

The Default Interest and Usury Law Conundrum – The Italian Supreme Court Provides Some Clarity

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On September 18, 2020, the Italian Supreme Court handed down a much-awaited decision on default interest and usury law (the “Decision”). In particular, the Supreme Court clarified that – at least from a civil law standpoint – usury law also applies to default interest charged in connection with financing transactions, holding among other things that “*default interest cannot be considered excluded from usury law (and the relevant regulatory framework), as the borrower needs greater protection.*”

Regardless of its content – briefly described below – the Decision is welcome insofar as it brings some clarity on a much- and long-debated issue (*i.e.* whether default interest falls within the scope of usury law), which has become all the more relevant in the past years, also considering the ongoing impact of the financial crisis and the current looming economic contraction. For the future, the Decision should hopefully dispel any doubt as to the rules applicable to default interest, and the civil law consequences resulting from it exceeding the applicable usury threshold.

A. Background and Regulatory Framework

Italian law makes it unlawful for a lender to apply interest or other charges in connection with a financing transaction in excess of a statutory threshold rate, independently of the nature or financial condition of the borrower (so-called “statutory usury”). Hence, the applicable threshold rate and the manner in which it is calculated are key for purposes of statutory usury.

The Law of March 7, 1996, no. 108 (“Usury Law”) sets out the relevant formula, providing that the threshold rate be calculated on the basis of the Average Annual Percentage Rate (“TEGM”) indicated in a decree to be published by the Ministry of Finance (“MEF”) on a quarterly basis. In turn, the TEGM published by the MEF is based on a survey of the economic conditions applied in the market in the previous quarter that the Bank of Italy carries out each quarter, on the basis of certain instructions that participants are required to follow (the “Instructions”).

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Because the Instructions have so far excluded default interest from the charges to be reported, default interest has never been included in the TEGM. Starting from 2003, however, the quarterly MEF decrees have included a statement that, based on a statistical survey carried out by the Bank of Italy once in 2002 and subsequently updated in 2015, lenders in Italy apply default interest at a certain average rate (2.1% based on the 2002 survey, and from 1.9% to 4.1% depending on the type of financing transaction based on the 2015 survey) above the basic rate of interest.

B. The Decision

After recapping the status of the debate on default interest and usury law and both sides' arguments, the Supreme Court ruled that Usury Law applies also to default interest. Specifically, the Supreme Court held, among other things, the following.

- (i). Usury Law also applies to default interest, on the basis that this is consistent with the purpose of the law to provide comprehensive protection to the borrower
- (ii). Because default interest is excluded from the TEGM calculation, in order to ensure that the comparison is made between homogeneous measures, courts should compare the cost of a financing, inclusive of default interest, against a so-called "default threshold rate", calculated on the basis of the TEGM + the average increase in interest rate for defaulted sums as reported in the MEF decrees (previously, 2.1%, now 1.9%-4.1%). (However, the Supreme Court somewhat contradictorily added that – for the period prior to 2003, for which no such default threshold rate exists – courts may continue to use the standard statutory threshold rate based on the standard TEGM, which did not include default interest)
- (iii). In case default interest is found to be usurious, the relevant contractual clause (but only that clause) is null and void. The Supreme Court further clarified that interest continues to accrue on defaulted amounts at the basic interest rate (provided

of course such basic interest rate is not itself in excess of the usury rate)

C. Possible Impacts

As noted initially, the Decision is most welcome insofar as it provides market participants with some clarity on an important and long-debated issue. For the future, there should no longer be any doubt on the following aspects: (i) that, at least as far as civil law is concerned, default interest is subject to statutory usury, (ii) which threshold rate is to be used for a finding of usury, and (iii) the consequences of a usury finding on the agreement and relevant contractual clauses.

As to its practical implications, it appears that the Decision:

- May not have a disruptive impact on existing lending processes. The Decision appears to be in line with the interpretation suggested by Italian Banking Association ("ABI") in 2003, in the aftermath of the publication of the first MEF Decree setting out the result of the Bank of Italy's 2002 statistical survey on default interest. At the time, ABI suggested that – out of caution – default interest be considered relevant for statutory interest purposes and the "default threshold rate" be used to verify compliance with usury law. Accordingly, those lenders that have followed this conservative approach likely do not need to amend their internal processes and procedures – including "cap" mechanisms – as a result of the Decision;
- Strikes a balance between the borrower's and the lender's needs. On the one hand, it increases the borrower's protection, by ensuring that it may not be charged usurious rates in the form of default interest. On the other hand, it does not overly penalize lenders, by holding that – in case default interest is found to be usurious – only the clause setting out default interest is null and void, and that default interest may still accrue (even if at a different rate), thus rejecting extreme

theories according to which no interest could be applied in such cases.

At the same time, the Decision leaves some matters unanswered. In particular, it remains to be seen whether the conclusions reached by the Supreme Court in the civil case will be confirmed in criminal cases. Even if, under Italian law, the

notion of “usurious interest” is one and the same for purposes of both civil and criminal law, criminal courts are not bound by the Decision and may depart (as they often did in the past) from the principles stated by the civil panels of the Supreme Court.

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