

COMPETITION COMMISSION OF INDIA

Case No. 15 of 2009

DATE - 21.03.2011
Informant

Shri Surinder Bhakoo
Chandigarh

Vs:

The HDFC Bank Ltd., Chandigarh
The HDFC Bank Ltd., Mumbai

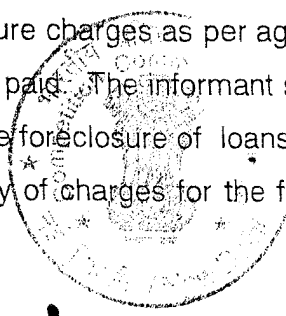
Opposite Parties

ORDER

Per R. Prasad, Member (dissenting):

Order under Section 27 of the Competition Act.

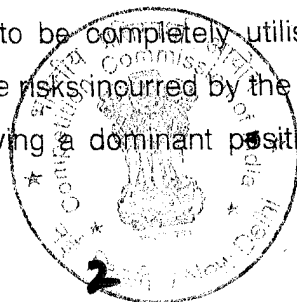
Shri Surinder Bhakoo submitted an information under Section 19(1) of the Competition Act that an agreement which were entered with HDFC Bank Ltd. was in violation of Sections 3(1), 3(2) and 19(b) of the Competition Act. The Informant also stated that the Bank was abusing its dominant position, as it was not accepting payment in accordance with the payment schedule given to the informant. Shri Bhakoo, therefore, wanted the foreclosure charges levied by the bank should be directed to stay. The facts of the case are the informant had obtained a loan of Rs. 15 Lacs at 10.91% interest for the purchase of a vehicle for the period of 5 years which started on 06.03.2009. A BMW car was purchased by the Informant. The informant had certain fixed deposits receipt yielding 12% interest. The interest on the deposits was reduced to 7-8% due to a fall in the interest rates. The informant wanted to reduce his interest liability for the auto loan by making payment out of his fixed deposits. The Informant approached the bank but the bank did not respond. On 5th November, 2009 the informant made a payment of Rs.13,11,561 being the outstanding amount against the auto loan. The cheques in respect of payment of Rs. 13,11,561 were returned by the bank to the informant. The bank also advised the informant by e-mail that foreclosure charges as per agreement dated 24.02.2009 amounting of Rs. 91,602/- has to be paid. The informant stated that the nationalised banks did not levy any penalty for the foreclosure of loans. It has been stated by the informant in his petition that the levy of charges for the foreclosure of the loan was



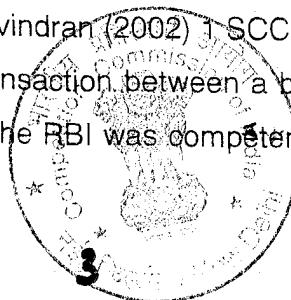
illegal, arbitrary and an unfair trade practice. It has been prayed that the loan agreement dated 24.02.2009 should be declared null and void as it was an agreement which had an appreciable adverse effect on competition under Section 3 of the Competition Act, 2002. It was also argued that as per the payment schedule given to the informant should be the basis for the foreclosures of the loan. It was also stated that the Commission may issue a stay order to restrict the bank from the recovery of any amount from his account in the Punjab National Bank. The informant has also asked for compensation from the bank for creating mental agony and harassment.

2. The Commission after considering the information received formed an opinion that a prima facie case existed in this case under the Competition act. The Commission therefore directed the DG under Section 26(1) of the Act to investigate the case.

3. A notice was given by the office of D.G. to HDFC Bank from whom the loan was taken. A copy of the loan agreement and total amount of the loan given by the bank was submitted to the D.G. As per Paras (3) to (6) of the loan agreement the Bank was entitled to levy prepayment charges for the foreclosure of the loan and the vehicle in question was hypothecated to the bank. It was also stated that the informant had availed loan of Rs.15.0 lacs from the bank and it was stated that a similar case was with the D.G. and was under investigation i.e. Neeaj Malhotra vs. Deutsche Post bank Home Finance Ltd. In this case the bank was one of the respondents. It was argued in the objections that the arguments taken in that case of home loan in respect of penalty for foreclosure of loan should be considered in this case. It was further argued that the practice of levying pre-payment charges was an industry practice and that customers themselves voluntarily opted to pay the prepayment charges. It was argued that the charges levied were to cover the expenses incurred on the cost of sanction, booking and maintaining the loan account. It was further considered that the pre-payment for the foreclosures of loan was not for the purpose of profit. It was further stated that the banks were required to ensure asset-liability match and to adhere to regulatory norms. It was stated that when a loan was prepaid there was a tenure of the loan and the fund expected to be received by the bank had to be completely utilised. Therefore, pre-payment charges are levied to protect the risks incurred by the bank. It was further stated that the bank in question not enjoying a dominant position in the market. It was also



stated that the pre-payment penalty was only on the outstanding amount. It was stated that the levy of penalty was in accordance with the circulars of the RBI which gave full freedom to banks to run the bank. It was further stated that the action of the bank in levying pre-payment charges does not impose any unfair or discriminatory condition on the sale or purchase of goods or services. It was argued that neither Section 3 nor Section 4 of the Act were violated. It was stated that the pre-payment charges in the loan agreement did not credit any hindrance for any perspective player to enter or the existing player to exit from the market. It was also stated that this practice was followed by the banks since the day auto loan market was created. It was further argued that this case should be linked with the case of Neeraj Malhotra. It was also argued that the interest paid by a borrower was covered by the Banking Regulation Act and that the rate of interest levied by the bank would not be subject to scrutiny by the courts. It was also argued that the levy of the interest was regulated by the RBI and could not be the subject matter any proceedings on account of public interest litigation. It was considered that only an expert body with full data could examine the auto loan market and that the Commission was not such a body. This jurisdiction of the Competition Commission was challenged. Reliance was placed on the ratio laid down in the case of Bharathi knitting Company vs. DHL Worldwide Express Commission, Division of Airfreight Ltd. (AIR 4 SCC 704) which states that when a person signs a document which contains certain contractual terms, normally parties are bound by such a contract. It was also argued that a person who took a loan would not be a deprived class. It was further argued that the an executive authority could not exercise a legislative power by subordinate legislation which was in excess of the power conferred on it and therefore it was stated that the Commission was not entitled to look into this aspect. To support this view reliance was placed on the ratio in the case of State of J&K vs. A.R. Zakki 1992 supp (1) SCC 548: AIR 1992 SC 1546. Reliance was placed them on the ratio in the case of Union of India & Anr. Vs. Deoki Nandan Aggarwal (AIR 1992 SC 96). On the basis of this decision it was argued that there was no power with an authority to enlarge the scope of the legislation and that no words could be substituted to enlarge the legislation. It was stated that the courts could only decide what the law is and what it should be. The bank then relied on the ratio in the case of Central Bank of India vs. Ravindran (2002) 1 SCC 367 wherein it was held that the court could not reopen any transaction between a banking company and its debtor. It was further stated that only the RBI was competent to decide this issue. Reliance



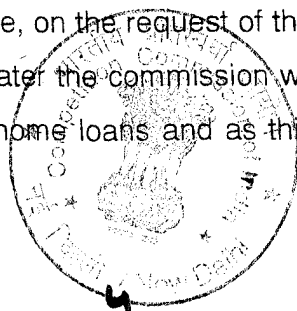
was then placed this on International cases. It was argued that international practice approved penalty for the prepayment of loans. In this connection Reliance was placed on the case of United States vs. Harris, 246 F.3d 566, 573(6th Cir.2001). It was argued that the banks as well as the borrower had fair idea of the transaction such as outstanding amounts. It was stated that if a person prepays a loan then no provision for extra funds was made and therefore if somebody prepays the loan the bank is a loser and for this reason the penalty was levied. It was further argued that the penalty levied was nominal and does not affect the lender. It was, therefore, argued that there existed a legal and a prudent justification for penalty for the foreclosure of loans.

4. It was further argued that there was no violation in the Competition Act. In fact it was stated that practice of charging pre-payment charges was not against competition. It was also argued that the practice does not violate the Section 3(3) of the Competition Act and therefore the findings of the DG appear to be erroneous. It was also stated that the DG had overlooked all the provisions of Section 19(3) of the Competition act. These replies were given after the report in the case of Neeraj Malhotra was submitted by the DG. In that case the issue was the pre-payment penalty for the foreclosure of the home loans. In view of submission given the bank argued that the case should be closed with no further directions.

5. The Director General considered the arguments of the bank. He found that the bank had demanded a penalty for the foreclosure of loans at 6% of the outstanding amount. The DG considered the facts of the case and the facts in the case of Neeraj Malhotra. Therefore, he recommended that as the issue involved was similar to that in the case of Neeraj Malhotra, the Commission may take its own view.

6. The Commission gave a hearing to the bank and the arguments raised before the DG were again submitted. It was further stated as the Commission had closed the case in the case of home loan i.e. Neeraj Malhotra vs. Deutsche Post Bank Home Finance the case being similar should be closed.

7. Incidentally in this case, on the request of the bank the case was clubbed with that of Neeraj Malhotra but later the commission was of the opinion that as the case of Neeraj Malhotra was on home loans and as this case was of car loan the cases



were dissimilar and could not be clubbed. Therefore this case was to be dealt separately.

8. Another view can be held that in this case that as this case is an individual case and no class action was involved, there is no case under the competition Law. There is no doubt that it is a case of a single complainant against a particular bank but according to the D.G. and the respondent the issue is the same as that in the case of neeraj Malhotra. I, therefore, agree that it is a single case but the issues involved here are one which is prevalent in the entire banking industry and is therefore the case is one of class action.

9. Before taking up the case it is necessary to discuss the auto industry in India. India has one of the fastest growing auto industry in the world. There is a pent up demand in this sector in India. Production of one auto leads to increase of employment of 5-6 persons which consists of production personnel, sales staff, transportation, driver, after sales mechanics, cleaners etc. The auto sales would be boosted if reasonable and cheap bank or institutional credit is made available to the buyers. Before taking an auto loan a buyer has to decide the model of the vehicle, his resources, his repayment capacity, the interest rate, switching costs etc. But his choice is affected by the information asymmetry. In any case, switching costs play a very important role in his decision especially when a person wants to foreclose his loan. Such switching costs also impede the growth of the market and stops lenders to come to the market with better and innovative products.

10. In this connection it is necessary to examine the concept of 'after market abuse' as explained by the U.S. Supreme Court in the case of Eastman Kodak Co. Vs. Image Tech. SVCS504 U.S. 451(1992). In this case, Kodak was the seller of photocopying machines. In the market of photocopying machines Kodak was not a dominant player. As far as the services and the repair market for the photocopiers was concerned, Kodak was initially selling the spares to various dealers who used to service the photocopiers and use the spares supplied by Kodak. Kodak found that some of these service dealers started developing their own spares to service the photocopiers and some of them used to give better service than Kodak themselves. Kodak therefore changed its business model and asked the equipment manufacturers to supply the equipment to it only. Kodak then used to sell the spares to those buyers of Kodak photocopiers who could service them themselves or used to service the photocopiers with spares in its own premises. In this manner, Kodak

had had 100% control over the entire spares and around 85% of the service itself. Thus many of the earlier Kodak dealers who used to service the Kodak photocopiers were driven out of business. These dealers filed any antitrust case against Kodak. The District Court ruled in favour of Kodak the dealers took the case in appeal to the court of Appeals for the Ninth Circuit. The court of appeals held that Kodak's approach was anticompetitive, exclusionary and involved a specific intent to monopolise. Aggrieved against the judgement of the Court of appeals Kodak went to the Supreme Court of the U.S.A.

11. The Supreme Court considered the facts of the case. In the opinion of the Supreme Court there were two markets i.e. a market of photocopiers where Kodak was not a significant player. The second market was described by the Supreme Court as an aftermarket and consisted of service after sales. In this after market, there was a tie in scenario as spares would be given with the service. The Supreme Court then relied on its own decisions on market power. In the case of Jefferson Parish 466 US at 14.9, Supreme Court had held that market power is power "to force a purchaser to do something that he would not do in a competitive market". In another case U.S. vs. E.I. du Point de Nemours & Co. 351 U.S. 377, 391(1956), the Supreme Court had defined market power as "the ability of a single seller to raise price and restrict output". The existence of such power is ordinarily inferred from the seller's possession of a predominant share in the market Jeffer Parish 466 US 17.1. The Supreme Court then held that in the aftermarket Kodak enjoyed monopoly power. The Supreme Court also held that a customer is "locked in" after the purchase of the equipment as the switching costs are high. The customer can then be subjected to abuse. The Supreme Court also held that it is a question of fact as to whether information costs and switching costs and switching costs foil the assumption that the equipment and service market act as a pure complement to each other. On these facts, the supreme Court held that the behaviour of Kodak was anticompetitive.

12. In this particular case, when Shri Bhakoo was going to take the auto loan, he was entering a competitive market where some of the players were not charging penalty for the foreclosure of loans. But due to information asymmetry, Shri Bhakoo chose HDFC Bank. At the time of taking the loan, Shri Bhakoo signed a contract where he agreed to the levy of penalty for the foreclosure of loan. As due to the clause of penalty, which worked as a switching cost, Shri Bhakoo became a locked

in customer. Considering the Kodak case (Supra), there are two markets in this case. The first market is the market where there were other players but Shri Bhakoo took the loan from HDFC Bank. The Second market i.e. the aftermarket or the loan recovery market where there was no competition as the loan had to be paid to HDFC Bank. Shri Bhakoo also could not migrate to another bank because of the high switching costs. The switching costs acted as an abuse also in the market for loan recovery i.e. the relevant market in the geographical territory of India especially as no such penalty was levied on over draft loan accounts by the bank.

13. Incidentally, in the case of Neeraj Malhotra (Supra) ~~where~~ I had given a dissenting judgement. Extract of my order is reproduced as under as they are relevant in this case (Pages 7 to 32)

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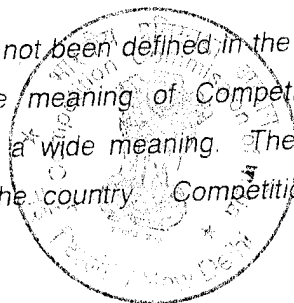
"14. After discussing the facts of the case, it is necessary to examine the provisions of the Competition Act. The preamble to the Act talks about:--

- (i) Establishment of a Commission to prevent practices having adverse effect on competition.
- (ii) To promote and sustain competition in markets.
- (iii) To protect the interests of consumers.
- (iv) To ensure freedom of trade carried on by the other participants in markets in India
- (v) Matters connected therewith or incidental thereto.

15. Section 18 of the Competition Act defines the duty of the Commission which are:

- (i) to eliminate practices having an adverse effect on competition.
- (ii) Promote and sustain competition
- (iii) Protect the interests of consumers
- (iv) Ensure freedom of trade carried on by the other participants in markets in India

16. Competition itself has not been defined in the Act. The reason could be that by defining Competition the meaning of Competition is restricted. Therefore competition has to be given a wide meaning. The purpose of competition is the economic development of the country. Competition leads to higher productivity



innovation, cheaper prices, freedom of choice and decreasing switching costs. Therefore practices which lead to decrease in productivity, innovation, higher prices, decrease of the freedom of choice and increasing switching costs may be classified as anti competitive or causing adverse effect on competition. It is the duty of the Commission to ensure freedom of trade, eliminate anticompetitive practices, promote and sustain competition and protect the interests of the consumers.

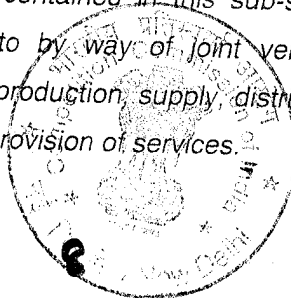
17. Section 3 of the Competition Act is reproduced and is as follows:-

Anti-competitive agreements

- (1) No enterprise or association of enterprise or person or association of persons shall enter into any agreement in respect of production, supply, distribution, storage, acquisition or control of goods or provision of services, which causes or is likely to cause an appreciable adverse effect on competition within India.
- (2) Any agreement entered into in contravention of the provisions contained in subsection (1) shall be void.
- (3) Any agreement entered into between enterprises or associations of enterprises or persons or association of persons or between any person and enterprise or practice carried on, or decision taken by, any association of enterprises or association of persons, including cartels, engaged in identical or similar trade of goods or provision of services, which –
 - (a) directly or indirectly determines purchase or sale prices;
 - (b) limits or controls production, supply, markets, technical development, investment or provision of services;
 - (c) shares the market or source of production or provision of services by way of allocation of geographical area of market, or type of goods or services, or number of customers in the market or any other similar way;
 - (d) directly or indirectly results in bid rigging or collusive bidding.

Shall be presumed to have an appreciable adverse effect on competition:

Provided that nothing contained in this sub-section shall apply to any agreement entered into by way of joint ventures if such agreement increases efficiency in production, supply, distribution, storage, acquisition or control of goods or provision of services.



Explanation – For the purposes of this sub-section, “bid rigging” means any agreement, between enterprises or persons referred to in sub-section (3) engaged in identical or similar production or trading of goods or provision of services, which has the effect of eliminating or reducing competition for bids or adversely affecting or manipulating the process for bidding.

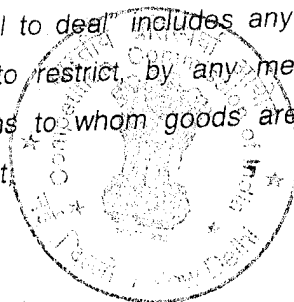
(4) Any agreement amongst enterprises or persons at different stages or levels of the production chain in different markets, in respect of production, supply, distribution, storage, sale or price of, or trade in goods or provision of services, including -

- (a) tie-in arrangement;
- (b) exclusive supply agreement;
- (c) exclusive distribution agreement;
- (d) refusal to deal;
- (e) resale price maintenance

shall be an agreement in contravention of sub-section (1) if such agreement causes or is likely to cause an appreciable adverse effect on competition in India.

Explanation – For the purposes of this sub-section –

- (a) “tie-in arrangement” includes any agreement requiring a purchaser of goods, as a condition of such purchase, to purchase some other goods;
- (b) “exclusive supply agreement” includes any agreement restricting in any manner the purchaser in the course of his trade from acquiring or otherwise dealing in any goods other than those of the seller or any other person;
- (c) “exclusive distribution agreement” includes any agreement to limit, restrict or withhold the output or supply of any goods or allocate any area or market for the disposal or sale of the goods;
- (d) “refusal to deal” includes any agreement which restricts, or is likely to restrict, by any method the persons or classes of persons to whom goods are sold or from whom goods are bought.

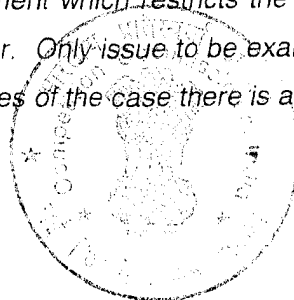


- (e) "resale price maintenance" includes any agreement to sell goods on condition that the prices to be charged on the resale by the purchaser shall be the prices stipulated by the seller unless it is clearly stated that prices lower than those prices may be charged.

The section consists of various parts. Sub Section (1) of Section 3 has wide ramifications. An agreement which causes appreciable adverse effect on competition in India in respect of production, supply, acquisition, control of goods and services is void as stated in subsection (2) of section 3 of the Act. Sections 3(1) and 3(2) do not deal only with the supply side of the market. A market works on the principle of demand and supply. The assumption here is that a consumer would make a decision to purchase or sell in a rational manner so as to maximize gains to it. If an enterprise deals with an individual by entering into an agreement which causes an adverse effect to competition in India would be hit by Sections 3(1) and 3(2) of the Act. Any other view would be a narrow view and not authorised by the Act.

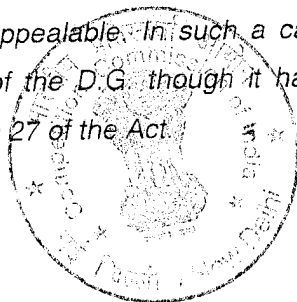
Section 3(3) of the Act is based on the concept of presumption. It is envisaged that if the factors as enumerated clauses (a), (b), (c) and (d) of Sections 3(3) exist then it would be presumed that there is an appreciable adverse effect on competition. No presumption is absolute as presumption can be rebutted. In the main section 3(3) of the Act, the behaviour of the persons or enterprises which are covered are agreements, practices carried on and decisions taken. Another aspect to be looked into is that the enterprises are engaged in similar trade of goods or provision of services.

Section 3(4) talks of an agreement between persons in a production chain in different markets in respect of production, supply, distribution, storage, sale or price of or trade in goods or provision of services. The Section has an inclusive definition which includes tie in arrangement, exclusive supply agreement, refusal to deal, exclusive distribution agreement and resale price maintenance. These five situations are not exhaustive and could include other situations. In any case exclusive supply agreement means an agreement which restricts the customer from buying goods or services from any other buyer. Only issue to be examined in Section 3(4) is whether on the facts and circumstances of the case there is an adverse effect on competition.



18. The next salient feature to be seen as to how the Act should operate. Under Section 16 of the Act, it is the duty of the Director General to assist the Commission to fulfill its obligation under Section 18 of the Act. It is not for the Commission to sit on judgement over the findings of the D.G. If the D.G. has not carried out proper investigation, the Commission can direct the D.G. to investigate the case on the issues to be directed by the D.G. It can inquire itself also. This is the scheme under Section 26(7) of the Act.

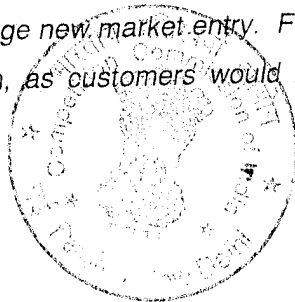
19. The procedure for inquiry has been laid down in Section 26 of the Competition Act. On the basis of own information or from any other source, the Commission can form an opinion that prima facie case exists it can direct the DG to carry out an investigation under the Competition Act [Section 26(1) of the Act]. If on the basis of information, the Commission forms a prima facie opinion that no case exists, it can close the case [Section 26(2)]. An appeal to the COMPAT lies against the Commission. Under Section 26(3) of the Act, the D.G. is required to submit his report to the Commission within the period specified. Under Section 26(4), the report of the D.G. is required to be forwarded to the parties concerned. Section 26(5) envisages a situation where the D.G. has not found a contravention of the Act. In such a case, the Commission is required to give a notice to all the parties and hear them. Under Section 26(6) of the Act, if the Commission agrees with the findings of the D.G. it can close the case by passing an order. This order under Section 26(6) is appealable. Section 26(8) talks of a situation where D.G. has found a contravention of the Act but the Commission finds that more enquiries are needed, it can carry out enquiries. No order dropping the case or penalizing the concerned parties can be passed under Section 26(8) of the Act because the section does not talk of an order as has been mentioned in sections 26(2) and 26(6) of the Act. It is implied in the Act when the Commission has formed a prima facie opinion under Section 26(1) of the Act and the D.G. has confirmed this prima facie view by investigation, the Commission cannot drop the proceedings. If it drops the proceedings it amounts to a recall of its orders passed under Section 26(1) of the Act. Further the legislative intent is clear. As discussed earlier no order under section 26(8) can be passed. If the intention of the legislature was to drop proceeding under section 26(8) then it should have mentioned that an order was required to be passed and the said order would have been appealable. In such a case, the Commission has to accept the recommendations of the D.G. though it has discretion to levy penalty of different types under Section 27 of the Act.



20. We also have to examine the economic considerations for the levy of penalty charged by the banks for the foreclosure of loans. We have to examine the economies of treatment of this phenomena of penalty for the foreclosure of loans in other countries. We also have to examine the home loan market in India and its contribution to the Indian economy and vice versa. We also have to examine whether the banks/financial companies are losers or gainers if their customers prepay their loans.

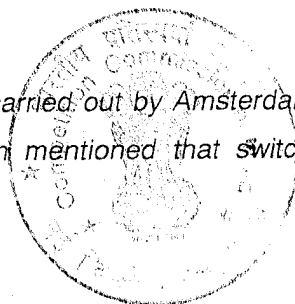
25. An economy would grow in the short run if consumer spending increases. If consumer spending increases the savings rate would go down. Savings rate increase in the long run may be beneficial but consumption spending in the short run is beneficial for the economy. Thus it is necessary to put surplus cash in the hands of the consumers. But the banks by having a prepayment fine on the consumers is decreasing the cash availability. Further, a cap has been put on the banks and other companies as far as housing loan is concerned. If a filip is given to housing by having cheap property prices and cheap loans, the housing industry would receive a boost. This in turn would lead to higher employment, higher industrial growth, higher growth of person income and increase of G.D.P.

26. It is therefore necessary that as India faces shortage of houses, the home loan market should be expanded. Mobility in the market for the customer should be encouraged. Competition in home loan banking is important in order to ensure an efficient banking industry and should not be viewed as dangerous to the banking sector. In fact in Norway mortgages are the main source of income for customers constituting 75% of the total income. In India as well as in various countries, the banks charge customers for terminating services. This reduces the mobility of customers. The ability of the customers to switch banks helps the competitors the benefits of a competitive banking market. Any obstacle which reduces customers' ability to switch banks will correspondingly reduce the competitive pressure on banks. High switching cost may result in increased bank market power and enable the banks to extract extra rent from the customers. High switching costs may also constitute barriers to entry as they make it harder for new entrants to attract customers and hence discourage new market entry. Further high switching cost may discourage product innovation, as customers would be reluctant to switch to new products and services.



27. The European Commission carried out a study of retail banking. Even the EFTA Authority had carried out a study of retail banking in the EFTA countries. The European Commission found potential competition concerns and consumer harm in some of the areas such as list of coordinated behaviour in the banks to the detriment of customer mobility through a non-transparent treatment of certain products such as mortgages. There are some economists who consider that banks form a big cartel but most of the economists are not of this view. The European Commission observed that the mortgages generated largest share of income in retail banking in European banks. It has also been stated in the said report that before customers change banks he considers all the factors which help him in switching banks. This would include switching costs also. It was also observed by the Commission that switching costs in the retail bank industry has three significant effects (i) it increases the bank market power and this leads the bank to discriminate between new customers and old customers. The bank would charge low charges to attract new customers and once the customers are locked, the banks would charge higher prices which may be in the form of switching costs. (ii) Switching costs served as an entry barrier because it does not allow switching to consumer to bank with cheaper and better product. If the switching costs are high it was uneconomic for new entrants in the market to induce customer to switching. (iii) The third aspect was it discourages product innovation. When a new product is introduced in the market due to innovation and the switching costs are low the customer would like to switch to the new product. But if the switching costs are high there would be no reward and no customer would like to switch. In the EFTA report it has been stated that in order to have the benefits of the competition in the banking sector the customers should be able to choose their banks. Any obstacle that reduces consumers' ability to switch banks would reduce the competitive pressure on the banks. If closing charges are charged by bank this would reduce the mobility of the customers. High level of switching cost in the banking industry results in increasing the bank market power and enables banks to extract extra rent form the customers. High switching costs also constitute barriers to entry as it makes harder for new entrants to attract new customers and hence it discourage new market entry. High switching costs also discourage product innovation as customers would be reluctant to switch to new products and services. The finding of the both European Commission and EFTA authority are similar.

28. A study was also carried out by Amsterdam Centre for Law and Economics. In this paper it has been mentioned that switching costs may be a reason for



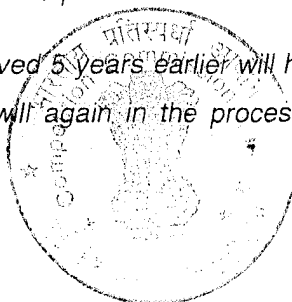
consumers' immobility as they remain locked-in one supplier. Switching costs also influence on behaviour as the firms should attract new customers by charge low prices and in order to exploit captured customers. The firms cannot discriminate between old and new customers due to high switching costs they have been giving incentives to keep their prices high and exploit their old customers instead of attracting new customers through lower prices. Therefore, it has been stated in the report that switching costs played an important role in consumers' decision. In another report the European Commission had analyzed the switching costs in the electricity market. In this report the Commission held that in the market of retail banking a policy of the mobility of the competitors has got to be followed.

30. In banking, asset and liability management is the practice of managing risks that arise due to mismatches between the assets and liabilities (debt and assets) of the bank. A corporation that wishes to acquire an asset must decide whether to pay cash, thereby reducing an asset, or take out a loan, thereby increasing a liability. The banks contended that due to the prepayment of the loans banks will be in a situation in which it will be difficult to manage the liabilities (saving accounts/fixed deposits/borrowing, etc.) of the banks. Further, the concern is also related with the depositors with the banks as they are being provided fixed interest rates on their deposits.

31. Although, through the pre-payment of loan, the principal money is repaid well in advance to the banks through foreclosure. Even if it has been paid through switching banks or availing loan by the other competitor banks, the bank foreclosing the loan will get their principal money returned well before the tenure and will provide opportunity to further pump in the market.

32. Concept of time value for money is well recognized in the financial market. As the money received today has better value than the same amount of money received in future. For example, Rs.100 of today's money invested for one year and earning 5 percent interest will be worth Rs.105 after one year. Therefore, Rs.100 paid now or Rs.105 paid exactly one year from now both have the same value to the recipient who assumes 5 percent interest; using time value of money terminology, Rs.100 invested for one year at 5 percent interest has a future value of Rs.105.

Accordingly a principal received 5 years earlier will have more value than received 5 years later, as the money will again in the process of generating interest through advances.



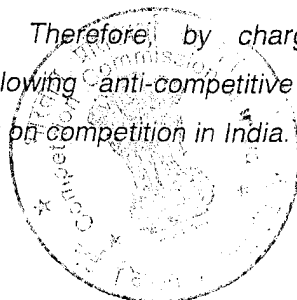
Further, the Equated Monthly Installments (EMI) is calculated in such a way that in the initial period of the payment, the component of the principal amount is very low and the interest portion is very high.

Suppose, if any customer wishes to foreclose the loan amount of 1 lakh in the 5th year which has been taken for 10 years at the rate of 10% per annum. The EMI of this will be Rs.16275/Annual. The EMI contains an interest component as well as a principal component. The interest component is always 10% of the balance - because the interest rate is 10%. The remaining amount is the principal repayment.

33. In view of the calculation of EMI and the 'time value for money' it is evident that banks are unreasonably charging foreclosure amount as the consumer is bound to pay more first in terms of interest portion in the initial months of the payments and later he is made to pay in terms of pre-payment charges, if he decides to foreclose for better options. As this practice is fleecing the consumers and also it is not generating any economic value to the development and restricting the consumer to exercise the right of freedom to choose better financial options for the loan.

34. Moreover, the practice of pre-payment penalty on loans is not helping the banks to be more service efficient and competitive on the interest rate being charged on loans to the existing customers as banks are sure of their secured customers due to the anti competitive agreement of pre-payment penalty.

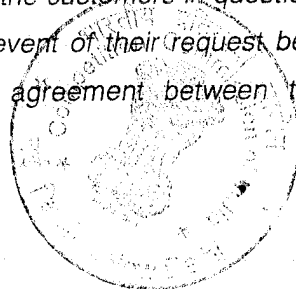
35. It is thus clear that the main aim of the banks or housing finance companies is to find the customers and not allow them to switch to other institutions. It also allows the banks to overcharge the customers as they are giving loans to new customers at lower rate of interest. Because of these facts, competition between the banks is killed and no new products would come and no innovation would be introduced. This practice also does not allow new banks/institutions with lower rate of interest to garner new business. Therefore, by charging pre-payment penalty, the banks/institutions are following anti-competitive practices which is having an appreciable adverse effect on competition in India.



36. Another argument which has been advanced is that if the customers prepay their loans what would the banks/HFCs do with the case which would be available with them. The market of home loan in India is very large and there is a very big shortage of houses in India. Further there is a cap placed on the banks as far as housing loans are concerned. The banks/HFCs would be in a position to loan the amount received as pre-payment to new loan creditors. This in turn would lead to construction of new houses or the purchase of new flats and would help in the economic development of India.

37. The housing loan market is a very secure market as the creditors which are banks/HFCs have the securities of the houses/flats to recover their loans. To spur economic activities and decrease the shortage of houses, the banks/HFCs have to increase the portfolio of the loans for homes. In India the home loan market constitutes a minuscule of the total loan given by the banks. The banks charge lower interest on large loans given to large industrial houses but they do not do so in the home loan market. When an industrial house is in financial trouble, the banks restructure the loans by waiving interest but it is not done in the case of home loans. Home loans are given in India in two forms. There is a fixed interest home loan and there is a floating interest home loan. In the case of floating interest, home loan if the interest rate rises, the home loan interest is raised by the banks and if the interest rate goes down, the interest on the home loan interest goes down. But in practice it is found that even when the interest has gone down, the banks have not reduced the interest. Thus, the banks/HFCs have been not very honest with their home loan customers.

40. A similar case came up before the French Competition Authority. In the year 2000, Couseil de la concurrence (French Competition Commission) found that several banks and institutions had entered into anticompetitive agreement in the sector of home loans. According to this agreement, the banks/institutions had reached an "inter-bank non-aggression pact" under which each of them refrained from making offers to customers of other banks who wished to renegotiate their property loans. Besides aiming to prevent competition between banks, this agreement enabled each of them to better resist requests by their own customers to renegotiate their loans, since the customers in question were subsequently unable to turn to another bank in the event of their request being refused. The Competition Commission held that this agreement between the banks constitutes an anti

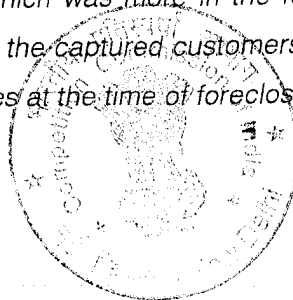


competitive practice and that was viewed seriously by all the competition authorities. It also ruled that banking activities are subject to competition law and that the competitive workings of the market are based on the independence and autonomy of the players involved. The authority held that because the agreement between the banks acts as barriers the consumers were deprived of the option of significantly reducing their property cost. The authority also hold that property represents the most substantial investment by households and the repayment of loans required for this investment accounts for 30% of their disposable income. Thus, disposable incomes of the household were decreased. For this reason economic development suffered and the markets were deprived of large amount of funds. The authority thereafter levied a fine of one hundred & fifty million on the banks.

41. In the background of the legal position and the fact of the case, we have to examine each and every argument which has been raised by the banks and HFCs before the Director General and the Commission. The first argument is that the Commission had no jurisdiction over banks as RBI is the regulator. This argument is without any basis as the jurisdiction over the competition issues is with the Commission and the regulation of banks / HFCs on other matters is with the RBI.

42. The second argument is that prepayment fines are more in the nature of unfair or restrictive trade practices and should be dealt with by the Consumer Courts rather than by the Commission. It was, therefore, stated that the Commission had no legal jurisdiction. No basis has been given as to how the issues under consideration are unfair and restrictive trade practices. This argument is therefore, without any basis. In fact, the issues here are ones which show that the banks/HFCs have created an adverse effect on competition.

43. The third argument taken is that the decision taken in the IBA Circular of 10th Sep, 2003 should have been disregarded by the DG and that the economic consequences should have been seen by the DG. It has been conceded that the Circular had the intention of disciplining the customers and to increase the income of the banks. In fact the circular which was more in the form of recommendation was issued with the idea of retaining the captured customers by the banks and stop them from switching by levying charges at the time of foreclosure of loans.

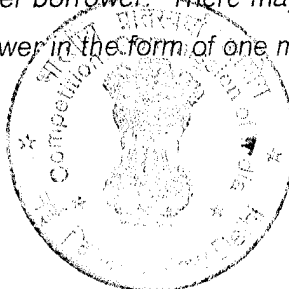


44. The fourth argument taken was that when a borrower prepaid his loan, the bank lost future interest and also lost avenues to invest the funds received. It was stated that this created a mismatch in the asset and liability tenure. It was, therefore, argued that the banks charged penalty from the customers to compensate the losses. Though, most of the banks argued on these lines but none of them brought any data or material to establish this claim. No material has been brought on record to establish that the banks had suffered a loss which entitled them to levy penalty for the foreclosure of loans. On the contrary, as already worked out above, as the banks recover the interest first and the principal in later years, by the foreclosure of loans, applying the principles of discounting, the banks are gainers. Regarding the funds received as prepayment, as the home loan market is very huge, the funds can be redeployed and the banks would be gainers. Therefore, this argument of the banks/HFCs are without any basis and ought to be rejected.

45. The fifth argument raised is that the DG has not gathered any evidence to establish the penalty levied is an anti-competitive practice. The DG has invoked section 3(3)(b) of the Competition Act which is a case of rebuttal presumption. It is for the banks./HFCs to establish that the presumption is wrong by bringing material on record. This onus cast by the operation of the Act has not been discharged by the banks/HFCs.

46. The sixth argument is that PPC enhances cash flow from the borrowers and reduces the volatility of interest rates and therefore enhances consumer welfare. This is a fallacious agreement because the levy of penalty decreases the cash surplus of the borrowers and therefore is detrimental to the welfare of the consumers.

47. The seventh argument is that PPC is a tool to manage reinvestment risk. It has been argued that when prepayment of loans is made, the banks would have surplus cash which they may not be in a position to invest. To compensate for this loss the penalty is levied. It has been discussed that the home loan market in India is very large with an insatiable demand for home loans and therefore the surplus cash can be lent to some other borrower. There may be a time lag for which a small compensation from the borrower in the form of one month's EMI may be collected.



48. The eighth argument was that the international treatment of PPC is not relevant in the Indian context. But no material was submitted to support this claim.

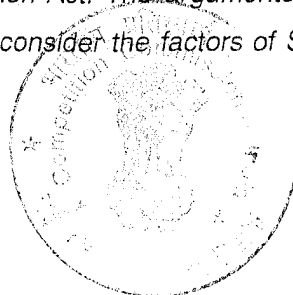
50. The tenth argument is that the market should be governed by a monopolist or by an oligarchy and then only it could be said to be anti-competitive. It was argued that in the absence of such a finding, Competition Act would not apply. The fact is that this argument is very simplistic. The provisions of the Competition Act would have to be examined as to whether they would be applicable in the Indian home loan market.

51. The eleventh argument is that the loans are prepaid due to cyclical factors and that PPC gives rise to demand constraints, as opined by the DG, is without any basis. The DG is to assist the commission and it is for the Commission to decide the anti-competitive behaviour of the participants in the market and not the DG.

52. The twelfth argument raised is that PPC is not usurious, otherwise it would have been declared so by the Courts. This argument is misplaced as the only issue before the Commission is whether the behaviour of the banks is anti-competitive in the home loan market.

53. The thirteenth argument is that the DG has recorded a finding that charging of PPC by National Housing Bank and other retail lenders is justified. As already discussed in the scheme of the Competition Act, DG is only an investigative branch of the Commission. If his findings are erroneous and without any basis, the Commission is not bound to perpetuate such erroneous findings. If PPC is found to be anti-competitive, the Commission is bound to take action against National Housing Bank and the other retail lenders.

54. The fourteenth argument is that the DG has not considered the factors of Section 19 of the Competition Act. The arguments are misplaced because it is the duty of the Commission to consider the factors of Section 19 of the Competition Act and not the DG.



55. In the fifteenth argument it has been conceded that PPC is harmful to the borrowers. But on the contrary it was stated to be beneficial to the depositors. This argument is without any basis because the gains from PPC have not been transferred to the depositors in the form of higher interest.

56. The sixteenth argument is that the court cases relied upon by the DG are not relevant. The argument raised here are correct because the court cases are with reference to the Consumer Act and not the Competition Act. Further, the Supreme Court has not opined on the legality of PPC and has left it open.

57. The seventeenth argument is that the home loan market has grown at a very high rate and that PPC has not deterred the entrance of new entrants to the market. This argument is without any basis because the market in India has grown inspite of the anti-competitive behaviour of the banks. The reason for growth of the market is the pent up demand for houses, a very high GDP growth and cash surplus with the people in India.

58. The eighteenth argument is that banks apply upward interest rates to new consumers and not to existing consumers. It was therefore, argued that prepayment penalty is welfare inducing and helps consumers. This argument is totally incorrect. The banks in order to attract new customers charge lower rate of interest and after a year or two put the customers on a floating rate of interest which is substantially higher. But the rate of interest is not reduced even when the interest rate comes down. Thus, the banks are extorting rent from their old customers.

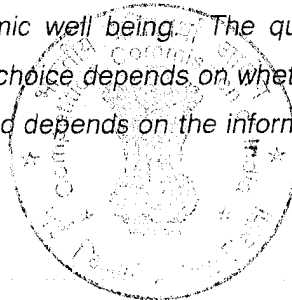
59. The nineteenth argument was that section 3(3) is not applicable to the banks/HFCs because there existed no agreement between the banks and that Section 3(3) would apply only in the case of agreements. A reading of Section 3(3) would show that the Section would apply when the following situations exist- (i) when there is an agreement between the parties. (ii) Practice carried out by the parties. (iii) a decision taken by the enterprises as an association including a cartel. It is also stipulated in the Section that the parties/enterprises should be in the same line of business. Section 3(3) would apply if the conditions of clauses (a) to (d) are satisfied. The existence of an agreement is not necessary for the application of

Section 3(3) of the Act. A practice carried out or a decision taken would also be hit by Section 3(3) of the Act provided the enterprises are in the same line of business.

60. It has also been argued that the levy of penalty for the foreclosure of loans creates a healthy competition in the market and the bank industry. Further with the existence of PPC the banks are showing very high profits and therefore PPC did not have any adverse effect on competition. It was also argued that banning PPC would have an adverse effect on competition. It has also been argued that the levy of penalty on the borrowers by the banks is beneficial to the consumers. Though these arguments were advanced no material was provided in support of these arguments. It could be possible that high profits of the banks/HFCs were due to the prepayment penalties of due to large home loan market. No bank furnished the details of their earnings through prepayment penalties. It is not clear how PPC leads to competition and how banning PPC would be anticompetitive. Even how PPC brings benefits to the consumers is not clear.

61. It was further argued that the PPC has been levied to stop the adventurism of the consumers, to stop volatility in the markets, to discipline the consumers and to stop the consumers from migrating to other home loan suppliers. It was further argued that PPC was a safeguard against competition and unfair trade practices and that PPC was levied to compensate for the losses suffered by the banks. It was also stated that World Bank also levied PPC. From these arguments it is clear that the main aim for the introduction of PPC was to hold on to customers and stop consumer choice. It has been conceded by some of the banks that PPC was introduced to increase profits and reduce competition in the markets. It is not material whether the World Bank charges PPC or not. What is to be examined is as to how the levy of PPC affects the competition in the home loan market.

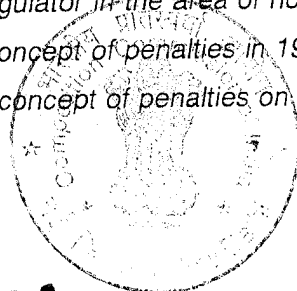
62. But before examining competition in the home loan market it is necessary to examine the behaviour pattern of consumers i.e. behaviour economics. Before a theory or hypothesis is formed, it is necessary to have certain axioms. In economics, the axiom is that in a perfect market, a consumer would make a rational choice which would increase his economic well being. The question is as to how this rational choice can be made. This choice depends on whether a person wants to improve his economic well being. It also depends on the information which is available to person



in the market. This choice is dependent on the advertisements which flood any market, it depends on brand value, it depends on the services which are given in the market or it could depend on the perceived advantage to the consumer. The consumer can suffer from processing overload. Consumer biases can set in the processing of information. For a market to function properly a consumer should be able to assess access and process information. Because of the bulky information which the consumer has to go through before he enters in the agreement he can enter into an agreement which is anticompetitive. This can happen due to processing overload. The agreement may lead him to high switching costs. If there are high switching costs, mobility of the consumers would be affected. Thus, a new entrants would not get customers and innovation would suffer. Even the allocative efficiency of the markets would suffer. Competition Authorities such as the OFT and others thus realize that behaviour economies plays a major role in the competition in the market. It is recognized that agreements are not sacrosanct as God's Ten Commandments. Even if a consumer has signed the agreement, it could be due to misinformation fed by the sellers of the products. Further, as discussed above, switching cost are being recovered even if there was no such factor in the agreement.

63. In the background of these facts, this case has to be decided. The facts are that the Indian home loan market is very large and is expanding at a very fast pace because of the growth of G.D.P. at a rate nearly 9%. There is a shortage of houses in the country and if the credit in the home loan market increases, due to high pent up demand for loan, the gross domestic product of the country would increase substantially. This in turn would give a boost to the cement and steel industry mainly because housing contributes nearly 6% to 7% to the G.D.P. of India.

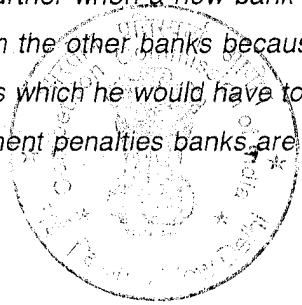
64. But the banking industry and the home finance companies have introduced the concept of fines on the foreclosure of loans before the loans come to an end. When HDFC entered this segment of home loans in 1978, there was no penalty on the prepayment of loans. When competition came in the market in the form of L.I.C. Housing Finance in 1993, HDFC introduced the concept of penalty on the foreclosure of loans. L.I.C Housing finance introduced the system of penalty in 1995. National Housing Bank which is the regulator in the area of home finance and which lends to banks/HFCs introduced the concept of penalties in 1997. ICICI Bank which entered this field later introduced the concept of penalties on prepayment in 2001. The PSU



banks entered the field of home loan at a later date and initially they did not charge any penalty. But after the meeting of the banks in September, 2003 the P.S.U. banks started charging penalties varying from 0.5% to 2%. Subsequently, many of the banks did not levy penalties from customers who prepaid the loans from their own funds. But if the loans were prepaid after taking loans from another bank, the banks levied penalty. Incidentally, according to a report of ICRA, HDFC and SBI have a market share of nearly 17% in the home loan market. ICICI Bank has a share of 13%. Even LIC Housing is a significant player in the market.

67. During the course of hearing of the banks, it was conceded by some of the banks that the concept of penalties for the foreclosure of home loans was introduced because the banks did not want to lose customers who could have migrated to banks giving loans at a lower rate. They thus wanted to reduce the mobility of consumers and reduce their choice. The banks also wanted to discipline the consumers. The banks wanted to extract rent out of the consumers by charging the penalty as they perceived losses. But what losses they had incurred to would have incurred was not worked out. The banks were also not aware of how much they had earned out of the prepayment penalties. The data was not available because home loans constituted a very small percentage of their total loan portfolio. In fact even today S.B.I. which is the largest bank in the country, has a total home loan portfolio of 13%. Most of the banks talked of asset liability mismatch when the consumers prepaid their loans. But no material to support this claim was furnished. On the contrary, as worked out above no loss is suffered by a bank if a consumer prepays his loan. In fact the prepayment enlarges and deepens the home loan market because there is an insatiable demand for home loans in India. I have already dealt with the arguments raised by the banks.

68. In view of the above noted factual position, the issues are to be examined with reference to the Competition Act, 2002. The question here is of switching charges which a consumer has to pay in the form of prepayment penalties. There is no doubt that by charging pre-payment penalty the banks reduced the choice of the customers. As a consequence of the prepayment penalty, a customer cannot shift from one bank to another. Further when a new bank enters the market it would not be able to get customers from the other banks because the customer would not like to shift in view of the penalties which he would have to pay if he shifts to a new bank. Thus by levying the pre-payment penalties banks are killing competition in the home

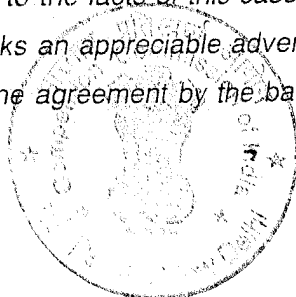


loan market. This also leads to decrease in the allocative efficiency of the market and a reduction of innovation. Under the provisions of Section 3(1) of the Act, no supplier of goods and services can enter into an agreement which causes or is likely to cause an appreciable adverse effect on competition. In all the cases where the banks enter into an agreement with a consumer for home loans, the banks have envisaged penalties provided the consumer pre-pays his loans. As already discussed the levy of switching charges in the form of pre-payment penalties causes an appreciable adverse effect on competition. Therefore, under Section 3(2) of the Act of these agreements entered into by the banks are anti-competitive agreements and therefore void.

69. Before declaring an agreement to be void the provisions mentioned in Section 19(3) of the Act have to be looked into. An appreciable adverse effect on competition under Section 3 cannot be determined without regard to the facts enumerated in Section 19(3) of the Act which are:

- (i) Creation of barriers to new entrant in the market.
- (ii) Driving existing competitors out of the market.
- (iii) Foreclosure of competition by hindering entry into the market.
- (iv) Accrual of benefits to consumers,.
- (v) Improvements in production or distribution of goods or provision of services.
- (vi) Promotion of technical, scientific and economic development by means of production or distribution of goods or provision of service.

In this particular case for the foreclosure of the loans, a barrier has been created for new entrant in the market as no consumer would shift to the new entrant as he would suffer a loss as prepayment penalties would have to be paid. Competition has also effected as hindrance is caused to the consumers by the levy of the penalties when a person shifts to another bank. The next issue is the accrual of benefits to the customers. When pre-payment penalty is levied there is no benefit to the consumer. In fact there is a decrease of benefits to the consumer as he has to pay penalty. Further the choice of the customer decreases. Therefore, the provisions of clauses (a), (c) and (d) are applicable to the facts of this case. Therefore, by the levy of the switching charges by the banks an appreciable adverse effect on competition within India is created. Therefore the agreement by the banks with the consumers for the



levy of penalty for the foreclosure of loans is an anti-competitive act and therefore void in accordance with the provisions of Section 3(1) and 3(2) of the Act.

71. The D.G. has carried out investigation in this case and he has found a contravention by the banks/HFCs under Section 3(3) (b) of the Act.

The findings of the DG are based on following facts/evidences:-

- (i) The Circular dated 10th September, 2003 issued by IBA suggests that there is a concerted action on the part of the banks.
- (ii) The internal circulars issued by the banks justifying their actions of charging pre-payment penalty are anti-competitive in nature.
- (iii) The origin and history of this practice.
- (iv) Regulatory position.
- (v) Judicial decisions, and;
- (vi) International practice.

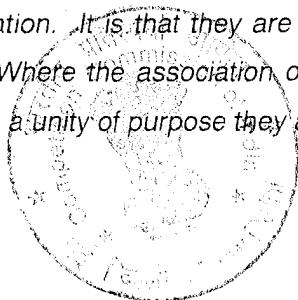
In order to find out whether the DG has applied the right provisions of law in the given situation, it is important to re-look into the provisions of the Act and find out whether this case fits into the entire scheme of things as provided therein.

Section 3(3) of the Act deals with the following situations:-

- (i) the agreements entered into between the entities of the class described therein, or
- (ii) any practice carried on by them, or
- (iii) any decision taken by them and
- (iv) Containing the terms set out in clauses (a) to (d) which in substance are fixing prices, limiting or controlling supply of goods or services or technical development, sharing the market, and bid-rigging or collusive bidding.

If the above conditions are satisfied, it shall be presumed to have an appreciable adverse effect on competition. They are deemed to be in per se violation of Section 3 and the onus is on the party to disapprove this claim.

The classes of parties to an agreement dealt with by section 3(3) are; enterprises, associations of enterprises; persons or associations of persons and they could act in any combination. It is that they are to be an association of persons or enterprises of services. Where the association of persons or enterprises is publicly identified as a group with a unity of purpose they are named as Cartel.



However, before applying this section, it is important to understand the definition of following "terms" of the provision.

"Practice carried on" – "Practice" has been defined in Section 2(m) of the Act and includes any practice relating to the carrying on of any trade by a person or an enterprise.

"Service"- "Service" means service of any description which is made available to potential users and includes the provision of services in connection with business of any industrial or commercial matters such as banking.....financing.....and advertising.

In view of the above definition, following questions need be answered in the present case:-

- a. Is 'Retail Home Loan Financing' is a service being provided by the banks?
- b. Is there any practice of pre-payment penalty being carried by the banks?
- c. Is there any association of banks?
- d. Is there any concerted action on the part of the banks?
- e. Are they engaged in identical or similar trade?
- f. Are these association of banks is in any way limiting or controlling this provision of services?

If the answer is "yes" then Section 3(3) (b) is clearly attracted in this case because as per definition, the "practice carried on by any association of enterprises or association of persons....., engaged in identical or similar trade of goods or provisions of services, which- limits or controls.....provision of services," is covered under Section 3(3) (b) of the Act and once the conditions mentioned in Section 3(3) of the Act are fulfilled, it is deemed to have "appreciable adverse effect on competition".

But before reaching a conclusion that the provisions of section 3(3) of the Act are attracted in this case the most important thing to find out is:-

- (i) Whether there is any agreement, arrangement or understanding or action in concert in writing or informal?
- (ii) Does this agreement or arrangement or understanding or action in concert cause or likely to cause an appreciable adverse effect on Competition within India?

As per Section 2(b) of the Competition Act, 2002, "Agreement includes any arrangement or understanding or action in concert"

- (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.

This means that in order to fall under this definition, a concerted action on the part of enterprises or persons is a pre-requisite. Even when party to such an arrangements do not intend to create any legally enforceable mutual duties and liabilities, it shall be considered as an agreement under this act.

In *Technip S.A Vs S.M.S holding private Ltd.* (2005) 5 SCC 465, the Court observed that the term "agreement" covers an arrangement or understanding which may be informal as well as formal. No written proofs of agreements are required, as writing has been done away with.

The definition is designed in such a way as to produce a vast and sweeping coverage for joint and concerted anti-competitive actions. There is no need for an explicit agreement in cases of conspiracy where joint and collaborative action is pervasive in the initiation, execution and fulfillment of the plan- *United States Vs General Motors* 384 US 127.

It has been a contentious issue as to what constitutes an agreement to come within the ambit of competition enquiry. In CFI Judgment in *Volkswagen AG Vs Commission* (2003), it has been held that there is no need for an explicit agreement in writing but there should be consensus between the parties concerned also referred to as meeting of minds or concurrence of wills.

It has further been held in *Commission vs. Bayer AG* (2004) 4 CMLR 13, that it is sufficient that the parties to the agreement have expressed their joint intention to conduct themselves in the market in a specific manner. As regards the form in which the common intention is expressed, it is sufficient for a stipulation to be the expression of the parties' intention to behave on the market in accordance with its terms.

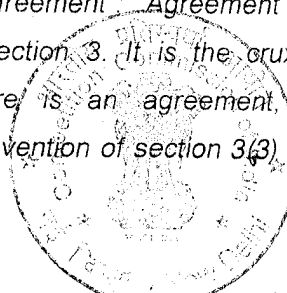
However, there have been practical difficulties to establish the existence of an anti-competitive agreement between the firms. The fact is the firms engaging in anti-competitive behaviour have developed sophisticated mechanics of hiding their behaviour so that they escape the liability under the anti-trust laws. Lord Denning in *RRTA Vs W. H. Smith & Sons Ltd.* have observed "People who combine together to keep up prices do not shout it from the house tops. They keep it quite. 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 wink will do."

From the above definition of "agreement", it can be concluded that if following conditions are there, then it can be said that there is an agreement:--

- Any formal or informal arrangement or understanding
- No need to have an explicit agreement in cases of conspiracy where joint and collaborative action is pervasive in the initiation, execution and fulfillment of the plan
- No need for an explicit agreement in writing but a consensus, between the parties concerned which referred to as meeting of minds or concurrence of wills, is sufficient.
- It is sufficient that the parties to the agreement have expressed their joint intention to conduct themselves in the market in a specific manner.
- As regards the form in which the common intention is expressed, it is sufficient for a stipulation to be the expression of the parties' intention to behave on the market in accordance with its terms.
- No need to have anything into writing or even into words. A nod or wink will do.

However, there is a feeling of some different inference on the term "agreement". There is a view that Section 3(3) is wider in scope than Section 3(1) as Section 3(1) deals only with any agreement whereas Section 3(3), in addition to any agreement, also covers practices carried on or decision taken by which results in AAEC. The fact that the Act uses, these three terms also indicates that "agreement", "practices carried on" and "decision taken" are envisaged as distinct and distinguishable. A "follow the leader" syndrome may lead to anti-competitive "practices carried on" and "decision taken" without being an "agreement". But these would still be actionable under Section 3(3) if they result in acts covered under sub-clauses (a) to (d).

The inference drawn can not be subscribed to. Section 3(1) is the covering section of the entire Chapter on "Prohibition of agreements" and it is the broader provisions which covers both Section 3(3) and Section 3(4). In fact, in Section 3(1) two situations i.e. 3(3) and 3(4) have been envisaged. It means that any contravention of Sections 3(3) and 3(4), the contravention of Section 3(1) has to be there. Section 3(1) is inherent and implicit in Section 3(3) and 3(4). It also can not be concluded that "practices carried on" or "decision taken by" as provided in section 3(3) can be without any "agreement". Agreement is a necessary element in all the sections provided under section 3. It is the crux of the Chapter "Prohibition of agreements". Unless there is an agreement, there can't be prohibition of agreements. Thus, a contravention of section 3(3) without having an agreement can



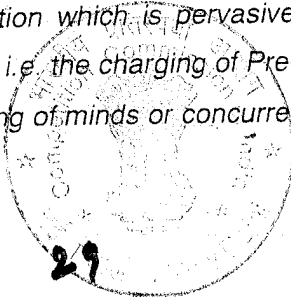
not be visualized. This presumption is further strengthened by the fact that in Section 19(3) also it is clearly mentioned that 'while determining whether an agreement has an AAEC under section 3, have due regard to all or any of the following factors, namely (a) to (f).

There is a feeling that to establish an "agreement" between persons, there has to be conclusive evidence. This is not a correct presumption. Even under Evidence Act two types of evidence have been prescribed to establish an offence – i.e. direct and circumstantial. As has been stated above and is a settled position also that in the case of cartels or anti-competitive agreements to establish an "agreement" of being anti-competitive in nature direct evidence can not be found unless through dawn raids, so, one has to depend on circumstantial evidence or the preponderance of probabilities. In the present case there is both circumstantial evidence as well as preponderance of probabilities which establishes that there was an "agreement" among the banks to carryout the practice of charging pre-payment penalty. Further, Evidence Act is strictly not applicable to these proceedings.

72. Now, let us examine whether any or all elements of an anti-competitive agreements are present in the case under consideration. Is it not a fact that there was a meeting of IBA in September, 2003 where all members bank were present and the issue of pre-payment penalty issue was discussed? It is irrelevant whether there was an agreement, consensus or a decision to impose the PPC. Why this meeting was held in 2003? There is a background to that. When HDFC was the only player in the home loan financing market from 1978 to 1993, they never felt the need of imposing PPC nor they raised any issue such as ALM, but when LIC HFC entered into the market in 1993 then they felt threatened and started charging PPC. Again when other players entered the Home Loan Market, the LIC HFC also started charging PPC to protect its market. Then other players also started advocating the imposition of PPC in order to hold their domain. That was the reason why this IBA meeting was held in 2003. Though, no consensus was reached due to opposition from some of minor players in HLF market, all major banks started this practice after this meeting.

So, what these signify?

- Was not there any tacit arrangement or understanding or a joint conspiracy and collaborative action which is pervasive in the initiation, execution and fulfillment of the plan i.e. the charging of Pre-payment penalty.
- Was not there meeting of minds or concurrence of wills?



- Have not they expressed their joint intention to conduct themselves in the market in a specific manner.
- Was any formal, explicit or written agreement is still required in this case.
- Is not there a concerted practice on the part of the banks to charge pre-payment penalty more or less at the same rate and terms & conditions.
- Is not there any coordination among the banks to charge pre-payment penalty to protect their market as held by the European Court of Justice in in Sugar Cartel Case (1969) 3 All ER 1065 that conceptually concerted practice is a form of coordination between the parties where they have not reached the stage of actual agreement but knowingly coordinate their actions and cooperate with one another instead of competing with each other.

73. Now, coming to the "Practice carried on" by these Banks" which is limiting or controlling the provision of services", it is a fact that the banks have adopted the practice of imposing prepayment penalty to Borrowers who wish to either repay their loan in advance or to the Borrowers who wish to migrate the said loan to another lender. The Banks are charging a rate of prepayment penalty varying from 1% to 4% on the outstanding loan amount. The banks have formed an association of banks known as Indian Banks Association (IBA). Though the Circular dated 10th September, 2003 issued by the IBA was not binding on any banks and it was optional for any bank to impose pre-penalty charge, it can not be denied that the practice adopted by most of the banks is a concerted action on the part of the banks in view of the settled legal position discussed as above. These banks are indulged in the restrictive practice as the consumers are not allowed to switch over from one bank to another because of this prepayment penalty clause. Switching costs are costs that existing customers have to incur when changing suppliers. Customer mobility and choice is essential to stimulate retail-banking competition but, here, consumers are tied to their bankers due to the existence of switching costs i.e., pre-payment penalty charge.

Secondly, the loans were provided to those customers by the banks on floating rate of interest were made to understand that the rates will fluctuate as per the prevailing conditions of the market, however, in practice, it is observed that interest rates were revised upward and not downward. Whenever there was condition in the market to lower the interest rate, lower rate of interest were being offered to the new customers and the existing customers were not being benefited.

Differential treatment were being given to the new loan customers by the banks by providing very lower interest rate on loan amount in comparison to the existing loan consumers. If the existing customer asked banks to lower the interest

rate at par with the new customers, it was conditioned by the banks to pay pre-payment penalty/ foreclosure amount on the outstanding loan, and then to apply for fresh loan.

If any customer decides to pre-pay/foreclose the loans, they had to pay a certain percentage as penalty amount i.e. normally 2%-5% on the outstanding loan amount to clear their account. Is not this practice anti-competitive, and the practice is limiting the provision of services?

74. Now, what is to be seen by the Commission? Under Section 19(3) of Competition Act, 2002, the Commission, while determining whether an agreement has an appreciable effect on competition under section 3, is required to consider the all or any of the following factors: -

- (a) creation of barriers to new entrants in the market;
- (b) driving existing competitors out of the market;
- (c) foreclosure of competition by hindering entry into the market;
- (d) accrual of benefits to consumers;
- (e) improvements in production or distribution of goods provision of services;
- (f) promotion of technical, scientific and economic development by means of production or distribution of goods or provision of services,

However, it is a wrong presumption that the parameters prescribed under Section 19(3) are not required to be applied while assessing an "agreement" under Section 3(3) as it is a deeming provision. Merely because it is a deeming provision, it does not mean that the Commission is deprived of its powers to apply these factors while determining AAEC. Section 19(3) is a mandatory provision and the Commission is bound to apply these factors for arriving at AAEC. In my opinion the deemed provisions of Section 3(3) is for forming a prima facie opinion and not the final one. The parameters given in Section 19(3) are not the 'cause' of AAEC but a result thereof. For example, if an "agreement" results into the creation of barriers or driving existing competitors or forecloses the competition and so on, there has to be AAEC.

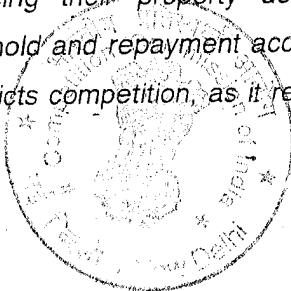
So, what Commission is to determine is that due to the practices followed by the banks are there any entry barrier is being created? Is the competition is being foreclosed by hindering entry into the market or due to such practice any benefit is being accrued to the consumers? Because, the principle objective of competition law is to maintain and encourage competition as a vehicle to promote economic efficiency and maximize consumer welfare. The focal point of competition should be

the actual and / or potential business conduct of firms in a given market and not on the absolute or relative size of firms. What needs to be seen by the commission is that whether a firm can exercise "market power", i.e. engage in business practices which substantially lessen or prevent competition. The relevant product market in this case is "retail market of home loan financing" and the relevant geographic market is whole of India.

75. The case was, therefore, examined from the point of view of Section 19(3) and it is found that:-

- (i) The practice of imposing prepayment penalty to borrowers who wish to either repay their loan in advance or to borrowers who wish to migrate the said loan to another lender, is rampant in the market and there is only one exception to that. The rates of prepayment penalty vary from 1% to 4% on outstanding loan. The said prepayment penalty charged from borrowers appears to be arbitrary, anti competitive and without any basis.
- (ii) The asset liability mismatch argument does not support a charge of 1-4% penalty. Moreover, at least in an increasing interest rate scenario, the lender is actually benefited by the prepayment because it should have raised the money at cheaper rate and now it can lend it at much higher rate, so there is no reason to levy a charge on the prepayment. Secondly, ALM is not account specific and it matches the tenors of all deposits with all loans. This aggregation effect should render the impact, if any, to an insignificant amount.
- (iii) Large corporate prepay hundreds of crores of loans (which should cause bigger ALM issue for banks) whenever they get cheaper funds, but it is a common knowledge that the banks do not charge any prepayment penalty. Moreover, the same corporate are given funds below PLR rates. It goes to prove that loss due to ALM is not the reason to charge prepayment penalty. It is mainly to restrict small borrowers from choosing a cheaper loan.
- (iv) The prepayment penalty is clearly to stop a borrower from going to a competitor for a cheaper interest rate or for better service. Through the prepayment of loan, the principal money is repaid well in advance to the banks through foreclosure. Even if it is paid through switching over from one bank to another, the banks get their principal money returned well before the tenure and this provides opportunity to the banks to further pump money in the market.

- (v) Prepayment penalty is in effect an enhancement of interest rate from back door. The lenders advertise a lower interest rate but in effect it is higher due to such penal charges.
- (vi) At the time of sanction of loans the lenders recover processing and other charges over and above the interest charge which is sufficient to cover all their risks plus a reasonable profit. There is no reason to impose prepayment penalty to the tune of 1-4% of outstanding amount.
- (vii) Most borrowers fail to reckon and compare the exit loads mentioned by the lender because they are not clear when they will need to repay the loan and what will the outstanding at that time. This situation is exploited by the lender.
- (viii) There appears to be no financial calculation to establish that prepayment charge of 1-4% is reasonable and justified as the concept of 'time value for money' is not recognized by these Banks. As the money received today has better value than the same amount of money received in future. If we calculate the EMI and the 'time value for money' it will be evident that banks are unreasonably charging foreclosure amount as the consumer is bound to pay more first in terms of interest portion in the initial months of the payments and later he is made to pay in terms of pre-payment charges, if he decides to foreclose for better options. This practice is fleecing the consumers and also it is not generating any economic value and restricting the consumer to exercise the right of freedom to choose better financial options for the loan.
- (ix) Moreover, the practice of pre-payment penalty on loans is not helping the banks to be more service efficient and competitive on the interest rate being charged on loans to the existing customers as banks are sure of their secured customers due to the anti competitive agreement of pre-payment penalty.
- (x) There has been a tacit agreement among banks to follow the practice of pre-payment penalty and foreclosure fees on loans as to hold back their customers from switching over to other banks. Since all lenders have imposed prepayment penalty, it indicates of a concerted action leading to suspicion of cartelization. In fact, many lenders have already admitted that this practice is being adopted by them to stop their customers to switch over from one bank to another.
- (xi) Even if it has not all the elements of cartel, which is prohibited under section 3(3) of the competition Act, 2002, customers were prevented from significantly reducing their property debts as it represented the most substantial household and repayment accounted for 50% of their disposable income. This restricts competition, as it restricts a consumer to avail banking



services of another bank which is ready to offer the loan at lower interest rates.

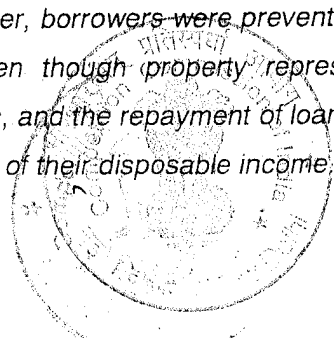
77. In another case, the French Competition Authority known as Conseil de la Concurrence, has dealt with the identical issue of giving property loans to individuals by different banks and charging pre-payment penalty. The gist of the decision is given below:-

Facts: In this decision, the Conseil de la Concurrence had, for the first time, to deal with anticompetitive practices in the banking sector. In 1993, the Conseil decided on its own initiative to investigate the property loans to individuals offered by the main French high-street and saving banks representing up to two-thirds of the relevant market.

The investigated period took place while the long-term property loans were fluctuating, peaking at 20 per cent in the early 1980s then falling gradually from 12 per cent in 1992 to less than 8.5 per cent in 1994. In such circumstances, any individual whose loan's maturity exceeded five—seven years, could have benefited from the fall. Loans holders were then interested in either renegotiating with their bank, or benefiting from the competitive situation by paying off their loan earlier and subscribing to a new one in a rival bank.

However, such a possibility allowing individuals to take full benefit of the market evolutions had been jeopardized by an "inter-bank non-aggression pact" which led to two main competition restrictions. First, the banks who signed the said agreement refrained from making offers to rival banks' customers who wanted to subscribe to a new loan. Secondly, the agreement enabled each of the banks to better resist requests by their own customers to renegotiate their loans, since these customers could not ask another bank in case their request was rejected.

The Conseil noted that, even if a cartel agreement between banks was not applied in a uniform manner, borrowers were prevented from significantly reducing their property debts, even though property represented the most substantial investment by households, and the repayment of loans required for this investment accounted for 30 per cent of their disposable income.



According to the banking establishments, the outstanding amounts likely to be affected by the renegotiation of property loans during the period in question amounted approximately to EUR 90 billion. However, households were only able to renegotiate around EUR 5.5 billion which represented for them an overall reduction in interest charges of about EUR 450 million over 10 years.

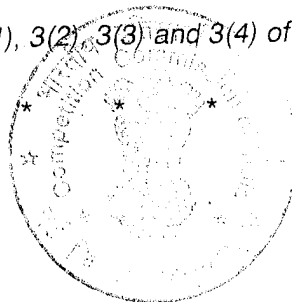
Given the seriousness of the practice and the national scope of the agreement implemented by the main property loans operators, the Conseil imposed fines to nine banks totaling more than EUR 150 million. This is one of the highest fines ever imposed by the Conseil de la Concurrence.

Comment: The Conseil de la Concurrence stated that, although banking activities are governed by specific regulations, they are still subject to competition law. The Conseil also indicated that any competitive market is based on the independence and autonomy of the players involved. It stated that when concerted practices lead to the removal of any uncertainty, they effectively distort competition; since each single actor is assured that the other banking networks will apply the same commercial policy.

78. In view of the facts and circumstances stated above there is no doubt that there is a contravention of Section 3(3) (b) of the Competition Act, 2002 as these Banks have adopted a practice of imposing pre-payment penalty by way of a concerted action which in effect limits or controls provision of services which resulted into foreclosing of customers mobility and by hindering entry into the market and thereby no benefit is being accrued to the consumers.

79. In the consequences by having a system of pre-payment penalties for the foreclosure of the loans, the banks and the home loan companies have contravened the provisions of Section 3(1), 3(2), 3(3) and 3(4) of the Competition Act."

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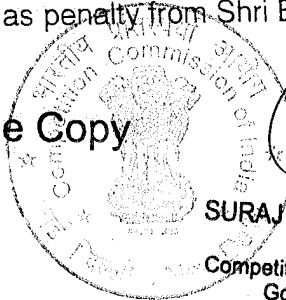


14. Considering the facts of the case , there is a contraventions of Sections 3(1), 3(3)(b), 3(4) and 4(1) of the Competition Act, 2002 by HDFC Bank in this case.

15. HDFC Bank is therefore directed under Section 27 of the Competition Act to

- (i) Stop this practice of charging prepayment of penalty on the foreclosure of the auto loan by different persons.
- (ii) refund the penalty recovered as penalty from Shri Bhakoo.

Certified True Copy



SP
Gahlaut
23/08/2011
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Competition Commission of India
Government of India
New Delhi