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Introduction

"Banking Everywhere, Never at a Bank" – as stated by the author Brett King is almost becoming a reality in Indian banking scenario. Today, UPI based instant digital payments and numerous other financial solutions are no longer a novelty for Indian banks customers, even in Tier 2 or 3 cities. New-age Fin-Tech companies, by using technologies like data analytics, machine learning are offering innovative digital services such as crowdfunding, alternative finance, digital lending, etc. Among all of them, digital lending services have evolved into one of the fastest growing segments in India and its market size is expected to reach USD 515 Billion by 2030 as per an IIFL Fintech Report (2023). Digital lending is a remote and automated lending process which uses seamless digital technologies in customer acquisition, credit assessment, loan approval, disbursement, recovery, and associated customer service (RBI Report, 2021).

In this policy note, we discuss the evolution of the regulatory framework pertaining to digital lending in India. We focus on the recent guidelines on Default Loss Guarantees in Digital Lending, issued by the Reserve Bank of India (RBI) on 8th June, 2023 and highlight the implications of the same for the financial markets.

Growth in Digital Lending

India witnessed a surge in credit card usage during COVID-19 pandemic, where card payments rose from INR 6,30,414 crore in FY 2020-21 to INR 10,49,065 crore as of September FY23. Despite the increase in credit demand, only 86 million (around 6%) Indians have credit cards as of April 2023. Low adoption of credit cards could be due to the reluctance of traditional banks to issue this service to customers with non-existent (or low) credit score. This provided an opportunity to Fintech companies, NBFCs and other similar entities to offer credit services to this segment of customers. Borrowers who lacked credit history could avail the service without tedious paperwork. Furthermore, leveraging the all-pervasive mobile app-based technology, Fintech companies could also access and on-board large numbers of potential credit customers.

A plethora of digital lending apps (DLAs) such as consumer durable loan, scan and pay, Buy Now Pay Later (BNPL), etc. are now offered in the market through mobile and web-based applications. Balance sheet lenders (BSL), like banks and NBFCs, can use their in-house DLAs to directly offer their own credit products and services to potential customers. Alternatively, banks may outsource some of the credit functions such as customer acquisition, underwriting and pricing support, monitoring and recoveries of loan, etc. to one or more third-party Lending Service Providers (LSPs), who may do so using their own digital platforms and capabilities. As such, the LSP, acting as an agent for one or more banks becomes an intermediary between the credit customer and the bank. Diagram 1 depicts these alternative mechanism of digital lending.

Regulatory Environment

The Indian Government and Reserve Bank of India have been taking a lot of initiative to drive digital innovation which would promote financial inclusion, while protecting consumer interest and reducing the risk in financial system. The RBI Working Group on Digital Lending was set up in January 2021 which released their recommendations in November 2021 focusing on three measure issues: conduct, technology and charges.

Among many of the issues highlighted by the RBI Working Group, a key focus was on the financial stability implications pertaining to the rapidly evolving digital lending landscape in India. Financial system risks could arise due to unethical practices, lack of track record and banking experience of the players to whom lending services are outsourced but who are outside the purview of formal financial sector regulations. Over-reliance on automated credit underwriting, over-selling in specific credit market segments, and absence of rigorous due diligence on customer suitability and KYC by the LSPs could also lead to creation of risky and concentrated loan portfolios on the books of the banks.

The Working Group also identified that in some cases, the LSP, as a non-banking non-financial company could be undertaking balance sheet lending in partnership with a bank or NBFC or on a stand-alone basis, while bypassing lending regulations. Another relevant concern was that balance sheet lenders often entered into First Loss Default Guarantee (FLDG) arrangements with the LSPs, whereby the LSPs implicitly or explicitly assumed the credit risk of loans originated by them without having direct credit exposure.

In September 2022, the RBI released Guidelines on Digital Lending applicable to all the Regulated Entities (REs) such as Commercial banks, Cooperative Banks and NBFCs including Housing Finance Companies who engaged in offering digital lending services directly or through LSPs. These guidelines incorporated many of the recommendations of the RBI Working Group. Through these guidelines, the onus of prudent management of digital lending was placed entirely upon REs, and through them on LSPs. These included compliance on

- Customer data maintenance and protection
- Credit fund flows from the RE to the customer and vice versa
- Disclosures to borrowers on digital loan products and their key terms
- Customer grievance redressal
- Reporting of digitally originated loans data to Credit Information Companies
- Transparency and due diligence of LSP partnerships

The guidelines stressed that disbursements and repayments on loans originated and serviced digitally through LSPs had to be routed directly through the borrower's bank account with the RE and not via any pass-through or pool account of any third party,

including accounts of LSPs or DLAs. This effectively eliminated any balance sheet lending exposures by unregulated, non-financial intermediaries and curtailed financial interconnectedness between REs and LSPs.

The guidelines enhanced the transparency of digital loans by mandating REs to provide certain disclosures about their products, annual rates, penal charges, recovery mechanism, etc. and insisted that any fee not mentioned, cannot be charged to the borrower. They also required that any fees or charges payable by REs to the LSP had to be paid directly and could not be collected by the LSP from the borrower.

By addressing many of the concerns of the RBI Working Group, RBI's guidelines on digital lending and subsequent FAQs were largely effective in creating safer and better regulated digital lending practices. However, in the context of FLDG arrangements between REs and LSPs, the guidelines were a little ambiguous. They referred to RBI's Master Directions on Securitisation of Standard Assets dated September 24, 2021, thereby implying that such arrangements would mostly be construed as "synthetic securitisation" and consequently be prohibited.

The First Loss Default Guarantee (FLDG) Mechanism

The FLDG is a contract between banks and other REs with Fintechs and LSPs, whereby the latter source credit customers for the bank and perform related services (like monitoring, pricing, collection and recovery) for a fee consideration and, if the loan(s) default, compensate the lender for a part of the loss up to a certain pre-agreed percentage of the loan amount. As a "first loss" guarantee, the bank has a right to recovery their bad debt loss on the defined loan portfolio by first claiming the amounts under the guarantee by the LSP, even before overdues are recovered from the borrower(s) or the underlying security. Diagram 2 portrays the FLDG arrangement in digital lending.

The FLDG provides both the REs and LSPs with a conducive mechanism for enhancing and safeguarding credit business. Banks which do not have direct customer reach in certain credit markets or are hesitant to lend directly to risky customer categories can leverage both the technology capabilities and the FLDG guarantee of their fintech partners, while reducing potential losses from such untested credit segments. The FLDG is also perceived by the lenders as the LSPs "skin in the game" and as such, an indirect tool to induce discipline in customer acquisition. LSPs on the other hand cannot lend directly, but earn fee revenue for their digital credit services to the REs, while also sharing the credit risk of the business they bring for the bank.

Prior to the RBI guidelines on Digital Lending (September 2022), the FLDG terms were negotiated between the RE and their LSPs without any regulatory restrictions or oversight. This obviously implied that the loss cover agreed would be subject to the inherent credit risk of the underlying portfolios and could potentially be very high (as high as 100% of the portfolio in some cases). Furthermore, various alternative forms of FLDG were negotiated between banks and LSPs. It could be a funded guarantee in the form of direct cash deposits of the LSP. It could be a non-funded corporate guarantee issued by the LSP in favour of the lender. The FLDG could also be implicit and self-funded, where the acquiring lender could defer the fees payable to the LSP under the outsourcing contract, and use those amounts to offset credit losses on the acquired portfolios.

The widespread use of default loss guarantees in digital lending threw up a number of critical regulatory concerns. First was a moral hazard issue. Banks, with the assurance of the guarantee backing their acquired loans, could be inclined to lend recklessly, while diluting their own underwriting and monitoring standards for such portfolios. Second, in the event that the FLDG was in the form of a corporate guarantee issued by the LSP, it created a significant counterparty risk for the lender if the LSP itself failed to honour its obligations. Thirdly, as pointed out by the RBI Working Group (2021), unregulated and sometimes unauthorised LSPs, could be participating in balance sheet lending or becoming "synthetic" lenders via the FLDG, without being subject to provisioning and capital adequacy norms for the assumed credit risk.

RBI Guidelines on Default Loss Guarantees in Digital Lending and its Implications

RBI's earlier move to ban FLDG arrangement between REs and digital lending service providers was clearly motivated by the potential risks to the financial system. However, in the process, legitimate technology-led business models, which allowed banks to lend more and created greater and easier access to formal credit in the economy also became severely constrained. Thus, on 8th June 2023, RBI issued fresh guidelines which permitted default loss guarantees, but with many caveats.

Firstly, such guarantees are now permitted only as a part of a formal outsourcing contract between an RE and an LSP and where the latter is incorporated as a Company under the Company's Act (2013). Furthermore, the RE is required to have Board approved policies in place for default loss guarantee arrangements and conduct appropriate evaluation of the LSPs' financial position and ability to honour the guarantee. This ensures that primarily legitimate, well-governed and financially sound entities with a direct stake in the outsourced digital lending business of the RE are eligible to provide the FLDG.

Secondly, the guidelines require the default loss guarantee itself to be formally structured and legally enforceable. At the minimum, the extent of the guarantee cover, its type and validity period, timeline for invocation and disclosure requirements by the LSP have to be specified upfront. This reduces any ambiguity in FLDG arrangements between the RE and LSP and enhances the transparency of LSP obligations under such structures.

Thirdly, regulatory limits and constraints are imposed on the extent, tenor and form of default loss guarantees taken by REs with the objective of creating a more disciplined environment for outsourced digital lending. The guarantee has to be in the explicitly funded form of cash deposited with the RE, lien on fixed deposits maintained with a scheduled commercial bank or a bank guarantee in favour of the RE. Corporate guarantees are therefore excluded. This will obviously come at an additional cost to the LSPs which may be passed on to the credit customers. Some newly founded LSPs may not have the financial capacity to provide this form of credit enhancement and hence they may not be able to participate in the process. But on the whole, the new arrangement will definitely ensure digital lending partnerships are created with sound players, thereby reducing the overall riskiness in the business.

The amount of default loss guarantee in each contract is capped at 5 per cent of the outstanding amount of the outsourced loan portfolio. Implicit covers are allowed but also restricted to maximum 5 per cent of outstanding loans. This stipulation envisages a

more balanced risk-sharing between the RE and LSP. It will motivate balance sheet lenders to evaluate digitally acquired loans more stringently since losses beyond 5% will not be covered by the LSP. This may also incline REs and LSPs both to focus more on inherently safer credit like housing loans and thereby reduce the volumes of risky unsecured loans originated on third-party digital platforms. The validity of the guarantee agreement has to be at least for a period equal to the longest tenor loan in the underlying portfolio. Thus, availability of the guarantee cover over portfolio lifetime will discourage perverse incentives of LSPs to use high risk-return strategies and over-extension of credit for short term gains.

The guidelines emphasise that for the REs, digitally originated loans will continue to be subject to extant regulatory capital adequacy norms, including application of credit risk mitigation benefits on individual loan assets. The implication here is that while credit risk capital charge under the Basel framework will apply to such loans, the cash margins or Bank guarantees provided by LSPs under the default loss guarantee may or may not reduce the capital allocated depending on whether they are attributed to individual loans or to the portfolio as a whole.

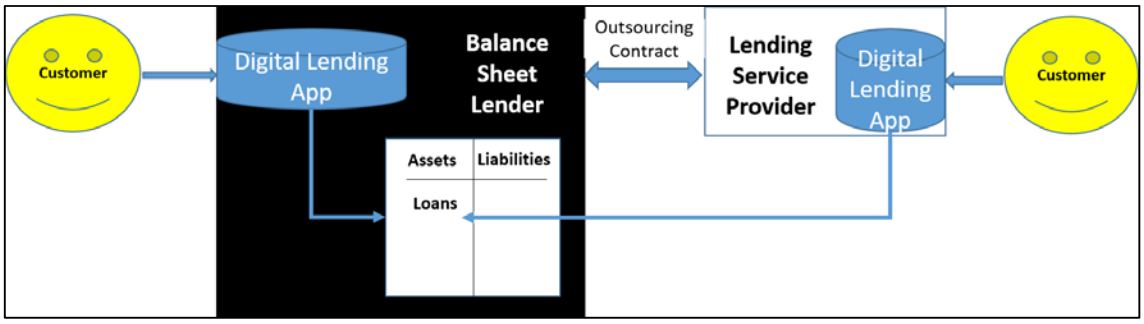
Finally, the guidelines require that irrespective of the default loss guarantee, any loans that default from the acquired portfolios need to be recognised as NPAs on the books of the RE and provisions for the same have to be made as per extant regulations. Furthermore, the FLDG has to be invoked by the RE within a maximum overdue period of 120 days but recoveries from guarantee invocation cannot be set-off against the underlying NPA. These rules thus pass on the responsibility and accountability of timely NPA recognition, provisioning costs and initiation of recovery proceedings against borrower principally on to the RE, thereby reducing moral hazard even further.

Conclusion

The Reserve Bank of India's green signal to the use of FLDG in digital lending collaborations between banks and Fin-techs in its latest guidelines is an industry positive move as compared to the previous digital lending guidelines (September, 2022) which had effectively forbidden such loss-sharing arrangements and created industry-wide confusion and concern. Beyond just permitting such arrangements, the guidelines provide clarity at granular levels on various aspects of guarantee itself, the providers of the guarantee and the treatment of portfolios subject to such guarantees.

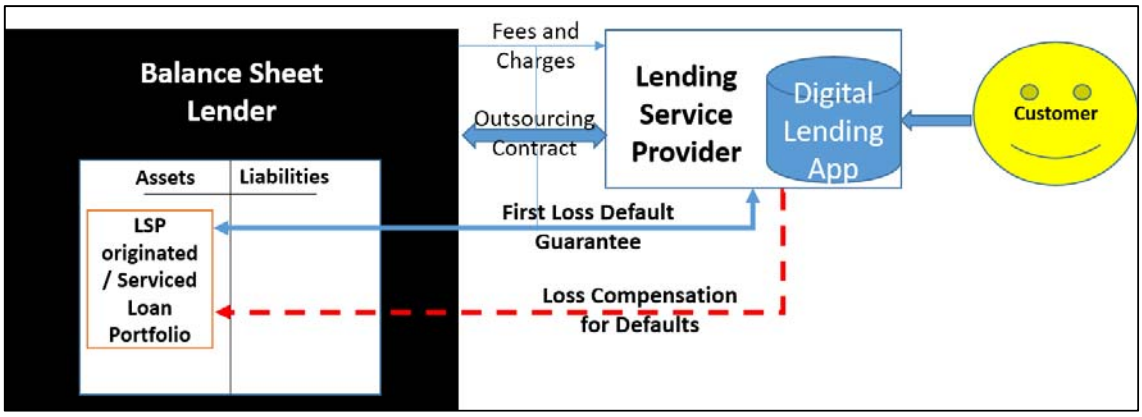
REs and LSPs will clearly have to face a few operational hiccups as they comply with the RBI guidelines. The digital lending business models will have to be streamlined; existing collaborations may have to be reviewed; digital outsourcing and FLDG contracts may have to be drawn afresh. REs may have to move from structures where loan portfolios and the self-funded default loss guarantee cover were fluid and evolved over time depending on the customers on-boarded by the LSP to well-defined structures which have an upfront specification and funding of FLDG cover. REs will also have to accept greater ownership and accountability of digital loans. However, as these issues get ironed out, there is no doubt that at the core, the regulatory intent is to continue to boost fintech innovations and financial outreach within a more transparent and customer-friendly framework, while safeguarding the financial system.

Diagram 1: Mechanisms for Digital Lending



Source: Authors' own construction

Diagram 2: FLDG Arrangement in Digital Lending



Source: Authors' own construct

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