RBI permits loan default guarantee in digital lending

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The **Reserve Bank of India** (RBI) has recently allowed **default loss guarantee** (DLG) in the **digital lending** to boost fintech activity in the **financial sector**.

[ref-outlook money]

About the Default Loss Guarantee:

- The Default Loss Guarantee is also known as **First Loss Default Guarantee** (FLDG).
- The First Loss Default Guarantee is an **arrangement** whereby a **third party** such as a **Lending Service Providers** (LSP) **compensates lenders** if the **borrower defaults**.
- The Default Loss Guarantee acts as a **safety-net arrangement** among **banks**, non-banking **finance** companies, and LSP.
  - Lending Service Providers is also known as financial technology (**fintech**) **player**.
- The LSP provides certain **credit enhancement** features such as **first loss guarantee** up to a **pre-decided** percentage of **loans** generated by it.
- For all purposes, **credit risk** is borne by the **LSP without** having to maintain any **regulatory capital**.
- The loan portfolio backed by **FLDG** is similar to the **off-balance sheet portfolio** of the LSP wherein the **nominal loans** are written in the books of the **lender** without having to participate in any **lending process**.
  - **Off Balance Sheet Portfolio** means **principal balance** of **loans** securitized, assigned, originated on behalf of other **institutions** in respect of which the **Issuer** has provided **credit enhancements** in any **form** or manner.

What reservations did RBI have initially?

- RBI had earlier reserved the **FLDG arrangement** as it felt that the **model** could pose a **systemic risk**.
- A **working group committee of the bank** has suggested that in some cases, **fintechs** were undertaking **balance-sheet lending** along with a **bank/ NBFC**.
  - **Balance sheet lending** is a **monetary loan** in which the **original lender** retains the **debt** throughout the **life cycle** of the loan.

    - This was happening outside the **RBI regulations**.
- The RBI has issued guidelines on **digital lending** in 2022, but it did **not** clarify on the **FLDG structure**.
- In the absence of clear directions, **regulated entities** like banks had stopped entering into such **arrangements** with **fintech players** which posed a **threat** to their business.

What does an LSP do?

- Lending service providers use **technology platforms** for the lending purpose.
- Lending service providers are **agents** of a **bank** or **NBFC** who carry out one or more of a **lender's functions** in customer acquisition, underwriting support, pricing support, disbursement, servicing, monitoring, recovery of specific loan or loan portfolio on behalf of **regulated entities** (REs).

RBI's Guidelines on FDLG:

- The RBI has stated an **RE** can enter into **DLG arrangements** only with an **LSP** or other REs with which it has entered into an **outsourcing** (LSP) **arrangement**.
    - **Outsourcing** is the business practice of hiring a party outside a **company** to perform some services that were traditionally performed by the company's own **staff**.
- The **LSP-**providing **DLG** must be **incorporated** as a company under the **Companies Act, 2013**.
- The RBI has allowed banks to accept DLG in **digital lending** only if the **guarantee** is in the form of a **cash deposit**, or **fixed deposits** in a bank in favour of the **RE**, or a **bank guarantee** in favour of the RE.
- Banks and NBFCs should ensure that the **total amount** of DLG cover on any outstanding portfolio does **not** exceed **5%** of the **amount** of that loan portfolio.

