UPDATES

TRILEGAL

RBI Press Release on Digital Lending

22 August 2022

Partners: *Rahul Matthan, Nikhil Narendran and Jyotsna Jayaram,* ***Senior Associate:*** *Rachana Rautray,* ***Associates:*** *Akanksha Singh, Sidharth Ray, Sindhu A and Vartika Tiwari*

This update covers:

1 Introduction

Considering dynamic innovations in financial lending products and services and its perceived risks, the Reserve Bank of India (**RBI**) constituted a working group on 13 January 2021 (**Working Group**) to study the digital lending landscape in India and recommend a regulatory framework to address concerns arising out of unregulated lending activities. Along with various recommendations, the Working Group through its report dated 18 November 2021, identified key stakeholders for digital lending, i.e., a lending service provider (**LSP**) and a *'balance sheet lender'*. The Working Group noted that an LSP is *'an agent of a balance sheet lender'* that assists, *inter alia*, with customer acquisition, underwriting or pricing support, disbursement, monitoring, collection, or liquidation of specific loans. Its role is restricted to a loan originator, unlike a *'balance sheet lender'* that is categorised as an entity in the business of lending which is equipped to carry credit risk, and to whom the LSP transfers the loan. Our detailed analysis on this report, may be accessed here.

To address regulatory concerns arising out of the offering of various digital loan and credit-based products and services, the Reserve Bank of India on 10 August 2022 issued a press release to immediately implement certain recommendations made by the Working Group on Digital Lending. Detailed instructions are expected to be released by the Reserve Bank of India separately.

Further to the above, on 10 August 2022, RBI has issued a press release (**Press Release**) requiring the immediate implementation of certain recommendations of the Working Group, specified under Annex I of the Press Release. The Press Release also sets out recommendations of the Working Group that are accepted in principle but require further examination, under Annex II of the Press Release, and those recommendations requiring engagements with the Government and other stakeholders, under Annex III of the Press Release. The Press Release seeks to curb unregulated lending activities, protect consumer interest, and ensure data privacy and accordingly, will likely impact pre-existing arrangements between RBI regulated entities (**RE**) and LSPs for digital lending.

2 Key Considerations for Stakeholders

2.1 Fund Flow Process

To address concerns arising out of the lack of transparency in the disbursement and repayment of loans through an LSP, REs are prohibited from utilising pooling or pass-through accounts for loan disbursal or repayment. The limited exemption to this is - (i) disbursals covered under statutory or regulatory mandates; (ii) co-lending transactions *inter-se* Res; and (iii) disbursements for specified end-use in accordance with applicable regulatory guidelines. While this mandate ostensibly restricts unregulated entities from participating in fund disbursements or repayments process, reasons for the introduction of this exemption are unclear. Further instructions pursuant to the Press Release may possibly provide insight into this exemption.

Notably, although an express prohibition has not been introduced, REs are instructed to ensure any third party guarantee (such as First Loss Default Guarantee[1]) to compensate for defaults in a loan portfolio of the RE adheres to the Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021 dated 24 September 2021. Given that an LSP's role is limited to an *'originator of loans'*, and adopting credit risk is a core RE function, the reasons for the lack of an express bar remains unclear.

2.2 Implications on Pricing

The Press Release prohibits an LSP from charging fees directly to borrowers. Such fees are required to be accounted for by the RE under the annual percentage rate (i.e., the all-inclusive cost) (**APR**) of the loan. In practice, fees are typically charged by LSPs for support services on a flat-fee basis and it is common for this to be borne by the borrower. Given this, it is to be seen whether the net effect of this prohibition would change the price exposure for the borrower, since it merely changes how the borrower is charged LSP fees.

Apart from the APR, the Press Release requires disclosure of the terms and conditions of recovery mechanism and details of the grievance officer designated to deal with *'digital lending or related matters'*, under the key fact statement (**KFS**) provided to borrowers. Any fees not specified in the KFS cannot be charged to the borrower at any stage during the term of the loan. Further, an express restriction has been introduced on increase of credit limits without the consent of the borrower.

Given the above, and the mandate on all REs (instead of only banks and NBFCs as previously stipulated by the RBI) to disclose the list of LSPs engaged by them and the role envisaged for LSPs, the commercial viability of the relationship *inter-se* the LSP, RE and a borrower will have to be reconsidered.

[1] The Working Group report notes that a 'First Loss Default Guarantee' is an arrangement where a third party compensates lenders if the borrower defaults.

2.3 Protective Measures

2.3.1 Transparency

To ensure transparency, several measures such as direct communication between RE and borrowers of the loan product, due diligence to be undertaken by REs to assess technical abilities of the LSP, adherence of the outsourcing guidelines by LSPs, and guidance to LSPs when acting as recovery agents, have been introduced. Although extensive, these requirements have, in spirit, been prevalent prior to the Press Release.

To combat regressive recovery practices, the Press Release requires an RE to communicate details of the LSP responsible for recovery of loan from the borrower, at different stages of the loan sanction process.

Since market practice differed, the Press Release expressly clarifies that irrespective of the nature or tenor of the loan, including if undertaken through digital lending apps (**DLA**) operated by REs or LSPs, details of all financing must be reported to Credit Information Companies.

2.3.2 Grievance Redressal

REs must ensure that they, as well as their LSPs, appoint grievance redressal officers to deal with FinTech, digital lending issues (such as complaints or issues raised by borrowers), or issues with a DLA. Contact details of the grievance redressal officer, along with details regarding the method of lodging of complaints must also be provided in the DLA, the RE or LSP website (as applicable), as well as in the KFS. For LSPs, an assessment may be undertaken on whether a grievance redressal officer appointed pursuant to the E-Commerce Rules, 2020 would suffice.

The Press Release also recognises the borrower's right of recourse to the Reserve Bank – Integrated Ombudsman Scheme, 2021 if the RE fails to address the complaint within the stipulated timeline (presently 30 days).

2.3.3 Cooling Off Period

REs are required to provide borrowers with a cooling-off or look-up period (as determined by the RE's board) to exit the loan by paying only the principal amount and the proportionate APR, without incurring any penalty. Borrowers will also be allowed to make pre-payments beyond the cooling-off period. Arguably, this recommendation would make digital loans preferable to traditional loans for similar amounts. However, different disbursement mechanisms may require different cooling off periods.

2.4 Data Localisation and Data Protection

REs are required to store all data pertaining to digital lending activities in servers located in India (**Localisation Requirement**). This Localisation Requirement is akin to the direction prescribed by the RBI on payment system providers and NBFC P2P lenders (**Payments Circular**), reflecting the continued attempt to drive localisation. However, unlike the Payments Circular localising payments data, this mandate expands the scope to any data. Practically, LSPs may also have to restructure their processing and storage related functions, since this could be contractually imposed by REs.

Further, LSPs are only allowed to collect and store information of borrowers as may be necessary to carry out its operations. However, given that its data logs are auditable, LSPs may need to demonstrate such necessity at the time of audit.

The RBI has also indicated that it may require REs to disclose proprietary algorithms used for underwriting of loans in a bid to balance transparency with innovation and adopt standards for ethical artificial intelligence (**AI**) to protect customer interests. These requirements are likely being imposed to assess bias within these algorithms and ensure that borrower welfare is accounted for. Stakeholders may however continue resisting these steps to protect their proprietary interests in their algorithms.

The RBI has also heavily underscored the need for a consent driven framework for digital lending. Greater autonomy is sought to be extended to borrowers, by requiring LSPs to take explicit consent for accessing phone features, allowing borrowers to revoke consent or limit disclosure of certain data, and explicitly requiring LSPs to formulate comprehensive privacy policies. This requirement therefore goes beyond the prescriptions set out under the existing rules of the Information Technology Act, 2000.

2.5 Other Proposals

While we can expect recommendations in Annex II to be implemented within a reasonable timeline, Annex III recommendations demand significant structural and governance changes. The main thrust of these recommendations is to monitor suspicious transactions and introduce accountability of actions on DLAs. Crucially, the RBI may green light the proposed self-regulatory organisation for digital lending to frame various codes of conducts, standard agreements, maintain a negative list of LSPs, etc.

In addition to this, the Government is also mulling over a legislation to ban unregulated lending and constitute an independent body for verification of DLAs. It remains to be seen how regulators will interact with each other and resolve overlapping functions if present.

3 Key Takeaway

Pursuant to the Press Release, it is clear that the role of an LSP is similar to that of a business correspondent – to function as an agent to the RE. In the light of this, as an immediate step, all LSPs should examine the nature of the deployment and integration of their services while engaging with REs (including all pre-existing relationships with REs) to assess whether such arrangements, fund flow structures and data processing practices are permissible.