What would happen if interest rates turned

NEGATIVE?

Colliers International | Debt Advisory

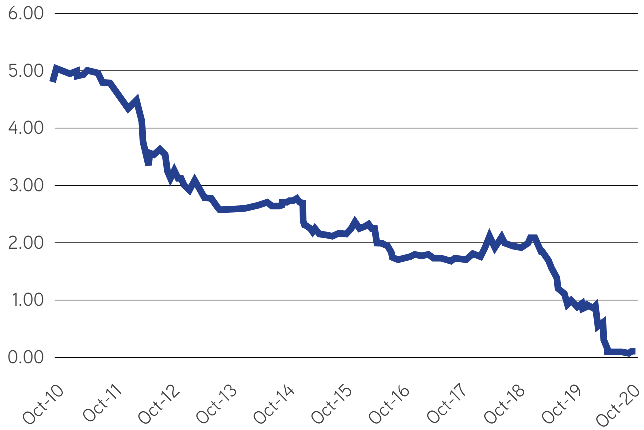
With Australian interest rates at historical lows and the RBA stating it was ready to do more to support the economy (possibly through more rate cuts), more frequently we are asked what would happen under loan facilities if interest rates turned negative.

We are not there yet and may not get there noting the RBA's stated current aversion to negative rates. Despite this, we acknowledge it is useful to understand what could happen under loan facilities should rates go below zero.

Background

- Australian interest rates have never been this low and are now approaching zero.

Last 10 Years BBSW3M



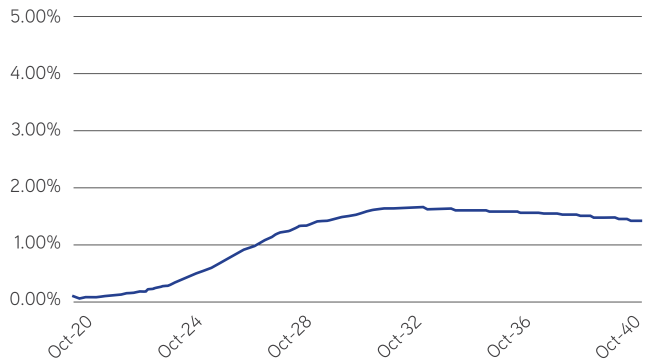
Source: Refinitiv / Chatham Financial

Last 12 Months BBSW3M Swap Rates

Source: Refinitiv / Chatham Financial

- Recent commentary from the RBA indicates they expect the Australian economic recovery to be 'bumpy and uneven'.
- The RBA has a range of policy options available to support the economy including lowering interest rates 'a little more without going into negative territory'.
- The RBA has maintained an aversion to reducing the cash rate below zero, however there remains a possibility this could occur should the outlook for inflation, economic growth, and employment not be consistent with the RBA's objectives.
- The market continues to expect the RBA will push back against the prospect of negative rates.

Forward Curve
20 Year Monthly BBSW3M



Source: Refinitiv / Chatham Financial

- However, should the economic recovery be weaker than the RBA expect, and/or other Central Banks (e.g. in the UK and the US) employ negative rates, the likelihood of the RBA reducing rates below zero increases.
- In the past, Lenders have required hedging to contain the risk of interest rates increasing, particularly in relation to investment loans.
- With a lower interest rate environment forecast, particularly in the short term, lenders may not have the same hedging requirements. However borrowers are still potentially at risk if rates go negative.

If interest rates are further lowered and become negative, what will happen to the interest rate payable?

- In order to understand the implications, borrowers need to consider the detail in their:
  - » Loan agreement; and
  - » International Swaps and Derivatives Association ('ISDA') agreement (if interest rate swaps are in place).
- Note the discussion below relates to loan facilities that are either unhedged or hedged through an interest rate swap.
- If the loan is provided on a fixed rate basis, the discussion below is not applicable.
- **Loan agreement**
  - » The interest rate payable is calculated as the base rate (i.e. BBSY) plus the margin.
  - » It is common in loan agreements for the base rate to be drafted with a 'zero floor', with typically only the more institutional borrowers able to negotiate its exclusion.
  - » This means that even if the actual base rate is negative it is deemed to be zero when calculating the interest rate.
  - » Therefore, the borrower will be required to pay at least the margin and no deduction is made even if the actual base rate is negative (borrowers do not receive the financial benefit below zero).
  - » Conversely, if there is no zero floor, then the negative base rate will reduce the margin in the interest rate calculation.
- **ISDA agreement**
  - » Most interest rate swaps use the Negative Interest Rate method meaning – there is 'no floor'.
  - » Payment mismatch issues will arise where there is a zero floor in the loan facility but no floor under the ISDA. Borrowers will not get the benefit of a negative base rate and will need to make an additional payment under the swap.

What are the possible outcomes?

If interest rates turn negative, and you have a variable base rate loan that is:

Hedged	'Zero floor' (Loan agreement)	'Zero floor' (ISDA agreement)	Possible outcome
✗	✗	-	Technically, the borrower will receive the financial benefit below zero [1]
✗	✓	-	Lowest interest rate payable will be the margin
✓	✗	✗	No payment mismatch issues [2]
✓	✓	✗	Likely to be payment mismatch issue. Borrowers receive no benefit of the movement in rates below zero under the loan agreement, but will have an additional payment obligation under the swap agreement, effectively doubling the impact.

1. We say "technically", as in practice this may not occur, as lenders also have other provisions in the loan agreement, they can refer to
2. Where both the loan agreement and the ISDA have matching provisions dealing with negative rates there will be no mismatch

Conclusion

- The focus on negative rates and the implications under loan facilities has been around for the last 12 months, but escalated since the start of COVID-19.
- The RBA has a stated aversion to negative rates but if economic conditions change, they could review this position.
- If interest rates turn negative and the base rate is unhedged then more commonly the interest rate payable will continue to be the margin.
- If the borrower's base rate is hedged, and there are matching provisions, there is unlikely to be a payment mismatch.
- However, if the provisions for negative rates do not match there is likely to be a payment mismatch.

If you think you may have a payment mismatch (resulting in not getting the benefit), then it is worth exploring how it can be addressed.

Similarly, if you're unsure whether there is a mismatch, or you'd like to discuss further, our team is ready to discuss.

The issue of 'zero floor' is an example of a 'value-trap' that can be overlooked impacting the overall value of your debt arrangements.

Colliers Debt Advisory is a team of real estate bankers that provide specialist debt advisory services. We focus on the total value of a debt facility, not just the margin. As the full economic impact of COVID-19 continues to evolve, loan conditions and covenants will have greater relevance to borrowers' returns. Our team are experts in ensuring our clients obtain the best value from their debt funding requirements.

To discuss this or other ways to 'future proof' your loan arrangements, get in contact with our team today.

Tim du Temple
National Director | Debt Advisory
Capital Markets
Direct +612 9017 6958
Mobile +61 403 040 990
tim.dutemple@colliers.com

Brooke Conlon
Director | Debt Advisory
Capital Markets
Direct +612 9249 2057
Mobile +61 409 777 311
brooke.conlon@colliers.com

Charles Singson
Associate Director | Debt Advisory
Capital Markets
Direct +612 9770 3131
Mobile +61 427 482 261
charles.singson@colliers.com