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### RBI PROPOSES TO CRACKDOWN ON PENAL CHARGES AS A REVENUE ENHANCEMENT TOOL

10 May 2023 The Reserve Bank of India (RBI), through its '*Draft Circular for Comments on Fair Lending Practice - Penal Charges in Loan Account*' (Draft Circular), released on 12 April 2023, has sought suggestions from the stakeholders on the implementation of the proposed guidelines relating to levying of penal charges on the loans disbursed by the RBI's regulated entities (REs) in India.

#### *Introduction*

Under the extant Indian laws, the RBI has issued various guidelines to the REs to ensure reasonable and transparent disclosure for charging of penal interest from its borrowers. The erstwhile regime confers operational autonomy on the REs to formulate board approved policies for imposing penal interest or penal charges.

The penal interest or penal charges is imposed to predominantly inculcate a sense of credit discipline amongst the borrowers through (a) negatively incentivizing such borrowers; and (b) providing a fair yet commensurate compensation to the lenders in whose accounts the defaults have occurred. Pertinently, penal interest or penal charges are not intended for revenue enhancement for the REs for which a contracted rate of interest is usually levied. However, divergent practices have come to the fore indicating that certain REs are wrongfully levying penal interest for non-compliance with the terms of contract.

#### *The Juxtaposition and the Ambiguity*

The two forms of penalties viz. penal charges and penal interest are seldom used interchangeably. However, both 'penal charges' and 'penal interest' are inherently disparate and there seems to be a thin line distinguishing the two, which essentially arises from a different accounting treatment accorded to each.

Penal interest is an additional rate of interest that is compounded on, *or added to*, an existing rate of interest charged by a financial institution from its borrower. *Per contra*, penal charges are to be imposed separately and are not meant to be compounded to the existing rate of interest.

Ergo, the underlying difference between penal charges and penal interest is the way each of these two is accounted and treated in the books of the lenders.

Prior to the Draft Circular, there was no definite directive of the RBI that clearly demarcated the instances as to where the penal interest and/or penal charges can be levied. Consequently, certain REs continued to impose penal interest, over and above the applicable interest rates, even in case of non-compliance by the borrower with the terms of the contract on which credit facilities were availed of.

With an intent to curb such malpractices, the RBI has come up with the Draft Circular stipulating various guidelines proposed to be adopted towards the REs for levying penal charges.

## *Key features under the Draft Circular*

The RBI covers the following REs under its Draft Circular:

- i All commercial banks (including small finance banks, local area banks and regional rural banks, and excluding payments banks);
- ii Primary (Urban) co-operative banks;
- iii Non-banking financial companies (including housing finance companies); and
- iv All India financial institutions.

To such REs, the RBI proposes to issue a host of the instructions (summarized below) which would be brought into effect from the date to be notified by the RBI in the final circular to be issued in pursuance of the Draft Circular:

- i The determination of interest rates on the credit facilities to be made available by the REs, including conditions for reset, shall be strictly governed by the relevant regulatory instructions issued in this regard. Appositely, the RBI has specifically restricted the REs from introducing any additional component to the rate of interest.
- ii Penal charges should be imposed towards default or non-compliance of 'material' terms and conditions of the governing contract and such penal charges should not be levied in the form of 'penal interest', which is added to the rate of interest on the advances. By virtue of this, capitalization of penal charges is sought to be rendered impermissible, thereby meaning that no further interest can be computed on penal charges.
- iii The quantum of penal charges shall be proportional to the defaults or non-compliances of 'material' terms and conditions of the contract beyond a threshold. The REs would be at liberty to determine such threshold which shall not be discriminatory.
- iv The penal charges in loans advanced by REs to individuals (for purposes other than business) should not be higher than the penal charges applicable to non-individual borrowers.
- v Penal charges and the conditions leading to levying of such charges shall be spelt out in the contract, in addition to being displayed on the websites of the REs.
- vi As and when any reminders for payment of installments are to be sent by the REs, the applicable penal charges are also required to be communicated to the borrowers.

The RBI, under the Draft Circular, mandates the REs to carry out appropriate revisions in their board approved policy framework to ensure implementation of the foregoing instructions, as and when these instructions are made effective.

The Draft Circular further lists out the following master directions or master circulars which shall be modified or amended in terms of the Draft Circular (once notified):

- i Master Direction – Reserve Bank of India (Interest Rate on Advances) Directions, 2016 dated 3 March, 2016;
- ii Master Direction – Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 dated 1 September, 2016;
- iii Master Direction - Non-Banking Financial Company -Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016 dated 1 September, 2016;
- iv Master Direction - Non-Banking Financial Company – Housing Finance Company (Reserve Bank) Directions, 2021 dated 17 February, 2021;
- v Master Circular- Management of Advances – UCBs dated 1 July, 2015;
- vi Master Circular- Customer Service in Banks dated 1 July, 2015; and
- vii Master Circular - Loans and Advances - Statutory and Other Restrictions dated 1 July , 2015.

## Comments

Though the Draft Circular may be a welcoming move for the genuine borrowers having a turbulent time, it also attempts to play a deterrent to the unfair lending practices reportedly adopted by some of the financial institutions.

However, even though the intent of the Draft Circular is righteous, the implementation of it may seem to be convoluted. The Draft Circular provides that the penal charges, and not penal interest, would have to be imposed for '*default/non-compliance of material terms*'. The term 'material' is fluid in its very nature. Often, the parties end up negotiating rather vociferously on the materiality aspects in a given terms of a contract. Further, the conditioning of a term to be a material or immaterial may vary transaction-wise and, sometime, lender-wise too. In such a scenario, imposition of 'penal charges' on the 'material' terms may well mean that the borrower continues to be at the mercy of the lenders thereby rendering the intent of the Draft Circular inefficacious. Further, it would be interesting to note how the RBI would address the existing contracts where the lenders have sought penal interest for a breach of a 'material' term under the regulating contract. Though some well-advised lenders may prefer to amend the terms of their contract, the others may choose to turn a blind eye leading to little respite for the borrowers.

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