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RBI NOTIFIES DIGITAL LENDING GUIDELINES

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Introduction

On 2 September 2022, the Reserve Bank of India (RBI) issued the '*Guidelines on Digital Lending*' (Guidelines) to banks and non-banking finance companies (NBFCs) which disburse loans through digital lending platforms. 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). Please refer to our analysis of the Press Release here.

Key Highlights

The Guidelines largely mirror the approach highlighted by the RBI in the Press Release, and set out various compliances to be followed by banks and NBFCs while engaging with third party service providers (who may assist with customer acquisition, underwriting support, portfolio monitoring and loan recovery) and lending through digital lending applications / platforms. The RBI has reiterated that banks and NBFCs must ensure that all service providers engaged by them must comply with regulatory requirements set out in the Guidelines.

While the various compliances prescribed under the Guidelines are in line with those contained in the Press Release, we have outlined below a few key aspects, including deviations from the Press Release:

- **Implementation timelines**

  The RBI has stipulated that the Guidelines will be effective from the date of the notification, ie 2 September 2022 for '*existing customers availing fresh loans*' as well as '*new customers getting onboarded*'. With respect to existing digital loans sanctioned prior to the date of the notification, the RBI has provided a transition period until 30 November 2022 for banks and NBFCs to put in place adequate systems and processes for compliance.

  Comment: *The absence of a general transition period (for both existing and new customers) could result in hasty implementation of the various compliance requirements prescribed under the Guidelines. Given that the digital lending industry involves 2 (two) primary types of market players (lenders such as banks and NBFCs on one hand, and fintech companies (who act as service providers to the lenders) on the other hand), satisfactory implementation of the Guidelines* *would require both lenders and service providers to efficiently collaborate to ensure full regulatory compliance.*

While the RBI had issued the Press Release around 20 (twenty) days prior to the date of the notification of the Guidelines, such short time-period appears to be insufficient given the various parties involved in multiple limbs of a digital lending transaction. The RBI could have instead adopted a phase-wise approach towards implementation of the Guidelines which would have provided sufficient time for compliance teams of banks and NBFCs to liaise with the various service providers engaged by them (as they would also need to analyse the capacity and capability of such service providers to ensure satisfactory compliance).

- **First Loss Default Guarantee (FLDG)**

In the Press Release, the RBI had mentioned that it was examining the recommendation suggested by the working group to prohibit FLDG arrangements in the market, and that in the interim, banks and NBFCs entering into FLDG arrangements must adhere to the Master Direction - Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021 (Securitisation Guidelines). This indicated that RBI was still examining the industry practice of banks and NBFCs obtaining FLDG comfort from lending service providers (who are not directly regulated or supervised by the RBI). It was also unclear as to what exact compliances under the Securitisation Guidelines must be followed by banks / NBFCs who intend to provide FLDG comfort to lenders.

The Guidelines now stipulate that for any contractual arrangements involving a third party compensating the lenders for up to a percentage of the default in a loan portfolio, the lending banks / NBFCs must comply with the Securitisation Guidelines, especially the provision relating to synthetic securitisation (which is an arrangement where the credit risk of an underlying pool of loan exposures is hedged by the originator through credit derivatives or credit guarantee arrangements). The Securitisation Guidelines impose certain restrictions on synthetic securitisation transactions. While lenders are not permitted to enter into such transactions in the normal course, any such transactions entered into by lenders must be subject to 100% capital charge, and will be subject to RBI's supervisory scrutiny and action. Based on the above, it appears that RBI is intending to completely restrict any FLDG arrangements in the market.

<u>Comment</u>: *These restrictions on FLDG will likely result in depriving several new-to-credit borrowers from obtaining access to credit. The FLDG model allowed banks and NBFCs to work with technology focused service providers to lend to the underserved borrower segment. This ensured that lending service providers and fintech platforms had skin in the game, and were equally invested (along with the lending bank or NBFC) in improving the credit profiling process and overall quality of the loan portfolio. Completely restricting FLDG arrangements would be a tremendous setback for bank-fintech partnerships and could adversely impact access to credit for the fintech industry. While the RBI's intent in reducing systemic risk arising due to such FLDG arrangements is well appreciated, the RBI could have regulated FLDG arrangements by prescribing phase-wise reduction in existing FLDG arrangements up to a reasonable cap, so as to ensure that market players are not drastically impacted in the short-term, and would have sufficient time to discuss and arrive at alternate solutions.*

- **Fund flows**

The RBI has prescribed that all fund-flows relating to loan disbursement and repayment must be directly between the bank account of the lender and borrower, without any pass-through or pool account of any third party. Limited carve-outs to this general rule have been provided for: (i) co-lending transactions entered into by banks and NBFCs in accordance with the existing regulatory instructions issued by the RBI; (ii) disbursements covered exclusively under the statutory or regulatory mandate of the RBI or any other regulator; and (iii) disbursements to third parties pursuant to specific end-uses of the loans (provided the loans are disbursed into the bank accounts of the relevant end-beneficiaries).

Comment: The exceptions or carve-outs provided by the RBI do not specifically cover any repayments made by borrowers through digital payment methods offered by payment service providers / payment aggregators (under which the funds would be routed through the escrow accounts required to be maintained by such payment aggregators). This could make it very cumbersome for lenders to offer digital payment options to borrowers for repayment of loan amounts disbursed by them.

Further, the RBI has not generally permitted digital lending platforms to enter into escrow account arrangements (similar to escrow accounts permitted to be utilised for lending fund-flows with respect to peer-to-peer (P2P) lending platforms where bank-promoted trustees are permitted to operate the escrow account based on instructions received from the lenders). Absence of such carve-outs could result in increased operational complexities for both lenders as well as fintech platforms in managing the disbursement and repayment fund flows.

- **Cooling-off Period / Look-up period**

  The RBI has prescribed a minimum cooling-off / look-up period to be adopted by banks and NBFCs (during which the borrower is permitted to exit the digital loan by making payment of the principal amount and proportionate annual percentage rate (APR) costs). For loans having tenor of less than 7 (seven) days, the cooling-off period must be at least 1 (one) day, and for other loans, such cooling-off period must be at least 3 (three) days. The board of directors of banks and NBFCs are required to determine the cooling-off period to be offered by such banks / NBFCs to their customers.

Concluding Remarks

The notification of the digital lending guidelines is a step in the right direction to protect digital lending consumers who have been subject to undue harassment and harsh treatment by certain market players in the past. The RBI has clearly emphasised the need for digital lenders to be completely transparent in the disclosure of the loan product features, and related terms and conditions. Banks / NBFCs as well as the lending service providers / fintech platforms must mandatorily appoint a grievance redressal officer who is entrusted to deal with any consumer complaints. While these measures will go a long way in improving consumer confidence and trust in the Indian digital lending ecosystem, the RBI must relook on a few aspects such as FLDG and fund-flows (as discussed above) to ensure effective participation of the digital lending stakeholders in achieving greater financial inclusion.

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