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Financial Law Board

Outline of the Approaches to Issues in Interpreting Contracts that Arise in Connection with the Introduction of a Negative Interest Rate

1. Introduction (Issues to be Discussed)

The Bank of Japan decided at the Monetary Policy Meeting held on January 28 and 29, 2016 to introduce a negative interest rate of -0.1% on certain portions of the current account balance held by financial institutions at the Bank of Japan. That will lead to a situation where benchmark interest rates (LIBOR, TIBOR, etc.) in transactions such as floating rate-linked loans and derivative transactions that refer to floating rates will become negative. It is expected that provisions that anticipate negative interest rates will be included in agreements such as loan agreements and interest rate swap agreements. However, there are not many examples where provisions anticipating negative interest rates have been incorporated in those financial transactions that are currently being conducted, and there is no guarantee that those provisions will be included in all financial transactions in the future. The Financial Law Board ("the Board") would therefore like to show an outline of the approaches in order to resolve as much as possible any uncertainty that might arise in the interpretation of agreements and improve the stability of financial transactions without clear provisions anticipating negative interest rates.

2. Floating Rate-Linked Loans and Corporate Bonds

If an interest rate that is calculated by adding a certain spread to a benchmark interest rate such as the LIBOR or the TIBOR ("Benchmark Interest Rate," and that calculated interest rate, the "Applicable Interest Rate") becomes negative for the purpose of calculation in a loan with a provision for the calculation of interest by multiplying the principal by the Applicable Interest Rate, will the lender owe an obligation to pay to the borrower an amount equivalent to the interest rate on a prescribed interest payment date? Here, the Board will examine relevant issues, anticipating cases where there are provisions in loan agreements that provide, for example, that "the borrower shall pay to the lender on each interest payment date interest calculated by multiplying the principal amount by the Applicable Interest Rate in proportion to the actual number of days with

respect to an interest calculation period where that interest payment date is the final day" ("Floating Interest Clause").

In this regard, if there is a clear provision that anticipates negative interest rates (in addition to a Floating Interest Clause) in a loan agreement stipulating, for instance, "if the Applicable Interest Rate becomes a negative value, the lender shall pay to the borrower an amount equivalent to interest calculated using the absolute value of the Applicable Interest Rate on the interest payment date," "if the Applicable Interest Rate becomes a negative value, it will be deemed that the Applicable Interest Rate is zero," or "if the Benchmark Interest Rate becomes a negative value, it will be deemed that the Benchmark Interest Rate is zero," it is believed that that provision will be valid based on the principle of the freedom of contract. In other words, it is believed that, in short, the issue is a question of what the parties have agreed on.

Hence, if there is no clear provision anticipating negative interest rates in a loan agreement, the basic approach would be to consider what is a reasonable inference as to an agreement that the lender and the borrower have reached on the details of the interest.

First, according to the wording of the Floating Interest Clause, which should be considered first, it is the borrower that owes an obligation to pay the floating interest. In other words, a Floating Interest Clause is a provision that stipulates the amount to be paid by the borrower to the lender on each interest payment date. Even when looking at a loan agreement as a whole, normally, only the details of the borrower's obligation to pay interest are set out. In that context, there is little room, if any, to read from a Floating Interest Clause that if the calculated result of the Applicable Interest Rate becomes a negative value due to reductions in the Benchmark Interest Rate, the lender would be obligated to pay to the borrower an amount equivalent to the absolute value of that calculated result. In fact, it can be assumed that in many cases, at the time of executing a loan agreement, the contracting parties would never expect that the calculated result of the Applicable Interest Rate would become a negative value. Given the above, it would be considered reasonable to interpret that if the calculated result of the amount of interest became a negative value (if it was no longer a positive value), there simply would be no amount for which the borrower owes an obligation to pay under the Floating Interest Clause.

Further, even apart from interpreting the wording of a Floating Interest Clause, given that it is generally believed that interest in a loan is consideration for using principal, it is something that by its nature should be paid by the borrower to the lender, so it should not be interpreted that the lender is to pay interest. It is therefore believed that no obligation for a lender to pay interest would arise unless there are special circumstances where it is found that there is an agreement for the lender to pay to the borrower an amount equivalent to interest (which has a different nature to interest in its true sense). From that perspective as well, it would be considered reasonable to interpret that if the calculated result of the Applicable Interest Rate in a loan became a negative value, that would only mean that there would no longer be an amount that has the nature of interest.

It is believed the above interpretation also applies to corporate bonds, since they have the characteristics of a loan. Unlike a Floating Interest Clause in a loan agreement, there are many cases where the subjects of sentences are not explicitly stated in conditions of corporate bonds, but conditions of corporate bonds set out the details of the obligations owed by the issuer to the bondholders, and unlike a bilateral contract in which mutual obligations are provided, bondholders do not make any promise to the issuer. Further, like interest on a loan, interest on corporate bonds has the nature of consideration for the use of principal and should be paid by the issuer to the bondholders. Also, with respect to corporate bonds, given that, for example, (i) there is no framework in place for issuers to collect money from bondholders on each interest payment date (with respect to book-entry corporate bonds, that is not anticipated in the book-entry transfer system) and (ii) (x) obligating a transferee of corporate bonds to pay an amount corresponding to the unpaid and accumulated negative interest to the issuer and (y) deducting such amount from the principal amount on the redemption date would be difficult without provisions providing for that, it would be considered reasonable to deny that bondholders would owe an obligation to pay an amount equivalent to interest if the Applicable Interest Rate becomes negative.

3. Derivative Transactions where a Party is to Pay an Amount equivalent to a Floating Interest Rate

If the Applicable Interest Rate becomes negative for the purpose of calculation in a derivative transaction where one party is to pay to the other party an amount equivalent to a floating interest rate such as an interest rate swap transaction where one party is to pay

to the other party an amount equivalent to a floating interest rate calculated by multiplying the notional principal by the Applicable Interest Rate and the other party is to pay to that party an amount equivalent to a certain fixed interest rate, will the other party owe an obligation to pay to that party an amount equivalent to the floating interest rate on a prescribed payment date? Here, the Board will examine relevant issues, anticipating cases where there are provisions in interest rate swap agreements that provide, for example, that "Party A shall pay to Party B on each payment date money in the amount obtained by multiplying the notional interest amount by the Applicable Interest Rate" ("Floating Interest Payment Clause").

Even in this case, besides a Floating Interest Payment Clause, if there is a clear provision that anticipates cases where the Applicable Interest Rate becomes negative, in principle that provision will apply (see 5 below for exceptions). There are in fact many cases where such a provision is included in an interest rate swap transaction. According to the 2006 ISDA Definitions, which are often referred to in interest rate swap transactions, unless the parties choose a clause where the minimum Applicable Interest Rate is zero, if the Applicable Interest Rate becomes negative in an interest rate swap transaction, a clause that provides that the party that would normally receive an amount equivalent to the floating interest rate pay the absolute value of the amount equivalent to the floating interest rate ("Negative Interest Rate Clause") would apply as a default rule.

As a matter of fact, there are interest rate swap agreements without any clear provisions that anticipate cases where the Applicable Interest Rate becomes negative. In those cases, just as with loan agreements, the basic approach would be to consider what is a reasonable inference as to an agreement that the parties have reached on the details of the amount equivalent to the interest rate to be paid.

In that case, even though the Floating Interest Payment Clause should first be considered when interpreting a contract, if that is read together with a clause that provides that Party B is to pay a fixed interest rate to Party A, it would be clear that interest rate swap transactions are, in principle, transactions that have characteristics where each party makes payments to and receives payments from the other party, and they are not a type of transaction where one party owes a unilateral payment obligation to the other party, so it is believed the significance of a contractual clause indicating an entity that owes an obligation is not absolute. In fact, in light of the nature of a transaction where cash flows

having the equal present value at the time of the execution of a contract are exchanged, it is also conceivable that in interest rate swap transactions it is a matter of course that it is anticipated in the provisions of the contract that the direction of payment of the amount equivalent to a floating interest rate could be reversed depending on fluctuations in the Benchmark Interest Rate.

Further, unlike the payment of interest in a loan, the payment of an amount equivalent to a floating interest rate in an interest rate swap transaction is not a payment by one party as consideration for the use of principal. Hence, there would not be difficulties when interpreting a contract type in switching the entity that is to pay an amount equivalent to a floating interest rate depending on fluctuations in the Benchmark Interest Rate. Moreover, if the parties wanted to set a minimum value (floor) of the Applicable Interest Rate in the process of determining the terms of an interest rate swap transaction, normally, the option value of that floor would be calculated and that would be reflected in the terms of the transaction, so if that were not reflected, it could be regarded that the parties negotiated with each other and agreed on the terms of the transaction on the assumption that the Applicable Interest Rate might become negative.

Given the above, it is thought that there is room to interpret a contract in an interest rate swap transaction without fixating on the wording of a Floating Interest Payment Clause, but it is believed that ultimately, the intention of the parties at the time of the execution of a contract concerning the details of an amount equivalent to a floating interest rate will be recognized depending on each individual transaction based on various factors including the process of determining the terms of the transaction, the contents of an explanation of the terms of the transaction given by a financial institution, which is one party, to the customer, which is the other party, and the linkage with other transactions conducted at the same time (for example, loans). This point, including cases where there is a Negative Interest Rate Clause, is explained in detail in 5 below.

4. Deposits

If the open market interest rate becomes negative, will banks and other deposit-taking financial institutions be able to set their posted rates applicable to deposits such as ordinary deposits and floating rate time deposits at a negative value and deduct an amount calculated using the absolute value of that negative value from deposit balances

on the interest payment dates?

In this regard, like interest in a loan, normally interest in a deposit should be paid to the depositor by the deposit-taking financial institution, and it cannot be interpreted that the depositor should pay that interest. Further, payments by depositors are not anticipated in any deposit general conditions (rules). Hence, even though there is room to collect consideration for a deposit or consideration for a service through a deposit account in accordance with the deposit general conditions, it is believed based on a reasonable interpretation of the intention of the parties involved in a deposit that if the open market interest rate becomes negative, it would not be possible for a bank or other deposit-taking financial institution to set its posted rates applicable to deposits such as ordinary deposits and floating rate time deposits at a negative value and deduct an amount calculated using the absolute value of that negative value from deposit balances on the interest payment dates.

5. Special Circumstances

The foregoing is an outline of the general approach that does not take into account the circumstances of individual transactions, but it is certainly possible to recognize an agreement that diverges from that general approach based on individual circumstances such as the specific wording of a contract, the economic rationality of a transaction, the motives of the parties to conduct a transaction (such as to hedge against a specific transaction), explanations and the negotiation process, and the attributions of the parties. Further, when recognizing such an agreement, it might be necessary to also consider accounting and tax issues to figure out the intentions of the parties.

For example, in the case of a floating rate loan, what would happen if an interest rate swap agreement were executed for the purpose of fixing a floating interest rate under a loan agreement between a lender and a borrower, and a clause (such as a Negative Interest Rate Clause) providing that the borrower might owe an obligation to pay a floating interest rate to the lender is included in the interest rate swap agreement? In a case where an explanation is given to the borrower that it will not bear any interest rate other than the payment of the fixed interest rate in view of interest rate swap agreements and loan agreements together and where it is recognized that an agreement was formed between the parties in line with that explanation, if it is interpreted that the lender would

not owe any obligation to pay an amount equivalent to a floating interest rate as an interpretation of the loan agreement, it should be interpreted for the purpose of the interest rate swap agreement that no obligation to pay an amount equivalent to a floating interest rate in the opposite direction would arise if the Applicable Interest Rate became negative. On the other hand, in other cases, it might be found that there is an agreement that payments are to be made in the opposite direction under a loan agreement if the Applicable Interest Rate becomes negative for the purpose of calculation, and the effect of a clause in an interest rate swap agreement providing that the borrower might owe an obligation to pay a floating interest rate to the lender might also be recognized as is. Discussions on those points might also be affected by whether the loan is a syndicate loan or a bilateral transaction, and whether the lender and the swap counterparty are the same bank. It is also possible an agreement to set the minimum Benchmark Interest Rate at zero will be recognized if it is clear that there is a guarantee that the lender will receive an amount equivalent to the spread until maturity without exception.

Further, in structured finance, if an SPV such as a trust or a special purpose company is established as a party to multiple agreements and a conduit for cash flows, even if the counterparties of the SPV are not the same, if all of those parties have executed agreements after accepting that that is the structure of the transactions, it would be likely that the interpretation should be such that the floating interest rates in those multiple agreements are interpreted in the same way.

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