



Avoiding the Floor on Negative Rates

The impact of the inability of a borrower to take advantage of negative base rates is significant.

Even before the widespread outbreak of COVID-19 and the related impact on financial markets, several developed countries and regions embraced monetary policy incorporating the use of negative interest rates.

The rationale for this monetary policy was that each country or region had been impacted differently by the financial crisis and, therefore, the monetary policy for each country or region needed to react to varying degrees to create the appropriate policy for its jurisdiction. For borrowers, negative base rates when added to the relevant credit spread can create attractive funding levels.

The COVID-19 crisis encircling the globe has only exacerbated this phenomenon as central banks have sought to further significantly ease monetary policy. The monetary authorities' intended goal is to reduce the economic impact of the COVID-19 crisis on the economy. However, not all borrowers can enjoy the benefit of negative rates due to a variety of funding constraints.

Bank loan documentation may contain provisions that prevent the base rate from being set below zero. Alternatively, borrowers may not have the capability to issue in a currency where negative rates exist, particularly given the current state of the financing markets. The inability to take advantage of negative rates may leave borrowers with inefficient financing levels.

The impact of the inability to take advantage of negative base rates is significant. While 3 month USD LIBOR is currently above 1.21%, 3-month CHF LIBOR (Swiss Franc) is around -0.69%, 3-month EURIBOR is -0.37%, and 3-month JPY LIBOR is -0.07%.

Fortunately, there are potential solutions to the issues at hand. As issuers review their business and funding plans, capital structure, and foreign exchange exposures, there are likely various alternatives that can create a more cost- and risk-efficient capital structure.

For example, there is a product in the swap market that allows one party to synthetically convert assets or liabilities in one currency to another currency. This product is called a "cross-currency swap."

In a typical cross-currency swap, an issuer would enter into a swap agreement where its principal and interest obligations are exchanged for principal and interest obligations in another currency. Each leg of a cross-currency swap can be either fixed or floating. That allows the issuer to customize the payments on the swap. Standard ISDA documentation now incorporates the concept of negative rates, thereby allowing the issuer to fully benefit from rate differentials.

From a market pricing perspective, there is a spread that is added or subtracted from one leg of the swap. This spread, which can be positive or negative, is based on the relative supply and demand for the particular cross-currency swap.

We can provide more information as to the factors that can influence this spread and the applicability for a relevant structure. As one example, USD LIBOR would indicatively convert into EURIBOR in the current market with a spread of -20 bps for 3 years. This means that a company can execute a cross-currency swap where the issuer receives USD LIBOR and pays EURIBOR minus 0.20%. When the above rate differentials between LIBOR and EURIBOR are incorporated, the initial rate differential benefit for the issuer is 178 bps.

Shown here are the indicative upfront value of 0% floors (twelve quarterly periods) as well as cross-currency basis swaps spreads, and initial rate differentials on select cross-currency swaps (all 3-year maturities) using market observations on March 23, 2020.

	0% Floor Value	X-CURR Basis	Initial Rate Differential
EUR	1.16%	-20 bps	+178 bps
CHF	0.45%	-15 bps	+205 bps
JPY	1.93%	-60 bps	+188 bps

There are a number of ways to account for these transactions including the potential to obtain hedge accounting.

This is one example of how companies should be evaluating financing alternatives during the COVID-19 crisis. Corporations should be aware of the challenges and alternatives that are available to them during these times.



William Kloehn is Managing Director and leads the firm's Project Finance and Derivatives advisory practices. Prior to EA, William was CEO of a project finance and infrastructure advisory firm where he built a \$25 billion annual capital markets and derivative advisory business. William started his career at Citigroup spanning a 23 year tenure that included mergers and acquisitions, structured finance, financial risk management, capital markets and derivative structuring and execution.
William.Kloehn@eamarkets.com

David Greenberg is Head of Business Development for EA Markets and leads the firm's origination activity across various products. David has more than 25 years of experience in corporate finance and derivatives structuring. He began his investment banking career at Barclays, where he provided interest rate and currency risk management products to large US Corporations and Canadian Provincials. David went on to hold senior investment banking positions at JPMorgan and Deutsche Bank, where he developed strong relationships within the leveraged finance markets.

David.Greenberg@eamarkets.com

