Competition Commission on Pre-payment charges in Retail Home Loans — A Missed Opportunity!

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The recent decision of the Competition Commission of India (CCI), by a majority of 4:2, holding that the pre-payment charges levied on the retail home loans by banks/housing finance companies, are neither anti-competitive nor amount to abuse of the dominant position, has raised a fresh debate in the academic circles and amongst the consumer groups regarding the approach of new competition regime in India. The majority verdict also raises serious questions regarding lack of economic analysis to be the basis of the findings. The order of CCI in this matter is widely seen to be in conflict with the very objective of implementation of the Competition Act.

The issue of legality of pre-payment clause (PPC) has been agitated on numerous occasions in past too. However, with the advent of new competition regime, it was the most appropriate time for CCI to analyse the issue threadbare and adjudicate upon the validity of pre-payment clause (PPC) in home loan agreements. In an economy where housing contributes to 6%-7% of the GDP and the market has been growing at the rate of 43% in last few years, this issue has widespread ramifications.

The legislative intent behind the enactment of the Competition Act can be gathered from the Union Budget Speech of 2009-2010, which provides as follows:

42. The Government has established Competition Commission of India, an autonomous regulatory body to promote and sustain competition in markets, protect interests of consumers and to prevent practices having adverse effect on competition. ...

43. The benefits of competition should now come to more sectors and their users and consumers. Now is the time for us to work on these aspects to eliminate supply bottlenecks, enhance productivity, reduce costs and improve quality of goods and services supplies to consumers.3

In more than one ways the majority verdict of CCI calls for a review, considering that the order has not only misinterpreted various provisions of the Competition Act, 2002 but also makes a departure from the very objective of enacting the competition law. In the first part, the article presents the background of the practice of levying PPC by banks/HFCs and the initial set of findings arrived by the Director General of CCI. The second part deals with the reasons on the basis of which CCI held that levying PPC does not amount to an anti-competitive practice. The third part discusses the relevant provisions of the Competition Act and the analysis of PPC of various banks/HFCs in the light of Sections 3(3) and 19(3) of the Competition Act. In the fourth part the article discusses some of the significant issues raised by banks/HFCs to defend the validity of PPCs. Finally, it concludes with recommendations to regulate the implementation of PPCs and the approach required at the appellate stage.

Reasons behind levy of pre-payment charges and genesis of the dispute PPC is the amount which a bank or retail home loan institution charges a borrower when such borrower returns the money borrowed before the stipulated tenure of the loan. Resultantly, a customer may migrate to a lower cost source of funds or return the loan before the due date only if he pays an additional sum as calculated by the banks. This, on the face of it, creates an exit load on borrowers.

In the present matter, the informant, Mr Neeraj Malhotra, filed the information before CCI alleging inter alia that levy of PPC by few banks/HFCs is in contravention to Sections 3 and 4 of the Competition Act, 2002. In September 2009, CCI directed the Director General to conduct an investigation and look into the allegations by the informant. As such the allegations were levelled against four banks/HFCs, but the Director General enlarged the scope of the inquiry (by issuing notices to 12 other banks/HFCs) considering the wide range of players functioning in the home loan market charging PPCs in the range of 1%-4% on the loan amount. Similar notices were issued to the Indian Banks Association (IBA) seeking their reply to ascertain an industry-wide perspective.

The Director General (DG) in its report concluded that levy of PPC is in contravention to Section 3(3)(b) of the Competition Act. It also observed that levy of PPC creates a barrier to new entrant in the market in way that if the new entrant is providing competitive interest rates, better services, etc. Levying of PPC by banks makes the exit expensive thus acts as a deterrent for a borrower in availing the best prevailing interest rate of other banks/HFCs. However, considering the number of players and evenly divided market share of the companies the levy of PPC was held not to be abuse of dominant position.

CCI in its majority decision observed that there was no agreement or action in concert on the part of banks/HFCs which led to levy of PPCs. It also gave detailed reasoning to justify its decision that PPCs are not anti-competitive, simply on the basis of lack of evidence to establish that the banks acted in concert and compulsion of asset-liability management. CCI non-chalantly brushed aside the ground of appreciable adverse impact by highlighting that retail home loan market is flourishing and has been growing with a CAGR of 24.9% between the period of 2004-2009.5
Anti-competitive agreement to levy pre-payment charges  The finding of CCI, which formed the bedrock of the majority decision, that there was no agreement between banks/HFCs to levy PPC on retail home loans is per se questionable. There can be only two ways to decide if there was an agreement between the banks. First, to examine the history and reasons for levy of PPC and second to test whatever evidence available on the touchstone of Section 2(b)6 i.e. definition of the term â€œagreementâ€• as provided under the Competition Act.

The history of home loan market of India can be traced back to late seventies when Housing Development and Finance Corporation (HDFC) was the sole player. In the year 1993, LIC Housing Finance Ltd. joined the home loan market. It is significant to note that, HDFC never levied PPC till the year 1993, when LIC Housing Finance forayed into the business. However, interestingly September 2003 onwards, all the banks/HFCs which were part of this investigation started charging PPC, pursuant to meeting of Indian Banks Association (IBA) dated 28-8-2003, which culminated into a circular dated 10-9-2003, wherein it was noted that PPC in the range of 0.5%-1% would be reasonable, and left the matter to be finally decided by the banks themselves. Immediately thereafter, all the banks started levying PPC at the rate of 1%-2%. This uniformity in practice clearly reflects a common understanding. In the dissenting opinion the learned Member of CCI, observed as follows:

(i) Prior to the meeting of IBA, there was no consensus amongst the banks for levying PPP;
(ii) Prior to the meeting of IBA, there existed no policy guidelines of banks and HFCs nor was there any uniform practice for levying PPP;
(iii) In the meeting of IBA, a concerted decision to adopt a common approach was arrived at by the banks for the first time. Thus the meeting of members of IBA can be treated as meeting of minds of the members for taking a concerted action against the home loan borrowers who opt to prepay the loan.
(iv) As very clearly stated in the circular of Punjab National Bank and implicit in the circulars of the other banks, the decision to levy a PPP was taken (a) in pursuance of the circular of IBA; and (b) to prevent the switching over by the consumers.7

Though this IBA circular was not binding on the banks, but the same could sufficiently be taken to be the basis of action in concert and common approach adopted in levy of PPC.

The definition of an â€œagreementâ€• under the Competition Act includes any arrangement or understanding or action in concert whether or not formal or in writing or legally enforceable. Thus, the provision itself contemplates any tacit agreement which shall also qualify under the definition of agreement. In the famous Registrar of Restrictive Trade Agreements case8, House of Lords analysed the nature of agreements contemplated under anti-trust legislations, and observed that:

... People who combine together to keep up prices do not shout it from the housetops. They keep it quiet. They make their own arrangements in the cellar where no one can see. They will not put anything into writing, nor even into words. A nod or a wink will do. Parliament was well aware of this. So it included not only an â€œagreementâ€• properly so-called, but any â€œarrangementâ€•, however informal.

These observations leave no room for any doubt that, even an informal arrangement, as present in this case, wherein all the banks/HFCs started charging PPC only after 2003 is sufficient to establish the element of agreement.

The majority judgment also concludes that the levy of pre-payment charges is not violative of Section 3(3) of the Competition Act. It is significant to note that horizontal agreements, including cartels, which, directly or indirectly adversely affect the Competition Act, hold a presumption for horizontal agreements (like the agreement in this case). Price fixation is one such element under Section 3(3), which refers to an agreement amongst the competing firms to rise, fix or maintain the price of goods or services they are selling. A collusive behaviour of price fixation conspiracy can be inferred from the following factors:

(a) prices stay identical for long periods of time; or
(b) prices previously were different; or
(c) price increases do not appear to be supported by increased costs.

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It would be interesting to recall at this stage that PPCs were virtually absent till 2003, but immediately after that all the banks/HFCs started levying PPC. It was not the case of banks that there was no issue of asset-liability management before 2003. Moreover, the said charges are not even contingent on the variable cost of funds. Even in a scenario where interest rates are heading southwards, no benefit of declining cost of funds is extended to customers.

Presumption of anti-competitiveness and the defence of ALM  Furthermore, under Section 3(3)(b) of the Competition Act which deals with cases having effect of limiting or controlling the provision of services horizontal agreements of this nature are kept in a special category and are presumed to have an appreciable adverse impact on the competition. This is also known as per se rule. In the present case CCI erred in observing that lack of evidence to illustrate that the adverse impact of practice of levy of PPC is sufficient to dismiss the matter.9
Contrary to this view, position of law is different and very cautiously chosen one. Law presumes such horizontal arrangement as present in this case to have the appreciable adverse impact. The object of applying per se rule to such horizontal arrangements, which amount to price fixation, was set out by the United States Supreme Court in Northern Pacific Railway Co. v. United States10 which observed that there are certain agreements or practices which because of their pernicious effects on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and illegal without any precise harm they have caused or the business excuse for their use.

Further, while analysing the element of appreciable adverse impact on competition, the Commission ignored that the ground that accrual of benefit to the consumer is being denied, in itself, is sufficient to establish appreciable adverse impact.11 CCI relied on the common submission made by all the respondents, that PPC is an effective ALM tool. To begin with, even if it is assumed that in case of pre-payment the banks shall incur a reinvestment risk, however, in an increasing interest rate scenario, the lender shall actually be benefited by pre-payment. Moreover, the minimal reinvestment risk, if any, is not commensurate with the higher quantum of pre-payment penalty which is usually levied between 1%-4%.

The majority judgment also bears a deafening silence about the practice of part-payment of retail loans. The Director General in his report had pointed out that many private banks allow part pre-payment of home loans and levy no charges on the same. It is only when the customers intend to repay the complete facility, that PPC is levied. Thus, the majority judgment has conveniently ignored a situation of asset liability mismatch caused by part pre-payment.

Intention of banks/HFCs in levying PPC is very relevant. Many banks in their internal circulars have indicated reasons like dissuading the customer from switching their loans from one bank to another or to make exit expensive.12 CCI in upholding the levy of PPC lost sight of the latest circular issued by National Housing Bank (NHB) dated 18-10-2010 wherein it was advised that pre-payment penalty should not be collected from the borrowers when the borrowing is preclosed from their own funds. Further, the Ministry of Finance vide its Letter dated 4-5-2010 instructed to all public sector banks to desist from levying PPC. Thus, the very practice of levying PPC despite the existing guidelines and which is completely based on whimsical consideration of banks is sufficient to make it questionable.

CCIâ€™s verdict on levy of pre-payment charges: A missed opportunity This verdict is a classic example of missing the objective in the very first shot. It not only lacks a rigorous economic analysis of law but turns a blind eye towards hidden practices like part pre-payment. The objective of an effective competition law seems to have taken a back seat considering the better bargaining strength of banking industry. Further, the majority judgment also harps on the fact that a booming retail loan market justifies any levy in the nature of PPC. However, the real investigation should have been that whether the levy of PPC is pulling back the growth of retail home loan market in India. As such, the regulatory bodies concerned must step in to immediately remove levy of any PPC on home loans prepaid by the customers from their own funds.

The dissenting opinion of Mr P.N. Parashar and R. Prasad comes as a silver lining in the dark cloud. Nonetheless, the fate of the litigation is in limbo. The real question is that in absence of the petitioner, who shall have the right locus to appeal the majority order of CCI before the Competition Appellate Tribunal.13 It is now for the appellate authorities to take this as an opportunity to revisit the majority judgment by applying tools of economic analysis and extend the real benefit of growing real estate market to Indian consumer.

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- Budget Speech of Shri Pranab Mukherjee, Minister of Finance, dated 6-7-2009 http://indiabudget.nic.in/ub2009-10/bss/speecha.htm, paras 42, 43.
- Supra, n. 1, para 18.5.
- Ibid, para 18.3.
- Section 2(b):
  2. (b) â€œagreementâ€• includes any arrangement or understanding or action in concert,â€”
  (i) whether or not, such arrangement, understanding or action is formal or in writing; or
  (ii) whether or not such arrangement, understanding or action is intended to be enforceable by legal proceedings.
- Supra, n. 1, para 18.4.