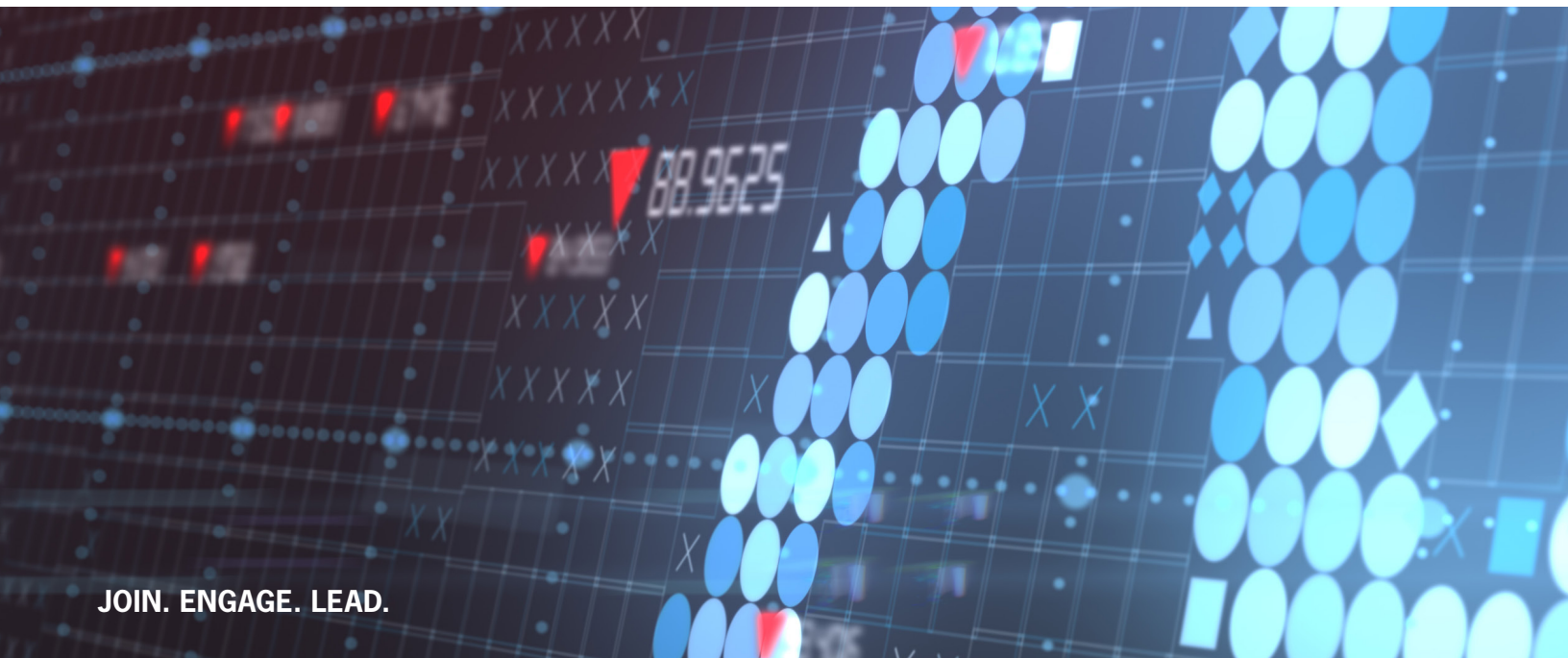




# YOUR FIRST RUN-IN WITH NEGATIVE INTEREST RATES?

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Considerations for negative interest rates in the U.S. and their potential impact on securities lending when the collateral is cash



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# INTRODUCTION NEGATIVE INTEREST RATES

Although they have been deployed across the globe in various places and at various times, including now, negative interest rates are not generally seen as a likely solution for the U.S. economy. Still, even with the Federal Reserve's stated opposition to them, the potential for negative rates given the extreme market volatility prompted in March by COVID-19 remains top of mind for many in the financial services industry.

This includes securities lending participants, who are concerned about the possibility of negative yields on cash collateral reinvestment funds and repurchase agreements—and how that could impact the economics of lending securities. They understand that, even if a negative rate environment is not probable, it is necessary to study how such a policy could impact their business, and to be prepared for that possibility.

Negative interest rates could affect every aspect of securities lending, including borrower demand, investment valuation, taxation, accounting, operating models, and more. This paper, written by the RMA Securities Lending Council, is a guide for agent lenders and direct lenders in assessing the implications of negative interest rates and their impact on negative cash reinvestment yields.



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## HOW LIKELY ARE NEGATIVE INTEREST RATES IN THE U.S.?

Since the global financial crisis of 2008, several central banks, including the European Central Bank, have employed negative interest rates as a policy tool to stimulate growth. While the Federal Reserve has been aggressive in its monetary stimulus actions to address the COVID-19 pandemic, including reducing the federal funds rate and enacting lending programs, it has indicated that it does not expect to utilize negative interest rates. In fact, Federal Reserve Chairman Jerome Powell has said negative rates are “not an appropriate or useful policy”<sup>1</sup> for the U.S, believing the costs outweigh the benefits. Still, RMA believes the potential impacts should be considered.

“SINCE THE GLOBAL FINANCIAL CRISIS OF 2008, SEVERAL CENTRAL BANKS, INCLUDING THE EUROPEAN CENTRAL BANK, HAVE EMPLOYED NEGATIVE INTEREST RATES AS A POLICY TOOL TO STIMULATE GROWTH.”

### Key questions include:

How would negative interest rates potentially impact the demand and economics of our business?

What are the operational and systemic considerations of negative cash reinvestment yields?

How would stable and floating net asset value (NAV) reinvestment funds be processed if the yields were negative?

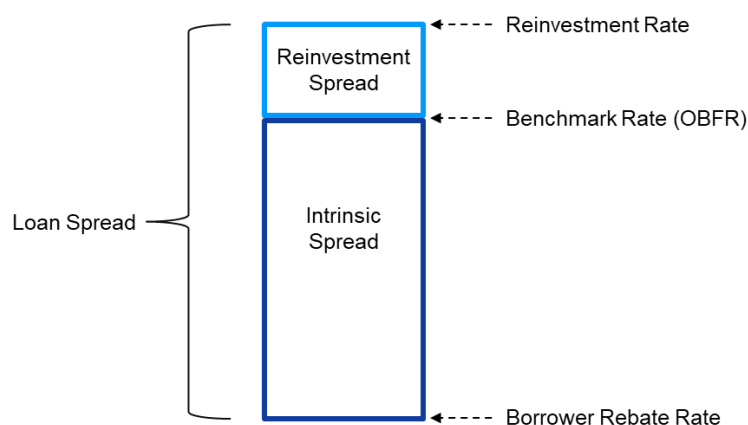
Are there specific tax issues to consider?

## HOW MIGHT NEGATIVE CASH REINVESTMENT YIELDS IMPACT SECURITIES LENDING EARNINGS?

Securities lending is a spread business, regardless of the interest rate environment (positive or negative). Therefore, the focus should be on whether the gross spread on the reinvestment yield covers the loan expense, generating positive earnings for lenders.



### Securities Lending Spread Components



The earnings calculation can be broken down into the following scenarios:

- **Rebate and reinvestment yield are both positive:** The calculation of earnings is the gross yield on reinvestment less the rebate to the borrower.
- **Rebate is negative and reinvestment yield is positive:** The calculation of earnings is the gross yield on reinvestment plus the fee paid by the borrower.
- **Rebate and reinvestment yield are both negative:** The calculation is reversed, with the lender earnings equal to the fee paid by the borrower less an amount needed to meet collateral return obligations.

<sup>1</sup> <https://www.cbsnews.com/news/jerome-powell-negative-interest-rates-federal-reserve/>

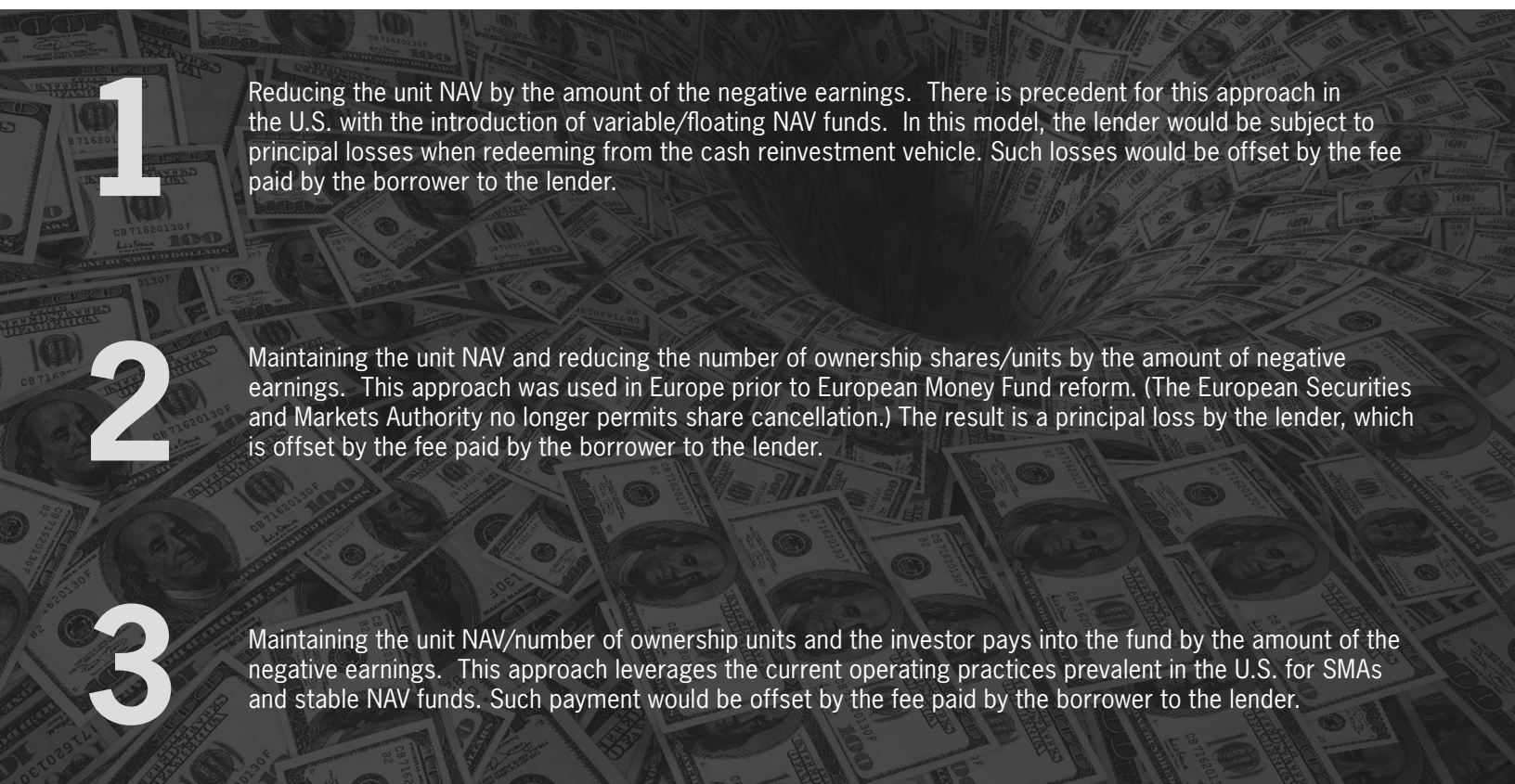
## CONSIDERATIONS FOR CASH REINVESTMENT PRODUCTS

Below are examples of commonly utilized cash collateral reinvestment vehicles:

- Registered Funds (both prime and government).
- Individual/separately managed investment accounts (SMA).
- Non-registered commingled vehicles.

Approaches for accruing, reporting, and accounting for negative cash reinvestment yields may vary. Each firm should consider the implications for their vehicles in consultation with their cash management teams and other internal experts.

### Potential alternatives include:



1

Reducing the unit NAV by the amount of the negative earnings. There is precedent for this approach in the U.S. with the introduction of variable/floating NAV funds. In this model, the lender would be subject to principal losses when redeeming from the cash reinvestment vehicle. Such losses would be offset by the fee paid by the borrower to the lender.

2

Maintaining the unit NAV and reducing the number of ownership shares/units by the amount of negative earnings. This approach was used in Europe prior to European Money Fund reform. (The European Securities and Markets Authority no longer permits share cancellation.) The result is a principal loss by the lender, which is offset by the fee paid by the borrower to the lender.

3

Maintaining the unit NAV/number of ownership units and the investor pays into the fund by the amount of the negative earnings. This approach leverages the current operating practices prevalent in the U.S. for SMAs and stable NAV funds. Such payment would be offset by the fee paid by the borrower to the lender.

There will be other considerations including the reporting of capital expenses when cash yields are negative, as well as determining whether there will be any operational impacts of receiving less than par upon maturity of an investment. It is important to note that whatever accounting treatment is employed, the lender is obligated to return to the borrower the full value of the collateral posted upon the maturity of the loan.

Regardless of the accounting approach utilized, lenders will generally remain in a position where net earnings are calculated the same as if cash reinvestment yields were positive. So, while the economic outcomes may be the same, the accounting methods utilized may be new to many lenders and require engagement with the lending and cash reinvestment agents to understand further.

## ARE THERE TAX CONSEQUENCES OF NEGATIVE INTEREST RATES AND CASH REINVESTMENT YIELDS?

While the tax consequences of negative interest rates and cash reinvestment yields will depend upon the accounting treatment employed, the IRS treatment of these events is unclear.

If a lender suffers a loss in its reinvestment vehicle, it likely constitutes a capital loss for U.S. federal income tax purposes, which may or may not be partially or fully deductible, depending on the individual lender's situation. Lenders in other jurisdictions may face similar tax consequences.

In addition, the character and source of negative interest payments (such as under a repurchase agreement) for general tax purposes is not clear. Although often described as a form of "interest" in the market, such payments do not fit within the traditional definition of the term. This raises substantive questions as to how such payments should be treated for withholding and tax reporting purposes, particularly in cross-border arrangements. Industry groups have offered a wide array of alternatives, including sourcing such payments based on the domicile of the payee (similar to derivatives) and the payor (akin to interest), but the IRS and other tax authorities have yet to formally publish any guidance.

## WHAT IS THE BOTTOM LINE?

While the probability of a negative interest rate policy in the U.S. is low, the securities finance industry and its lenders and borrowers should consider the implications across securities finance front-to-back, including loan demand, cash collateral yields, taxation, and operating models. Market participants should conduct the necessary business assessments and make plans for a negative rate environment.



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