

## FAIR LENDING PRACTICE – PENAL CHARGES IN LOAN ACCOUNTS



As per the loan covenants between Banks/NBFCs and borrowers, the borrowers are obliged to pay Interest on the principal amount and pay the instalments every month till the repayment of loan. If the borrower does not comply with the terms and conditions, such as not paying the EMI, the Banks and NBFCs are authorized to levy penalty. *Vide* RBI/2015-16/59 DBR No.Leg.BC. 21/09.07.006/2015-16 dated July 1,2015; RBI/DBR/2015-16/20 Master Direction DBR.Dir.No.85/13.03.00/2015-16 dated March 3, 2016 and RBI/DNBR/2016-17/44 Master Direction DNBR.PD.007/03.10.119/2016-17 dated Sep 1, 2016, RBI has empowered Regulated Entities (REs) to levy penal charges on the borrowers in the case of non-payment or delayed payment. But it has been noted by the regulator that the facility for penal charges is being used by some of the REs for profit-making, instead of its originally intended use of promoting credit-discipline.

Responding to the concerns raised against the penal charges from customers, RBI has issued amendments to the extant guidelines on 'Fair Lending Practices' by Banks and NBFCs.

The Reserve Bank of India (RBI) has issued guidelines for REs, regulating the penal charges in loan accounts:

- to inculcate a sense of credit discipline.
- to ensure transparency in the disclosure of penal charges and interest rates in loan accounts.

**Penal charges:** *Penal charges are the additional charges levied by the lender on the borrower in case of delay in repayment and/or non-payment of loan by the borrower.*

The guidelines are as follows-

**Penal charges, not Penal Interest-**

- Penalty, if charged, for non-compliance of material terms and conditions of loan contract by the borrower shall be treated as ‘penal charges’ and shall not be levied in the form of ‘penal interest’ that is added to the rate of interest charged on the advances.
- The penal charges in case of loans sanctioned to ‘individual borrowers, for purposes other than business’, shall not be higher than the penal charges applicable to non-individual borrowers for similar non-compliance of material terms and conditions.
- The Regulated Entities (REs) shall not introduce any additional component to the rate of interest and ensure compliance with these guidelines in both letter and spirit.
- The REs shall formulate a Board approved policy on penal charges or similar charges on loans.
- The quantum of penal charges shall be reasonable and commensurate with the non-compliance of material terms and conditions of the loan contract without being discriminatory within a particular loan/product category.

**Clear Communication with borrowers –**

- The quantum and reason for penal charges shall be clearly disclosed by REs to the customers in the loan agreement and most important terms & conditions / Key Fact Statement (KFS) as applicable, in addition to being displayed on REs website under Interest rates and Service Charges.
- Whenever reminders for non-compliance of material terms and conditions of the loan are sent to borrowers, the applicable penal charges shall be communicated. Further, any instance of levy of penal charges and the reason, therefore, shall also be communicated.

The guidelines will be effective from January 1, 2024 on all Commercial Banks (including Small Finance Banks, Local Area Banks and Regional Rural Banks, excluding Payments Banks), all Primary (Urban) Co-operative Banks, all NBFCs (including HFCs) and all India Financial Institutions. These guidelines will not apply to Credit Cards, External Commercial Borrowings, Trade Credits and Structured Obligations which are covered under product specific directions.

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