UPDATES

Guidelines on Default Loss Guarantee in Digital Lending

6 July 2023

Partners: *Joseph Jimmy, Shruti Rajan, Jyotsna Jayaram,* ***Counsel:*** *Anubhav Ghosh,* ***Senior Associates:*** *Rachana Rautray, Varsha Yogish* ***Associates:*** *Prabal De, Pranvi Jain*

On 8 June 2023, the Reserve Bank of India (**RBI**) issued the Guidelines on Default Loss Guarantee in Digital Lending (**DLG Guidelines**) setting out the conditions under which RBI regulated lending entities (**RE**) can enter into default loss guarantee (**DLG**) arrangements amongst each other, or with lending service providers (**LSP**). The DLG Guidelines have been introduced after considerable engagement between RBI and the fintech industry, following RBI's earlier decision to treat guarantee arrangements between LSPs and REs as '*synthetic securitisation*' under the RBI's Guidelines on Digital Lending dated 2 September 2022 (**Digital Lending Guidelines**) (To read our update on digital lending, click here).

After considerable engagement between the Reserve Bank of India and the fintech industry, RBI regulated lending entities have now been permitted to enter into default loss guarantee arrangements pursuant to the recently issued Guidelines on Default Loss Guarantee.

This treatment had led to apprehensions that DLG arrangements could be prohibited in the digital lending ecosystem. In a relief to the fintech industry the RBI has, through the DLG Guidelines, exempted DLG arrangements conforming to the guidelines from being treated as synthetic securitisation.

Conditions under the Default Loss Guarantee Guidelines

The DLG Guidelines define DLG as a contractual arrangement between the RE and a DLG provider under which the latter guarantees to compensate the RE for any loss due to default on loans. The DLG Guidelines also clarify that any other *implicit guarantee* of similar nature linked to the performance of the loan portfolio of the RE would be covered within the scope of a DLG and would therefore also be subject to the conditions under the DLG Guidelines.

The key conditions and considerations under the DLG Guidelines are discussed below.

1 LSPs providing DLG must be Indian incorporated companies and REs acting as LSPs must also meet requirements applicable to LSPs

A DLG provider may be an LSP or another RE. For an LSP to provide a DLG, it must be incorporated as a company in India under the Companies Act, 2013 or acquire existing LSPs (incorporated companies). Further, the DLG Guidelines recognise DLG arrangements between REs where one RE operates as an LSP. Such RE providing the DLG will be subject to the same requirements applicable to LSPs under the DLG guidelines including the cap on risk-sharing (discussed below).

2 5% cap on DLG cover on loan portfolio

Under the DLG Guidelines, REs are required to:

a. limit the DLG cover on outstanding portfolios (specified upfront) to up to 5% of such portfolio; and

b. in case of implicit guarantees, ensure that the LSP does not bear a performance risk of more than the equivalent amount of 5% of the underlying loan portfolio.

The guidelines also specify that such DLG arrangements cannot substitute credit appraisal requirements and require robust credit underwriting standards to be in place by the REs irrespective of the DLG cover.

In this regard, while the limit of 5% is specified at the outset, the DLG Guidelines do not appear to clarify how the outstanding or underlying loan portfolio and performance risk will be determined. Given the limited cap, the industry will need to rethink existing structures where corporate guarantees and/or other arrangements have been provided without any specific limit.

3 Permissible DLG Structures

REs are permitted to accept a DLG in only one or more of the following forms:

a. cash deposits;

b. fixed deposits maintained with a scheduled commercial bank with a lien in favor of the RE; or

c. bank guarantees.

REs and LSPs must also enter into an explicit contract which should set out the extent of the coverage, timeline for invocation, and tenor of the DLG (subject to such period being not less than the longest tenor of the underlying loan portfolio). However, as discussed above, there is also a recognition that an implicit guarantee can qualify as a DLG and thereby be subject to the DLG Guidelines.

Given the above, parties entering into contractual arrangements in the digital lending ecosystem should take note of the following:

a. Any obligation (including from any third party) to compensate for defaults or negative performance of a loan portfolio whether explicit or implicit (such as by conduct) including indemnities or damages for loan defaults, would be subject to DLG Guidelines.

b. Payouts from guarantee arrangements would need to be restricted to cash deposits or liens over fixed deposits irrespective of coverage being in the nature of damages or other third-party arrangements. Given the limited forms of a guarantee arrangement, feasibility of uncapped and/or unlimited coverage may need to be reassessed.

c. Treatment of risks and liabilities under outsourcing arrangements entered between LSPs and REs would need to be carefully structured to ensure that the form of DLG is in line with the DLG Guidelines.

4 Capital relief for loans covered through guarantee arrangements

The extant norms for computation of regulatory capital (capital adequacy) permit certain REs to claim capital relief if an underlying loan has the benefit of a guarantee arrangement by treating the guarantee as '*credit risk mitigation*'. DLG Guidelines clarify that these extant norms will continue to apply to underlying individual loan assets in the portfolio. In their clarification, the RBI seems to have implied that while DLG arrangements may be for the entire loan portfolio, capital relief may be claimed by averaging the DLG cover on an individual loan basis in proportion to the entire portfolio, subject to such DLG meeting the parameters under the extant norms (including the nature of the guarantee and the guarantee cover).

5 Invocation of DLG and classification of non-performing assets

The DLG Guidelines require REs to invoke a DLG within a maximum period of 120 days once the loan becomes outstanding. This requirement is independent of the RE classifying the loan as a non-performing asset (**NPA**) as per existing norms within the stipulated time periods. The RE is responsible for recognition of individual loans within the portfolio as NPAs and to adequately provide for them irrespective of any DLG (or its invocation). It is also provided that in case the borrower repays the loan after the RE has invoked the DLG, such repaid amount can be shared with the DLG provider.

6 Due diligence and disclosure requirements

The DLG Guidelines require REs to undertake the following actions:

a. Formulate a board approved policy setting out the minimum eligibility criteria for DLG providers, nature and extent of cover, process of monitoring/reviewing the arrangement, and fees payable.

b. Obtain adequate information to satisfy itself that the DLG provider has the capacity to honour the DLG. The information obtained must include a declaration from the DLG provider which is certified by the statutory auditor, and which clearly states the aggregate DLG amount that is outstanding, the number of REs and the respective number of portfolios against which DLG has been provided, as well as past default rates.

c. Ensure that LSPs publish the total number of portfolios and the respective amount of each portfolio on which DLG has been offered, on their website. This requirement is in addition to the other disclosure obligations on LSPs under the Digital Lending Guidelines, such as providing details of product features, loan limit and costs, links to the RE website, privacy policies, etc.

As REs are allowed to develop their own board-approved policy, they can exercise some flexibility to determine the eligibility of the LSP. This may be undertaken after assessing the LSP's arrangements with competing REs.

Conclusion

The DLG Guidelines are a significant development for the digital lending ecosystem since the RBI, despite its initial reservations, has now permitted unregulated entities to participate as LSPs in the lending ecosystem and provide DLGs. This will permit REs to diversify their loan portfolio and reach wider borrower classes and, at the same time, maintain RBI's regulatory oversight of REs.

As far as next steps go, the lending ecosystem now awaits clarity on the interpretation of key aspects of the DLG Guidelines and the implementation of the DLG limit. In the interim, market practice is likely to evolve on other commercially viable mechanisms in relation to DLG arrangements. It is also anticipated that RBI will keenly observe compliance with DLG Guidelines to further assess the risks and benefits arising out of DLGs.