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New Framework for Guaranteed Losses in Digital Lending Models

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- Default loss guarantees permitted in digital lending models; up to 5% of the loan portfolio
- Due diligence to be exercised by lenders along with necessary contractual arrangements with the default loss guarantee providers
- Default loss guarantee providers to provide declarations certified by a statutory auditor
- Requirement of cash collateralization

WHAT IS DLG?

In India, banks and non-banking financial companies ('NBFCs') are permitted to extend loans, whilst fintechs such as lending service providers ('LSPs') specialize in ancillary functions such as customer acquisition, underwriting and pricing support, servicing, recovery and technological support and infrastructure. If banks and NBFCs are hesitant to extend loans in certain instances, the LSPs may guarantee a part of the loss (up to a certain percentage), if the borrower defaults in repayment. This concept in the digital lending space is called First Loss Default Guarantee ('FLDG') or Default Loss Guarantee ('DLG'). DLG which is a form of risk sharing and helps in banks and NBFCs extend loans to a larger customer pool, which also in return benefits the LSPs.

REGULATORY DEVELOPMENTS

The Reserve Bank of India ('RBI') issued Guidelines on Digital Lending issued on September 2, 2022 ('Digital Lending Guidelines').[1] The Digital Lending Guidelines advised various types of banks and NBFCs ('Regulated Entities' or 'REs') to adhere to the provisions of RBI's Master Direction on Securitisation of Standard Assets[2], specifically relating to synthetic securitization.[3] The Digital Lending Guidelines appeared to prohibit any transfer of risk by an RE to a third party in relation to lending, and therefore led to some industry-wide confusion on whether REs could enter into DLG arrangements.

Thereafter, RBI issued Guidelines on Default Loss Guarantee in Digital Lending on June 8, 2023 (‘DLG Guidelines’)[4] which permits DLG arrangements subject to certain conditions. The DLG Guidelines are applicable to DLG arrangements offered by REs or LSPs in digital lending[5] operations undertaken by REs.[6]

NEW FRAMEWORK FOR DLG

- REs are permitted to enter into DLG arrangements only with LSPs[7] or other REs, with which it has entered into an outsourcing LSP arrangement. In the event the DLG arrangement is being provided by an LSP, then the said LSP must be a company incorporated under the Companies Act, 2013.[8]

- DLG arrangements must be backed by an explicit legally enforceable contract between the RE and DLG provider. The contract must comprise the following details[9]:

  - Extent of DLG cover,

  - Form in which DLG cover is to be maintained with the RE,

  - Timeline for DLG invocation, and

  - Disclosure by LSPs on their website about the total number of portfolios and the respective amount of each portfolio on which DLG has been offered.

- An RE shall accept DLG only when it is in one of the following forms:

  - Cash deposited with the RE,

  - Fixed deposits maintained with a scheduled commercial bank with a lien marked in favour of the RE,

  - Bank Guarantee in favour of the RE.[10]

- The RE should ensure that the total amount of DLG cover is specified upfront on any outstanding portfolio, and the cover cannot exceed 5% of the amount of the loan portfolio.

- Implicit guarantees such as those linked to performance of the loan portfolio of the RE are also considered as DLG. In case of implicit guarantee arrangements, the DLG provider shall not bear the performance risk of more than the equivalent of 5% of the underlying portfolio.[11]

- Capital computation i.e., computation of exposure and application of credit risk mitigation benefits on individual loan assets in the portfolio, shall continue to be governed by existing norms.[12]

- The DLG agreement shall remain in force for at least the longest tenor of the loan in the underlying portfolio.[13] DLG can be invoked within a maximum overdue period of 120 days, unless made good by the borrower prior to that.[14]

- **DUE DILIGENCE REQUIREMENTS**

- It is mandatory that REs establish a board-approved policy before entering into DLG arrangements. The policy must cover the eligibility criteria for the DLG provider, the nature and extent of DLG cover, the mechanism of monitoring and reviewing the DLG arrangement, and details of the fees payable to the DLG provider.

- Every time the RE enters or renews a DLG arrangement, it shall obtain adequate information to satisfy itself that the entity extending the DLG can honor it. More importantly, there needs to be a declaration from the DLG provider which is also certified by a statutory auditor detailing the aggregate DLG amount outstanding and the number of REs and the respective number of portfolios against which DLG has been provided.

- The RE is responsible to put a disclosure mechanism in place, to ensure that LSPs with whom they have a DLG arrangement publish the total number of portfolios and the respective amount of each portfolio on which DLG has been offered, on their LSP website.[15]

- DLG arrangements cannot act as a substitute for credit appraisal requirements. Robust credit underwriting standards must be put in place, irrespective of the DLG cover.

KEY TAKEAWAYS

Since the Digital Lending Guidelines had not expressly permitted or prohibited DLG arrangements, the DLG Guidelines provide much-needed clarity to the industry by explicitly permitting DLG arrangements up to a certain extent and subject to certain conditions (as mentioned above).

As LSPs are defined as ‘agents’ of REs[16], confusion may arise whether the DLG cover is the risk exposure of the LSP or the ultimate risk and liability of the RE of whom the LSP is an agent. The latter may not be the case, as the risk could lie in the hands of the LSPs, as it may not be necessary that all activities undertaken by the LSP would be in the capacity of the RE’s agent. The agency relationship contemplated under the Digital Lending Guidelines seems to extend to LSP functions like customer acquisition, underwriting support, pricing support, servicing, monitoring, recovery etc. which the LSP performs on behalf of the RE. The act of the LSP offering DLG cover can be outside the ambit of the agency relationship between the LSP and RE, and to that extend the exposure of the LSP can be up to 5% of the loan portfolio.

In the past, fintechs were offering up to 100% DLG cover[17] to their banking partners and such covers were largely contractual with no cash collateralization. Seemingly, RBI appeared unconvinced on how such fintechs could take on such a high credit risk, manage their risk management, debt-to-equity ratio requirement and capital adequacy norms, preparedness etc.[18] The introduction of these DLG Guidelines including the cash collateralization requirement appears to be a risk mitigation measure as it ensures the business interests of REs and fintechs are balanced. Further, the DLG Guidelines focus on transparency, ensuring that DLG cover is based on a contractual arrangement and requiring LSPs to publicly disclose the DLG cover offered by them. This appears to be a move to ensure that the DLG cover is not misused, but industry players may argue that the threshold of 5% could have been made higher given the compliance and due diligence requirements, including that of a contractual arrangement between the RE and the DLG provider.

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FOOTNOTES

1See our analysis of the Digital Lending Guidelines here: https://www.ij lt.in/post/dig ital-lending-i n-india-analys is-and-implica tions (last accessed June 14, 2023).

2Available at: https://www.rb i.org.in/Scrip ts/BS_ViewMasD irections.aspx ?id=12165 (last accessed June 14, 2023).

3Para 15, Digital Lending Guidelines.

4Available at: https://www.rbi .org.in/Scripts /NotificationUs er.aspx?Id=12514&Mode=0 (last accessed June 14, 2023).

5Para 2.3, Digital Lending Guidelines: “Digital Lending: A remote and automated lending process, largely by use of seamless digital technologies for customer acquisition, credit assessment, loan approval, disbursement, recovery, and associated customer service.”

6Para 1, DLG Guidelines.

7Para 2.5, Digital Lending Guidelines: “Lending Service Provider: An agent of a Regulated Entity who carries out one or more of lender’s functions or part thereof in customer acquisition, underwriting support, pricing support, servicing, monitoring, recovery of specific loan or loan portfolio on behalf of REs in conformity with extant outsourcing guidelines issued by the Reserve Bank.”

8Para 3, DLG Guidelines.

9Para 4, DLG Guidelines.

10Para 5, DLG Guidelines.

11Para 6, DLG Guidelines.

12The existing norms are: Master Circular on Basel III Capital Regulations’ dated May 12, 2023, Master Direction - Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, Master Direction - Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, Master Circular on ‘Prudential Norms on Capital Adequacy - Primary (Urban) Co-operative Banks (UCBs)’ dated April 20, 2023, Circular on ‘Operating Guidelines for Small Finance Banks’ dated October 06, 2016.

13Para 10, DLG Guidelines.

14Para 9, DLG Guidelines.

15Para 11, DLG Guidelines.

16Para 2.5, Digital Lending Guidelines.

17Available at: https://economic times.indiatimes .com/news/econom y/policy/rbi-rul es-on-fldg-coul d-give-lending-f illip-to-fintech s/articleshow/10 0847421.cms (last accessed June 14, 2023).

18Available at: https://yourstor y.com/2023/06/f ldg-explained- new-rules-chan ges-impact-bor rowers-fintech s-banks (last accessed June 18, 2023).

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