

Interim Note on Prepayment Fees and Upfront Fees with regard to the Interest Rate  
Restriction Act and the Contributions Regulation Act  
(Summary)

1. Treatment of the Prepayment Fee

(a) Issue

Some loan agreements executed by financial institutions in a wholesale market stipulate that the borrower will need to pay a certain fee if such borrower prepays the loan before the maturity (which for the purpose of this paper shall include the break cost, the "Prepayment Fee"). This presents the question of how a Prepayment Fee should be treated under the Interest Rate Restriction Act (the "IRRA") and the Act Regulating the Receipt of Contributions, Receipt of Deposits and Interest Rates (the "Contributions Regulation Act") (i.e. does the Prepayment Fee constitute interest for the purposes of such legislation and should the interest rates under those legislations be calculated by using the actual period of borrowing until the prepayment rather than the original period).

(b) Interpretation that the Prepayment Fee does not constitute "Deemed Interest"

(i) Interest rate limits under the IRRA and the Contributions Regulation Act

Both the IRRA and the Contributions Regulation Act set limits by percentage as to what extent the lenders can receive in return for lending money to the borrower and, as an anti-avoidance measure, the law sets out the concept of "Deemed Interest" (providing that any amount other than principal which the lenders receive with regard to a loan agreement is to be regarded as 'interest', regardless of how such amount is described). However, the IRRA limits sums that will constitute "Deemed Interest" to "money, other than principal, that the creditor receives *in connection with* a monetary loan" and the Contributions Regulation Act similarly specifies "Deemed Interest" to be "money that a person who loaned money is to

receive *in connection with* that loan".

It is well accepted that regulatory laws such as the Contributions Regulation Act should be purposively interpreted; such interpretation should also be applied to the IRRA, which has the same legislative intent as the Contributions Regulation Act. Therefore, even taking into account the legislative intent of these laws to penalize usury, if it can be objectively and reasonably said that there is no risk of undermining such legislative intent, it is possible to conclude that the Prepayment Fee received by a lender is not received "in connection with a monetary loan" or "in connection with that loan" and thus should not be included in "Deemed Interest".

(ii) Analysis

The Prepayment Fee is paid to indemnify the lender who sought financing in the interbank market against losses incurred as a result of the prepayment and/or to compensate the lender for lost profits, especially in a transaction where it is difficult to find an alternative. Voluntary prepayment can also be seen to release the borrower from its obligations under the loan agreement, such as the payment of future interest and the various covenants and can be explained that it is a condition to satisfy the borrower's need to shorten the borrowing period. Consequently, there is an economically rationale for both parties to agree to a Prepayment Fee.

Moreover, based on the Civil Code (proviso to Article 136(2)) and the Supreme Court judgment, a party who waives its vested time interest ("*kigen no rieki*") must compensate the other party if such other party incurs damage by the waiver. In the context of a loan agreement, the lender's vested time interest until the maturity of the loan should also be protected under the Civil Code. Therefore, the Prepayment Fee can be legally characterised as compensation for the lender's vested time interest that is payable pursuant to the proviso to Article 136(2) of the Civil Code.

It can also be said that a situation where the borrower voluntarily makes its decision as to whether to keep borrowing or to make a prepayment with payment of the Prepayment Fee is different from the situation where an economical weak needs to be protected by usury laws.

(iii) Conclusion

As set out in the analysis in paragraph (ii) above, it can objectively and reasonably be said that there is no risk of undermining the legislative intent of the IRRA and the Contributions Regulation Act even with the legislative intent of these laws to penalize usury taking into account. Consequently, we may conclude that the Prepayment Fee received by a lender is not received "in connection with a monetary loan" or "in connection with that loan" and thus is not included in "Deemed Interest".

(c) Interpretation which bases the calculation of the interest rate on the original period

In contrast to the view given in (b) above, it is also possible to take the view that, while the Prepayment Fee constitutes "Deemed Interest", the interest rate in question should not be recalculated over the accrued period until the time of prepayment, but should be calculated based on the initially contracted period of the loan (including the period from the prepayment date to the maturity date) since the Prepayment Fee is paid as compensation for the vested time interest corresponding to the remaining period until the maturity date of the loan. Given that the restrictions on maximum interest would apply based on the initially envisioned loan period under this interpretation, it can be said that this view is more capable of assuring predictability for the parties.

2. Treatment of Upfront Fees

In some cases, fees such as a loan commission or a structuring fee (the "Upfront Fee") are payable at the time of the utilisation of a loan. Whether a specific Upfront Fee constitutes "Deemed Interest" is the first issue to be considered but, assuming it does, the relevant period used as the basis for calculating the interest rate will also need to be determined.

"Deemed Interest" is treated as interest under the IRRA and the Contributions Regulation Act, but it essentially has no connection to the period in which the principal is used, nor is it envisioned to correspond to a certain period of time. Therefore, it follows that the Upfront Fee accrues to the entire period of the loan as

initially envisioned. Consequently, as long as the effective interest rate calculated initially over the period of the loan does not exceed the maximum interest rate, then neither the IRRA nor the Contributions Regulation Act would apply, even if an Upfront Fee is actually paid on the day after the loan is executed. This approach is consistent with the method to calculate the effective interest rate published by the General Secretariat of the Supreme Court, which is used in practice when applying the IRRA.

### 3. Treatment if Prepayment is made after an Upfront Fee is paid

If a prepayment is made after an Upfront Fee is paid, the question of whether it is necessary to recalculate the effective rate based on the period until the time of prepayment may arise. The publication by the General Secretariat of the Supreme Court mentioned above does not consider this. Nevertheless, if the initial effective interest rate does not exceed the maximum interest rate under the IRRA and the Contributions Regulation Act, then these usury laws would appear to have fulfilled their essential function and it is reasonable to conclude that the lender's vested time interest within that limit is worth protecting in its entirety. For this reason we consider that there would be no requirement to recalculate the effective interest rate based on the actual period of borrowing even if a prepayment is made, if the effective interest rate (calculated with the Upfront Fee taken into account) was no greater than the maximum interest rate.

### 4. Issues for Further Consideration

In the above text, we have considered whether a clarification through an affinitive interpretation under the existing interest rate regulations can be obtained, assuming business-to-business transactions in the wholesale market. However, if a more precise and reasonable system of regulation that corresponds to the attributes of the parties and the nature of the transactions is aspired to, it would be desirable, to identify the differences in the function of the wholesale market and the retail market, and to take legislative responses that are consistent with the actual conditions of these markets in order to maintain the predictability of transactions and the transparency of markets in Japan within an international context.

Note: The full text of this paper is available in Japanese only.