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Project 11

SOUTH AFRICAN LAW COMMISSION

REPORT

RELATING TO THE COMMON LAW RULE THAT INTEREST ON A DEBT CEASES TO RUN WHEN THE ACCUMULATED UNPAID INTEREST REACHES THE AMOUNT OF THE PRINCIPAL DEBT

PROPOSAL

1. That the common law rule prohibiting the accumulation of interest in excess of the principal debt be abolished, or alternatively, that loans under insurance policies be exempted from the operation of the rule.

REPRESENTATIONS

2. The Life Offices' Association of Southern Africa submitted to the Commission a comprehensive memorandum proposing the abolition of the rule. It was pointed out that under Roman Law there were several rules which were directed against the practice of usury. Firstly, there was the rule prohibiting compound interest. Secondly, there was the rule which limited the rate of interest to 6 per cent. Thirdly, there was the rule that arrear interest may not accumulate beyond the amount of the principal debt. In our law the rule against compound interest and the rule limiting the rate of interest to 6 per cent were abrogated through desuetude. The rule against the accumulation of interest beyond the principal debt is, however, still

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part of our law (Van Coppenhagen v Van Coppenhagen 1947 ( ) 576)

2.2 The effect of the rule is that as soon as the accumulated interest reaches the amount of the principal debt interest ceases to run. If the accumulated interest is, however, reduced to an amount less than the principal debt, interest again starts to run until the amount of the principal debt is reached. This leads to anomalous results, especially in view of the fact that it has become general practice to charge compound interest. Also in view of the fact that the maximum rate of interest allowed is much higher today than the 6% under the old rule referred to above, interest accumulates much faster and the amount of the principal debt may be reached within a relatively short period. A lender will therefore have to take special precuations to ensure that the benefits of compound interest and a higher rate of interest are not extinguished.

2.3 The rule does not seem logical. In contrast with the borrower who properly honours his obligations by the payment regularly of interest due, it benefits the borrower who fails to honour his obligations with respect to interest due.

2.4 The rule has become even more unnecessary with the enactment of the Prescription Act, 1969, which provides for the extinction of debts entirely within a fairly short time unless prescription is interrupted. This is a sufficient protection to a borrower against being caught unawares by the accumulation

of a vast amount of interest on a debt which both he and the lender might have forgotten about.

2.5 Where the parties have agreed that a debt should not be repaid forthwith but should continue to the advantage of both parties - the borrower who continues to have the use of the lender's money, and the lender who continues to be compensated for not having the use of his money - the law should not intervene to go against the intention of the parties.

2.6 The price of money is the rate of interest payable for its use. The Limitation and Disclosure of Finance Charges Act, 1968, limits the rate of interest chargable and in this respect protects the borrower. Further protection does not seem necessary. The rule departs from the natural requirement that the lender's reward should be commensurate with the period during which he does not have the use of his money.

2.7 With no interest paid the rule comes into operation after a period of approximately 18 years if the rate of compound interest is 4% and after 9 years if it is 8%. The 'protection' to the borrower fluctuates considerably as interest rates vary from time to time. The variation need have no element of exploitation but may merely be the result of changing market conditions.

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2.8 The vigilant lender avoids the operation of the rule by merely limiting the period of the advance or by seeing to it that interest is prevented from accumulating by contracting that the non-payment of interest will cause the loan to become repayable forthwith. The unwary lender or the one whose business denies him this safeguard suffers undeservedly.

2.9 A life insurer advances small loans to his policy holders on security of their policies, and his natural remedy to avoid the rule coming into operation is to call up the loan and to reimburse himself out of the proceeds of the security, i.e. the policy, and to pay out the balance to the insured. The result is, however, that the cover provided by the policy comes to an end. The contention of the Life Offices' Association is that policy loans are distinguishable from ordinary loans in that they consist of advances made out of moneys belonging to the policy holders themselves. For the sake of simplicity a formal loan agreement is entered into between the policy holder and the insurer. There is, however, no reason for the insurer to insist on payment of interest since often the policy holder is prepared to let the amount payable on maturity of the policy be reduced by the amount advar plus interest thereon. Should it therefore be decided not to abolish the rule in general, the Association strongly urges the abolition thereof in respect of policy loans.

COMMENT ON THE PROPOSALS

3.1 Copies of the representations were made available

to all bodies and institutions which the Commission considered could assist it in coming to a conclusion on the matter. All the banking institutions, chambers of commerce, the Institute of Credit Management, several bar councils, the Registrar of Insurance, the Chief State Attorney and Die Afrikaanse Handelsinstituut supported the proposed abolition of the rule unreservedly.

3.2 The Department of Commerce expressed the opinion that the rule should be abolished in respect of policy loans only. The Department was not convinced that the rule would necessarily create hardship in the case of other loans under which the borrower is normally pressed to repay the principal debt and interest thereon.

3.3 The Association of Law Societies of the Republic of South Africa is of the opinion that the limitation of the rule should be left to the courts to consider in the light of changing circumstances. The Association is not in favour of the abolition of the rule by the legislature, especially in view thereof that it has been applied by the courts over a number of years up to recently. The rule was designed to protect the innocent borrower against the wiles of the unscrupulous lender. The Association is, however, in favour of exempting policy loans from the operation of the rule.

FINDINGS/...

FINDINGS OF THE COMMISSION

4. The Commission has given careful consideration to the representations and the comments received in respect thereof. The Commission came to the conclusion that the rule prohibiting the accumulation of interest in excess of the principal debt discriminates unfairly against the debtor who prevents the interest from accumulating. The lender who is not in a position to prevent the operation of the rule suffers a loss. As regards loans on insurance policies it is often the intention of both parties that payment of interest would not be demanded until maturity of the policy. Where the rule leads to the surrender of a policy the interest of the policy holder is detrimentally affected. In view hereof, and also in view of the protection afforded to a debtor by modern legislation, such as the Limitation and Disclosure of Finance Charges Act, 1968, and the Prescription Act, 1969, the Commission is satisfied that no justification exists for the retention of the rule, not only as regards policy loans but also in general.

5. RECOMMENDATION

The Commission recommends that the common law rule that interest ceases to run when the accumulated unpaid interest reaches the amount of the principal debt be abolished.