BANKING - AUSTRIA

Supreme Court rules on negative interest rates

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Introduction

Before 2010 it was common practice for Austrian banks to grant foreign currency loans (in particular, loans denominated in Swiss francs and Japanese yen) to consumers for the acquisition of real estate. However, even where a loan was agreed in euros, consumer loan agreements regularly provided for floating interest rates based on the Euro Interbank Offered Rate (EURIBOR) or the London Interbank Offered Rate (LIBOR) as reference interest rates. Documentation regularly failed to provide for minimum and maximum thresholds that could mitigate the risks arising from interest rate fluctuations. Accordingly, as soon as the reference interest rates started to fall below zero, the question of whether banks had to pass on negative interest rates to consumers where the contractual arrangements did not limit the aggregate interest rate to zero became the subject of public interest and fierce discussions among legal scholars.

Following a period of legal uncertainty and controversy in Austrian jurisprudence,(1) the Supreme Court recently provided answers to the question of whether, against the backdrop of negative reference interest rates, a bank can unilaterally floor an overall floating interest rate at 0.00001%(2) or apply a fixed reference rate of 0% when calculating the overall floating interest rate.

Decisions

General and procedural aspects

Even though the facts of both decisions were substantially similar, the procedural bases underlying the respective decisions by the Supreme Court were completely different and so is their relevant outcome.

In both cases, the parties agreed on foreign currency loans with floating interest rates based on a LIBOR (or an EURIBOR) reference rate. The parties did not agree on floors or caps limiting the overall floating interest rate from dropping below zero or skyrocketing. In one case, the defendant (the bank providing the loan) indicated in a letter sent to its borrowers its intention to floor the overall interest rate at almost zero. In the other case, the defendant indicated – again in a letter – its intention to use a fixed rate of zero if the reference rate became negative (ie, to charge the full margin).

By fixing the minimum aggregate interest rate, both banks tried to prevent the negative reference rate ultimately leading to a reduction of the aggregate amount to be repaid by the borrower.

March 2017 decision

In this case(3) the plaintiff, the Association for Consumer Information, was a 'qualified entity' within the meaning of EU Directive 2009/22/EC(4) that was, subject to statutory prerequisites, empowered to bring an injunction action in accordance with Section 28a of the Consumer Protection Act(5) (ie, the Austrian equivalent of a class action lawsuit). Such an action is, for example, permitted against entrepreneurs that violate statutory obligations or prohibitions while conducting business with

consumers, thereby adversely affecting the overall interest of consumers.

With respect to these procedural aspects, the Supreme Court held that based on the wording of the letter – and considering that in February 2015, the applicable one-month LIBOR was already negative – consumers could validly assume that the defendant was on the verge of implementing the unilateral fixing of the minimum interest rate. Accordingly, consumers' interests were affected, thus justifying the injunction action.

Due to the procedural background of this action, the Supreme Court limited its review of the legality of a unilateral post-contractual implementation of an interest rate floor solely to the general banking practice and violation of statutory laws. The Supreme Court repeatedly emphasised that a standalone interpretation of individual contracts may well lead to a different conclusion, potentially allowing for negative interest to be paid.

May 2017 decision

In this case(6) the Supreme Court was asked to rule on an action for declaratory judgment sought by a borrower on the basis of two individual loan agreements. Due to the letters sent by the bank, the borrower asked for a declaratory judgment that the bank was prohibited from unilaterally fixing the reference interest rate at zero when calculating the overall interest rate.

Reasoning

In both cases, the outcome largely depended on the legal methodology applied by the Supreme Court and the courts of first and second instance – in particular, the way in which the courts addressed the missing contractual provisions on (potential) overall negative interest rates.

March 2017 decision

Although the Supreme Court held that the procedural requirements were adequately met, the action was unsuccessful.

The plaintiff based the action on two main arguments:

- a violation of the principle of the sanctity of contracts; and
- a violation of the principles of balance and symmetry, which apply to price adjustment clauses pursuant to Section 6(1)(5) of the Consumer Protection Act.

With respect to the alleged infringement of the principle of the sanctity of contracts, the Supreme Court confirmed that the sanctity of contracts is a core principle of Austrian law. However, the purpose of an action pursuant to Section 28a of the Consumer Protection Act is to prevent a commercial behaviour from violating statutory laws, in particular (but not limited to) the statutory obligations or prohibitions set out in the Civil Code. The Supreme Court held that the principle of the sanctity of contracts is not part of Austrian written law, and as such is not a suitable legal provision within the requirements under Section 28a of the Consumer Protection Act.

Further, the Supreme Court dismissed the plaintiff's argument that the unilateral flooring of the minimum aggregate interest rate at 0.00001% violated the protective scope of Section 6(1)(5) of the Consumer Protection Act.

According to the Supreme Court's reasoning, the parties to a consumer credit agreement regularly agree – and it is a common understanding between them – that the borrower must pay interest for the loan. Further, a consumer-borrower may not reasonably expect the lender to pay interest. Based on these findings, the Supreme Court gave this "natural consensus of the contracting parties" predominance over any other type of interpretation.(7)

Moreover, the Supreme Court held that the wording of Section 6(1)(5) of the Consumer Protection Act solely addresses disproportionate alterations of a consideration to be paid by the borrower to the lender (entrepreneur), not vice versa. By introducing a base for the aggregate interest at zero, the bank conceded that the consideration payable by the borrower could be reduced to zero. Accordingly, the Supreme Court held that the requirement of balance and symmetry was sufficiently satisfied in respect of both parties, and that there was no basis for an action pursuant to Section 28a

of the Consumer Protection Act.

In addition to the abovementioned main arguments, the Supreme Court briefly addressed the supportive refinancing argument used by the plaintiff, holding that due to the reduction of the compensation to "almost zero", the borrowers would not bear the risk of external refinancing of the loan taken out.

May 2017 decision

In this judgment, the Supreme Court confirmed the appellate court's decision, which granted the declaratory judgment that the bank cannot unilaterally fix the agreed reference interest rate at zero even if it becomes negative. However, due to the wording of the declaratory judgment sought, the Supreme Court refused to render a final verdict on whether a negative overall interest rate is permissible and, consequently, whether a bank has to pay for providing a loan.

In its reasoning, the Supreme Court referred to the March 2017 decision and provided a brief summary of the divergent views expressed by Austrian legal scholars. The Supreme Court also expressed its opinion that:

- banks cannot be forced to pay interest in case of a negative reference interest rate (however, the court provided no detailed reasoning for this opinion, but merely repeated opinions from legal scholars); and
- the overall interest rate to be paid by the borrower may drop below the agreed margin and even to zero depending on the development of the reference interest rate (thereby following the March 2017 decision).

By referring to the wording of the provisions on the floating interest rate calculation as included in the two loan agreements under scrutiny, the Supreme Court out rightly dismissed the applicability of the legal methodology of supplementary interpretation, allowing the bank to retroactively fix the reference interest rate at zero. The Supreme Court held that while the loan agreements did not provide the bank with a right to charge the full margin where the reference interest rate dropped below zero, the parties had evidently and bilaterally agreed on sharing the risks arising from the fluctuations of the reference interest rate. The Supreme Court further held that a supplemental interpretation to this end – as argued by the defendants – would also lead to a violation of applicable laws – in particular, Section 6(1)(5) of the Consumer Protection Act, which sets out the principle of balance and symmetry applicable to price adjustment clauses.

Again by referring to the March 2017 decision, the Supreme Court held that since the parties individually agreed to the wording of the floating interest rate, the natural consensus argument used in the preceding decision could not be applied to the case under scrutiny.

Finally, the Supreme Court held that the characteristic of remuneration of a loan agreement is not impaired if a borrower does not pay interest for a certain period of time, as long as the borrower paid, for example, commitment fees or other fees and interest rates in earlier interest periods. By referring to the wording of the declaratory judgment sought, the Supreme Court did not venture further into the – albeit crucial – question of whether payments made by the bank due to a negative overall interest rate can impair the general legal qualification of the underlying loan agreement.

Comment

Considering the significant public interest in the negative interest issue and the well-argued controversy in Austrian jurisprudence, the Supreme Court's decisions initially seem to be disappointing, as they explicitly leave the core issue untouched (ie, whether a bank has to pay negative interest).

However, when closely scrutinising the Supreme Court's decisions and the opinions expressed by legal scholars addressed therein, the Supreme Court has provided some insight what a final verdict on this issue may look like: in its reasoning, the Supreme Court sided with the opinions of those legal scholars who refuted the obligation to pay negative interest, without giving any detailed reasoning. It appears that the Supreme Court already has a clear opinion on this issue, without seeing the need to emphasise it further.

However, the Supreme Court will need to provide a comprehensive verdict, as the solutions offered in the two decisions are insufficient to address the various legal issues triggered by the negative interest rate scenario. There remain a few significant legal issues that require well-conceived solutions.

First, the assumption made by the Supreme Court in the March 2017 decision – that is, that a "natural consensus of the contracting parties" is that the borrower cannot validly expect the lender to pay interest – is unconvincing. In particular, Vonkilch(8) had already published his well-argued opinion that parties usually do not form a "natural consensus" or a "specific common understanding" on issues that they did not think of when entering into an agreement. Accordingly, Vonkilch clearly rejected attempts to solve this legal problem by referring to a "natural consensus" and held that classic rules of interpretation of contracts (Section 914 of the Civil Code) – in particular, by interpreting the wording used by the parties – must be applied, even though this would result in the bank's obligation to pay negative interests. The Supreme Court basically followed Vonkilch (and others) in the May 2017 decision, but nonetheless upheld the opinion that a bank cannot be forced to pay negative interest.

Apart from this dispute, based on legal methodology, this assumption does not sufficiently address the fact that the contractual arrangements do not provide for caps for the interest rate. If one party is allowed to unilaterally introduce an overall interest rate floor serving its economic interests, a reasonable interest cap in favour of the consumer also seems to be mandatory.

This second issue is based on the principle of balance and symmetry applicable to price adjustment clauses pursuant to Section 6(1)(5) of the Consumer Protection Act. This principle requires that the respective adjustment is mutual in regard to both parties. While the Supreme Court addressed this principle in both decisions, it did not address the implications which may arise where a reference interest rate drops below the agreed margin and thus leads to a negative overall interest rate. Against the background of the March 2017 decision and the fact that the minimum overall interest rate may validly be capped at 0.00001% (ie, more than zero), the borrower would be obliged to pay a consideration to the lender even if the agreed overall interest rate (ie, reference rate plus margin, as calculated based on the agreement reached) was zero or below.

In such a scenario, allowing a fixed minimum overall interest rate without amending the initial floating interest rate agreement requires a floating margin, as the margin must increase in proportion to the negative interest rate dropping below the initially agreed margin. A payment obligation arising from an interest rate at 0.00001% is regularly relatively small; however, it will not be zero, and the consumer/borrower will be obliged to pay a consideration to the lender. The economic effect of this floating margin, which by definition can only be increased (never decreased, as there is no overall interest cap limiting the agreed interest rate), is the same as an increase in the compensation unilaterally imposed by the lender. Following this view, the Supreme Court's solution infringes the principle of balance and symmetry as set out in Section 6(1)(5) of the Consumer Protection Act and is not in line with the court's previous decisions, which have found that floating interest rate agreements must not be solely in favour of the banks.

It remains to be seen whether a solution will be provided in the future.

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Endnotes

(1) For further details please see "Negative interest – who must take the risk?".

(2) OGH, March 21 2017, 10 Ob 13/17k.

(3) *Supra*.

(4) Directive 2009/22/EC of the European Parliament and of the Council of April 23 2009 on

injunctions for the protection of consumers' interests.

(5) *Konsumentenschutzgesetz* BGBl 140/1979, last amended in BGBl I 50/2017.

(6) OGH, May 3 2017, 4 Ob 60/17b.

(7) Again, the Supreme Court highlighted that this decision was based on general considerations, and that a contractual price adjustment mechanism (if agreed along the lines of the case at hand) may have a different legal fate when evaluated on an individual basis.

(8) Vonkilch in "*Negativzinsen beim Kreditvertrag?*" in FS Eccher [2017] 1237ff.
