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Date: 15/01/2024

Fair Lending Practice - Penal Charges in Loan Accounts

(Reference [Circular: DoR.MCS.REC.28/01.01.001/2023-24 dated August 18, 2023](#) and [DoR.MCS.REC.61/01.01.001/2023-24 dated December 29, 2023](#))

1. Para 3(viii) of the circular specifies that in the case of existing loans, the switchover to new penal charges regime shall be ensured on next review or renewal date or six months from the effective date of the circular, whichever is earlier. Whether such date of next review or renewal can be counted only after the effective date or even before the effective date if the accounts are subjected to review/ renewal?

In case of existing loans as well, the instructions shall come into effect from April 1, 2024 and the switchover to new penal charges regime shall be ensured on the next review / renewal date falling on or after April 1, 2024, but not later than June 30, 2024.)

2. Trade credit and structured obligations have been excluded from applicability of the circular. Whether Penal interest can be charged on these products, given the deletion of provision related to Penal interest from existing RBI guidelines on “Interest rates on advances”?

The instructions as contained in the circular are not applicable to products covered under the [RBI Master Direction - External Commercial Borrowings, Trade Credits and Structured Obligations dated March 26, 2019](#) (as amended from time to time) and the banks may be guided by the relevant instructions contained in the aforesaid Master Direction.

3. The guidelines on penal charges are applicable in case of non-compliance with the material terms and conditions of loan contract by the borrower. What could be termed as material terms and conditions?

The material terms and conditions may be defined, if not already done, as per the credit policy of the bank and they may vary from one category of loan to another, and also, from lender to lender based on their own assessment.

4. Whether these guidelines would also be applicable in case of default in repayment by the borrower? If yes, whether the penal charges in such cases shall be based on the default amount or outstanding amount?

Default in repayment by the borrower is also a type of non-compliance of material terms and conditions of loan repayment contract by the borrower and penalty, if charged, for such default may only be levied in the form of penal charges and not penal interest. Such penal charges shall be reasonable and levied by the lenders only on the amount under default in a non-discriminatory manner as per their Board approved policy. Further, it must be ensured that there is no capitalization of the penal charges i.e., no further interest computed on such charges.

5. Whether the interest charged for the period of default (including in case of unpaid EMI) will also be treated as penal interest or regular/overdue interest?

In terms of para 3(i) of the circular, the prescribed guidelines will not affect the normal procedures for compounding of interest in the loan account. Therefore, REs may charge interest on unpaid interest (including on unpaid EMI) at the contracted rate of interest till the date of remediation, and not at the penal rate of interest.

6. (a) Can the penal charges be different within the same product category depending upon the amount of loan?

Yes. REs may formulate an appropriate Board approved policy and adopt a suitable structure of penal charges that is 'reasonable' and 'commensurate' with the non-compliance of material terms and conditions of the loan contract.

(b) With respect to para 3(iv) of the circular, whether the structure of penal charges in the same category of loan/product shall be uniform for all borrowers irrespective of their constitution (individual & non-individual)?

Yes. The structure of penal charges within a particular loan / product category shall have to be uniform irrespective of the constitution of the borrower.

7. If penal charges are not paid, whether fresh penal charges can be levied on the earlier outstanding amount of penal charges?

No. Additional penal charges cannot be levied on the earlier outstanding amount of penal charges.

8. Whether Cash Credit and Overdraft (OD) facilities are exempted from penal charges guidelines and subject to penal interest?

The instructions issued vide the circular are applicable to all credit facilities except those specifically exempted in the circular.

9. If the schedule of penal charges is displayed on the website of the RE and only a reference of the said schedule is given in the sanction letter and loan agreement issued to the customer, whether the same may be treated as compliance to para 3(vi) of the circular?

No. The quantum and reason for penal charges shall have to be clearly disclosed by REs to the customers upfront in the loan agreement and Most Important Terms & Conditions (MITC) / Key Fact Statement (KFS), as applicable.

10. Will there be any upper limit/cap for charging penal charges?

Although no upper limit/ cap for penal charges has been prescribed in the circular, the REs, while formulating their Board approved policy on penal charges, should keep in mind that the intent of levying penal charges is essentially to inculcate a sense of credit discipline and such charges are not meant to be used as a revenue enhancement tool. Accordingly, the quantum of penal charges shall have to be 'reasonable' and 'commensurate' with the non-compliance of material terms and conditions of loan contract.

11. Whether GST would be applicable on penal charges? If yes, at which stage the GST would be payable i.e., at the time of accrual or the day on actual realization/recovery?

Since instructions related to GST are issued by Central Board of Indirect Taxes & Customs (CBIC), instructions and clarifications, if any, issued by CBIC in this regard may be followed.

12. In case of invocation of Bank Guarantee (BG) /devolvement of Letter of Credit (LC), whether the provisions of the circular would apply on penal charges being imposed?

In case of the funded facility created on account of invocation of BG/ devolvement of LC, the bank may charge an appropriate rate of interest on the devolved amount taking into account the associated credit risk premium as per the bank's credit underwriting policy. However, penalty, if any, on that funded facility on account of non-repayment by the borrower within the due date may only be levied in the form of penal charges and not penal interest.

13. In case a loan account becomes Non-Performing Asset (NPA), whether penal charges will be reversed and put in the bucket of unrealised income or will continue as part of the outstanding in the account?

Banks may be guided by para 3.2.3 of the [Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances dated April 1, 2023](#), as per which in respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed with respect to past periods, if uncollected. Accordingly, in respect of NPA accounts, penal charges shall be reversed to the extent it remains uncollected for the specific purpose of non-recognition of income. However, the same shall be part of the total liability of the borrower to the lender, unless it is waived as per the bank's Board approved policy.

14. Whether RBI has specified any accounting process as well for crediting such penal charges or banks are free to decide for crediting realization of the penal charges under their 'Interest Income Head'?

In terms of Annexure II Part A (Notes and Instructions for compilation) for Schedule 13: Interest Income of [Reserve Bank of India \(Financial Statements – Presentation and Disclosure\) Directions, 2021](#), Schedule 13 will include all types of interest / discount income for the banks. Accordingly, banks will disclose fees and charges, including penal charges, recovered from customers in 'Schedule 14: Other Income'.

15. Whether the prescribed instructions on penal charges are applicable in case of securitisation and co-lending portfolios?

Yes. The prescribed instructions on penal charges are also applicable in case of securitisation and co-lending portfolios.

16. Whether the prescribed instructions on penal charges are applicable in case of rupee/ foreign currency export credit and other foreign currency loans?

No. The prescribed instructions on penal charges are not applicable in case of rupee/ foreign currency export credit and other foreign currency loans.

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