Banking & Finance

Floor clauses, embedded derivative and risk of legal controversies

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In the banking and finance sector, the debate regarding the *floor* clauses of many leasing contracts and mortgages has reopened.
The *Arbitro Bancario e Finanziario* (the Banking and Finance Arbitrator or "ABF") had issued several decisions on the matter when faced with complaints stating the unfair nature of such clauses. The ABF ruled out the unfair nature of floor clauses, deeming them to be sufficiently clear and understandable.

However, the decisions of the ABF do not exclude the possibility to resort to ordinary courts. Therefore, the ABF's opinion – reaffirmed more than once – according to which floor clauses are not unfair, could be re-examined by courts.

Nevertheless, ***floor* clauses have recently been at the centre of a new legal debate, on a theory which is even more dangerous for banks.**

It has been claimed that a *floor* clause contained in a loan agreement is an embedded derivative that could be assimilated to an interest rate floor.

According to such characterization, supported by many consumers' associations, floor clauses in a loan contract can be considered as a hedging derivative by means of which banks protect themselves from the risk that the interest rate of the loan falls under the strike price (*i.e.* the minimum interest ensured by the floor clause).

As a consequence, it has been stated that **banks are not compliant with the diligence, fairness and transparency obligations they are subject to**.

Considering floor clauses as an embedded derivative has led some consumers' associations to claim that such a clause is void since it entails a one-sided risk, to the detriment of the client who receives no compensation in exchange of such derivative, without even having the possibility to benefit from future fluctuations of the interest rate in the case of an increase.

If the principle according to which *floor* clauses are void takes off, banks would be responsible for refunding; the repercussions on banking would be extremely dangerous. Indeed, banks would have **refund obligations towards the client** even for a single loan contract.
Moreover, banks would have to **reconsider their policies in respect of their regulatory capital for prudential reasons**, thereby significantly modifying their budgets. The bank credits that have so far been "protected" thanks to an interest guaranteed by *floor* clauses would suddenly be exposed to a reduction of rates, which have been at their lowest over these past few months (short term inte-

rest rates have been negative for a while now).
Therefore, considering repayments for the past and missed profits for the future, the risks for banks deriving from legal controversies on *floor* clauses should not be underestimated.

In general, it must be underlined that the numerous legal theories regarding the alleged invalidity or ineffectiveness of *floor* clauses have not been examined by courts so far. Only in some cases, **courts suspended the enforcement of legal measures** (i.e. proceedings for *"decreto ingiuntivo"*, that is, an injunction order) in favour of the banks. In these cases, the judge asked to further examine the presence, within the loan agreement, of an embedded derivative (although in such cases it was not a matter of *floor* clauses but rather of *currency swaps* in relation to a leasing indexed at the Euro/Swiss Franc exchange rate).
Consequently, it was not possible to state with certainty the exact credit claimed by the bank.

At present, the issue has become even more delicate, as **the use of *floor* clauses is under scrutiny by the Italian Antitrust Authority** ("Autorità Garante della Concorrenza e del Mercato" or AGCM**)**.
In particular, last 7th May the AGCM commenced an investigation aimed at establishing the **existence of an alleged cartel** among six credit institutions operating in Alto Adige which had all fixed the rate floor at 3% on variable rate mortgages for the purchase of the first house.

According to the AGCM, the homogeneous application of such rate, comparable to a common strike price, would allow bank operators to coordinate their policies in order to avoid competition.
Moreover, last 2nd February, the AGCM reported that it has extended the investigation to another 13 banks in the same territory; further extensions cannot be excluded.
Apart from sanctions, the risks deriving from anti-trust behaviour, involve compensation before the civil judge for violating the ban on non-competitive agreements, therefore making the clause void. The world of banking should pay close attention to *floor* clauses since, as mentioned above, the risks associated to serial legal controversies are likely to be significant and coming from various sides.

A more careful analysis shows that the various reconstructions and legal theories regarding floor clauses present legal ambiguity and are sometimes contradictory, something banks and other credit institutions could take advantage of in order to contrast future legal controversies.

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