Banking & Finance

Negative interest rates: what could be the consequences on existing loans and future contracts?

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The downward trend of the main interest rates (Euribor and Libor) has reached an all-time low.

Weekly rates have been negative for a while now and a scenario in which also longer-term rates go negative, which would have seemed unthinkable until a couple of weeks ago, is now becoming more and more likely. Suffice it to consider that the year 2014 closed with Euribor 3M at 0.078%, which was then rated at 0.060% right at the start of 2015.

This macro-economic situation entails radically **new practical and legal consequences**.

Negative interest rates may find financial and banking market players lacking adequate preparation from a practical and legal perspective.

The banking market of other countries is starting to get used to this situation; for the first time in recent history a private commercial bank in Germany has started to apply negative rates on deposit accounts.

But apart from bank deposits, the fields that shall be left most vulnerable to uncertainties are that of medium and long-term loans and that of derivatives on interest rates.

A proper and rigorous outlining of the legal framework of negative interest rates applicable to existing relationships is therefore necessary in order to avoid consequences capable of damaging market players.

Most loan agreements entered into in the past, whether months or years ago, do not contain any provisions clarifying how one should behave in case the variable component of the applied rate falls below zero, regardless of the spread.

How should parties to a loan agreement execute the loan if, in light of the interest calculation formula, such agreement requires the application of a negative interest rate? Would it be lawful to bring the negative rate down to “zero”, or is it necessary to apply the numerical rate and thereby potentially determine a negative value?

As one can imagine, so far such uncertainties have found no answers in market practice as well as in banking case law. **Negative interest rates require operators to carry out a careful legal analysis** in order to find adequate practical solutions for existing loans and also to identify new contractual regulation techniques for future loans.

In any case, **a proper analysis cannot be carried out in a general or abstract way**. The negative interest rates represent not only an “unforeseen variable” in legal and contractual terms but also a field that requires operators to find **legally viable solu-**

tions with regard to a number of aspects, such as transparency and the effectiveness and validity of clauses that have an impact on financial remuneration or on the exchange of cash flows in derivatives.

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