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Draft Federal Law N 134365-6 with respect to restriction of usurious transactions



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with any questions and comments related to the subject matter of this Legal Alert

*The Draft of the Federal Law N 134365-6 'On Amendments to Certain Legal Acts of the Russian Federation (with respect to restriction of usurious transactions)' (the 'Draft Law') was passed to the State Duma of the Federal Assembly of the Russian Federation on September 3, 2012. The Draft Law introduced the set of rules dedicated to provide negative incentive for the banks to make usurious transactions by motivating the borrowers to recover in an action against banks the amount of the money paid above the approved interest rate. It provides that the Central Bank of the Russian Federation (the '**Central Bank**') shall establish the maximum interest rate and that the borrowers are entitled to claim a return of the amount overpaid. The Draft Law allows the borrower to claim the difference between the usurious interest rate and the Central Bank's refinancing rate¹. It does not recognize usurious transactions as void or voidable.*

It should be noted that the concept of usurious loans is initially proposed by the Draft of the Civil Code of the Russian Federation, passed to the State Duma in June this year². However, these provisions refer only to the interest rate for loans between individuals and provide that the rate of interest on loan agreement which significantly

¹ For the comparison of average interest rates for mortgage loans, consumer loans and Central Bank refinancing rate for the last three years please see attached Exhibit 1 (*Interest rate chart*).

² The Draft of the Federal Law N 47538-6 'On Amendments to Part One, Part Two, Part Three, and Part Four of the Civil Code of the Russian Federation and to Certain Legal Acts of the Russian Federation'.

exceeds the average interest rate in similar cases and which is therefore exceedingly onerous for the debtor (usurious interest) can be reduced by court to the rate of interest which is usually applied in similar cases. The Draft Law introduces remedies for borrowers with respect to the credits (loans)³ granted to individuals by credit institutions, microfinance organizations, credit cooperatives, and other commercial lenders, as well as it establishes the procedure for the maximum interest rate determination.

1. Usurious credit (loan) criteria

The Draft Law provides for the following criteria for credit (loan) to be usurious:

- ❖ with regard to credits (loans) granted by credit institutions, microfinance organizations, credit unions to an individual it is established that the full cost of credit (loan) **shall not exceed double full average cost of credit (loan) which is established by the Central Bank** with respect to credits (loans) of certain type in the preceding quarter (please refer to Clause 2 of this Alert for the consequences of failure to comply with the maximum interest rate requirements);
- ❖ with regard to loans granted by pawnshops it is established that the interest rate **shall not exceed one third per cent per day, 10 per cent per month, or 120 per cent per annum** (please refer to Clause 2 of this Alert for the consequences of failure to comply with the maximum interest rate requirements);
- ❖ with regard to loans granted by a lender, which is not a credit institution, a microfinance organization or a pawnshop, it is established that the full cost of loan **shall not exceed the market average full cost of the credit paid for the loans of similar type which were granted by credit institutions in the preceding quarter, and that in case of disputes the court shall determine the type of loan and its full cost according basing on the procedure established by the Central Bank with respect to loans granted by credit institutions** (see Clause 2 of this Alert for the consequences of failure to comply with the maximum interest rate requirements).

2. Who is in charge with methodology and publications?

³ In the Russian legislation there are two types of agreements for borrowing money at interest: credit and loan. The agreement is qualified as a credit agreement, if the lender is a bank (an organization which has a license granted by the Central bank to conduct banking business). If the lender is not a bank, the agreement is qualified as a loan agreement. The regulation of these two types of agreements varies in some aspects, however such differences do not apply to usury.

As per the Draft Law, the calculation methodology of the full cost of credit shall be enacted by the Central Bank regulation and published quarterly:

- ❖ The Central Bank (the authorized federal government agency together with the Central Bank for loans granted by credit unions and microfinance organizations) shall determine a list of loan types and establish the methodology for quarterly calculation as well as the procedure for publication of information on the average market funding cost for each type of loans;
- ❖ The Central Bank (the authorized federal government agency together with the Central Bank for loans granted by credit unions and microfinance organizations) shall calculate and publish the average market funding cost for each type of loans no later than 10 days before the end of each quarter.

3. Consequences of exceeding of the maximum interest rate

In case when a full cost of credit exceeds the maximum interest rate, a debtor (or where the lender is not a credit institution, microfinance organization or a pawnshop - an authorized officer of the state supervisory body on protection of consumer rights) is entitled to seek amendment of the credit agreement (loan agreement), i.e. to claim reduction of the interest rate and other charges specified in the credit agreement (loan agreement) **to the amount which is specified in Paragraph 1 of Article 395 of the Civil Code of the Russian Federation (i.e. to the Central Bank refinancing rate).**

However, the Draft Law does not introduce any provision that limits such claims only to future claims (i.e. it doesn't prevent the debtor from claiming mandatory amendment of the credit agreement (loan agreement) from the date when the court decision comes into effect). As such we cannot exclude that the court practice may show a tendency to reduce interest rate under a credit agreement (loan agreement) right from the date of its conclusion which may result in the debtor's claim (i) for the recovery of unfairly paid money and payment of interest accrued on such amounts for their groundless use by the lender, or (ii) to offset the excess payments against the principal amount of debt. In this context we would like to mention that in some other jurisdictions the legislator recognizes usurious rate provisions in the loan agreement as void from the date on which the credit agreement (loan agreement) came into effect (it is directly established, for example, in Articles 313-3, 313-4 of the Consumer Code of France)⁴.

Usury laws of France, New York and Washington establish the rule that interest rate is recognized as usurious, if it does not correspond to the maximum interest rate at the

⁴ Legifrance // <http://www.legifrance.gouv.fr> // September 17, 2012.

moment when the credit is granted⁵. The Draft Law does not directly provide for the same rule, but in our opinion, courts will make the same conclusion, as according to the Russian legislation it is prohibited to unilaterally change the interest rate on the credit (loan) granted to a consumer by an organization⁶.

4. Enactment of the Draft Law

Article 6 of the Draft Law provides for the stage-by-stage entering into effect of the Federal Law 'On Amendments to Certain Legal Acts of the Russian Federation (with Respect to Restriction of Usurious Transactions)':

- ❖ The Federal Law comes into effect six month after the day of its official publication;
- ❖ Provisions of the Federal Law shall apply to agreements concluded as of one year after its enactment.

5. Consequences for RMBS documentation

In our opinion, when the Draft Law is enacted, the rating agencies will have to additionally weight up the usurious credits (loans) risk incurred to mortgage portfolios used at securitization transactions.

In the United States, for instance, the Moody's Criteria for Evaluating Representations and Warranties in U.S. Residential Mortgage Backed Securitizations (RMBS)⁷ contain *the special provision on representations and warranties in RMBS transaction documentation with regard to the fact that credit agreements in mortgage pool are not usurious transactions pursuant to the law*. This approach is determined by the fact that the maximum interest rate provisions in the USA are established by special regulation of states⁸, including New York⁹ and Washington¹⁰.

⁵ New York State Legislature // <http://public.leginfo.state.ny.us> // September 17, 2012;

Washington State Legislature// <http://apps.leg.wa.gov> // September 17, 2012

⁶ Paragraph 4 of Article 29 of the Federal Law of December 02, 1990 N 395-1 'On Banks and Banking Activity'; Article 12 of the Federal Law of July 02, 2012 N 151-FZ 'On Microfinance Operations and Microfinance Organizations'; Articles 7, 8 of the Federal Law of July 19, 2007 'On Pawnshops'.

⁷ Moody's // <http://www.moodys.com> // September 17, 2012.

⁸ LoanBack.com // <http://www.loanback.com> // September 17, 2012.

⁹New York State Legislature // <http://public.leginfo.state.ny.us> // September 17, 2012.

¹⁰Washington State Legislature// <http://apps.leg.wa.gov> // September 17, 2012.

It should be noted that currently the language of the Russian RMBS transactions is limited by general representations and warranties that the credit agreements in the mortgage pool are in compliance with the laws of the Russian Federation¹¹. But since the Draft Law does not treat usurious credit (loans) as void or voidable transactions, entering into such transactions cannot be prohibited or considered as unlawful. Thus, usury credits (loans) will pass the “compliance-with-the-law” test, even if the Draft Law is enacted. Thus, in case the Draft Law is enacted, documents and methodologies, as applied by rating agencies when rating Russian RMBS transactions, will most likely be amended and might be aligned with the model of representations and warranties in U.S. RMBS (credits in the pool are not usurious transaction).

6. Effect on rating assigned to RMBS transactions

Despite the probable change which is likely to be made in documents, the rating of future Russian RMBS transactions itself will not be influenced by enactment of the Draft Law due to the following reasons:

- ❖ first, the home lending is the most competitive and transparent market in the Russian lending sector, the interest rates for such loans are the lowest ones, therefore, the risk that interest rates for credit agreements in the mortgage pool will be considered usurious is low;
- ❖ second, due to characteristics of the Russian concept of the usury credit (loan) and general characteristics of the Russian legal system as detailed below.

100 per cent above the market average

The Draft Law establishes a comparatively high level of interest rate to be recognized as usurious: interest rate is considered usurious if **it exceeds** the double average full cost of credit (loan) which is established by the Central Bank. For instance, according to the legislation of France the credit agreement (loan agreement) is recognized as usurious if the interest rate **exceeds at least one-third** of the average effective rate applied during the prior quarter of the year by credit institutions for loans of the same

¹¹See, for instance: Moody's // Moody's MILAN Methodology for Rating Russian RMBS; Moody's Approach to Rating Russian Residential Mortgage Backed Securities // <http://www.moody.com> // September 17, 2012.

nature, as defined by the relevant administrative authority¹². Legislation of New York and Washington **prohibits any exceeding** of the statutory maximum interest rate¹³. Permission of a material exceeding of the market average full cost of credit (loan), established by the Central Bank, also mitigates the risk of downgrading a credit rating of the Russian RMBS deals.

No class-action lawsuits for consumer credits (loans)

In general, adoption of usury laws cannot cause the risk of downgrading a credit rating of RMBS deals because it gives borrowers or third parties the right to pass a class-action lawsuit against usurious interest rates established in loan agreements, included in a mortgage pool, and to claim damages. For instance, sustaining a class-action lawsuit and awarding damages against RMBS trusts for alleged usurious second-lien by Arkansas circuit court has led to subordination of the noteholders payments to damages awarded to borrowers¹⁴. But there is no risk of filing such a class-action lawsuit in the Russian Federation, as such remedy is not provided by the Russian law on the civil procedure for borrowers.

The Russian legislation entitles state bodies and organizations, authorized to protect consumer rights and interests, to file a lawsuit to defend the rights of generic class of consumers and to claim that the lender shall stop unlawful actions. However, while sustaining such a claim the court is only entitled to state that credit (loan) is usurious. Such a judgment will not oblige the bank to pay money back to all its borrowers. Each borrower in order (i) to refund the money paid groundless and the interest thereon or (ii) to offset excess payments against credit (loan), shall file individual claim to the court for this purpose.

Thus, there is no risk of filing a class-action lawsuit. There is also no risk for the lender to become obliged to pay money back in the amount exceeding the rate of refinancing to *all* its borrowers at one moment in time. Thus, we believe that these risks cannot be the ground for downgrading of the credit rating of RMBS transactions in the Russian Federation.

¹² FindLaw // <http://corporate.findlaw.com> // September 17, 2012

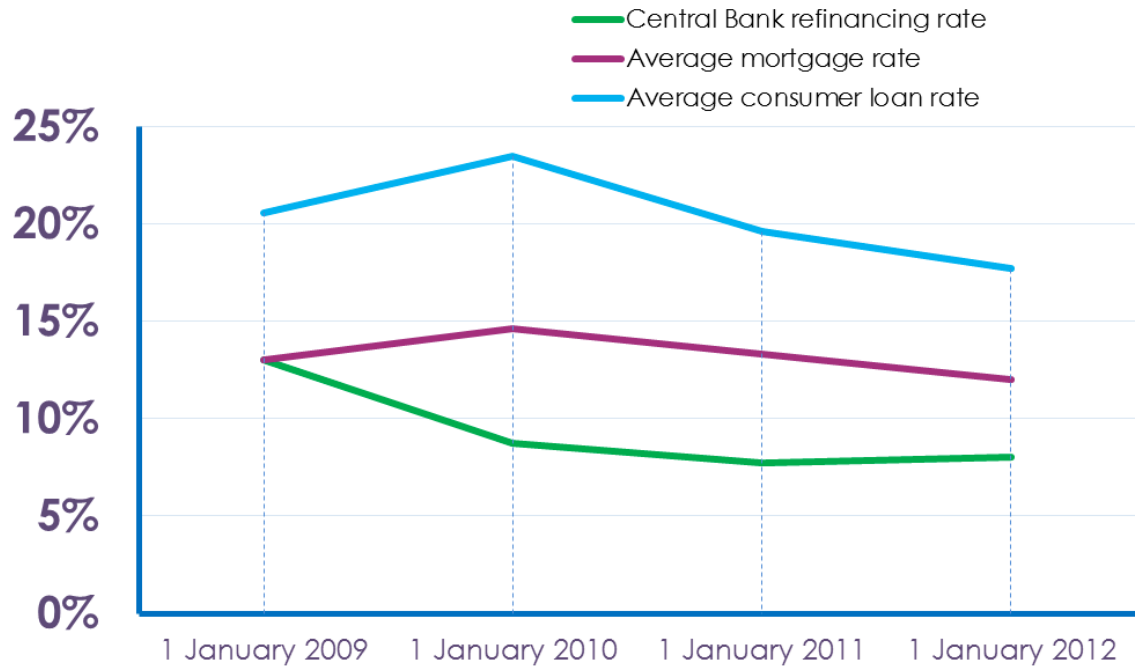
¹³ Washington State Legislature// <http://apps.leg.wa.gov> // September 17, 2012;

New York State Legislature // <http://public.leginfo.state.ny.us/> // September 17, 2012

¹⁴ Usury Settlement Impacts US RMBS Deals Differently Based on Their Legal Structures // Moody's // <http://www.moody.com/> // September 17, 2012.

Exhibit 1. Interest rate chart¹⁵

Interest rate chart



¹⁵ According to the information published at the website of the Central Bank of the Russian Federation (<http://www.cbr.ru/eng/daily.aspx>) and the website of RIA Novosti (<http://en.ria.ru/>).