Update

Prepayment Penalty: Present Stand of RBI

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Update

Prepayment penalties and foreclosure charges burdened the willing and able customer to discharge off his liability by paying extra for such relief. In the home loan sector such a practice prevented the customers to switch to banks offering better interest rates. The Reserve Bank of India (RBI) took a stand in this matter and announced to abolish foreclosure charges and pre-payment penalties for home loans offered on a floating interest rate basis. These directions were published in the Monetary Policy Statement 2012-13[1] (points 81-83) dated April 17, 2012.

A committee was formed for this purpose known as the Damodaran Committee which opined that such foreclosure charges and pre-payment penalties are highly resented by the customers since banks hesitate too much to pass on the benefits of lower interest rates to its existing borrowers. Followed this; a number of notifications[2] issued by the RBI in this regard stipulating directions to various categories of banks.

Banking system has been empowered to offer loans of all categories. They are able to extend these loans on both floating and fixed interest basis. Fixed rate mortgages have been predominant globally; however, in India floating rate housing loans have been prevalent for few years now. Till a few years back majority of the loans in India were of the nature of fixed rate loan products. These drift has been largely driven by the asset liability mismatches of the banks, where banks liabilities are short and medium term in nature and the long term loan products would be fixed rate, absence of medium/ long term interest rate swap market or GSEs to buy fixed rate loan products etc.

The Reserve Bank of India (RBI), in its Monetary Policy Statement 2012-13 announced the formation of Working Group "*to assess the feasibility of introducing more long-term fixed interest rate loan products by banks.*" The Committee submitted its report to the RBI which was published by the RBI in its website on November 15, 2012 for public comments.

Some of the recommendations of the Committee were:

a. Banks should introduce a long-term fixed rate loan product with a reset clause in seven to ten years,

b. Banks to popularize fixed deposit schemes above five years which are eligible for tax exemptions and could lead to banks meeting their long-term funding requirements.

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[1] http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=7136&Mode=0#p81

[2] http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=7258&Mode=0
http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=7271&Mode=0
http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=7273&Mode=0
http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=7301&Mode=0

c. Banks to charge a pre-payment penalty only on the outstanding amount and not on the initial payment. Pre-payment penalty could be graded, based on the period after which the loan is repaid
d. Fixed rate loans of 30 years tenor may be provided to reduce the EMI of borrowers
e. Banks periodically review the premium charged for new long-term fixed rate loans and not charge off-market rates.
f. Large institutional investors such as pension funds, provident funds, insurance companies, etc. should be encouraged to invest in bonds issued by banks, by suitably amending the relevant investment guidelines.
g. National Housing Bank (NHB) may look at the feasibility of extending refinancing schemes to banks offering long-term fixed housing loans products to other than low-income households.

Fixed rate loan products are popular in developed nations as they are less volatile to the interest rate changes and are popular due to the existence of an efficient secondary market, presence of GSEs and liquid interest rate swaps. The draft report is a feeler to the intent of the regulators in promoting the bond market.