Market Guidance concerning Interest Rates on Cash Collateral
Under ISDA Collateral Agreements

March 13, 2015

This market guidance note is provided by the ISDA Collateral Steering Committee, with the intention of providing additional clarity and promoting market consistency regarding the treatment of negative interest rates and the ISDA 2014 Collateral Agreement Negative Interest Protocol. Each derivative market participant should evaluate this guidance in the context of their own specific documentation and take such legal and other counsel as they may consider appropriate.

On May 12, 2014 the International Swaps and Derivatives Association, Inc. (“ISDA”) published the ISDA 2014 Collateral Agreement Negative Interest Protocol (the “Protocol”), which is intended to provide an efficient method for market participants to clarify how negative interest is to be settled under most\(^1\) forms of ISDA-published collateral agreements. Specifically, the Protocol provides that when a negative interest rate for cash collateral is observed in the market, that interest rate should be utilized in the computation of the relevant interest amount, which may therefore be negative\(^2\). Further, the Protocol provides that negative interest amounts shall be settled between the parties, in a manner similar to positive interest amounts except that the direction of payment is reversed.

We note that key index and central bank rates continue to fix with negative values around the world, and many Euro-zone government bonds trade, or have been issued, at negative yields. Negative interest rates have arisen in part as a result of economically stimulative policies that incentivize investment. ISDA is supportive of these policies and the recognition of the resulting rate levels, whether positive or negative.

The balance of this document uses a Q&A format to address some of the questions that market participants may have on the topic of negative interest rates and the Protocol. Capitalized terms used in this document but not defined herein have the meaning given to such terms in the Protocol. Any further questions may be directed to John Pucciarelli or Yani Martes at ISDA.

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\(^1\) The Protocol does contain certain exclusions, amongst which are that CSAs must not have been amended in the interest rate and related sections, including changes to make a CSA one-way, to add a spread, to document an explicit interest rate floor and other amendments. Parties with these modified documents may undertake bilateral amendments to adjust the approach to negative interest, if necessary.

\(^2\) Nonetheless, an overall monthly interest accrual may still be net positive even if several days have experienced negative rate fixes.
1. **Where are negative rates observed in practice?**

Many market participants, and all major dealers and clearinghouses, are using OIS rates as the relevant index for interest on cash variation margin. Several clearinghouses are passing through negative interest rate fixes on cash collateral in the form of negative interest, including LCH.Clearnet\(^3\). Historically, financing markets in some currencies have set at negative levels for a number of years, amongst them CHF, DKK and SEK. The EONIA rate has also been setting below zero since late August 2014. Eurozone government bonds currently trade at negative yields, and in some cases have been issued with negative yields, in Austria, Finland, Germany, Sweden, the Netherlands and Switzerland.

2. **There seems to be a lack of prevailing market standard, why should I make a decision as to the treatment of negative rates now?**

The Protocol is gathering momentum with over 235 adherents from both the buy-side and sell-side. This includes 13 of the G14 largest dealers and major asset managers and investors, spanning all regions of the world. ISDA has been in close contact with members to understand their views and intentions regarding the treatment of negative interest and the Protocol. We understand that many institutions have operational impediments to rolling out payment mechanics for negative rates but that once they have enhanced technology to be able to compute and process negative interest, they expect to adhere to the Protocol. We also understand that some firms may be taking a more cautious view to see how industry practice develops. We encourage all market participants to assist ISDA in bringing clarity and consistency to the market by considering adoption of the Protocol.

3. **Does adhering to the Protocol introduce a floor at zero?**

No. The Protocol offers a mechanism for adhering parties to modify their Protocol Covered Collateral Agreements such that if an Interest Amount is negative for any Interest Period, that negative accrual is clearly required to be settled by the party posting cash collateral.

4. **How do I know if my CSA can be amended by adherence to the Protocol?**

In general, the Protocol is designed to cover the following agreements: 1994 ISDA Credit Support Annex (NY law), 1995 ISDA Credit Support Annex (English law), 1995 ISDA Credit Support Deed (English law), 1995 ISDA Credit Support Annex (Japanese law), 2008 ISDA Credit Support Annex (Loan/Japanese pledge) or 2001 ISDA Margin Provisions.

However, the amendments in the Protocol do not apply where any underlying collateral agreement contains any of the following modifying language: (i) a floor, (ii) a spread, (iii) a unilateral posting structure, (iv) any custodial provisions or (v) negative interest provisions. If an underlying collateral agreement contains any of these provisions, the parties can instead elect to amend it bilaterally to clarify the application of negative rates.

\(^3\) This is the case for negative interest on variation margin. The treatment of initial margin by clearinghouses is different and beyond the scope of this paper.
5. If the benchmark rate fluctuates above and below zero intra-month, is the accrual calculated net?

Yes, the Interest Amount is calculated over an Interest Period and the rate will fluctuate during that period. As such, the party obligated to pay the interest will depend on whether the Interest Amount is net positive or net negative for that Interest Period.

6. What happens to the Credit Support Balance if parties amend an English Law CSA by adhering to the Protocol?

An accrued positive Interest Amount that has not been paid will be rolled into the Credit Support Balance. An accrued negative Interest Amount that has not been paid shall, in certain instances, reduce the Credit Support Balance by the absolute value of that amount (the AV Negative Interest Amount). The reason that an AV Negative Interest Amount (or a portion thereof) may only reduce the Credit Support in only some instances is that the reduction can only happen to the extent there is enough Eligible Credit Support, which is cash in the same currency as the AV Negative Interest Amount to result in the reduction. For example, if the Credit Support Balance includes euros for most of an Interest Period and there is a negative Interest Amount determined for that period, but the Transferor substitutes securities for the euros, there will be no euros by which to reduce the Credit Support Balance. Given the increases and decreases to the Credit Support Balance effected by the Protocol (assuming that there is relevant cash and reductions occur for all negative Interest Amounts), eventually the Credit Support Balance will be settled between the parties, and in the meantime, the adjusted Credit Support Balance will have accrued interest at the relevant Interest Rate. This is therefore economically equivalent as settling the negative interest amount at the end of the interest period for which it accrues and investing the received negative interest at the same Interest Rate.