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NEGATIVE INTEREST RATES – COULD FINANCIERS BE REQUIRED TO PAY INTEREST?

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Legal Briefings – By **Patrick Lowden, Josie Essery and Brendan Hord**

The unprecedented economic impact of COVID-19 has seen the introduction of "quantitative easing" in Australia, raising the possibility of negative interest rates.

Typically, a borrower or note issuer will pay interest to a lender or noteholder as compensation for the use of their capital. However, where the interest is calculated on a floating rate basis (usually as a base rate of BBSY or BBSW plus a fixed margin), if the base rate falls below zero, a negative interest rate could result.

Responding to this, the current trend in senior wholesale Australian debt capital market issuances is to specify that the minimum interest rate applying to the notes is zero, and this practice is also starting to be seen in loan facilities which do not otherwise specify that the reference rate to which the margin is applied cannot be less than zero. Whilst this practice may be helpful in making the position clear, does it imply that noteholders / lenders may be charged negative interest in circumstances where the relevant documentation doesn't provide for a zero floor?

Although always a question of construction of the individual contract, Australian case law suggests investors and lenders are on firm ground.

In 2006, the Federal Court of Australia considered whether negative interest could be charged to members of a superannuation fund in *Vision Super Pty Ltd v Poulter* (2006) 154 FCR 185.

Vision Super Pty Ltd was the trustee of a registered superannuation fund (the **Fund**) under the *Superannuation Industry (Supervision) Act 1993* (Cth). Three members of the Fund (**the Members**) complained to the Superannuation Complaints Tribunal when the trustee deducted money from their accounts as a result of negative returns on the Fund's investments.

The complaints arose from interest which was payable on a “Deferred Benefit” under the superannuation scheme. If a member of the Fund resigned their job before turning 55 years old, the Trust Deed provided that the member generally needed to elect between one of the following options:

1. **Immediate Lump Sum payment**: An immediate lump payment of 15% of the adjusted final salary of the member applied to the period of their service (and subject to other adjustments); or

2. **Deferred Benefit**: Defer the lump sum payment until (subject to certain exceptions) the member turned 55 years old. Under clause C.4.10(a), the Member would then receive a lump sum equal to the sum of:

    a. The retirement benefit calculated under clause C.4 (essentially being a payment of 21% of the adjusted final salary applied over the period of service); and

    b. interest on the amount of that retirement benefit from the date on which that benefit falls due (being the date of resignation) until the date it is paid.

The Trust Deed did not define “interest” and gave the trustee broad discretion to set the rate of interest.

Each of the Members resigned from their positions before turning 55 and each chose the deferred benefit option. However, due to negative investment returns, the trustee applied “negative interest” to the Members’ accounts and deducted amounts ranging from approximately $10,000 up to $27,000 for the period 1 July 2001 to 31 March 2003.

The Members argued that the trustee could not charge negative interest under clause C.4.10(a): they argued that the clause only permitted the trustee to *credit* interest to their accounts. The Members succeeded before the Superannuation Complaints Tribunal which found that the trustee had acted unfairly and unreasonably towards the Members by debiting negative interest from their accounts. The trustee challenged this decision in the Federal Court.

Justice Young found that the use of the word “interest” in clause C.4.10 did not allow the trustee to apply a negative interest rate. The term “interest“ was not defined in the Trust Deed. However, his Honour referred to the classic formulation of the term which provides that:

> “Interest is, in general terms, the return or consideration or compensation for the use or retention by one person of a sum of money, belonging to, in a colloquial sense, or owed to, another” (*Reference as to the Validity of s 6 of the Farm Security Act 1944 of the Province of Saskatchewan* [1947] SCR 394 at 411 per Rand J; see also *Commissioner of Taxation v Myer Emporium Ltd* (1987) 163 CLR 199 at 219 per the Court).

His Honour rejected the argument of the trustee that in the context of the Trust Deed and the absence of a debtor-creditor relationship the term “interest” should be construed as referring to investment returns, rather than given its “ordinary meaning”. His Honour also considered the formulation of clause C.4.10(a) in contemplating the payment of interest as something in addition to the original sum, and the absence of any express right to debit negative interest to the member’s account, as leading to the conclusion that the trustee had no power to apply negative interest to a member’s account.

Accordingly, Young J found that the clause on its proper construction did not permit or authorise the trustee to reduce the deferred retirement benefits on account of negative interest or a negative investment return.

Although the case concerned construction of a trust deed for a superannuation fund, much of the reasoning in the case seems readily applicable to the terms of a note or loan contract. The case affirms the “ordinary meaning” of interest as an amount payable by a debtor to a creditor as compensation for use of the principal sum, and suggests that, in the absence of specific drafting leading to that conclusion, an obligation on a debtor to pay interest is unlikely to be construed as an obligation on the creditor to pay interest, or as a right on the part of the debtor to reduce the principal balance, merely because the specified interest rate becomes negative.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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