New interest rate legislation

A new Act on Interest Rates and Indexation, no. 38/2001, entered into effect as of July 1 this year, replacing Act no. 25/1987. The following is an outline of some of the changes involved, particularly with respect to penalty interest and the Central Bank's duty to publish interest rates.

The new act grants a certain degree of freedom to negotiate penalty interest. Instead of being unilaterally decided by the Central Bank, penalty interest can now be negotiated, either as a fixed surcharge on a specific base rate or as a fixed rate. Consumer lending penalty rates are not negotiable, however. If no specific agreement is made on penalty interest or surcharges on default, the penalty interest rates decided and published by the Central Bank shall apply. These are, firstly, a base rate for penalty interest equivalent to the interest rate on the most common form of Central Bank short-term lending to credit institutions, and secondly, a surcharge for defaults, which may be in the range 7 to 15 percent. The resulting total represents the penalty interest rates decided by the Central Bank, which are in effect for six months at a time i.e. from January 1 and July 1.

Under the new legislation, the Central Bank ceased its monthly announcements of all general interest terms for commercial banks and savings banks, together with a weighted average rate. Details of average and highest interest rates will therefore no longer be formally published after the act enters into effect. Thus it is important for new loan agreements not to refer to concepts such as average interest rates on bonds, average yield on lending or maximum interest rates allowed by law. Instead, the Central Bank will publish rates based on the lowest interest on new lending by credit institutions. Parties wishing to include variable interest rates in loan agreements can then use these as a reference point, and there are no obstacles to negotiation of specific deviations from them. A report accompanying the bill proposing the new interest rate legislation outlines the reasons for these changes. Since the prior legislation entered into effect, it points out, major changes have taken place in the commercial banks and savings banks' interest rate spectrum, among other things with the introduction of prime lending rate systems. This has greatly complicated the calculation of average interest rates. In addition, the report points out that average interest rates represent an abnormal reference for a large number of loan agreements, since the average is obtained on the basis of low interest for high-rated borrowers with good collateral, high interest for parties with poorer collateral, and the whole spectrum between these two poles. However, there are grounds for urging parties to agree on interest rates among themselves, instead of "instinctively" using the general reference of market interest rates.

As hitherto, the Central Bank will continue to gather detailed data on credit institutions' interest rates. It is also likely to publish various interest rate series in connection with coverage of economic issues. The interest rates that the Central Bank is obliged to publish will appear in the Legal Gazette and on the Bank's website.

A new reference for interest rates in damages claims will be used, instead of the earlier act's yardstick of interest on ordinary savings accounts. Since this form is now obsolete and hardly used, the new act stipulates that interest on damages claims will be equivalent to two-thirds of the lowest interest rate published by the Central Bank each month. This entails a considerable rise in the interest rates applying to damages claims.

Loan agreements made before the law enters into effect, and carrying variable interest based on average or highest rates, are covered by a provisional clause ensuring that the interest rate to use can be identified. If interest is linked to the Central Bank's published average rate, the new published rate shall be used with a supplement amounting to 3.5 percent for non-indexed loans or 2.5 percent for indexed loans. Where terms refer to the highest published rate at any time, the supplement is 4.5 or 3.5 percent on top of the Central Bank's published rate for non-indexed and indexed liabilities respectively.

Principles for indexation of savings and credit remain unchanged from earlier legislation. The report accompanying the bill states that official rules on indexation of financial liabilities primarily served the purpose of protecting general savings and credit in

Iceland from being eroded by domestic inflation as it is customarily measured, i.e. as the average change in prices of a wide sample of goods and services. However, this arrangement was not intended to hinder normal capital market evolution. Thus it is specifically stated that derivatives are not subject to the provisions of the act. Furthermore, authorisation is granted for using equity indices as a reference in loan agreements. Agreements on derivatives and equity indices are both innovations in Iceland but long familiar from other countries.