RECOMMENDATIONS OF THE WORKING GROUP ON DIGITAL LENDING – IMPLEMENTATION: FLDG

Authored by
Shivi Rastogi, Managing Partner
Sonalika Ahuja, Senior Associate

The regulatory framework issued by the Reserve Bank of India ("RBI") on implementation of the Recommendations of the Working Group on Digital Lending on 10.08.2022 ("Implementation Framework")[1] has resulted in much discussion on permissibility of first loss default guarantee ("**FLDG**"). While interpreting the regulatory framework feels like looking at an Escher painting in our view, the *Master Direction – Reserve Bank of India* (Securitisation of Standard Assets) Directions, 2021 dated September 24, 2021 ("Securitisation Directions") (referred to in the Implementation Framework) provide definitive guidance and clarity on the extant applicable law.

Regulated Entities Only

The Working Group on Digital Lending ("**WGDL**") made a recommendation only in respect of prohibiting FLDG structures which result in sharing of credit risk by unregulated entities, and not by regulated entities. RBI's position on assumption of credit risk by non-regulated entities is evident from the Implementation Framework which is "*based on the principle that lending business can be carried out only by entities that are either regulated by the Reserve Bank or entities permitted to do so under any other law."*[2] It sets out the clear tone that for RBI lending business, and the inseparable credit risk, are the exclusive domain of regulated entities.

It is also relevant to note that while the Implementation Framework states that "the recommendation pertaining to First Loss Default Guarantee (FLDG) is under examination", this has been put under the head of WGDL recommendations which have been "accepted in- principle" but require further examination. The in principle

[1] Recommendations of the Working Group on Digital Lending – Implementation issued by RBI on 10th August, 2022.
[2]Para 2 of the Press Release on the Implementation Framework.

acceptance of the WGDL recommendation makes the direction of regulatory intent clear, and it's reasonable to expect that any regulatory accommodation on FLDG will be for regulated entities only.

Also, in our view, by directing regulated entities to comply with the Securitisation Directions in respect of any third party guarantees for pool level support, the RBI has indicated that, as
and when permitted, such credit enhancement will be restricted only to regulated entities[3] and is likely to be subject to limits similar to those set out in the Securitisation Directions.

But…

We would, however, like to caution that while the Implementation Framework indicates the likely direction of future regulatory accommodation, the reference to the Securitisation Directions cannot be read as presently permitting FLDG structures even between regulated entities. This is on two accounts.

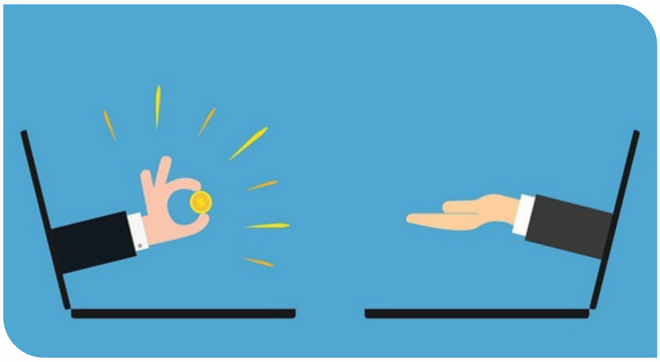
First, the credit enhancement permitted under the Securitisation Directions relates only to securitisation structures where the financial asset portfolio is transferred to an SPE. Therefore, while one may argue that such credit enhancement can be applied to non-securitisation transactions on grounds of economic equivalence, there is, presently, no clear regulatory certainty on this.

Second, the current Securitisation Directions unequivocally prohibit regulated entities from undertaking securitisation activities or assume securitisation exposures in the nature of "synthetic securitisation"[4]. The term "synthetic securitisation" has been defined in the Securitisation Directions as "a structure where credit risk of an underlying pool of exposures is transferred, in whole or in part, through the use of credit derivatives or credit guarantees that serve to hedge the credit risk of the portfolio which remains on the balance sheet of the lender."[5] It is meaningful to note that the Securitisation Directions were made effective in September 2021, and the previous guidelines did not include any such prohibition. Therefore, the regulatory intent in bringing this restriction into applicable directions must not be ignored.

[3]Para 34 of the Securitisation Directions require that entities providing credit enhancement facilities within the context of securitisation transactions must be regulated by at least one financial sector regulator.
[4] Para 6(c) of the Securitisation Directions.
[5] Para 3(s) of the Securitisation Directions.

Amicus
Transcending Frontiers

The Securitisation Directions, as they exist, clearly prohibit structures where the whole or part of credit risk for a pool of assets is transferred by a regulated entity to another, while retaining the pool on its books. It is difficult to read the language in a manner which would exclude its applicability to FLDG structures. The RBI's express mandate in the WGDL Implementation Framework that regulated entities should abide by the Securitisation Directions in considering third party guarantees cannot be interpreted without reference to this. While it is tempting to read the reference to the Securitisation Directions in the Implementation Framework as being directed only to the provisions which enable credit enhancement by regulated entities, ignoring the unequivocal restriction that the Securitisation Directions place on synthetic securitisation violates all canons on maintaining integrity of the regulatory direction. It is also likely that auditors will look at the fine print of the Securitisation Directions, including the provision on synthetic securitisation, to evaluate and scrutinise FLDG transactions.



So, then...

The RBI may amend the Securitisation Directions to provide clarity on how regulated entities can undertake guarantee/ FLDG based risk sharing on pooled loan accounts. Such amendments may come with clarity on reporting of such risk sharing, the extent to which it can be undertaken and other regulatory requirements on transparency, capital adequacy and risk management. Till these are promulgated, regulated entities can only look to the existing and plain language of the Securitisation Directions for compliance, which the RBI has asked regulated entities to comply with both in letter and spirit.

Reach out to the authors:
shivi@amicusservices.in
sonalika.ahuja@amicusservices.in