A CRITICAL EVALUATION OF DIGITAL LENDING GUIDELINES: AN ANALYSIS OF ITS IMPACT ON FINTECH COMPANIES

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ABSTRACT

Digital lending holds great promise for financial inclusion, but with it comes inherent risks that demand regulatory oversight. The Reserve Bank of India's recent guidelines on digital lending has sparked debates, particularly regarding the first loss default guarantee (FLDG) model. This paper delves deep into the nuances of the guidelines and their implications for the fintech industry, aiming to bridge the gap between regulatory intent and practical industry concerns. Fintech players using this model are seeking clarity on the line of permissibility, as RBI's guidelines push for improvisation within the confines of existing laws. This paper aims to analyze and interpret the August 2022 Press Release, the September 2022 Guidelines on Digital Lending, and relevant provisions on synthetic securitization in the RBI's Master Guidelines 2021 to understand the regulator's ultimate intention behind the regularization. The paper delves deep into three main factors; the position of the third party in an FLDG model, the degree of compliance suggested by RBI's use of the word "advice," and the possible consequences for the fintech industry. In conclusion, this paper aims to bridge the gap between regulatory intent and practical industry concerns regarding digital lending in India. It highlights the importance of striking a balance between promoting financial inclusion and mitigating associated risks. With clarity and adherence to regulations, digital lending can continue to be a valuable tool for financial inclusion and economic growth in India.

INTRODUCTION

Digital lending has the potential to increase the public's access to financial services and products in a way that is both fair and effective. Digital lending does come with some inherent risks, however, including direct third-party engagement, mis-spelling, data privacy breaches, unfair business practices, the charging of exorbitant interest rates, and unethical recovery practices. If these risks are addressed, the public's confidence in digital lending may

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be maintained. The Reserve Bank of India ("RBI") issued the "Guidelines on Digital Lending" (Guidelines) on 2 September 2022[1]to banks and non-banking finance companies (NBFCs) that disburse loans through digital lending platforms. These Guidelines recognize the related risks to ensure the orderly development of digital lending, the preservation of financing stability, and the protection of depositors' and customers' interests. This follows the press release issued by the RBI on 10 August 2022 on the implementation of the recommendations of the Working Group on Digital Lending (Press Release).[2]

However, the issue arises regarding RBI's stance on first loss default guarantee (FLDG), which has put the fintech players who use this model extensively on the spot with regards to finding the line of permissibility and are seeking clarity from the regulator on the same. This surging dilemma is hidden in the recent 2022 guidelines mentioning provisions on synthetic securitization given in RBI's 2021 master directions on securitization on standard assets to be the guiding force for regulated entities in governing the industry practice of offering financial products involving contractual agreements, such as FLDG. Without clearly defining the legal limits of such techniques, RBI pushes players to improvise while staying within the confines of the already-existing laws.

This paper attempts to analyze and interpret the August 2022 Press Release, the September 2022 Guidelines on Digital Lending, along with the relevant provisions on synthetic securitization in relation to FLDG laid down in RBI's Master Guidelines 2021 with respect to three main factors: position of the third party in an FLDG model, RBI's correct implications behind using the word "advice" with regards to the degree of compliance suggested, as well as the fintech industries' resultant probable setback to get a more precise grasp of the objective and possible consequences that might follow RBI's Guidelines on Digital Lending.

Because this study aims to understand and analyze the root reasoning behind RBI's new August 2022 Press Release, September 2022 Digital Lending Guidelines, as well as its 2021 Master Directions regarding the securitization of standardized assets, it is of utmost importance that the researcher keeps in mind the regulator's ultimate intention while going forward with the necessary research. According to Shaktikanta Das, the governor of RBI, the need for fintech regulation emanates from the challenges they pose to the financial system

[1] Reserve Bank of India, Guidelines on Digital Lending, RBI/2022-23/111 (Issued on September 2, 2022).
[2]Reserve Bank of India, Recommendations of the Working Group on Digital Lending – Implementation, 2022-2023/689 (Issued on August 10, 2022).

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and the new risks they carry, as these risks have a bearing on overall financial stability and market integrity. Therefore, the line of deliberation in this paper has been made to investigate the possible consequences of the changes made while comparing them with RBI's intended outcome.

Since this paper is a form of legal doctrinal study rather than an empirical one with its emphasis on examining existing regulations and notifications, the researcher will be following the formerly used and established practice of thematic analysis of the pertinent changes introduced by the RBI and enquire into the embedded objective of these provisions to grasp the backbone of the reasoning while putting out practical industry concerns that might arise as a result of the new regulations.

FLDG AND ITS SIGNIFICANCE IN FINTECH INDUSTRY

An FLDG arrangement is one in which Lending Service Providers (LSPs) guarantee loans up to a certain percentage while an NBFC advances the loan via the LSP. Loans would continue to be recorded on the LSPs' balance sheets, allowing them to inflate their financial statements without maintaining regulatory capital. Therefore, the LSPs essentially made balance sheet loans while evading the regulation. This system ensures that lenders are compensated in the event of a borrower default. Lenders are more willing to make loans as long as a third party serves as loss protection.

Given that there is a guarantee on a portion of the loan, FLDG enables lenders to alter their underwriting procedures and take on greater risk. These plans assist in getting money into the hands of borrowers who would not otherwise be able to do so. They also assist in increasing liquidity, which can lower the risk for investors in debt mutual funds. Furthermore, the government is not required to give the borrower cash outright. When the borrower defaults and there is little chance of recovery, it saves resources and only makes up the difference in those situations. The Centre has employed this mechanism on a few occasions in the past to increase lender confidence.

RECENT DEVELOPMENTS

The RBI, on 13 January 2021 issued a press release confirming the constitution of a Working Group for the purpose of studying all aspects of digital lending activities in the regulated financial sector as well as by unregulated players in an effort to move towards engineering an

appropriate regulatory framework that could be put in place for digital lending through online platforms for consumer protection.

On 18 November 2021, the Working Group submitted its report to the RBI where it put forth various recommendations for addressing the existing and potential risks in the digital lending ecosystem without stifling innovation, on which RBI also sought public comments. Further to this, the RBI, on 10 August 2022, issued a press release laying down the preliminary regulatory framework for the relevant entities based on the recommendations of the Working Group, while on 2 September 2022, the new Comprehensive Guidelines governing the Regulated Entities were released. Such recommendations and guidelines have been discussed thoroughly hereunder.

RBI's Press Releases and New Guidelines

On 2 September 2022, RBI issued Comprehensive Guidelines which would govern Digital Lending by the Regulated Entities in India. These guidelines cover a wide range of topics, including hiring service providers, credit scoring, data privacy, upholding open systems and processes, reporting, and a grievance redressal procedure. These rules also apply to "existing customers" who take out new loans and 'new customers getting onboarded'. Until 30 November 2022, Lenders have to set up the necessary systems and procedures to guarantee that "existing digital loans" also adhere to these regulations in letter and spirit.

The RBI stated in the press release that it was reviewing the Working Group's recommendation to ban FLDG arrangements in the market and that, in the interim, banks and NBFCs entering FLDG arrangements must abide by the Master Direction - RBI (Securitization of Standard Assets) Directions, 2021 ("Securitization Guidelines").[3]This showed that the RBI was still looking into the practice in the industry of banks and NBFCs obtaining FLDG comfort from LSPs who are not directly regulated or supervised by the RBI. It also needed to clarify what specific compliances under the Securitization Guidelines must be adhered to by the banks and NBFCsto provide the lenders who are users of FLDG any comfort. If the RBI mandates the advisory, REs will not be able to participate in synthetic securitization like FLDG and transfer the risk to a pool of exposures, in whole or in part.

[3]Reserve Bank of India, Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021, RBI/DOR/2021-22/85, (Issued on September 24, 2021).

The Guidelines now require lending banks and NBFCs to abide by the Securitization Guidelines, particularly the provision relating to synthetic securitization, for any contractual arrangements involving a third party compensating the lenders for up to a percentage of the default in a loan portfolio. Synthetic securitization transactions are subject to certain limitations outlined in the Securitization Guidelines. While such transactions are not permitted for lenders to engage in regularly, any such transactions that lenders do engage in must be hundred percent capital based and subject to RBI supervision. While consequently, RBI wants to restrict any FLDG arrangements in the market altogether.

RBI's Master Directions 2021

As has been mentioned before, in the recent RBI guidelines, FLDG is permitted subject to adherence to the provisions on synthetic securitization contained in Para (6)(c) of the Master Direction – RBI (Securitization of Standard Assets) Directions, 2021. As per the said guidelines, lenders, including overseas branches of Indian banks, cannot undertake synthetic securitization "where credit risk of an underlying pool of exposures is transferred", in whole or in part, using credit derivatives or credit guarantees that serve to hedge the credit risk of the portfolio which remains on the balance sheet of the lender.[4]

COMPARISON WITH PAST REGULATIONS

Any form of risk transfer in a pool of loans by any lender to a third party is not allowed if the relevant provision of the RBI's new guidelines is taken literally. To clarify, even though the term "FLDG" is used, the said provision still applies if the entire pool is protected. It is unclear whether it is improper for the third party, who is the risk transferee, to acquire a stake in the mezzanine tranche if the guarantee is for the second loss piece and the lender retains ownership of the first loss risk.

Without a doubt, synthetic securitizations are where mezzanine risk transfers occur the most frequently. However, if the RBI's goal was to ensure that the party holding the loans did not also hold the risk, this issue does not arise in the case of mezzanine risk transfers. Furthermore, the application is applicable even though a regulated entity is offering the guarantee. For loans made digitally, the Guidelines would still apply.

[4]Direction (6)(c), Reserve Bank of India, Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021, RBI/DOR/2021-22/85, (Issued on September 24, 2021).

Additionally, it is also possible for a co-lender to receive the risk transfer. Hence, as a way to protect the funding co-lender from losses during such a transaction, the originating co-lender offers a default guarantee. In the majority of co-lending arrangements, such agreements are very typical. It should be noted that the prohibition on "third party guarantees" only applies to the co-lender, who is also a lender himself. Insofar as the default guarantee does not invalidate the fundamental nature of co-lending as a partnership between two lenders, it is not covered by the text of the Guidelines. It is a different matter if a co-lender with a 20% stake assumes the risk of the entire pool and receives returns from it, in which case it is essentially no different from synthetic lending of the other 80%. One could, however, decide to follow the letter of the guideline rather than the spirit.

ISSUES AROSE

As the recent steps of RBI have proven to effectuate a tectonic shift in the fintech world, certain issues and challenges are bound to surface as a result of the same. Hereunder, this paper highlights a few such key issues that arise subsequent to the studied developments:

Fogginess Regarding *'Advice'*

The new guidelines on digital lending say, "The REs are advised to ensure that the LSPs engaged by them and the DLAs (either of the RE or the LSP engaged by the RE) comply with the guidelines contained in this circular."[5] Now, there is a problematic aspect to the wording used herein, especially with regard to the connotations behind the word "*advised*". The same is owing to the fact that it raises questions about whether 'advised' means mandatory or is just a recommendation without obligation. Furthermore, the aim is to make it mandatory, considering the spirit and the language in Annexure II of RBI's 2022 August Press Release. In that case, there is still substantial confusion to be resolved regarding the ceiling of compliance reaching only till Para 6(c), or the entire Master Directions, on the grounds that the recent guidelines also say, "boards of REs shall ensure that the extant regulatory instructions are complied with in both letter and spirit."[6] This dilemma needs to be put to rest as the implications of both these undertones ought to have contrasting effects which might raise unintended consequences in the future for the fintech industry.

[5] Reserve Bank of India, Guidelines on Digital Lending, RBI/2022-23/111 (Issued on September 2, 2022).
[6] *Id*at 5.

Banning of Third-Party *FLDGs*

Grave concerns about the prohibition of third-party FLDGs have been raised by multiple market players and experts. According to the RBI's recently announced digital lending guidelines, regulated firms must abide by the master instruction on the securitization of standardized assets, including synthetic securitization, when issuing financial products containing contractual commitments, such as FLDG. According to the FLDG model, the LSP offers specific credit-improving features, such as a first-loss guarantee of up to a predetermined percentage of loans issued. Offering FLDG, in the LSP's view, serves as a showcase of its underwriting abilities. According to the lender, it assures that the platforms have some financial stake in the company. The industry, as a whole, needs to be more precise about what is and is not allowed in FLDG. The regulator still needs to provide more explanation on this matter. Before, unregulated Digital Lending Apps (DLAs) and LSPs used to provide regulated organizations with some form of FLDG. The RBI has since declared its intention to prohibit transactions under the ambit of synthetic securitization, and it had made it all the more challenging to determine where the limits should be drawn.

Restrictions on Credit Access

Several first-time borrowers will likely be denied credit access due to the restrictions outlined above on FLDG. With the aid of technology-focused service providers, the FLDG model enabled banks and NBFCs to lend to the underserved borrower sector. This ensured that lending service providers and fintech platforms had stakes in the outcome and were equally invested, together with the lending bank or NBFC, in raising the standard of the loan portfolio and the credit profiling process. Banning FLDG altogether agreements would be a significant setback for bank-fintech collaborations and might negatively affect the fintech sector's ability to acquire loans. While the RBI's intention to lower systemic risk brought on by these FLDG arrangements is well understood, the RBI could have regulated FLDG arrangements by dictating a phase-wise reduction in existing FLDG arrangements up to a reasonable cap to ensure that market participants are not significantly impacted in the short-term and would have enough time to discuss and come up with alternative solutions.

Obtaining NBFC License

A Digital Lending Expert, Parijat Garg, stated that FLDG has changed into a system where platforms are rewarded with cash incentives for bringing in business as long as there are no penalties associated with any performance shortcomings. Nalin Agarwal, the co-founder and director of Snapmint, believes that these arrangements could be temporary and only last until the platform obtains an NBFC license. However, acquiring an NBFC license has become more challenging for fintech platforms due to increased applications received by the RBI following new regulations. Consequently, larger players are expected to acquire smaller platforms with NBFC licenses, leading to more consolidation in the sector. MyShubhLife's Chief Executive Monish Anand said that since a significant part of the market does not have an NBFC license, there will be consolidation and cleaning up of the market. By acquiring an already registered NBFC, players can continue operating without having to wait for their application to be accepted by the regulator. Additionally, Garg noted that acquiring an NBFC through acquisition is nearly as time-consuming as obtaining a new NBFC license.[7]

CONCLUSION

The publication of the standards for digital lending is a positive step toward protecting consumers of digital lending who have previously been the target of unfair harassment and harsh treatment at the hands of certain market participants. The RBI has made it clear that digital lenders must be entirely transparent when disclosing the characteristics of the loan product and any associated terms and conditions. Banks, NBFCs, loan service providers, and fintech platforms must appoint a grievance redressal officer to handle any customer concerns. While these steps will go a long way toward boosting consumer confidence and trust in the Indian digital lending ecosystem, the RBI needs to take another look at the arising issues, amongst the instance with reference to FLDG, to ensure minimal faulty transactions with malaise intentions while also keeping the market open and inviting for the interested newcomers and those involved in digital lending to make certain that everyone involved is effectively contributing to the optimum goal of greater financial inclusion and evolution.

[7]Aman Rawat, Fintechs get on the job to comply with RBI lending norms, Mint (Mar 27, 2023, 4:25 PM) https://www.livemint.com/