

Features Essay

Interest Rates and Human Rights: Reinterpreting Risk Premiums to Adjust the Financial Economy*

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This Article proposes an innovative and human rights-based interpretation of interest rates applied to public and private loans where interest rate and risk premium are adjusted after the full payment of the principal.

Risky borrowers pay more for the same loan than low-risk clients due to risk-weighted interest rates that are based on the absence or the quality of collateral. While this approach treats collateral and risk premium as exchangeable, it is only the collateral that is returned at the end of the contract; the risk premium is not. The practice of charging a risk premium on top of the prime rate is legally justified since it serves as a protection of the lender's property in a riskier environment by accelerating the return of the principal.

But the Article argues that the price difference loses its economic and legal justification once the risk premium has fulfilled its purpose of ensuring the payment of the principal. Beyond that point, the risk premium becomes a form of discrimination based on economic status because it unjustifiably imposes a greater burden on risky clients than on low-risk clients. Additionally, the Article demonstrates that this risk premium cannot be a mere compensation that a risky borrower must pay for the lender's increased risk. Under this interpretation, adjusting the interest rate and the risk premium after the full payment of the principal is legally required because it prevents discrimination by securing the equal treatment of all borrowers once they have paid the principal. This argument is based on contract law, international human rights law, and international financial regulations. Furthermore, this approach would free resources in the current dramatic Covid-19 context where fiscal space and household incomes must be devoted to save lives and ensure that basic economic and social rights are realized.

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I. INTRODUCTION. THE NEED FOR A HUMAN RIGHTS-BASED INTEREST RATE SYSTEM

The Covid-19 pandemic struck in a moment when the global indebtedness of households, governments, and corporate sectors combined had reached an *all-time high* at the end of 2018 and when, according to UNCTAD, even further economic challenges due to debt servicing are expected.¹ This is of specific concern for developing countries, which have to service an average total debt of almost twice the size of their GDP.² That debt belongs to an

1. *The Coronavirus Shock: A Story of Another Crisis Foretold and What Policymakers Should Be Doing About It*, UNITED NATIONS CONF. ON TRADE AND DEV. (Mar. 9, 2020), https://unctad.org/en/PublicationsLibrary/gds_tdr2019_update_coronavirus.pdf.

2. “In 2018, the total debt of developing countries – private, public, domestic and external - reached 191 per cent of their combined GDP, the highest level on record.” UNITED NATIONS CONF. ON TRADE AND DEV., *supra* note 1, at 5.

unparalleled variety of owners, including institutional investors.³

A growing literature has demonstrated that the size and contractual conditions of both private and public debts are intrinsically linked to the realization of human rights.⁴ The unprecedented explosion of private debt⁵ has been associated with wide inequality, macroeconomic instability, and financial crises, where millions of debtors fall into a debt trap, jeopardizing their human rights.⁶ This can be seen, in particular, in microcredit, health, education, and housing-related debts. The adverse human rights implications of over-indebtedness, abusive contractual terms and collection practices, and the criminalization of debtors are well documented.⁷

In the context of the Covid-19 crisis, the resulting economic recession will leave some people with no choice but to rely on debt to meet their basic needs and rights. It is unsurprising that in many countries, private debt-servicing for individuals unable to cope with the public health crisis has been legally suspended, through methods such as mortgage moratoriums and temporary halts in evictions.

Additionally, sovereign debt vulnerabilities⁸ and retrogressive economic and fiscal policies (such as austerity, fiscal consolidation and privatization of public services)⁹ normally implemented to ensure the full debt payment, violate human rights too frequently, in particular the economic and social rights of the

3. *The Risky Interconnectedness Between Investment Funds and Developing Country Debt*, Cent. for Rsch. on Multinational Corps. (Oct. 2019), <https://www.somo.nl/wp-content/uploads/2019/10/Interconnectivity.pdf>.

4. See, e.g., Cristiano Perugini, Jens Hölscher & Simon Collie, *Inequality, Credit and Financial Crises*, 40 CAMBRIDGE J. ECON. 227 (2016); Rémi Bazillier & Jérôme Héricourt, *The Circular Relationship Between Inequality, Leverage, and Financial Crisis*, (Laboratoire d'Économie d'Orleans, Working Paper No. 1968, 2015); Gail Hurley, *Sovereign Debt and the Right to Development*, in SOVEREIGN DEBT AND HUMAN RIGHTS 248, 248-266 (Ilias Bantekas & Cephas Lumina eds., 2018).

5. *Trade and Development Report 2019: Financing a Global Green New Deal*, UNITED NATIONS CONF. ON TRADE AND DEV. (2019), https://unctad.org/en/PublicationsLibrary/trd2019_en.pdf.

6. Juan Pablo Bohoslavsky, *The Explosion of Household Debt: Curse or Blessing for Human Rights?*, 43 HUM. RTS. Q. 1 (2021).

7. See ASPEN INSTITUTE EXPANDING PROSPERITY IMPACT COLLABORATIVE, CONSUMER DEBT: A PRIMER (2018); MILFORD BATEMAN, STEPHANIE BLANKENBURG & RICHARD KOZUL-WRIGHT, THE RISE AND FALL OF GLOBAL MICROCREDIT: DEVELOPMENT, DEBT AND DISILLUSION (2019); David Bank & Jenny Griffin, *Financing Out-of-Pocket Medical Debt and Keeping Bill Collectors at Bay*, ASPEN INST. (Feb. 5, 2015), <https://www.aspeninstitute.org/blog-posts/financing-out-pocket-medical-debt-and-keeping-bill-collectors>; Susanne Soederberg, *Subprime Housing Goes South: Constructing Securitized Mortgages for the Poor in Mexico*, 47 ANTIPODE 481 (2014); *Human Rights Impact of Unsecured Lending and Debt Collection Practices in South Africa*, S. AFR. HUM. RTS. COMM'N (Mar. 2017), <https://www.sahrc.org.za/home/21/files/SAHRC%20BHR%20RA%203%20-v3.pdf>.

8. Juan Pablo Bohoslavsky (Independent Expert), *Report of the Independent Expert on the Effects of Foreign Debt and Other Related International Financial Obligations of States on the Full Enjoyment of All Human Rights, Particularly Economic, Social and Cultural Rights*, U.N. DOC. A/70/275 (Aug. 4, 2015).

9. Juan Pablo Bohoslavsky (Independent Expert), *Impact of Economic Reforms and Austerity Measures on Women's Human Rights*, U.N. DOC. A/73/179 (July 18, 2018); Juan Pablo Bohoslavsky, *Complicity of International Financial Institutions in Violation of Human Rights in the Context of Economic Reforms*, 52 COLUM. HUM. RTS. L. REV. 203 (2020).

most vulnerable groups.¹⁰ While attention has mainly focused on such high-profile cases as the Greek sovereign debt crisis,¹¹ economic and fiscal adjustment measures were expected to impact 130 countries in 2021 – and that was *before* the Covid-19 crisis.¹²

In order to fight Covid-19 most governments are now implementing expansionary measures to tackle the most immediate health, social, and economic challenges that the pandemic entails. Frequently, fiscal deficits and increased borrowing go hand in hand with a painfully slow economic recovery from the latest financial crisis and an emerging debt crisis. International financial institutions are currently granting multibillion dollar loans to their clients¹³ and designing debt relief programs for their poorest members.¹⁴ Yet these institutions are already sending clear signals that fiscal discipline and pro-market options will continue being the priorities as soon as the emergency has been overcome.¹⁵ As states must protect not only economies but also all human rights during pandemics,¹⁶ they must demonstrate that every effort has been made to mobilize all available resources, even in times of economic crisis. In particular, states must generate, adequately allocate, and make maximum use of their available resources to move as expeditiously and effectively as possible towards the full realization of economic, social, and cultural rights.¹⁷

10. See SOVEREIGN DEBT AND HUMAN RIGHTS (Ilias Bantekas & Cephas Lumina eds., 2018); MAKING SOVEREIGN FINANCING & HUMAN RIGHTS WORK (Juan Pablo Bohoslavsky & Jernej Čermeč eds., 2014); ECONOMIC AND SOCIAL RIGHTS AFTER THE GLOBAL FINANCIAL CRISIS (Aoife Nola ed., 2014); VOLUME 41 SPECIAL EDITION ON SOVEREIGN DEBT, Yale J. Int'l L. (2016), <http://www.yjil.yale.edu/volume-41-special-edition>.

11. Juan Pablo Bohoslavsky (Independent Expert), *Mission Report to Greece*, U.N. DOC. A/HRC/31/60/Add.2 (Feb. 29, 2016), <https://socialprotection-humanrights.org/resource/foreign-debt-human-rights-ahrc3160add-2-mission-greece>.

12. Isabel Ortiz & Matthew Cummins, *Austerity: The New Normal – A Renewed Washington Consensus 2010-24* (Initiative for Policy Dialogue et al., Working Paper 2019), <http://policydialogue.org/files/publications/papers/Austerity-the-New-Normal-Ortiz-Cummins-6-Oct-2019.pdf>.

13. *Funding Mechanisms for COVID-19 Response*, UNITED NATIONS DEP'T OF ECON. AND SOC. AFF. (Apr. 2020), <https://www.un.org.development.desa.financing/files/2020-05/Mapping%20of%20COVID-19%20Response.pdf>.

14. *IMF Executive Board Approves Immediate Debt Relief for 25 Countries*, INT'L MONETARY FUND (Apr. 13, 2020), <https://www.imf.org/en/News/Articles/2020/04/13/pr20151-imf-executive-board-approves-immediate-debt-relief-for-25-countries>.

15. *Fiscal Monitor Report*, INT'L MONETARY FUND (Apr. 2020), <https://www.imf.org/en/Publications/FM/Issues/2020/04/06/fiscal-monitor-april-2020>; David Malpass, *Remarks by World Bank Group President on G20 Finance Ministers Conference Call on COVID-19* (Mar. 23, 2020), <https://www.worldbank.org/en/news/speech/2020/03/23/remarks-by-world-bank-group-president-david-malpass-on-g20-finance-ministers-conference-call-on-covid-19>; *Over 500 Organisations and Academics Around the World Call on IMF to Stop Promoting Austerity in the Coronavirus Recovery Period*, INT'L TRADE UNION CONFEDERATION (Oct. 6, 2020), <https://www.ituc-ctsi.org/imf-stop-austerity?lang=en>.

16. Juan Pablo Bohoslavsky, *COVID-19 Economy vs Human Rights: A Misleading Dichotomy*, 22 HEALTH & HUM. RTS. J. 383 (2020).

17. International Covenant on Economic, Social and Cultural Rights art. 2, Dec. 16, 1966, 993 U.N.T.S. 3; Committee on Economic, Social and Cultural Rights, general comment No. 3 (1990) on the nature of States parties' obligations, ¶¶ 9–12; and general comment No. 24 (2017) on State obligations under the International Covenant on Economic, Social and Cultural Rights in the context of business activities, ¶ 23.

One way to mobilize resources effectively is through human rights-based policies and regulation, including this new legal interpretation of interest rates applied to debt. Innovative, human rights-based interpretations are needed more than ever in the pandemic era, where fiscal space and household incomes need to be prominently devoted to saving lives and ensuring that basic economic and social rights are realized. Groundbreaking measures are also necessary to bridge the disconnect between the financial industry, with its continuing returns, and the real economy, which is stagnant throughout much of the world.

After a two-year collective and transparent process, with the active participation of states, international financial institutions, international organizations, scholars and experts, unions, civil society organizations, and national human rights institutions,¹⁸ in March 2019 the UN Human Rights Council endorsed the Guiding Principles on Human Rights Impact Assessment of Economic Reforms (“Guiding Principles”).¹⁹ The Guiding Principles establish that an interest rate formation regime must be established by law, democratically discussed, and transparent. Monetary and fiscal policies as well as financial regulations must be coordinated and consistent with other policies with the aim of respecting, protecting, and fulfilling human rights. States should use a mix of tools to ensure appropriate global and domestic financial market regulation with the aim of curbing excessive credit growth. This mix should include measures of prudential regulation, debt sustainability analysis, and capital controls.

Working from the premise that the financial system is also a tool for ensuring the realization of human rights, and not a goal in and of itself,²⁰ this Article argues that risk premiums – the component of an interest rate that is supposed to offset the default risk of a potential borrower – used in public and private loans must be reinterpreted in line with their true economic function and the fundamental legal principle of prohibition of discrimination. This approach determines the operational implications of the Guiding Principles on human rights impact assessment of economic reforms²¹ as they are specifically recommended to assess economic policies and human rights in the context of

18. Contributions submitted are *available at* Guiding Principle for Human Rights Impact Assessments for Economic Reform Policies, UNITED NATIONS HUM. RTS. COUNCIL, <https://www.ohchr.org/EN/Issues/Development/IEDebt/Pages/DebtAndImpactAssessments.aspx>.

19. *Guiding Principles on Human Rights Impact Assessments of Economic Reforms*, U.N. Doc. A/HRC/40/57 (Dec. 19, 2019); Human Rights Council Res. A/HRC/40/8 (May 4, 2019), https://ap.ohchr.org/documents/dpage_e.aspx?si=A/HRC/RES/40/8.

20. *See generally* DAVID KINLEY, NECESSARY EVIL. HOW TO FIX FINANCE BY SAVING HUMAN RIGHTS 3 (2018).

21. On further elaborations on the implementation of these Guiding Principles *see* Aoife Nolan & Juan Pablo Bohoslavsky, *Human Rights and Economic Policy Reforms*, 24 INT’L J. HUM. RTS. 1247 (2020), and other contributions within the same volume, a special issue on this topic.

the Covid-19 crisis.²²

Risky borrowers pay more for the same loan than low-risk clients due to risk-weighted interest rates. Risk-weighted means that an interest rate consists of a prime rate that is offered to the ideal client only, plus an added premium that depends on the risk every other client poses to the fulfillment of the loan contract. These risk premiums are ubiquitous, having their origins in the work of the Basel Committee on Banking Supervision.

The Basel Committee on Banking Supervision (“Basel Committee”) was formed amidst turbulence in national financial markets during the mid-1970s.²³ The Committee recommended aids to co-operation among the supervisory authorities of home states from which a financial institution originates and the host states in which that institution operates through its subsidiaries.²⁴ The Committee has also established international standards for bank regulation, most notably its accords on capital adequacy, collectively known as the Basel Accords.²⁵

The Latin American debt crisis of the early 1980s increased international risk while the capital ratios of major international banks were eroding. As a countermeasure, the Basel Committee decided “on a weighted approach to the measurement of risk, both on and off banks’ balance sheets.”²⁶ The work resulted in the Basel Capital Accord of 1988, also known as Basel I,²⁷ which was supposed to strengthen the stability of the international banking system by reducing credit risk and remove a source of competitive inequality arising from differences in national capital requirements.²⁸ Regarding risk weights, the Committee gives preference to a weighted risk ratio over other approaches,

22. In May 2020, the European Network of National Human Rights Institutions issued a document recommending to use the *Guiding Principles* to assess the recovery measures in order to help protect people against discrimination and a widening of existing inequalities, see *The EU Must Put Economic and Social Rights at the Heart of Its Economic Response to COVID-19*, ENNHRI (May 6, 2020), <http://ennhri.org/statement-covid-19-esr>. The *Business and Human Rights: Inter-American Standards* issued in 2019 by the Inter-American Commission on Human Rights (IACHR) and the Special Rapporteur on Economic, Social, Cultural and Environmental Rights also refer to the Guiding Principles as relevant legal framework, see <http://www.oas.org/es/cidh/informes/pdfs/EmpresasDDHH.pdf>.

23. *History of the Basel Committee*, BANK FOR INT’L SETTLEMENTS, <https://www.bis.org/bcbs/history.htm> (“[A]t the end of 1974 in the aftermath of serious disturbances in international currency and banking markets (notably the failure of Bankhaus Herstatt in West Germany” the Central Banks of the Group of Ten (G10) Countries established the Basel Committee on Banking Supervision “to enhance financial stability by improving the quality of banking supervision worldwide, and to serve as a forum for regular cooperation between its member countries on banking supervisory matters.”).

24. *Report to the Governors on the Supervision of Banks’ Foreign Establishments*, COMMITTEE ON BANKING REGULATIONS AND SUPERVISORY PRACTICES, <https://www.bis.org/publ/bcbs00a.pdf>.

25. BANK FOR INT’L SETTLEMENTS, *History*, *supra* note 23.

26. *Id.*

27. *International Convergence of Capital Measurement and Capital Standards*, BASEL COMMITTEE ON BANKING SUPERVISION (July 1988), <https://www.bis.org/publ/bcbs04a.pdf>.

28. BANK FOR INT’L SETTLEMENTS, *History*, *supra* note 23.

since this makes a fairer international comparison of different risks possible.²⁹ Basel I states that “[f]or most banks the major risk is *credit risk*,” meaning counterparty failure.³⁰

As a result of the Basel Committee’s work, weighing credit risk has formed part of the architecture of international banking supervision for over three decades. In accordance with the Basel Accords, the world’s largest economies – and most jurisdictions trading with them – use risk-weighted interest rates.³¹ The Basel Accords are implemented in the G20 member States³² and today, the Basel Committee on Banking Supervision comprises 45 members from 28 jurisdictions, consisting of central banks and national regulators of the banking industry.³³ The Committee “expects full implementation of its standards by its member jurisdictions and their internationally active banks” and monitors the implementation of the Basel standards to ensure fair international competition among banks.³⁴ Demonstrating the ubiquity of the Accords in the banking sector, the report of the Basel Committee’s 2019 Basel III monitoring exercise includes data from 257 major banks, 29 of which have been designated as global systemically-important banks (G-SIBs).³⁵ In turn, risk-weighted interest rates have become ubiquitous in the Basel era. In the United States, risk-weighted pricing – composed of a prime rate and a risk premium that depends on the borrower’s risk profile – was prevalent already before 2000.³⁶ In Austria, for example, risk weighting has been legally required since 1993, and had become an industry practice earlier yet.³⁷

In combination with the equally widespread principle of compound interest, risk-weighted interest rates have led to an enormous growth of financial obligations for riskier clients with obvious adverse implications for

29. BASEL COMMITTEE ON BANKING SUPERVISION, *International Convergence of Capital Measurement and Capital Standards*, *supra* note 27 at 8.

30. *Id.* at 8-9.

31. An up to date version of the Basel Framework and risk-based capital requirements is also available through the Bank for International Settlements. *The Basel Framework*, BANK FOR INT’L SETTLEMENTS, https://www.bis.org/basel_framework/index.htm.

32. *Implementation and Effects of the G20 Financial Regulatory Reforms: Fifth Annual Report*, FIN. STABILITY BOARD, <https://www.fsb.org/2019/10/implementation-and-effects-of-the-g20-financial-regulatory-reforms-fifth-annual-report/#dashboard>.

33. *Basel Committee Membership*, BANK FOR INT’L SETTLEMENTS, <https://www.bis.org/bcbs/membership.htm>.

34. *Policy Development and Implementation Review*, BANK FOR INT’L SETTLEMENTS (APR. 14, 2018), https://www.bis.org/bcbs/review_process.htm. Additional monitoring information on the implementation of the Basel III standards by the Financial Stability Board is available as well. *Basel III – Implementation*, FIN. STABILITY BOARD, <https://www.fsb.org/work-of-the-fsb/implementation-monitoring/monitoring-of-priority-areas/basel-iii>.

35. *Basel III Monitoring Report*, BANK FOR INT’L SETTLEMENTS, <https://www.bis.org/bcbs/publ/d477.htm>.

36. Matthew D. Diette, *How Do Lenders Set Interest Rates on Loans? A Discussion of the Concepts Lenders Use to Determine Interest Rates*, FED. RESERVE BANK OF MINNEAPOLIS (Nov. 1, 2000), <https://www.minneapolisfed.org/article/2000/how-do-lenders-set-interest-rates-on-loans>.

37. Email from Austrian National Bank to authors (June 23, 2020) (on file with authors).

financial stability, economic growth, and human rights. While this risk-weighted approach treats collateral and risk premium as exchangeable,³⁸ it is only the collateral that is returned at the end of the contract. This causes different prices based on the risk premium and begs the question: should it be lawful to charge clients different prices for the same product if the only difference between them is their property? While the lender will take many factors into account when assessing risk, by far the most important is the expected default risk. If the collateral can reduce the default risk to almost zero, a corresponding reduction in the cost of the loan can be expected. But the Basel Accords increase the cost (or make loans entirely unavailable) to borrowers with poor credit history, for risky business, or in poor economic environments.³⁹

The Article focuses on loans as they are “the largest and most obvious source of credit risk” for most banks, according to the Basel Committee.⁴⁰ To compare the impact of risk premiums and their effect on loans, this Article works with three identical loans that differ only in the risk profile of their clients *A*, *B* and *C*.

This Article argues that the risk premium is a collateral *sui generis*, meaning classified as a unique kind of collateral, which must be adjusted to prime-rate levels once (or if) the principal has been paid, eliminating the default risk. Although private loans are generally repaid while sovereign debt is frequently rolled over, loan pricing in both contexts generally follows the basic method described above. Therefore, the analysis and conclusions of this Article apply to sovereign debt and private debt alike. The Article bases its analysis on the calculation of risk-weighted interest payments and their ultimate impact on financial stability and human rights. While lenders would eventually earn less at the beginning if our recommendations were implemented, they would most likely gain more stability due to more predictable risk and face less defaults, which could ultimately lead to a more reliable revenue stream. States and private parties would retain more money for the protection of human rights and for economic activity, without compromising risk management in the banking sector.

Banking regulations based on the Basel Accords have largely gone unnoticed by the human rights community,⁴¹ yet contribute to economic structures with negative human rights impacts. Laws based on the Basel

38. DEUTSCHES UND EUROPÄISCHES BANK- UND KAPITALMARKTRECHT § 13 AT 3 (Peter Derleder, Kai-Oliver Knops & Heinz Georg Bamberger eds., 3d. ed. 2017).

39. *Id.*

40. *Principles for the Management of Credit Risk*, BASEL COMMITTEE ON BANKING SUPERVISION I No. 3 (Sept. 2000), <https://www.bis.org/publ/bcbs75.pdf>.

41. There are a few exceptions, *see, e.g.*, Motoko Aizawa, Daniel Bradlow & Margaret Wachenfeld, *International Financial Regulatory Standards and Human Rights: Connecting the Dots*, 15 MANCHESTER J. INT'L ECON. L. 2 (2018).

Accords affect millions of people around the world, since they make risk-weighted interest rates obligatory.⁴² The impact of risk-weighted interest rates on human rights is immense since money or the lack of it has a direct impact on almost all human rights, regardless of who borrows: states, corporations, or households. On the one hand, job creation, robust public health and social policies, as well as development are threatened by unpayable corporate and public debt while funding needed for investment is syphoned off. Empirical studies demonstrate a positive correlation between income inequality, fiscal deficit, and mounting sovereign debt.⁴³ On the other hand, while household debt is not regarded as a human rights violation *per se*, it forces families and individuals to borrow in order to exercise their basic rights to healthcare, housing, food, water sanitation, and education.⁴⁴ Over-indebted persons, in turn, are frequently subjected to abusive contractual terms and collection practices.

These links between interest rates and human rights remain largely overlooked in the academic literature, as it has been by lawyers, economists, regulators and policymakers. While studying these links poses interdisciplinary methodological challenges, this lack of academic interest corresponds with a more general political backwardness and underdevelopment of legal theory (until very recently) addressing the links between finance and human rights.⁴⁵ These links do not attract attention from finance industry because human rights law imposes limits on what is economically possible. Notably, most developed countries systematically reject initiatives at the General Assembly and the Human Rights Council of the United Nations that elaborate the relationship between finance and human rights.⁴⁶ At a more technical level, while the economic literature has studied how the premiums should be adjusted based on market considerations,⁴⁷ a corresponding literature on the legal nature and

42. Another case of regulation that goes generally unnoticed by human rights advocates is bankruptcy law in the context of sovereign debt, see Christopher K. Odinet, *Of Progressive Property and Public Debt*, 51 WAKE FOREST L. REV. 1101 (2016); Kunibert Raffer, *Internationalizing U.S. Municipal Insolvency: A Fair, Equitable, and Efficient Way to Overcome a Debt Overhang*, 6 CHICAGO JOURNAL OF INTERNATIONAL LAW 361 (2006).

43. See Joshua Aizenman & Yothin Jinjarak, *Income Inequality, Tax Base and Sovereign Spreads*, 68 FINANZARCHIV: PUB. FIN. ANALYSIS 431-444 (2012), <https://www.nber.org/papers/w18176>; Santo Milasi, *Top Income Shares and Budget Deficits*, 10 Centre for Economic and International Studies, Research Paper Series (2013), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2121344.

44. This falls on top of the already precarious and fragile picture in the world where many vulnerable and marginalized people were already having to make choices between adequate food and adequate housing or medical care. See Juan Pablo Bohoslavsky (Independent Expert), *Report of the Independent Expert on the Effects of Foreign Debt and Other Related International Financial Obligations of States on the Full Enjoyment of Human Rights, Particularly Economic, Social and Cultural Rights*, U.N. Doc. A/HRC/43/45 (Jan. 3, 2020).

45. See above note 10.

46. See, for example, the way states vote resolutions in the context of the mandate on debt at Special Procedures of the United Nations. *Resolutions and Decisions on the Mandate*, UNITED NATIONS HUM. RTS. COUNCIL,

47. For classic and current work on interest rates see, for example, JOHN MEYNARD KEYNES, *THE GENERAL THEORY OF EMPLOYMENT, INTEREST & MONEY* 142 (Wordsworth Editions Ltd. 2017) (1936); Gabriela Castro & Carlos Santos, *Bank Interest Rates and Loan Determinants*, ECONOMIC

economic function of risk premiums has yet to develop.

This Article helps to fill this gap by considering one basic question: based on the true function of risk premiums, what are its human rights implications? The structure of this Article is as follows. Section II gives a general overview on interest rates in loan contracts. Section III delivers a legal analysis of the risk premium. It explains why it is not a price for risk or an insurance but rather a substitute for collateral. It also explains why risk-weighted pricing ultimately causes different prices for identical products. Section IV analyzes the lender's risk before and after the principal has been paid with two identical discrimination tests. These tests lead to the conclusion that risk changes over time, which necessitates the adjustment of the risk premium. Section V offers an overview of the legal implications of discrimination based on property against individuals, corporations, and States in different jurisdictions. The Article ends with an outlook on potential benefits for the economy and human rights in Section VI.

II. THE INTEREST RATES OF LOANS

The loan is the typical product of banks. In other words, banks are in the business of letting money to clients for a certain period of time, just like landlords let houses or apartments to tenants.⁴⁸ The money that banks rent clients is called *commercial bank money*, because it is created by the bank by recording a deposit in the client's account, or *fiat money*, because it is created instantaneously without physical production.⁴⁹ Commercial banks have created around 97% of all money in circulation in the United Kingdom.⁵⁰ States vest private banks with the right to create commercial bank money, regulating the money's creation in order to facilitate economic growth.⁵¹

BULLETIN BANCO DE PORTUGAL (2010); Group Of Ten, *Saving, Investment and Real Interest Rates – A Study for the Ministers and Governors by the Group of Deputies*, INSTITUTO POLIGRAFICO E ZECCA DELLO STATO (1995); Raghuram G. Rajan, *Has Financial Development Made the World Riskier?*, KANSAS CITY FED. 313 (2005), <https://www.kansascityfed.org/publicat/sympos/2005/PDF/Rajan2005.pdf>; Richard Rosenberg, Scott Gaul, William Ford & Olga Tomilova, *Microcredit Interest Rates and their Determinants*, CGAP, MIX & KfW (2013).

48. This simplified definition does not make a distinction between the way banks and non-banks (financial institutions without a banking license that do not offer all financial services a bank offers) hand out loans because both financial institutions rely on risk profiles to determine how they treat clients. This reliance on risk profiles leads to differential risk premiums and, therefore, outcomes in contractual obligations. For more details on the funding of banks and non-banks, see AMERICAN BANKERS ASSOCIATION, *THE BUSINESS OF BANKING: WHAT EVERY POLICY MAKER NEEDS TO KNOW* 33, 57 (2013), and Iain Ritchie, *Funding Liquidity Risk*, ACTUARY (June 5, 2017), <https://www.theactuary.com/features/2017/06/2017/06/05/funding-liquidity-risk>.

49. Fiat is Latin for “let there be” or “so be it.” For a scientific proof of money creation, see Richard A. Werner, *Can Banks Individually Create Money Out of Nothing?—The Theories and the Empirical Evidence*, 38 INT'L R. FIN. ANALYSIS 1 (2014).

50. Michael McLeay, Amar Radia & Ryland Thomas, *Money Creation in the Modern Economy*, BANK OF ENG., no. 1, 2014, at 14, 15, <https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2014/money-creation-in-the-modern-economy.pdf?la=en&hash=9A8788FD44A62D8BB927123544205CE476E01654>.

51. That a state authorizes private banks to issue commercial bank money is not exceptional:

In contrast, money in the form of coins and bills is produced only by a central bank. Although cash has very little intrinsic value and digital fiat money has none, both kinds of money can and are used by the client for purchases and payments, such as for the payment of taxes or debt. As this kind of money is obviously fit for purpose, it cannot be argued that a bank had no claim to payment or to the collateral because it had created the loan merely by an entry into its ledger instead of giving the client real money, like in the frequently quoted *Credit River Case*⁵² and similar U.S. cases.⁵³ Such cases were bound to remain unsuccessful simply because domestic currency and commercial bank money are legally used for payments.

While both, national currency and commercial bank money, are used as legal tender, the right of private banking institutions to create commercial bank money is not set in stone, as the right to mint coins originally belongs to the sovereign who can decide to withdraw this right if necessary.⁵⁴

In fact, the practice of private banks creating commercial bank money in the same way as central banks, but in much larger quantity and with little collateral, has long been criticized. For example, Rolf Gocht, former director of the German Central Bank, published a 1975 book on the monetary system in which he assails the sparse scientific discussion on the creation of commercial bank money and criticizes the current model as open for the purposeful manipulation of money circulation and credit supply.⁵⁵ Gocht proposes a monetary system without commercial bank money, enabling a strict division of state and economy.⁵⁶ Yet, the practice of commercial bank money is unlikely to change in the near future, as the current system helps expand the economy. However, monetary policies can change and a reform similar to Gocht's proposal has already been proposed as a draft law in Switzerland. But when asked in the 2018 referendum on the so-called 'Sovereign Money Initiative' if they wanted to introduce such a new monetary system, Swiss citizens rejected

states authorize private entities to conduct sovereign activity in various fields. In some instances, states vest agencies, corporations, or associations with certain sovereign rights in order to execute state tasks. For instance, some states bestow private associations with the mandate to monitor the reliability of cars or industrial machinery.

52. *First Nat'l Bank of Montgomery v. Daly* (Just. Ct., Credit River Twp., Scott County, Minn. 1968). The decision was nullified on formal grounds because the sitting justice of the peace had only power to decide on claims of up to USD \$100 while the mortgage in dispute amounted to USD \$14,000.

53. For example, in *Tuttle v. Chase Home Finance, LLC*, 2008 WL 4919263 (D. Utah Nov. 17, 2008), the plaintiff unsuccessfully argued that banks had no right to claim performance of the loan contract since only gold or silver were legal tender and paper dollars worthless.

54. German Central Bank, *Coinage prerogative*, <https://www.bundesbank.de/dynamic/action/en/homepage/glossary/729724/glossary?firstLetter=C&contentId=653538#anchor-653538> ("Coinage prerogative is the sovereign right to design and mint coins. In the past, this was the right of the state ruler (e.g. the king). Today, the coinage prerogative lies with the government or the central bank.").

55. ROLF GOCHT, KRITISCHE BETRACHTUNGEN ZUR NATIONALEN UND INTERNATIONALEN GELDORDNUNG 64, 67 (2d ed. 2011).

56. *Id.* at 65.

the proposal.⁵⁷ For the time being, commercial bank money will therefore remain to be in use and will be handed out in loans against interest.

The price for the loan is the interest rate. In the banking industry's now-obsolete "cost-plus loan-pricing model", the interest rate was composed of four components: the funding cost, the operating costs, a profit margin, and a risk premium to compensate the bank for the degree of default risk inherent in the loan request.⁵⁸ Due to increased competition and deregulation, banks are now instead using the "price-leadership model" to determine the price of loans.⁵⁹ Using the price-leadership model, the bank offers its most creditworthy client for short term loans a *prime rate* (also called a *base rate*), which serves as a yardstick for all other loans offered to less creditworthy clients.⁶⁰ Credit scoring and credit rating (in the case of states and corporations) are risk pricing tools to determine the risk premium which is added to the prime rate and must be paid by all riskier clients. Risk pricing enables banks to offer competitive prime rates for good clients and to offer loans at a high premium to high risk clients, or to reject them.⁶¹ If the clients' cash flow and the sum of the loan are identical, two main factors influence the risk premium: the collateral offered and the duration of the loan. The lender's risk decreases if the loan is secured by a collateral, particularly valuable collateral. And since the borrower's ability to pay the loan is less likely to change in the near term than in the long term, the lender's risk decreases as the loan term shortens.⁶²

Apart from determining risk premium and interest rate, the interest calculation is decisive for the financial burden of the client. Most loans compound interest, regardless of whether the clients are states, businesses or natural persons. This *compound interest* is paid on the principal and the previously-accumulated interest. Alternatively, *simple interest*, where the same percentage rate is calculated as interest from the same principal annually, might also be used. There appears to be no preference or compelling reason for compound interest in economic theory.⁶³ Nor is there a preference from a legal point of view: freedom of contract equally permits compound or simple

57. On June 10, 2018, the Swiss electorate rejected the initiative with 24.3% in favour of and 75.7% against the proposal. Schweizerische Eidgenossenschaft, *Bundesratsbeschluss über das Ergebnis der Volksabstimmung vom 10. Juni 2018*, BBI 7757 (2018).

58. Diette, *supra* note 36.

59. Diette, *supra* note 36; accord *DEUTSCHES UND EUROPÄISCHES BANK- UND KAPITALMARKTRECHT*, *supra* note 38, at § 14 at 5.

60. Diette, *supra* note 36. *If* course, potential prime rate clients could also face higher risk premiums in case they failed to pay for previous loans. But since this non-payment is either deliberate or negligent and therefore solely dependent on the will of the client, the article does not discuss this option any further.

61. *Id.*

62. *Id.*

63. For example, there is no indication of a preference in KEYNES, *supra* note 47 nor in DAVID RICARDO, *ON THE PRINCIPLES OF POLITICAL ECONOMY AND TAXATION* (Amazon Fulfillment 2017) (1817), nor in GOCHT, *supra* note 55.

interest.⁶⁴ In practice, however, compound interest is the finance industry standard.⁶⁵ Combined with weighted risk, which is additionally priced into the interest rate if only poor collateral exists or is entirely unavailable, the economic outcome of compound interest is very different in comparison to simple interest.

III. THE RISK PREMIUM FROM A LEGAL POINT OF VIEW

Courts, governments, and the public accept a higher risk premium as the price that a borrower with a poor credit rating must pay to obtain the same loan that a borrower with good credit would get at a cheaper price. In contrast, the price for rented cars or apartments does not depend on the financial background of the client or tenant but solely on the market.⁶⁶ Different prices for the same good or service seem discriminatory if the determining factor is the property of the client,⁶⁷ unless the risk premium – as an independent element of the interest rate – offers something in return.

Should the risk premium offer no additional benefit but only be a driver of cost for the borrower, a remedy can be found in the well-established legal doctrines which provide equitable results for the contractual parties where the return for one party proved to be exceptionally low. In Roman law, for example, the concept of *laesio enormis* granted a contracting party the right to nullify a contract if the relationship of price and value or other contractual relations were extremely disproportionate.⁶⁸ Common law and civil law jurisdictions contain codified versions of *laesio enormis*, such as adjustment and rescission of contracts. While these practices seem to collide with freedom of contract, they are common practice. For example, Article 1168 of the French Civil Code permits the lack of equivalent contractual duties, stating that law can determine otherwise. Accordingly, in Article L650-1 the French Commercial Code provides for an adjustment of collateral in case its value is inadequate. Section 934 of the Austrian Civil Code (ABGB) permits rescission

64. RUTSEL SILVESTRE J. MARTHA, *THE FINANCIAL OBLIGATION IN INTERNATIONAL LAW* 304 (2015) (“given that the obligation to pay interest must have been agreed, there cannot be any presumption one way or the other. The question whether interest payable is to be simple or compound interest is to be approached without reference to any predisposition one may have in favour of simple interest as against compound interest.”)

65. See John Yukio Gotandaii, *Compound Interest in International Disputes*, 2004 Oxford Comp. L. Forum 1 (2004), <https://ouclf.law.ox.ac.uk/compound-interest-in-international-disputes/#fn2anc>. In 2004 most jurisdictions had accepted compound interest as part of the freedom of contract. Following the decision in *Sempra Metals Ltd v. Inland Revenue Commissioners & Anor* [2007] UKHL 34, [2008] AC 561 (appeal taken from Eng.), English law similarly accepted compound interest.

66. The practice of some landlords to verify a prospective tenant’s ability to pay by inspecting his bank statement does not influence the rent but is a mere background check.

67. On the prohibition of discrimination based on economic status see U.N., Comm. on Econ., Soc. & Cultural Rights, Gen. Comment No. 20, Non-discrimination in Economic, Social and Cultural Rights, E/C.12/GC/20 (July 2, 2009).

68. Latin expression describing an enormous or abnormal injury or damage. See *laesio enormis*, BLACK’S LAW DICTIONARY (11th ed. 2019) (summarizing applications).

in case one party received less than half in value of what it gave in order to fulfill the contract, unless it is compensated by the other party. The Swiss and German civil codes declare contracts void that are contrary to public policy or unconscionable due to advantages that are clearly disproportionate to the performance.⁶⁹ And Lord Denning held in the British case *George Mitchell (Chesterhall) Ltd. v Finney Lock Seeds Ltd* that freedom of contract could lead to an abuse of power, if contracts could not be adjusted.⁷⁰

Thus, it is generally acknowledged that the disproportionality of reciprocal contractual duties has legal limits. In the loan context, that means the bank's client must get something adequate in return for paying the risk premium. The risk premium is supposedly the lender's compensation for the risk of issuing a loan to someone with a lower credit rating. It goes without saying that it is indispensable to secure claims. Where conventional collateral is available in the form of physical goods or legal claims, this security can be easily obtained. But if the price of a loan is supposed to be the same interest rate for all borrowers in order to avoid discrimination and only the risk premium differs based on the risk of the borrower,⁷¹ then it is necessary to analyze how the risk premium works in order to clarify its legal character. This chapter demonstrates the risk premium is neither an insurance premium nor a compensation for regulatory expenses, but rather a substitute for collateral.

A. The Search for the Risk Premium's Function: It's Not Insurance

The risk premium could easily be mistaken for an insurance premium. After all, it is a premium that borrowers with less property pay on top of the interest rate in order to cover risk. Without that risk premium, the lender would not enter into a loan contract with the borrower.⁷² But the risk premium is not paid to an insurer to compensate for defaults.

The prime rate is the lowest interest rate a bank is willing to offer to its most creditworthy clients. This interest rate already contains a price for the risk.⁷³ Riskier clients must pay a higher interest rate because the higher risk is added to the prime rate in form of the risk premium. But this risk premium does not lead to an insurance coverage. If this were the case, the risk premiums would have to be paid to an insurer, meaning to a third party with insurance license, and lenders could claim the payment of the principal from the insurer in case of a default as long as the insurance premium – the risk premium – had been paid by the borrower. However, the risk premium is not paid to an insurer to insure the default risk of the borrower but it is paid to the lender and in

69. See Federal Act on the Amendment of the Swiss Civil Code, 1911 (Part Five: The Code of Obligations) (SR 220) art. 21; Bürgerliches Gesetzbuch [BGB] [Civil Code], § 155.

70. *George Mitchell (Chesterhall) Ltd. v Finney Lock Seeds Ltd* [1982] EWCA Civ 5.

71. DERLEDER, KNOPS & BAMBERGER, *supra* note 38, § 13 at 3.

72. Similarly, the risk premium is also called the price the borrower must pay for the risk.

73. See Diette, *supra* note 36; see also DERLEDER, KNOPS & BAMBERGER, *supra* note 38, § 14 at 5.

practice no insurer pays for the lender's loss in case of a default based on risk premiums that the lender received. Consequently, the risk premium cannot be an insurance built into the credit contract.

The lender could use part of the revenue from the loan contract in order to obtain a Credit Default Swap (CDS) in order to hedge the default risk, a procedure similar to insurance.⁷⁴ This means that an insurance against borrowers' defaults exists, but is contained in a derivative product encompassing a multitude of loans, not an individual one. The insurance is not located in the risk premium, but it is provided for by a third party. If the risk premium would fulfill the functions of a CDS and Collateralized Debt Obligations (CDOs), these products would be redundant, and the financial industry would have avoided CDSs as a mere additional expense.

Some lenders demand that the borrower has life insurance, which would cover the remaining payments should the borrower die before the fulfillment of the contract. This practice provides security for both sides of the contract: the lender and the potential heir of the borrower. In an insurance event – the death of the borrower – the insurance pays and fulfills the loan contract instead of its client. Unlike with risk premiums, the borrower thus gets something in return for the paid insurance premium. Again, the insurance is provided by a licensed third party that indemnifies the contractual parties in return for the payment of insurance premiums. And the insured borrower must also cover a risk premium nevertheless.

Some businesses mix calculations in an attempt to compensate potential losses in one field with profits in the other. In the context of loans, risk premiums could, in theory, be used to cross-finance losses within one risk class or between different risk classes as a form of internal insurance. This means poorer and riskier clients would be forced to subsidize the insurance of other equally-risky clients. If the risk premiums were calculated well, the high-risk client class might then be as profitable for the lender as the low-risk client class. Alternatively, low-risk clients could be used to subsidize risky clients. But this cross-financing could be compared to an insurance-like contract

74. Credit Default Swaps (CDS) are used in order to hedge the default risk of Residential Mortgage Backed Securities (RMBS) and other financial products. RMBS belong to a class of financial instruments called Asset Backed Securities (ABS). A single loan's payment would be threatened if the particular borrower defaults, which makes it difficult to sell these loans individually. But if thousands of these loans are pooled in RMBS, on average even a majority of high-risk borrowers are likely to pay. Technically, this pooling of borrowers' risk functions like an insurance. The formerly illiquid asset, like the loan or a mortgage of an individual client, is turned into a commodity that can be sold more easily. In the past two decades Collateralized Debt Obligations (CDO) were developed by combining several ABS or RMBS. And in order to protect investors and lenders from defaults on the CDOs a derivative called Credit Default Swap (CDS) was developed which acted as an insurance policy for the CDOs. See HA-JOON CHANG, *ECONOMICS: THE USER'S GUIDE* 291-293, 297, 302 (2004), 2. Of course, CDOs can be based on CDS as well and these instruments are not only used to hedge the risk but also to pass on risk by selling it. See also John Lanchester, *Outsmarted*, *NEW YORKER* (May 24, 2009), <https://www.newyorker.com/magazine/2009/06/01/outsmarted> (detailing Blythe Masters' development of the CDS).

without consent. Furthermore, also this approach would mean that the different risk classes are treated in a discriminatory manner, because the low-risk class would then benefit from better prices than the high-risk class, leading to different prices for the same product.

But this is not how risk-based pricing works. As the main advantage of risk-based pricing the Federal Reserve Bank of Minneapolis points out:

Since a bank is determining a reasonable default premium based on past credit history, borrowers with good credit histories are rewarded for their responsible financial behavior. Using risk-based pricing, the borrower with better credit will get a reduced price on a loan as a reflection of the expected lower losses the bank will incur. As a result, less risky borrowers do not subsidize the cost of credit for more risky borrowers.⁷⁵

This means that cross financing as an internal insurance is excluded while it is the individual financial behavior that is sanctioned or rewarded. Interest, therefore, is determined by the individual client's risk and bears no resemblance to an insurance.

B. The Search Continues: Regulatory Expenses Constitute Only a Fraction of the Risk Premiums

Once a bank issues a loan, it must adjust its capital according to the regulatory requirements of the applicable national and transnational laws designed to manage risk.⁷⁶ This precautionary measure can increase expenses, which are commonly passed on to the client. In the banking industry risk management regulation is based on the Basel Accords, transposed into national law and administered by national central banks.⁷⁷ The current Basel III Accord seeks to increase the banks' resilience against economic and financial crises by strengthening the capital and reserve requirements according to risks. In the European Union, for example, Basel III is implemented through EU Regulation 575/2013.⁷⁸ Article 114(4) of this regulation determines that where a commercial bank holds its own government's debt, that debt is weighted at 0% risk, as it is considered risk-free. Any other loan is considered riskier, which leads to higher capital requirements. Capital that is captured⁷⁹ by the higher

75. Diette, *supra* note 36.

76. In case a bank receives a deposit, it must adjust its reserves according to the regulatory reserve requirements. If the client would keep the loan deposited at the client's account at the loan-giving bank, the bank would need to meet the reserve requirements additionally, until the loan is transferred or paid out to the client in cash.

77. The Basel Accords describe how different kinds of counter party risk have to be weighted in order to determine how much capital must be allocated to secure the loans in each particular category. They do not describe how the bank must deal with loans on individual level but the Basel Accords are reflected in the banks' approaches to individual loans, otherwise banks could not satisfy the average requirements in each category.

78. Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, 2013 O.J. (L 176). For the intended effects of the regulation, see the recitals at the beginning of the regulation.

79. Captured capital is not available in a special account but it is capital of the financial institution that is designated to be the capital increase which serves as a risk buffer as required by the

capital requirements according to Basel III is not an expense in the sense of a tax or fee and therefore is not lost. But since it is supposed to be an internal safety buffer, this money cannot be invested elsewhere.⁸⁰

Hypothetically, for a better business opportunity the bank would need to look for a different source of funding, for example by raising capital. Since this captured capital is unavailable, the bank's problem is one of opportunity cost. Poorer clients and therefore riskier loans would necessitate larger capital buffers with no or insignificant interest rates, meaning the bank cannot produce additional income with the captured capital. It could thus be argued that risk premiums are supposed to compensate the bank for both the opportunity cost and the poor yield it receives from the larger captured capital in the case of risky loans.

As opportunity costs are based on the capital requirement and therefore on a fraction of the loan, any opportunity cost amounts only to a fraction of the risk premium of the full loan. Moreover, a business that is potentially better and therefore causes opportunity cost is only a hypothetical question and therefore this cost is not protected like property.⁸¹ If a lender decides to give a loan to a high-risk client which entails higher opportunity cost and lower yields, then this was the best possible option at that very moment. It is never certain a better business opportunity in the future would emerge and the lender is also not forced to gather new capital in order to finance the new hypothetical opportunity, either. The lender will do so immediately, if the new business is profitable even if the opportunity costs are to be borne.

The difference between the lender's regulatory expense and the borrower's risk premium is that the lender's opportunity cost is a marginal and hypothetical expense which is not paid by the financial institution to any party. In contrast, the borrower's risk premium is included into compound interest and must, in actuality, be paid by the borrower to the lender. Regulatory expenses are reflected in risk-weighted interest and paid by the clients, but are not comparable to the main expenses in the interest rate which are borne by the borrowers. Equally significant is that risk premiums are supposed to be compensation for increased risk due to the absence of collateral, rather than compensation for regulatory expenses. In other words: "The less likely the repayment, the more expensive the credit becomes."⁸² Consequently, the dimension of interest in loans is determined by the expected default risk,

Basel Accords in case a loan is handed out. *See also supra* note 76, which describes the opposite business, the adjustment of reserves in case the bank receives a deposit.

80. The capital requirement can be generated by outside capital, a fee the bank charges the borrower discounting it from the loan, or a combination of both.

81. *See infra* Section IV.B.2, which discusses how the principal has a similar status to property. Unlike the principal the interest rate is the price of the loan and is determined by the market. Therefore, the interest rate does not enjoy the same level of legal protection as property. A hypothetical price such as the opportunity cost enjoys even fewer protections.

82. DERLEDER, KNOPS & BAMBERGER, *supra* note 38, § 13 at 3.

whereas expenses for refinancing and inflation are insignificant.

C. New Approach Part 1: The Risk Premium as Collateral Sui Generis

Collateral is an asset put up by the borrower as security for a loan. The lender retains the right to use or sell the asset in case a default occurs. If coverage is in danger, prudent lenders sell the asset in order to prevent losses. This collateral is normally returned to the borrower once the credit is paid, as it remains in the borrower's ownership while serving as security.

The size of risk premiums is linked to the loan's duration and volume as well as to the borrower's cash flow. These factors being equal among clients, the size of risk premiums will be inversely proportional to the quality of the collateral, with lower quality collateral resulting in higher risk premiums. Risk premiums will be highest in cases involving borrowers without any collateral to offer. On the other hand, the higher the quality of the collateral, the more it can replace the risk premium.⁸³ This principle holds regardless of whether the borrower is an individual, a business, a bank or a sovereign,⁸⁴ even though lenders' practices in the *degree* of replacement differ with each type of borrower. This inverse relationship between risk premiums and collateral is evident in the laws derived from Basel III, which regulates the risk management of banks by increasing the capital requirements for loans to riskier borrowers. Basel III reflects the finance industry's practical approach to lending, enabling poorer clients to obtain credit if necessary, even if they lack collateral, because collateral can be substituted by a risk premium.

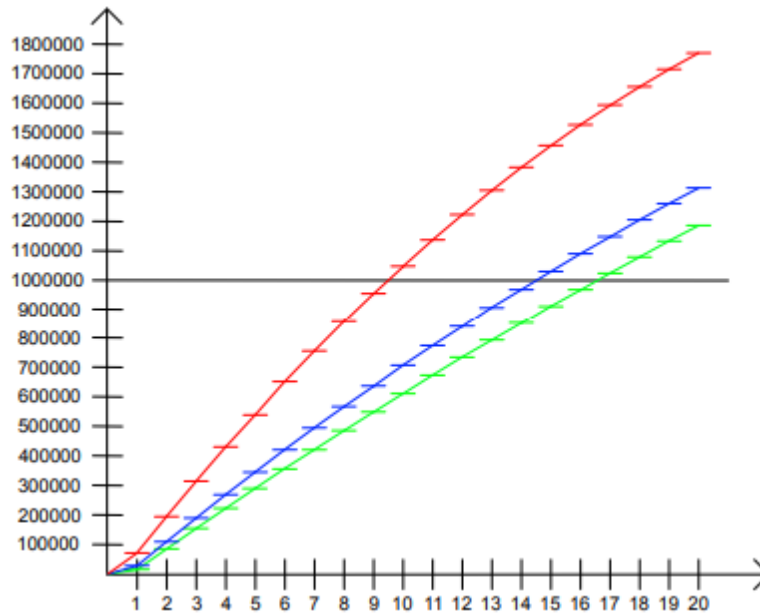
This collateral-substituting character of the risk premium has been ignored by the conventional approach.⁸⁵ Correctly applied, the risk premium benefits both parties: the borrower is able to obtain a loan and the lender minimizes overall risk by reducing the amount of time until repayment of the principal. Compounded with interest rates, risk premiums lead to even stronger exponential growth, resulting in an earlier *de facto* payment of the principal. As a result of this acceleration, the last installment of the principal is paid earlier in cases involving interest rates with high risk premiums than in loans with no or very low risk premiums. Earlier payment of the principal shortens the time for risk exposure, thus reducing the overall risk to the lender. The graph below, which compares loans with low-, medium-, and high-interest rates, illustrates this relationship between risk premiums, the reduction of time, and overall risk

83. *Id.* at § 14 at 8.

84. For an up-to-date overview on the policy debates in the context of individual, corporate and sovereign lending, see Susan Block-Lieb & Mark C. Weidemaier, *Lenders' Roles and Responsibilities in Sovereign Debt Market*, 2019 U. Ill. L. Rev. 1589 (2019).

85. For publications about the legal and economic aspects of interest rates and financial products which do not treat risk premiums as collateral *sui generis* and do not demand their repayment or an adjustment of interests over time, see e.g. SATYAJIT DAS, *SWAPS AND FINANCIAL DERIVATIVES: THE GLOBAL REFERENCE TO PRODUCTS, PRICING, APPLICATIONS AND MARKETS* (1994); MARTHA, *THE FINANCIAL OBLIGATION IN INTERNATIONAL LAW*, *supra* note 64; ROGER MCCORMICK, *LEGAL RISK IN THE FINANCIAL MARKETS* (2010).

to a lender:



Installments of principal paid over time by high-, medium- and low-risk borrowers

Key

Horizontal black line: payment of 1 million from borrower to lender

Loan: 1 million; duration of 20 years; first year redemption-free, payments made quarterly

Interest rate (including risk premium) per annum and time to full payment of principal (redemption)⁸⁶

<i>Borrower</i>	<i>Interest rate</i>	<i>Pays 1 million after (approx.)</i>
Low-risk borrower A (green)	1.75%	16.5 years
Medium-risk borrower C (blue)	2.95%	14.5 years
High-risk borrower B (red)	7.25%	9.5 years

A comparison of borrower A and borrower B (represented by the red and green curves of this graph) shows that an increase of the risk premium by 5.5% leads in practice to an earlier full payment of the principal by seven years. Since a loan to a borrower with poor collateral becomes riskier the longer the loan lasts, this is a logical—and welcome—consequence. The use of compound interest in the finance industry is therefore justified: with simple interest, the

86. Examples based on offers of the Bavarian Development Bank LfA in Munich, Germany, for environmentally-friendly construction loans, offer EG7 calculated by homepage loan calculator on June 19, 2018; LfA loans were taken for illustration only; the example in the article does not mean that the LfA will behave as described. In comparison: the Italian 10-year bond yield moved above 7,05% in 2011; see Ben Rooney, *Italian bonds flashing warning signs*, CNN Money, (Nov. 9, 2011) https://money.cnn.com/2011/11/09/markets/bondcenter/italy_bond_yields/index.htm.

full payment of the principal would happen at a much later stage, while the risk premium in combination with compound interest accelerates the payment of the principal.

While risk premiums are used to replace collateral, they are more advantageous in comparison to customary forms of collateral. Risk premiums are not unique in that they are intangible, since patents or other forms of intellectual property rights are also used as collateral, just as real estate and other valuable goods. But all these customary forms of collateral have a market price fluctuating in value. This price fluctuation becomes problematic for lenders if and when they sell the collateral for compensation, making the quality of the asset extremely important. With limited exceptions such as gold and land, all physical goods and rights that could be used as collateral lose value over time, whether through “wear and tear” or becoming outdated. This depreciation is, in turn, reflected in the applicable tax laws.⁸⁷

The risk premium, on the other hand, does not depreciate. To the contrary, the interest rate grows exponentially through compound interest. The risk premium thus proves to be the best form of collateral. As long as the borrower pays, a risk premium appreciates, rather than depreciates, over time.

While high-risk borrower B pays a higher risk premium, the risk premium on its own does not offer the lender the same protection against risk as normal collateral. On the graph above, the portion of the red line underneath the horizontal black line constitutes the period of time during which the lender’s risk is not covered. Only once borrower B has paid the principal (shown as the point at which the red line cuts through the black line) does the lender’s risk of losing the principal disappear. If borrower B pays the principal amount more quickly (*i.e.*, if the red line increases more sharply), the lender will be better protected from this risk. The beginning of the loan contract is therefore the riskiest period for the lender since a default by borrower B cannot be compensated with the sale of collateral. Understandably, lenders seek to close this gap as early as possible using high-risk premiums. If the lender receives high-quality collateral for coverage, the risk is low from the start of the loan contract, so it does not matter that a prime-rate borrower pays the full principal at a much later stage. In this example, borrower A pays seven years later, which is significant relative to the 20-year loan term. Thus, while an ideal collateral would provide the lender with protection for the entire loan *including* profit from the beginning of the loan contract, the risk premium cannot provide for the same level of protection at the start. Lenders regularly evaluate this

87. Interest rates of any kind (compounded, simple, or risk-based) are not considered goods that can be depreciated, unless they are connected to tangible assets, such as real estate. *See generally* Department of the Treasury-Internal Revenue Service, *How to Depreciate Property*, (March 23, 2020), <https://www.irs.gov/pub/irs-pdf/p946.pdf>; For the United Kingdom, where depreciation is called capital allowances, *see generally* HM Revenue & Customs, *HMRC Capital Allowances Manual*, (April 16, 2016), <https://www.gov.uk/hmrc-internal-manuals/capital-allowances-manual/ca10020>.

increased risk as acceptable and enter into loan contracts nevertheless, since the financial situation of borrowers is less likely to change in the near future.

Because it not only replaces the collateral but also has the effect of accelerating payment of the principal, the risk premium constitutes a collateral *sui generis*.

D. Risk-Weighted Pricing Causes Different Prices for Identical Products

The previous example not only demonstrates how much earlier the principal is paid when a higher risk premium is used, but also how much more a risky borrower must pay over the loan term (here, 20 years) compared to a prime-rate client:⁸⁸

Low-risk borrower A (green): 1.75%, total interest paid: 185,937.50

Medium-risk borrower C (blue): 2.95%, total interest paid: 313,437.50

High-risk borrower B (red): 7.25%, total interest paid: 770,312.50

It is clear that the risk premium not only serves as a substitute for a customary collateral, but also shifts the full payment of the principal to a much earlier stage. Equally clear, however, is that absent a default, high-risk borrower B pays the entire principal plus the interest of the prime rate and the amount of risk premium. Thus, for the lender, the risk premium produces a far better yield than any other possible collateral. In addition, while the money paid by the borrower as collateral based on the risk premium stays with the lender, any conventional collateral is returned to its owner after the loan contract has been fulfilled. Ultimately, once the last installment of the loan has been paid, high-risk borrower B faces three distinct disadvantages: 1) B will have paid a higher price, 2) B will not have the risk premium returned, although it is a substitute of the collateral, and 3) B will have had less time to use the principal than low-risk borrower A.

Lenders might respond to these disadvantages faced by high-risk borrowers by framing the risk premium as part of the loan price and arguing that a loan to riskier borrowers simply entails more work, such as more detailed credit analysis and closer monitoring. The problem with this claim is that, at the outset of the risk assessment of a potential borrower, the lender does not know the borrower's risk profile. To comply with duties under Know Your Client guidelines,⁸⁹ banks must conduct equally detailed and comprehensive

88. See figure above, examples based on offers of the Bavarian Development Bank LfA in Munich, Germany, offer EG7 calculated by homepage loan calculator on June 19, 2018.

89. Know your client / know your customer (KYC) guidelines are part of an international attempt to fight corruption and money laundering. They also serve to determine the suitability of banking products for clients. In the UK, for example, they are part of the Money Laundering

risk assessments for all clients. Thus, regardless of whether clients are perceived as high- or low-risk at the outset, risk assessments result in nearly identical expenses for all clients. Besides, housing bubbles in sub-prime markets attest to the fact that doing business with high-risk borrowers is profitable. The lender usually does not bear whatever additional expense is involved with riskier clients but passes them on to the clients.

Because lenders are obliged to keep their default risk as low as possible, risk premiums force borrowers to pay additional expenses. High-risk borrowers end up paying far more than low-risk borrowers for the same loan in retrospect. If the twin objectives of non-discriminatory loan pricing and security for lenders are to be achieved, the interest rate must be gradually adjusted over time so that the loan remains protected and the price becomes the same for all borrowers at the end. Alternatively, the sum a risky borrower must pay above the prime rate could be returned just like any other collateral, although this would mean a free credit for the financial institution. Neither of these two alternatives occurs in practice although the risk premium as a collateral *sui generis* remains the borrower's property just like any other collateral. Without adjustment or repayment, the accelerating character of the risk premium—which serves as legitimate protection for the lender at the beginning of the loan contract—becomes an additional burden on the borrower once the principal is paid.

IV. LACK OF ADJUSTMENT LEADS TO INTEREST RATE-BASED DISCRIMINATION

After the borrower's duties are fulfilled, the lender must return the collateral (if not, the borrower has a restitution claim against the lender).⁹⁰ It follows from the collateral-substituting character of risk premiums that, if risk-weighted interest rates are not adjusted to prime-rate level once the principal has been paid in full, the amount paid in excess of the prime rate based on the risk premium must also be repaid to the borrower. Non-adjustment or

Regulations 2017, SI/2017/692. In the EU they are based on Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015 on the Prevention of the Use of the Financial System for the Purposes of Money Laundering or Terrorist Financing, 2015 O.J. (L 141) as amended by Directive 2018/843, 2018 O.J. (L 156) In the US, KYC takes the form of the Customer Identification Program (CIP) rule mandated by Section 326 of the USA PATRIOT Act. See 31 U.S.C. 5318(1); 31 C.F.R. 103.121.

90. The restitution claim may be based on the contract itself as the borrower retains ownership of the collateral or on unjust enrichment, which exists as a legal principle in both civil law and common law jurisdictions and establishes the remedies available to the party that suffered a loss of property without legal cause which led to the enrichment of another party. See, e.g., Allgemeines Bürgerliches Gesetzbuch [ABGB] [Civil Code], § 877, 1041, 1042, 1174, 1431, 1435 (Austria); Bürgerliches Gesetzbuch [BGB] [Civil Code], § 812 (Ger.); Code Civil [C. civ.] [Civil Code] [art. 1303-1304] (Fr.); or (the ["Jogalap nélküli gazdagodás" of the Hungarian civil code) paragraphs 6:579 – 6:582]. In *Benedetti v Sawiris* [2013] UKSC 50 and *Bank of Cyprus UK Ltd v Menelaou* [2015] UKSC 66, the UK Supreme Court recognized that claims for since unjust enrichment were well-established in common law and turned on a four-question inquiry: "(1) Has the defendant been enriched? (2) Was the enrichment at the claimant's expense? (3) Was the enrichment unjust? (4) Are there any defences available to the defendant?"

repayment of the risk premium – which currently is standard practice – is discriminatory since high-and low-risk clients are treated differently based on their property status, despite posing the same degree of risk to the lender upon payment of the principal (*see* Section V for the legal analysis of discrimination based on economic grounds). Under the new approach to interest rates proposed herein, the loan contract would be understood to consist of two phases: the time before the principal is paid, during which prime-rate clients and high-risk clients belong to different risk classes; and the time after the payment of the principal, when these clients belong to the same risk class. Therefore, the time before payment of the principal and after payment require two separate discrimination analyses.⁹¹

A. No Discrimination Before the Payment of the Principal

The lender has a right (and an obligation to shareholders) to protect the investment and an interest in making a profit. Therefore, clients wanting to borrow are classified according to the risk they could pose to the fulfillment of the loan contract (*see* Section III). Only then will the lender be able to sign the contract with the borrower. Once the principal has been disbursed to the borrower, the first phase of the loan begins.

1. Difference in Treatment

Based on the risk classification conducted by the lender, clients will be either offered the prime rate or the prime rate plus a risk premium. This risk premium is the precondition for riskier borrowers to obtain the same principal as low-risk borrowers by accelerating the payment of the principal through the higher interest rate. As a result, borrowers A and B in the example above are treated differently based on their risk classification. Equal in all characteristics except for property status, borrowers A and B have to pay different prices for the same principal.

2. Objective and Reasonable Justification

The difference in treatment could be objectively and reasonably justified if a legitimate aim is pursued and the means are proportional to achieving that aim.

a. Legitimate Aim to Protect the Principal

The absence or the poor quality of collateral increases the risk that the lender will be unable to recover the principal in case of a default. In such a case, the lender's investment, consisting of commercial bank money that is protected by law, similar to property, would be in danger. A higher interest rate

91. For further information on the prohibition of discrimination, see for example European Court of Human Rights, *Guide on Article 14 of the European Convention on Human Rights and on Article 1 of Protocol No. 12 to the Convention – Prohibition of Discrimination*, 15 (Dec. 31, 2019), https://www.echr.coe.int/Documents/Guide_Art_14_Art_1_Protocol_12_ENG.pdf.

accelerates the payment of the principal, thus shortening the first phase of the loan. During this first phase, risk exposure is particularly high as the payment of the principal has just begun and a security is unavailable or insufficient. This accelerated payment of the principal is a necessary security (and, in some cases, the only possible security) for the lender's commercial bank money at that stage. For this reason, compound interest in combination with risk premiums is widely used instead of simple interest. As banks otherwise would not give loans to potential borrowers lacking adequate collateral, this compensation for lenders through a higher interest rate is an acceptable and necessary practice. The risk premium, and therefore the interest rate, must be set in such a manner that they do not constrain clients' economic activity and financial capacity in such a way that would endanger the loan agreement. Consequently, any prudent lender would use risk-weighted interest rates in loaning to risky borrowers. Thus, the use of individual risk classifications to differentiate between borrowers serves a legitimate aim in the first phase of the loan.

b. Proportionality of the Use of Risk-weighted Interest

The use of risk premiums is proportionate in the first phase of the loan if the differential treatment of borrowers is the least intrusive means to protecting the lender's property.

As demonstrated above, the higher risk premium is necessary in the beginning of the loan. It is the only available option that shortens the high-risk period by accelerating the payment of the principal, which consists of commercial bank money. Because banks have been legally authorized to create commercial bank money, this kind of money is legally similar to property.⁹² Commercial bank money thus benefits from a similar standard of protection to real property upon its creation through a loan contract. The right to property is for example guaranteed by Article 1 of Protocol No. 1 to the European Convention on Human Rights, which provides that: "[E]very natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law." The lenders' approach to treating borrowers in a comparable situation differently based on their property status in order to protect the loan is objectively and reasonably justified. Differential treatment during the first phase of the loan is therefore not discriminatory.

92. The sovereign decides on all money-related matters, such as legal tender and commercial bank money. That some EU member states have given up their own currency to adopt the Euro and regulated the creation of commercial bank money at the EU-level, *see* HAHN HÄDE, WÄHRUNGSRECHT 22-23 (2d ed. 2010), shows that banks and other financial institutions, as well as their owners, know about the conditionality and cannot argue that the ability to create commercial bank money is protected like an acquired right.

B. Discrimination after Payment of Principal

The current practice of lenders is to treat borrowers throughout the loan contract in the same way as they did at the beginning. Over the course of the loan, however, the risk to the lender's investment decreases as the amount the borrower has paid off increases. This reduced risk needs to be taken into account, particularly since a larger degree of risk determined the size of the risk premium at the beginning of the loan.⁹³

1. Difference in Treatment

Once the principal has been paid and no longer must be secured, the second phase of the loan begins. At that moment, prime-rate borrower A and high-risk borrower B pose the same amount of risk to the investment of the lender. Yet, their risk premiums continue to differ considerably.

If neither low-risk borrower A nor high-risk borrower B defaults, they will have paid a different price at the end of the loan agreement, although both obtained the same principal as a loan. Additionally, there are several differences in the treatment of prime-rate borrower A and high-risk borrower B that persist in the second phase of the loan. While low-risk clients like borrower A will receive back the collateral that had been securing the loan, high-risk clients like borrower B will not receive the risk-premium that replaced the collateral. Similarly, low-risk clients can use their funds for a longer time before full payment than high-risk clients. This ability to use funds for a longer or shorter time impacts economic activity since a higher-risk premium and an accelerated payment of the principal may necessitate higher prices. For instance, if prime-rate borrower A and high-risk borrower B ran competing businesses, it is possible that B would need to ask for higher prices in comparison to A in order to satisfy the loan. Borrower A thus has a competitive advantage in not having to pay the principal at the same speed as B and, consequently, could afford to offer lower prices.

2. No Objective and Reasonable Justification

If the risk posed by client A and client B levels out, upholding different risk-premiums for these two borrowers can only be justified if a new and legitimate aim arises and if the means of achieving said aim are proportional to its end. Thus the question arises: does a legitimate aim exist once the lender's risk has dropped to zero in both cases?

93. If the high-risk borrower is just as successful in paying the loan as the low-risk borrower, he should be treated identically. The borrower should obtain the same price and a better credit score or credit rating. This can only be determined *ex post* or from the moment the principal was paid—from *ex ante* it is necessary to have a different price. Therefore, it is necessary to perform two discrimination tests.

a. No Legitimate Aim

Similar to a collateral, the aim of the risk premium is to protect the lender's investment, the principal. According to the individual risk of the borrower, the lender is initially justified in charging A and B different risk premiums. However, once the principal has been paid to the lender, no risk and therefore no legitimate aim remains. The risk premium is only the tool to achieve the property-like protection of the principal if collateral is insufficient or nonexistent, but the right to property does not extend to interest rates and their components.

The right to property is guaranteed in all major human rights instruments, for example in the European Convention on Human Rights⁹⁴ and its additional protocols. In *Marckx v. Belgium*⁹⁵ the European Court of Human Rights set the scope of Article 1 of Protocol No. 1, which applies solely to already existing possessions and "does not guarantee the right to acquire possessions". It could be argued that commercial bank money comes within the coverage of Article 1 Protocol No. 1 as long as banks are permitted to create it, since then commercial bank money is akin to central bank money. That means the principal is sufficiently concrete to be protected under this provision. As legal persons also enjoy property rights according to Article 1 of Protocol No. 1, any financial institution can act if its property rights have been violated. But unlike the principal, interest is only a derivative, as it is derived from the principal and therefore cannot have a property-like status. It is the price for the product and like any other price it depends on the market's price discovery. Due to price discovery, the price changes constantly and is not concrete. Interest rates, therefore, cannot be protected like property.⁹⁶ There is no legal guarantee to be successful in economic endeavors. If success, meaning a profit, would be legally guaranteed, society would be exposed to endless and limitless risk. As a result, interest rates are less protected than the principal.

Currently, the balance treats principal and interest as if they were legally both equally akin to property: in the example at hand, all three clients still owe 526,315.79 after ten years despite the fact that client A had already paid 612,417.76, client C 707,549.34 and client B had paid even 1,048,437.50 because no distinction is made between principal and interest. The conclusion that interest is legally seen not property but a price necessitates a new way to read the balance, based on which the payment of the loan in the aforementioned example can be divided up into two phases with different levels of legal protection: the first phase during which the client is simultaneously paying redemption rates and interest until the principal is paid, and the second phase

94. Convention for the Protection of Human Rights and Fundamental Freedoms, Nov. 4, 1950, Europ.T.S. No. 5; 213 U.N.T.S. 221

95. *Marckx v. Belgium*, 31 Eur. Ct. H.R. Ser. A) at 39 (1979).

96. In comparison, the rent that must be paid for an apartment is never the same as the property claim related to the property, the apartment itself.

where redemption rates and interest are simultaneously paid for the interest only. In the diagram above, the first phase is represented by the field below the black 1 million line until it is crossed by the red, blue and green payment curves. The second phase is the field above the 1 million line after the payment curves have crossed it.⁹⁷

The current approach, however, extends the property protection beyond the principal to encompass the interest rate. This approach leads to a discriminatory and therefore unlawful outcome by supporting different prices for the same product based on the economic status of the borrowers.

To require high-risk clients to maintain payments on risk premiums once they paid the principal to the lender is therefore not a legitimate aim.

b. No Proportionality

The use of risk premiums would also be proportionate in the second phase of the loan if the differential treatment of borrowers were necessary to protect the lender's property in the least intrusive manner. However, this is not the case. The lender's property is secured already in the first phase. The only further payment that could be requested from both clients A and B alike would be the prime rate, as it covers the expenses and profit for the lender in the case of prime rate clients. Paying the risk premium in the second phase of the loan is no longer proportional as an interest rate around prime-rate level would be sufficient to reach the same price after 20 years.

C. New Approach Part 2: Interest Rate Adjustment, a Well-Known Judicial Technique

The justification for using risk premiums in the first phase does not hold in the second phase. Therefore, it is necessary to restructure payments in such a way that strikes a balance between the lender's right to protect its property—the principal—and the borrower's right to be free from discrimination. Certain countries across Latin America, Africa and Asia have attempted to do this by introducing interest rate caps.⁹⁸ While interest rate caps have been useful in some instances – such as Bolivia, where they have contributed to more affordable housing⁹⁹ – they are not without shortcomings.

97. Paying first the interest and the principal afterwards does not make sense for a prudent lender because that leaves the principal longer in the realm of a potentially risky client. Paying first the principal and the interest after also increases the risk, although less than in the first alternative, as this approach does not combine compound interest with risk premiums in order to accelerate the payment of the principal. Accordingly, the current system which sees the simultaneous payment of redemption rates and interest is optimal for prudent lenders by virtue of its payment-accelerating character.

98. HOWARD MILLER, EPS-PEAKS, INTEREST RATE CAPS AND THEIR IMPACT ON FINANCIAL INCLUSION 6 (2013).

99. Bolivian decrees No. 1842 (18 December 2013) and No. 2055 (10 July 2014); Juan Pablo Bohoslavsky, *Development and Human Rights in Bolivia: Advances, Contradictions, and Challenges*, 11 *LATIN AM. POL'Y* 126, 129 (2020).

Unlike risk premiums which force the borrower to repay the principal early on, interest rate caps extend the time it takes to repay the principal and thus increase the risk posed to the lender's principal. This increased risk is not only detrimental to the individual lender but could also damage the credit market. By rendering the principal repayment less secure, interest rate caps could disincentivize lenders from participating in the credit market. This, in turn, is likely to deplete the amount of credit available, undermining the interests of lenders and borrowers alike. Most importantly, interest rate caps are as discriminatory as the current practice since capped interest rates will likewise consist of different interest rates and contain risk premiums based on the financial background of the borrower. Thus, interest rate caps do not replace the discriminatory price regime and do not solve the problem that money paid in excess based on risk premiums is not returned like any other collateral.¹⁰⁰ A better alternative would be a new approach that reflects the progressive reduction in risk that comes as more of the principal is repaid.

The current loan repayment model would be far more equitable were it to adjust risk premiums over time. The logic behind this proposal is well established. For example, in *De jure belli ac pacis*, Grotius describes that borrowers are simply released from their obligations proportionally to what the lender has received.¹⁰¹ Provisions of German and Austrian law adhere to this view as well. The German Federal Court of Justice (*Bundesgerichtshof*), for example, has demanded the release of collateral, proportionate to and dependent upon continuing payments on the principal, in cases where the value of the collateral was excessive relative to the underlying claim.¹⁰² The Court reasoned that excessive collateral unreasonably impairs the economic activity of the borrower. In so saying, the Court found that agreements containing a clause that could lead to excessive collateral could be found unconscionable unless the contract releases the collateral gradually back to the borrower once it is no longer necessary.¹⁰³ The Austrian courts have taken a near identical approach to over-collateralized claims.¹⁰⁴ The release of collateral must take

100. *Id.* at 129 (Interest rates vary between 5.5% and 6.5% for social housing and from 6% to 11.5% for credits to the production sector).

101. HUGO GROTIUS, *THE RIGHTS OF WAR AND PEACE INCLUDING THE LAW OF NATURE AND OF NATIONS* Chapter X Nr. 11 at 192 (1901) (Grotius uses the example of agricultural real estate mortgages to illustrate this claim further. Specifically, he refers to a situation in which the owner of the collateral no longer has access to it and the lender makes use of the collateral's fruit. In doing so he argues that the usufruct produced by the collateral payments should be deducted from the principal); *See also* PETER DERLEDER, KAI-OLIVER KNOPS & HEINZ GEORG BAMBERGER, *DEUTSCHES UND EUROPÄISCHES BANK- UND KAPITALMARKTRECHT* § 29 at 59 (2017) (Contemporary practice is to use collateral as a means of reducing the claim against the borrower).

102. This kind of excessive collateral is referred to as "Übersicherung" in German.

103. BGHZ 137, 212, 218. The *Bundesgerichtshof* found that the fiduciary nature of security agreements require the secured lender to return the collateral once it is no longer necessary. It also suggested that the lender only has discretion to choose which collateral to return if there are several options, but not over whether or not to return the collateral.

104. ÖSTERREICHISCHES BANKVERTRAGSRECHT – BAND VIII: KREDITSICHERHEITEN, TEIL I (Peter Apathy, Gert Michael Iro & Helmut Koziol eds., 2d ed. 2012) nr. 1/170, fn. 612 and 613.

place proportionally to the lender's reduced need for a security because Austrian law demands an adjustment in cases where collateral must be supplemented or replaced.¹⁰⁵ This norm explicitly requires the proportionality of collateral and secured claim, so the release should follow the same principle.¹⁰⁶ As with the German courts, the Austrian courts have found that a contract requiring excessive collateral could be deemed unconscionable and thus voidable, unless it is adjusted according to the gradual reduction of risk.¹⁰⁷

As loan agreements may turn unconscionable because of excessive collateral, the risk premium may reach a similar effect over time. Keeping the collateral creates a claim against the lender to return it and the growth of compound interest could lead to an unconscionable contract at one point, due to the collateral-substituting character of an interest rate that becomes excessive. But reducing interest to prime rate levels after full payment of the principal accords with the views of the Austrian and German courts that collateral must be gradually released overtime. Alternatively, the sum paid above the prime rate could be returned at the end of the contract.

It is well-established that courts may adjust contracts based on the proper allocation of risk where adjustment is more equitable than annulment of the contract or bankruptcy of one of the contract parties. In *Till v. SCS Credit Corp.*,¹⁰⁸ for example, the U.S. Supreme Court held that the lender's interest in receiving the outstanding payment should be balanced against the borrower's risk that excessive interest rates on the receivables may potentially lead to bankruptcy.¹⁰⁹ The Court's plurality further endorsed a simple and uniform method for bankruptcy courts to use in reforming interest rates, which it referred to as the "formula approach:"¹¹⁰ starting with the national prime rate¹¹¹ and adjusting it to account for the greater default risk which bankrupt debtors typically pose.¹¹² *Till* not only clarifies that bankruptcy courts may adjust

105. ALLGEMEINES BÜRGERLICHES GESETZBUCH [ABGB] [CIVIL CODE] § 458 (Austria).

106. ÖSTERREICHISCHES BANKVERTRAGSRECHT – BAND VIII: KREDITSICHERHEITEN, TEIL I nr. 1/171.

107. See BGHZ 137, 212, 224; See also BGHZ 138, 367 (The German Federal Court of Justice set a limit of 150% of the total loan sum as a rule of thumb. The actual value is exceeded by 50% because it acknowledges the necessity of the lender to cover expenses for the sale and eventual legal expenses); But see BGHZ 137, 212 c) (1) - (4) Rimmelpacher, Stürmer, *Kreditsicherungsrecht* (2017) at 155 nr 42 (if both parties are able to prove that this limit is either enough or insufficient and could demand a reduction or increase based on the market value).

108. *Till et ux. v. SCS Credit Corp.*, 541 U.S. 465 (2004). The respondent in this case was required to pay 9.5% in interest on the monthly payments: 8% constituted the prime rate and 1.5% reflected the risk premium.

109. Justice Stevens, writing for the Court's plurality, relied upon Chapter 13 of the U.S. Bankruptcy Code which enables bankruptcy courts to modify the rights of any lender whose claim is secured by an interest in anything other than "real property that is the borrower's principal residence." *Id.* at 475.

110. *Id.* at 466.

111. The national prime rate refers to the financial market's estimate of the amount a commercial bank should charge a creditworthy commercial borrower to compensate for the loan's opportunity costs, the inflation risk, and the relatively slight default risk.

112. The Court suggests that, when undertaking this analysis, bankruptcy courts must choose an

interest rates in situations where they might otherwise endanger the bankruptcy plan's sustainability, but also that the collateral is to remain the property of the borrower, provided the borrower completes its payments in accordance with the bankruptcy plan.

Existing judicial practice establishes that collateral and interest rates may be adjusted to reflect the economic interests of the parties. It would be a logical extension of this existing case law to permit the adjustment of risk premiums as well. Only existing property, meaning "lawfully acquired possessions", is protected by the law.¹¹³ Future profit automatically generated by compound interest and risk premiums beyond any equitable security is not protected. Therefore, it would not violate lenders' property rights to adjust risk premiums by operation of law. Alternatively, the lump-sum repayment of all interest paid above the prime rate could take place at the end of the loan period, just as all collateral must be handed back.

While both practices would improve the current system, courts deciding between these solutions should weigh three considerations: (1) the different levels of property protection that apply to the principal and to the interest rates; (2) the varying risk posed by borrowers by virtue of their economic background; and (3) the changing levels of risk over time as borrowers complete their payments on the principal. The status quo ignores that risk changes over time and that pricing cannot be discriminatory in a free market that abides by the rule of law and human rights. The only proportionate, non-discriminatory means of protecting lender's property is the adjustment of interest rates over time.

It goes without saying that if the lender must adjust the risk premium over time in order not to discriminate against the borrower, it can adjust its risk management *vis-à-vis* the supervisory institutions – in most instances, the central bank. A commercial bank would otherwise be trapped in a situation that leads to reduced revenue from the client and the obligation to manage risk as though the client were still high-risk. But under the Basel III regime, the bank must anyway perform frequent stress calibrations on their entire portfolios with current market data in order to adjust counterparty risk.¹¹⁴ Paragraph 61 of Basel III states: "In all cases, the data must be updated quarterly or more frequently if market conditions warrant." This not only means that the adjustment of risk management and risk premiums can go either way, but that it

interest rate that is sufficiently high to adequately compensate a creditor for undertaking their risk but not so high as to doom the bankruptcy plan. *Id.* at 466-67.

113. For example, Charter of Fundamental Rights of the European Union, art. 17(1), 2010 O.J. (C83) 389

114. Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems*, December 2010 (revised November 2011), II. A. 1. 98. ¶¶ 25(I) & 61, pp. 30-31, available at <https://www.bis.org/publ/bcbs189.pdf>

is already done on a regular basis.¹¹⁵ Commercial banks are required to collect the necessary data and are able to adjust their capital accordingly, but the cost savings which these risk calibrations yield are not passed on to their clients.

V. LEGAL ASPECTS OF DISCRIMINATION BASED ON PROPERTY

Under the Basel Accords, banks typically apply risk-weighted interest to all loans, sovereign and private alike. This Article urges a re-interpretation of the law whereby risk premiums function legally as a replacement of collateral which banks must adjust over time according to the diminishing risk. This prescription would apply with equal force to sovereign and private loans. This chapter discusses a variety of legal issues that arise in cases where the protection of property and the prohibition of discrimination are applied to private individuals and entities, as well as to states.

A. The Prohibition of Property-Based Discrimination Against Private Borrowers

Cases where risk premiums lead to prices dependent on a client's property bear similarity to legal provisions and cases where a difference in pricing is based on sex or ethnicity. The Equal Treatment in Goods and Services Directive 2004¹¹⁶ prohibits business practices in the European Union that discriminate on the basis of sex. The *Test-Achats* case, where the Court of Justice of the European Union held that gender-specific pricing violates the non-discrimination and gender equality provisions of the EU's Charter of Fundamental Rights (CFR),¹¹⁷ led to gender-neutral insurance premiums.¹¹⁸ The European Convention on Human Rights prohibits discrimination based on property in Article 14 in combination with Protocol 12, as does the CFR in Article 21(1). Some constitutions, such as the Hungarian Constitution in Article XV (2), have similar provisions. Additionally, several international conventions establish the prohibition of discrimination.¹¹⁹ The general prohibition of discrimination as codified in the major international and regional

115. This is also supported by the Guidelines On ICAAP And ILAAP Information Collected For SREP Purposes of the European Banking Authority, EBA, EBA/GL/2016/10 §§ 57(a)-(b) (Feb. 10., 2017), which state that risk changes are tracked, and that the banks' risk management must reflect these changes.

116. THE COUNCIL OF THE EUROPEAN UNION, COUNCIL DIRECTIVE 2004/113/EC OF 13 DECEMBER 2004: IMPLEMENTING THE PRINCIPLE OF EQUAL TREATMENT BETWEEN MEN AND WOMEN IN THE ACCESS TO AND SUPPLY OF GOODS AND SERVICES) (2004), <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32004L0113>. OFFICIAL JOURNAL OF THE EUROPEAN UNION, L 373 (2004), <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:L:2004:373:TOC>.

117. Charter of Fundamental Rights of the European Union, articles 21, 23, 2010 O.J. (C83) 389.

118. Case C-236/09 *Association belge des Consommateurs Test-Achats ASBL v Conseil des ministres*, 2011 E.C.R. I-773.

119. African Charter on Human and Peoples' Rights (Art. 28), American Convention on Human Rights (Art. 1, 24), International Covenant on Economic, Social and Cultural Rights (Art. 2) and the International Covenant on Civil and Political Rights (Art. 26).

human rights conventions is, of course, applicable in the financial field.¹²⁰ This implies that an adjustment of pricing in order to avoid discrimination is not only possible but legally required.

An authoritative source is General Comment No. 20 of the Committee on Economic, Social and Cultural Rights, which also deals with discrimination based on property which is prohibited based on Article 2 of the International Covenant on Economic, Social and Cultural Rights.¹²¹ States that ratified that International Covenant must “immediately adopt the necessary measures to prevent, diminish and eliminate the conditions and attitudes which cause or perpetuate substantive or de facto discrimination.”¹²² Apart from direct discrimination that this article’s example with clients A, B and C illustrates, today’s risk-weighted interest rate system also results in indirect discrimination, as defined in the relevant European anti-discrimination directives as a system that creates a disparate negative impact for a certain group of people.¹²³ In the case of risk-weighted interest, the disparately- and negatively-affected class includes anyone who does not get the prime rate, a class in which minorities, women and people with lower incomes are over-represented.

This point bears repeating: while the system of weighted interest seems objectively fair, it has a negative effect on all but prime-rate clients. All others pay for the full risk estimate, even if they prove to be less risky than the lenders’ forecasts had anticipated. Since risk premiums are currently not understood as a collateral *sui generis* that compensates for inadequate or missing collateral, they cause direct and indirect discrimination. Also, since the lack of property is frequently regarded as an individual problem rooted in laziness rather than being “deeply entrenched in social behavior and organization, often involving unchallenged or indirect discrimination”, risk premiums also contribute to systemic discrimination.¹²⁴ In this regard, the UN Special Rapporteur on extreme poverty and human rights, Magdalena

120. See generally Motoko Aizawa, Daniel Bradlow, & Margaret Wachenfeld, *International Financial Regulatory Standards and Human Rights: Connecting the Dots*, MANCHESTER J. OF INT’L ECON. L. 1 (2018).

121. General Comment No. 20, Non-discrimination in economic, social and cultural rights (art. 2, ¶ 2, of the International Covenant on Economic, Social and Cultural Rights), Committee on Economic, Social and Cultural Rights, U.N. Doc. E/C.12/GC/20 (Jul. 2, 2009).

122. *Id.* ¶ 8(b).

123. The Race Equality Directive 2000/43/EC of 29 June 2000 states in Article 2 Nr. 2 (b) that “(...) indirect discrimination shall be taken to occur where an apparently neutral provision, criterion or practice would put persons of a racial or ethnic origin at a particular disadvantage compared with other persons, unless that provision, criterion or practice is objectively justified by a legitimate aim and the means of achieving that aim are appropriate and necessary.” The Equal Treatment in Goods and Services Directive 2004 (2004/113/EC) of 13 December 2004 defines indirect discrimination as a situation “where an apparently neutral provision, criterion or practice would put persons of one sex at a particular disadvantage compared with persons of the other sex, unless that provision, criterion or practice is objectively justified by a legitimate aim and the means of achieving that aim are appropriate and necessary.”

124. General Comment No. 20, *supra* note 131, ¶ 12.

Sepúlveda Carmona, has demanded that States “take all appropriate measures to modify sociocultural patterns with a view to eliminating prejudices and stereotypes.”¹²⁵

Financial technology (fintech) algorithms that are based on conventional credit scoring methods represent a modern form of systemic discrimination. The World Bank’s Technical Guide to Credit Scoring in Financial Inclusion, for example, recommends predictive analytic methods that merely perpetuate the *status quo* in credit scoring.¹²⁶ But since the claim to the principal no longer needs to be protected once the principal is paid, maintaining risk premiums afterwards is neither reasonable nor objective, no matter if the decision is made by a bank clerk or an algorithm. Unadjusted risk premiums leave the permissible scope of differential treatment, that is valid for conventional as well as modern forms of discrimination.¹²⁷ General Comment No. 20 clarifies that property status, as a prohibited basis of discrimination, is a broad concept and includes all sorts of property, or the lack of it.¹²⁸ Risk premiums have an effect on those with property and on those without. As wealthy clients are more likely to use good collateral, they benefit in three ways: (1) by obtaining a cheaper interest rate, (2) by having the collateral returned at the end, and (3) by being able to use the principal for a longer time. In turn, a shorter availability of the principal, a high-risk premium and its full payment without having it returned at the end is the sanction for not having sufficient collateral. In the present example, B pays 770,312.50 while A pays only 185,937.50 for the identical loan and has his collateral returned on top of this. Once B paid the full principal, he must shoulder 584,375 more than A,¹²⁹ just because there is no collateral. This different treatment based on property in business practice is not proportional and therefore discriminatory.

Human rights are frequently understood as a defense of the individual against the state, but under established jurisprudence, human rights law may develop a direct effect between individuals and private entities.¹³⁰ For example, in *Deaconu v. Romania*, the European Court of Human Rights asserted its competence to review a national court’s interpretation of a private contract where it appears inconsistent with rights protected by the Convention.¹³¹ A growing body of property-based discrimination cases is developing, involving

125. A/HRC/21/39 para 21.

126. Fernandez Vidal, Maria, & Barbon, Fernando, *Credit Scoring in Financial Inclusion – How to use advanced analytics to build credit-scoring models that increase access*: CONSULTATIVE GROUP TO ASSIST THE POOR 1, 24 n.5 (2019).

127. General Comment No. 20, *supra* note 131, ¶ 13.

128. *Id.*, ¶ 25.

129. $770.312,50 (B) - 185.937,50 (A) = 584.375$.

130. The discussion on different aspects of the relationships between private individuals in the context of human rights is also known under its German legal term *Drittwirkung*. For an overview, see THE CONSTITUTIONALISM IN PRIVATE RELATIONS: EXPANDING CONSTITUTIONALISM (András Sajó & Renáta Uitz, eds., 2005).

131. *Deaconu v. Romania*, no. 66299/12, [2019] ECHR 98, ¶ 24.

discrimination by and against the state and private entities. The next section offers a sample of court cases of national and international courts from European and North American jurisdictions that deal with discrimination based on property.

1. Property-Based Discrimination Against Individuals: Overview of Jurisprudence

*a. Shelter Corp. v. Ontario*¹³²

At issue in this case was the respondent landlords' use of income criteria to deny rental accommodation to lower-income applicants. The landlords maintained a policy of refusing to rent to prospective tenants who would pay more than 30% of their gross income in rent on the assumption that such tenants were likely to default. The Ontario Human Rights Commission and complainants challenged this practice on the grounds of discrimination based on age, sex, and income because the application of this rule results in the exclusion or the restriction or preference of designated groups. The respondents claimed the law did not prohibit landlords from screening tenants based on their ability to pay. They also disputed the discriminatory or selective character of their criteria and argued that without the ability to screen tenants and thereby limit their risk, landlords would face undue business hardship.

The Ontario Board of Inquiry (now the Human Rights Tribunal of Ontario) found that the housing expenditure-to-income ratios yielded invalid and unreliable results due to a variety of theoretical and conceptual errors. Moreover, it observed that over 30 % of households in Canada spent more than 30 % of their gross income on housing. Additionally, the Board found no evidence connecting rent-to-income ratios with default.¹³³ Rather, the Board found that "the evidence supports a conclusion that it is unexpected changes in one's circumstances after entering into a tenancy which are the most common cause of a tenant's default."¹³⁴ On review, the Ontario Superior Court of Justice, Divisional Court confirmed the Board of Inquiry's approach and its findings of indirect discrimination.¹³⁵

*b. Chassagnou and others v. France*¹³⁶

A French law forced smaller landowners to cede their hunting rights to

132. *Shelter Corp. v. Ontario (Human Rights Comm.)*, 2001 CanLII 28414 (ON SDC).

133. *Ontario Human Rights Commission and Kearney et al v. Bramela Corporation et al*, Board Of Inquiry 98-021, 221998. *Id.* at 44 ("There is no relationship between the percentage of income that a person spends on rent and the probability that such person will default in the payment of rental obligations.").

134. *Id.* at 46.

135. *Shelter Corp. v. Ontario (Human Rights Comm.)*, 2001 CanLII 28414 (ON SDC).

136. *Chassagnou and others v. France* [GC, 29. April 1999], nos. 25088/94, 28331/95 and 28443/95, ECHR 1999-III.

large hunting associations. The law granted compensation to landowners who lost income because of the compulsory transfer but made no provision for those who opposed hunting and planned a different use of their estate. Additionally, owners of large estates were able to refuse the transfer of hunting rights. Ms. Chassagnou and her fellow claimants were smaller landowners who opposed hunting, wished to ban it on their properties, and unsuccessfully petitioned the French courts to prevent the transfer of hunting rights.

The European Court of Human Rights held that the compulsory transfer of the hunting rights of smaller landowners, such that others could use the property in a way that collides with the owners' beliefs, constituted a disproportionate burden, without justification, on their right to property, and thus violated Article 1 of Protocol No. 1.¹³⁷ The Court found a violation of the right to property in conjunction with discrimination (Article 14 of the Convention) because, unlike the smaller land owners, those with large estates could decide on the use of their land freely and could therefore prohibit hunting on their land. In addition, the Court held there was a discrimination based on property within the meaning of Article 14 of the Convention, since the difference in treatment between large and small landowners results in granting only the former the right to use their land in accordance with their conscience.¹³⁸

The Court held that the arbitrary decision as to who is sufficiently small to have their hunting rights transferred against their will is not only a violation of property rights but also a discrimination based on property, as this decision is based on the size of the property, meaning its value¹³⁹. French law impermissibly discriminated against Ms. Chassagnou based on her smaller-sized property. Similarly, banks impermissibly discriminate against lenders by setting risk premiums based on a borrower's smaller property or lack thereof, and thereafter failing to adjust the risk premium as the risk decreases.

Following this criterion, if a lender were permitted to keep the proceeds from the risk premium once the principal was paid, courts would extend the property rights of lenders beyond already existing property. This extension would affect all borrowers that are not prime-rate clients, meaning all those with lower financial and lower social status, for no legitimate reason. On the other hand, low risk prime-rate borrowers, who could provide for customary collateral are not affected because their property must be returned by law once the loan agreement was fulfilled. There are two extremes in pricing: low-risk prime rate client A with excellent collateral and high-risk client B without collateral. Once the lender's risk vanishes due to the payment of the principal, two different prices exist. Basel III and other laws seem to offer no reason why

137. *Id.* § 85.

138. *Id.* § 95.

139. *Id.* § 93.

credit agreements for prime rate clients would justify lower prices while loans for riskier clients would necessitate higher prices after the payment of the principal as the risk of loss and the duty of prudent lenders to protect the principal has dropped to zero at that point. These laws and recommendations are therefore at odds with the prohibition of discrimination. In fact, the prohibition of discrimination demands that both situations are to be treated equally once they become equal, otherwise this practice forces borrowers to use the funds they legally own for payments on a risk-premium that has turned redundant.

c. Decision No. 42/2012 (XII. 20.) of the Hungarian Constitutional Court on the Annulment of Certain Provisions of the Act on Legal Aid¹⁴⁰

A 2011 legal reform in Hungary established a requirement of legal representation in constitutional complaints. Previously, unrepresented persons could draft their own submissions to the Constitutional Court. But as the law regulating legal aid was not amended simultaneously, legal aid for constitutional complaints remained unavailable.

In a 2012 judgment, the Hungarian Constitutional Court decided that this situation resulted in discrimination based on a litigant's financial situation. According to the Constitutional Court, it is the state's constitutional duty to facilitate the defense and enforcement of an individual's rights. Consequently, the state is obliged to provide for a court system accessible to all.¹⁴¹ In order to maintain access for parties in disadvantageous financial positions, the state provided for legal aid in lower instance courts, except for constitutional complaints. Therefore, all potential parties to such a complaint were indiscriminately excluded. Nevertheless, the Hungarian Constitutional Court found this situation to be discriminatory: someone who could afford to pay an attorney had an advantage over one who could not since the latter was not able to start any proceedings and was therefore barred from accessing the court system.¹⁴² The Court could not find any constitutional reason for a different treatment of the two groups,¹⁴³ and stated that article XV.2 of the Hungarian Constitution¹⁴⁴ does not presuppose a test of necessity or proportionality but prohibits discrimination altogether.¹⁴⁵ Article XV.2 of the Hungarian

140. Magyar Alkotmánybíróság [Hungarian Constitutional Court] Dec. 18, 2012, 42/2012 (XII. 20.) AB határozat (Hung.); <http://www.codices.coe.int/NXT/gateway.dll/CODICES/precis/eng/eur/hun/hun-2012-3-008> (English summary).

141. *Id.* at 14.

142. *Id.* at 32-33.

143. *Id.* at 35.

144. MAGYARORSZÁG ALAPTÖRVÉNYE [THE FUNDAMENTAL LAW OF HUNGARY] art. XV(2) ("Hungary shall guarantee the fundamental rights to everyone without any discrimination, in particular on grounds of race, color, sex, disability, language, religion, political or other opinion, national or social origin, property, birth or any other status.")

145. Magyar Alkotmánybíróság [Hungarian Constitutional Court] Dec. 18, 2012, 42/2012 (XII. 20.) AB határozat (Hung.) at 39.

Constitution contains a non-exhaustive list of grounds for discrimination, including property. These grounds are mostly unchangeable characteristics of an individual. Property, like political opinion and religion, could eventually change over time but not in every case at will.¹⁴⁶ According to the Court, differential treatment based on a characteristic that cannot be changed at will or that is hereditary is discriminatory without detailed examination because it restricts a human right based on a constant characteristic.¹⁴⁷ The Constitutional Court found that the requirement to have an attorney differentially affected those who were able to pay attorney fees and those who could not and therefore amounted to differential treatment based on property. This differential treatment was the direct consequence of the law on legal aid.¹⁴⁸

In so holding, the Hungarian Constitutional Court acknowledged property as a personal characteristic which can form the basis of discrimination because poverty cannot be traded in for wealth at the very moment in which a submission of a constitutional complaint becomes necessary. The rationale of the Hungarian Constitutional Court applies with equal force to the business practice of financial institutions of requesting high risk premiums from poor clients and low rates from the rich.

2. Property-Based Discrimination Against Private Legal Persons

Article 1 of Protocol No. 1¹⁴⁹ protects property owned by private legal entities (for instance, corporations, but also non-profit organizations that build housing for people living in poverty), the use of which can be only restricted or regulated according to the law. Legal persons and natural persons alike have property rights, as reflected in Article 19(3) of the German Basic Law: “The basic rights shall also apply to domestic legal persons to the extent that the nature of such rights permits.”¹⁵⁰ Property ownership by corporations is legally undisputed, and the recent case law recognizes that corporations may also be the subjects of discrimination. Bilateral investment treaties, tax and competition laws, world trade regulation by the World Trade Organization, and domestic constitutions and jurisprudence all materialize the prohibition of discrimination against private legal entities, which also can be borrowers.

But the fact that the property rights of corporations are legally protected

146. *Id.* at 40.

147. *Id.* at 41.

148. *Id.* at 44.

149. Article 1 of Protocol 1 to the European Convention of Human Rights reads: “Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law. The preceding provisions shall not, however, in any way impair the right of a state to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties.”

150. GRUNDGESETZ [GG] [BASIC LAW] art. 19(3), *translation at* http://www.gesetze-im-internet.de/englisch_gg/index.html.

against discrimination does not mean these legal entities hold and exercise human rights the same way as individuals do.¹⁵¹ Of course, companies can be treated differentially if there is a legitimate reason. For instance, in the context of the COVID-19 crisis, states can decide that companies that pay out dividends, buy back own shares, or are registered in tax havens should not be eligible for any of their financial support programs, as the Austrian, Danish, French and Polish governments did in April 2020.¹⁵² But discriminating (or tolerating discrimination in private contractual relations) based purely on the economic status of borrowing legal entities is not legally permissible.

Similarly, in *White Glove v. Methodist Hospitals*, the U.S. Court of Appeals for the Fifth Circuit held that a staffing corporation had statutory standing to bring a racial discrimination claim under section 1981 of the Civil Rights Act of 1866, which guarantees the right of all persons, regardless of race, to make and enforce contracts.¹⁵³ The U.K. Employment Appeal Tribunal granted a corporation standing in a discrimination case in *EAD Solicitors LLP v. Abrams*.¹⁵⁴ Mr. Justice Langstaff held that the term “person” in the Equality Act must include also a corporate body, “for it is familiar to any employment lawyer that many corporations are alleged to be discriminators and no one has so far considered that is inappropriate.”¹⁵⁵ Likewise, the Justice held that the Equality Act did not restrict the term “person” to an individual,¹⁵⁶ and that this finding was in accordance with the European Equality Directive and the Race Discrimination Directive, Council Directive 2000/43.¹⁵⁷ Hence, discrimination against corporations exists. When they are borrowers, they can also be discriminated against based on their property.

B. The Prohibition of Property-Based Discrimination Against States

A foundational provision in the UN Charter is that all states are equal under international law regardless their economic or military power.¹⁵⁸ More specifically, the 1970 Friendly Relations Declaration provides that “[a]ll states

151. Even when Article 1 of Protocol No. 1 to the European Convention on Human Rights seems to indicate otherwise, see Marius Emberland, *The Human Rights of Companies: Exploring the Structure of ECHR Protection* (2006). See also Stefanie Khoury & David Whyte, *How Human Rights Law Has Been Used to Guarantee Corporations a ‘Right to Profit’*, THE CONVERSATION (Mar. 15, 2017), <https://theconversation.com/how-human-rights-law-has-been-used-to-guarantee-corporations-a-right-to-profit-74593>.

152. See, e.g., Morten Buttler, *Denmark Extends Business Aid to Increase Spending By \$15 Billion*, BLOOMBERG (Apr. 18, 2020), <https://www.bloomberg.com/news/articles/2020-04-18/denmark-extends-business-aid-to-increase-spending-by-15-billion>; *Francia tampoco rescatará a las empresas registradas en paraísos fiscales*, PÁGINA 12 (Apr. 24, 2020), <https://www.pagina12.com.ar/261931-francia-tampoco-rescatara-a-las-empresas-registradas-en-para>.

153. *White Glove Staffing, Inc. v. Methodist Hospitals of Dallas*, 947 F.3d 301, 305-08 (5th Cir. 2020).

154. *EAD Solicitors LLP v Abrams* [2015] UKEAT/0054/15/DM (Eng.).

155. *Id.* at ¶ 9.

156. *Id.* at ¶¶ 21, 25.

157. See *id.* at ¶ 30.

158. U.N. Charter art. 2, ¶ 1; see also R. P. ANAND, *SOVEREIGN EQUALITY OF STATES IN INTERNATIONAL LAW* (2008) (discussing states’ equality under international law per the U.N. Charter).

enjoy sovereign equality. They have equal rights and duties and are equal members of the international community, *notwithstanding differences of an economic, social, political or other nature.*¹⁵⁹ This state equality principle must be read in conjunction with the principles of international cooperation¹⁶⁰ and non-intervention,¹⁶¹ which add economic content to the behavior expected towards states.¹⁶²

In this vein, the 2019 Guiding Principles on human rights impact assessment of economic reforms¹⁶³ determine that states, international financial institutions,¹⁶⁴ and non-state actors should not exert undue influence (including through the use of economic measures) to secure from other states advantages of any kind that undermine the ability of those states to protect human rights.¹⁶⁵ Similarly, the Millennium Development Goals resolution had established that states were “committed to an open, equitable, rule-based, predictable and non-discriminatory multilateral trading and financial system.”¹⁶⁶

Though this topic is underdeveloped in the legal literature, discrimination against states—unequal treatment without legitimate reason—is not permissible under international law. This principle is explicit and well-developed in a number of areas, such as the World Trade Organization and the Paris Club.¹⁶⁷

159. Declaration on Principles of International Law Concerning Friendly Relations and Cooperation Among States in Accordance with the Charter of the United Nations, G.A. Res. 2625 (XXV) (Oct. 24, 1970) (emphasis added). Yet, see United Nations General Assembly Resolution 36/103 of 9 December 1981 (Declaration on the Inadmissibility of Intervention and Interference in the Internal Affairs of States [‘1981 Non-Intervention Declaration’]), to which most developed States opposed.

160. See U.N. Charter art. 55; International Covenant on Economic, Social and Cultural Rights arts. 1, 2, 11, Dec. 16, 1966, 993 U.N.T.S. 3.

161. See U.N. Charter art. 2.

162. For an updated study of the implications of this principle in the context of Third World Approaches to International Law (TWAIL), see THE BATTLE FOR INTERNATIONAL LAW. SOUTH-NORTH PERSPECTIVES ON THE DECOLONIZATION ERA (Jochen von Bernstorff & Philipp Dann eds., 2019).

163. See Human Rights Council Res. 40/8, U.N. Doc. A/HRC/RES/40/8 (Apr. 5, 2019); Human Rights Council Res. 40/57, U.N. Doc. A/HRC/40/57, at 14-15 (Dec. 19, 2018).

164. The IMF applies surcharges of 2% or 3% based on how long payments are overdue and once a certain threshold has been reached. These are not risk premiums, but a closely connected discriminatory practice, since usually only the poorest countries are burdened with these surcharges. In times of near-zero or even negative interest rates, these surcharges, which are not market driven and depend solely on the IMF, are strikingly high. They are not a collateral *sui generis* accelerating payment as discussed in this article but merely a sanction for being poor that is applied against the poorest countries, thus driving them even more into debt. As they do not help protect the IMF’s investment, the existence of these surcharges is not justified, and their use should be abolished. See also Kevin P. Gallagher, *The IMF’s surcharges are unfit for purpose - It’s time for a rethink*, FINANCIAL TIMES, Mar. 4, 2021, <https://www.ft.com/content/cc82f5bf-36c6-454f-b7f0-a4a18576ff2b>.

165. Guiding Principles, Principle 14 and commentary 14.1. On the relevance of the policy space in the economic realm, see also Sustainable Development Goal 17.15; Addis Ababa Action Agenda of the Third International Conference on Financing for Development, annex, § I, ¶ 9; and General Assembly resolution 25/2625.

166. G.A. Res. 55/2, United Nations Millennium Declaration, U.N. Doc. A/RES/55/2, at ¶ 13 (Sept. 18, 2000).

167. See generally WILLIAM DAVEY, NON-DISCRIMINATION IN THE WORLD TRADE ORGANIZATION (2012); Alexis Rieffel, *The Paris Club, 1878-1983*, 23 COLUM. J. TRANSNAT’L L. 83 (1984).

If anything, differential treatment is possible in order to promote international cooperation.¹⁶⁸ Loan contracts with discriminatory interest-rate terms, especially when combined with regulatory policies that erode a country's fiscal space, have grave implications for human rights, in particular for resource-sensitive economic and social rights.

Judicial review of loan agreements between states and non-state actors is unproblematic because such agreements generally provide for sovereign debt to be auctioned off to the lowest bidder in accordance with private-law contracts. Citizens in comparable situations are protected by consumer protection laws, and their human rights are protected by constitutions and international treaties, but the same does not necessarily apply to states. However, recovery and unjust enrichment claims will nevertheless apply to state parties to a private-law loan contract. As a result, governments must insist on non-discriminatory treatment in comparison to prime-rate states after the principal has been fully paid. But discrimination does not only take place between private actors, nor are natural persons alone subjected to discriminatory state actions. Discrimination may also occur among states or between states and other public and private institutions.

The U.S. Supreme Court recognized inter-state discrimination of this sort in *Franchise Tax Board v. Hyatt*.¹⁶⁹ California had sent officers to Nevada in order to investigate Hyatt's change of residence as it assumed he had not paid taxes in California. These California officers examined his mail, harassed him and his friends in Nevada, and in return Hyatt sued for damages. Despite the general principle of state immunity, a Nevada state court exercised jurisdiction over Hyatt's suit on the basis of a controversial 1979 U.S. Supreme Court ruling, *Nevada v. Hall*, which held that a state's immunity does not extend to private suits in other states.¹⁷⁰ The Supreme Court in *Hyatt* deadlocked on whether to overrule *Hall* and thus affirmed the Nevada court's jurisdiction over California's Franchise Tax Board. But the Supreme Court also held that the Nevada court violated the U.S. Constitution's Full Faith and Credit Clause by awarding higher damages against a California state agency than it would have awarded in a comparable situation against a Nevada agency:

A constitutional rule that would permit this kind of discriminatory hostility is likely to cause chaotic interference by some States into the internal, legislative affairs of others It is difficult to reconcile such a system of special and discriminatory rules with the Constitution's vision of 50 individual and equally dignified States. In light of the "constitutional equality" among the States, . . . Nevada has not offered "sufficient policy considerations" to justify the application of a special rule of Nevada law that discriminates against its sister States.¹⁷¹

168. Philippe Cullet, *Differential Treatment in International Law: Towards a New Paradigm of Inter-state Relations*, 10 EUR. J. INT'L L. 549, 571-72 (1999).

169. *Franchise Tax Bd. v. Hyatt*, 136 S. Ct. 1277 (2016).

170. *Nevada v. Hall*, 440 U.S. 410 (1979).

171. *Franchise Tax Bd. v. Hyatt*, 136 S. Ct. 1282 (citations omitted).

In *Shelby County v. Holder*, which invalidated the coverage formula for states subject to the preclearance requirement of section 5 of the Voting Rights Act of 1965, the U.S. Supreme Court ruled that the coverage formula effected a “dramatic departure from the principle that all States enjoy equal sovereignty” because “the Act required [only some] States to obtain federal permission before enacting any law related to voting—a drastic departure from basic principles of federalism.”¹⁷² This case does not relate to a discriminatory practice between states but between the federal government and some states.

Franchise Tax Board v. Hyatt and *Shelby County v. Holder* arise in very different contexts, but are both based on general principles such as comity and the sovereign equality. These principles, which are also enshrined in the Friendly Relations Declaration, apply in both the federal and international contexts.¹⁷³ Judicial review of cases that involve loans and discriminatory treatment between states or states and international financial institutions or similar organs is therefore conceivable in courts as well.

VI. CONCLUDING REMARKS

The practice of charging a risk premium on top of the prime rate is legally justified since it serves as a protection of the lender’s property (or its commercial bank money) in a riskier environment by accelerating the return of the principal. But to the extent that risk premiums lead to interest rates that harm the economic abilities of the borrower by infringing his property rights or by distinguishing between clients based on their financial status in a discriminatory manner, they must be adjusted. Once the risk premium has lost its purpose of ensuring the loan repayment, the price difference loses its justification and turns into a discriminatory practice, placing a greater burden on clients previously classified as risky compared to low-risk clients. This price difference thus leads to discrimination and the infringement of the right to property, against which all states and courts are obliged to take action. This demand is in line with the UN guiding principles on extreme poverty and human rights:

States must ensure that persons living in poverty are equal before and under the law and are entitled, without discrimination, to the equal protection and benefit of the law. States must repeal or modify laws and regulations that are biased against the rights, interests and livelihoods of persons living in poverty. All forms of legislative or administrative discrimination, direct or indirect, on grounds of economic situation or other grounds associated with poverty must be identified and eliminated.¹⁷⁴

It is in the public interest to protect the principal, which is generated as

172. *Shelby County v. Holder*, 570 U.S. 529, 535 (2013)

173. G.A. Res. 2625 (XXV), U.N. Doc. A/RES/2625(XXV) (Oct. 24, 1970)

174. Human Rights Council Res. 21/39, U.N. Doc. A/HRC/21/39, at ¶ 19 (July 18, 2012).

commercial bank money, because this provides for a flexible credit supply. Upholding risk-premium payments fully throughout the duration of the loan agreement, without adjustment corresponding to the decreasing default risk, runs contrary to the public interest, violates the prohibition of discrimination, and frequently infringes upon borrowers' human rights. It reduces economic activity since it captures funds that could be used either for consumption or investment. It also captures funds needed to implement social and economic policies and household financial strategies for coping with the COVID-19 crisis. Were interest rates adjusted after full principal payment, the bankruptcy risk of states, legal persons, and individual borrowers would likely be reduced, and discussions about debt forgiveness would become less urgent and widespread.

The Basel Committee on Banking Supervision has recommended factoring weighted risk into loans. However, its recommendations do not consider the collateral-substituting character of risk premiums and that they have to be treated as collateral *sui generis*. They also ignore that risk premiums are more favorable to a lender than conventional collateral since compound interest grows exponentially, whereas most other collateral is subject to depreciation. Additionally, banks and other lenders cannot credibly claim they face increased costs because of their increased capital requirements when they issue a loan to a risky client instead of a low-risk one: the additional capital expenses are small in comparison to the profits gained from the risk premiums and interest rates, while expenses are passed on to the client. Therefore, the same rule ought to apply to risk premiums as to collaterals: they should be returned once their purpose of securing the principal has been fulfilled.

This reinterpretation represents merely an adjustment of interest rates and risk premiums according to the mechanisms already established by courts for physical security and conventional claims. It is counterposed to the Basel III approach, which gives preference to banks over their clients by demanding permanent control and adjustment of counterparty risk.¹⁷⁵ While commercial banks are legally required to collect the necessary data anyway and are able to adjust their capital accordingly, the Basel Accords do not require them to pass on saved expenses to their clients that occur when capital is being reduced because the client turns less risky over time. The Basel Accords did not really *code* risk premiums to enrich the banks' shareholders on the expense of their clients, but in practice they work as if such a "codification" had taken place.¹⁷⁶ All states, in particular G20 member states, should live up to their human rights obligations and protect the property of their citizens and corporations by introducing regulations that would oblige banks to pass on such client-related

175. Basel Committee on Banking Supervision, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems*, *supra* note 114. See also *Guidelines on ICAAP and ILAAP Information Collected for SREP Purposes*, *supra* note 115.

176. KATHARINA PISTOR, *THE CODE OF CAPITAL: HOW THE LAW CREATES WEALTH AND INEQUALITY* (2019).

savings by returning the risk premiums in accordance with the risk adjustment over time instead of letting finance institutions keep these savings as a windfall.

The current interest rate system is also not proportionate since the adjustment of interest rates over time would be a less burdensome alternative. Currently, risk premiums contribute to the enrichment of those with property while channeling money away from those in less advantageous positions, such as poor households or developing countries. This should be regarded as an exploitative financial mechanism. At present the commercial application of risk premiums collides with the right not to be exploited as enshrined, in a very explicit way, by article 21 of the American Convention on Human Rights, which states that “[u]sury and any other form of exploitation of man by man shall be prohibited by law.”¹⁷⁷

Adjusting interest rates and risk premiums after the full payment of the principal prevents discrimination by securing the equal treatment of all borrowers once they have fulfilled their principal payment obligation. It would free up resources of the poorest borrowers to improve their living conditions, enable sovereign borrowers to implement poverty eradication policies, and facilitate businesses and create wealth for corporate borrowers. Using payment in full as a precondition for equal payment conditions among borrowers strikes the balance between the interest of the lender and the borrower. This approach creates no additional burden for lenders; it simply corrects a poorly-constructed finance practice without interfering with freedom of contract or market forces by treating interest rates as prices rather than property.

Just like their citizens, most states worldwide are borrowers rather than lenders. The new approach also contributes to the realization of economic and social rights since it frees up financial means to satisfy immediate needs, such as food, housing, education and health care, either by directly releasing individuals’ funds or by enabling states to live up to their commitments and human rights obligations. This effect is particularly relevant and acutely needed amidst the COVID-19 pandemic. Its implementation would prove that human rights law can provide sophisticated solutions capable of tackling complex financial challenges.

By strengthening the demand side through a legal adjustment of loan agreements, this approach can contribute to higher demand, affecting the economy on a broad scale, something Quantitative Easing has failed to do. Additionally, risk premium adjustment could eventually help decrease the volume of Quantitative Easing since central banks will be able to reduce that share of money printing necessary to satisfy claims based on artificially high

177. American Convention on Human Rights, art. 21(3), Nov. 22, 1969, O.A.S.T.S. No. 36, 1144 U.N.T.S. 123.

interest rates. Quantitative Easing has also been identified as a driving factor of the wealth and income gap. An April 2019 Dutch Central Bank working paper stated that expansionary monetary policy strongly increases the share of national income held by the top one percent, irrespective of the state of the economy:

“The results . . . indicate that loose monetary conditions strongly increase the top one percent’s income and vice versa. In fact, following an expansionary monetary policy shock, the share of national income held by the richest 1 percent increases by approximately 1 to 6 percentage points....”¹⁷⁸

Consequently, “central bankers need to be attentive not only to the aggregate consequences of monetary policy but also to their side effects.”¹⁷⁹ Central banks are legal creations of their home states; therefore, they are bound by their home states’ international human rights obligations in conducting their operations.¹⁸⁰ A central bank’s choice of which financial instruments to trade and what interest rates to fix can have an impact on society and the environment. Accordingly, some central banks have begun to incorporate environmental risks as well as social criteria into their monetary assessments.

Risk-based pricing has the advantage that responsible financial behavior results in good credit histories. As a result, less risky borrowers are not forced to subsidize the cost of credit for more risky borrowers.¹⁸¹ Currently, risk-based pricing is not free of discrimination. But when employed in combination with the adjustment of interest rates, borrowers will have a clear target: the moment when the principal has been paid completely as they will be put into the same position as a client with a low risk profile.

The approach proposed in this Article is likely to contribute to a more stable financial system in three ways. First, borrowers will no longer be unduly burdened. Private and sovereign defaults should become less likely, and more resources would be available to invest in or to facilitate the realization of human rights. Second, if borrowers knew that their higher risk premiums would lead to faster payment of the principal and therefore to the same price level that prime rate clients enjoy, they would be motivated to maintain regular payments, which could make the whole financial system less exposed to risks. Additionally, knowledge about the adjustment of interest rates could bring about a welcome side effect by making borrowers more interested in the legal side of loans and how risk premiums affect their contracts, thus contributing to

178. Mehdi El Herradi & Aurélien Leroy, *Monetary Policy and the Top One Percent: Evidence from a Century of Modern Economic History* 1, 5 (De Nederlandsche Bank, Working Paper No. 632, 2019), https://www.dnb.nl/binaries/Working%20paper%20No.%20632_tcm46-383633.pdf.

179. *Id.* at 28.

180. Daniel Bradlow, *Why Central Banks Need to Take Human Rights More Seriously*, OPEN DEMOCRACY (July 9, 2019), <https://www.opendemocracy.net/en/oureconomy/why-central-banks-need-to-take-human-rights-more-seriously/>.

181. Diette, *supra* note 36.

an overall improvement of financial literacy. Third, the new approach is likely to reduce moral hazard and to correct the current incentive structure. The example used in this Article illustrates that currently it is extremely profitable to issue loans to risky clients. Because of the additional revenue that high-risk borrower *B* must pay for as opposed to low-risk borrower *A*, *B* is currently the more attractive client. Even if it becomes foreseeable that *B* might default in an upcoming economic downturn, it is easy to sell the claim against *B*. If the lender obtains an investment-grade rating for the loan with *B* despite the higher risk, the lender could sell that contract at a similar price as the contract with *A*. This was also the starting point of the 2008 financial crisis which originated in the United States sub-prime market. But if the contract with *B* was rated in correspondence with the real risk development over time, the market price would be far more realistic, correcting the misleading incentive structure currently in place.

The 2019 Guiding Principles on human rights impact assessment of economic reforms require that the interest rate formation regime be established by law, democratically discussed, and transparent. They also require that monetary and fiscal policies as well as financial regulations be coherent and aimed at ensuring the realization of human rights,¹⁸² while states must use a mix of tools that ensures appropriate financial market regulation in order to curb excessive credit growth. This Article has illustrated that the prevailing risk-weighted interest rates system is in tension with these Guiding Principles and with international human rights law more broadly. Specifically, the Article has shown that laws based on the Basel Accords are not the result of informed and participatory discussions of their social and economic implications. Although some central banks have started incorporating social criteria into their monetary assessments, they do not conduct human rights impact assessments.¹⁸³ As a result, borrowers who most acutely bear the discriminatory consequences of the risk-weighted interest rates system are excluded from participating in the regulatory discussions around interest rates. The Article proves that the way financial institutions adjust risk-weighted interest rates over time is not publicly disclosed. It also validates that the risk premiums, if they are not returned to clients once they fulfilled their purpose, are not consistent with fiscal policies that truly aim at protecting human rights, in particular in the current context where having adequate resources is crucial to survive the health and economic crisis.

This Article also substantiates that the human rights movement's ambition to improve distributive justice is hampered by political factors, not by normative or technical limitations to international human rights law.¹⁸⁴ Human

182. See Human Rights Council Res. 40/57, U.N. Doc. A/HRC/40/57, at 11 and 11.10. (Dec. 9, 2018); Human Rights Council Res. 40/8, U.N. Doc. A/HRC/RES/40/8 (Apr. 5, 2019).

183. Although as state organs, they are obliged to do so. See *supra* note 182.

184. Compare SAMUEL MOYN, NOT ENOUGH: HUMAN RIGHTS IN AN UNEQUAL WORLD (2018).

rights law, in fact, is well-equipped to reduce the widening inequalities exacerbated by finance, and to respond effectively to the pandemic and its aftermath.