

Fair Lending Practice – Penal Charges in Loan Accounts

The Reserve Bank of India (“**RBI**”) *vide* notification dated August 18, 2023, has issued comprehensive guidelines for Regulated Entities (“**REs**”) to promote reasonableness and transparency in the levy and disclosure of penal interest/charges in loan accounts in the lending practices of financial institutions (“**Guidelines**”).

Key points covered under the Guidelines are:

1. The RBI has observed the tendency of REs to use penal rates of interest over and above the applicable interest rates in case of defaults/ non-compliance of terms by borrowers.
2. The Guidelines highlight the difference between ‘penal charges’ and ‘penal interest’. The penalty for non-compliance of any material terms and conditions of the loan contract by the borrower will be treated as ‘penal charges’ and will not be levied as penal interest (i.e., any interest that is added to the rate of interest charges on the advances). Penal charges are also not to be capitalized, i.e., no further interest may be charged on such penal charges.
3. The RBI has clarified that the normal procedure for compounding interest in the loan account will not be affected.
4. REs are mandated to be transparent in their dealings with borrowers and not introduce any additional components to the rates of interest. REs are also required to formulate a board approved policy on such penal charges in accordance with the Guidelines.
5. The quantum of penal charges charged by the REs should be reasonable and justified with the non-compliance of material terms and conditions of the loan contract and should not be discriminatory within a particular loan category.
6. The Guidelines state that penal charges for loans sanctioned to ‘individual borrowers, for purposes other than business,’ should not be higher than the penal charges applicable to non-individual borrowers for similar non-compliance of material terms and conditions.
7. The Guidelines further state that the quantum and reason for penal charges should be clearly disclosed to borrowers in the loan agreement / key fact statement, as applicable in addition to being displayed on the REs’ website.
8. At the time of levy of penal charges, REs are required to communicate the applicable penal charges to borrowers and the reason for such penal charges.
9. These Guidelines will not be applicable to credit cards, external commercial borrowings, trade credits and structured obligations – all of which are covered under specific directions.

10. These Guidelines will come into effect from January 1, 2024, and REs are encouraged to revise their frameworks and policies to ensure the implementation of the Guidelines for all loans availed or renewed from January 1, 2024. In relation to existing loans, the change to the new regime is to be ensured on the next review or renewal date or 6 (six) months from January 1, 2024, whichever is earlier.

JSA Comment

The prevailing issues of high penal interest rates being used by the REs as a revenue enhancement tool has been recognized by the RBI. Concerns with such penal interest rates have led to numerous disputes and grievances.

The Guidelines focus on preventing REs from capitalizing on penal interest/ charges as a means of enhancing the interest rate beyond what was agreed. The RBI has emphasized for penal charges to be reasonable and justified to the degree of 'non-compliance' with the material terms of the loan contract. The RBI has directed for more transparency by the REs with the borrowers regarding the quantum and reason for the penal charges. We also understand that the above Guidelines will be applicable to instances of digital lending.

These measures adopted by the RBI on fair lending practices will ensure greater accountability from lending institutions. The clear difference between 'penal charges' and 'penal interest' will establish charges which are reasonable and not discriminatory to a specific loan category. Borrowers will be able to analyze the penal charges applicable prior to availing the loan facilities. This change in regime will be welcomed by borrowers and will assist in negating grievances and defaults. The steps taken by the RBI are borrower friendly and will require changes to be effected in loan documentation to implement the Guidelines. However, the non-applicability of penal interest to critical covenants (such as timelines for security creation) may lead to delays in compliance by the borrowers and affect the ability of the lenders to recover their dues or to enforce their rights.

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24 Ranked Lawyers



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11 Ranked Lawyers



7 Practices and
2 Ranked Lawyers



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