Finance & Banking

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In this issue

KENYA

Increase in interest rates:
A delicate balance between contractual freedom and consumer protection

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Increase in interest rates: A delicate balance between contractual freedom and consumer protection

That parties have contractual freedom is not in doubt. To this end, courts have upheld the sanctity of contracts entered into by parties, except in cases where the parties contracted outside statute or where holding parties to their bargain would be unconscionable or result in unjust enrichment to one party at the expense of the other.

Contractual freedom is not limitless, as is evidenced by judicial intervention by the Kenyan courts. A plethora of suits have been filed by disgruntled borrowers on grounds that a bank or financial institution violated the agreed contractual terms thereby overcharging interest on loans advanced to the borrowers.

One fact is certain, the granting of banking facilities to borrowers by banks and financial institutions is based on a contractual relationship with the borrower often agreeing to the bank/financial institution charging a variable interest rate. However, where the bank/customer relationship goes sour, most borrowers would invariably challenge the amount paid to the bank/financial institution on the grounds that the agreed contractual interest rate was disregarded by the bank/financial institution.

In Kenya, banking or financial business is regulated by the Banking Act. Section 44 of the Banking Act stipulates that a bank or financial institution licensed under the Banking Act can only increase its rate of banking or other charges with the approval of the Cabinet Secretary for Finance.

An issue that has sparked debate is whether interest rates are a component of the rate of banking or charges associated with a loan thereby being subject to approval by the Cabinet Secretary for Finance.

It is worth noting that the Banking Act does not succinctly define the rate of banking. Further, section 52(1) of the Banking Act espouses the principle of contractual freedom by stipulating that any contract between a bank/financial institution is not invalidated on grounds of contravention of the provisions of the Banking Act or the Central Bank of Kenya Act (CBK Act).

Despite the acknowledgment of contractual freedom in section 52(1) of the Banking Act, section 52(3) of the Banking Act reinforces the provisions of section 44 of the Act by limiting the interest to be recovered by a bank or financial institution to such amount as is permitted under the Banking Act and the CBK Act.

Given the fact that the phrase "rate of banking" is not defined in the Banking Act, and following the repeal of section 33B of the Banking Act in 2019, which capped the interest rates to be charged by banks/financial institutions, and noting the contractual freedom recognised in section 52(1) of the Banking Act, there have been conflicting decisions by the Kenyan Court of Appeal and the High Court on whether the levying of interest by banks is a matter that requires prior approval.

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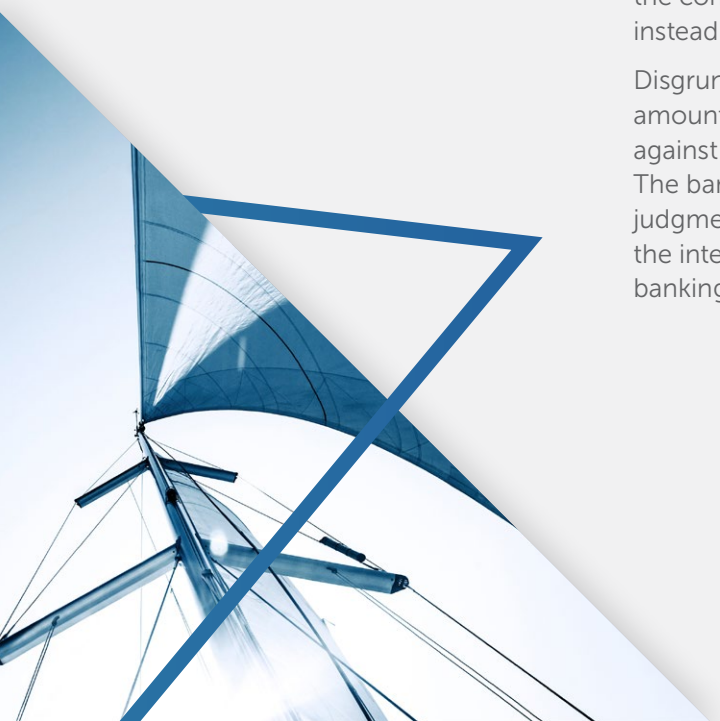

The debate has now been settled by the Kenyan Supreme Court in *Petition Number E005 of 2023 Stanbic Bank Kenya Limited v Santowels Limited* [2024]. The bank had advanced banking facilities to the borrower on various dates between 1993 and 1997. Upon repayment of the facilities, the borrower engaged a third party to recalculate the interest that had been charged and paid as the borrower was of the view that the bank had overcharged interest. On receiving the computation of the amount that ought to have been paid to the bank, the borrower noted a discrepancy between what had been contractually agreed and what was repaid. The borrower sued the bank for overcharging interest. The High Court found in favour of the borrower by holding that the bank had breached section 44 of the Banking Act by failing to seek approval from the Cabinet Secretary for Finance prior to varying the interest rate. Despite its finding, the High Court relied on the computation of interest based on the contractual rate instead of the interest rate cap.

Disgruntled with the High Court's decision regarding the amount due to the borrower, the borrower appealed against the High Court judgment to the Court of Appeal. The bank also cross appealed against the High Court judgment arguing, among other grounds, that variation of the interest rate did not amount to a variation of the rate of banking as provided in section 44 of the Banking Act.

The Court of Appeal agreed with the findings of the High Court judge that the bank had breached section 44 of the Banking Act. The Court of Appeal did not fault the High Court's computation of interest based on the contractual rate, instead, the court raised the amount to be refunded to the appellant by approximately KES 2 million. The bank took the view that the interpretation of sections 44 and 52 was a matter of public importance and lodged an appeal in the Supreme Court.

The Supreme Court's findings

In seeking to provide clarity, the Supreme Court adopted a purposive interpretation of section 44 of the Banking Act by drawing a correlation between the definition of banking business and levying of interest being a component of banking business.

Consequently, the Supreme Court held that any variation of interest which comprises a charge on a bank loan is subject to approval as stipulated in section 44 of the Banking Act. The court clarified that the regulation of interest rates was not a new concept, the same having commenced in Kenya as early as 1966, and that while banks and financial institutions are at liberty to agree on contractual interest rates with their customers, such rates should not be exorbitant; hence the need for oversight by the Cabinet Secretary for Finance.

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Regarding the contractual freedom set out in section 52 of the Banking Act, the Supreme Court held that such contractual freedom is not absolute. The Supreme Court reaffirmed the Court of Appeal decision in *Margaret Njeri Muiruri v Bank of Baroda (Kenya) Limited* [2014] eKLR; in which it was held that:

> *"Once interest is agreed upon and an agreement is entered into which in effect gives a lender the discretion to vary the interest it is our view that the discretion cannot be exercised willy nilly to charge exorbitant interest."*

With the debate regarding prior approval of variation of interest rates having been settled, all licensed commercial banks and financial institutions in Kenya are required to seek the approval of the Cabinet Secretary for Finance prior to varying the interest rate. A notice to the borrower on variation of the interest rate without more will not suffice. There is also a possibility of a flurry of suits by borrowers seeking to challenge the variation of interest rates charged by banks/financial institutions on grounds that prior approval was not obtained.

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Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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