July 2023

Guidelines on Default Loss Guarantee in Digital Lending

The Reserve Bank of India ("**RBI**") issued the 'Guidelines on Default Loss Guarantee in Digital Lending' ("**DLG Guidelines**") on June 8, 2023, bringing in clarity and permissibility to loss sharing arrangements in digital lending which are termed as default loss guarantee ("**DLG**") or first loss default guarantee ("**FLDG**").

Background

Prior to the DLG Guidelines, the RBI's digital lending guidelines issued on September 2, 2022 ("**Digital Lending Guidelines**") require the industry practice of offering financial products with contractual agreements like FLDG, in which a third party guarantees to compensate up to a certain percentage of a default in the loan portfolio of a regulated entity (i.e., banks or non-banking financial companies) ("**RE**"), to comply with the provisions of "synthetic securitisation" under paragraph 6(c) (of the RBI (Securitisation of Standard Assets) Directions, 2021 ("**Securitisation Directions**") . Under the Securitisation Directions, REs are prohibited from undertaking or assuming any exposure under such "synthetic securitisation" structures. Therefore, there has been considerable confusion and difference in the views in the market practice of FLDGs which have been offered by digital lending platforms or lending service providers ("**LSPs**") to REs which participate on such platforms.

RBI's concern relating to such guarantees and loss sharing arrangements originated from the Report of the Working group on digital lending through online platforms and mobile apps ("**RBI Working Group Report**") constituted by it. The RBI Working Group Report referred pejoratively to synthetic structures that enabled unregulated entities to lend, without complying with prudential norms, through credit risk sharing arrangements by way of an FLDG extended by LSPs. The RBI Working Group Report further stated that in such cases, credit risk was being borne by the LSP without having to maintain any regulatory capital which provides a potential for risk build-up and counterparty risks.

The DLG Guidelines which have been issued to all commercial banks (including small finance banks), co-operative banks and non-banking financial companies, now expressly permit an RE to enter into a DLG.

Such DLG arrangements have been made subject to the conditions discussed below.

Key Changes

1. **What is a DLG?**

   A contractual arrangement between an RE and an eligible DLG provider, to obtain a guarantee to compensate the RE on account of loss caused by default in the loans provided by such RE up to a certain percentage of the loan portfolio as specified under the contract. Implicit guarantees of similar nature that are linked to the performance of the loan portfolio of an RE and have been specified upfront are also covered under the scope of a DLG.

2. **Who can be a DLG provider?**

   a) It must be an LSP, as defined under paragraph 2.5 of the Digital Lending Guidelines i.e., an agent of the RE which carries out partial or whole component of lenders' functions such as customer acquisition, recovery of loan, monitoring, pricing support, etc. in conformity with the outsourcing guidelines issued by the RBI;

   b) an RE that has entered into an outsourcing (LSP) arrangement with another RE; and

   c) such an LSP must be incorporated as a "company" under the Companies Act, 2013.

3. **Structure of the DLG arrangement**

   The DLG Guidelines mandate that an RE and an LSP must enter into legally enforceable contract, which must include certain key provisions such as:

   a) **Form of the DLG:**

      The RE can accept a DLG only in the form of: (i) cash deposited with such RE, (ii) fixed deposits maintained with scheduled commercial banks with lien marked in favour of such RE or (iii) a bank guarantee in favour of such RE.

   b) **Extent/Cap of the DLG:**

      While the total amount of DLG cover on any outstanding loan portfolio of the RE must be specified upfront, it has been limited to 5% of the amount of such loan portfolio. Even in the case of an implicit guarantee arrangement, the performance risk undertaken by the DLF Provider cannot exceed an amount equivalent to 5% of the underlying loan portfolio.

   c) **Tenor of the DLG:**

      The DLG contract must be valid for a period equivalent to the longest tenor of the loan of the underlying loan portfolio and not less.

   d) **Invocation of the DLG:**

      The RE can invoke a DLG within a maximum overdue period of 120 (one hundred twenty) days unless the default is made good by the borrower before that.

   e) **Disclosures of the DLG:**

      The RE is responsible for establishing a mechanism to ensure that the contracted LSPs comply with disclosure requirements and publish the total number of portfolios and the respective amounts under such portfolios on which DLGs have been offered, on their websites.

4. **Due Diligence Requirements**

   REs are required to put in place a policy approved by its board for entering into DLG arrangements, specifying the eligibility criteria for DLG providers, the nature and extent of the DLG cover, the monitoring and review process of the DLG arrangements, etc.

   In order to enter into or renew an existing DLG arrangement, REs are required to obtain adequate information to ensure that the entity extending the DLG will be able to honour its terms, including a declaration from the DLG Provider on the aggregate DLG amounts outstanding, the number of REs and the respective number of portfolios against which DLGs have been provided, and past default rates on similar portfolios.

5. **Exceptions from the scope of DLG**

   The DLG Guidelines specify that the following guarantee schemes, namely: (i) Credit Guarantee Fund Trust for micro and small enterprises; (ii) Credit Risk Guarantee Fund Trust for low income housing and (iii) Individual

Schemes under National Credit Guarantee Trustee Company Limited; and (iv) credit guarantees provided by banks for International Settlements, International Monetary Fund and Multilateral Development Banks are not covered within the scope of a DLG.

6. **Recognition of non-performing asset ("NPA")**

   Irrespective of any DLG cover available at the portfolio level, the responsibility of recognizing individual loan assets in the portfolio as NPA and the consequent provisioning will be the responsibility of the RE as per extant asset classification and provisioning norms.

Key Takeaways

By allowing unregulated fintechs to enter the digital lending ecosystem, the DLG Guidelines have bought in a business-friendly change that legitimizes DLG arrangements, which will bolster the growth and stability of the digital lending industry, boost credit growth in the economy and increase funding in the digital lending space. The disclosure requirements mandated by the DLG Guidelines also expose such loan portfolios for public scrutiny thereby increasing transparency. In prescribing a cap and other conditions, the RBI is attempting to strike a balance between permissiveness in innovation in the fintech space and regulation aimed at addressing spread of systemic risk in the economy.

However, the 5% cap on DLG arrangements which has been prescribed may not address the credit support requirements of REs under such DLG arrangements from the fintech platforms, which were being provided under the general industry practice. It also would be interesting to note whether alternative arrangements would be structured by fintechs to fall outside the realm of DLGs as a manner of regulatory arbitrage.

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