First Notes

RBI issues guidelines on Default Loss Guarantee

27 June 2023

First Notes on

Financial reporting

Corporate law updates

Regulatory and other information

Disclosures

Sector

All

Banking and insurance

Information, communication, entertainment

Consumer and industrial markets

Infrastructure and government

Relevant to

All

Audit committee

CFO

Others

Transition

Immediately

Within the next three months

Post three months but within six months

Post six months

Forthcoming requirement

Background

The significant expansion of digital lending in India, drove RBI to issue the Digital Lending guidelines (DL guidelines)[1] in September 2022. The DL guidelines struck a balance between the need for an innovative and inclusive system of lending and protecting the customer's interest.

The DL guidelines focussed on three main areas:

- Customer protection and conduct requirements
- Technology and data requirement
- Regulatory framework.

However, specific guidelines were not provided for contracts involving Default Loss Guarantee (DLG). RBI in its press release issued in August'22 clarified that recommendations around this area were under examination. Until then, Regulated Entities (REs)[2] entering into financial contracts that included a clause on First Loss Default Guarantee (FLDG) or DLG were required to comply with the Securitisation Guidelines, especially the provision relating to synthetic securitisation[3].

What is DLG ?

A DLG is a contractual arrangement, called by whatever name, between the RE and a DLG provider, under which the latter guarantees to compensate the RE, against a loss due to default, up to a certain percentage of the loan portfolio of the RE, specified upfront. Any other implicit guarantee of similar nature linked to the performance of the loan portfolio of the RE and specified upfront, shall also be covered under the definition of DLG[4].

Prior to the DL guidelines, many arrangements entered into by LSPs with REs included a DLG clause.

[1]Digital lending guidelines were issued on 2 September 2022.

[2]Regulated entities includes all commercial banks (including small finance banks), primary (urban) co-operative banks, state co-operative banks, central co-operative banks; and Non-Banking Financial Companies (including Housing Finance Companies (HFCs)) (NBFCs).

[3] Synthetic securitisation 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.

[4]This definition is as per the Guidelines on Default Loss Guarantee for digital lending. It is to be noted that guarantees covered under certain schemes would not be covered under DLG, these include:

- Guarantee schemes of Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE),
- Credit Risk Guarantee Fund Trust for Low Income Housing (CRGFTLIH) and
- individual schemes under National Credit Guarantee Trustee Company Ltd (NCGTC).
- Credit guarantee provided by Bank for:
  - International Settlements (BIS),
  - International Monetary Fund (IMF), as well as
  - Multilateral Development Banks

Who is a DLG provider ?

A DLG provider can be a Lending Service Provider (LSP). An LSP is an agent of a regulated entity (banks and NBFCs) who carries out one or more of its functions or part thereof in customer acquisition, underwriting support, pricing support, servicing, monitoring, recovery of specific loan or loan portfolio on behalf of regulated entities in conformity with extant outsourcing guidelines issue by RBI)/ other RE with which it has entered into an outsourcing (LSP) arrangement. Further, the LSP providing DLG must be incorporated as a company under the Companies Act, 2013.

New development

The RBI, vide a statement[5] dated 8 June 2023 has now permitted REs to enter into agreements with LSPs or other REs involving DLGs, subject to compliance with the Guidelines on Default Loss Guarantee (DLG) in digital lending (the Guidelines)[6]. The Guidelines are applicable from 8 June 2023.

The Guidelines have provided clarification on the pre-requisites to a DLG arrangement and points to consider while entering into or after entering into a DLG arrangement. These are given below:

Pre-requisites to DLG arrangement

- Board approved policy
- Eligibility of DLG provider
- Declaration from DLG provider
- Credit appraisal requirements
- Structure of DLG arrangements

After/during the DLG arrangement

- Forms of DLG
- Five per cent cap and minimum tenor of DLG
- Regulatory capital and recognition of NPA
- Invocation of DLG
- Disclosure requirements of LSP

(*Source: KPMG in India's analysis, read with Guidelines on Default Loss Guarantee (DLG) in Digital Lending, issued by RBI on 8 June 2023*)

In this issue of the first notes, we aim to provide an overview of the Guidelines.

Overview of the DLG guidelines

The Guidelines would be applicable to DLG arrangements entered in 'digital lending' operations undertaken by REs- key points for REs to consider are bifurcated into pre-requisites to DLG arrangement and matters to consider while entering into or after entering into DLG arrangements. These are further explained below:

A. Pre-requisites to DLG arrangements

The pre-requisites to be considered by REs before entering into DLG arrangements are:

1. **Board approved policies:** REs should put in place policies that are approved by their board of directors (board) before entering into any DLG arrangement. The board policies should at the minimum include the following:
   - The **eligibility criteria** of the DLG provider (refer note A2)
   - Nature and extent of **DLG cover**
   - Process of **monitoring** and reviewing the DLG arrangement
   - Details of **fees payable** to DLG provider

[5] Statement on Development and Regulatory Policies
[6] DLG arrangements conforming to the Guidelines would not be treated as 'synthetic securitisation' and/or shall also not attract the provisions of 'loan participation'.

1. **Eligibility of DLG provider:** An LSP or an RE can be considered as a DLG provider if it satisfies the following conditions:
    - ***Outsourcing arrangement:*** The RE should have entered into an outsourcing arrangement with the LSP or the other RE.

    - ***LSP should be a corporate:*** LSP that is providing DLG should be incorporated as a company under the Companies Act, 2013.

3. **Declaration from DLG provider:** Prior to initiating or renewing a DLG arrangement, the RE should at the minimum obtain a declaration from the DLG provider, certified by the LSP's statutory auditor on the following matters:
    - Aggregate DLG amount outstanding
    - The number of REs
    - The respective number of portfolios against which DLG has been provided
    - Past default rates on similar portfolios.

4. **Credit appraisal requirements:** While DLG arrangements would provide credit relief to the REs to a certain extent, RBI has reiterated that the DLG arrangement should not act as a substitute for credit appraisal requirements and robust credit underwriting standards.

5. **Structure of DLG arrangements:** Every DLG arrangement should be backed by an explicit ***legally enforceable contract*** between the RE and the DLG provider. Such contract, should inter alia include:
    - Extent of DLG cover
    - Form in which DLG cover is to be maintained with the RE (Refer note B1 of the First Notes)
    - Timeline for DLG invocation (Refer note B4 of the First Notes)
    - Disclosure requirements of the LSPs (Refer note B5 of the First Notes)

B. After or during the DLG arrangement

1. **Forms of DLG:** The guarantee provided by the DLG provider should be in one or many of the below forms:
    - Cash deposited with the RE
    - Fixed deposits maintained with a Scheduled Commercial Bank with a lien marked in favour of the RE
    - Bank guarantee in favour of the RE.

2. **Cap on and tenor of DLG:** Details of cap on and tenor of DLG are given below:
    - **Cap on DLG:** Total amount of DLG cover on any outstanding portfolio should not exceed **five per cent** of the amount of that loan portfolio[7].
    - **Tenor on DLG:** The DLG arrangement will remain in force for a minimum period of the longest tenor of the loan in the underlying loan portfolio. (For example, a loan portfolio for which DLG arrangements have been entered into includes three loans with a tenor of 6 months, 2 years and 5 years respectively. The DLG arrangement entered into with a DLG provider should be for a minimum tenor of 5 years.)

3. **Regulatory capital and recognition of Non-Performing Asset (NPA):** RBI has provided the following clarification:
    - ***Recognition of NPA:*** Despite there being a DLG cover available at the portfolio level, individual loan assets within the portfolio would be recognised as NPA and provision for the same would be computed as per the extant asset classification and provisioning norms. Additionally, the following should be considered:
        i. The amount of DLG invoked would not be set off against the underlying individual loans.
        ii. Recovery by the RE, if any, from the loans on which DLG has been invoked and realised, can be shared with the DLG provider in terms of the contractual arrangement.

    - ***Treatment of DLG for regulatory capital:*** Capital computation on individual loan assets[8] in the portfolio shall continue to be governed by the extant norms.

[7] In case of implicit guarantee arrangements, the DLG provider should not bear performance risk of more than the equivalent amount of five per cent of the underlying loan portfolio.
[8] This includes computation of exposure and application of Credit Risk Mitigation benefits on individual loan assets

4. **Invocation of DLG:** The RE should invoke DLG within a maximum overdue period of 120 days, unless made good by the borrower before that.

5. **Disclosure requirements of LSP:** The RE should ensure that LSPs with whom they have a DLG arrangement publish on their website the total number of portfolios and the respective amount of each portfolio on which DLG has been offered.

Our comments

- **Supporting the fintech ecosystem:** With the issuance of the Guidelines, RBI has acknowledged the importance of LSP and other fintech REs. They have also recognised the need for creating a sustainable business and oversight model by clearly defining the responsibility of each player in the digital lending journey. This will now result in a stronger partnership between REs and DLG providers, and a transparent and reasonable amount of risks and rewards sharing between them. As a result, REs would be encouraged to introduce technology enabled lending products and thereby contributing to enhanced credit penetration in India.

- **Applicability of the Guidelines:** It is important to note that these guidelines apply specifically to digital lending arrangements and accordingly, the conditions specified in the Guidelines may not apply to loans sourced through other channels.

- **Compliance by LSPs:** The Guidelines have reiterated (this was already required by the DL guidelines) the requirement for REs to ensure that LSPs comply with all the requirements set out by RBI. Post the issuance of the DL guidelines, most REs have adopted processes that would enable them to monitor compliances by the LSPs. They would now need to set up additional processes and controls to ensure that new requirements prescribed by the Guidelines are complied with by the LSPs.

  In case of non-compliance of the Guidelines by the LSPs or by the REs, the entities would not be able to take benefit of relaxations set out in the Guidelines and consequently, the related arrangements would need to comply with the provisions of the Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021 dated September 24, 2021, especially, synthetic securitisation contained in Para (6)(c).

- **Ultimate customer relationship by REs:** While LSPs play a significant part in marketing the products of the RE, and facilitating lending to the borrower, including providing DLG arrangements to their partnering REs, LSPs are neither participants in lending nor lenders themselves. Accordingly, both the operational aspects relating to the loan (e.g. correspondence with customers - including exchange of documents, disbursals of loan and collection of amounts) and commercial considerations relating to the respective loans (e.g. credit risk) would be primarily rest with the REs. This will also imply that compliance with all applicable guidelines relating to providing loans to customers including maintaining necessary technology infrastructure will be the responsibility of the REs.

Our comments (cont.)

- **Arrangements with other REs:** While the primary focus of the Guidelines is to cover the arrangements between REs and other LSPs (who are not REs), the Guidelines also acknowledge that an outsourcing arrangement between two REs may be covered. Accordingly, all existing and new arrangements between REs will have to be carefully evaluated to determine whether these arrangements represent outsourcing arrangements or whether these are other arrangements (e.g. co-lending).

- **Greater onus of credit assessment upon REs:** The quantum of financial guarantee generally provided by LSPs prior to the issuance of the DL guidelines was not capped and hence, in certain cases, LSPs provided significant DLG support to the loans (to the extent of 50 to 60 per cent of the portfolio in some cases). The Guidelines have now introduced a cap on the quantum of DLG to the extent of five per cent of the portfolio. This makes the commercial positions of the parties with reference to the contracts clear- i.e. the REs are responsible for the loans including substantial credit risk, while the LSPs are providing a guarantee for the same (as a third party). Thus, REs would need to ensure they put in robust underwriting processes and credit assessment of the ultimate borrowers before the loans are issued to the customers.

- **Impact on provisioning for NPAs:** While preparing financial statements, many companies (e.g., NBFCs) are required to comply with Ind AS. As per Ind AS 109, *Financial Instruments*, companies are required to compute impairment loss on all financial assets by applying the principles of Expected Credit Loss (ECL). While computing ECL on loans advanced by an RE, Ind AS 109 requires cash flows expected from a collateral and other credit enhancements that are considered to be a part of the contractual terms to be adjusted in the ECL computation. Accordingly, REs would need to assess whether the relevant conditions for inclusion of DLG as a part of the ECL computation[9] are met.

  For banks, the provision for NPA is required to be maintained in accordance with RBI's Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances (IRACP norms)- where the DLG would not be considered as a part of the classification and provisioning requirements. Similar considerations will apply for the purpose of computation of impairment reserve for NBFCs.

  In future, once the proposal for ECL-based impairment provisions for banks is finalised, banks would also need to consider the impact of these guidelines on the provision for NPAs based on the approach discussed in this comment.

  Further, from a capital adequacy perspective, it is to be noted that REs would not obtain any benefit of the guarantee offered by DLG providers while computing the capital requirements.

- **Accounting for guarantee amounts received by RE:** The guidelines are currently silent on the accounting for amounts that would be received by the RE from the DLG provider in the case of a loss event. However, such accounting would be dependent on whether the guarantee has been considered as an integral or a non-integral part of the underlying loan agreement.

[9] While assessing whether the DLG is an integral element of the debt instrument, and is accounted for as a part of that instrument, factors that may be considered include:
- The guarantee is implicitly part of the contractual terms of the debt instrument - e.g. because the loan agreement refers to it;
- The guarantee is required by laws and regulations that govern the contract of the debt instrument;
- The guarantee is entered into at the same time as and in contemplation of the debt instrument;
- The guarantee or the credit exposure that it covers can be assigned to a new holder independently from the other; and
- The guarantee is given by the parent of the borrower or another company within the borrower's group.

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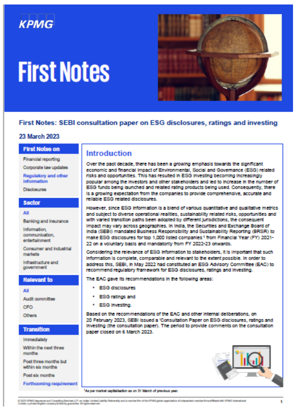
Issue no. 82 – May 2023

The topics covered in this issue are:

- Assessment of control and significant influence for consolidated financial statements
- Application of derecognition requirements to a factoring arrangement
- Regulatory updates

To access the publication, please click here



Framework on green deposits and its use for green activities

26 May 2023

In India, in recent times, there has been an increase in focus of the financial system to move towards green financing.

A key mode of green finance that has progressively gained traction is ‘green deposit’. Green deposit refers to an interest-bearing deposit, received by a Regulated Entity (RE) for a fixed period and the proceeds of which are earmarked for being allocated towards green finance.

Consequently, on 11 April 2023, RBI issued a Framework for Acceptance of Green Deposits (the framework). The framework is effective from 1 June 2023.

The framework aims to direct the flow of funds to sustainable projects and initiatives, protect the interest of the depositors and address greenwashing concerns.

In this issue of the First Notes, we have summarised the key elements of this framework.

To access the First Note, please click here

KPMG in India is pleased to present Voices on Reporting – Annual updates publication 31 March 2023

Voices on Reporting – Annual updates publication (for the year ended 31 March 2023) provides a summary of key updates from the Securities and Exchange Board of India (SEBI), the Ministry of Corporate Affairs (MCA), the Reserve Bank of India (RBI), the National Financial Reporting Authority (NFRA), the Ministry of Finance, the Institute of Chartered Accountants of India (ICAI) and the Insurance Regulatory and Development Authority of India (IRDAI).

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