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High Default Interest Rate Held To Be A Penalty.

Why Your Default Interest Rate Could Be Unenforceable

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Date: 9th July, 2025

In the recent decision from the Supreme Court of Queensland, KF Garty Pty Ltd as Trustee for the Tiger Trust v Prasad & Ors (2025) QSC 91, two self-represented guarantors managed to have a default interest provision struck out as a penalty.

For Lenders, this case highlights the importance of taking careful consideration into setting default interest rates which may be considered penalties and therefore unenforceable.

Key Legal Principles Behind the Decision.

A contractual clause found to be penalty will be struck out under the common law principle known as the rule against penalties. In the 2012 case of Andrews v ANZ Banking Group Ltd (2012) 247 CLR 205, the High Court of Australia defined a penalty as being:

> *"in the nature of a punishment for the non-observance of a contractual obligation and consists upon breach of the imposition of an additional or different contractual liability"*

In this matter the standard interest, for a short-term loan with a loan term of 6 months, was 4% per month and the default rate 8% per month.

The drafting of the loan agreement was in accordance with standard industry practice developed to avoid the rule by:

- labelling the lower (standard) rate as "the Concessional rate";
- labelling the higher (default) rate simply as "the Interest rate"; and
- providing that the Interest rate ordinarily applied but the Concessional rate would be accepted where there were no defaults by the borrower.

Adopting this practice did not assist the lender in this case.

In their material provided to the Court, the guarantors argued that viewed as annual rates of interest, the higher rate at 96% per cent per annum which kicked in on the borrower's default under the loan contract was a penalty compared to the 48% per annum for the standard or discount rate. By the time the parties went to Court the lender had already received payments greater than the capital the borrower had received in the loan.

Justice Smith calculated the difference between the interest two rates as totalling $260,050.60 and accepted the guarantors' arguments that the difference in calculations between the rates amounted to a penalty, stating:

> One can see that the plaintiff stood to gain a very large sum under the higher interest rate. Far higher in my view than was warranted in all of the circumstances particularly when one considers the defendants have in fact paid the same amount as the principal.
>
> In the circumstances I find the clause imposing the default interest rate of 8% per month to be void and unenforceable.

Two New South Wales decisions were relied upon by His Honour in making his decision in this matter, which had the following different standard and default interest rates:

- one had 30% p.a. standard and 60% p.a. default
- the other had 1.75% per month standard and 9.75% per month default

In the latter decision where a significantly more humble increase of 8% applied for the default rate, the NSW judge considered that it:

> *"was extravagant and unconscionable as compared to a loss which could be proved to have flowed from the breach"*

Implications for Mortgage Lenders

While most lenders will presumably not fall afoul of the rule (or charge such eye-watering rates of interest), this unusual case is a reminder that:

- the Courts will intervene in credit contracts where long held common law principles justify such intervention; and
- that provisions applying default interest rates out of proportion to a lender's expected losses will be held void and unenforceable, notwithstanding standard industry drafting practices designed to avoid the rule against penalties.