

FIDC

Finance Industry Development Council

(A Representative Body of NBFCs in India)

101/103, Sunflower, 1st Floor, Rajawadi Road No.2, Ghatkopar (East), Mumbai – 400 077

Tel: 022 21029898/9820035553 • E-mail: directorgeneral@fidcindia.org.in

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April 08, 2024

Shri Sanjay Mangal
Principal Commissioner GST Policy Wing
Room No 220A, Central Board of Indirect
Taxes and Customs Department of
Revenue, North Block,
New Delhi 110001

SUB: Representation seeking clarification that mere recharacterization of 'penal interest' as 'penalty' or 'penal charge' due to Reserve Bank of India Circular (RBI letter no. RBI/2023-24/53 DoR.MCS.REC.28/01.01.001/2023-24 dated 18th August 2023) does not change the GST clarification issued Circular No. 102/21/2019-GST dated 28 June 2019

Respected Sir,

Finance Industry Development Council (FIDC) is a Representative Body of the NBFCs including HFCs registered with the Reserve Bank of India. FIDC was formed 19 years ago and is the recognized face of the NBFC sector. Almost all the leading NBFCs and a large number of small and medium sized NBFCs are our members.

We write to you in the context of the much deliberated matter on GST applicability on penal interest. The industry had approached the CBIC in January 2019 post which a specific clarification was issued through Circular No. 102/21/2019-GST dated 28 June 2019 clarifying that additional / penal interest recovered on delay in payment of EMI loan repayments satisfies the definition of "interest" covered under Exemption Notification No. 12/2017-Central Tax (Rate) dated 28 June 2017 (Entry 27) and is not liable to GST ('Circular 102').

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Recently the Reserve Bank of India has issued Circular No. DoR.MCS.REC.28/01.01.001/2023-24 dated 18 August 2023 (RBI Circular) read with FAQs dated 15 January 2024, clarifying that:

- (i) The intent of levying penal interest/charges is essentially **to inculcate a sense of credit discipline** and such charges are not meant to be used as a revenue enhancement tool over and above the contracted rate of interest.
- (ii) 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.
- (iii) Penalty, if charged, for non-compliance of material terms and conditions of loan contract by the borrower **shall not be compounded (as interest on interest); but shall be treated as ‘penal charges’**. It shall not be charged as penal interest.

We believe that the aforesaid RBI Circular should not change the taxability of such penal interest / penal charges under the GST Law, as:

- (i) The substance of the transaction remains unchanged, and the penal interest/charge continues to be recovered by financial institutions primarily on account of failure to pay the EMIs as per the agreed term loan (resulting in a requirement to review the initial credit offer made to the borrower).
- (ii) Alternatively, as suggested by the RBI Circular, the trigger for penalty/ penal charge should be non-compliance of any material terms and conditions of the loan terms by the borrower, including the timely repayment of the EMIs by the borrower to the financial institution. Based on the same, penalty/ penal charges of any nature would qualify to be in the nature of liquidated

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damages recovered for 'breach of agreed contract' and not liable to GST (as clarified specifically under CBIC Circular 178/ 10/ 2022-GST dated 3 August 2022 ('Circular 178')).

We have set out our detailed submissions in the Annexure.

Through this letter, we request your office to issue necessary clarification reiterating that neither penal interest nor penal charges on loans (under the new RBI guidelines) are liable to GST in light of the principles already set out under both CBIC Circular 102 and CBIC Circular 178. The same would clear the existing ambiguity and questions on the many contentious arguments that the industry is facing while dealing with assessments as well as any unwarranted litigation in future on account of the new RBI Circular.

Absence of a specific clarification on this issue (or update to Circular 102) will trigger high pitched assessments in the hands of members, defeating the very purpose of issuing Circular 102 and Circular 178.

The members of FIDC seek a personal meeting to explain our point of view.

With regards

For FINANCE INDUSTRY DEVELOPMENT COUNCIL

**MAHESH THAKKER
DIRECTOR GENERAL
98200 35553**

Encl: Annexure - Detailed Representation on Non-applicability of GST on Penal Interest/ Penal Charges

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Annexure

DETAILED REPRESENTATION ON NON-APPLICABILITY OF GST ON PENAL INTEREST/ PENAL CHARGES

1. **Background - Lending transaction and current position on penalties/ penal interest**

1.1. Our member NBFCs are engaged in the business of providing loans and advances to customers at pre-agreed and assessed interest rates. The customer makes payment of loans and advances by way of Equated Monthly Instalments ('EMI'). An EMI is fixed amount paid by a borrower to a lender at a specified date as per agreed periodicity (i.e. monthly/ quarterly, etc).

1.2. EMIs are composed of both the principal loan amount as well as the interest applicable for the loan extended. The consideration for the lending services is interest which is exempt from GST *vide* Notification No. 12/2017-Central Tax (Rate) dated 28 June 2017 (as amended) ['Exemption Notification']. The rate of interest is determined based on market considerations, the credit assessment of the borrower, while maintaining the guidelines prescribed by the regulator i.e. the RBI.

Over and above the interest in the event the NBFC charges any fee such as processing fee, etc, the same is being considered as a taxable supply and appropriate GST is being discharged on the same.

1.3. In addition to the above, loan agreements may also provide for recovery of penalties in the form of penal interest or penal charge in the event any

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material terms and conditions prescribed in the loan agreement are not satisfied, including the timely payment of the EMIs. The penal interest/charge is typically recovered as an incremental percentage of interest payable. Penal charge may also be a fixed amount.

The key premise of recovery of penal interest/ charge is:

- a) Delay in periodic repayment of loan instalments i.e. EMIs, as agreed in the loan terms (hereafter referred to as 'EMI Default'); or
- b) Due to breach of conditions or non-compliance of any terms and conditions in the loan contract which may increase the risk grading of the loan, such as failure to provide agreed collateral for grant of loan, failure to submit details of assets required to review the loan, failure to furnish guarantees agreed in the contract, etc (hereafter referred to as 'Other Defaults')

Penal Interest/ Penal Charges for EMI Default

- 1.4. To undertake lending, NBFCs perform fund mobilization activities which involve procuring funds from various sources such as equity, public deposits, loans and advances from banks/ financial institutions etc. Debt related fund mobilization sources create an obligation on the NBFC to settle the payment (along with interest) as per payment schedule agreed with the lending institution. Funds sourced through public deposits are further subject to RBI's liquid asset investments requirement and the surplus thereafter is utilized for offering lending and credit facility to Customers.
- 1.5. The applicable rate of interest for lending funds (to the customers) is thereafter determined based on factors such as cost of borrowed funds, tenure of loan, liquidity conditions, relative interest rate prevailing in the

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market, cost of operations, credit and default risk of the borrower, earning and repayment ability of the borrower, targeted IRR etc. Disclosure of the same and related governance aspects is also governed by guidelines on fair practices code for NBFCs issued by RBI. The NBFC endeavours to arrive at the cost of lending (which primarily consists of fund mobilization interest cost) and derive an annualized IRR throughout the loan tenure assuming relative consistency amongst other variables outlined above.

- 1.6. Accordingly, NBFCs arrive at a standard interest rate which is assigned for each type of product category/ class of borrowers. However, **such assigned interest rate is based on a multitude of factors inter-alia including credit risk of the borrower.** The process of determining offered interest rate takes into consideration the standard interest rate and further incorporates a risk premium as per customer's credit worthiness. Typically, lending agreement outlines the range of interest payable (i.e. offered base rate and an additional rate) along with a repayment schedule. Hence, while a base rate applies for loans as per the tenure agreed in the repayment schedule any extended lending attracts a higher interest rate. This higher interest rate is an aggregation of the base rate, increased cost of short-term fund acquisition, Customer Credit Risk Premium and may be referred to as the 'penal/ additional interest rate' for further discussion. From 1 April 2024, the same would be termed as 'Penalty' or 'Penal Charge'.
- 1.7. **In order to utilise the debt funds optimally, the NBFC endeavours to align customer repayment schedule with self-payment obligations agreed for funds sourced through debt/positions.** As a prudent approach, the asset liability management is governed at an entity level by an Asset Liability Management Committee¹ and default risk at product portfolio level,

¹ Formed under the Asset Liability Management (ALM) System for NBFC guidelines issued by RBI [DNBS (PD).CC.NO.14/02/03/2000-2001 dated 27 June 2001

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customer profile, date of maturity, target, liquidity ratio etc. is considered by the said committee to maintain adequate position.

- 1.8. However, given the competitive market, **NBFCs typically operate on a tightly drawn accrual disbursal plan and minimal margin.** The cash inflows on account of the interest and principal of the loan are slotted in respective time buckets as per the timing of the cash flows as stipulated in the original/revised payment schedule. **As a result, any default in repayment of the instalments by the borrower (on the scheduled dates) triggers the following aspects viz:**

- (a) Change in the risk parameters of the loan-agreement because of decline in customer's credit rating – As per internal policy such as change in risk parameters results in revalidation/review of the offered interest rate. This typically enhances the base interest rate (due to increased customer credit risk premium) which may be agreed at lower value within the loan agreement subject to the then existing credit rating of the borrower in default; and
- (b) Mis-match in asset-liability position of NBFC given the near matching payment liability on the funds borrowed from external sources and thereby may require the NBFC source expensive short term fund sourcing exercise

- 1.9. The additional payment obligation and negative impact on the targeted Internal Rate of Return ('IRR') is therefore recovered by way of additional/ penal interest and wef 1 April 2024 as 'Penalty' or 'Penal charge'. The commercial business rationale for charging penal interest/ additional interest and penalty/ penal charge (wef 1 April 2024) is **to levy a compensatory recovery** to safeguard the increased cost and risk of lending and thereby proposes to **inculcate sense of credit discipline** among the

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customer by adhering to the timely re-payment schedule as well as adherence to conditions of the loan agreement. **This is not at all comparable to fees charged by NBFC, which are for services rendered in relation to the loan transaction – like processing fees, fees for balance confirmation, fees for issuing credit rating report, etc.**

RBI Circular has only put regulatory parameters for recovery of the same penal interest by way of penalty/ penal charge

1.10. The intent of recovery of penal interest (now penalty/ penal charge) continues to be to ensure financial institutions are not impacted negatively from the targeted IRR. We wish to submit recovery of penal interest by way of a ‘penalty’/ ‘penal charge’ as mandated by RBI should not alter the characterisation of penalty/ penal charge as penal interest/ additional interest for determining non-taxability under GST Law – where penal interest/ additional interest has been clarified as being not liable to GST under CBIC Circular 102. The Circular clearly suggests that the charge is to inculcate discipline. Also, the Circular suggests that such penalty should not be compounded (interest on interest). This is a change in the method of computation of the penalty, which is being implemented by NBFCs.

Notwithstanding the above, penalty/ penal charges are in the nature of deterrent to a contract and is not a ‘consideration’ towards supply of services.

1.11. In case of lending by NBFC, the intention of the lender is to supply lending service and not with the intent that there would be non-compliance or default in repayment of the EMIs leading to invocation of penal clauses to recover penal interest/ penal charges from the borrower. The penal clauses are to safeguard the commercial interest of the lender and instil sense of discipline amongst the customer so that such defaults are not repeated. It is

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not the intention of the lender to impose any penalty upon the customer nor is it the intention of the customer to get penalised.

The expectation of RBI Circular and the NBFCs is that the customer complies with the terms of the contract and compounding of additional interest or penal interest or by whatever name called is prohibited. The penalty/ penal charges would act as a deterrent as the same are levied for ensuring discipline to comply with the conditions of the contract with lender. Deterrence is a method of punishment intended to discourage non-compliant behaviour through the imposition of penalty/ penal charge.

- 1.12. With reference to the above, for GST to be applicable on penalty/ penal charges, it is necessary for a transaction to qualify as 'Supply'. As per Section 7(1) of the Central Goods and Services Tax Act, 2017 ('CGST Act'), 'supply' includes all forms of supply of goods or services' or both such as sale, transfer, barter, exchange, license, rental, lease or disposal made or agreed to be made **for** a 'consideration' by a person in course or furtherance of business.
- 1.13. With respect to proposed 'penalty'/ 'penal charges' for delayed payment of loan instalments as well as for breach of terms of the loan, the clarification under Circular 178 on applicability of GST on recoveries made as liquidated damages, compensations and penalty arising out of breach of contract / provisions of the law, are directly applicable.

Circular 178 has clarified the following principles which are applicable in the context of 'penalty'/ 'penal charges' if squarely considered as a mechanism to instil financial discipline and dissuade borrowers from breach of terms and conditions of the loan agreement, as per the RBI Circular (*Reference is made to para 7 and 7.1 of Circular 178*)

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- There should be an express or implied agreement for payment of consideration for tolerating an act or situation. Tolerating of an act should not be presumed to exist just because there is a flow of money;
 - Amounts recovered for preventing breach of contracts or non-performance are mere 'events' and should not be construed as recoveries for tolerating an act;
 - Such charges/penalty are a measure of loss and damage that parties agree would arise due to breach of contract;
 - They do not act as a remedy for breach of contract. Performance is the essence of the contract. Hence contract is executed for execution/performance of specific activity and not for its breach;
 - The liquidated damages/penalty are not the outcome of the desired contract;
 - Every flow of money cannot be a *consideration* for tolerating an act;
 - Consideration cannot be *de hors* the contract / agreement between the parties.
- 1.14. Applying the above principles in the context of 'penalty' / 'penal charges' that will be collected by NBFCs as per RBI Circular with effect from 1 April 2024, the penalty/ penal charges are to be levied to discourage any breach or non-performance of the material terms and conditions of the loan agreement and there is no underlying "activity" for which the penalty/ penal charges will be recovered. The spirit of the loan agreement is to advance money to the borrowers, collecting of penalty/ penal charges for non-performance of terms of contract is not the essence of the agreement

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and it is a mere event or eventuality that may arise during the term of the agreement.

- 1.15. The above principle has been not only clarified under the *erstwhile* Service Tax regime under the CBEC Service Tax Education Guide (para 4.2) but has been upheld by courts in various judicial precedents that charges relating to recovery on account of breach of terms and conditions of the contract cannot be termed as ‘consideration’ and hence not liable to Service tax².
- 1.16. Further, penal charge/ penalty with respect to delay in payment of loan is similar to the following contracts wherein the same is not considered as a service/ supply:
- Recovery/ forfeiture of salary from employees for releasing earlier than the agreed contractual period
 - Forfeiture of earnest money by a seller in case of breach of agreement to sell in the event of successful bidder failing to act after winning the bid
 - In case where there is delay in the construction on account of the builder, a penalty is paid by the builders to the buyers to compensate for the loss that they suffer due to the delayed construction
- 1.17. In view of the above, we wish to submit that notwithstanding that penalty/ penal charge is same as penal interest in nature and if the RBI Circular is literally extended and the penalty/ penal charge is treated as a charge and not interest , the penalty/ penal charges are levied for material breach of the terms and conditions of the loan agreement as explicitly stated in the

² - Brindavan Bottlers Ltd. [2019 (27) G.S.T.L. 354 (Tri. - All.)]
- Chittosho Finance Private Limited [2019-VIL-1588-CESTAT-CHD-ST]
- Cholamandalam Investment & Finance Company Ltd.[2023-VIL-558-CESTAT-CHE-ST(Chennai CESTAT)]; South Eastern CoalFields Ltd. vs. Commissioner of Central Excise and Service Tax [2020-TIOL-1711-CESTAT-DEL] read with Civil Appeal No. 2372 of 2021; REPCO Home Finance Ltd. vs Commissioner of Service Tax [2020-TIOL-1039-CESTAT-MAD-LB]

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RBI Circular and therefore, should be considered as liquidated damages not liable to GST in accordance with CBIC Circular 178.

Penal Interest/ Penal Charges for Other Defaults

- 1.18. As per the RBI Circular, Other Defaults for which a penalty/ penal charge could be recovered is any other “*non-compliance of material terms and conditions of loan contract by the borrower*”. These could include failure to provide collateral documents, failure to submit details of assets required to review the loan, failure to furnish guarantees agreed in the contract, etc.
- 1.19. Relying on the intent of the RBI Circular, even in the event if a percentage charge for the period of default or a flat charge is recovered by the financial institution from the borrower for breach of the material terms and conditions of the loan agreement, the same should qualify as a liquidated damage and not a consideration for any supply for the purposes of GST. Accordingly, as per the submissions made at paras 1.12 to 1.17 above, the same should not be liable to GST in accordance with the principles laid out by the CBIC under Circular 178.

2. Our Prayer

- 2.1. **Given the continued questions being raised during assessments on penal interest despite the favourable CBIC Circular 102 as well as the expected litigation that is likely to ensue with the change of penal interest to penalty/ penal charge with effect from 1 April 2024 (as mandated by the RBI Circular), we submit that a specific clarification be issued clarifying that penalty/ penal charge for both EMI Defaults as well as Other Defaults being in the nature of penal interest/ recovery of liquidated damages, continues to be not liable to GST.**

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- 2.2. **It would be pertinent to highlight that in the event of default in repayment of loans, the industry is already plagued with high non-recoveries of the principal amounts itself. The actual recovery of penal interest/ penalty/ penal charges typically is very low as compared with the amounts levied and the same would vary based on the nature of the loan product and/or segment to which the borrower belongs to. To now impress another 18% GST on penalty/ penal charges accrued to the financial institution, would mean an incremental 18% cost on the NBFCs themselves.**

We humbly request to take the above on record. Further, we will be obliged to have an opportunity to meet you in person and discuss the above in detail.
