DEFAULT LOSS GUARANTEE | KEY TAKEAWAYS

1. INTRODUCTION

In a recent development, the Reserve Bank of India ("**RBI**") on June 08, 2023, permitted Default Loss Guarantee ("**DLG**") in the digital lending sector, and issued the Guidelines on Default Loss Guarantee ("**DLG Guidelines**").[1] The DLG Guidelines were issued by the RBI shortly after the issuance of its 'Statement on Developmental and Regulatory Policies', wherein it had stated its intention to issue a regulatory framework on DLG.[2]

2. REGULATORY EVOLUTION OF THE DLG

In the digital lending space, DLG or first loss default guarantee (*as used in common parlance*) ("**FLDG**") arrangements had been a common market practice for RBI regulated entities ("**REs**") (such as non-banking financial companies). As part of such arrangements, REs would typically transfer the whole or a substantial part of the credit risk, arising out of a default, to third parties (*mostly e-commerce and fintech companies*) that assist such REs in sourcing borrowers along with collection and recovery efforts.

The RBI had initially maintained a studious silence in relation to FLDG arrangements, primarily to encourage customer participation in the banking space and also to enable REs to learn digital lending from venture capital ("**VC**") backed startups. This position changed with the publication of the Report of the Working Group On Digital Lending Including Lending Through Online Platforms and Mobile Apps dated November 18, 2021 ("**Working Group Report**") by the RBI, wherein a complete prohibition on 'synthetic structure arrangements' between REs and 'lending service providers' ("**LSPs**")[3] was recommended.[4] Subsequently, the RBI issued a press release dated August 10, 2022,[5] *inter alia* stating that the recommendation on prohibition of FLDG in the Working Group Report was under further examination,[6] and that REs should adhere to the Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021, dated September 24, 2021 ("**Securitisation Guidelines**").[7] The regulatory status of FLDG thus remained in the grey.

A month later, the RBI issued the Guidelines on Digital Lending on September 02, 2022 ("**Digital Lending Guidelines**").[8] While the Digital Lending Guidelines continued to stipulate that REs must adhere to the

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[1] The DLG Guidelines can be accessed here.
[2] The Statement on Developmental and Regulatory Policies can be accessed here.
[3] An LSP is in essence, an agent of the RE, who carries out one or more of an RE's functions such as customer acquisition, recovery of loans etc., in conformity of the outsourcing guidelines issued by the RBI.
[4] Recommendation Number 3.4.3.1 of the Working Group Report, and the Working Group Report can be accessed here.
[5] The press release can be accessed here.
[6] Recommendation Number 3.4.3.1 of the Report as referenced in the press release.
[7] The Securitisation Guidelines can be accessed here.
[8] The Digital Lending Guidelines can be accessed here. Under the Digital Lending Guidelines, digital lending has been defined as "*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.*" Further, the FAQs have clarified that the phrase "*largely by use of seamless digital technologies' has been used in the 'Digital Lending' definition to accord operational flexibility to REs in 'Digital Lending'. Therefore, even if some physical interface with customer is present, the lending will still fall under the definition of Digital 'Lending'. However, while doing so, the REs should ensure that the intent behind the Digital Lending Guidelines is adhered to.*"

Securitisation Guidelines,[9] it specifically stated that FLDG must be subject to the provision in the Securitisation Guidelines that prohibited the practice of synthetic securitization.[10] This was widely interpreted to mean that any form of FLDG would also be considered as synthetic securitization and is accordingly prohibited. Moreover, the Frequently Asked Questions on Digital Lending Guidelines, dated February 14, 2023 ("**FAQs**") did not provide any clarity on the position on FLDG under digital lending.[11]

With the recent introduction of the DLG Guidelines, which in effect, permits and regulates FLDG, the RBI aims to maintain a balance between innovation and prudential risk management.[12] The guiding principle being, to facilitate development of the digital lending ecosystem and enhance credit penetration in the economy.[13] We have laid out some highlights of the DLG Guidelines, below.

3. HIGHLIGHTS OF THE DLG GUIDELINES

3.1 Scope and Applicability

The DLG Guidelines apply to 'DLG arrangements' between an RE[14] with an LSP (or another RE performing LSP services), wherein, the latter guarantees to compensate the RE for losses due to default up to a specified percentage of the loan portfolio, and includes any other implicit guarantee linked to the loan portfolio's performance.[15]

While the DLG Guidelines clarify that REs can also provide LSP services, it remains unclear if restrictions in relation to DLG would continue to apply if another RE performing LSP services is providing such DLG. This is especially critical given that the Working Group Report had identified increasing reliance on third-party service providers (such as LSPs) for providing DLG to REs, as a possible risk to the digital lending ecosystem.[16] More specifically, the intent behind prohibiting synthetic structures such as FLDG between an RE and an LSP was to ensure that REs do not allow their balance sheets to be used by unregulated entities in any form to assume credit risk.[17] Accordingly, the applicability of the DLG Guidelines remains unclear when two REs enter into a DLG arrangement. While it should not trigger the concern expressed by the RBI, in the absence of explicit exceptions in favour of REs, it may be difficult to conclude that REs can provide DLG cover beyond the prescribed cap (*elaborated upon in Section 3.3 below*).

3.2 Structure of DLG arrangements

The RBI has stipulated that DLG arrangements between an RE and an LSP need to be captured in an explicit legally enforceable agreement, which, *inter alia,* must contain (a) the extent of DLG cover,[18] (b) the form in

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[9] Section 15 of the Digital Lending Guidelines.
[10] Under the Securitisation Guidelines, synthetic securitization has been defined as "*a structure where credit risk of an underlying pool of exposures is transferred, in whole or in part, through the use of credit derivatives or credit guarantees that serve to hedge the credit risk of the portfolio which remains on the balance sheet of the lender*".
[11] The FAQs can be accessed here. Further, please see our analysis on the FAQs to digital lending, available here.
[12] The RBI Statement on Developmental and Regulatory Policies can be accessed here.
[13] The RBI Governor's Statement dated June 08, 2023, can be accessed here.
[14] For the purposes of the DLG Guidelines, REs mean (a) Commercial Banks (including Small Finance Banks); (b) Primary (Urban) Co-operative Banks, State Co-operative Banks, Central Co-operative Banks; and (c) Non-Banking Financial Companies (including Housing Finance Companies).
[15] Section 2.1 of the DLG Guidelines.
[16] Paragraph 3.3.1.2 of the Report.
[17] Section 3.4.3.1 of the Report.
[18] Section 4(a) of the DLG Guidelines.

which the DLG cover will be maintained with the RE,[19] (c) the timeline for invocation of DLG,[20] and (d) disclosure requirements of LSPs, wherein the LSP would be obligated to publish on its website, details in relation to (i) the total number of loan portfolios and (ii) the amount of each of such portfolio on which the LSP has offered a DLG cover.[21] However, it has been clarified that any DLG cover provided shall not involve any actual transfer of the underlying loan exposure from the books of the RE to the books of the LSP.[22]

3.3 Form of DLG and Applicable Cap

DLG must be in the form of either (a) cash deposits with the RE, (b) fixed deposits maintained with a Scheduled Commercial Bank with a lien marked in favour of the RE, (c) bank guarantee in favour of the RE, or (d) a combination of the three forms.[23]

The RBI has specified that the DLG cover on any outstanding portfolio that is specified up front, must be capped at 5% (five per cent) of that loan portfolio. The RBI has also clarified that in case of implicit DLG arrangements, the performance risk borne by the LSPs should be capped to the equivalent amount of 5% (five per cent) of the underlying loan portfolio.[24] This might impact the LSPs that the REs choose to partner with or the revenue sharing arrangements between REs and LSPs, given that LSPs would now be able to take on only a small part of the overall risk. Accordingly, REs are likely to push LSPs to agree to a lesser revenue share.

3.4 Operationalisation of DLG arrangements

The DLG tenor should not be less than the longest tenor of the loans in the underlying loan portfolio.[25] REs are also required to ensure that certain due diligence measures, as per a board approved policy, are undertaken prior to entering into DLG arrangements (and may also include renewals of DLG arrangements). Such due diligence measures must include (a) eligibility criteria of the LSP, (b) nature and extent of DLG cover, (c) process of monitoring and reviewing of the DLG arrangements, (d) details of fees (*if any*) payable to the LSP by the RE,[26] and (e) obtaining adequate information for the RE to satisfy itself that the LSP will be able to honour the DLG guaranteed by it (this must include *a declaration from the LSP which shall be certified by a statutory auditor, on the aggregate outstanding DLG amount, the number of REs and the number of loan portfolios of such REs against which DLG has been provided, and past default rates on similar loan portfolios)*.[27] Such measures are essentially the bare minimum due diligence measures that the RE must undertake, and accordingly, REs have the freedom to adopt due diligence measures over and above the abovementioned minimum measures.

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[19] Section 4(b) of the DLG Guidelines.
[20] Section 4(c) of the DLG Guidelines r/w Section 9 of the DLG Guidelines, which mandates REs to invoke DLG within a maximum overdue period of 120 days, unless paid back by the borrower before this time duration.
[21] Section 4(d) of the DLG Guidelines r/w Section 11 of the DLG Guidelines.
[22] Citation 2 of the DLG Guidelines.
[23] Section 5 of the DLG Guidelines.
[24] Section 6 of the DLG Guidelines.
[25] Section 10 of the DLG Guidelines.
[26] Section 12.1 of the DLG Guidelines.
[27] Section 12.3 of the DLG Guidelines.

Having said that, despite the existence of DLG arrangements, the RE must have robust credit underwriting standards in relation to its borrowers, and such DLG arrangements must not act as a substitute for credit appraisal requirements.[28]

Given the due diligence measures that will now be adopted by the REs, LSPs may have to structure their operations in a manner compliant with the DLG Guidelines, such that they meet the eligibility criteria, along with other due diligence criteria that the RE sets out.

Further, REs may face regulatory scrutiny from the RBI in relation to the due diligence measures adopted by them. Such measures will essentially govern how they will enter into DLG arrangements, and the entities they enter into such arrangements with. Accordingly, LSPs may also have to bear the brunt of enhanced regulatory oversight of the REs and the RBI, in relation to their partnerships with REs and their LSP operations.

3.5 Further Clarifications

The RBI has clarified that LSPs with which the RE enters into DLG arrangements must be incorporated in India, thereby <u>prohibiting foreign incorporated companies and their branch offices in India from acting as an LSP</u>.[29] The RBI has also confirmed that consumer protection and grievance redressal measures (*such as appointing a nodal grievance redressal officer*) stipulated in the Digital Lending Guidelines must be adhered to.[30] Further, it has been clarified that recognition of individual loan assets as non-performing assets and provisioning will continue to be the RE's responsibility in accordance with extant norms, regardless of the DLG cover provided by the LSP to the RE. The intent is to prevent REs from subtracting the DLG cover recovered, resulting in under-reporting of non-performing assets on its books. Additionally, in instances where the loan has been repaid by the borrower after the DLG cover has been invoked, the RE and the LSP can share such recovered amounts in accordance with the contractual terms between the RE and the LSP.[31]

Further, the RBI has also prohibited setting off the amount of DLG invoked against any underlying individual loans, and has clarified that capital computation in relation to individual loan assets will continue to be governed by extant norms.[32] This essentially implies that regardless of the invocation of DLG by the RE, the impact on the credit score of the defaulter, would continue to be computed in the same manner as it would ordinarily, in the absence of any DLG cover.

3.6 Exceptions

The RBI has also carved out guarantees provided under specific schemes / entities, such as the Credit Guarantee Fund Trust for Micro and Small Enterprises, Credit Risk Guarantee Fund Trust for Low Income Housing, and individual schemes under National Credit Guarantee Trustee Company Ltd, and credit guarantees provided by Bank for International Settlements, International Monetary Fund, and Multilateral Development Banks, as being outside the ambit of the definition of DLG.[33]

[28] Section 12.2 of the DLG Guidelines.
[29] Section 3 of the DLG Guidelines.
[30] Section 13 of the DLG Guidelines.
[31] Section 7 of the DLG Guidelines.
[32] Sections 7 and 8 of the DLG Guidelines.
[33] Section 14 of the DLG Guidelines.

4 INDUSLAW VIEW

Given that the Digital Lending Guidelines were interpreted to have prohibited FLDG arrangements, LSPs in the digital lending industry faced several challenges. One of them being that REs expected LSPs to share the risk, as such LSPs were providing several loan related services. Accordingly, LSPs started seeking NBFC licenses to be able to enter into lending arrangements with borrowers directly, or adopting alternative arrangements. However, LSPs did not achieve much success in both approaches. REs became apprehensive of alternative arrangements that came close to the hot button phrase 'synthetic securitisation', and receiving regulatory authorisation to operate as an NBFC was not the light at the end of the tunnel it was made out to be, particularly for foreign VC funded start-ups.

Now, finally after a decade of DLG / FLDG arrangements, they seem to have received regulatory blessing from the RBI, with the issuance of the DLG Guidelines. The DLG Guidelines are certainly a positive development for fintech players, offering them respite from the regulatory flux they found themselves in, and will likely serve as a significant boost to the digital lending ecosystem, especially for LSPs, for whom DLG / FLDG arrangements are key business offerings. With the specific regulation of DLG, the RBI has taken a welcome step towards building trust in the digital lending ecosystem by ensuring that such offerings are subject to certain regulations and caps. Further, given that the cap on DLG is limited, with REs bearing the risk for the majority loan portfolio, REs would be encouraged to undertake more stringent credit risk assessment measures for each borrower, which may result in sanctioning of loans only to specific borrowers who meet these criteria. Accordingly, defaults will be lesser, and REs may eventually be able to offer better interest rates.

Additionally, given that LSPs providing DLG will not be construed as transfer of loan interest to their books and will not be viewed as loan participation; and given that the cap of 5% (five per cent) which is very nominal, it could be said that DLG services are unlikely to be viewed as financial services. Accordingly, DLG services provided by LSPs, may be less likely to be hindered by any restrictions on foreign direct investment, and related scrutiny at the time of fund raise.

Lastly, since the DLG Guidelines have been made effective from the date of the notification (June 08, 2023), it has created a scramble amongst REs and LSPs who have existing relationships, to rework the existing arrangements in a manner, that gives REs comfort and are 'kosher' for the purposes of the DLG Guidelines. While said guidelines are indicative of the RBI's intention to foster development in the fintech space, the extent to which DLG arrangements will be factored into existing contracts between REs and LSPs remains to be seen.

Authors: Avimukt Dar | Namita Viswanath | Shreya Suri | Annupriya Agarwal | Abhijit Chakrabarti | Srika Agarwal

Practice Areas: Technology, Media, Telecommunications; Financial Services; Government and Regulatory

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