A CORPORATION BANK

v.

D.S. GOWDA AND ANR.

JUNE 20, 1994

B [A.M. AHMADI AND S.C. AGRAWAL, JJ.]

Banking Regulation Act 1949—Sections 21, 21-A and 35- A—Reserve Bank of India's Circulars and directives issued thereunder—Interest with periodical rest chargeable by banks—For commercial loans, interest with
C *quarterly rests held permissible—For agricultural loans interest can only be fixed with annual rests coinciding with the time when the farmers can repay—Compound interest chargeable only when entire loan becomes overdue—Held : Circulars and directives of Reserve Bank are based on rational policy, have statutory force and binding on banks—Where rate of interest with*
D *periodical rests is fixed by Bank in disgard of RBI circulars, held, Court can reopen transaction and grant suitable relief.*

Mysore Usurious Loans Act 1923—Section 3(1) Explanations I & II (a) and (d)—Commercial loan—Bank charging interest at 16.5% per annum with quarterly rests—In accordance with maximum prescribed by cir-
E *culars/directions of RBI under Sections 21 and 35 of Banking Regulation, Act 1949—Substantial unfairness—Rebuttal of—Special circumstances'—No evidence led by borrower to rebut—Held : Interest charged not excessive.*

Banker and customer—Bank loan—Interest with periodical rests—
F *Governed by terms of agreement between bank and borrower—In the absence of agreement the practice is to debit accrued interest to borrower's account at regular periodic intervals.*

In these appeals by Corporation Bank against the Judgment of the
G **Karnataka High Court, the following questions arose for consideration:**

1. Whether the Bank is entitled to claim interest with periodical rests, e.g., a monthly rest, a quarterly rest, a six monthly rest, or a yearly rest, or compound interest in any other manner, from a borrower who has obtained a loan or an advnace for agricultural/commercial purposes,
H **as the case may be?**

2. Whether the Banks are bound to follow the directives/circulars issued by the Reserve Bank of India in exercise of power conferred by Section 21 of the Banking Regulation Act, 1949 prescribing the structure of interest to be charged on loans/advances made from time to time, and if yes, to what extent? A

3. Whether in view of the insertion of Section 21A in the Banking Regulation Act, 1949 by Banking Loans (Amendment) Act, 1983, Courts are precluded from subjecting transactions entered into between the Banks and borrowers from scrutiny under the provisions of the Usurious Loans Act, 1918 or any other similar State law, with a view to giving relief thereunder, and, if yes, whether relief under such laws is wholly impermissible? and B C

(4) Whether the directives/circulars issued by the Reserve Bank of India under Section 21 of the Banking Regulation Act, 1949 can be termed as a 'Special circumstance' within the meaning of Explanation 1 to Section 3 of the Mysore Usurious Loans Act, 1923? If yes, what is its effect? D

Disposing of the appeals, this Court

HELD : 1.1. Although there is no common law right to charge interest on an overdraft by universal custom of bankers a reasonable rate of interest on overdrafts is permissible. So also charging of interest with periodical rests or compounding of interest would be allowed if there is evidence of the customer having acquiesed therein, provided the relationship of banker and customer is subsisting. However, if the relationship under goes a change into that of mortgagee and mortgagor by the taking of a mortgage, the charging of interest would be governed in accordance with the terms of the mortgage. The taking of a mortgage to secure the fluctuating balance of an overdrawn account, being not inconsistent with the relationship of banker and customer, would not displace an earlier right to charge compound interest. Thus the practice of bankers to debit the accrued interest to the borrower's current account at regular periodic intervals is a recognised practice. The circulars issued by the Reserve Bank are not inconsistent with this recognised practice. [190-A-B-C-D] E F G

1.2. As under the common law there is no right to charge even simple H

A interest on overdrafts, the claim of interest has to be supported on the ground of universal custom of bankers or on the basis of implied agreement. This would be so in a case where there is no agreement between the bankers and customer in regard to the payment of interest but where the loan or advance is made on certain terms reduced to writing, the parties B would be governed by those terms and there could be no question of falling back on practice or custom. The normal practice of banks in India was to charge interest with yearly or half-yearly rests but shorter rests also prevailed. Sections 21 and 35-A of the Banking Regulation Act enable the Reserve Bank to issue directives in public interest to regulate the charging C of interest on loans or advances made from time to time. It is in exercise of this power that it issued the various circulars fixing the rates of interest to be charged from borrowers. A Bank could ignore the directive on pain of being penalised. The Reserve bank not only desired to bring about uniformity but also controlled the rate of interest. It cannot, therefore, be D said that no rational policy could be discerned from the directives of the Reserve Bank. It cannot also be said that the Reserve Bank did not pay "adequate attention" to the question of rests or compounding of interest when it was the precise question of bringing uniformity in that behalf to which the Reserve Bank addressed itself. [176-E-F, 193-A-B-C-D-E]

E 1.3. The interest rate of 16.5% per annum with quarterly rest on a secured loan is not so excessive as to render the transaction substantially unfair within the meaning of the Mysore Usurious Loans Act 1923. If the Reserve Bank, keeping in view the economic scenario of the country and the impact that interest rates would have on the economy, fixes the F minimum and maximum interest rates banks can charge excessive and would in any case amount to a "special circumstance" within the meaning of the Explanation to Section 3(1) of the Mysore Act. The guidelines issued by the Reserve Bank permitted a maximum interest rate of 16.5% per annum with quarterly rests. The borrower neither contended in his G written statement that the interest charged was excessive nor did he lead evidence to show that the prevailing market rate was lower than the interest charged by the Bank. Nor was it shown that any other Bank would have charged less. Admittedly he has not paid a farthing towards the loan or interest till the date of the execution of the mortgage. This H shows he was a bad pay master. The property was still under construc-

tion and did not yield any income on the date of the mortgage and so it could not be said that the security was sound. Though he came out with a statement that the property was worth Rs. 20.25 lakhs it is the value of the property at the date of the mortgage which is relevant, for which there is no evidence. The benefit of the rise in value will enure to the borrower but that subsequent fact cannot help in evaluating the risk factor at the date of the mortgage. Admittedly at no point of time, not even at the time of confirmation of balance, did he protest that the interest charged was excessive. He was totally indifferent. He did not make any mention of deposit rates etc., in his written statement or oral testimony on which the High Court has based its opinion.

[195-C-H & 196-A-C-D]

1.4. However, if in any case, it is shown that the Bank was claiming interest in excess of that permitted by the circular/direction of the Reserve Bank, the Court could give relief to the aggrieved party notwithstanding Section 21-A to the extent of interest charged in excess of the rate prescribed by the Reserve Bank. A distinction must be drawn between the Court's interference on the premise that the interest charged is excessive and Court's interference on the premise that the interest charged is in contravention of the circulars/directions issued by the Reserve Bank. But if the Reserve Bank has fixed the maximum rate of interest in exercise of the powers conferred by Sections 21/35-A of the Banking Regulation Act, Section 21-A would be attracted and the transaction would not be liable to be reopened on the ground that the rate of interest fixed is excessive even though not exceeding the ceiling determined by the Reserve Bank. [199-G-H, 200-H, 201-A]

2.1. However, agricultural loans stand on a different footing. The circular issued by the Reserve Bank from time to time in exercise of power conferred by Sections 21/35-A of the Banking Regulation Act provide that agricultural advances should not be treated on par with commercial loans in so far as the rate of interest thereon is concerned because the farmers do not have any regular source of income except sale proceeds of their crops which income they get once a year. The question of recovery of interest with quarterly or six-monthly rests from farmers is therefore not feasible. The fact that farmers are fluid at a given point of time every year has to be kept in mind in determining the point of time when they should

A be expected to repay the loan or pay the instalment/interest on advance. Therefore, to allow the banks to charge interest on quarterly or half-yearly rests from farmers would tantamount to virtually compelling them to pay compound interest, since they would not be able to pay the interest except once in a year i.e. when they receive the income from sale proceeds of their
B crops. According to the circulars/directions of the Reserve Bank so far as the loans for agricultural purposes are concerned, at best interest may be charged with yearly rests and may be compounded if the loan/instalment becomes overdue. [198-C-H]

2.2. In the instant case, since interest was charged with six-monthly
C rests that was clearly in contravention of the Reserve Bank circulars/directions. Compounding of interest on current dues on agricultural advances having been discouraged, the Bank was not entitled to charge interest with shorter periodical rests and compound the same. The Bank could add interest outstanding to the principal and compound the interest when the
D crop loan or term loan becomes overdue, having regard to the tenor of the circular date 14-3-1972. [199-A-B]

D.S. Gowda v. *Corporation Bank*, AIR (1983) Kant. 143 = (1982) 2 Kant LJ 40, reversed

E

Bank of India v. *Kamam Ranga Rao*, AIR (1986) Kant. 242, affirmed.

H.P. Krishna Reddy v. *Canara Bank*, AIR (1985) Kant 228, approved.

Bank of India v. *Rao Saheb Krishna Rao Desai*, (1980) 2 Kar LJ 495;
F *K.C. Venkateswarlu* v. *Syndicate Bank*, AIR (1986) AP 290 and *State Bank of India*, v. *Eluru*, AIR (1986) AP 291, referred to.

Yourell v. *Hibernian Bank*, (1918) AC 372; *Holder* v. *IRC*, [1932] All ER 265 : 1932 AC 624 and *Reddie* v. *Williamson*, [1863] 1 Macph (Ct. of
G Sess) 228, reffered to.

Paget's *Law of Banking* 8th Edn. (1972) Chapter V Halsbry's *Laws of England* (4th Edn.) Vol.3, Page 118 para 160, referred to.

CIVIL APPELLATE JURISDICTION : Civil Appeal No. 4214 of
H 1982.

From the Judgment and Order dated 22.10.82 of the Karnataka High Court in Regular First Appeal No. 107 of 1981.

With

Civil Appeal No. 544 of 1986.

With

SLP (C) No. 16444/92.

K.N. Bhat, S.S. Javali, S.N. Bhat, Ranjit Kumar, H.S. Parihar, Kuldeep S. Parihar, Vineet Kumar, Ms Niha Gupta, Nand Kumar, U.A. Rana and Rajiv Tyagi for M/s Gagrat and Co. . for the appearing parties.

The Judgment of the Court was delivered by

AHMADI, J. These appeals brought by the aforementioned Banks by special leave raise certain important questions of law touching the business activities of the Banks in the matter of grant of loans/advances and recovery thereof which may be formulated as under :–

1. Whether the Bank is entitled to claim interest with periodical rests, e.g., a monthly rest, a quarterly rest, a six monthly rest, or a yearly rest, or compound interest in any other manner, from a borrower who had obtained a loan or an advance for agricultural/commercial purpose, as the case may be?

2. Whether the Banks are bound to follow the directives/circulars issued by the Reserve Bank of India in exercise of power conferred by Section 21 of the Banking Regulation Act, 1949 prescribing the structure of interest to be charged on loans/advances made from time to time, and if yes, to what extent?

3. Whether in view of the insertion of Section 21A in the Banking Regulation Act, 1949 by Banking Loans (Amendment) Act, 1983 (Act No. 1 of 1984), Courts are precluded from the subjecting transactions entered into between Banks and borrowers from scrutiny under the provisions of the Usurious Loans Act, 1918 or any other similar State law, with a view to giving relief thereunder, and, if yes, whether relief under such laws is wholly impermissible?

A and

4. Whether the directives/circulars issued by the Reserve Bank of India under Section 21 of the Banking Regulation Act, 1949 can be termed as a 'special circumstance within the meaning of Explanation 1 to Section 3 of the Mysore Usurious Loans Act, 1923 (Mysore Act No. IX of 1923)? If yes, what is its effect?

B

These questions which have a bearing on the day to day transactions of loan/advance entered into by the Banks arise in the following background.

C In *Bank of India* v. *Rao Saheb Krishna Rao Desai*, (1980) 2 Karnataka Law Journal 495, the Bank had advanced a loan for purchasing a tractor to improve the agricultural land. The borrower executed a promissory note as also a hypothecation deed whereby he agreed to repay the said sum on demand with interest at 4.5% per annum over the Reserve Bank rate, minimum being 9.5.% per annum 'with quarterly rests'. The original rate D fixed was 10.5% per annum. On the failure of the borrower to adhere to the terms of the loan, the Bank instituted a suit for recovery of the loan wherein it claimed compound interest on the strength of the term 'with quarterly rests'. The suit was decreed by the trial court with future interest at 10.5% per annum. The claim for compound interest was rejected. Feeling aggrieved, the Bank preferred the aforesaid appeal which was E heard by a division Bench of the Karnataka High Court. The Division Bench referred to *Paget's* law of Banking, 8th Edition (1972), Chapter V, wherein under the caption 'interest' it was stated :

"There is no common law right to charge even simple interest on F an over-draft, but the claim could be supported on the ground of universal custom of bankers or on the basis of implied agreement. Where the customer has acquiesced in the system under which the interest is charged, that also would justify the claim. Such acquiescence will justify the charging compound interest or interest with G periodical rests, so long as the relation of banker and customer exists, and the relationship is not change into that of mortgagee and mortgagor. The taking of a mortgage or a charge by way of legal mortgage to secure the fluctuating balance of an account is not however, inconsistent with the relation of Banker and customer so as to preclude compound interest. The effect of the practice of H bankers in debiting interest to an over-drawn current account

periodically and thereby increasing the capital sum was considered in *Yourell* v. *Hibernin Bank*, [1918] AC 372, in which Lord Atkinson said : A

> "The Bank, by taking the account with these half yearly rests, secured for itself the benefit of compound interest. This is a usual and perfectly legitimate mode of dealing between banker and customer." B

In *Holder* v. *Inland Revenue Commissioners*, [1932] AC 624 = 1932 All E.R. 265, the Court of Appeal approved the statement of Lord Cowan in *Reddie* v. *Williamson*, [1863] 1 Macph (Ct. of Sess.) 228 : C

> "That the periodical interest at the end of each year is a debt to be then paid, and which must be held to have been paid when placed to the debit of the account as an additional advance by the bank for the convenience of the obligations."

D

Relying on the above passage, the Division Bench observed that the custom of charging compound interest by Banks would be normally applicable in the matter of over-draft facilities only and that too, when there exists relationship of banker and customer, which relationship has not been transformed into that of mortgagee and mortgagor. Sabhahit, J., speaking for the bench, observed : E

> "Compound interest or the practice of quarterly or half-yearly rest is something strange to agricultural financing where the loans are either short-terms, middle-term or long-term. Short-term financing is done for growing the annual crops. They are termed as 'crop loans'. Middle term financing is done for improvements in the lands and the period would be about three years to five years. Long-term financing is given for clearing off old debts and for the long-term investment. That being so, in agricultural financing, the question of the normal commercial banking conditions as in over-drafts would not come into play and the Bank 'custom' and habits which are usual in the case of commercial banking cannot be smuggled into agricultural financing." F G

On facts, the court found that the parties understood, if at all, 'quarterly rest' to mean that interest is to be paid every quarter and nothing H

more. It was also noticed that the loan advanced was in fact a mortgage transaction and therefore the usual practice and custom prevailing in the case of over-drafts would have no application. The Court, therefore, held that the clause 'quarterly rests' used in the printed form was never intended to burden the borrower with the obligation to pay compound interest. Hence the Division Bench held that the clause which was noted by the parties at its inception and execution to permit the Bank to recover compound interest must be deemed to be void in the eye of law and cannot be allowed to be enforced by the Bank. We have referred to this decision even before we refer to the decisions impugned in these appeals as it has a direct bearing on the subsequent decisions.

The decision of the Division Bench of the Karnataka High Court impugned in Civil Appeal No. 4214 of 1982 is reported as *D.S. Gowda* v. *M/s. Corporation Bank*, AIR (1983) Karnataka 143. D.S. Gowda who was allotted a building site by the Banglore Development Authority, had approached the Bank for financial help to construct residential flats on the said site. The Bank acceded to his request and granted over-draft facility upto Rs. 2,50,000. The borrower accepted the facility and commenced construction at the site. However, it was soon realised that the sanctioned facility was insufficient and so he approached the Bank for additional finance. Since he had failed to pay interest/instalments his financial indebtedness had risen. On November 26, 1973, he executed in irrevocable Power of Attorney authorising the Bank Manager to supervise and/or to put up construction according to the sanctioned plan to induct tenants and recover rents from them in repayment of the loan and interest due to the Bank. Unfortunately for him, the building could not be completed and by 1975 the outstanding loan and interest had swollen to over Rs. 4 lacs. The Bank then felt the need for adequate security whereupon on October 10, 1975, the borrower executed a deed of equitable mortgage by deposit of title deeds for Rs. 5 lacs. The Bank gave him further accommodation on the execution of the said document. Under the terms of the mortgage, the borrower covenanted to repay the mortgage loan of Rs. 5 lacs with interest at 16.5% per annum subject to such rate of interest as may be prescribed within a period of two years. It was further agreed by the mortgagor that he will pay interest on the mortgage amount at the end of each calendar month without default and in the event of default over due interest may be charged. On November 7, 1975, he at the instance of the Bank executed a promissory note by way of collateral security undertaking to pay Rs. 5 lacs with interest at 16.5% per annum 'with quarterly rests'. By March 1, 1978,

the amount payable with penal interest, service charges, etc., stood at Rs. 7,56,934.17 paise. The Bank instituted a suit for recovering the said amount with future interest and costs by the sale of mortgaged property under Order XXXIV of the Code of Civil Procedure. The borrower admitted the execution of the equitable mortgage deed and the promissory note, but contended that the promissory note was executed as a collateral security and the provision of quarterly rest provided therein was not one of the conditions of the loan granted to him. He further contended that the amount actually borrowed under the mortgage was Rs. 4 lacs but the Bank got the mortgage deed executed for Rs.5 lacs by including the interest due on Rs. 4 lacs. He, therefore, contended that he was not liable to pay compound interest or penal interest since such a liability did not arise under the loan transaction. In any event he contended that the interest charged was exorbitant, the transaction was substantially unfair and, therefore, he was entitled to relief under the provisions of the Mysore Act.

It was urged on behalf of the borrower that there was no banking practice to charge interest with monthly or quarterly rests and in the absence of statutory sanction from the Reserve Bank of India, the Bank could not collect compound interest. Counsel for the Bank however submitted that there was a banking practice to charge compound interest by providing for monthly or quarterly rests as also to charge penal and service charges from the defaulter. The minimum lending rate of 12.5% prescribed by the Reserve Bank of India did not preclude the Bank from charging interest at 16.5% with quarterly rests. He, therefore, submitted that there was nothing substantially unfair in the transaction to attract the provisions of the Mysore Act. The trial court decreed the suit holding that the borrower was initially given Rs. 4,22,000 as loan and Rs. 78,000 were added thereto by way of accrued interest making a total of Rs. 5 lacs for which he executed the equitable mortgage. The trial court further held that the borrower had not proved that he was not liable to pay interest with quarterly rests and hence the Bank was justified in charging interest as claimed in the suit. Lastly, the trial court stated that the borrower had not established that the loan transaction was substantially unfair or that the interest charged was excessive to entitle him to relief under the Mysore Act. The trial court, therefore, directed that a preliminary decree be drawn up for the suit claim along with costs and future interest at 16.5% per annum to be realised by sale of the mortgaged property if not paid within six month. Feeling aggrieved the borrower appealed to the High Court. The Divisions Bench of the High Court formulated two principal questions

A for consideration, namely, (1) whether the terms of the mortgage deed providing for payment of interest at 16.5% with monthly rests are valid under statutory directives of the Reserve Bank of India or could be supported by banking practice, and (2) whether the interest charged by the bank including penal interest and service charges was excessive and whether the Court could call into aid the provisions of the Mysore Act to B mitigate the rigour of the loan transaction, and if so, what relief defendant is entitled to? The Division Bench thereafter examined the provisions of the Reserve Bank of India Act, 1934, the Banking Regulation Act, 1949 and the Banking Companies (Acquisition and Transfer of undertakings0 Act, 1970 as amended from time to time and noticed the various direc- C tives/circulars issued by the Reserve Bank in exercise of power conferred by Section 21 of the Banking Regulation Act, 1949 and concluded as under:–

> "It is thus clear that the ordinary practice or custom of Banks was only to charge interest with yearly or half-yearly rests and that too D only on over-draft amounts and unsecured loans. The monthly and quarterly rests, therefore, does not appear to be the recognised banking practice."

The Division Bench next examined whether the Reserve Bank of India while prescribing quarterly rests under its directive of March 13, 1976 had E recognised any such banking practice. Taking note of the background material in this behalf, the Division Bench concluded as under :–

> "From the above narration, one thing becomes very clear that the Reserve Bank did not pay adequate attention to the question of F "rests" or the compound interest to be charged by Banks on loans, advances and other facilities save those connected with agriculture."

Relying on Section 3(1) of the Mysore Act the Court held that the directives of the Reserve Bank of India cannot by themselves constitute a G 'special circumstance' under the explanation to section 3(1) and therefore since the Bank had charged compound interest as well as penal interest, there can be no doubt that a presumption arose that the transaction was substantially unfair and the burden of rebutting the presumption that the interest charged was not excessive squarely lay on the Bank which it had H to discharge. The Division Bench, therefore, held that the borrower was

entitled to relief and sliced down the interest rate to 12.5% per annum with annual rest. As to the levy of penal interest, the Division Bench pointed out that there was no stipulation in the agreement to support it. In regard to the service charges, it noticed that the Reserve Bank by circular dated November 15, 1976 had directed that Banks in their discretion could charge at a flat rate from January 1978 at 1/20th of 1% upto a maximum of Rs. 25.000 on a once for all basis as processing fees. The Division Bench, therefore, allowed the Bank to recover Rs. 25,000 by way of processing fees. In the above view, the appeal was allowed and the matter was remitted to the trial court for working out the dues in the light of the above decision. It is this decision which is assailed in Civil Appeal No. 4214 of 1982.

Next is the case of *H.P. Krishna Reddy* v. *Canara Bank, Bangalore*, AIR (1985) Karnataka 228. The facts of the case show that the suit filed by the Bank for recovery of money due under an equitable mortgage and promissory note was contested mainly on the ground that the Bank's claim to interest at the rate of 13% per annum with quarterly rests was unsustainable. That claim was laid on the rules of business, trade, usage and custom. This claim was based on a Circular of the Reserve Bank dated August 17, 1978 which in turn referred to an earlier Circular of October 5, 1974. By the time this decision was rendered Section 21-A was introduced in the Banking Regulation Act, 1949 which reads as follows :

> "21A: Rates of interest charged by Banking Companies not to be subject to scrutiny by Court. - Notwithstanding anything contained in the Usurious Loans Act, 1918, or any other law related to indebtedness in force in any State, a transaction between a Banking Company and its debtor shall not be re-opened by any court on the ground that the rate of interest charged by the banking company in respect of such transaction is excessive."

The Division Bench came to the conclusion that the loan in question was for agricultural purposes and, therefore, under the Reserve Bank's Circulars the Bank was precluded from recovering interest with quarterly rests. On the question whether the contractual rate of 13% was excessive, the Division Bench ruled against the borrower. However, on the question of applicability of section 21A it observed that the said provisions had no bearing on the question of court's jurisdiction to give relief to an aggrieved partly if the bank in any particular case has charged interest in excess of

A the limits prescribed by the Reserve Bank, since that would render the bank liable to penalty under the Banking Regulation Act. Therefore, it was observed that if in any case it is shown that the bank had charged interest in disobedience of the Reserve Bank directive, the court would be justified in granting relief to the borrower, notwithstanding section 21A extracted
B earlier. As regards the grant of interest *pendente lite*, the rate of interest at 6% per annum was justified in view of the constraints of explanations 1 and 2 to proviso to section 34 of the Civil Procedure Code since the loan was admittedly for agricultural purposes. We have referred to this decision at this stage to indicate the trend of the said High Court.

C The judgment impugned in Civil Appeal No. 544 of 1986 has been reported as *Bank of India* v. *Karnam Ranga Rao and others*, AIR (1986) Karnataka 242. The said matter arises out of the suit instituted by the Bank for recovery of Rs. 30,564, (principal sum being Rs. 10,000) borrowed for raising sugarcane crop. Under the documents executed by and between the
D parties the borrowers were liable to pay interest at the rate of 4% above the rate prescribed by the Reserve Bank subject to a minimum of 13% per annum with quarterly rests. The Bank, however, had charged only half yearly rests and had claimed at the same rate in the suit. The borrowers while admitting the fact of having taken the loan denied their liability to pay interest with quarterly rests on the ground that the loan was for
E agricultural purposes and it was settled practice that the Bank should not charge interest with periodical rests i.e. compound interest. The Trial Court held that it was well settled that for agricultural loans in India charging of compound interest was not permissible. The Bank was, therefore, directed to submit a revised statement which it did determining the
F dues at Rs. 19,851.66. The Trial Court decreed the suit for the said amount with future interest at 6% per annum. Feeling aggrieved by the said decreed the Bank approached the High Court in appeal. Since the question raised in appeal related to the Bank's right to charge compound interest on agricultural advances and since in a number of matters pending before the court the same question was involved, the court thought it advisable to
G issue notice under Order I Rule 8 of the Code Civil Procedure as also to the Reserve Bank of India with a direction to inspect the accounts and submit a report. Accordingly the report came to be submitted on June 7, 1985. That report disclosed that the Bank had debited interest to the crop loan account thrice with half yearly rest before the due date of payment of
H the loan and had also compounded the interest. The Division Bench

observed as under : A

> "The Bank, however, could not add interest outstanding to the principal and compound the interest when the crop loan becomes overdue keeping in view what has been stated in the Circular dated March 14,1972. As such the Bank's compounding of interest at half yearly intervals after the loan amount has become overdue cannot be questioned." B

Reference was made to as many as six circulars issued by the Reserve Bank between March 14, 1972 and September 15, 1984. The Division Bench held that Banks were bound to follow the directives or circulars issued by the C Reserve Bank prescribing the structure of interest to be charged on loans and any interest charged in excess of the prescribed limit would be illegal and void. Following its earlier decisions it was further held that Banks could not charge interest with quarterly rests on agricultural advances. It was pointed out that agricultural advances could not be equated with D commercial loans in the matter of compounding of interest. In the case of agricultural loans it was pointed out that since farmers did not have by regular source of income other than the sale proceeds of their crops, they received income once in a year and were, therefore, not in a position to pay interest at fixed rests and hence in such transaction the parties could never be taken to have intended that the interest should be compounded E quarterly or half yearly. On the question of applicability of section 21A of the Banking Regulation Act it was said that unless it is proved that the interest charged by the Banks is not in conformity with the rates prescribed by the Reserve Bank, the Court would be precluded form re-opening the transaction. However, if the rate charged is in violation of the Reserve F Bank's circular, the excess rate of interest can be chopped off as illegal and void. On this line of reasoning the Bank's appeal was dismissed.

At this stage it would be convenient to notice two decisions of the Andhra Pradesh High Court which have a bearing on some of the points G under consideration. In *K.C. Venkateswarlu* v. *Syndicate Bank, Udayagiri*, AIR (1986) A.P. 290, the Division bench held that the newly added Section 21A of the Banking Regulation Act made the provisions of the Usurious Loans Act, 1918, inapplicable to a transaction of loan between a bank and a borrower. The Division Bench recorded its conclusion in paragraph 5 of the judgment thus : H

A "It is clear that the said provision makes the provisions of Usurious Loans Act inapplicable to any transaction between a banking company and its debtor. The Courts' power to reopen the transaction, under the provisions of the Usurious Loans Act on the ground that the rate of interest charged is excessive is no longer available. It is not disputed that it affects the pending proceedings also though the Act came into force on 15.2.1984. Thus it is clear that the Usurious Loans Act is no longer applicable to any debt due to a Banking Company".

B

It is important to note that it was not disputed before the Court that C restriction imposed on the Court's power by Section 21A extended to pending proceedings as well.

In the matter of the *State Bank of India, Eluru* AIR (1986) A.P. 291, a learned Single Judge of the said High Court, however, held that Section D 21A cannot have overriding effect over the Usurious Loans Act, 1918, as amended by the Madras Amendment Act No. VIII of 1937, in its application to agriculturists. According to the learned Judge, the use of the generic word 'debtor' in Section 21A was not intended to refer to agriculturists. The learned Judge also held Section 21A *ultra vires* the power of Parliament on the ground that it was not a law relating to Banking but was E intended to deny relief to agriculturists from indebtedness which was beyond the legislative competence of Parliament. He felt that the said provision could not be saved by the application of even the pith and substance doctrine. Further, the learned Judge found Section 21A *ultra vires* Article 14 on the plea that a law which requires or compels courts to F implement harsh, unequal and unconscionable transactions providing for payment of compound interest or usurisous rates of interest by depriving the debtors of their right to claim relief under the provisions of the Usurious Loans Act or similar State laws would offend Article 14 inasmuch as it permits discrimination against hapless debtors. Holding that the provisions of Section 21A was arbitrary, partisan and offensive to our sense G of equity an equality, the learned Judge refused to apply it in the fact of the case. It may, however, be mentioned that the attention of the learned Single Judge was not invited to the Division Bench decision in the case of *Venkateswarlu* (supra) which was rendered only a few days before, However, in the appeals before us neither the Parliament's competence to enact H section 21A nor its constitutional validity based on Article 14 has been

challenged. We are, therefore, not required to go into these questions. A

Before we notice the circulars/directives issued by the Reserve Bank of India, it would be advantageous to briefly capitulate the functions of this Country's Central Bank. It was established under the Reserve Bank of India Act with effect from 1st April, 1935 and was nationalised immediately B after independence in 1948. Amongst others, its functions are to act as a banker to the Government, regulate the issue of currency in India, act as a banker to other commercial banks, exercise control over the volume of credit of commercial banks to maintain price stability, to control advances granted by commercial banks and to prescribed the rates of interest on which advances may be granted. One of the ways it employs to control the C volume of bank credit is through the fluctuations in the bank rate i.e., the rate of interest at which it discounts bills or exchange from commercial banks. By the increase or decrease of the bank rate it reduces or increases the volume of credit with the commercial banks. Section 21 of the Banking Regulation Act enables the Reserve Bank to give directions to all other D banks in regard to loan policies with a view to control credit facilities and curb speculative activities. This is clearly a matter of public interest. This provisions authorises the Reserve Bank to give directions to other banks *inter alia* in regard to the rate of interest to be charged on advances/financial accommodation. The newly added section 21A restricts the Court from E reopening a transaction between a banking company and its debtors on the ground that the rate of interest charged is excessive, the Usurious Loans Act or any other similar State Act, notwithstanding. If any of the directions given by the Reserve Bank are violated, apart from the punishment that can be imposed on the officers, section 47A empowers the Reserve Bank to penalise the banking company also. These, in brief, are the powers and F functions of the Reserve Bank.

We may now notice the directives/circulars issued by the Reserve Bank relating to charging of interest on advances. The first circular, by far G the most important, is dated March 14, 1972. It takes note of the fact that agricultural finance stands on a different footing for the reason that agriculturists do not have any regular source of income other than the sale proceeds of their crops. They would, therefore, be in a position to pay interest only when they receive the sale proceeds of their crops. Taking note of the said position, the circular proceeds to state as under : H

A "Having regard to the special characteristics of agricultural finance, banks are advised to bear in mind the following principles in the matter of application of interest on such advances.

(i) Repayment period of agricultural advances, whether short-term or medium-term, should be so fixed as to coincide with the period when the farmer is fluid i.e., after harvesting and marketing of his crops. Payment of interest should also be insisted upon only at the time of repayment of loan/instalment so fixed.

(ii) Interest on current dues should not be compounded.

(iii) When crop loans or instalments under medium-term loans become overdue, banks can add interest outstanding to the principal amount and compound the interest keeping in view what has been stated in paragraph 1 above."

The circular further says that banks may adopt suitable accounting procedures in the matter of charging interest on agricultural loans. In paragraph 1 of the circular it is stated that there is at present no uniformity in the matter of charging interest on various types of agricultural advances and although interest is compounded at monthly, quarterly or half yearly rests on advances, such a system of compounding in the case of agricultural advances may not be suitable. Thus the aforesaid circular recognises the fact that agriculturists have to be treated differently from other loanees for the reason that they do not have any regular source of income other than the sale proceeds of thier crops. That is why it advised the banks to fix the repayment period of agricultural advances, short-term or medium-terms, in such a manner as to coincide with the period when the farmer is fluid, meaning thereby, when the farmer gets money on the sale of his corps. It is at that point of time that payment of interest should be insisted upon. The second circular is dated October 5, 1974. By this circular the Reserve Bank reiterates that interest on current dues in respect of agricultural advances should not be compounded. It has, therefore, advised all banking institutions to advise their branches to follow the first mentioned circular. The third circular dated March 13, 1976 is general in nature and prescribes that the rate of the interest should not more than 16.5% per annum with quarterly rests. It, however, permits recovery of penal interest in addition to normal interest even if both put together exceed the prescribed ceiling.

The fourth circular dated August 17, 1976 addressed to all Scheduled Commercial Banks in regard to the method of charging interest on agricultural advances states :

> "Please refer to our directive..... dated 13th March, 1976 stipulating the maximum rate of interest that could be charged on loans, advances, etc., by scheduled commercial banks. It has been stated therein that interest shall be charged with quarterly rests. It is clarified that this aspect of the directive will not apply to agricultural advances in respect of which the instructions issued in our letters ...dated the 14th March, 1972 and ..... dated the 5th October, 1974 will continue to prevail. In other words, payment of interest on agricultural advances should be insisted upon only at the time of repayment of principal/instalment of principal and interest on current dues should not be compounded."

The circular makes it clear that the circular dated March 13, 1976 would not apply to agricultural advances which would continue to be governed by the first two circulars dated 14th March, 1972 and 5th October, 1974. The fifth circular dated February 28, 1978 was issued in supersession of the third circular dated March 13, 1976. By this circular the maximum rate of interest prescribed under the third circular was reduced from 16.5% to 15%. In regard to compounding of interest it is directed that interest. shall be charged with quarterly or longer rests. The sixth circular dated September 15, 1984 restates the general guidelines laid down in the previous circulars in regard to the procedure for charging interest on loan accounts and adds that banks can charge interest on loan accounts at quarterly or longer rests. In respect of agricultural advances it says that banks should not compound the interest in the case of current dues, i.e., crop loans and instalments not fallen due in respect of term loans, as the agriculturists do not have any regular source of income other than the sale proceeds of their crops. Therefore, when crop loans or instalments under term loans become overdue, banks can add interest outstanding to the principal. It further adds that where the default is due to genuine reasons banks should extend the period of loan or reschedule the instalments under term loan. Once such a relief is extended the overdues become current dues and banks should not compound interest. This reveals the concern of the Reserve Bank towards agriculturist- loanees.

A From the above circulars issued by the Reserve Bank from time to time it is evident that the procedure for charging interest on loans advanced to agriculturists, be they short term or middle term loans, was different from loans advanced to other borrowers. The first and the second circulars in terms refer to charging of interest on agricultural advances. There is nothing equivocal or ambiguous about it. The third circular is B general in nature and prescribes the ceiling for the recovery of interest with the qualification that if there is an agreement permitting charging of penal interest it will be permissible to charge the same for the default period in addition to the interest rate regardless of the fact that normal interest and penal interest may cross the ceiling. As the third circular was likely to raise C doubts in regard to the applicability of the first and second circulars, it was clarified by the fourth circular that it (third circular) shall have no application to agricultural advances. The fifth circular superseded ceiling to 15% with effect from 1st March, 1978, with quarterly or longer rests. The proviso further reduces the ceiling in case of term loans with a maturity of D not less then three years. This circular is once again a general circular. The sixth circular while providing that Banks can charge interest on loan accounts at quarterly or longer rests stipulates that in respect of agricultural advances Bank should not compound the interest in case of current dues unless term loans have become overdue. Thus this circular draws a distinction between loanees other than agriculturists and advances made to E agriculturists in the matter of charging interest. It is, therefore, quite clear that agricultural loans stand on a different footing from other loans including a loan or advance secured for construction of flats, as in the case of D.S. Gowda. So far as agricultural loans are concerned, having regard to its special characteristics and the time factor relating to the farmer's F capacity to meet his financial obligations, it was realised that farmers would not be in a position to pay interest at short periodical rests and if their inability to do so is visited with compounding of interest it would be too harsh and unjust on the farmers. The Reserve Bank, conscious of this difficulty of the farmers, directed the banks that repayment period should be so fixed as to coincide with the period when the farmer is fluid and G payment of interest should also be insisted upon only at the time of repayment of the loan or instalment. Further it directed that interest on current dues should not be compounded but if and when the crop loans or medium-term loans become overdue, interest outstanding to the principal amount may be added and compounded. The procedure in regard to

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charging of interest on short-term and medium-term agricultural loans is, therefore, clearly spelt out in the first circular of March 14, 1972. There is no ambiguity about it. In regard to loans belonging to the non-agricultural category, the circular dated March 13, 1976, February 28, 1978 and September 15, 1984, clearly state that the Banks may charge interest with quarterly on longer rests. Therefore, loans advanced for construction of flats would fall in the latter category against which interest can be charged with periodical rests. The case of respondent Karnam Ranga Rao falls in the former category since it was a loan taken for raising sugarcane crops whereas the case of the respondent D.S. Gowda falls in the latter category of non-agricultural loan as it was secured for construction of flats. This position emerges on a plain reading of the relevant Reserve Bank circulars.

In Halsbury's *Laws of England* (Fourth Edn), Volume 3 at page 118, para 160 read thus :

> "160. Interest. By the universal custom of bankers, a banker has the right to charge simple interest at a reasonable rate on all overdrafts. An unusual rate of interest, interest with periodical rests, or compound interest can only be justified, in the absence of express agreement, where the customer is shown or must be taken to have acquiesced in the account being kept on that basis. Whether such acquiescence can be assumed from his failure to protest at an interest entry in his statement of account is doubtful.
>
> Acquiescence in such charges only justifies them so long as the relation of banker and customer exists with respect to the advance. If the relation is altered into that of mortgagee and mortgagor by the taking of a mortgage, interest must be calculated according to the terms of the mortgage, or according to the new relation.
>
> The taking of a mortgage to secure a fluctuating balance of an overdrawn account, is not, however, inconsistent with the relation of a banker and customer, so as to displace a previously accrued right to charge compound interest.
>
> It is the practice of bankers to debit the accrued interest to the borrower's current account at regular period (usually half-yearly); where the current account is overdrawn or becomes overdrawn as the result of the debit the effect is to add the interest to the

A principal, in which case it loses its quality of interest and becomes capital."

From the above note, which by and large corresponds to Pagets' opinion extracted earlier, it is evident that although there may be no common law right to charge interest on an overdraft, by universal custom or bankers a B reasonable rate of interest on overdrafts is permissible. So also charging of interest with periodical rests or compounding of interest would be allowed if there is evidence of the customer having acquiesced therein, provided the relation of banker and customer is subsisting. However, if the relationship undergoes a change into that of mortgagee and mortgagor by the C taking of a mortgage, the charging of interest would be governed in accordance with the terms of the mortgage. The taking of a mortgage to secure the fluctuating balance of an overdrawn account, being not inconsistent with the relationship of banker and customer, would displace earlier right to charge compound interest. Thus, the practice of bankers to debit the accrued interest to the borrower's current account at regular periods D is a recognised practice. The circulars issued by the Reserve Bank referred to earlier are not inconsistent with this recognised practice.

We may now deal with *D.S. Gowda's* case. He had secured overdraft facilities upto Rs. 2,50,000 from the Bank to construct flats on the plot E allotted to him by the Bangalore Development Authority. However, the borrower failed to repay the loan and interest thereon. By 1975 the dues had risen to over Rs. 4,00,000. To secure the debt the Bank obtained an equitable mortgage on 10th October, 1975 for Rupees five lacs. Under the said mortgage deed the borrower covenanted to reply the loan with F interest at 16.5% per annum. The borrower further agreed that he would pay the interest at the end of each calendar month and in case of default he would pay overdue interest. This was followed by the execution of a promissory note on 7th November, 1975 for Rupees five lacs repayable on demand with 16.5% interest per annum, with quarterly rest. The borrower did not dispute the execution of the aforesaid documents but contended G that the amount actually borrowed under the mortgage was only Rs. 4,00,000 but the bank had added Rs. 1,00,000 as interest due from him under the earlier advance which included compound interest and penal interest. He stated that the promissory note was executed as a collateral security. Lastly, he contended that the interest charged was excessive and H hence he was entitled to the protection of the Mysore Act. In his oral

evidence he deposed that in 1975 further loan was sanctioned and a mortgage deed for Rs. 5,00,000, (comprising Rs. 4,22,000 actual loan plus Rs. 78,000 interest) was obtained from him. He deposed that Rs. 78,000 was added to the principal amount even though there was no agreement to that effect. This shows a deviation from his version in the written statement in the suit. The trial court, therefore, was disinclined to place reliance on his version. On the question of interest on the loan advanced it was noticed that under the promissory note Exh. P-1 dated 26th November, 1973 he had agreed to pay interest at 12% per annum with quarterly rests and thereafter under the mortgage deed of 10th October, 1975 he undertook by clause 3 to pay interest at the end of each calendar month failing which he agreed to pay overdue interest. However, under the promissory note dated 7th November, 1975 he agreed to pay interest at 16.5% with quarterly rest. The trial Court also held that since he had admittedly not paid any interest on the overdraft as agreed under terms of the promissory noted dated 26th November, 1973 till the date of the execution of the mortgage deed, the Bank was perfectly justified in adding the outstanding interest of Rs. 78,000 to the actual loan amount to constitute the principal or mortgage money. The calculation of interest due on the overdraft facility at the specified rate with quarterly rest perfectly justified as the relationship of banker and customer subsisted till the date of the execution of the mortgage deed. After the relationship changed to mortgagee and mortgagor on the execution of the mortgage deed, interest had to be charged as agreed under the terms of the mortgage which was 16.5% per annum to be paid monthly failing which the Bank was permitted 'overdue interest'. The learned trial judge rightly notes that if interest is charged with monthly rest under the mortgage instead of quarterly rest as claimed the same would prove disadvantageous to the borrower. On the question of the transaction being 'unfair' or the interest being 'excessive' the learned trial judge points out that the borrower who is a graduate, an ex-MLA and a man of repute (as claimed by him), would have objected to the same if it were so and would not have acquiesced in it till the suit was commenced against him. The trial judge thus brushed aside the defence version and ordered a preliminary decree to be drawn up. Future interest was allowed under Section 34 of the Civil Procedure Code at 16.5% on the sum decreed, i.e., Rs. 7,56,934.17.

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On appeal the Division Bench, in the light of the submissions made at Bar, formulated two questions extracted earlier for determination and, H

A after considering the relevant statutory provisions governing banks, the structure of the Reserve Bank of India with its power of superintendence and control over all banking institutions including the directive and circulars issued by it, concluded that the ordinary practice or custom of banks was only to charge interest with yearly or half yearly rests and that too only on overdrafts and unsecured loans. The High Court, however, inferred that
B the monthly or quarterly rests do not appear to be the recognised banking practice. It, however, noted that some banks might have charged interest with quarterly rests or monthly rests on some transactions but it could not be said that there existed a generally accepted or universally followed banking practice to charge interest accordingly. On the circulars/directives
C of the Reserve Bank the High Court observed that the Reserve Bank had not paid 'adequate attention' to the question of "rests" or the compound interest to be charged by banks on loans, advances and other facilities except to those connected with agriculture. It is obvious from the above that the High Court fell into two errors. Firstly, it failed to recognize that
D as under common law there was no right to charge even simple interest on overdrafts the claim for interest had to be supported on the ground of universal custom of bankers or on the basis of implied agreement. This would be so in case where there is no agreement between the banker and the customer in regard to the payment of interest but where the loan or advance is made on certain terms reduced to writing, the parties would be
E governed by those terms and there would be no question of falling back on practice or custom. Besides, we have already pointed out earlier that Paget's opinion and the statement of law in para 160 of Halsbury clearly show that it has been the practice of bankers to debit accrued interest to borrowers' account at regular periods usually half yearly. The High Court
F notices that banks in India were not following a uniform practice and some banks charged interest with monthly or quarterly rests while others charged with yearly or six monthly rests and hence the Reserve Bank had to issued directives to bring about uniformity in that behalf. What is important is to realise that the normal practice was yearly or half yearly rests but shorter rests also prevailed. Secondly, the High Court was wrong in going behind
G the circulars/directives of the Reserve Bank on the plea that the Reserve Bank did not pay 'adequate attention' to the question of rests or compound interest to be charged from borrowers other than agriculturists. As pointed out earlier, under the Banking Regulation Act wide powers are conferred on the Reserve Bank to enable it to exercise effective control over all
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banks. Sections 21 and 35A enable it to issue directives in public interest to regulation the charging of interest on loans or advances made from time to time. It is in exercise of this power that it issued the circulars referred to earlier fixing the rates of interest to be charged from borrowers. The Corporation Bank was nationalised with effect 11th July, 1980. Since the suit in question was filed in 1978 it was governed by the said guidelines which prescribed a minimum rate of 12.5% per annum. Any bank which committed a breach of the directives was liable to be penalised under section 47A. A bank could ignore the directive on pain of being penalised. Therefore, before issuing guidelines or directives the Reserve Bank must be taken to have given serious thought to the nature of directives to be issued. The Reserve Bank Governor's letter dated March 12, 1976, shows that it was to bring about uniformity that the banks were advised to charge interest with quarterly rests because some banks charged interest with half yearly or yearly rests, some others charged the same on monthly or quarterly basis. It is also evident from the circulars or March 13, 1976, February 28, and September 15, 1984 that the Reserve Bank not only provided that interest may be charged with quarterly or longer rests but also provided the maximum rate of interest that could be charged. The Reserve Bank, therefore, not only desired to bring about uniformity but also controlled the rate of interest. It is, therefore, difficult to appreciate how it can be said that no rational policy could be discerned from the aforesaid directives of the Reserve Bank.

The High Court has next observed that the Reserve Bank did not pay 'adequate attention' to the question of rests or compounding of interest. In the view of the High Court even though the banking policy had been completely reoriented after nationalisation yet the evil practice of quarterly rests had resisted all reform. It hoped that the Reserve Bank would fall in line with the universal banking practice of charging half yearly or yearly rests. True it is that while the universal banking practice is usually to charge interest with half yearly rest, there is nothing to prevent the practices from agreeing to quarterly rest and such an agreement would be perfectly valid unless it is shown to be opposed to public policy. The reasons why it became necessary to enact the Usurious Loans Act, 1918, and similar State legislations was to relieve the debtor from exploitation by empowering the courts to grant relief if the interest charged is excessive rendering the transaction substantially unfair. Such laws would not have been necessary if an agreement providing for excessive rate of interest was *per se* violative

A of section 23 of the Contract Act. Besides it is difficult to say that the Reserve Bank did not pay adequate attention to the question of "rests" when it is evident from the directives referred to earlier that it was the precise question of bringing about uniformity in that behalf to which the Reserve Bank addressed itself. The High Court has not put down the policy but has merely condemned it. Unless the directives lying down the said B policy are declared illegal and unenforceable Banks would be bound to follow them for otherwise they would be penalised. We, however, find it difficult to agree that adequate attention to the question of 'rests' was not paid by the Reserve Bank.

C The real question, therefore, is whether the charging of interest at 16.5% per annum with quarterly rests is so obnoxious as would attract the provisions of the Usurious Loans Act, in this case the Mysore Act. Section 3(1) indicates that if in any suit the court has reason to believe that the transaction in question was substantially unfair the court may reopen the transaction provided that if shall not reopen any agreement purporting to D close previous dealings and to create a new obligation entered into by the parties. Explanation I says that if the interest is 'excessive' the court shall presume that the transaction was 'substantially unfair' but the said presumption could be rebutted by proof of 'special circumstances' justifying the rate of interest. Clause (a) of Explanation II says that the term E 'excessive' means in excess of what the court deems to be reasonable having regard to the risk incurred by the creditor while advancing the loan. Clause (d) of that Explanation further provides that in considering whether the transaction was 'substantially unfair' regard shall be had to the various factors set out therein. Therefore, before the Court can direct reopening of the transaction it must have reason to believe that the transaction is F substantially unfair as the interest charged is excessive. If compound interest is charged from agriculturist a presumption of the transaction being unfair can arise which can be rebutted. If it is shown that the transaction in question is substantially unfair and the court must reopen the same, the question may arise whether the newly added Section 21A to the Bank G Regulation Act bars such an enquiry. It may be mentioned that this provision was inserted after the High Court's judgment and, therefore, the view of the High Court on this point is not available. It may also have to be considered if Section 21A would apply to pending proceedings like the present one.

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Now on the question of unfairness of the transaction, the High Court rejected the Bank's contention that the obligation to follow the Reserve Bank guidelines/directives constituted a 'special circumstances' within the meaning of Explanation I. So also the High Court rejected the contention that the provisions of the Mysore Act cannot apply where the creditor is a bank supervised and controlled by the Reserve Bank. The High Court then held that there was no warrant for charging interest with monthly as well as quarterly rests. The High Court examined the interest rates on deposits as well as the Bank Rates and concluded that the reasonable rate would be 12.5% per annum with annual rests. Penal interest was refused on the ground that the mortgage-deed did not provide for it.

The point boils down to whether interest rate of 16.5% per annum with quarterly rest on a secured loan can be said to be so excessive as to render the transaction substantially unfair? Now, as we have pointed out earlier, the said rate of interest with the duration of the rest was prescribed and claimed consistently with the Reserve Bank directions. Having regard to the powers and functions of the Reserve Bank to which we have drawn attention, can it be said that interest rates prescribed by the Reserve Bank with the minima and maxima fixed, are unfair particularly when they have been fixed in public interest? Can the Court have reason to so believe? Do the facts of the case warrant a conclusion of the interest rate being excessive? The term 'excessive' is a relative terms; what may be excessive in one case may not be so in another. Much will depend on the circumstances obtaining at the material date. In our view if the Reserve Bank, keeping in view the economic scenario of the country and the impact that interest rates would have on the economy, fixes the minimum and the maximum interest rates that banks can charge on loan/advances, the same cannot be termed to be unreasonable or excessive and would, in any case, amount to a 'special circumstances' within the meaning of the Explanation to section 3(1) of the Mysore Act. In the present case the borrower did not specifically contend in his written statement that the interest charged was excessive but merely contended that the Bank was not entitled to quarterly rest and hence the claim made in the plaint on that basis was not admitted. Secondly he had shifted ground on what was the principal sum an interest which went to make the total of Rs. 5,00,000. Admittedly he had not paid a farthing towards the loan interest till the date of execution of the mortgage. This shows he was a bad pay master. The property was still under construction and did not yield any income at the date of the

A mortgage and so it could not be said that the security was sound. True it is that is re-examination he came out with a statement that the property was worth Rs. 20-25 lacs. But the value of the property at the date of the mortgage is relevant for which there is no evidence. The benefit of the rise in value will ensure to the borrower but that subsequent fact cannot help in evaluating the risk factor at the date of the mortgage. Admittedly at no point of time, not even at the time of confirmation of balance, did he protest that the interest charged was excessive. He went to the length of saying 'even now I cannot say what is excessive interest'. That is because he never bothered to repay any part of the loan nor did he attempt to pay interest. He was totally indifferent. He led no evidence to show that the prevailing market rate was lower than the interest charged by the Bank. Nor is it shown that any other bank would have charged less. There is no mention of deposit rates, etc., in his written statement or oral testimony on which the High Court has based its opinion. The learned counsel for the bank was justified in contending that the decision of the High Court is based on no evidence since the borrower did not lead any evidence and if he had done so the Bank would have led evidence to rebut the same.

The track record of the borrower was poor. Till 1975, admittedly, he had not paid a single paisa by way of instalment or interest. Presumably because he was an influential person, the bank granted him further indulgence on his agreeing to execute a mortgage. Till that date the building was not complete and did not yield any income. In the circumstances the Bank was justified in being cautions. The guidelines issued by the Reserve Bank permitted a maximum interest rate of 16.5% per annum with quarterly rests. The fluctuations in the rates of interest between 1973 and 1975 on borrowing in the mercantile community is not on record. There is also no evidence on record as to the rate at which loans could be had in 1975 on the security of immoveable property in the open market. The High Court has concluded that the rate of interest charged was excessive solely on the basis of rates of interest allowed by Banks on deposits and the interest charged by the Reserve Bank on borrowings by banking institutions. The High Court concludes as under :

> "It is thus seen that as on today banks get advances from the Reserve Bank at 10% and pay the interest on deposits not more than 10% for deposits of three years and above."

On this finding the High Court thought that 12.5% interest with annual rest from the date of equitable mortgage would meet the ends of justice. The learned counsel for the Bank pointed out that since no evidence was led in this behalf the Bank could not draw the attention of the High Court to the fact that out of every hundred rupees mobilised as deposit by Banks, 7% has to be deposited with the Reserve Bank of India free of interest, 35% has to be invested in the form of cash and Government securities (Government securities yield a low rate of simple interest), 10% has to be compulsorily lent to the Food Corporation of India carrying interest at 12.5% per annum and the remaining 48% becomes available to the Banks for lending purposes out of which 40% goes to priority sectors which yield interest at 10.5% to 11.55 per annum, 1% has to be compulsorily lent to members of the weaker sections at simple interest of 4% per annum under the DIR Scheme and the balance has to be utilised in other sectors. Thus the cost of acquisition to funds by Banks average at 12% per annum and if the High Court judgment is upheld the Bank will earn 0.5% only. The learned counsel pointed that if the Bank had an opportunity to place these facts before the High Court, the High Court would not have sliced down the rate of interest to 12.5% as it did by the impugned judgment. It was further contended that the rate of interest prescribed by the Reserve Bank take into consideration the true financial and economic policy of the country and operate as bench-makers against which private lending parties are supposed to adjust and compare their own rates of interest and, therefore, the court should ordinarily show reluctance to interfere in such matters as it may have the effect of disturbing the economic policy meticulously framed and implemented in the country. We find considerable substance in this line of reasoning, particularly where the minima and the maxima are prescribed by the Reserve Bank.

The second limb of the argument was that the provisions of Usurious Loans Act would have no application as fixation of rates interest is governed by the special law, namely, Banking Regulation Act which must prevail over the former. To put the matter beyond the pale of doubt section 21A came to be introduced in the Banking Regulation Act to clarify that the provisions of the Usurious Loans Act would have no application to transactions between a Banking Company and its debtor on the plea that the rate of interest charged is excessive. It is not necessary for us to go into

A the question whether the provisions of the Banking Regulation Act would prevail or whether the newly added section 21A would apply to pending cases as on the facts stated hereinbefore we are satisfied that the High Court fell into an error in holding that the rate of interest on the mortgage is question was excessive.

B Insofar as Civil Appeal No. 544 of 1986 is concerned it relates to the bank's right to charge compound interest i.e. interest with periodical rests on agricultural advances. We have already referred to the various circulars issued by the Reserve Bank from time to time in exercise of power conferred by section 21/35A of the Banking Regulation Act. We have C pointed out that the said circulars/directives provide that agricultural advances should not be treated on par with commercial loans insofar as the rate of interest thereon the concerned because the farmers do not have any regular source of income except sale proceeds of their crops which income they get once a year. The question of recovery of interest with quarterly or D six monthly rests from farmers is, therefore, not feasible. The fact that the farmers are fluid at a given point of time every year has to be kept in mind in determining the point of time when they should be expected to repay the loan or pay the instalment/interest on advances. Therefore, to allow the banks to charge interest on quarterly or half yearly rests from farmers E would tantamount to virtually compelling them to pay compound interest, since they would not be able to pay the interest except once in a year i.e. when they receive the income from sale proceeds of their crops. The Reserve Bank has shown concern for the farmers by directing all banking institutions to so regulate the recovery of interest as to coincide with the point of time when the farmers are fluid. It has, therefore, been emphasised F by the Reserve Bank that interest should be charged once a year to coincide with point of time when the farmer is fluid and interest on current dues should not be compounded although it may be done when the advance/instalment becomes overdue. Thus according to the circulars/directives, so far as loans for agricultural purposes are concerned, G at best interest may be charged with yearly rests and may be compounded if the loan/instalment becomes overdue. In the present case, since interest was charged with six monthly rests that was clearly in contravention of the Reserve Bank circulars/directives. Compounding of interest on current dues on agricultural advances having been discouraged, the Bank was not

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entitled to charge interest with shorter periodical rests and compound the same. The Bank could add interest outstanding to the principal and compound the interest when the crop loan or terms loan becomes overdue having regard to the tenor of the circular dated March 14, 1972. The High Court was, therefore, fully justified in coming to the conclusion that the Bank was not entitled to charge interest with half yearly rest.

The learning counsel for the Bank, however, invoked section 21A of the Banking Regulation Act introduced by Act No. 1 of 1984. We have already extracted the said provision in the earlier part of this judgment. Under the said provision a transaction between a Banking Company and its debtor is not liable to be reopened by any court on the ground that the rate of interest charged by the Banking Company in respect of such transaction is excessive, the provisions of the Usurious loans Act, 1918 and similar State laws notwithstanding. In *Krishna Reddy* v. *Canara Bank*, AIR (1985) Karnataka 228 it was observed as under :

> "The mandate of this section is that Court cannot re-open the account relating to a transaction between a Banking Company and its customers on the ground that the rate of interest charged, in the opinion of the Courts, is excessive or unreasonable. The Courts, in other words, cannot exercise jurisdiction under the Usurious Loans Act or any other law relating to indebtedness for the purpose of giving relief to any party, This appears to be the intent of the Legislature in enacting the Banking Laws (Amendment) Act. 1983."
>
> Section 21A has, however, no bearing on the jurisdiction of Courts to give relief to an aggrieved party when it is established that the Bank in a particular case has charged interest in excess of the limit prescribed by the Reserve Bank of India."

Therefore, according to the High Court if, in any case, it is shown that the Bank was claiming interest in excess of that permitted by the circular/direction of the Reserve Bank, the Court could give relief to the aggrieved party notwithstanding section 21A to the extent of interest charged in excess of the rate prescribed by the Reserve Bank. A distinction must be drawn between court's interference on the premise that the interest charged is excessive and court's interference on the premise that the interest charged

A is in contravention of the circulars/directions issued by the Reserve Bank. These circulars/directions having been issued under section 21/35A of the Banking Regulation Act would have statutory flavour. In the judgment impugned in this case the Division Bench of the High Court summed up thus :

B

> "The Courts cannot re-open any account maintained by Banks relating to transaction with its customers on the ground that the rate of interest charged, in the opinion of the Courts, is excessive or unreasonable. Section 21A of the Banking Regulation Act is a restraint on such power of Courts, However, in any case, if it is
> C proved that the interest charged by Banks on loans advanced is not in conformity with the rate prescribed by the Reserve Bank then the Court could disallowed such excess interest and give relief to the party notwithstanding the provisions of Section 21A. Banks are bound to follow the directives or circulars issued by the
> D Reserve Bank prescribing the structure of interest to be charged on loans and any interest charged by Banks in excess of the prescribed limit would be illegal and void. Banks cannot charge compound interest with quarterly rests on agricultural advances."

E We are in respectful agreement with the above interpretation place on section 21A of the Banking Regulation Act. We must, however, clarify that we should not be understood to be expressing any opinion whatsoever on the question whether section 21A would debar the courts from interfering if the circulars/directives issued by the Reserve Bank do not fix the
F maxima and leave to the discretion of the Banks to determine the rate of interest above the minimum fixed. To put it differently if under the Reserve Bank circulars/directives the minimum rate of interest is fixed, say 12.5% without a ceiling, leaving it to the discretion of each Bank to fix a higher rate of interest at its sweetwill above 12.5%, a question may arise whether the interest fixed by the Bank is excessive and unconscionable and whether
G in such situation section 21A would debar the court from reducing the rate of interest to a reasonable limit. We do nor express any opinion on this question as the same does not arise in the present case. But if the Reserve Bank has fixed the maximum rate of interest in exercise of the powers conferred by section 21/35A of the Banking Regulation Act, section 21A
H would be attracted and the transaction would not be liable to be reopened

on the ground that the rate of interest fixed is excessive even though not exceeding the ceiling determined by the Reserve Bank. In the case of agricultural loans/advances the position has been made amply clearly by the circulars referred to earlier which do not permit Banks to charge compound interest with quarterly rests. In such cases as observed earlier the interest can be fixed with annual rests coinciding with the time when the farmer is fluid and if thereafter the farmer fails to pay the interest it would be open to compound the interest on the crop loan or instalments upon the term becoming overdue. In view of the above we do not see any flaw in the reasoning of the High Court so far as this appeal is concerned. We, therefore, must dismissed the appeal.

In the result Civil Appeal No. 4214 of 1982 is allowed and the decision of the High Court is restored, with this modification that the post-decree interest shall be calculated at 12.5% per annum. In the facts and circumstances of the case we make no order as to costs. Civil Appeal No. 544 of 1986 is, however dismissed with cost.

SLP (C) No. 16444/92

The grievance of the respondent-association in the High Court related to charging of compound interest on loans given to its members for the purchase of tractors.

The Division Bench of the High Court of Orissa presided over by the then learned Chief Justice held that the agreement entered into by the Bank with the borrower did not stipulate the payment of compound interest and hence it was unnecessary to examine if there existed such a stipulation, the same would have been enforceable by the Bank. See paragraph 13 of the judgment. It is true that in the body of the judgment reference has been made to the case of *Bank of India* v. *Karnam Ranga Rao*, AIR (1986) Karnataka 242 and it is observed that since farmers do not have regular source of income other than sale proceeds of their crops, and receive the sale proceeds annually, they cannot be expected to have agreed to pay interest with periodical rests. In paragraph 8 of the judgment the High Court has observed :

> "The present, therefore, is a case which would make the finding of the Karnataka High Court relevant insofar as the policy circulars

A of the Reserve Bank of India are concerned."

But the High Court ultimately decided in favour of the borrower because in its view the agreement did not provide for periodical rests nor did it stipulate for payment of compound interest, making the above quoted observations *obiter dicta.* In that view of the matter, we see no reason to B interfere as the decision does not ultimately rest on the aforequoted view based on the Karnataka High Court decisions. We may incidentally say that we have today by a separate judgment dismissed the Bank's appeal against the said decision. We dismiss this petition on the short ground that the agreement on which the Bank's claim is founded does not provide for C payment of compound interest or interest with periodical rests.

R.R. CA. Nos. 4214/82 allowed.
CA. No. 544/86 and SLP (C) No. 16444/92 dismissed.