Negative interest – who must take the risk?

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Introduction

Negative interest is normally approached from the depositor's perspective. However, as some reference rates for floating interest rates fall below zero, this topic is also of interest in relation to loan agreements. A recent regional court decision brought attention to some earlier legal jurisprudence on this topic.

However, the main question remains unanswered: which party must bear the risk of a negative reference interest rate? This update gives a brief overview of the opposing positions and the court's amalgamated opinion on this matter.

Borrower's position

Pursuant to the borrower's position,**(1)** a debtor's obligation to pay consideration does not necessarily include an obligation to pay interest in every period. If a fixed interest rate is replaced with a moving index rate, the loan agreement includes a certain element of risk. As the total return is not fixed in such loans, a balance between chance and risk must be maintained for both of the parties. In the case of a back-to-back transaction, the lender will experience no real loss if the reference rate falls below zero, as the generally negligible difference in the interest rate between refinancing and the loan will limit its losses. If the loan is extended for liquidity management purposes, any loss due to the negative reference rate is relative to the eventual losses arising from not offering the money for the loan.

In relation to former low-interest phases and the general economic outlook since 2008, the argument that the decline in reference rates was unforeseeable is unconvincing. As such, lenders are responsible for any failure to implement floor caps or collar clauses. In short, there is a chance that a lender could be obliged to pay negative interest to a debtor.

Lenders' position

Following a more lender-friendly approach, a 'loan contract' is legally defined as lending out money against a valuable consideration, interest and charges.**(2)** By using this legal construct, the parties agree on their general aims and purposes and will include additional clauses where they disagree. Consequently, only the debtor has a general obligation to pay interest. By using a floating interest rate agreement, both parties initially aim for a cheaper loan compared to a fixed-rate loan and seek to roll over a portion of the risk associated with future reference rate movement onto the debtor. The counterargument that lenders use lower interest rates to refinance loans is unconvincing, as there are a wide array of possibilities for refinancing – particularly in the banking industry. By applying a combination of these methods, the lender does not refinance at the well-known interest rate benchmarks. Thus, from a lender's standpoint, there are only two possible solutions in the case of negative interest:

- a reference rate cap of zero with the full mark-up still due; or
- an overall interest rate cap of zero where the mark-up shrinks according to the lower interest rate.

While it may be possible to have an interest rate of zero on a loan, a lender cannot be obliged to pay negative interest on a loan.

Court's position

The regional court**(3)** followed the legal definition of a 'loan' summarised under the lender's position, but emphasised that the consideration payable by borrowers consists of interest, margin and charges. Accordingly, the court ruled that considerations do not disappear where only one element is missing. The court held that it had long been unclear whether a reference rate could fall below zero; as such, considerations could not fall below zero. Further, the court denied the lender's calls for fictional automatic zero cap clauses, as it was its responsibility to implement such clauses. The court also rejected the use of the statutory rules on interest rates, as they were neither implied by the parties' intent nor applicable to the agreed reference rates.

According to the court, on entering the contract, the debtor was obliged to pay compensation; however, the lender's total return was uncertain due to the use of a more speculative approach. The court further held that, as the borrower was obliged to pay charges for the loan (eg, standard margin and borrowing costs, including commissions), the consideration still existed. However, according to the court, the lender was not responsible for paying negative interest, as it fell outside the parties' original intentions.

The Commercial Court in Vienna**(4)** recently ruled on the attempt of an Austrian bank to unilaterally amend, by way of a customer letter sent to all of its foreign currency loan debtors, their foreign currency loan agreements so that the minimum interest rate on London Interbank Offered Rate-benchmarked foreign currency loans was fixed at 0.00001%. Pursuant to the information available, the court rejected this attempt and ruled that the bank had to pay negative interest to its customers if the agreed benchmark became negative.

Neither of the two judgments addressed in this update has become legally binding and it remains to be seen how the Supreme Court will finally decide who must bear negative interest. Notwithstanding this, these first-instance decisions may serve as a strong signal to the Austrian courts in general.

Comment

A loan is a contract which serves as credit against consideration, consisting of charges and interest. In general, the debtor must pay the interest. By using a reference rate to determine the interest rate, both parties wilfully add a speculative element to the contract. The parties seek to increase or lower the interest

rate as much as possible. Where the reference rate changes significantly, one side will suffer losses. However, by using cap or collar clauses, such losses may be limited, as will the possible profits arising from the lower or higher rates.

While the decline in the reference rate may be unforeseeable, by agreeing on a reference rate-based compensation without using security measures, the risk must be shared as agreed, even if it is against some of the original intentions of one of the parties. Faith in the contract forces the parties to apply the consideration as agreed. The same is true if the reference rate increases substantially. In this case, the debtor would be responsible for covering the entire consideration (ie, charges and a greatly increased interest payment based on the unexpectedly high reference rate).

In short, a lender must pay any negative interest to the debtor, as it would have gambled with a floating interest rate and lost. Since Austrian banking practice included collar clauses in standard loan documentation several years ago, the risks lenders face with regard to old loan transactions based on unlimited interest rate agreements is limited.

It may also be time for the banking sector to redefine its views on interest. The approaches developed by the Islamic financial system – which offer a range of possibilities to establish financial solutions without using interest – could be considered. A combination of interest-free loans and specifically adapted project finance patterns would circumvent the question of who must bear negative interest.

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(1) Dr Petra Leupold, *Negativzinsen beim Kreditvertrag*, *Zeitschrift für Verbraucherrecht* 2015/53.
(2)University Professor Dr Brigitta Zöchling-Jud, *Zum Einfluss von negativen Referenzwerten auf Kreditzinsen, Österreichisches Bankarchiv* 2015/318.
(3) Landesgericht Feldkirch, 5 Cg 18/15z, August 28 2015.

(4) See www.ots.at/presseaussendung/OTS_20151021_OTS0013/vki-negativzinsen-urteil-gegen-unicredit-bank-austria.


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