

# CY Newsletter

Vol. 5

## **The effect of the introduction of negative interest rates of the Bank of Japan in the payment of interest for variable interest rate loans**

—focus on negative loan interest issues—

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### <Background>

At the Monetary Policy Meeting held on January 29 2016, the Bank of Japan (“BOJ”) decided to adopt a three-tier system of basic balance, macro add-on balance and policy-rate balance for the current deposit accounts of BOJ held by financial institutions and to apply negative interest rates of -0.1 % to the policy-rate balance. Such policy was implemented on February 16.

Along with the introduction of negative interest rates, there are increasing effects on the financial markets including, on February 17, transactions with negative interest rate being executed in the call market (uncollateralized overnight call rate) which accommodates short term financing between financial institutions and prior to that, on February 9, the ten year Japanese Government Bond yield, which is the primary index for long term interest rates, became negative. In such situation, the potential reality that benchmark interest rates such as LIBOR and TIBOR will become negative in the near future is now being discussed.

Benchmark interest rates such as LIBOR and TIBOR are widely used as standard interest rates in variable interest rate loans and variable rate bonds where the interest rate adding a set spread to the standard interest rate will be the applicable interest rate. If such benchmark interest rates become negative and the spread will be entirely eaten up, then the applicable interest may become negative. There is an ongoing controversy over the issue as to whether the lender (bondholder) will have an obligation under the loan agreements (bond terms and conditions) currently being used to pay the borrower (the bond issuer) for the amount calculated with the applicable negative interest rate as interest<sup>1</sup>.

## <Topic>

This Newsletter will discuss the issue of payment obligations for interest calculated with a negative applicable interest rate on the basis of narrowing down such issue to the cases of variable interest rate loans having a standard interest rate clause in the loan agreement to the effect that “the borrower shall pay to the lender on an interest payment date interest calculated by multiplying the principal amount by the Applicable Interest in proportion to the actual number of days with respect to the interest calculation period corresponding to such interest payment date. ” This issue is an issue of contract construction for which all the circumstances should be comprehensively taken into account and thus it is not possible to exhaustively discuss the entire subject in this Newsletter. This Newsletter provides commentary on two approaches of the contract construction, which may be used to deny the lender’s obligation to pay negative interest, and gives certain suggestions for analysis on such obligation.

## <Comment>

### 1. Approach from the meaning of “interest”

#### (1) Details of the approach

The legal meaning of “interest” is defined commonly as “money or any other fungible things payable proportional to the amount of principal and period of use thereof based on a certain interest rate as consideration for use of money or any other fungible things” based on the commercial concept (“commonly accepted meaning”)<sup>2</sup>. If “interest” as used in a loan agreement is understood to have the commonly accepted meaning, it will be “consideration for use of money”. As “consideration for use of money” is something paid by the borrower, the amount calculated with negative applicable interest rate (“negative loan interest”) will not constitute “interest” to the extent that it will be paid by the lender to the borrower and therefore, there will be no lender’s obligation to pay negative loan interest under the interest clause<sup>3</sup>.

#### (2) Determining the meaning of “interest” as a matter of contract construction

The meaning of “interest” in the Civil Code, the Commercial Code, the Interest Rate Restriction Act and other laws is established based on case precedent and commentaries of legal scholars which coincide with the purpose of the applicable law. The meaning of the terms used in an agreement, however, indicates the agreed content of the parties and how to establish such meaning is an issue of contract construction. Depending on the results of such construction, “interest” in the loan agreement may have a meaning which is broader than the commonly accepted meaning, namely, a meaning which includes consideration paid to the party using the money (“broadened meaning”). If construed in this way, the lender’s obligation to pay negative loan interest under the interest clause cannot be denied based on only the use of the term “interest.”

Consequently, when using this approach, it is necessary to examine when as a result of construction of the loan agreement, “interest” is understood to have the commonly accepted meaning and when “interest” is understood to have the “broadened meaning.”

#### (3) Standards for construing the meaning of “interest”

In general, in regard to the construction of contract wording, the common intention of the parties is

first sought and if the intention is not clear, it is said that the basis for construction is the “circumstances at the time of execution of the contract”, “business customs” and the “main purpose of the contract”<sup>4</sup>.

In regard to the meaning of “interest” under the agreement, the common intention of the parties should be first sought. As the common intention of the lender and borrower, if it is clear that the broadened meaning is given to “interest”, the meaning of “interest” will be understood to be such. However, what is actual the issue is the case where the opinion of the lender and the borrower in regard to the meaning of “interest” differs, namely, it is probable that the lender will assert the commonly accepted meaning and the borrower will assert the broadened meaning. In such case, mostly the common intention of the parties will not be clear and the “circumstances at the time of execution of the contract,” “business customs” and “the main purpose of the contract” will be referred to as the next step.

In determining the meaning of “interest” in the agreement under such standard, it seems that “business customs” will be key as a starting point. Such “business customs” are understood to be “actions which are conducted repeatedly for a transaction among a certain scope of persons who belong to certain commercial society, and can be generally recognized to the extent that it can be anticipated to be observable in specific transactions for which the agreement was executed.”<sup>5</sup> In light of such meaning of “business customs”, in determining the meaning of “interest” under the agreement, it should be taken into account how the term “interest” is understood and used in transactions of the same type as the loan transaction which have been repeatedly conducted by both parties in the business area to which both parties belong. While referring to “business customs” in such form, if there are particular circumstances which should be taken into account as the “main purpose of the agreement” or the “circumstances at the time of execution of the contract”, those circumstances should also be referred to when determining the meaning of “interest” in the loan agreement.

#### (4) Meaning of “interest” in existing loan agreements

On the assumption that the common intention of the parties is not clear, we provide an examination of the meaning of “interest” in existing loan agreements using the construction standards explained above.

If transactions which were generally conducted by the parties to the loan agreement at the time of execution of the loan agreement were ordinary lending transactions, it may be argued that “interest” in the loan agreement was understood by the parties to have the commonly accepted meaning. The reason is that the commonly accepted meaning explained above was established by referring to the generally accepted commercial concept for “interest”. Therefore, “interest” in the loan agreement will be determined to have the commonly accepted meaning unless there are special factors contrary to that in the “circumstances at the time of execution of the contract” or the “main purpose of the agreement.” In such case, as explained above, for the reason that the term of “interest” is used in the interest clause, the existence of lender’s obligation to pay negative loan interest will be denied.

On the other hand, if “negative yield transactions” whereby as a matter of substance the payer of consideration is the investing or financing party were commonly conducted and the concept of “negative interest” was generally accepted in the transaction environment to which the parties to the loan agreement belonged,<sup>6</sup> it seems that the possibility remains that “interest” in loan agreements is understood to have the broadened meaning. In such case, the lender’s payment obligation for

negative loan interest cannot be denied only for the reason that the term of “interest” was used in the loan agreement and it will be necessary to seek other reasons to deny that (e.g. approach from the provisions for payment explained in 2.).

#### (5) Meaning of “interest” in future loan agreements

In considering the meaning of “interest” in the loan agreements to be executed in the future, we consider that it is necessary to take into consideration a different situation compared to existing loan agreements.

In the introduction of negative interest rates by the BOJ, negative interest is defined<sup>7</sup> as rates for “interest”<sup>8</sup> of current deposit account and the amount of the difference netting out interest calculated with positive interest and interest calculated with negative interest will be paid by BOJ (or received by BOJ) as “interest” for the supplementary current deposit account system<sup>9</sup>. Although Article 17, Paragraph 1 of the Current Account Rules of the BOJ provides that a financial institution as depositor may be obligated to pay to BOJ commissions separately determined by the BOJ, interest calculated with negative interest is treated as interest provided for in the proviso of Article 16 of the Rules rather than the commissions under Article 17, Paragraph 1.

It seems that the giving of broadened meaning to “interest” in current deposit accounts of the BOJ will have a certain effect on general understanding for the meaning of “interest”. As well, there is starting to be a wide awareness of the possibility of negative interest in normal variable interest loans along with the introduction of the negative interest by the BOJ. If that situation becomes more common, the concept of “negative interest” between the parties conducting normal financial transactions may become common and it may become the case that “interest” will be interpreted to have the broadened meaning in loan agreements even based on the interpretation in light of usual business customs.

## **2. Approach from provisions for payment**

### (1) Details of approach

It may be argued, without commenting on the meaning of “interest”, that the fact that only the borrower’s obligation to pay interest to the lender is provided for in the loan agreement reflects the intentions of the parties to not impose payment obligation for negative loan interest on the lender.<sup>10</sup>

### (2) Review of anticipated counterarguments

A possible counterargument against the above mentioned approach would be that, the fact that there is provision for only the borrower’s payment obligation in the interest clause means that negative loan interest was simply not anticipated and such fact does not show the parties’ intent not to impose on the lender the obligation to pay negative loan interest even if applicable interest rate becomes negative. In the loan agreement executed under the circumstance where negative loan interest can be anticipated to a certain degree, it may be argued that if there was an intention to not impose a payment obligation for negative loan interest on the lender even when the applicable interest becomes negative, it would be natural to have a provision to such effect, and it would be unnatural for the parties to consider that such intention was fully reflected in the loan agreement by only providing for the borrower’s payment obligation.

Therefore, although the fact that there is provision for only the borrower's payment obligation in the interest clause is one factor for denying the existence of lender's obligation to pay negative loan interest, it seems that it is not decisive.

### **3. Meaning of examining the existence of the lender's payment obligation for negative interest rates**

The existence of the lender's payment obligation for negative loan interest will not be an issue only from the viewpoint of whether the lender will actually be demanded by the borrower for payment of negative loan interest. As a practical measure to cope with the possibility of accrual of negative loan interest, contract amendment that the applicable interest rate minimum is zero is now considered on a case-by-case basis. However, depending on whether there exists the lender's payment obligation for negative loan interest under the original loan agreement, the legal implication of such measures will be different. If there is no lender's payment obligation for negative loan interest in the first place, such agreement amendment is for "avoidance of doubt" and it seems there is no particular legal issue. On the other hand, if there is the lender's payment obligation for negative loan interest in the original agreement, such agreement amendment will be an amendment favorable to the lender and examination will be required for the requirement of consideration therefor and the legality depending on the case.

As the issue of whether or not the lender's payment obligation for negative loan interest exists is a contract construction issue for which various factor should be taken into account as explained above, if the opinion of the lender and the borrower differ, it will be difficult for one party to determine with certainty. However, it is desirable for each party to proceed with the next step at least after establishing such party's view on such issue.

- 1 Study “Outline of the Approaches to Issues in Interpreting Contracts that Arise in Connection with the Introduction of a Negative Interest Rate” (“Outline of Approaches”) published by the Financial Law Board on February 19, 2016 discussed this issue.
- 2 Okuda Masamichi (ed), Commentary on the Civil Code [10] I. Claims (1) (Yuhikaku, 2003) (“Commentary on the Civil Code (10) I”) Page 340
- 3 Outline of Approaches Page 2
- 4 Takeyoshi Kawashima and Yoshio Hirai (eds), Commentary on the Civil Code [3] General Provisions (3) (Yuhikaku, 2003) (“Commentary on the Civil Code (3)”) Pages 70-71
- 5 Commentary on the Civil Code (3) Page 74
- 6 It is difficult to anticipate a specific case, however, as explained in (5), if taking into account the giving of the broadened definition to “interest” in the Current Accounts Rules of the BOJ, it seems that transaction environment similar to the transaction environment between the BOJ and the transactional financial institution is anticipated.
- 7 Guidelines for System for Supplement for Current Account for Facilitating Financing subject to the proviso of Article 16 the Current Account Rules of the BOJ was revised on January 29, 2016 and the applicable rate for -0.1% in the policy interest balance is provided in 4. Applicable Interest.
- 8 It is provided in Article 16 of the Current Account Rules of the BOJ that “The current deposit account shall not bear interest; provided, however, that if deemed particularly necessary by the BOJ, the current deposit account shall bear interest based on the rules provided separately by the BOJ.”
- 9 Answer for Q7 for practical Q&A for concerning negative interest application for the current deposit account of BOJ (for transactional financial institutions) (Page 4)
- 10 Outline of Approaches Page 2

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