

## Key takeaways of RBI's draft circular on Penal Charges on loan accounts

Research & Advisory (Corporate Laws)

Are you tired of being hit with unfair and hidden penalties on your loan accounts?

The Reserve Bank of India (RBI) is here to change that! In a ground-breaking move, the RBI vide Press Release no. 2023-2024/56 dated April 12, 2023 has released a draft circular on Fair Lending Practice - Penal Charges in Loan Accounts, aimed at establishing transparent and equitable practices for the imposition of penal charges.

Get ready to say goodbye to the days of being charged unreasonable fees for defaulting on your loans, and hello to a new era of fairness and accountability in the lending industry!

Let us delve into draft guidelines and unfold the key takeaways of the draft circular which are as follows:

### **1. Regulated Entities (REs) to be prohibited from introducing additional components to interest rates**

In order to curb the autonomy of lenders in levying interests, the RBI through its draft circular plans to ensure that the determination of interest rates on credit facilities, including conditions for resetting of interest rates, is strictly governed by the relevant regulatory instructions issued in this regard. The Regulated Entities (REs) shall not introduce any additional component to the interest rate.

### **2. Penalties for default to be treated as 'penal charges' rather than 'penal interest'**

Presently, penalties for default or non-compliance with material terms and conditions in loan contract by the borrowers are treated as penal interest. Now, the RBI has proposed that they shall be treated as 'penal charges' rather than 'penal interest' which will be added to the interest rate charged on the advances.

Further, there shall be no capitalisation of penal charges, i.e., no further interest computed on such charges. However, this change will not affect the normal procedures for compounding interest in the loan account. The operationalisation of the 'penal charges' in place of 'penal interest' will be subject to appropriate review during supervisory examination by the RBI.

### **3. Recognition of Credit Risk Premium in Loan Interest Rates**

It is important to recognise that the rate of interest on a loan includes an appropriate credit risk premium that reflects the credit risk profile of the borrower. If the credit risk profile of the borrower undergoes change, the Regulated Entities (REs) will have the flexibility to alter the credit risk premium in accordance with the contracted terms and conditions.

### **4. Proportionate penal charges to be levied for breaches beyond loan default threshold**

Now, the RBI has proposed to keep the quantum of penal charges proportional to the defaults/non-compliance of material terms and conditions of the loan contract beyond a certain threshold.

This threshold is to be determined by the REs and shall not be discriminatory within a particular loan / product category.

### **5. Penal charges for loans granted to individual borrowers not to exceed charges levied on non-individual borrowers**

The RBI has proposed that penal charges for loans sanctioned to individual borrowers, for purposes other than business, shall not be higher than the penal charges applicable to non-individual borrowers. As a result, the REs must clearly disclose the penal charges and conditions precedent to customers in the loan agreement and most important terms & conditions/Key Fact Statement (KFS).

Also, REs must display the penal charges on their website under “Interest rates and Service Charges”.

### **6. RBI recommends communication of applicable penal charges to borrowers**

It has been proposed that whenever reminders for payment of instalments are sent to borrowers, the applicable penal charges, shall also be communicated.

### **7. Regulated Entities (REs) to ensure mandatory Board-approved policy on penal charges for loans**

The RBI has proposed that the REs shall ensure that there is a clearly laid down Board approved policy on penal charges or similar charges on loans.

## 8. Conclusion

The proposed draft circular on fair lending practices aims to establish guidelines and limit the discretion of lending institutions when imposing additional penal rates of interest in cases of non-compliance or borrower default. This initiative by the RBI may help protect borrowers from excessive and arbitrary penal interest rates, ensuring fair lending practices in the financial sector.

Further, comments by the stakeholders on the 'Draft Circular' may be submitted by May 15, 2023 to the Chief General Manager, Department of Regulation, Central Office, Reserve Bank of India or by e-mail with the subject line "Draft Circular on Fair Lending Practice - Penal Charges in Loan Accounts".