

PENALTY INTEREST, INTEREST ON ARREARS, DEFAULT CHARGES

There is no quarrel with the HFCK charging interest on arrears at the mortgage interest rate. However, the enhanced interest rate applied on arrears by HFCK is not contractual.

The charge document only allows HFCK to vary the mortgage interest rate. It does not allow HFCK to charge penalty interest, default charges and interest on arrears at an interest rate higher than the mortgage interest rate.

HFCK has a contractual right to vary the normal mortgage interest rate PROVIDED that they first advise the mortgagor of the proposed increase and obtain either the mortgagor's acquiescence, or the mortgagor's refusal to accept the changed terms, say by writing a cheque in full and final settlement. This is the practice that should be encouraged by the court so that mortgagors are not caught in a vicious cycle of debt where they enter on favourable terms and are then trapped into penury. The court should uphold the right of the borrower to engage the lender on any change of the fundamental term of a borrowing contract – interest payable.

Does HFCK have a contractual right to vary the mortgage interest rate and apply an enhanced 'penal' interest rate on arrears, or some default charge? We think not. It is ok to vary the mortgage interest rate subject to giving notice to the mortgagor. It is NOT ok to begin levying arbitrarily set penal interest rates. HFCK levying an extra 1.5% per month is the same as levying an extra 18% per year over and above the normal mortgage interest rate! Further, the levying of penalty interest, howsoever described, is not one of the remedies provided for under the respective legal charges and under the respective loan documentation for any breach of contract on the borrower's part. IRAC's understanding of HFCK's options on default of prompt monthly repayment is that HFCK is entitled to call in the entire mortgage debt and/or exercise their statutory power of sale. This is the reason why IRAC does not think that HFCK can arbitrarily re-write the contracts and proceed to impose a higher financial burden on mortgagors in the manner that they do with "penalty interest", "interest on arrears" and "default charges".

On whether HFCK is entitled to charge higher interest to compensate it for increased administrative costs and enhanced risk of non-payment etc? IRAC's answer is as follows;

- (a) The method of calculating interest on monthly rests (reducing balance method) automatically gives HFCK interest on arrears at the mortgage interest rate. This is what defaulting borrowers must be taken to have agreed under the loan documentation and under the legal charges.
- (b) When mortgagors default in making prompt repayments at the end of the month or stated period, HFCK calculates a higher interest than they would otherwise have calculated due to the method of calculating interest above. The mortgagor pays more automatically due to the method of calculating interest when they default.
- (c) HFCK is therefore already compensated under the loan documentation and under the legal charges for default in prompt repayment.
- (d) What is denied is that HFCK can arbitrarily impose a higher interest rate on the arrears. This is not provided for in the loan documentation, is not provided for in the legal charges and is not allowable as a trade custom or usage because the loan documentation and legal charges are COMPLETE on what happens when there is default. The contracts do not need to be supplemented. Even if they do, such supplementation cannot be by unilateral decisions by one party to the contract. Proof is that HFCK mortgagors cannot be taken to have agreed that HFCK could unilaterally, arbitrarily and without any consultation apply enhanced penalty interest.
- (e) HFCK is already satisfactorily compensated. They get interest on arrears at the mortgage interest rate. They should be satisfied with this not only because it is fair, but also because it is what is provided for in the loan documentation and in the legal charges. This is their contract with the mortgagors. Anything else is a unilateral re-writing of the contract with the mortgagors.

The defence taken by HFCK to justify this unilateral and arbitrary variation of the applicable interest rate is that the practice is backed by "trade usages and customs". IRAC's considered opinion is that:

- This amounts to no more than unilateral (and arbitrary in nature) re-writing of a complete contract that already specifically provides for and sets out the events and consequences of default.
- The contractual terms as contained in the "Offer to Advance" and Legal Charge are complete and exhaustive on what is to happen in the event of default. Consequently, they do not need to be supplemented by "trade

customs and usages”, especially when these are applied unilaterally, arbitrarily and when they serve only to profit one party. In any event,

- An implied trade usage or custom may be incorporated into a contract so long as the custom is not inconsistent with the express terms of the contract, or with terms necessarily implied in the contract otherwise than by custom. In cases of such inconsistency, the custom is said to be ‘unreasonable’. Where the custom is ‘reasonable’ the parties are bound by it whether they know of it or not. Any express term overrides a term that might be implied by custom.

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