Banking, Finance & Projects

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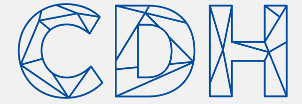

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KENYA

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Cabinet Secretary approval required before loan interest rate adjustments: Clarification by the Supreme Court

The Central Bank of Kenya (CBK) is reviewing its current risk-based credit pricing model. This model involves banks setting their lending rates based on the CBK's base rate and a borrower's risk profile, rather than applying a uniform interest rate. Borrowers with a higher risk profile get higher interest rates on their loans. This model has, however, led to some banks overcharging their clients and imposing additional fees that exceed the true underlying risk. As a result, CBK is proposing to introduce a new model where all loan interest rates will be tied to the Central Bank Rate plus a clear, bank-specific margin that will be published 30 days before any change.

The ongoing review comes just after judicial clarification was rendered on the issue of interest rate variation and approval requirements in the banking sector. The Supreme Court reaffirmed its previous decision in Supreme Court Petition No. E005 of 2023 (*Stanbic Bank Kenya Limited v Santowels Limited*) that banks and financial institutions must comply with section 44 of the Banking Act, Cap 488 (Banking Act). This section prescribes that a bank must seek approval from the Cabinet Secretary for Finance (Cabinet Secretary) before increasing interest rates on loans and credit facilities. The decision followed an application to review its earlier judgement and hopefully marks the end of a protracted dispute between Stanbic Bank Kenya Limited (Stanbic) and Santowels Limited that was canvassed from the High Court, Court of Appeal, and finally at the apex court.

At the High Court

The dispute began in the High Court where Santowels sued Stanbic, claiming the bank had unlawfully charged it excessive interest rates on various banking facilities advanced between 1993 and 1997. The facility letters between Stanbic and Santowels set the interest rate for the loans at 3% above the bank's base lending rate, which ranged between 19.5% and 29%, with the bank reserving the discretion to vary the rates from time to time, including applying higher interest when Santowels exceeded its overdraft limit. Stanbic contended that, at all material times, the maximum interest rate that all commercial banks were allowed to charge their borrowers for loans granted for less than three years was 16.5% per annum. This was provided for in Gazette Notice No. 1617 of 1990 under section 39 of the Central Bank of Kenya Act, Cap 491 (CBK Act), which gave the Governor of the Central Bank the powers to regulate the minimum and maximum rates of interest chargeable by commercial banks.

Although the cap was later revoked by Gazette Notice No. 3348 on 23 July 1991, Santowels argued that, in the absence of a new cap, the original 16.5% limit still applied until section 39 of the CBK Act was repealed in 1996. After that, regulatory control shifted to section 44 of the Banking Act, which requires banks to seek the Cabinet Secretary's approval before increasing interest rates. Therefore, Santowels argued that Stanbic had charged it interest rates that exceeded the 16.5% statutory cap and sought a refund of the surplus interest.

Stanbic responded to the accusations by Santowels by asserting that the interest terms for the facilities had been negotiated and explicitly agreed by both parties. The bank

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further held that following the revocation of Gazette Notice No. 1617 of 1990, the statutory interest cap no longer applied, and banks were at liberty to negotiate interest rates with their borrowers.

The court disagreed with Stanbic's assertion that the revocation of Gazette Notice No. 1617 of 1990 meant there was no regulatory oversight over interest rates. The court further emphasised that the Governor of the CBK retained residual regulatory powers under section 39 of the CBK Act until its repeal in 1996. After the repeal of section 39, section 44 of the Banking Act came into effect, requiring banks to obtain the Cabinet Secretary's approval before increasing interest rates. Consequently, Stanbic had failed to demonstrate it had obtained approval from the Cabinet Secretary to exceed the capped rate.

Despite Stanbic's reliance on contractual terms that allowed interest variation, the court found that it had imposed unlawful interest rates on Santowels, noting that section 52(3) of the Banking Act prohibits parties from entering into contracts that contravene the provisions of the CBK Act and the Banking Act. Judgment was entered in favour of Santowels based on the amount by which interest exceeded the contractually agreed rate of 3% above the base lending rate and not on application of the 16.5% cap.

In the Court of Appeal

Both parties were aggrieved by the High Court's decision and appealed to the Court of Appeal. Santowels was dissatisfied with the computation of the overcharged interest based on its contracts with Stanbic. Santowels argued that the sum of the overcharged interest should have been calculated based on the 16.5% cap. On the other hand, Stanbic contended that the court erred in finding that section 44 of the Banking Act required financial institutions to obtain the Cabinet Secretary's approval before varying their interest rates, noting that the section referred to the term *"rate of banking"*, which in its view, did not relate to interest variation. Stanbic further relied on section 52 of the Banking Act, which it held gives banks and their customers freedom to contract, including mutually agreeing to terms on interest rate variation.

The Court of Appeal upheld the High Court's finding that the clauses in the contracts between Stanbic and Santowels that allowed for interest variation could not supersede the law. The court emphasised that statutory compliance is required even when the customer signs off on interest variation clauses. It also upheld the High Court's finding on the applicability of section 39 of the CBK Act. It affirmed that the 16.5% cap was valid until 1997 and that Stanbic had unlawfully varied its interest rates. The court, however, rejected Santowels' argument that the sum of the overcharged interest should have been calculated

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based on the 16.5% cap. It agreed with the High Court that the contractual terms between the parties governed the calculation of interest. However, it noted an error in the High Court's computation of the overcharged contractual interest and revised the amount upwards to correct the error.

At the Supreme Court

Stanbic appealed to the Supreme Court, arguing that the court failed to correctly distinguish between the rate of banking and contractual interest rate as governed by sections 44 and 52 of the Banking Act respectively. Stanbic maintained its position that "*rate of banking or other charges*" under section 44 did not relate to interest rates under section 52. Santowels argued that the interpretation of sections 44 and 52 of the Banking Act was not raised in the lower courts and was thus not properly before the Supreme Court. It also asserted that the lower court's decision requiring Stanbic to seek approval from the Cabinet Secretary before varying interest rates was correct.

The Supreme Court dismissed Stanbic's appeal and Santowel's cross-appeal, affirming that section 44 of the Banking Act requires banks to obtain the Cabinet Secretary's approval before increasing interest rates on loans. This is because "*rate of banking*" encompasses interest charges. The court clarified that while the 16.5% cap that was stipulated in Gazette Notice No. 1617 of 1990 was revoked by Gazette Notice No. 3348 of 1991, the regulatory oversight of interest rates did not cease. Instead, section 44 of the Banking Act continued to play a crucial role in regulating interest rates. The court also upheld the contractual overcharge interest computations that had been made by the Court of Appeal.

Current review

Following the Supreme Court judgment, Stanbic sought a review and clarification of the decision. It argued that the judgment of the Supreme Court overlooked legal developments, including Legal Notice No. 35 of 2006, which delegated the Cabinet Secretary's powers under section 44 of the Banking Act to the Governor of the CBK. It claimed the judgment could potentially expose banks to litigation as past increases in interest rates could be invalidated.

The court found that the appeal had been filed out of time and was brought pursuant to the wrong provisions of the law. As a result, it did not delve into the merits of the argument by Stanbic. That notwithstanding, the court held that the delegation of authority under section 44 of the Banking Act to the Governor of the CBK did not absolve the Cabinet Secretary of their responsibility of approving interest rate increases. It also rejected the argument that the Governor of the CBK could act independently in this context. Ultimately, the application was dismissed.

Conclusion

The effect of the judgment is that banks and financial institutions are required to seek approval from the Cabinet Secretary rather than the CBK, before increasing interest rates on loans and facilities advanced to customers. Any interest charged above the permissible statutory maximum or adjusted without seeking the approval of the Cabinet Secretary is unenforceable.

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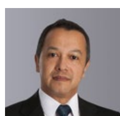

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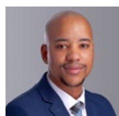

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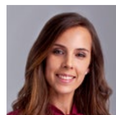

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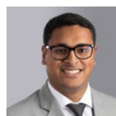

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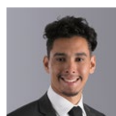

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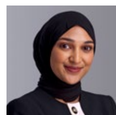

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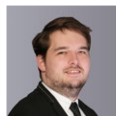

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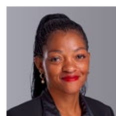

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BBBEE STATUS: LEVEL ONE CONTRIBUTOR
Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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