ICMA

Appendix A9a

Negative interest rates

Insert 2016-07

Appendix A9a - Negative interest rates

1. Concerns periodically arise in relation to negative reference interest rates and the impact they may have on payments of interest or repayment of principal under floating rate bonds. In terms of payments of coupons and redemption amounts under existing bonds, this should predominantly be a legal question, although structuring decisions on new bonds may have a market practice element. Set out below are some relevant considerations. *July 2016*

2. The impact of negative interest rates will generally be decided by the terms and conditions applicable to the bond concerned, which are usually set out in the related contractual documentation (although sometimes provisions of general law will be relevant) and disclosed in a related offer document. To understand the impact of a negative interest rate on individual bonds, market participants will need to review the relevant terms and conditions and may wish also to consult their legal advisers. *July 2016*

3. In this respect, ICMA understands that typical English law governed terms and conditions for non-structured ('vanilla') bonds: *July 2016*

   (a) might sometimes expressly provide that the minimum interest due by the issuer in any case is zero or a specified minimum margin but generally would not, since it is implicit;

   (b) customarily only provide a 'promise to pay' by the issuer, with no corresponding contractual promise by investors to pay anything (investors usually having already discharged their contractual obligations by paying the subscription/purchase price of the bonds);

   (c) would not provide that any negative interest can be offset against subsequent positive interest due or principal redemption; and

   (d) are not interpreted by market participants as requiring any interest payment by investors where the rate becomes negative (leaving aside whether that would be practicable – see further below) or allowing any negative interest to be offset against subsequent positive interest due or principal redemption, in the absence of any express provision to the contrary.

4. Requiring payments of interest by investors is not compatible, at least under English law, with the concept that bonds are negotiable instruments. Indeed, any provision requiring payments by investors would alter the nature of the one-way promise to pay by the issuer and so require structural changes to bond documentation and secondary market trading practices. Clearing system and stock exchange eligibility criteria are also unlikely to be satisfied. Careful consideration of prominent disclosure of any such terms to investors would therefore be essential (and see R3.9). *July 2016*

5. ICMA further understands that some structured debt securities might specifically provide for negative interest to be offset against subsequent positive interest due or principal redemption or a 'negative' payment by investors, perhaps because such securities were specifically structured to match as closely as possible[1] a related derivative contract (e.g. under ISDA's contractual architecture[2]) but that such securities are likely to be bespoke, with the investors concerned fully participating in (and thus knowledgeable of) the initial structuring. Careful consideration of prominent disclosure of any such terms to investors is nevertheless essential (and see R3.9). In addition, advice may be needed in relation to the tax and accounting consequences of such provisions in any relevant jurisdictions. *July 2016*

6. ICMA also understands that some issuers of non-structured bonds may (for various reasons) wish to enter into a related derivative contract to swap their obligation to pay floating rate interest for an obligation to pay fixed rated interest. Under such a swap, the issuer will pay a fixed rate (say 3%) and receive a floating rate nominally corresponding to the rate on the underlying debt security (say LIBOR plus 0.15%). Such issuers may be unwilling to pay the extra cost to include a 'floor' on the floating leg of the swap. This means that if LIBOR was negative (say minus 0.25%), the issuer would be bound to pay the swap counterparty the 3% fixed leg plus the 0.1% negative margin on the floating leg (LIBOR at minus 0.25% plus 0.15%). In so doing, issuers are consciously taking a mismatch risk with the underlying bond in light of paragraph 3 above. *July 2016*

Notes

1. *A complete match is impracticable. See A3.*

2. *Incidentally, ISDA published the ISDA 2014 Collateral Agreement Negative Interest Protocol on 12 May 2014.*