, which is missing in RFRs, in the overall interest charged to a borrower. Regulators have recognised the rationale for a credit adjustment spread (CAS) to be applied to the RFRs when transitioning. This CAS can be documented as a separate component of the total interest (RFR plus CAS plus margin) or can be subsumed within the margin (RFR plus (higher) margin). Where a LIBOR-referencing loan containing an



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interest floor switches to an RFR-based loan, there is a question as to whether an interest rate floor should apply at all, whether it should apply to the RFR component only or to the combined RFR plus CAS. Given that CAS is intended to minimise any transfer of economic value as a loan moves from a LIBOR to an RFR basis, fairness suggests that any interest rate floor should be applied to the aggregate of RFR plus CAS. If CAS is subsumed within the margin, then that becomes tricky to effect in practice. This will be an increasing issue as we move into 2022 and beyond in a world where all loans are based, from inception, on RFRs. New loan pricing will not (necessarily) have to take into account the old realities of LIBOR. The recommendations from regulators relating to how a CAS should be calculated only apply to the transition of existing LIBOR-referencing loans and not to loans that reference RFRs from day one. Those recommendations envisage a CAS that is fixed rather than credit-sensitive and dynamic and, as such, there will increasingly be discussions around the necessity for documenting two separate fixed components on top of the floating RFRs (i.e., CAS and margin) rather than combining them as one. However, there will be an incentive for borrowers to retain the separate components if interest rate floors apply, so that the floor can be applied against the aggregate of RFR plus CAS rather than the RFR alone (which would more likely trigger the invocation of any floor).

For loan-linked hedging for RFRs, in addition to the already-mentioned possible mismatch if no zero floor is included in the hedging arrangements but is included in the loan agreement, the new standard ISDA documentation will present a further mismatch opportunity (you can read more about the new ISDA documentation in our article ["ISDA 2020 IBOR Fallbacks Protocol and ISDA 2020 IBOR Fallbacks Supplement - The Next Phase of IBOR Transition Begins for the Derivatives Market"](#)). For a fixed/floating interest rate swap transaction, the RFR component is calculated using the cumulative compounded rate approach (and a two-business day lookback period and an observation shift). Whilst the overall interest for a period should be the same if calculating using the cumulative and noncumulative approaches (provided certain rules relating to rounding conventions are followed), this would not be the case if the hedging applied a floor to the result of the cumulative calculation and the loan agreement applied daily floors. In addition, whilst the standard market position is still evolving, official recommendations for US dollar and Sterling loan agreements contemplate a longer lookback period and/or a calculation methodology without an observation shift.

Lenders will also be paying increasing attention to interest rate floors as a means of ensuring a certain level of return. In syndicated loans, lenders have typically been able to call on the borrower to pay more interest if a certain percentage of them consider that their actual cost of funding the loan exceeds LIBOR (a so-called "market disruption" clause). This type of clause is predicated on the assumption that LIBOR was a proxy for lenders' funding costs. With the move to RFRs, that link is broken and market practice around the continued use and form of market disruption clauses in RFR-referencing loans is underdeveloped. If market disruption clauses do fall out of favour, lenders may look, in the alternative, to include above-zero interest floors as a buffer.

Lenders and borrowers should not lose sight of the impact of negative interest rates among all the other LIBOR-transition considerations. All parties must consider whether an interest rate floor should apply (and the correct level), whether it should be applied to each daily RFR or to the overall compounded RFR and whether to the RFRs only or to the aggregate of the RFRs and CAS and, of course, minimising any hedging mismatches.

You can read more articles from Baker McKenzie on LIBOR transition at our [LIBOR Transition Hub](#).





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