DLG - HAS RBI FELT THE PULSE?

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The Reserve Bank of India ("**RBI**") has recently released the Guidelines on Default Loss Guarantee ("**DLG Guidelines**") in digital lending that has left the FinTech space and digital lending market in high spirits. This note covers a prelude as well as a high-level view of the DLG Guidelines.

Working Group on DLG

RBI had constituted a working group in 2021 to look into the digital lending sector, which was unregulated. Furthermore, there were several complaints from customers who had borrowed from digital lending apps regarding excessive interest, charges and high handed recovery mechanisms. This pushed RBI to constitute the working group.

While the working group looked at various facets of digital lending, one area which it specifically looked at was the FLDG mechanism used by Lending Service Providers ("**LSPs**") (i.e. lending apps) as a risk sharing arrangement. Under this, the LSP underwrites a pre-decided percentage of loans generated by it, wherein in case of any default of loans, LSP would make good the loss to the lender. The working group's main concern was that LSPs were undertaking balance sheet lending in partnership with banks/ NBFCs or on a stand-alone basis, while not being registered as NBFCs, remaining outside the scope of regulation. It also emphasised on the risk build-up, including counterparty risk posed by LSPs to the lenders.

Taking a cue from the working group recommendations, RBI released the Digital Lending Guidelines in September, 2022. While the Digital Lending Guidelines explicitly did not debar the use of DLG, it referred to the RBI Master Direction on Securitisation of Standard Assets and specifically to synthetic securitisation, thereby hinting that DLGs are a type of synthetic securitisation which is not allowed.

Synthetic Securitization

The said Master Direction defines synthetic securitisation 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. Explanation: The above definition does not include the use of instruments permitted to lenders for hedging under the current regulatory instructions.*

While RBI is still examining the mechanics of DLG, the reference made to DLG in the Digital Lending Guidelines has essentially indicated the direction in which RBI's policy on DLG would be heading. Cut to July 2023, after much deliberation and keeping its ear to the ground, RBI released the DLG Guidelines regulating the use of DLG by RBI regulated entities and LSPs.

Broad contours of DLG Guidelines

What is DLG?

RBI defines DLG as a contractual arrangement between a regulated entity and an entity meeting specific requirements (LSPs), under which the LSP guarantees to compensate the regulated entity (lender), loss due to default up to a certain percentage of the loan portfolio of the regulated entity, specified upfront. Any other implicit guarantee of similar nature would also be considered as DLG.

A very important inclusion is that only companies registered under the Companies

Act, 2013 would be eligible to provide DLGs to lenders. This excludes LSPs which are LLPs, partnerships, sole proprietorships from the DLG ecosystem.

Enforceability

The DLG Guidelines require DLGs to be backed by legally enforceable contract between LSPs and lenders, which shall contain among other things – (a) Extent of DLG Cover; (b) Form of DLG cover; (c) timeline for invocation; and(d) disclosure requirements for LSPs.

The only acceptable form of DLG Cover that may be provided to lenders are – (a) Cash Deposits; (b) a lien marked on FDs maintained with Scheduled Commercial Banks;(c) Bank Guarantee. The DLG provided shall not exceed 5% of the total loan portfolio. In case of implicit guarantee arrangement, the LSP shall not bear more than 5% of the underlying portfolio.

Responsibilities of a Lender

RBI has made it clear that irrespective of DLGs in place, lenders shall follow provisioning norms for NPAs and shall not be allowed to set off the DLG invoked against underlying loans. Upon recovery, lenders shall share the recovered amount with the LSPs as per agreed contractual terms.

Lenders are required to invoke DLG within a maximum overdue period of 120 days, unless made good by the borrower before that. The DLG agreement is required to remain in force for a period not less than the longest tenor of the loan in the underlying loan portfolio. Specific disclosure requirements for LSPs providing DLGs have been put in place, for which the lenders would be responsible to ensure that the requirements are met.

RBI has put the onus on lenders to ensure that the DLG framework, if adopted is monitored and functioning in a robust manner. It requires the lenders to put in place a board approved policy which shall contain eligibility criteria for LSPs, DLG cover, fees payable to the LSP and such other important aspects. RBI has categorically called out that DLGs are not a substitute to credit appraisal mechanisms/credit underwriting and lenders/regulated entities must ensure the LSPs are capable of honouring the DLGs.

Conclusion

RBI's change in stance on DLG provides a boost for FinTech activity as well as certainty in policy. It will surely have a wide-ranging positive impact on credit growth and availability.

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