RBI Guidelines on Default Loss Guarantee (DLG) in Digital Lending

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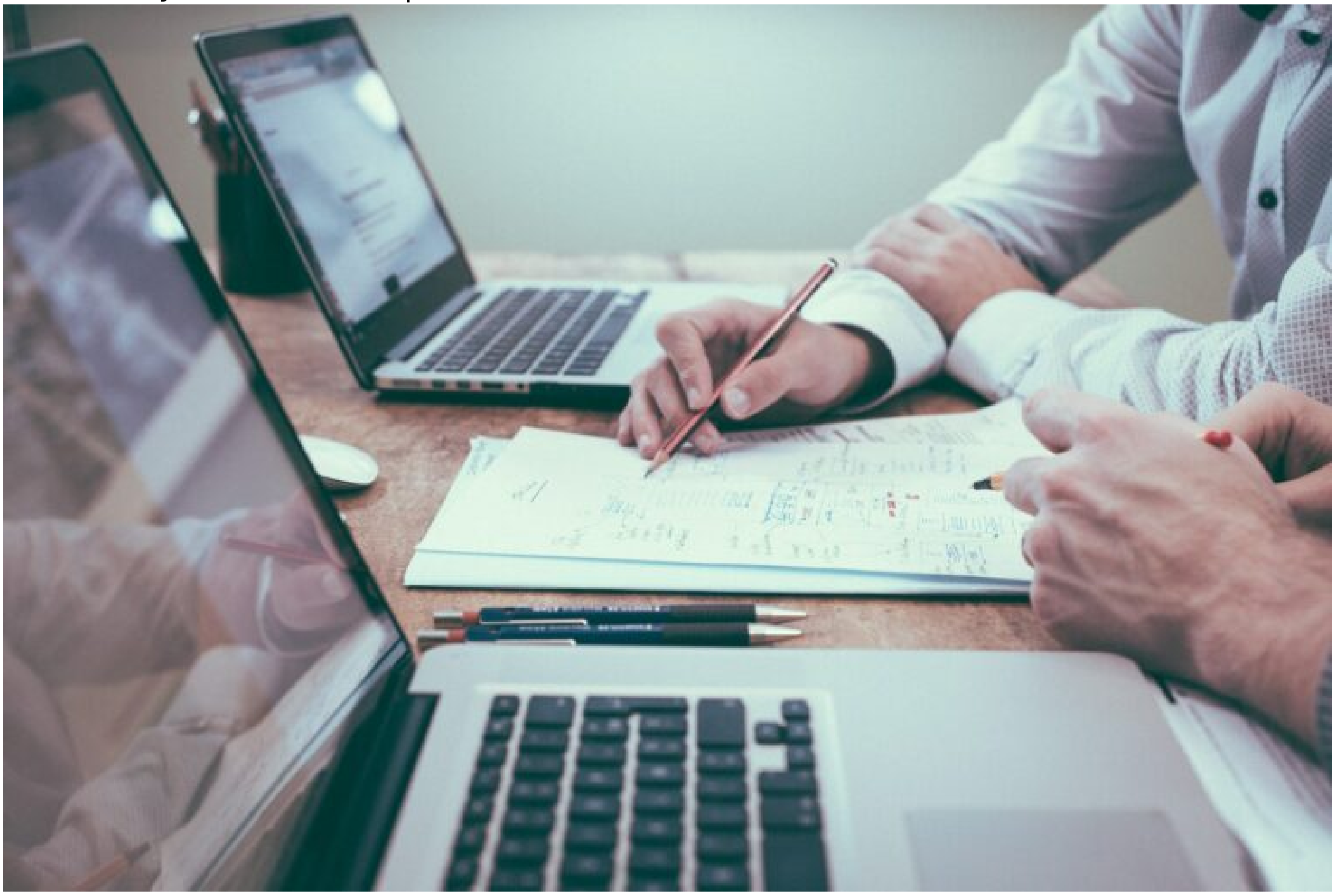

Introduction

Recently, the Reserve Bank of India (RBI) issued guidelines regarding Default Loss Guarantee (DLG) in digital lending.[1] These guidelines are intended to govern agreements between Regulated Entities (REs) and Lending Service Providers (LSPs) or between two REs involving DLG, also known as First Loss Default Guarantee (FLDG). The RBI's decision to permit such arrangements is contingent on the immediate implementation of the circular's guidelines. Various sections of the Banking Regulation Act, Reserve Bank of India Act, National Housing Bank Act, and Factoring Regulation Act authorize the issuance of these regulations.

The recommendations of the Working Group on Digital Lending were the impetus for the Reserve Bank of India (RBI) to issue guidelines on Default Loss Guarantee (DLG) in digital lending. The RBI issued a press release on August 10, 2022, highlighting the recommendations of the working group, which included a review of First Loss Default Guarantee (FLDG).[2] Subsequently, the RBI reviewed DLG arrangements between REs and LSPs or between two REs. These guidelines provide a regulatory framework for DLG digital lending arrangements.

Main Points Of The Guideline

Scope of Application, Definitions, and Eligibility

- Applicable to Regulated Entities (REs) conducting digital lending operations, such as Commercial Banks, Cooperative Banks, and Non-Banking Financial Companies (NBFCs).
- DLG is a contractual agreement between RE and a qualified entity that guarantees compensation for default-related losses. The terms and definitions from the Circular titled 'Guidelines on Digital Lending' dated 02 September 2022 apply.[3]
- DLG arrangements are only permitted with LSPs or other REs with whom the RE has an outsourcing arrangement. An LSP that offers DLG must be a company incorporated per the Companies Act of 2013.

Structure, Forms, and Cap on DLG

- DLG arrangements must be governed by a legally binding contract between the RE and DLG provider. The contract should outline the extent of DLG coverage, the type of DLG maintenance, the timeframe for invoking DLG, and the disclosure requirements.
- REs will accept DLG in the form of cash, fixed deposits with a Scheduled Commercial Bank, or a bank guarantee in the RE's favor.
- The total DLG coverage on outstanding loans should not exceed five percent of the outstanding loan portfolio. The performance risk of implicit guarantee arrangements should not exceed five percent of the underlying loan portfolio.

Recognition for NPAs, Treatment for Regulatory Capital, and Other Important Timelines

- Regardless of DLG coverage, recognition of individual loan assets as Non-Performing Assets (NPAs) and provisioning remains the responsibility of the RE. The DLG amount cannot be deducted from the underlying individual loans.
- Exposure calculation, credit risk mitigation, and regulatory capital continue to adhere to existing standards.
- Unless the borrower makes the payment earlier, RE must initiate DLG within 120 days of the due date.
- The duration of the DLG agreement should not be less than the longest tenor of loans in the underlying loan portfolio.

Other Requirements and Exceptions

- On their websites, LSPs with DLG arrangements must disclose the number of portfolios and respective quantities covered by DLG.
- REs should have a board-approved policy for DLG arrangements that includes eligibility requirements, a monitoring procedure, fees payable to the DLG provider, etc. The DLG arrangement is not a replacement for credit evaluation requirements, and robust credit underwriting standards are required.
- Concerning DLG arrangements, customer protection, and grievance redress should adhere to Digital Lending Guidelines and other applicable norms.
- Certain schemes/entities, including the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE), are excluded from DLG coverage.

Industry Observations on the Guidelines

- **Positive for Credit Penetration:** The introduction of First Loss Default Guarantee (FLDG) arrangements in digital lending is viewed as a positive development that will enhance credit penetration and the digital lending ecosystem.
- **Transparency and Discipline:** It is anticipated that the regulatory framework for FLDG arrangements will foster greater transparency and discipline in the digital lending environment.
- **Clarity and Harmonisation:** The proposed regulatory framework will offer clarity and harmonization to the digital lending industry's regulated entities.
- **Partnership and Collaboration:** The guidelines have been welcomed as encouraging greater partnerships and collaboration among traditional banks, regulated entities, NBFCs, and fintech firms, thereby democratizing access to credit and fuelling growth for the unserved and underserved segments.
- **Enhanced Ecosystem:** The guidelines are viewed as a positive step that will improve the ecosystem and provide opportunities for innovative solutions, such as digital escrow services, which enable secure collections and transactions.

Overall, industry stakeholders are optimistic about the guidelines, anticipating that they will foster growth, transparency, and collaboration in the digital lending industry, while also ensuring adequate safeguards and regulation.

Conclusion

In conclusion, the RBI has implemented a regulatory framework for LDG arrangements in digital lending to promote transparency, discipline, and credit penetration while addressing regulatory concerns. The guidelines have been established with input from various stakeholders and are intended to promote the orderly expansion of credit delivery via digital lending methods. The framework emphasizes that lending must be conducted by entities regulated by RBI or authorized by applicable laws. The industry has responded positively to these guidelines, with stakeholders expressing optimism regarding the potential for increased credit access, collaboration, and overall expansion of the digital lending ecosystem.

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[1]https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12514&Mode=0.

[2]https://rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=54187.

[3]https://rbi.org.in/Scripts/NotificationUser.aspx?Id=12382&Mode=0.

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