Article

VINOD KOTHARI & COMPANY

Revamping of Fair Practice Code for NBFCs

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Article

India seems to be all set to achieve high GDP growth with focus largely on the MFI sector, a sector expected to develop fast with increasing importance on priority sector lending. The Reserve Bank of India ("RBI") has framed Regulatory Framework for the MFIs and has provided these entities with adequate reliefs from time to time, e.g. the implementation of asset classification and provisioning norms has been deferred recently. Along with so many benefits, comes a major responsibility-the responsibility of conducting the business in a fair manner so that the borrowers are not oppressed or misguided in any manner.

In the light of the above, the RBI revamped the ***Fair Practices Code (FPC)*** to be followed by ***Non-Banking Finance Companies*** (NBFCs) in the ordinary course of their lending business. Originally the guidelines on FPC were issued by the RBI vide its circular dated September 26, 2006[1].

The reviewed Guidelines cover general principles on adequate disclosures on the terms and conditions of a loan and also adopting a non-coercive recovery method. The RBI Circular[2], on Guidelines on Fair Practices Code for NBFCs dated 26th March, 2012 stated that the review has been made in view of the creation of a new category of NBFC-MFIs and also rapid growth in NBFCs' lending against gold jewellery. This Circular has been issued in supersession of all earlier circulars issued in this respect.

Within one month from the date of this Circular, the NBFCs' Board of Directors and the management team are required to implement the fair practices hereinafter detailed. The Board of Directors is also required to have a periodical review of the compliance of the FPC and the functioning of the grievances redressal mechanism at various levels of management.

FPC for all NBFCs

The FPC to be adopted by all the NBFC Companies in pursuance of the said Circular covers the following areas:

Loan appraisal and terms/conditions:

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1 http://rbidocs.rbi.org.in/rdocs/notification/PDFs/73029.pdf
2 http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=7089&Mode=0

Article

- Upon approval of the loan, an agreement/sanction letter indicating the amount of loan sanctioned along with detailed terms and conditions, annualized rate of interest applicable, including method of application thereof, shall be conveyed to the borrower(s) in writing. A written acceptance of such terms and conditions by the loan applicant shall be retained by the Company.
- Loan applications to be assessed in accordance with the Company's credit appraisal process.
- The penal interest charged/to be chargeable for late repayment should be mentioned in bold in the loan agreement.
- NBFC shall furnish a copy of the loan agreement (preferably in vernacular language) along with a copy of all enclosures quoted in the loan agreement to the customers at the time of sanction / disbursement of loans.

Applications for loan and their processing

- All relevant information pertaining to the loan and affecting the interests of the borrower(s) should be made available in the relevant loan application form(s), including the necessary loan information and documents required to be submitted together with the duly completed application form.
- Devise a system of acknowledgment of receipt of completed loan applications forms. The acknowledgement should preferably also indicate the approximate time frame within which the loan applications will be disposed off.

Disbursement of loans, including changes in terms and conditions:

- In case of any change in the terms and conditions, including disbursement schedule, interest rates, service charges, prepayment charges, etc., the NBFC shall give notice individually to the borrowers in case of account specific changes, and in case of others, the same shall be available at the Registered Office / Corporate Office of the Company.
- Changes in the interest rates and charges shall be effected prospectively and shall have no retrospective effect. This condition shall also be incorporated in the loan agreement.

Article

- Decision to recall / accelerate payment or performance under the agreement shall be in accordance with the terms and conditions of the loan agreement.
- All securities pertaining to the loan should be released on repayment of all dues or on realisation of the outstanding amount of loan, subject to any legitimate right or lien, and set-off for any other claim that the NBFC may have against the borrower(s). Moreover, if such right of set-off is to be exercised, the borrower shall be given notice about the same, with full particulars about the remaining claims and the conditions under which the NBFC is entitled to retain the securities until the relevant claim is settled /paid.

General Provisions:

- The NBFC should not interfere in the affairs of the borrower, except for the purposes provided in the terms and conditions of the loan sanction documents (unless new information, not earlier disclosed by the borrower, has come to the notice of the Company).
- In case of receipt of request from the borrower for transfer of borrowal account, the consent or objection of the Company, if any, shall be conveyed within 21 days from the date of receipt of request. Such transfer shall be as per transparent contractual terms in consonance with law.
- In the matter of recovery of loans, the Company shall not resort to undue harassment and would operate within the legal framework. It shall also ensure that its staff is adequately trained to deal with the customers in an appropriate manner.
- The Board of Directors of the Company shall lay down an appropriate grievance redressal mechanism with in the organization to resolve disputes and also provide for a periodical review of the compliance of the Fair Practices Code and the functioning of the grievances redressal mechanism at various levels of management.

Regulation of excessive Interest rates charged by NBFCs:

- The Board of Directors of the NBFC shall lay down appropriate internal principles and procedures to determine the interest rates and processing and other charges. For this purpose the Board shall adopt an interest rate model taking into account relevant factors such as, cost of funds, margin and risk premium, etc and determine the rate of interest to be charged for loans and advances.

- As a fair lending practice, the rate of interest and the approach for gradations of risk and rationale for charging different rate of interest to different categories of borrowers shall be explicitly disclosed individually to the borrower(s) in the sanction letter and shall also be made available on the web-site of the Company or published in the relevant newspapers.
- The rate of interest should be annualised rates so that the borrower is aware of the exact rates that would be charged to the account.

FPC to be adopted by NBFC-MFIs:

A. General Guidelines:

The NBFC-MFI shall:

- display the FPC (in vernacular language)at its Registered Office and all branch premises;
- prepare a statement articulating their commitment to transparency and display the same in their premises and loan cards;
- provide necessary training to field staff to make necessary enquiries with regard to existing debt of the borrowers; and also to make the borrowers fully aware of the procedure and systems related to loan / other products;
- display the effective rate of interest charged and the grievance redressal system set up by it in all its offices and in the literature issued by it and on its website;
- make a declaration in the loan agreement and also in the FPC displayed in its Registered office/branch premises with regard to its accountability for preventing inappropriate staff behavior and timely grievance redressal;
- comply with the KYC Guidelines of RBI and carry out Due-diligence to ensure the repayment capacity of the borrowers;
- ensure that sanctioning and disbursement of loans should be done only at a central location with close supervision of the disbursement function and more than one individual should be involved in this function;

Article

- ensure that loan disbursements are done as per pre-determined time structure.

B. Disclosures in loan agreement / loan card

All NBFC-MFIs shall have a Board approved, standard format of loan agreement (preferably in vernacular language) which shall contain the following disclosures:

- all the terms and conditions of the loan;
- the pricing of the loan involves only three components;
  - the interest charge;
  - the processing charge; and
  - the insurance premium (which includes the administrative charges in respect thereof)
- there will be no penalty charged on delayed payment;
- no Security Deposit / Margin is being collected from the borrower;
- the borrower cannot be a member of more than one SHG / JLG;
- the time lag between the grant of the loan and the due date of the repayment of the first instalment (as guided by the NBFC-MFIs(Reserve Bank) Directions, 2011);
- an assurance that the privacy of borrower data will be respected.

In addition to the above the loan card should reflect the following details as specified in the Non-Banking Financial Company - Micro Finance Institutions (Reserve Bank) Directions, 2011:

- effective rate of interest charged;
- all other terms and conditions attached to the loan;
- information that adequately identifies the borrower;
- acknowledgements by the NBFC-MFI of all repayments including instalments received and the final discharge;
- the grievance redressal system set up by the MFI and also the name and contact number of the nodal officer;

Article

- Non-credit products issued shall be with full consent of the borrowers and fee structure shall be communicated in the loan card itself.

Keeping in view consumer complaints, the RBI further laid down that the NBFC-MFIs shall follow non-coercive methods of recovery as specified in the NBFC-MFIs (Reserve Bank) Directions, 2011 and recovery should normally be made only at a central designated place. Moreover, field staff shall be allowed to make recovery at the place of residence or work of the borrower only if borrower fails to appear at central designated place on 2 or more successive occasions. Penalties may also be imposed for better compliance on cases of non-compliance of field staff with the Code of conduct.

C. Lending against collateral of gold jewellery:

The NBFC-MFI shall adopt the following additional guidelines while lending to individuals against gold jewellery:

NBFC-MFI shall essentially put in place Board approved policy for lending against gold. The policy should essentially cover the following:

a. Adequate steps to ensure that the KYC guidelines stipulated by RBI are complied with;
b. Ensure that adequate due diligence is carried out on the customer before extending any loan;
c. Proper analysis procedure for the jewellery received;
d. Internal control systems to satisfy ownership of the gold jewellery;
e. Put in place adequate systems for storing the jewellery in safe custody, reviewing the systems on a continual basis, training the concerned staff and periodic inspection by internal auditors to ensure that the procedures are strictly adhered to.
f. Loans against the collateral of gold should not be extended by branches that do not have appropriate facility for storage of the jewellery;
g. The jewellery accepted as collateral should be appropriately insured;
h. The loan agreement shall also disclose details regarding auction procedure;
i. Prior notice to the borrower should be given before the auction date.

Article

j. The auction should be announced to the public by issue of advertisements in at least 2 newspapers, one in vernacular language and another in national daily newspaper;
k. The NBFCs themselves shall not participate in the auctions held;
l. Gold pledged will be auctioned only through auctioneers approved by the Board;
m. The policy shall also cover systems and procedures to be put in place for dealing with fraud including separation of duties of mobilization, execution and approval.

NBFCs are directed to disseminate information to all borrowers in their vernacular language or a language understood by them, incorporate necessary information in the loan application form which affects the interests of the borrowers, so as to enable them to take an informed decision and also devise a system of giving acknowledgement for receipt of all loan applications. Let us see how fair the entities will be while implementing the revised "*Fair Practices Code*" which requires more disclosures for the borrowers.