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RBI MANDATE- CRACKDOWN ON PENAL CHARGES

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INTRODUCTION

As per the extant guidelines of the Reserve Bank of India (**RBI**), the banks and NBFCs (**RE**) have the liberty to levy penal rates of interest over and above the interest rates on the loan facility without any threshold limit. Such charges are levied in case of any default or non-compliance by the borrower of the terms and conditions of the loan facility agreement including breach of representation, warranties, covenants, non-adherence to payment schedule, failure to create and maintain security, or the failure to supply information under the loan facility agreement.

NEW RBI GUIDELINES ON LEVYING PENAL INTEREST

While the intent of levying penal interest or charges is to deter the borrowers from defaulting on terms and conditions of the loan facility, it is observed that the same is being used as a revenue enhancement tool, leading to customer grievances and disputes.

In order to curb the prevailing practice and address the concerns of the borrowers, the RBI has issued new guidelines titled "Fair Lending Practice- Penal Charges in Loan Accounts" to regulate the RE from levying penal interest on borrowers.

Some of the key conditions required to be adopted in letter and spirit by the RE as per the new guidelines are as under:

➢ The penalty for any non-compliance of material terms and conditions of the loan facility by the borrower shall be treated as 'penal charges' and not in the form of penal interest that usually gets added to the interest rate;

➢ There shall be no capitalisation of penal charges (*i.e. no further interest can be levied on such charges*). However, the RBI has clarified that it will not affect the right of the RE for compounding of interest in the loan account;

➢ RE shall not introduce any additional component to the rate of interest and shall be required to formulate a policy on penal charges or similar charges (*by whatever name called*); and

➢ Quantum of penal charges shall be reasonable and should be clearly disclosed to the customer at the time of entering into a contract and before levying of such charges.

CONCLUSION

The RBI which permits *ad hoc* levying of penal interest and charges will be prohibited with the new guidelines. With the conditions required to be put in place by the RE, it will ensure that the borrowers do not end up being burdened with additional and higher interest and charges. Moreover, with the materiality test, the RE will not have any window to levy charges (a) on trivial and non-significant breaches of the loan facility, and/or (b) under any other name.

The new guidelines, which shall come into effect from January 1, 2024, also provide for grandfathering provision making it applicable to existing as well as new loan facility.

Hence, these new guidelines can be seen as a sigh of relief for the borrowers.

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