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Court of Appeal Clears Up ISDA CSA Uncertainty: No Negative Interest accrues

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The Court of Appeal has issued its judgment in a recent case The State of The Netherlands v Deutsche Bank AG [2019] EWCA Civ 771 in which the issue under dispute was simple: did negative interest accrue on substantial amounts of cash collateral posted by Deutsche Bank AG (the "Bank") and held by The State of the Netherlands (the "State") under the terms of a fairly standard version of the 1995 ISDA Credit Support Annex (English Law - Transfer Form) (the "CSA")? The Court of Appeal agreed with the first instance Judge in deciding that the State's claim for "negative interest" failed.

In today's derivatives market, parties would typically expect interest to be paid by a collateral provider when the agreed interest rate yields a negative figure; however, the collateral relationship in this case was set up many years ago before such an interest rate environment was a reality. Accordingly, the position was not explicitly dealt with in the contract. The State proposed an "*ingenious interpretation*[1]" in an attempt to convince the Court that negative interest could be accounted for under the terms of the CSA. However, the Court, having considered the contract as a whole, chose instead to adopt the other available rival interpretation proposed by the Bank, which it felt was more consistent with "*business common sense*"[2]. The Court concluded that the parties simply had not put their minds to negative interest at the time of entering and amending the CSA. Moreover, the Court felt it was not unfair to exclude negative interest as the derivatives market around the time of the execution of the CSA was of the view that interest under a CSA should be floored at zero as was evidenced by an ISDA Best Practice statement issued soon after the CSA was executed.

The decision may not be the outcome that derivatives market participants wanted. However it will at least provide a degree of guidance as to how the ISDA 1995 CSA should be interpreted. This may enable other disputing parties to settle their disputes out of court. Having said that, a number of issues in this case revolved around the factual matrix and the timing of the entering into of the arrangements as regards the various industry Best Practice statements and ISDA Protocol amendments regarding negative interest rates. It is possible therefore that some collateral takers will nonetheless seek to claim negative interest where their factual matrix supports a claim.

Other noteworthy points arising from the case:

- This is one of few cases where the Courts have been called upon to interpret the ISDA CSA. The judgment provides a very interesting (and succinct) overview of the key cases on the topic of contractual interpretation.

[1] See Judgment para 62.

[2] See Judgment para 53.

- The Court considered the pre- and post-contractual factual matrix surrounding the arrangements and unusually gave some evidential value to post-contractual facts as indicative of ISDA's thinking at or around the time of the CSA.

Case Background

In March 2001 the parties, The State of The Netherlands (the "State") and Deutsche Bank AG (the "Bank"), entered into an ISDA Master Agreement and Credit Support Annex based on the 1995 ISDA Credit Support Annex (*English Law - Transfer Form*) standard version (the "CSA") to govern the exchange of collateral arising from their derivatives trading relationship. Nine years later in March 2010 they agreed to amend the CSA into the form under consideration in the dispute. A couple of negotiated provisions mean that the CSA cannot be said to have been totally standard, namely,

1. **One-way Collateral** - The CSA provided for one-way collateral payable by the Bank to the State. As is commonly done by parties wishing to have a one-way collateral arrangement, the parties agreed to include a statement that the term "Transferor" when used in the CSA would always and only be read to refer to the Bank and the term "Transferee" to refer to the State.
2. **Bespoke Floor Provision** - Another bespoke provision was included which became relevant to the dispute. Under this bespoke provision interest would be floored at zero if the Bank paid the cash collateral to the wrong account at the State's bank (the "Bespoke Floor Provision").

   The parties had agreed that the interest rate payable on collateral would be EONIA minus 4 basis points (the "Interest Rate"). In June 2014 the interest rate environment meant that the Interest Rate became negative for the first time. The Judge highlighted a number of market initiatives which formed part of the factual matrix that the Court considered in coming to its judgment some of which occurred before, and others after, the relationship commenced.

- 1999 ISDA User's Guide to the ISDA Credit Support Documents under English Law – Has a section on "*Distributions and Interest Amounts*" but makes no reference to negative interest[3].
- 30 June 2010 ISDA issued a statement Best Practices for the OTC Derivatives Collateral Process The statement contained a section "*Flooring of Interest Rates*" which provided for the principle that "*[a]t no point should the interest accrual (rate minus spread) drop into a negative figure. If this occurs the rate should be floored at zero"*[4]. It acknowledged that *"[m]any Credit Support Annexes were written and agreed when it was not anticipated that interest rates would reach extremely low levels"*.
- 30 November 2011 ISDA issued another statement Best Practices for the OTC Derivatives Collateral Process This second statement also contained a section "Flooring of Interest Rates" which amended the principle so that "[i]n the circumstances where market conditions cause the interest accrual (rate minus spread) to drop to a negative figure and the CSA is not explicit on the flooring of interest rates, parties should bilaterally agree interest accrual handling."
- 23 October 2013 ISDA issued a further statement Best Practices for the OTC Derivatives Collateral Process adding a section on "*Negative Interest rates*" which summarised that "*where the floating rate index (e.g. OIS rates such as Fed Funds,*

[3] See Court of Appeal Judgment para 11.

[4] See Court of Appeal Judgment para 13.

EONIA, SONIA, etc) sets in the market at a negative level, then under the standard published text of the CSA this negative rate should be used in the Interest Rate and Interest Amount calculations."

12 May 2014 ISDA published its Collateral Agreement Negative Interest Protocol. This gave parties wishing to provide explicitly for negative interest a simple mechanism to amend their Credit Support Annexes to do so. It was also accompanied by a Background Note which explained that the 2014 Protocol had been developed to address the concerns of ISDA members that "if negative interest rates were to set in OIS benchmarks used as the Interest rate for cash collateral it may be unclear how such negative rates should be treated under ISDA collateral documentation". The Background Note also indicated that an ISDA Study Group (composed of derivative dealers and end-users) had considered it desirable, from a commercial perspective, for negative interest to flow so as to be economically consistent with other areas of the market (e.g. the wholesale funding market (where much collateral is funded), the repo market (where much collateral is sourced or deposited) and the cleared OTC derivative market (where many collateralized trades are hedged). The note also acknowledged that the issue of negative interest rates remained an "*important and timely issue to resolve*".

Deutsche Bank's argument

The Bank submitted that the sole interest obligation was in paragraph 5(c)(ii) of the CSA and that provision simply did not require payment of negative interest. If negative interest had been intended, it would have said so in paragraph 5(c)(ii). Moreover, the parties confirmed, rather than amended, paragraph 5(c)(ii) at paragraph 11(f)(ii) (i.e. the *Distributions and Interest Amount* Elections section of the CSA). Therefore, when considering the CSA as a whole they submitted that the parties to the dispute never contemplated or intended negative interest would be accrued or paid.

The State of Netherland's argument

Whilst acknowledging that paragraph 5(c)(ii) of the CSA provides only for the transfer of positive interest from the State to the Bank, the State submitted that the provisions of the CSA that relate to the "delivery" and "return" of collateral require that negative interest is accounted for " *the State submits that the defined term "Interest Amount" can include negative interest, and the definition of "Credit Support Balance" requires that that negative interest should form part of the "Credit Support Balance*."[5] In other words, it argued the fact that negative interest is not paid under paragraph 5(c)(ii) does not mean it does not have to be accounted for when there is a "Return Amount" or a "Delivery Amount" payable.

Judgment

Having determined that the Judge at first instance had been a little too simplistic in coming to his judgment that there was no negative interest obligation in the CSA, the Court took considerable care in its exposition. The Court of Appeal's judgment includes relevant extracts from the CSA to explain how the Credit Support Annex works e.g. the mechanism for determining the State's "Exposure" to the Bank and setting out defined terms such as "Credit Support Amount" and "Credit Support Balance" used to determine whether any payments of "Delivery Amounts", "Return Amounts" or "Interest Amounts" are required.

[5] See Court of Appeal Judgment para 4.

Five reasons why the claim for negative interest failed. In summary, the five reasons why the claim for negative interest failed are: -

1. The 1999 ISDA Users' Guide did not refer to negative interest. Moreover, once negative interest rates became a commercial reality ISDA drafted wholesale revisions to the standard Credit Support Annex and provided a Protocol for parties to amend their existing agreements.
2. Paragraph 5(c)(ii) is the most obvious place to have included a provision on negative interest so the absence was "*a powerful indicator that it was not contemplated as payable*".
3. The State's arguments gave rise to a number of anomalies in the document to the treatment of other aspects of the collateral (e.g. (i) under the Delivery Amount provisions, there is a Minimum Transfer Amount of €1 million, whereas paragraph 5(c)(ii) requires every amount to be paid, and (ii) all amounts, other than Interest Amounts, are rounded under the CSA, which would give rise to a disparity between accounting for positive and negative interest.)
4. If the parties had intended the Bank to pay negative interest then the Bespoke Floor Provision, which was an attempt to penalise the Bank for any error in making payments to the wrong account, would not have been such a disincentive.
5. The Court considered a number of authorities on interpretation and concluded,
   a. Having contemplated the CSA as a whole (as required by authorities see *Wood v Capita*[6]), it found nothing to suggest negative interest had been contemplated or intended.
   b. The Court felt this was a case where there were two contrasting interpretations of the CSA available and relied on *Wood v Capita* and *The Rainy Sky case* as authority for the proposition that where there are two rival constructions the court can "*give weight to the implications of rival constructions by reaching a view as to which construction is more consistent with business common sense*".
   c. The Court felt the 2010 ISDA Best Practice statement could not be ignored as it had some significance in that it shows ISDA's thinking at or around the time of the CSA (despite being a post-contractual document which would not normally be looked at as being indicative of the factual matrix).
   d. The Court felt it was a case (envisaged by Lord Neuberger in *Arnold v Britton*[7]) where an event subsequently occurred which was plainly not intended or contemplated by the parties. Moreover, the Court's view was that ISDA's initial reaction to the onset of negative rates (i.e. ISDA issued a Best Practice statement on 30 June 2010, three months after the CSA had been amended, providing for the flooring of interest rates in a negative interest rate environment) demonstrated that excluding negative interest was not unfair.

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[6] *Wood v. Capita Insurance Services Limited* [2017] 2 WLR 1095 ("*Wood v. Capita*"). In the *Wood v Capita* case Lord Hodge JSC explained the latest authorities required the court to ascertain the objective meaning of the language which the parties have chosen to express their agreement and in doing so the Court "*must consider the contract as a whole*". The *Rainy Sky* case [2011] 1 WLR 2900 at para 21 is authority for the proposition that where there are rival meanings "*the court can give weight to the implications of rival constructions by reaching a view as to which construction is more consistent with business common sense.*"

[7] Lord Neuberger's seven points in *Arnold v. Britton* [2015 UKSC 36], para 77 ("*Arnold v Britton*").

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