

INDIA LEGAL UPDATE

June 22, 2023

Reserve Bank of India (RBI) issues Guidelines on Default Loss Guarantee (DLG) in Digital Lending

Notification Date:

June 8, 2023

Effective Date:

June 8, 2023

Legal Framework:

Banking Regulation Act, 1949;
Reserve Bank of India Act,
1934;
Factoring Regulation Act,
2011

Government Authority:

Reserve Bank of India

Weblink:

[RBI Notification](#)

LEGAL UPDATE

RBI has examined arrangements between REs (Regulated Entities) and LSPs (Lending Service Providers) or between two REs involving DLG (Default Loss Guarantee), also known as FLDG, and has decided to permit such arrangements subject to these guidelines.

DLG arrangements in compliance with these guidelines shall not be treated as 'synthetic securitisation' and/or shall also not attract the provisions of 'loan participation'.

Applicability:

- 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)

Default Loss Guarantee (DLG) means a contractual arrangement, by whatever name called entered between the RE and DLG Provider, under which the latter guarantees to compensate the RE, 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.

Eligibility as DLG Provider:

- RE may enter into DLG arrangements only with a Lending Service Provider (LSP) / other RE with which it has entered into an outsourcing (LSP) arrangement.
- The LSP providing DLG must be incorporated as a company under the Companies Act, 2013.

KEY QUESTIONS

What is the Structure of DLG Arrangements?

DLG arrangements must be backed by an explicit legally enforceable contract between the RE and the DLG provider containing the following details:

- the extent of DLG cover;
- form in which DLG cover is to be maintained with the RE;
- timeline for DLG invocation; and
- disclosure requirements: LSPs to **publish on their website** the total number of portfolios and the respective amount of each portfolio on which DLG has been offered.

What are the forms of DLG?

RE shall accept DLG only in one or more of the following 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

Is there any cap on DLG?

- RE shall ensure that the total amount of DLG cover on any outstanding portfolio which is specified upfront shall not exceed 5% of the amount of that loan portfolio.
- In the case of implicit guarantee arrangements, the DLG Provider shall not bear a performance risk of more than the equivalent amount of 5% of the underlying loan portfolio.

How can NPA be recognised?

- Recognition of individual loan assets in the portfolio as NPA and consequent provisioning shall be the responsibility of the RE.
- The amount of DLG invoked shall not be set off against the underlying individual loans.
- 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.

How to treat DLG for regulatory capital?

Capital computation, i.e., computation of exposure and application of Credit Risk Mitigation benefits on individual loan assets in the portfolio shall continue to be governed by the extant norms.[1]

[1] Para 7 of the 'Master Circular on Basel III Capital Regulations' dated May 12, 2023, Master Direction – NBFC– Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, Master Direction – NBFC - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, Master Circular on 'Prudential Norms on Capital Adequacy - Primary (Urban) Co-operative Banks (UCBs)' dated April 20, 2023, Circular on 'Operating Guidelines for Small Finance Banks' dated October 6, 2016.

KEY QUESTIONS

Can an RE invoke DLG?

The RE shall invoke DLG within a maximum overdue period of 120 days unless made good by the borrower before that.

What will be the tenor of DLG?

The period for which the DLG agreement will remain in force shall not be less than the longest tenor of the loan in the underlying loan portfolio.

Is there any due diligence or any other requirements with respect to the DLG provider?

- REs shall put in place a Board approved policy before entering into any DLG arrangement.
- Any DLG arrangement shall not act as a substitute for credit appraisal requirements and robust credit underwriting standards need to be put in place irrespective of DLG cover.
- Every time an RE enters into or renews a DLG arrangement, it shall obtain adequate information to satisfy itself that the entity extending DLG would be able to honour it.

Are there any exceptions?

Guarantees covered under the following schemes/ entities shall not be covered within the definition of DLG:

- 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.

Queries?

If you have any queries about this article, please reach out to our experts:



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