



CIVIL

A Deep Dive into RBI's draft circular on "Responsible Lending Conduct – Levy of Foreclosure Charges/ Pre-payment Penalties on Loans"

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The Reserve Bank of India (RBI) has released a draft circular on 'Responsible Lending Conduct – Levy of Foreclosure Charges/ Pre-payment Penalties on Loans' proposing new rules for public comments. This move is aimed at making the lending process fairer and more transparent for borrowers. The RBI found that some financial institutions impose high charges or restrictive clauses that discourage borrowers from switching to another lender for lower interest rates or better services. These practices create unnecessary financial burdens, especially for Micro and Small Enterprises (MSEs) and individuals taking loans.

In its Statement on Developmental and Regulatory Policies dated October 9, 2024, RBI had announced that it would review the rules regarding these charges. Based on its findings, the central bank has now proposed a set of new regulations that will apply to all regulated lenders, including banks, NBFCs, and financial institutions.

Under the proposed rules, floating rate loans taken by individuals for non-business purposes will no longer attract any foreclosure or pre-payment penalties. This means that borrowers can repay their loans early without any extra costs. Regulated Entities (REs), except Tier 1 & Tier 2 Urban Co-operative Banks and Base Layer NBFCs, cannot charge foreclosure or pre-payment penalties on floating rate business loans taken by individuals and MSE borrowers. However, for MSE borrowers, this exemption applies only up to a total sanctioned limit of ₹7.50 crore per borrower.

The new rules also ensure that borrowers are not penalized for using any source of funds, whether from personal savings or another lender, to repay their loans early. In the case of dual-rate loans, where a loan has both fixed and floating interest rates, foreclosure charges will depend on the type of interest rate applicable at the time of pre-payment.

In other cases, foreclosure charges or pre-payment penalties may be applied as per the Board-approved policy of the lender. However, these charges must be calculated based on the outstanding amount for term loans and the sanctioned limit for cash credit/ overdraft facilities.

To further protect borrowers, RBI has made it clear that lenders cannot impose a lock-in period before allowing foreclosure or pre-payment. Additionally, if a lender itself asks a borrower to foreclose the loan, no penalties or extra charges can be levied.

Another important measure is that lenders must clearly disclose all applicable charges in a Key Fact Statement (KFS) at the time of loan sanctioning. They also cannot impose charges retrospectively, meaning borrowers should not be surprised by unexpected costs at the time of loan closure.

These instructions will be issued under the legal authority of the Banking Regulation Act, 1949, the Reserve Bank of India Act, 1934, and the National Housing Bank Act, 1987.

The RBI has invited public feedback on these proposed rules until March 21, 2025. The final circular will be issued after reviewing the responses from borrowers, financial institutions, and other stakeholders. Once finalized, these rules will apply to all loans foreclosed on or after the effective date specified in the final circular.

With these changes, RBI aims to promote fair lending practices, encourage healthy competition among lenders, and give borrowers the freedom to choose better financial options without unnecessary costs. By eliminating foreclosure charges in key areas, these rules will make borrowing more flexible and borrower-friendly, benefiting individuals and small businesses alike.

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