

Banks barred from compounding penal interest on loan defaults

ABHIJIT LELE

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To ensure fair lending, the Reserve Bank of India (RBI) on Friday prohibited lenders from compounding penal interest arising from loan defaults with future repayments.

Also, the penalty imposed by regulated entities (REs) on customers for default and breaching loan conditions are to be treated as “penal charges”, the RBI said. REs are debarred from imposing such charges as “penal interest”, which is added to the rate of interest.

These instructions will come into effect from January 1, 2024.

The RBI, in a communication to REs, said “there shall be no capitalisation of penal charges aka no further interest computed on such charges. However, this will not affect the normal procedures for compounding of interest in the loan account”.

These instructions will, however, not apply to credit cards, external commercial borrowing, trade credits and structured obligations covered under product-specific directions. REs may carry out revisions in their policy framework and ensure implementing the instructions in respect of fresh loans or those renewed. For the existing loans, the

RBI allows IDF-NBFCs to tap ECB funds

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The Reserve Bank of India (RBI) has permitted non-banking finance companies operating as Infrastructure Debt Fund (IDF-NBFCs) to raise money through external commercial borrowings (ECBs). These borrowings will be subject to a minimum tenor of five years, and IDF-NBFCs are prohibited from sourcing the ECB loans from the foreign branches of Indian banks, as stated by the RBI in communication to the companies.



This decision came after the guidelines applicable to IDF-NBFCs were reviewed in consultation with the Government. The aim was to enable IDF-NBFCs to play a more substantial role in financing the infrastructure sector and to bring the relevant regulations into harmony. IDF-NBFCs are non-deposit-taking entities.

They are allowed to refinance post commencement operations date (COD) infrastructure projects that have completed at least one year of satisfactory commercial operations.

switch to the new charges regime will happen after the next review or renewal date, or six months from the date of this circular, whichever is earlier.

Veena Sivaramakrishnan, partner, banking and finance, and insolvency and bankruptcy practice, Shardul Amarchand Mangaldas & Co, said against the backdrop of a non-transparent approach in the way penal interest was levied, it was not surprising the RBI

had sought to govern this specifically. For customers, the most important change is transparency.

The regulator said it had been observed many REs used penal rates of interest over and above the applicable interest rate in the case of defaults/non-compliance by the borrower with the terms of loans. The idea of levying penal interest/charges was to inculcate a sense of credit discipline and such

charges are not meant to be used as a revenue enhancement tool. However, supervisory reviews have shown divergent practices among REs with regard to levying penal interest/charges, leading to customer grievances and disputes. The RBI said lenders should not introduce any additional component to the rate of interest and ensure compliance with these guidelines in both letter and spirit.

They have to formulate a board-approved policy on penal charges or similar charges on loans. The amount of penal charges should be reasonable and commensurate with non-compliance with material terms and conditions of loans without being discriminatory within a particular loan/product category. The penal charges for loans sanctioned to “individual borrowers, for purposes other than business” will not be higher than the penal charges applicable to non-individual borrowers for similar non-compliance with material terms and conditions.

Ashutosh Narang, Partner, INDUS-LAW, said the RBI’s notification on “fair lending offers relief to borrowers while urging lenders to adopt more equitable practices. This change will enhance transparency and fairness, fostering a balanced lending environment”.