NATIONAL LAW UNIVERSITY, JODHPUR

SCHOLASTICUS

VOLUME XI, ISSUE I **DECEMBER, 2023** **ISSN: 0975-1157**

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FIRST LOSS DEFAULT GUARANTEE: FINANCIAL INCLUSION THROUGH DIGITAL LENDING?

Abir Lal Dey[⊥], *Ananya Ghosh*[Ø]*&* *Arnav Sinha*[⊤]

ABSTRACT

Touted as the game changer in the fintech sector, the Reserve Bank of India's (RBI) new first loss default guarantee (FLDG) Guidelines are creating a positive outlook in the digital lending space. Prior, to the new FLDG Guidelines, the then-existing rules and regulations pertaining to FLDG in digital lending transactions were ambiguous. The fintechs who wished to introduce newer and fresher lending products to their customers incorporating FLDG structures were constrained to do so due to the lack of clarity in this regard. Thus, the new FLDG Guidelines are a welcome move and extremely encouraging for the fintech ecosystem. This will further augment deeper partnerships and alliances between Banks, NBFCs, regulated entities and new-age fintechs thus penetrating access to credit and fuel growth for the unserved and underserved.

The authors through this paper have deliberated the genesis of FLDG Guidelines and its impact on the fintech and digital lending sectors. Digital lending has been emerging significantly and has played a momentous role in augmenting financial literacy and financial inclusion in India. The RBI's FLDG Guidelines might be the much-needed magic elixir to the uncertainty-stricken default loss guarantee arrangement in digital lending, leading to the dawn of a new era of possibilities in the fintech sector. This paper is an attempt to answer these vital regulatory changes in the fintech ecosystem.

[⊥]Abir Lal Dey is a Partner at Saraf and Partners and may be contacted at abir[dot]dey[at]sarafpartners[dot]com.

[Ø]Ananya Ghosh is an Associate at Saraf and Partners and may be contacted at ananya[dot]ghosh[at]sarafpartners[dot]com.

[⊤]Arnav Sinha is an Associate at Saraf and Partners and may be contacted at arnav[dot]sinha[at]sarafpartners[dot]com.

I. INTRODUCTION

Financial technology or fintech has been thriving in India due to the digitalisation boom witnessed in the country in the past few years. As per a Boston Consulting Report, India's fintech sector is expected to be multiplied by an approximate revenue of six times by the year 2030.[1]

The impetus towards this mushrooming of fintechs instead of traditional brick-and-mortar solutions is primarily due to the demand for alternative credit mechanisms which the 'play-it-safe' traditional banking systems are hesitant to provide. Newer versions of technological solutions are surpassing their previous versions on a day-to-day basis. This technological momentum has not left any stone unturned in the digital lending space as well. Fintechs have developed from their nascent stages of serving niche audiences to households by providing various integrated solutions to their ever-increasing customer base. Along these developments, one such concept introduced and employed by fintechs is the concept of first loss default guarantees *a.k.a* FLDG.

FLDG may be in the form of a contractual arrangement in a lending transaction, wherein a fintech company or lending service provider ("**LSP**") i.e. FLDG provider agrees to compensate the lender for loss that occurred by the lender when the borrower defaults on its repayment commitments

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[1] Vidisha Debsarkar, *Fintech Industry: Marketing trends based on consumer behaviour and challenges faced by the sector*, THE ECONOMIC TIMES (Jan. 16, 2022), available at: https://brandequity.economictimes.indiatimes.com/news/marketing/fintech-industry-marketing-trends-based-on-consumer-behaviour-and-challenges-faced-by-the-sector/88928682.

in return for compensation, which may be charged as additional commission or fees. FLDG became so popular in lending transactions that the FLDG providers started providing up to nearly a hundred per cent guarantee on the defaults of the borrower, essentially stepping into the shoes of the lender, as far as credit exposure is concerned.

The sudden rise in the fintechs necessitated the Reserve Bank of India ("**RBI**") to act as the watchdog for the fintech sector and introduce guidelines and directions to ensure that digital lending by the fintech players is adequately monitored. These guidelines and directions by the RBI ensures that the ambit of digital lending does not go astray and turn into a bane for these platforms, and the lending products introduced by them, crucially serve as the boon for promoting financial inclusions in the country.

It was only a matter of time before the RBI noted the increased usage of FLDG in digital lending transactions through synthetic business structures and therefore, after due contemplation, RBI introduced the Guidelines on Default Loss Guarantee in Digital Lending on June 8, 2023 ("**FLDG Guidelines**"), which governs the FLDG arrangements between Regulated Entities ("**REs**") and LSPs or between two REs.

The term "regulated entity" is an umbrella term that covers commercial banks, small finance banks, cooperative banks, and non-banking financial companies ("**NBFCs**"). LSP is an agent of a RE, which undertakes the functions of the RE, such as customer acquisition.[2] As a requirement, LSPs are mandated to be incorporated under the Companies Act, 2013 to be

[2] The Reserve Bank of India, Guidelines on Digital Lending, RBI/2022-23/111,DOR. CRE.REC.66/21.07.001/2022-23, at cl. 2.5, available at: https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12382&Mode=0.

eligible for providing default loan guarantee ("**DLG**") structures under paragraph 3 of the FLDG Guidelines.

It may be observed that before the FLDG Guidelines, the RBI's Report of Working Group on Digital Lending including Lending through Online Platforms and Mobile Apps dated November 18, 2021[3], prohibited unregulated entities from participating in synthetic structures, such as FLDG.

The FLDG Guidelines brings necessary clarity required for lending arrangements between fintechs (who are eligible to act as LSPs) and REs, which have the potential to alter the landscape of this space acting as a pathbreaking milestone for India's digital lending and fintech space. The FLDG Guidelines serves as a powerful tool to promote innovation in the digital lending space with the development of transformative financial solutions.

Banks are wary of extending loans to high-risk areas with a higher probability of bad loans. These areas generally suffer from information asymmetry due to borrowers' limited credit past, and include sectors such as the MSME, agriculture, and blue-collar, among others.

This collaboration brought in by the FLDG Guidelines will ensure that banks (which have capital and licenses to lend) are working in harmony with the fintechs (which have technological backing). The fintechs can therefore

[3] *Report of the Working Group on Digital Lending including Lending through Online Platforms and Mobile Apps*,RESERVE BANK OF INDIA (Nov. 18, 2021), available at:https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=1189.

focus on innovation and security. They can use big data and secure banking data with the help of technology. The fintechs, which cannot lend directly, can ensure that the banks undertake certain services such as sourcing the loan and recovery and the fintechs carry out the underwriting work, and the customer acquisition, among others. In case the loan becomes a bad loan, the default loss guarantee model will ensure that a certain percentage of the loss is covered by fintech.

Therefore, by framing the FLDG Guidelines, RBI approved the FLDG program thus facilitating the sharing of credit risks between unregulated entities and REs. The FLDG providers act as shock-absorbers and provide guarantees to the REs in the event of default by the borrowers. With this green signaling of the FLDG Guidelines, a percentage of the default in the loan of the registered entity is guaranteed by the LSPs[4]or fintech.

Through the new FLDG arrangements between banks/NBFCs and fintechs, the trust towards the fintechs in the eyes of banks/NBFCs will increase the reliability towards fintechs, which helps improving the business relationships with the backing of fintech's underwriting capabilities.

In this paper, an attempt has been made to analyse the FLDG Guidelines from an all-encompassing viewpoint. A micro and a macro attempt have been undertaken with a worm's eye view and at the same time a bird's eye view to solve the labyrinth of queries in the FLDG space. ***First***, the authors have delved into the historical background and scheme of statutes prior to

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[4] Guidelines on Digital Lending dated September 2, 2022, issued by the RBI defines a 'Lending Service Provider' under Clause 2.5 as *"an agent of a Regulated Entity who carries out one or more of lender's functions or part thereof in customer acquisition, underwriting support, pricing support, servicing, monitoring, recovery of specific loan or loan portfolio on behalf of REs in conformity with extant outsourcing guidelines issued by the Reserve Bank*."

the introduction of the FLDG Guidelines on June 8, 2023. ***Second***, an attempt has been made to provide a detailed, in-depth analysis of the structure of the FLDG Guidelines ***Subsequently***, the authors have analysed the increase in financial inclusion in India resulting from the clarity provided by the FLDG Guidelines to the fintech space. ***Thereafter***, the authors have highlighted the loopholes in the FLDG Guidelines and followed by remedial recommendations in the FLDG Guidelines. The authors conclude this paper with an all-encompassing viewpoint of the FLDG Guidelines.

II. HISTORICAL TRAIL LEADING TO THE FLDG GUIDELINES

With the boom of internet connectivity in India, both mobile and web-based, the country has witnessed immense growth in the usage of technology in the lending space. This overlap of technological development and financing in India has directly resulted in the development of "digital lending" in Indian markets. In simple terms, digital lending is the process of providing credit through online platforms, avoiding traditional intermediaries like banks.

Since its inception, digital lending has been marked by constant development of newer and more complex forms of lending products to achieve improvements in quality, inclusion, and efficiency, which made digital lending a lucrative space for banks, financial institutions, and other players in the Banking, Financial Services and Insurance ("**BFSI**") sector in India. Due to the spurt but unregulated growth of the digital lending space in India, it was inevitable for the RBI to step in and take note of the

unintended consequences and concerns attached to the growth of digital lending in India.

A. RBI Working Group Report and Its Reservation on FLDG

In view of the developments, the RBI constituted a Working Group ("**Working Group**") on digital lending on January 13, 2021, to study all aspects of digital lending activities by regulated as well as unregulated players so that appropriate regulatory measures can be put in place to focus on enhancing customer protection and making the digital lending ecosystem safe and sound while encouraging innovation. The Working Group submitted a report on November 21, 2021 titled "**Report of the Working Group on Digital Lending including Lending through Online Platforms and Mobile Apps**"[5] ("**Working Group Report**"), which underlined various precautionary measures for the digital lending space in India.

The Working Group Report underlined the concept of synthetic lending structures such as the FLDG as a means for unregulated LSPs, as defined under the Digital Lending Guidelines, to circumvent the RBI's prudential norms while undertaking lending transactions. As observed in the Working Group Report under paragraph 3.3.1.2:

> "*A synthetic structure enabling unregulated entities to lend without complying with prudential norms is through credit risk sharing arrangements by way of a "First Loss Default Guarantee (FLDG)" extended by the LSPs. Under this, the LSP provides certain credit enhancement features such as first loss guarantee up to a pre-decided*

[5] RESERVE BANK OF INDIA, *supra* note 3.

> *percentage of loans generated by it. From the LSP's perspective, offering FLDG acts as a demonstration of its under-writing skills whereas from the lender's perspective, it ensures platform's skin in the business.* ***For all practical purposes, credit risk is borne by the LSP without having to maintain any regulatory capital. The loan portfolio backed by FLDG is akin to off-balance sheet portfolio of the LSP wherein the nominal loans sit in the books of the lender without having to partake in any lending process.***"[6]

Additionally, the Working Group Report further delved into its reservations on FLDG by stating that the same allows for LSPs to undertake "balance-sheet lending" while not satisfying the "principal business criteria" in addition to other operational risks posed by FLDG. The Working Group Report under paragraph 3.3.12 underlined that:

> **"*In some cases, the LSP, as a non-banking non-financial company (NBNC) may be undertaking balance sheet lending in partnership with a bank/ NBFC or on stand-alone basis, while not satisfying the principal business criteria to remain outside regulation.*** *Besides, there are higher operational risks which arise due to increasing reliance of lenders on third-party service providers. With increasing share of digital lending in retail/ personal space, there is a potential for risk build-up because of these platforms. This may also be adding to counterparty risks posed by the platform to its lending partners.*"[7]

The Working Group Report under paragraph 3.1.2. specifies that financial activity is treated as a principal business when a company's financial assets constitute more than 50 % (fifty per cent) of the total assets and income from financial assets constitute more than 50% (fifty per cent) of the gross

[6] *Id* at para. 3.3.1.2.
[7] *Id* at para. 3.3.1.2.

income[8]. A company fulfilling both these criteria may acquire registration from the RBI to operate as an NBFC.

Additionally, the Working Group Report was also concerned about the passing of the costs associated with the implementation of FLDG onto the borrowers resulting in higher interest rates. The Working Group Report under paragraph 5.3.4.3. specifically draws concerns in employing such mechanisms in digital lending as the same may lead to unethical and non-transparent loan pricing – having a significant bearing on the interest rate charged to customers:

> "…*Specifically, in digital lending, it has been observed that -*
>
> - *The existence of layer(s) between the borrower and the balance sheet lender leads to non-transparent and unethical loan pricing. The regulated entities are at times not aware of the additional charges/ fees being levied by their third parties.*
> - *As has been explained in Section 3.3.1.2, credit risk sharing mechanisms have also emerged in the form of first loss default guarantee. Internal cost compensation arrangement between the balance sheet lender and the LSP has a bearing on the interest rates being charged to the customers.*
> - *Costs associated with FLDG or any other such mechanism are passed on by the platforms to the borrowers resulting in higher interest rates.*"[9]

B. Recommendations On FLDG Under The Working Group Report

However, unsurprisingly, the Working Group, in its list of recommendations submitted to the RBI under the Working Group Report

[8] *Id* at para. 3.1.2.
[9] *Id* at para. 5.3.4.3.

specifically recommended the prohibition of structures such as the FLDG under paragraph 3.4.3.1:

> "*To prevent loan origination by unregulated entities,* ***REs should not be allowed to extend any arrangement involving a synthetic structure, such as, the FLDG to such entities. REs should not allow their balance sheets to be used by unregulated entities in any form to assume credit risk****."*[10]

Thus, the Working Group specifically recommended the RBI to prevent REs from extending any arrangement involving synthetic structures such as FLDGs. When the draft of the Working Group Report was released for stakeholder comments, it was suggested that FLDG may not be done away with altogether and the same may be allowed considering the capital adequacy ratio of the LSP. It was suggested that a capital adequacy ratio of about 15-20% (fifteen to twenty per cent) may be imposed on LSPs to prevent any systemic risks. This would encourage the LSPs to become regulated by the RBI and acquire a certificate of incorporation accordingly.

C. Guidelines on Digital Lending

Basis Working Group Report, the RBI issued Guidelines of Digital Lending on September 2, 2022 ("**Digital Lending Guidelines**")[11]. However, in what be seen as an endorsement of the Working Capital Report's reservations on FLDG and their consequent recommendations, Digital Lending Guidelines failed to provide specific provisions to govern structures like FLDG. It was widely reported[12] that the RBI's reservations

[10] *Id* at para. 3.4.3.1.
[11] RESERVE BANK OF INDIA, *supra* note 2.
[12] Hitesh Vyas, *RBI permits loan default guarantee in digital lending: Will it boost fintech activity?*,THE INDIAN EXPRESS (June 09, 2023), available at:

on FLDG were that it could pose a 'systemic risk', something which was of concern under the Working Group Report. LSPs, which will provide FLDGs, will in essence be undertaking balance-sheet lending without acquiring registration with RBI which may pose a challenge to RBI's efforts in preventing consumer fraud. The matter of specific concern was primarily that since these LSPs are generally unregulated, they would lack adequate supervision. The high credit risk undertaken by them will not be backed by strong risk management, debt-to-equity ratio requirements, capital adequacy requirements etc. This would, in turn, expose fintech platforms to a high degree of risk and at the same time expose them to potential losses, and therefore would mean an imprudent decision for the regulated entities to enter into.

D. Increased Ambiguity on FLDG

This lack of clarity on the FLDG structures increased with the promulgation of the Digital Lending Guidelines has created more confusion given the ambiguity in the Digital Lending Guidelines. *Prima facie,* it appears that the Digital Lending Guidelines prohibit structures such as the FLDG. However, paragraph 15 of the Digital Lending Guidelines suggests that for loss-sharing arrangements in case of default such as FLDGs, the REs are 'advised' to adhere to the provisions of the **Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021 dated September 24, 2021**, ("**Securitisation Directions**") especially, for synthetic securitisation contained in paragraph (6)(c). Securitisation Directions under paragraph 6(c) specifically prohibited

https://indianexpress.com/article/explained/explained-economics/rbi-permits-loan-default-guarantee-in-digital-lending-to-boost-fintech-activity-8654538/.

REs from taking exposures in the form of synthetic securitisation; leading to further confusion on the RBI's stance on structures like FLDG and casting the impression that the RBI is, if not explicitly, but impliedly, preventing REs from employing FLDGs into their lending transactions.

E. FLDG Guidelines –much-needed clarification on FLDG?

In the absence of clear directions, REs like banks had stopped entering into such arrangements with fintech players, posing a threat to their business in the digital lending space. The fintech industry was demanding that the RBI allow FLDG arrangements basis the suggestions purported by them and in line with suggestions of the Working Group Report.

This has since been modified with the FLDG Guidelines wherein the RBI has laid down the model with stricter restrictions on the partnership between fintech players and REs. With the FLDG structure laid down at present through the FLDG Guidelines, an upper cap of 5% (five per cent) on the total default guarantee has been implemented[13].

In view of the above, a detailed analysis of the FLDG Guidelines has been provided in the next section herein.

[13] The Reserve Bank of India, Guidelines on Default Loss Guarantee (DLG) in Digital Lending, RBI 2023-24/41, DOR.CRE.REC.21/21.07.001/2023-24, available at: https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12514.

III. UNDERSTANDING THE STRUCTURE OF THE FLDG GUIDELINES

FLDG is a contractual arrangement whereby LSP, as a licensed third-party, guarantees a certain percentage of the default in the loan portfolio of a RE entered into outsourcing agreements.[14] The duration of the agreement should be at least as long as the tenure of the loans with the farthest repayment schedule in the underlying portfolio.[15] This ensures that there is a safeguard against any potential risks in the portfolio of the lender.[16] However, it is to be noted that FLDG is different from a co-lending arrangement given that an FLDG arrangement only secures the default by way of guarantee, which does not entail any transfer of underlying loan exposure from the books of the RE to the books of the guarantee provider whereas a co-lending arrangement envisages the sharing of the loan exposure as per a pre-determined understanding between two lenders.

In the recent times, the guarantee providers have started charging fees against the guarantee as opposed to the earlier practice of sharing of the residual income provided in exchange for the guarantee. This exposed them to significant risks since they had to absorb the first loss and at the same time, the residual income is variable in nature. With the FLDG Guidelines,

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[14] *Id* at cl. 4.
[15] *Id* at cl. 10.
[16] Team Finserv, *FAQs on Default Loss Guarantee in Digital Lending*, VINOD KOTHARI CONSULTANTS(Jun. 9, 2023), available at https://vinodkothari.com/2023/06/faqs-on-default-loss-guarantee-in-digital-lending/.

the parties may mutually decide on a contract on the amount to be given to the fintech lending service provider.[17]

A paramount point for observation is the 5% (five per cent) cap on FLDG arrangements prescribed under the FLDG Guidelines. This move has been made to ensure that the total default guarantee by the fintech platform does not go beyond the said upper limit prescribed therein.

Additionally, REs can provide a guarantee only when the fintech provides a guarantee in the form of cash deposited[18], or fixed deposits which are maintained with scheduled commercial banks with a lien (security interest over a property) marked in favour of the regulated entity, or with bank guarantee marked in favour of the regulated entity. This security mechanism ensures that the fintech/LSPs that are providing the guarantee are capable enough to fulfil their obligation in the case of default.

The RBI, as a financial regulator, avoids situations where the borrowings are provided to a person or any entity without sufficient safeguards. Therefore, RBI has provided conditions such as the requirement of a board-approved policy before entering into a default loss guarantee transaction. There are also requirements such as maintaining the standard of ownership and accountability. This has been encompassed by the introduction of credit risk management policies, credit underwriting requirements, regulatory capital requirements, and due diligence

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[17]Sibasish Panda & Ayush Shandilya, *Viewing the RBI's New DLG Guidelines through a Fintech Company's Lens,* IRCCL (Aug.6, 2023), available athttps://www.irccl.in/post/viewing-the-rbi-s-new-dlg-guidelines-through-a-fintech-company-s-lens.

[18] *Id.*

requirements, amongst others. The diligence requisites, to be undertaken by the REs prior to entering into a partnership with an LSP would include the eligibility criteria, nature and extent of the default loss guarantee cover, and the manner of reviewing the default loss guarantee arrangement, provisions for fees (if any) to be paid to the default loss guarantee provider. Fintech entities with their technological capabilities may be able to support the gauging of the creditworthiness of borrowers and may use big data and artificial intelligence while analysing the banking data to ensure that bad loans are avoided. REs have been permitted to opt for a 'first loss default guarantee' within a duration of 120 (one hundred and twenty) days.[19]The purpose of the RBI as demonstrated through this attempt points towards the commitment of the RBI, commitment to timely address the resolution of defaults.

Further, RBI has also mandated stricter disclosure norms[20] such as the requirement for LSPs to publish the details of the total number of portfolios and the amount on which the FLDG was provided on their websites[21] to ensure greater transparency in the process. It will also ensure transparency in the market, analysis of the risks, promoting healthy competition, and strengthening the credit underwriting standards.

The REs are required to obtain necessary information each time enters it into or renews its previous FLDG arrangement to ensure that LSPs have the capability to honour the guarantee provided. The LSP would also be

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[19] RESERVE BANK OF INDIA, *supra* note 13,cl. 9.
[20] RESERVE BANK OF INDIA, *supra* note 13, cl. 11.
[21] Naina Sood, *FLDG Explained: New rules, changes, and how the new framework impacts borrowers, fintechs,* YOURSTORY (June 10, 2023), available at:https://yourstory.com/2023/06/fldg-explained-new-rules-changes-impact-borrowers-fintechs-banks.

required to provide a certificate from a statutory auditor on the guaranteed amount, the number of REs it is dealing with, and the portfolios against which the guarantee is being provided. Further, there should be information on past default rates pertaining to similar portfolios. The FLDG Guidelines thereby encompasses all mitigating factors to avoid financial risks.

Hereinafter, the financial inclusivity promoted by the FLDG Guidelines has been delved in the next section.

IV. FINANCIAL INCLUSIVITY PROMOTED THROUGH THE FLDG GUIDELINES

It is expected that the FLDG Guidelines will provide the fintech space with much-needed clarity on the relation between the REs and the LSPs, thereby promoting financial inclusivity in the BFSI space. The enumeration of the positive outcomes of the FLDG Guidelines has been enlisted below:

A. Level playing field – with a separate guideline to cater to default loss guarantee

The FLDG Guidelines will provide a level playing field to the fintech players by opening more possibilities of collaboration and help in reducing compliance costs, aid business expansion and expand the customer base for lenders and fintech players governed by the FLDG Guidelines as opposed to synthetic securitisation[22], governed under the Securitisation Guidelines.

[22] The Reserve Bank of India, Master Direction - Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021 (Updated as on December 05, 2022),RBI/DOR/2021-22/85, DOR.STR.REC.53/21.04.177/2021-22,para. 5(y), available at: https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=12165.

The FLDG Guidelines will ensure that all participants operate within a consistent and fair regulatory framework. The FLDG Guidelines, applicable to the default loss guaranftee arrangements between REs and LSPs or between two REs, have also been distinguished explicitly by the RBI from the provisions of loan participation[23] as provided under the Master Direction - Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021.[24] This is the manner in which the FLDG Guidelines have differentiated itself from the Digital Lending Guidelines[25], wherein the RBI had directed the REs to adhere to the provisions of the Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021, pertaining to synthetic securitisation.[26]

B. Bolstering foreign investment

FLDG Guidelines provide the fintechs to structure their business in a uniform manner providing their investors with greater clarity[27] on their compliance with the applicable laws. The FLDG Guidelines will ensure necessary safeguardsfor private sector banks and foreign banks, having most of their digital lending portfolio unsecured and specifically, the third-party app sourced loans in private sector banks which are unsecured. Since interest income plays an important role in the revenue stream of a

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[23] The Reserve Bank of India, Master Direction – Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021,(Updated as on December 05, 2022), RBI/DOR/2021-22/86,DOR.STR.REC.51/21.04.048/2021-22, para. 9(e), available at: https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=12166.
[24] *Id.*
[25] RESERVE BANK OF INDIA, *supra* note 2,cl. 15.
[26] *Id.*
[27] RS Sanjanaa, *Securing Borrowers, Shielding Lenders: RBI's Default Loss Guarantee Regulations,* INDIACORPLAW (June 23, 2023), available at:https://indiacorplaw.in/2023/06/securing-borrowers-shielding-lenders-rbis-default-loss-guarantee-regulations.html.

credit/lending platform, FLDG Guidelines will boost the fintech players by providing them with an opportunity to increase their revenue as the FLDG Guidelines would now ensure creditability and trust in the space of digital lending in India.

C. Augmenting credit availability:

With the clarity provided to the fintech sector through the FLDG Guidelines, credit availability through digital lending methods will be given a significant impetus thereby enhancing partnership between institutions like banks, REs, NBFCs and new age fintech companies, who are willing to enter into the digital lending space. This would in turn improve the acceptance towards FLDG structures, therefore promoting greater penetration to the at-present financially excluded regions and increased transparency.[28]

D. Mitigation of risk

The risk that the REs possess from potential losses mitigates significantly with the cap of 5% (five per cent) risk sharing guarantees provided by the LSPs, thereby maintain a balance in the books of the REs. This also allows REs avoid into risky transactions and lending arrangements, therefore resulting in improved and prudent risk management.

[28] Nirav Choksi, *RBI's new FLDG guidelines propel FinTech innovation and financial inclusion*,FINANCIAL EXPRESS (June22, 2023), available at:https://www.financialexpress.com/industry/banking-finance/rbis-new-fldg-guidelines-propel-fintech-innovation-and-financial-inclusion/3136838/.

This cautious approach of restricting the DLG cover on any outstanding portfolio to a maximum of 5% (five per cent) of the amount of loan portfolio, serves as a threshold to avoid risks of the LSPs. In the case of implicit guarantee arrangements,[29]the fintechs has been barred from bearing a performance risk of more than 5% (five per cent) of the underlying loan portfolio.[30] The RBI has also expanded the scope of the definition of 'direct lending to government'. As per the FLDG Guidelines, implicit guarantees can now include 'direct lending to government' and may not be classified as 'synthetic securitisation' or 'loan participation',[31] provided that they are subject to the same requirements as explicit guarantees. This would consequently result in risk mitigation significantly. Additionally, the FLDG Guidelines clearly indicate that this arrangement shall be distinguished from 'synthetic securitisation' and 'loan participation'. The rationale behind this must have been the decision to dissociate the FLDG Guidelines from other directions and guidelines of the RBI, to provide clarity and reduce confusion or overlaps, therefore paving the way for newer opportunities in the fintech space.

The cap of 5% (five per cent) on guarantees would also induce the regulated entities to undertake prudent decisions when undertaking lending arrangements. At this juncture, it may be pointed out that prior to the promulgation of the FLDG Guidelines, with the absence of the cap of guarantees under the FLDG Guidelines, certain fintech partnerships

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[29] *Id.*
[30] RESERVE BANK OF INDIA, *supra* note 13,cl.6.
[31] *Id.*

offered up to 100% (one hundred per cent) FLDG coverage.[32] This resulted in numerous REs being exposed to higher risks of default, as a means of generating more business.

With the restriction now imposed on the guarantees that may be given by the REs, the RBI will effectively prevent REs from entering into such arrangements. REs will now be required to undertake prudent lending decisions in consonance with the FLDG Guidelines.

E. Promoting partnerships between fintechs and regulated entities

The FLDG Guidelines seeks to facilitate partnerships between REs and the upcoming fintechs. The REs and the fintech companies are required to abide by the FLDG Guidelines thereby ensuring better uniformity in the same and resulting in an increased transactions of such nature in the future. This would improve financial literacy and digital penetration in the country, which is still significantly deprived of financial inclusion.

F. Boon for Micro, Small and Medium Enterprises ("MSMEs")

The MSME sector, which is generally deprived of the benefits which the borrowers in a traditional banking sector avail, due to their constraints in size, has found their ray of hope with the FLDG Guidelines. In view of the

[32] Rohit Arora, How the *RBI's* FLDG guidelines are set to transform digital lending in India, THE ECONOMIC TIMES (July 1, 2023), available at:https://bfsi.economictimes.indiatimes.com/news/policy/how-the-rbis-fldg-guidelines-are-set-to-transform-digital-lending-in-india/101400979.

FLDG Guidelines, the REs will be interested to delve into the MSME sector and less reluctant to extend micro-sized loans to MSMEs. This has been made possible due to the FLDG Guidelines whereby strong underwriting platforms would be utilised by the fintech platforms to analyse the customer base. The backing provided through the guarantees would provide the regulated entities with the much-needed comfort and confidence to extend loans to the MSME sector.

Therefore, it can be observed that there would be greater clarity reducing the cloud of confusion in the FLDG space. The traditional lending systems in India are slowly getting replaced due to the recent developments such as demonetisation, the Unified Payment System (UPI) and the post-COVID shift towards digitisation. The clarity provided by the FLDG Guidelines would have a rippling effect on increasing digital lending and would have a positive correlation to increasing financial inclusivity in the country, benefiting stakeholders across the board. The scrutiny to determine eligibility criteria, guidelines for disclosures, due diligence requirements, customer safeguard techniques and other such tools serve as a protective mesh. With the well-structured FLDG framework, fintechs can ensure that proper credit availability no longer remains a coveted dream and converts into a reality for the otherwise deprived MSME sector, amongst the other underserved sectors.

However, the FLDG Guidelines are not devoid of certain improvements, which need timely redressal. In the following section, we have delved into the loopholes and provided our recommendations on the same.

V. LOOPHOLES AND SUITABLE SOLUTIONS

It can be observed from the structure of the default loss guarantee that the DLG offered to an RE can solely be in the form of cash deposits with the RE, or through fixed deposits maintained with scheduled commercial banks with lien marked in favour of the regulated entity. In addition to the aforementioned, bank guarantees in favour of the RE are permitted. It can be viewed that this arrangement of close linkage to traditional banking arrangements, makes the complete process of FLDGs a 'pseudo-digital' in nature.

As per the FLDG Guidelines, the REs shall be responsible for recognising individual loans in the portfolio as non-performing assets and thereafter, it shall make the requisite provisioning. Recovery from a loan, for which a default loss guarantee has been invoked, needs to be shared with the lending service provider as per their contractual arrangement. The above shall apply irrespective of the presence of the first loss default guarantee at the portfolio level, and the amount of default loss guarantee invoked shall not be set off against the underlying individual loans. The reason behind this is not clear, since the amount invoked in respect of default loss guarantee would subsequently reduce the outstanding in respect of that loan.[33]In the case of non-performing assets, the RBI expects the non-performing asset to continue to be recognised in the books of the lender. This approach of

[33] Sawant Singh & Aditya Bhargava, *Default loss guarantees in digital lending revisited*, LAW.ASIA (Aug.14, 2023), available at: https://law.asia/digital-lending-revisited/.

not setting off the loan is therefore in line with the non-performing assets system, which needs to be carefully navigated.[34]

It is to be noted that even if the guarantee is provided in a manner such that it is pre-agreed and deposited with the recipient i.e., the regulated entity, upfront, it can still be utilised by the regulated entity only when there is proportionate disbursement. However, the lending service provider is required to provide a declaration certified by a statutory auditor on the aggregate default loss guarantee amount which is outstanding. It shall also include the number of regulated entities and the portfolios against which the default loss guarantee has been provided. There shall also be information on the default rates in the past on such portfolios and other information, as required by the regulated entity, to ensure that the default loss guarantee would be honoured. It is viewed that this requirement is not reasonable because the guaranteed commitment has already been funded. Therefore, such a detailed inquiry for the default loss guarantee amount, which is outstanding, with an auditor's certificate might be a futile exercise.[35]

It is also to be noted that the FLDG Guidelines might also attract borrowers who are default-prone since they would have an assurance that a certain portion of their loan is covered. This means that FLDG Guidelines might attract borrowers who have a greater tendency to commit defaults, subsequently affecting the loan portfolio. Better quality checks on the creditworthiness of the Borrower might tackle this problem.

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[34] *Id.*

[35] Team Finserv, *supra* note 16.

Contrary to the above, it can be argued that the hard limit of 5% (five per cent) on the amount credited as the default cover can be said to be a mechanism to ensure that the regulated entities are vigilant themselves while providing the loans since their risks are still significantly higher than the fintech lending service provider. However, it may be argued that 5% (five per cent) is still a relatively low percentage to facilitate greater access to credit for the fintech platforms.It is also to be noted that sectors such as student loans etc., lack adequate credit history and both banks and NBFCs avoid the facilitation of such loans. Some lenders have provided credit in these sectors provided that fintech companies protect them against any potential losses. With a hard cap of 5% (five per cent) on the guarantee, the lenders would still face significant risks and may be deterred from furthering such loans. With a higher percentage, the lending service providers would have more skin in the game. This will then foster faith amongst the regulated entities towards the lending service providers. A higher percentage would also ensure that different lending service providers target different percentages, as long as there is abidance with the upper cap. That will promote better competition in the marketplace, improving efficiency in the system in the long run.

It is also noteworthy that the FLDG Guidelines provide the regulatory framework, however, they fail to consider the sector default rates.[36]The FLDG Guidelines undertake a generalised approach that overlooks the nuanced sector-specific details such as varied default rates. In case a sector

[36] *Id.*

has a greater propensity to default, there shall be lower possibility of the fintechs providing the guarantees. Instead of having a fixed cap, a sector-wise analysis will ensure that default-prone portfolios are provided with a low percentage of cover whereas specific sectors with a low-default history are provided with higher cover. MSME sectors generally have a low default rate[37]. It is imperative that the risk isanalysed and managed prudently. A higher cap of 10% (ten per cent) or 20% (twenty per cent) will ensure that there is flexibility and competition in the fintech sector. They shall therefore compete to access credit and at the same time also have risk safeguards. This higher cap of 10% (ten per cent) or 20% (twenty per cent) may have sub-limits for different sectors and this should also be coupled with periodic revisions, basis market analysis of historical data and present trends. This will ensure a more tailored approach instead of a one-size-fits-all approach like the one taken at present.[38]

The FLDG Guidelines will open up the market for fintech, by promoting their partnership with regulated entities, without having to wait for NBFC licenses. However, there can be attempts by regulated entities to have the bigger size of the pie and have a greater hold on the revenue share.[39] This can be monitored by adequate oversight by the RBI. Given RBI's focus in this area, it can be viewed that any scope of lacunae will be avoided by it to ensure proper implementation of the FLDG Guidelines.

[37] TNN, *MSME default rate lowest in biz loans*, THE TIMES OF INDIA (May 8, 2020), available at: https://timesofindia.indiatimes.com/business/india-business/msme-default-rate-lowest-in-biz%20loans/articleshow/75610706.cms.
[38] RESERVE BANK OF INDIA, *supra* note 13.
[39] *Id.*

VI. CONCLUSION

The RBI has made sincere attempts to encourage all stakeholders in the fintech space through the FLDG Guidelines and avoided the grey areas of overlap with other laws such as those on synthetic securitisation. Thus, entities would be required to structure their existing setup and compliances in accordance with the FLDG Guidelines.

As stated above, it can be suggested that once the RBI is satisfied withthe practical success of the FLDG Guidelines, the existing cap of 5% (five per cent) on the underlying loan portfolio may be eventually increased to 10% (ten per cent) or 20% (twenty per cent), the introduction of which may with itself bring in better competition among market players, subsequently improving efficiency.

After the COVID-19 pandemic, several borrowers could not repay their loans successfully on account of the economic hit caused due to the pandemic. This has already created a situation whereby lending service providers owe default guarantees to their partner-regulated entities. Sectoral assessments could have aided in avoiding such scenarios. Once these hindrances are successfully addressed, it can be viewed that the FLDG Guidelines will be a complete success.

It can be concluded that the FLDG Guidelines will encourage financial inclusion. They provide greater clarity and also set clear boundaries while creating the proper ambience for developments and innovations in the fintech space resulting in groundbreaking products in the financial space. Whilst the FLDG Guidelines do require updates in line with relevant

market practices, it is encouraging to see that the RBI is open to exploring the new instruments that emerge in the lending market with the onset of digital lending and fintech. Given, the rise of the fintech sector in India and the positive approach taken by the RBI, it can be observed that the future for the fintech sector in India is bright.