Can Falling Interest Rates Increase a Company's Financing Costs?

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Background

A company that borrows or issues floating-rate debt – debt with an interest rate that periodically resets based on an underlying index (typically LIBOR or EURIBOR) – will often hedge the risk of an increase in the floating rate by entering into an interest rate swap agreement ("IRS"). Under an IRS, such a borrower or issuer – the "fixed-rate payer" – agrees to pay periodic "fixed amounts" to its swap counterparty based on an agreed "fixed rate," in exchange for the payment of periodic "floating amounts" by the swap counterparty – the "floating-rate payer" – based on a "floating rate" equal to the underlying index of the debt instrument the borrower or issuer is seeking to hedge.

To take a simple example, assume a company borrows a $100 million term loan that accrues interest at a per annum rate of 3-Month LIBOR plus 3.5%. Concurrently, the company enters into an IRS with a swap dealer obligating the company to pay a fixed amount at 2.0% per annum on a notional amount of $100 million in exchange for payment by the swap dealer of a floating amount based on 3-Month LIBOR on the same notional amount. Taken together, the company's aggregate financing costs relating to the term loan should be 5.5% per annum, with the LIBOR component of the term loan interest payment completely offset by the floating amount received from the swap dealer under the IRS.[1]

Negative Interest Rates Have an Impact on Hedging Costs

But what happens if LIBOR turns negative?

Under a market standard IRS, if the floating rate is negative for any applicable calculation period, the fixed-rate payer is required to make an additional payment to the floating-rate payer in an amount based on the absolute value of such negative interest rate. In the example above, if 3-Month LIBOR has declined to -25 basis points for an entire year, in addition to the fixed amount payment, the company will be required to pay the swap dealer an additional amount equal to 25 basis points of the notional amount.

The effect of this additional payment on a company's aggregate financing costs will depend on whether the underlying debt instrument contains an express limitation that the rate of the underlying index may never fall below 0% (or some greater positive percentage). Where the debt instrument does not include such a "zero interest rate limit," then the terms of the IRS and the terms of the debt instrument will precisely match, as the interest rate under the credit agreement will similarly be reduced by such negative index rate. In the case of the company above, its obligation to pay the additional 25 basis points to the swap dealer (for an aggregate swap payment of 2.25%) under the IRS will be offset by the reduction in the interest rate under the credit agreement to 3.25% for such period, with the aggregate financing costs remaining at 5.50%.

[1] Note that under a market standard IRS, on any payment date, payments required to be made by the floating-rate payer will be net against payments required to be made by the fixed-rate payer, with only the absolute value of the difference payable by the applicable party. In the example above, if 3-Month LIBOR on any valuation date is equal to 1.5%, the 2.0% fixed amount due from the fixed-rate payer will be net against the 1.5% floating amount due from the floating-rate payer, resulting in a net 50 basis point amount payable by the company to the swap dealer.

Where, however, the underlying debt instrument includes such a zero interest rate limit (as many loans made in the recent past do) but the IRS does not, the LIBOR-based payments under the two agreements will no longer match. In the case above, the company's aggregate financing costs for that period will accrue at 5.75% per annum; the sum of 2.25% under the IRS, as described above, and the 3.50% applicable margin on the term loan.

Can This Mismatch Be Resolved by a Contractual Election?

In an IRS documented using ISDA forms, the parties will provide that either the 2000 or 2006 ISDA Definitions apply. These definitions set forth the mechanical terms of the IRS and permit the parties to select between two methodologies to address negative interest rates. The Floating Negative Interest Rate Method, which is the default methodology that applies unless the parties expressly elect otherwise, provides (as described above) that where the floating rate is negative, the fixed-rate payer will be required to pay an additional amount based on the absolute value of the negative floating rate. In contrast, under the Zero Interest Rate Method, when the floating rate is negative, no payment is required from either party on account of the floating rate and only the fixed amount payable by the fixed-rate payer remains. We understand from market sources that no express election is generally made in IRS documentation, resulting in the Floating Negative Interest Rate Method governing the overwhelming majority of existing IRS and leading to the potential mismatch described above.

A simple fix would appear to be the selection of the Zero Interest Rate Method in an IRS being used to hedge a debt instrument with a "zero interest rate limit." However, given the broad market practice, this election will result in the IRS being "off the run" and lead to an increase in the pricing (i.e., in the agreed fixed amount) of the IRS. From a commercial perspective, companies may have historically concluded that the remote probability of negative interest rates did not justify such increase in pricing. However, given current market conditions, companies should be sure to analyze the specific terms of their debt instruments which, as noted above, will often contain a zero interest rate limit, before entering into a new IRS. Borrowers with an existing IRS should similarly analyze their terms to determine whether the mismatch to the hedged debt instrument exists and, if so, whether it may be prudent to modify or even terminate the IRS.

Do Negative Interest Rates Have an Impact on Principal?

A related issue may arise for LIBOR-based debt without a "zero interest rate limit," if a negative LIBOR rate exceeds the applicable margin of such debt. The construction of interest rate provisions will certainly vary depending on the specific language in a particular instrument, but as a preliminary matter, such a circumstance would pose important questions of interpretation, including whether the lender or holder of the debt might be required to pay interest or absorb a reduction of principal, whether an effective "zero interest rate limit" in the underlying debt documentation would be implied by the courts, and whether lenders would be able to switch to charging borrowers their "cost of funds" (i.e., the amount banks pay in obtaining the source of the loans they make) instead of a rate based on an underlying index. We note that in Europe, where negative interest rates have existed long enough for some of these questions to be addressed, albeit in specific instances, at least one bank has been required to pay borrowers interest on real estate mortgages by deducting negative interest payments from the principal amount of such mortgage[2] and a central bank has required banks to pay interest on loans to consumers or other banking customers if the sum of the base rate and spread turns negative.[3] If no "zero interest rate limit" is implied

[2] http://www.wsj.com/articles/as-interest-benchmarks-go-negative-banks-may-have-to-pay-borrowers-1428939338.

[3] https://www.gfmag.com/topics/syndicate/33970278-portugal-central-bank-loans-must-reflect-negative-rates.

and a reduction in the principal amount occurs, borrowers may find themselves with a mismatch between the principal amount of their debt and the notional amount hedged by any corresponding IRS. On the other hand, if a "zero interest rate limit" is implied or if lenders are able to switch to charging "cost of funds," borrowers will once again find themselves with a mismatch between the IRS and the underlying debt instrument.

Hedge Accounting

To the extent that a company enters into an IRS to hedge its interest rate risk, it will typically seek to ensure that such IRS benefits from hedge accounting treatment. To the extent that such IRS is found to be ineffective in hedging the underlying debt obligation (in accordance with the accounting literature and practice), the hedge will be accounted for on a mark-to-market basis and, depending on size and swings in rates, may lead to significant fluctuations in the company's financial reporting.

In the current interest rate environment and assuming a mismatch between the terms of an IRS and underlying debt instrument, whether or not the IRS will continue to benefit from hedge accounting treatment is dependent, among other criteria, on whether negative interest rates are anticipated to be a short-term occurrence (relative to the life of the hedge) or expected to remain for a longer period. Because negative interest rates have not been prevalent in the past, it may be challenging for a company to rely on historical data showing merely that offsetting changes in cash flows are periodically expected between the IRS and the underlying debt obligation. As interest rates approach negative territory, companies should consult their auditors to evaluate the circumstances under which their IRS may no longer function as an adequately effective hedge for accounting purposes.[4]

Conclusion

In light of the risk that negative interest rates may become more prevalent, it is critical for companies that desire to hedge their exposure to floating interest rate risk to consider the terms of the underlying debt documentation to determine the effectiveness of any existing or new interest rate swaps from both a commercial and accounting perspective.

[4] http://www.ey.com/Publication/vwLUAssets/EY_-_Impact_of_sub-zero_interest_rates_on_hedge_accounting/$FILE/EY-Impact-of-sub-zero-interest-rates-on-hedge-accounting-FAAS-Denmark.pdf.

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

James A. Florack	**212 450 4165**	**james.florack@davispolk.com**
Joseph P. Hadley	**212 450 4007**	**joseph.hadley@davispolk.com**
Jason Kyrwood	**212 450 4653**	**jason.kyrwood@davispolk.com**
Meyer C. Dworkin	**212 450 4382**	**meyer.dworkin@davispolk.com**
Michele Babkine	**212 450 3285**	**michele.babkine@davispolk.com**
Michael Fan	**212 450 3105**	**michael.fan@davispolk.com**