2021 LIBOR Phaseout and Negative Interest Rates: Some Legal and Contractual Considerations*

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ABSTRACT

There are two recent global "interest rate"-related events that raise important legal and contractual issues in the banking and financial system: (i) the 2021 phaseout of the London Interbank Offered Rate ("LIBOR"), and (ii) the emerging phenomenon of negative interest rates. *First*, the LIBOR is one of the most widely used reference rates for a variety of debt instruments and derivatives, not just in the Philippines, but in the entire world. Some of these existing financial contracts have terms extending beyond 2021. After the 2021 LIBOR phaseout, the question remains as to how these LIBOR-based financial contracts must transition into a world without LIBOR. This includes the following issues: what benchmark rate should apply? How should the adoption of a replacement reference rate be contractually implemented? What sample fallback clauses are triggered by the phaseout, or should be instituted to address the gap in the documentation of LIBOR-based financial contracts? *Second*, many central banks in the world have started to adopt negative interest rates, which have begun affecting certain financial products with variable rates that go in the negative. The existing documentations for many of such products have not contemplated the scenario where the reference rate and the total payment obligation dip below zero. Does a negative interest create an obligation to pay on the part of the lender or the obligee? What types of clauses can be instituted in a financial contract to address interpretation issues when a total payment obligation becomes negative? This Article tries to address these questions.

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* *Cite as* Russel Stanley Q. Geronimo & Francis Paul U. Baclay, *2021 LIBOR Phaseout and Negative Interest Rates: Some Legal and Contractual Considerations*, 94 PHIL. L.J. 265, [page cited] (2021).

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I. INTRODUCTION

There are two recent global "interest rate"-related events that raise important legal and contractual issues in the banking and financial system.

First, the "most important number in finance"[1] will disappear after December 31, 2021.[2] The London Interbank Offered Rate ("LIBOR"), which is a set of interbank interest rates at which banks on the London money market are willing to lend to one another, will soon be phased out.[3] The benchmark administrator will cease publishing LIBOR, and it will no longer appear on the Thomson Reuters and Bloomberg screens. This has a significant impact on financial markets, as the notional value of debt instruments and financial derivatives referencing the LIBOR is estimated by practitioners to be at 350 trillion dollars worldwide.[4] In the Philippines, LIBOR is referenced in syndicated loan agreements, credit facility agreements, floating rate notes, foreign currency forwards, foreign currency swaps, and interest rate swaps.[5] Some of these existing financial products have terms extending beyond 2021. After the LIBOR phaseout, what benchmark rate should apply to these instruments? How should the transition to a new rate be contractually implemented?

Second, the phenomenon of negative interest rates is slowly becoming a global trend. Negative interest rates modify the economics of ordinary lending and derivative transactions and present challenging interpretation questions. To stimulate lending activities, several central banks in the world have already adopted a negative interest rate policy.[6] In 2020, at the height of the COVID-19 pandemic and community quarantine restrictions, the Philippines approached negative real interest rate territory when the Bangko Sentral ng Pilipinas (BSP) imposed a policy rate lower than

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[1] Nicholas Burgess, Libor Benchmark Reform: An Overview of Libor Changes and Its Impact on Yield Curves, Pricing and Risk (Sept. 6, 2019), *available at* http://dx.doi.org/10.2139/ssrn.3479833.

[2] Andrew Bailey, The Future of LIBOR, Speech delivered at Bloomberg London (July 27, 2017), *available at* https://www.fca.org.uk/news/speeches/the-future-of-libor.

[3] *Id.*

[4] PricewaterhouseCoopers Intl Ltd., *LIBOR and reference rate reform,* PWC WEBSITE, *at* https://www.pwc.com/gx/en/industries/financial-services/publications/libor-reference-rate-reform.html.

[5] *See also* BSP Mem. No. M-2020-083 (2020), Annex A for a listing of LIBOR-based financial products.

[6] Carlos Arteta et al., *Negative interest rate policies: sources and implications*, 5 (World Bank, Policy Research Working Paper No. 7791, 2016), *available at* https://documents.worldbank.org/en/publication/documents-reports/documentdetail/235551470834953672/negative-interest-rate-policies-sources-and-implications.

the inflation rate.[7] While the country is not yet in a negative nominal rate environment, the option for this unconventional monetary policy tool remains open. Does the lender have an obligation to pay the absolute value of the negative interest? Can a zero-interest rate floor be presumed?

This Article outlines these emerging issues, describes their legal implications and practical risks to banks, financial institutions, investors, and multinational enterprises, and offers contractual interpretation and implementation solutions to mitigate potential risks arising from these "interest rate"-related events.

II. THE 2021 LIBOR PHASEOUT

A. Floating Interest Rates

The Philippine Supreme Court recognizes the validity and enforceability of floating or variable interest rates, as long as they comply with the general legal requirements of valid contractual stipulations of interest.[8] Citing the BSP's Manual of Regulations for Banks ("MORB"), the Court defines a floating rate of interest as "the variable interest rate stated on a market-based reference rate agreed upon by the parties."[9] It pertains to an interest rate that is not fixed, but rather adjusts according to prevailing market rates, subject to the principle of mutuality of contracts.

Still citing the MORB, the Court states that banks and borrowers may agree on a floating rate of interest, provided that it be anchored on market-based reference rates. The provision cited in the relevant decision has since been amended, and the current version provides:

> *Floating rates of interest.* The rate of interest on a floating rate loan during each interest period shall be stated on the basis of Manila Reference Rates (MRRs), T-Bill Rates or other market[-]based

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[7] Neil Morales & Enrico Dela Cruz, *UPDATE 2-Philippine c.bank surprises with 5th rate cut this year as economy struggles,* REUTERS, Nov. 19, 2020, *at* https://www.reuters.com/article/philippines-economy-rates/update-1-philippine-c-bank-surprises-with-5th-rate-cut-this-year-as-economy-struggles-idUKL1N2I50I8.

[8] Security Bank Corp. v. Mercado [hereinafter "*Security Bank*"], G.R. No. 192934, 868 SCRA 323, 349, June 27, 2018.

[9] *Id.*

> reference rates plus a margin as may be agreed upon by the parties.[10]

The Court recognizes that this BSP requirement is consistent with the principle that the determination of interest rates cannot be left solely to the will of one party.[11] It further emphasizes that the reference rate must be stated in writing and must be agreed upon by the parties.

B. The 2021 LIBOR Phaseout

LIBOR, which is administered by the ICE Benchmark Administration, is the most widely used market-based benchmark or reference rate in stipulations of floating rates of interest.[12] Philippine banks enter into various financial contracts referencing the LIBOR.[13] These LIBOR-based financial contracts can be in various foreign currencies, and can reference the USD LIBOR, GBP LIBOR, JPY LIBOR, CHF LIBOR and EUR LIBOR.[14] LIBOR quotes can also be classified based on the term of the underlying instruments which formed the basis of the quote, in that there is actually a set of LIBOR quotes for different maturities.[15]

LIBOR is referenced in a diverse array of financial products, including loans and derivatives.[16] Loans referencing the LIBOR include, among others: syndicated loans, loans to government, corporate loans, retail mortgages, consumer loans, bonds and notes, short-term instruments, securitized products, deposits, bills payable, and bonds payable. Derivatives referencing the LIBOR, on the other hand, include, among others: interest rate swaps and cross-currency swaps.

In 2017, the Financial Conduct Authority of the United Kingdom, which is tasked with the oversight of the LIBOR, announced the LIBOR Phaseout by December 31, 2021.[17] Market participants have been strongly encouraged since then to institute mechanisms to transition to the use of alternative reference rates.

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[10] *Id.*, *citing* BSP Manual of Regulations for Banks (2018), § 305.3. (Emphasis omitted.)

[11] *Id.* at 350.

[12] Asian Dev. Bank, LIBOR Transition Frequently Asked Questions, at 2 (Sept. 2020), *at* https://www.adb.org/sites/default/files/page/649276/libor-transition-briefing-faqs.pdf.

[13] BSP Mem. No. M-2020-083 (2020).

[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] Bailey, *supra* note 2.

According to the BSP, every BSP-supervised financial institution ("BSFI") with LIBOR or LIBOR-related exposures must have a viable transition plan in place to ensure that the cessation of LIBOR does not disrupt its operations and the efficient provision of services to its clients and other market counterparties.[18] This transition plan should be anchored on a clear understanding on the part of the BSFI of its exposures and risks. The plan shall likewise include strategies for actively reducing reliance on LIBOR sufficiently in advance of the discontinuation of the benchmark. Currently, the BSP is monitoring the progress of BSFIs in transitioning away from LIBOR.

Pursuant to BSP Memorandum No. M-2020-083 or "Transition from the London Inter-Bank Offered Rate (LIBOR) and Reporting Requirements on LIBOR-Related Exposures" dated November 17, 2020, banks are required to file quarterly reports to the BSP on their LIBOR exposures. The quarterly reports also require banks to indicate whether such exposures have a fallback clause.[19] A "fallback clause" is a clause in a LIBOR-based financial contract that addresses the failure to determine the value of the benchmark interest rate.[20] This may include the case where the benchmark administrator ceases the publication of the benchmark interest rate.

C. Contractual Uncertainty

To illustrate the dilemma created by the 2021 LIBOR Phaseout, suppose a corporation issued a 10-year corporate bond on January 1, 2020 to investors at a stipulated yield of LIBOR plus 2%. The corporate bond will expire on January 1, 2030. The payouts on the bond are variable. The yield requires the determination of the value of the floating rate (i.e. the LIBOR) from time to time. If the LIBOR will no longer be quoted in 2021, what should be the payout on the bond in 2022 and the succeeding years? Does the existing LIBOR-based financial instrument have a fallback or benchmark transition clause which provides an alternative or replacement rate in case the LIBOR becomes undeterminable? If the instrument does not have a fallback or benchmark transition clause, how should parties renegotiate or amend the instrument to institute such clause or to stipulate a replacement benchmark?

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[18] BSP Mem. No. M-2020-083 (2020).

[19] *Id.*

[20] Christopher Click, *Death of a Benchmark: The Fall of LIBOR and the Rise of Alternative Rates in the United Kingdom and United States*, 22 N.C. BANKING INST. 283, 301 (2018).

If the parties do not institute such clause or do not provide a replacement benchmark, what rate should apply by default?[21]

D. Contractual Solutions

Fallback clauses are standard stipulations in loan documentations. These clauses usually provide a formula for determining the applicable benchmark interest rate, should the LIBOR be unavailing. For example, a revolving credit facility agreement may provide an alternative rate that will apply in the event that adequate and reasonable means do not exist for ascertaining LIBOR for a relevant interest period, such as when the LIBOR is not available or published on a current basis, and such circumstances are unlikely to be temporary.[22]

In the following sections, we provide a survey of sample fallback clauses or benchmark transition clauses. We then proceed to examine how they may address the 2021 LIBOR Phaseout for existing LIBOR-based financial contracts.

1. Benchmark Replacement Clause

A publicly available copy of a term loan facility between a Philippine corporation and a couple of banks illustrates the use of a fallback clause to replace LIBOR as the benchmark rate if the publication of LIBOR becomes unavailable. The Facility Agreement dated July 14, 2020 ("Sunpower Facility Agreement") between Sunpower Philippines Manufacturing Ltd., as borrower ("Borrower"), DBS Bank Ltd. and Standard Chartered Bank, Philippine Branch, as lenders ("Lenders"), and DBS Bank Ltd. as facility agent ("Facility Agent") provides that each Lender will commit to extend loans to the Borrower, with each loan earning a rate of interest equal to 3.90% per annum plus LIBOR.[23]

Under the Sunpower Facility Agreement, LIBOR is defined, in relation to each loan, as:

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[21] Russell Stanley Geronimo, *Is the Philippines Ready for the 2021 LIBOR Phaseout?*, BUSINESSMIRROR (PHIL.), Aug. 17, 2020, at A7.

[22] *Id.*

[23] Sunpower Phil. Facility Agreement (July 14, 2020), *available at* https://www.sec.gov/Archives/edgar/data/867773/000119312520195042/d76584dex105.htm.

> (a) [T]he applicable Screen Rate as of the specified time for the currency of that loan and for a period equal in length to the interest period of that loan; or
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> (b) as otherwise determined pursuant to Clause 4.3 (*Default interest*), and if, in either case, that rate is less than zero, LIBOR shall be deemed to be zero.[24]

Meanwhile, "Screen Rate" is defined as:

> [T]he London interbank offered rate administered by ICE Benchmark Administration Limited (or any other entity or person which takes over the administration of that rate) for the relevant currency and period displayed (before any correction, recalculation, or republication by the administrator) on page LIBOR01 or LIBOR02 of the Thomson Reuters screen (or any replacement Thomson Reuters page which displays that rate) or on the appropriate page of such other information service which publishes that rate from time to time in place of Thomson Reuters. If such page or service ceases to be available, the Facility Agent may specify another page or service displaying the relevant rate after consultation with the Borrower.[25]

To anticipate scenarios where the LIBOR is undeterminable during any relevant interest period, the Sunpower Facility Agreement provides a *Replacement of Screen Rate* clause. It states that if an event triggers the replacement of the Screen Rate for a currency that can be selected for a loan, the Facility Agent (acting on the instructions of the lenders) and the Borrower may agree to amend or waive the use of a Replacement Benchmark.[26] These Screen Rate Replacement Events contemplate situations like:

> (ii) [T]he administrator of that Screen Rate publicly announces that it has ceased or will cease, to provide that Screen Rate permanently or indefinitely and, at that time, there is no successor administrator to continue to provide that Screen Rate;
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> (iii) the supervisor of the administrator of that Screen Rate publicly announces that such Screen Rate has been or will be permanently or indefinitely discontinued; or

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[24] *Id.* (Emphasis in original.)
[25] *Id.*
[26] *Id.* at Clause 8.1.

> (iv) the administrator of that Screen Rate or its supervisor announces that that Screen Rate may no longer be used.[27]

"Replacement Benchmark" is defined as a benchmark rate which is, among others, formally designated, nominated or recommended as the replacement for a Screen Rate by: (i) the administrator of that Screen Rate, provided that the market or economic reality that such benchmark rate measures is the same as that measured by that Screen Rate; or (ii) any applicable central bank, regulator or other supervisory authority or a group of them, or any working group or committee sponsored or chaired by, or constituted at the request of, any of them or the Financial Stability Board.[28]

The 2021 LIBOR Phaseout may trigger the *Replacement of Screen Rate* clause of the Sunpower Facility Agreement as it is a potential Screen Rate Replacement Event. The ICE Benchmark Administration, being the administrator of LIBOR, has publicly announced that it will cease to provide LIBOR permanently or indefinitely, and there is no successor administrator to continue to provide the LIBOR.

Note that the Sunpower Facility Agreement does not expressly prescribe a specific replacement benchmark rate. It only provides a contractual mechanism by which it can be determined, i.e. through an amendment or waiver which relates to providing for the use of a Replacement Benchmark. Some guidelines are provided in the determination of a Replacement Benchmark, but no benchmark rate is fixed in the agreement. Thus, the Facility Agent (acting on the instruction of the Lenders) and the Borrower will likely go back to the negotiating table to identify the Replacement Benchmark. This type of fallback clause provides flexibility for the parties since they can negotiate the applicable Replacement Benchmark once the 2021 LIBOR Phaseout occurs.

2. Alternative Rates

Unlike the Sunpower Facility Agreement, other credit agreements are definite with respect to the applicable replacement benchmark rate. Consider a syndicated loan agreement involving a multinational corporation with Philippine subsidiaries and an international syndicate of lending institutions. The Second Amended and Restated Credit Agreement dated October 1, 2019 ("Fresh Del Monte Credit Agreement") among Fresh Del Monte Produce Inc. and certain subsidiaries as borrowers ("Borrowers"), Bank of America,

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[27] *Id.* at Clause 8.2.

[28] *Id.*

N.A., as administrative agent ("Administrative Agent"), and various lending parties ("Lenders"), provides that LIBOR may be replaced by the secured overnight financing rate ("SOFR") published by the Federal Reserve Bank of New York.[29]

The Fresh Del Monte Credit Agreement provides that the Lenders shall extend Eurocurrency Rate Loans to the Borrowers. A Eurocurrency Rate Loan may either be a revolving loan or term loan that bears interest at the Eurocurrency Rate, which includes the rate per annum equal to the LIBOR or a "comparable or successor rate designated by the Administrative Agent, as published on the applicable Bloomberg screen page (or such other commercially available source providing such quotations as may be designated by the Administrative Agent from time to time)."[30]

The agreement provides an *Inability to Determine Rates* clause, whereby the Administrative Agent is obligated to ascertain whether the following scenarios exist:

> (1) Adequate and reasonable means do not exist for ascertaining LIBOR for any requested interest period, including, without limitation, because the LIBOR Screen Rate is not available or published on a current basis, and such circumstances are unlikely to be temporary;[31]
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> (2) The administrator of the LIBOR Screen Rate or a Governmental Authority having jurisdiction over the Administrative Agent has made a public statement identifying a specific date after which LIBOR or the LIBOR Screen Rate shall no longer be made available, or used for determining the interest rate of loans;[32] or
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> (3) Syndicated loans currently being executed are being executed or amended (as applicable) to incorporate or adopt a new benchmark interest rate to replace LIBOR.[33]

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[29] Second Amended and Restated Credit Agreement (Oct. 1, 2019), *available at* https://www.sec.gov/Archives/edgar/data/1047340/000119312519263746/d813314dex101.htm.

[30] *Id.* at art. 1.01.

[31] *Id.* at art. 3.03(c).

[32] *Id.*

[33] *Id.*

Once the Administrative Agent determines that any of these scenarios are applicable, the Administrative Agent and the Borrowers will amend the Fresh Del Monte Credit Agreement solely for the purpose of replacing LIBOR with SOFR-Based Rates or another alternate benchmark rate, giving due consideration to any evolving or then existing convention for similar U.S. dollar denominated syndicated credit facilities for such alternative benchmarks ("LIBOR Successor Rate").[34] "SOFR-Based Rates" include the SOFR and a forward-looking term rate that is based on the SOFR, and determined by the Federal Reserve Board and/or the Federal Reserve Bank of New York, or a committee officially endorsed or convened by the Federal Reserve Board and/or the Federal Reserve Bank of New York for the purpose of recommending a benchmark rate to replace LIBOR in loan agreements similar to the Fresh Del Monte Credit Agreement.[35]

The Administrative Agent shall post the proposed amendment to the Lenders and Borrowers and the amendment shall be effective at a specified time unless there are permissible objections. The Administrative Agent is tasked with certain technical, administrative, or operational matters required to transition the applicable interest rate from LIBOR to the LIBOR Successor Rate.

The Fresh Del Monte Credit Agreement differs from the Sunpower Facility Agreement in that it already fixes the benchmark replacement rate in advance and determines the limits of possible objections from certain parties. Unlike the Sunpower Facility Agreement, the Fresh Del Monte Credit Agreement leaves a smaller room for renegotiation, which allows the parties to better anticipate their future interest rate risk exposure.

3. Benchmark Replacement Adjustments

Other LIBOR-based credit agreements do not simply adopt a replacement benchmark rate, but also introduce benchmark replacement adjustments. Benchmark replacement adjustments are spread adjustments to the benchmark replacement rate for the purpose of minimizing the difference between LIBOR and the benchmark replacement rate.

Consider the Credit Agreement dated September 4, 2020 ("Knowles Credit Agreement") among Knowles Corp. ("Company"), its Philippine subsidiary, Knowles Electronics (Philippines) Corp., various lenders ("Lenders"), J.P. Morgan Chase Bank, N.A. as administrative agent

[34] *Id.*

[35] *Id.* at art. 1.01.

("Administrative Agent"), and other parties.[36] The Knowles Credit Agreement substantially contains the benchmark replacement clauses provided in the Fresh Del Monte Credit Agreement. In addition, however, the Knowles Credit Agreement defines "Benchmark Replacement" as the sum of (a) the alternate benchmark rate (which may be a SOFR-based rate) and (b) the Benchmark Replacement Adjustment.[37]

The Benchmark Replacement Adjustment is defined as:

> [T]he spread adjustment, or method for calculating or determining such spread adjustment (which may be a positive or negative value or zero), that has been selected by the Administrative Agent and the Company giving due consideration to (i) any selection or recommendation of a spread adjustment, or method for calculating or determining such spread adjustment, for the replacement of the LIBO[R] [...] with the applicable Unadjusted Benchmark Replacement by the Relevant Government Body and/or (ii) any evolving or then-prevailing market convention for determining a spread adjustment, or method for calculating or determining such spread adjustment [...] for syndicated credit facilities denominated in the applicable currency.[38]

Certain financial supervisory bodies, such as the Alternative Reference Rates Committee ("ARRC") and the International Swaps and Derivatives Association ("ISDA"), recommend a spread adjustment methodology of a five-year median spread adjustment for instruments transitioning from LIBOR to SOFR-based benchmark replacement rates.[39] This may be calculated by obtaining the historical median difference between LIBOR and SOFR over a five-year lookback period prior to a trigger event. Such recommendations may be adopted by the Administrative Agent in determining the spread adjustment.[40]

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[36] J.P. Morgan Credit Agreement (Sept. 4, 2020) *available at* https://www.sec.gov/Archives/edgar/data/1587523/000158752320000055/exhibit101tokn8-k9x8x202.htm.

[37] *Id.* at § 1.01.

[38] *Id.*

[39] Alternative Reference Rates Comm., ARRC Announces Recommendation of a Spread Adjustment Methodology for Cash Products, (Apr. 8, 2020), *at* https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_Spread_Adjustment_Methodology.pdf.

[40] *Id.*

4. Replacement Interest Rates Normally Set by Administrative Agent

Another type of benchmark replacement clause is one where the parties have broad discretion as to the determination and calculation methodology of the benchmark replacement rate. In an Amended and Restated Credit Agreement dated December 19, 2018 ("Korn/Ferry Credit Agreement") among Korn/Ferry International, as borrower ("Borrower"), its Philippine subsidiary, Korn Ferry Futurestep (The Philippines) Inc., a group of various lenders ("Lenders"), Wells Fargo Bank, National Association, as administrative agent ("Administrative Agent"), and other various parties,[41] the *Alternative Rate of Interest* clause provides that the Administrative Agent may determine if "reasonable and adequate means do not exist for the ascertaining of the LIBOR [...] for such Interest Period with respect to a proposed LIBOR[-based] [...] Loan."[42] After this determination, the Administrative Agent and the Borrower may establish a replacement interest rate, generally in accordance with similar situations in other transactions in which the Administrative Agent is serving as administrative agent, or otherwise consistent with market practice ("Replacement Rate").[43] The Replacement Rate shall then replace all references to LIBOR in all loans issued under the Korn/Ferry Credit Agreement.

The difference between this clause and the benchmark replacement clause in the Sunpower Facility Agreement is that the former gives a broader discretion to the Administrative Agent in recommending the benchmark replacement rate, in accordance with general practice and experience in previous transactions, while the latter requires the adoption of rates formally designated, nominated, or recommended by a set of government bodies.

5. Summary of Guidance on 2021 LIBOR Phaseout

There are three contractual implementation approaches to address the LIBOR phaseout:

> First, parties must resort to fallback clauses, or stipulations in the instrument that anticipate contingencies in case there is failure in the determination of the benchmark rate. If there are no fallback clauses, they must renegotiate the LIBOR-based contract to

[41] $650,000 Amended and Restated Credit Agreement (Dec. 19, 2018), *available at* https://www.sec.gov/Archives/edgar/data/56679/000119312518353774/d676696dex101.htm.

[42] *Id.* § 5.8(a).

[43] *Id.*

> stipulate a replacement rate in an amended and restated agreement. If there are no fallback clauses and parties fail to renegotiate and amend their contract, parties will apply the default rule in the law governing the LIBOR-based contract. The last approach will prove to be the costliest solution, since more often than not, the default interest rate in a given jurisdiction (i.e. the "legal" interest rate) will drastically change the risk profile of a financial instrument. Thus, efforts to address the LIBOR phase-out must focus on the first two approaches: application of fallback clauses and contractual amendment.[44]

Several replacement rates to the LIBOR have already been proposed. The Federal Reserve Board and the Federal Reserve Bank of New York organized the Alternative Reference Rates Committee, which recommended the SOFR as an alternative to the LIBOR in the United States.[45] The SOFR is based on the interest rates on repurchase agreements, or "repos" A repo is a transaction whereby a party sells a security to another with an agreement to buy back the same security after a certain period and at a stipulated repurchase price. Another is the Sterling Overnight Index Average, which is the weighted average of overnight interest rates for unsecured transactions in the UK sterling market.[46] In Asia, there is the Tokyo Overnight Average Rate, which is considered the risk-free rate in Japan, and is administered by the Bank of Japan based on money market rates.[47]

With the COVID-19 pandemic still wreaking havoc on the economy, the banks and financial institutions will probably focus on loan defaults and non-performing assets. However, the LIBOR transition should not be taken lightly. Parties should try to avoid a situation where they would not know what interest rate to apply, since this can lead to costly litigation.[48]

III. NEGATIVE INTEREST RATES

The phenomenon of negative interest is another global issue related to floating or variable interest rates and benchmark rates, changing the way

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[44] Geronimo, *supra* note 21.

[45] Andreas Schrimpf & Vladyslav Sushko, *Beyond LIBOR: a primer on the new reference rates*, 2019 BIS Q. REV. 29, 35.

[46] *Id.* at 36.

[47] *Id.* at 35.

[48] Geronimo, *supra* note 21.

interest usually works.[49] The ordinary economics of a lending transaction involves a borrower and a lender, whereby the lender provides funds (the principal) to the borrower for the latter's use. In turn, the borrower is obligated to repay the principal at a future date, and to pay interest for the use of the principal. With negative interest, the payment flow can be reversed, and the lender will have the apparent obligation to pay a certain amount (i.e. the absolute value of the negative interest) to the borrower. This reversed payment flow may be irreconcilable with the very essence of a loan. Where normally, the borrower pays the consideration for the use of the funds, it is now the lender who pays consideration to the borrower.

A. Negative Interest Rate Policy of Central Banks

Negative interest rates originate in central banking policy. The effects of such policy on the interbank money market then proceed to influence debt instruments and derivatives that reference floating interbank money market rates.

Most jurisdictions, including the Philippines, require banks to store their excess reserves at a central bank. In this scenario, the bank is acting as a lender and the central bank is acting as a borrower. The central bank, as borrower, pays interest on the excess reserves. These reserve requirements constitute a certain percentage of bank deposits and deposit substitute liabilities that banks set aside in deposits with the BSP which these banks cannot lend out.[50]

By virtue of its powers as a central bank, the BSP sets certain key policy rates, including the overnight deposit rate, which is the rate at which BSP pays banks for depositing their excess reserves.[51] Under normal circumstances, the overnight deposit rate should be more than zero percent. In a normal loan contract, it is equivalent to the consideration paid by the borrower for the use of the lender's funds.

Some central banks in the world have started to adopt a negative interest rate policy,[52] in which banks will no longer receive interest payments

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[49] Gregory Harrington et al., *Legal Considerations in a Negative Interest Rate Environment*, ARNOLD & PORTER, Mar. 30, 2021 *at* https://www.arnoldporter.com/en/perspectives/publications/2020/03/legal-considerations-negative-interest-rate-enviro.

[50] *See* BSP Manual of Regulations for Banks (2018), § 252.

[51] § 601.

[52] Harrington et al., *supra* note 49.

for their deposits with the former. Instead, they will pay negative interest to the central bank for borrowing their excess reserves. Again, this may be contrary to the ordinary notion of a loan, where the borrower pays interest. Here, the lender pays the interest.

This negative interest rate policy started with the European Central Bank and the Central Bank of Japan. Other central banks soon started to adopt it, such as those in Denmark, Sweden, and Switzerland.[53]

One of the goals of negative interest rate policy is to penalize banks for holding excess reserves, so that they will be incentivized to lend out their funds to the public, thus stimulating lending activities in the economy and generating economic growth. In the case of the central banks of Denmark, Sweden, and Switzerland, the policy purpose is to slow down the flow of money from the eurozone and to weaken their respective jurisdictions' currencies to boost their exports.[54]

B. How Negative Interests Arise

Floating rates, by nature, can have positive, zero, or negative values. A margin, which is a fixed rate, can also be added to the floating rate, such that the total interest obligation is equal to the sum of the floating rate and the fixed margin. Even with a fixed margin, it is still mathematically possible that a negative floating rate may render the total interest obligation in the negative. For example: adding up a floating rate of -0.05 and a fixed margin of 0.03 results in a total interest of -0.02.

The setting of negative overnight deposit rates has affected the supply and demand of funds in the interbank money market for certain jurisdictions. Banks there have preferred lending to other banks, even at negative rates, rather than depositing their excess reserves with the central bank at a deeply negative level. While the interbank money market still returns a negative interest, it may still be cheaper compared to the central bank's negative overnight deposit rate.[55]

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[53] Jana Randow et al., *Negative Interest Rates*, BLOOMBERG, Aug, 4, 2020, *at* https://www.bloomberg.com/quicktake/negative-interest-rates; Reuters Staff, *Explainer: How do negative interest rates work?*, REUTERS, Feb. 5, 2021 *at* https://www.reuters.com/article/health-coronavirus-economy-rates-idUSL8N2KA3ZH.

[54] Reuters Staff, *supra* note 53.

[55] For a more technical discussion of the interplay between central bank policy rates and interbank rates, *see* Stefan Angrick & Naoko Nemoto, *Central Banking Below Zero: The Implementation of Negative Interest Rates in Europe and Japan*, (Asian Dev. Bank Inst., Working

Since interbank money market rates, such as the LIBOR and the Euro Interbank Offered Rate ("EURIBOR"), are used as benchmark interest rates in several debt instruments and derivatives, this may result in the floating or variable rates of banking products going in the negative as well. Hence, negative interest rate policy not only affects the central bank and banks, but also firms and households.

C. Is Negative Interest Payable?

One legal question raised in several jurisdictions is whether the absolute value of the negative interest triggers a payment obligation on the part of the lender, or in the case of a derivative, a payment obligation on the part of the obligee with respect to the positive interest.

The Philippine Civil Code and other relevant laws, including banking laws and financial regulations, do not explicitly address the lender's payment obligation when a floating rate turns negative. Case law likewise does not provide any answers on the matter. The current line of Supreme Court decisions deals only with the validity and enforceability of floating or variable interest rates in general, with no rules on negative interest rates.[56]

In the absence of clear guidance on this matter, resort must be made to foreign case law. While these are not binding on parties operating under Philippine law, they are nevertheless instructive insofar as general principles, judicial attitudes, and interpretative tendencies about negative interest payment obligations go.

1. Lessons from Foreign Case Law on Negative Interest

i. Swiss Federal Supreme Court
Decision on a Consumer Loan
with a Negative Interest

On May 7, 2019, the Swiss Federal Supreme Court issued Decision 4A_596/2018 ("Swiss Decision"),[57] dealing with the question of whether the

Paper No. 740, 2017), *available at* https://www.adb.org/sites/default/files/publication/317926/adbi-wp740.pdf.

[56] *Security Bank*, 868 SCRA 323, 349.

[57] Tribunal fédéral [TF] [Federal Supreme Court] May 7, 2019, 4A_596/2018. The original decision is in French, which the authors translated to English using an online translation service for their use.

lender of a consumer loan is obliged to pay negative interest to the borrower. In 2006, the parties executed a consumer loan, which stipulated that the loan will bear interest at the sum of: (1) the six-month LIBOR-CHF rate, which is a variable rate, and (2) a fixed margin of 0.0375% per annum. The borrower undertook to repay the principal amount in full upon the interest payment due in August 2026. The interest rate clause did not provide an interest rate floor, and the loan was silent as to the possible consequences of the six-month LIBOR-CHF rate turning negative. The parties also did not explicitly agree that the borrower will guarantee the payment of at least the fixed margin at any event.

In 2015, the Swiss National Bank implemented a negative interest rate policy, which charged a -0.75% rate on the minimum reserves of banks. This direction in monetary policy spilled over to the interbank money market, causing the six-month LIBOR-CHF rate to go in the negative.[58] The borrower demanded the application of the negative rate, while the lender insisted on the application of a zero-interest rate floor. At one point, the lender had proposed that the consumer loan be amended to expressly stipulate a zero-interest rate floor to anticipate the change in the six-month LIBOR-CH rate into negative values, but the amendment was not executed.

The *Swiss Decision* did not find basis to impose a negative interest payment obligation on the part of the lender, ruling that:

(1) The consumer loan is a contract by which the lender undertakes to transfer the ownership of a sum of money or other fungible things to the borrower, on condition that the latter return the same amount, of the same kind and quality, at the end of the contract. The provisions governing the consumer loan contract are not mandatory in nature, so that in principle, the parties can freely arrange their contractual relationship.

(2) The consumer loan in question is onerous in nature, as it provides for an interest rate obligation.

(3) In the context of bank loans, the parties often provide for an interest rate indexed to a variable rate like LIBOR or EURIBOR, so that the calculation of contractual interest is linked to the conditions of the market.

[58] *See supra* Part III.B. on the mechanics of the central bank policy rate's interaction with the interbank money market.

(4) The fall of the reference rate into negative values may, depending on the margin agreed by the parties to a loan contract, lead to a negative total interest rate.

(5) Interest is generally considered to be the compensation due to the creditor for the capital of which the latter is deprived. It constitutes the consideration for the provision of capital during the term of the loan. Its amount is determined according to the rate applied, the sum loaned and the duration of the loan.

(6) In the presence of negative interest, there is a reversal of payment flows. It is no longer the borrower who pays the lender, but on the contrary the latter who pays him. Hence, a negative interest does not constitute an interest in the sense of the term in item (5) above.

(7) Negative interest affects the very balance of the loan contract, since the interest no longer constitutes the consideration for the provision of the capital, but an additional obligation borne by the lender. In other words, the borrower is remunerated for the use of the capital placed at his disposal and may be content to reimburse a sum less than the amount loaned.

(8) By virtue of the principle of contractual freedom, the parties are free to agree that the borrower may return, at the end of the loan, an amount lower than that which he received. By the same principle, they are also free to expressly provide for the payment of negative interest by the lender to the borrower.

(9) Notwithstanding item (8), the Swiss Federal Supreme Court did not make a pronouncement as to whether a negative interest is compatible with the very essence of a loan—i.e. whether a credit agreement with a negative interest is still a loan contract. Nevertheless, the Court upheld the validity of a negative interest stipulation and it may characterize the credit agreement as an innominate contract.

(10) The question of whether the passage into negative territory of the reference rate, or even of the total interest rate including the bank's margin, may lead to the elimination of this margin, or even to the reversal of the obligation to pay interest in the sense that it is the lender who must pay negative interest to the borrower, must be resolved by the interpretation of the contract.

(11) The Court examined three possible interpretations: (a) the overall interest rate cannot be lower than the bank's margin; (b) if the total interest rate becomes negative so much that the margin is reduced to nil, the total interest rate is equal to 0% and neither party must pay interest to the other; and (c) the overall interest rate can enter negative territory, thus allowing the borrower to claim interest from the lender.

(12) The Court noted the following circumstances: (a) the contract does not contain any provision on the consequences of a possible shift of the six-month LIBOR-CHF rate into negative territory; (b) the parties did not contemplate a guarantee of the margin of 0.0375% agreed in favor of the lender; (c) no clause in the contract expressly deals with the possibility of a reversal of the obligation to pay interest; and (d) several of the provisions expressly refer to the payment of interest by the borrower alone. Based on these circumstances, the Court did not find basis in requiring the lender to pay negative interest to the borrower.

ii. English Commercial Court Decision on Negative Interest on Collateral Support for Derivative Transactions Under ISDA Documentation

On July 25, 2018, the English Commercial Court issued *The State of Netherlands v. Deutsche Bank AG* ("English Decision"),[59] dealing with the question of whether the bank in a derivative transaction, using ISDA documentation, is obliged to pay negative interest on the collateral support transferred to the counterparty.

In 2001, the State of the Netherlands ("State") and Deutsche Bank AG ("Bank") executed an ISDA Master Agreement along with its Schedule and Credit Support Annex ("CSA") ("ISDA Documents"). Pursuant to the ISDA Documents, the parties executed a number of derivative transactions. Where the State has a net credit exposure to the Bank under these transactions, the CSA requires the Bank to provide credit support to the State. The material form of credit support is cash collateral provided by the Bank to the State. The CSA provides for interest to be paid by the State to the Bank

[59] [2018] EHWC 1935 (Comm).

on that cash collateral. The agreed rate is the Euro Overnight Index Average ("EONIA") minus 0.04%. However, since June 13, 2014, the value of the rate has gone negative. Thus, the question is whether the ISDA Documents require the Bank to pay negative interest.

Paragraph 5(c)(ii) of the CSA provides:

> Interest Amount. Unless otherwise specified in Paragraph 11(f)(iii), the Transferee will transfer to the Transferor at the times specified in Paragraph 11(f)(ii) the relevant Interest Amount to the extent that a Delivery Amount would not be created or increased by the transfer, as calculated by the Valuation Agent (and the date of calculation will be deemed a Valuation Date for this purpose).[60]

Paragraph 10 of the CSA provides that interest amount is calculated as the amount of cash in a relevant currency on a relevant day, multiplied by the relevant interest rate in effect for that day, and divided by 360. The interest rate here pertains to EONIA minus 0.04%. Paragraph 11 of the CSA provides that "Transferee" refers to the State and "Transferor" refers to the Bank.

The *English Decision* held that while it is true that the interest amount, as defined in the CSA, is capable of allowing for a negative figure, it does not follow that the agreement includes a payment obligation on the part of the Bank if such amount is negative. Various clauses in the CSA envisage payment from the State to the Bank, but not the other way around.

Moreover, the *English Decision* finds that the parties did not intend to impose a negative interest obligation based on the commercial circumstances surrounding the transaction. The Court stated:

> Why should commercial parties have been concerned only with interest where positive and not also where negative? One answer is simply that they accepted there should be simplicity in their arrangements. Another is that the parties intended that where cash collateral could be expected to make money simply by being held, some reflection of that benefit should be received by the Transferor [i.e. the Bank]. It does not follow that the parties intended that where cash collateral could be expected to lose money if simply held, that some reflection of that burden should be shouldered by the Transferor [i.e. the Bank]. The former is a price for having the

[60] *Id.*

> use of the collateral; the latter is a potential cost of the collateral being in cash.[61]

Hence, the State's claim for negative interest did not prosper.

iii. German Court Decision on Variable-Interest Banking Products with Negative Interest

On January 26, 2018, the Tübingen Regional Court in Germany, issued a decision under case number 4 O 187/17 ("German Decision"),[62] which deals with the question of whether negative interest is payable in a consumer banking product with a floating rate. The products in question involve variable-interest time deposits and fixed-term deposits. Pursuant to a statutory provision, the *German Decision* characterized the said banking products as loan agreements. Under Section 700 (1) of the German Civil Code, a loan does not include any remuneration duty on the part of the lender. The court states that interest is understood to be the remuneration independent of profit and turnover and dependent on term to be paid in monetary form or in other acceptable forms for the possibility of using capital.[63] The transition from a positive or zero interest rate to a negative interest rate for deposits causes a reversal of payment obligations. This contradicts the character of bank deposits as loans. Hence, the negative interest rate on the deposits is not payable by the bank.

2. Negative Interest Stipulations

i. Uncertainty in Contractual Interpretation and Treatment of Negative Interest

The above disputes originated from the uncertain interpretation and contractual treatment of negative interests. To avoid this uncertainty, parties may stipulate clauses to set the terms on how they will interpret and treat floating interest rates going in the negative. In this case, they can either provide a stipulation that the lender, or the obligee with respect to positive interest, will be liable for the payment of negative interest. In the alternative,

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[61] *Id.*

[62] Landgericht Tübingen, Jan. 26, 2018, 4 O 187/17, juris (Ger.), *available at* https://landgericht-tuebingen.justiz-bw.de/pb/site/jum2/get/documents/jum1/JuM/Landgericht%20T%c3%bcbingen%20neu/Urteile/LG%20T%c3%9c%204%20O%20187-17.pdf. The original page is German, which the authors translated to English using an online translation service for their use.

[63] *Id.*

they may also provide an interest rate floor at 0% if they do not intend for the negative interest to be payable.

ii. Sample Negative Interest Rate Clauses

An example where both a negative interest payment obligation clause and an interest rate floor stipulation are present is in a publicly available copy of an interest rate swap. Interest Rate Swap Confirmation dated April 7, 2004 ("Swap Confirmation"), between JPMorgan Chase Bank ("Bank") and Baker Hughes Incorporated ("Counterparty") provides that the Bank and the Counterparty shall enter an interest rate swap with a notional amount of USD 325,000,000, with the Counterparty as the floating rate payer and the Bank as the fixed rate payer. The floating rate is LIBOR plus 2.741%.[64] The Schedule to the ISDA Master Agreement governing the Swap Confirmation provides the following negative interest rate stipulation:

> (i) NEGATIVE INTEREST RATES. (i) FLOATING AMOUNTS. "Swap Transaction" means, for the purposes of this provision concerning Negative Interest Rates, a rate exchange or swap transaction, including transactions involving a single currency or two or more currencies. Party A [i.e., the Bank] and Party B [i.e., the Counterparty] agree that, if with respect to a Calculation Period for a Swap Transaction either party is obligated to pay a Floating Amount that is a negative number (either due to a quoted negative Floating Rate or by operation of a Spread that is subtracted from the Floating Rate), the Floating Amount with respect to that party for that Calculation Period will be deemed to be zero, and the other party will pay to that party the absolute value of the negative Floating Amount as calculated, in addition to any amounts otherwise owed by the other party for that Calculation Period with respect to that Swap Transaction, on the Payment Date that the Floating Amount would have been due if it had been a positive number. Any amounts paid by the other party with respect to the absolute value of a negative Floating Amount will be paid to such account as the receiving party may designate (unless such other party gives timely notice of a reasonable objection to such designation) in the currency in which that Floating Amount would have been paid if it had been a positive number (and without regard to the currency in which the other party is otherwise obligated to make payments).[65]

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[64] Interest Rate Swap Confirmation (Apr. 7, 2004), *available at* https://www.sec.gov/Archives/edgar/data/808362/000095012905001852/h21636exv10w55.txt.

[65] *Id.* at part 5.

In a normal scenario where the floating rate is positive, the floating rate payer or the Counterparty pays the floating interest to the Bank, while the fixed rate payer or the Bank pays the fixed interest to the Counterparty. In this stipulation, if the floating rate becomes negative, the Counterparty does not need to pay anything to the Bank. As far as the Counterparty is concerned, the negative interest rate is deemed to be a zero-interest rate. Meanwhile, the Bank pays the absolute value of the negative interest. In other words, a zero-interest rate floor applies to the floating rate payer while a negative interest rate obligation applies to the fixed rate payer.

D. Summary of Guidance on Negative Interests

With the above considerations, we summarize below the guidance from foreign case law and sample negative interest stipulations:

(1) The stipulation of floating rates in credit agreements is valid and enforceable in Philippine law as long as it complies with the general legal requirements for a contractual interest stipulation, pursuant to the ruling in *Security Bank Corp. v. Sps. Mercado.*[66]

(2) Floating rates, by nature, can have positive, zero, or negative values. Even with a fixed margin, however, it is still mathematically possible that a negative floating rate may render the total interest obligation in the negative.

(3) Parties may expressly stipulate a zero-interest rate floor in the credit agreement, such that if the total interest obligation calculated from the floating rate is negative, the lender is not obligated to pay any amount to the borrower.

(4) If there is no zero-interest rate floor clause in the credit agreement, the question of whether the lender is liable to pay the negative interest to the borrower depends on whether the agreement expressly stipulates that the lender has a negative interest payment obligation.

(5) If there is no express negative interest payment obligation, other circumstances may be considered to determine that the parties intended that the negative interest be payable, such as: (a) whether there are other contractual stipulations that contemplate the

[66] *Security Bank*, 868 SCRA 323, 349.

> consequences of negative rates; (b) whether the parties guarantee that the margin should at all times be paid; (c) whether the parties provide the payment mechanics for payments from lender to borrower, when normally the parties only provide payment mechanics for payments from borrower to lender; (d) whether there are provisions on the possibility of a reversal of the obligation to pay interest; (e) whether the credit agreement only expressly refers to the payment of interest by the borrower alone; and (f) the parties' common and ordinary understanding of the transaction.

IV. CONCLUSION

The impact on the Philippine financial markets of the 2021 LIBOR Phaseout and the global rise of negative rates will depend on the level of exposure of Philippine-based financial contracts to LIBOR, and on reference rates going in the negative. As of writing, it is too early to tell whether there is sufficient exposure to nudge the BSP, Philippine banks, and other financial institutions towards seriously addressing and anticipating contractual interpretation issues, given that the pandemic is still wreaking havoc on the economy. It is telling that, as of writing, the only BSP issuance on this matter was aimed merely to measure the level of exposure with respect to LIBOR. This signals that bank and financial regulators do not have the ready information to estimate the impact of these "interest rate"-related events. Such level of exposure will determine whether these events will ultimately lead to judicial disputes centered on contractual interpretation issues and give rise to a new line of jurisprudence concerning floating interest rates.

With respect to the 2021 LIBOR Phaseout, the outcome of such questions will largely depend on whether the LIBOR-based financial contracts have fallback clauses, which introduce mechanisms for adopting replacement reference rates. With respect to negative interest rates, the outcome will depend on how effectively parties have expressed or implied their intent to render the same as an enforceable obligation. In either case, these will give rise to new case law on floating interest rates, and should be of interest to practitioners and students alike in the field of credit transactions and banking.

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