# Below zero

## As the Swiss National Bank introduces negative interest rates, Prager Dreifuss's Daniel Hayek and Nadja Zink discuss strategies for derivative transactions

The Swiss National Bank (SNB) lifted the fixed minimum exchange rate for Swiss Francs (CHF) to Euros (EUR) and introduced 'negative interest rates' of -0.75% per annum as of January 22 2015.

Interest in the legal sense is usually qualified as part of a consideration that the lender receives from the borrower in return for giving money to the borrower. In addition, interest in the legal sense depends on the amount of money that is being lent as well as the length of time it is lent for.

So far, negative interest rates have not affected deposits of customers at banks. Banks have not been passing negative interest rates on, with the exception of charges on very large deposits of companies, and Alternative Bank Schweiz which has introduced negative interest rates on its customers' deposits irrespective of size.

### Loan contracts

However, negative interest rates have affected loan contracts. Loan contracts often determine that the lender is to receive payments that are the sum of a margin plus interest. The rate of interest is often linked to a floating reference rate such as three-month CHF Libor [London interbank offered rate]. Since the introduction of negative interest rates by the SNB, three-month CHF Libor has noted negative and other reference rates such as three-month Euribor [euro interbank offered rate] are also negative. This raises the issue whether negative interest rates lead to erosion of the lender's margin and, if sufficiently negative, result in an overall negative interest rate. After an initial transitional phase most Swiss banks and other lenders have addressed this issue by amending their existing loan agreements and incorporating a 'zero floor'. The applicable interest rate such as, for example, Libor, is then determined to be never less than zero, that is, it is 'floored' at zero. Further, industry associations such as the Loan Market Association, International Swaps and Derivatives Association (Isda) or Swiss Bankers Association have adapted the definitions for their standard contracts to incorporate a zero floor. By providing for a zero floor, the lender's margin is therefore protected where reference interest rates such as Libor or Euribor are negative.

### Interest rate swaps

Other transactions affected by a negative interest rate environment are derivatives such as fixed-to-float interest rate swaps. Fixed-to-float interest rate swaps provide that one party (A) exchanges a fixed interest rate with a floating interest rate such as three-month CHF Libor with another party (B). In an environment of positive interest rates B would pay A the floating reference rate while receiving fixed interest rate payments from A. Where interest rates are negative the question arises whether B is entitled to receive payment of the notional amount of the negative floating rate. If so, A not only has to pay B the fixed interest rate but also the notional amount of the negative floating interest rate, thus having to pay twice while B is receiving payments twice.

In contrast to loan agreements, interest rate swaps purport to hedge interest rate risk. They are a means of making loans cheaper to give for lenders and thus also cheaper to receive for borrowers because the interest rate risk inherent in a loan with a floating reference rate can be passed on to the counterparty of the interest rate swap. However, since the very essence of interest rate swaps is to hedge interest rate risk they do not easily lend themselves to incorporating a zero floor. Accordingly, section 6(4) Isda 2006 definitions as well as Part C section 3.3 of the Swiss Master Agreement for OTC [over-the-counter] derivative instruments determine that a negative interest rate method which fully reflects negative reference rates applies unless the parties choose the zero interest rate method. Failure to make an explicit choice will therefore oblige A to pay both the fixed and the floating rate to B if the floating rate such as three-month CHF Libor is negative. Even though it is possible to choose a zero floor in order to align the interest rate swap with an underlying loan which is floored at zero this will only be available to A at additional cost. If A is a borrower these additional costs may be so high as to outweigh the burden of a zero floor, in other words, not being able to profit from a negative interest rate, in the underlying loan. This leads to A's interest rate swap dealing differently with negative interest rates than A's loan contract. The interest rate swap fully reflects negative interest rates loan whereas the underlying loan contract incorporates a zero floor. As a consequence, A's interest rate swap no longer accurately reflects the interest rate risk of A's underlying loan.

> "This raises the issue whether negative interest rates lead to erosion of the lender's margin

### Negative interest rates and hedging

In this respect, the question arises whether interest rate swaps are affected by recently enacted financial markets legislation. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), European legislation such as Regulation Number 648/2012/EU (Emir) as well as the Swiss Financial Markets Infrastructure Act (FMIA) and the Financial Markets Infrastructure Ordinances (FMIO and FMIO-Finma), OTC derivatives have to be cleared through a central counterparty (CCP). This can generate substantially higher costs for parties and potentially reduces their flexibility when hedging positions.

#### *Swiss Financial Markets Infrastructure Act and clearing obligations*

FMIA, FMIO and FMIO-Finma, which entered into force on January 1 2016, mirror the European rules as set out in Emir and related legislation and potentially affect any party who has its seat in Switzerland. The FMIA establishes a general obligation to clear OTC derivatives, that is, derivatives which are not traded on a formal exchange, through CCPs. However, certain OTC derivative contracts are entirely exempt from the clearing obligation established under FMIA, just as under the Dodd-Frank Act and Emir. The Swiss Financial Markets Supervisory Authority (Finma) is competent for defining the classes of OTC derivatives that fall under the clearing obligation. Finma has not yet defined any of the classes of OTC derivatives that are to fall under the clearing obligation. However, Finma will determine which classes of OTC derivative contracts will fall under the clearing obligation according to the same criteria as under Emir. This means Finma will take into account the degree of standardisation as well as the liquidity, trading volumes, the availability of pricing information and counterparty risks associated with the OTC derivative when determining the classes of OTC derivative contracts which fall under the clearing obligation. Even though Finma has not yet defined any of these classes of OTC derivatives, inferences can be made from the situation in the EU. So far, even in the EU, only the class of 'interest rate derivatives' has been specified. Under EU legislation, basis swaps, fixed-to-float swaps, forward rate agreements and index overnight swaps in EUR, GBP, JPY and USD referencing Euribor or Libor, fall under the clearing obligation. It is thus likely that Switzerland will make similar classes of interest rate derivatives, such as fixed-to-float interest rate swaps referencing CHF Libor, subject to the clearing obligation through a CCP under FMIA as well.

However, even when trading OTC derivatives that are generally within the ambit of the clearing obligation, such as fixed-to-float interest rate swaps referencing CHF Libor, certain parties are exempt from the clearing obligation under FMIA. Parties are not subject to the clearing obligation through a CCP under FMIA if their rolling average of gross positions in OTC derivatives does not exceed a certain threshold. The reason is that the volume of OTC derivative transactions in which these parties engage is considered to be too small to cause systemic risks for financial markets. In this respect, the FMIA distinguishes between financial and non-financial counterparties. Broadly speaking, banks, insurance, reinsurance and fund management companies, parent companies of financial or insurance groups, collective investment and pension schemes as well as investment foundations are financial counterparties under the FMIA. Any other party, for example an independent external asset manager or a company of the real economy, qualifies as non-financial counterparty.

For non-financial counterparties the rolling average of gross positions is calculated with reference to each particular class of OTC derivatives. For OTC interest rate derivative contracts the relevant clearing threshold is CHF 3.3 billion ($3.3 billion). OTC derivative contracts which protect non-financial counterparties against their commercial risks (hedging transactions) do not count towards this threshold. Once the threshold is exceeded, however, all OTC derivative transactions, no matter whether they are for hedging or other purposes, need to be centrally cleared. Any party who has its seat in Switzerland and concludes OTC derivative transactions, therefore, needs to be aware that it is potentially subject to the clearing obligation established under FMIA.

### *Do negative interest rates affect clearing obligations?*

It is important for a non-financial counterparty to know whether a hedging transaction that deliberately opts against mirroring the interest rate risk of the hedged transaction no longer qualifies as protecting the party against its commercial risks and is therefore more likely to put the party into the scope of the clearing obligation.

Where party A to the interest rate swap is paying both the fixed and the floating rate to party B because the floating rate is negative but A's related loan contract is floored at zero, the interest rate swap no longer accurately reflects the underlying risk. During a transitional phase, when negative interest rates had only been recently introduced, it could be argued that the hedging relationship was nevertheless effective because it reflected the underlying risk when viewed retrospectively. Even then, this qualification was called into question when viewed prospectively. In any event, where interest rates have been negative for a while and A's obligations stem from contracts which were concluded when reference rates were already negative, a qualification of the hedging relationship as effective may be questioned even when viewed retrospectively.

FMIA and FMIO determine that macro, portfolio or proxy hedging and transactions which qualify as hedging transactions according to international accounting standards such as the International Financial Reporting Standards (IFRS), do not count towards the clearing threshold. In addition, the European Securities and Markets Authority (Esma) has clarified that the definition of hedging transactions under the relevant EU legislation is wider than the definition under IFRS. Since the Swiss legislation is supposed to mirror the EU regulation in this respect, it can be assumed that the same applies to Switzerland. It is unclear as yet whether micro hedging has been deliberately left out so as not to fall under the exception granted by the Swiss legislation.

On the one hand, this indicates that an interest rate swap without zero floor would still be considered a hedging transaction for

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the purposes of FMIA and FMIO. On the other hand, reference to the IFRS points to International Accounting Standard 39 (IAS 39). IAS 39 requires an expectation that the hedging instrument's fair value or cash flows offset changes in the fair value or cash flow of the hedged item in order to qualify as a hedging instrument. This would require an expectation that the fair value or cash flow of the interest rate swap offsets changes in the fair value or cash flow of the corresponding loan in order for the interest rate swap to qualify as a hedging instrument. However, an asymmetry between the hedged loan with a zero floor and the interest rate swap without zero floor renders the hedging relationship ineffective. Consequently, it can be argued that the fair value or cash flow of the derivative are no longer expected to offset changes in the fair value or cash flow of the hedged item. This reasoning applies even more when interest rates have been negative for a while and are considered to be representative for the future interest rate environment. As a consequence, transactions under such interest rate swaps would count towards the clearing threshold and would be more likely to make A subject to the clearing obligations under FMIA.

> **Any party with its seat in Switzerland that concludes OTC derivative transactions is potentially subject to the clearing obligation established under FMIA**

No other indicators, such as case law, are available since the Swiss legislation only entered into force on January 1 2016. Even under EU legislation there is no clear guidance on whether deliberate asymmetry between a loan and the derivative has any consequences for calculating clearing thresholds. Consequently, parties need to monitor developments closely and prepare to react to any future guidance of authorities such as Finma and Esma.

## Outlook

On March 17 2016 the SNB stated that it expects to continue its expansive monetary policy and charge negative interest of -0.75% per annum on deposits for the next two years. Likewise, the European Central Bank (ECB) announced on March 10 2016 that it will keep interest rates on deposit facilities at -0.4%. Even though the US Federal Reserve raised its interest rates on December 17 2015, it is less than certain that a positive interest rate environment is to return any time soon and parties should revisit their strategies for generating interest accordingly. Parties engaging in OTC derivative transactions need to monitor the developments under Emir and related legislation such as the Swiss FMIA and FMIO as well as under the Dodd Frank Act. Here, parties need to watch out for clarifications on whether divergences in interest rates between a hedged item such as a loan with a zero floor, and the hedging instrument such as an interest rate swap following the negative interest rate method, affect their clearing obligations under the relevant legislation.