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Non-banking Financial Companies

Capital impact expected with clarification on default loss guarantee in digital lending; draft guidelines emphasise greater transparency

April 2024

List of abbreviations

NBFC	Non-bank finance company
RBI	Reserve Bank of India
RE	Regulated entity
DLG	Default loss guarantee
LSP	Lending service provider
FAQ	Frequently asked questions
APR	Annual percentage rate
FD	Fixed deposits
BG	Bank guarantee
CG	Corporate guarantee
NPA	Non-performing asset
IRAC	Income recognition and asset classification

Highlights

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Based on the clarification given as FAQs by the RBI, the capital/funding requirement for entities extending DLG shall increase.

The draft guidelines focus on improved transparency for borrowers. This can favour the larger lender partners of the LSPs.

Move is a long-term positive for the industry and for borrower information.

- Digital lending has experienced a sharp expansion over the past couple of years, necessitating the development of a robust regulatory framework. Consequently, the Reserve Bank of India (RBI) has been issuing guidelines for the last two years for this business.
- On April 26, 2024, the RBI issued draft guidelines on Digital Lending – Transparency in Aggregation of Loan Products from Multiple Lenders, for public comments. This is in the backdrop of a circular issued in September 2022, providing detailed guidelines on digital lending. Also, in its circular dated June 8, 2023, the RBI had given detailed guidelines on default loss guarantee (DLG) in digital lending. Subsequently, the RBI issued FAQs on these guidelines on April 26, 2024.
- The latest FAQs provide clarity on the capital allocation for entities providing DLG and the cap applicable for DLGs. ICRA believes that the capital and funding requirement for entities extending DLG would go up as DLG would have to be provided on the disbursed loan amount and this would have to be retained for the tenor of the loans. Further, the entire DLG would be knocked off from capital for capital adequacy computation.
- The FAQs also indicate that the DLG provided for specified loans, once invoked on account of delinquency or write-off, cannot be replenished during the remaining tenor of those loans, even if those loans are recovered. This can result in delayed invocation of DLGs, going forward, and thus higher reported NPAs; at present, DLG can be invoked once an account becomes delinquent in the books of the regulated entity.
- The FAQs also provided some clarity on the operational aspects of digital lending. The RBI further released draft guidelines on the aggregation of loan products from multiple lenders. This is aimed at improving transparency for the end borrowers and could require some tweaking of the business models for LSPs.
- LSPs would have to disclose all the loan offers available for the borrowers in case an LSP has outsourcing arrangements with multiple lenders. This could turn out to be favourable for lenders with strong brand presence/recall vis-a-vis other lenders, in cases where the loan terms are not different.
- Overall, ICRA expects the impact of these regulations/draft regulations, on implementation, to be a long-term positive for the industry, providing clarity on risk sharing among the various participants and also improving borrower information/protection in the digital lending space.

Timeline of RBI regulations on digital regulations

Evolving regulatory landscape

August 2022

Recommendations of the working group on digital lending - implementation

Sept 2022

Guidelines on digital lending

June 2023

Guidelines on default loss guarantee (DLG) in digital lending

ICRA's analysis on this can be accessed here

April 2024

Key facts statement for loans & advances

April 2024

1. Draft circular on transparency in aggregation of loan products from multiple lenders
2. FAQ on DLG

Universe of digital lending ecosystem

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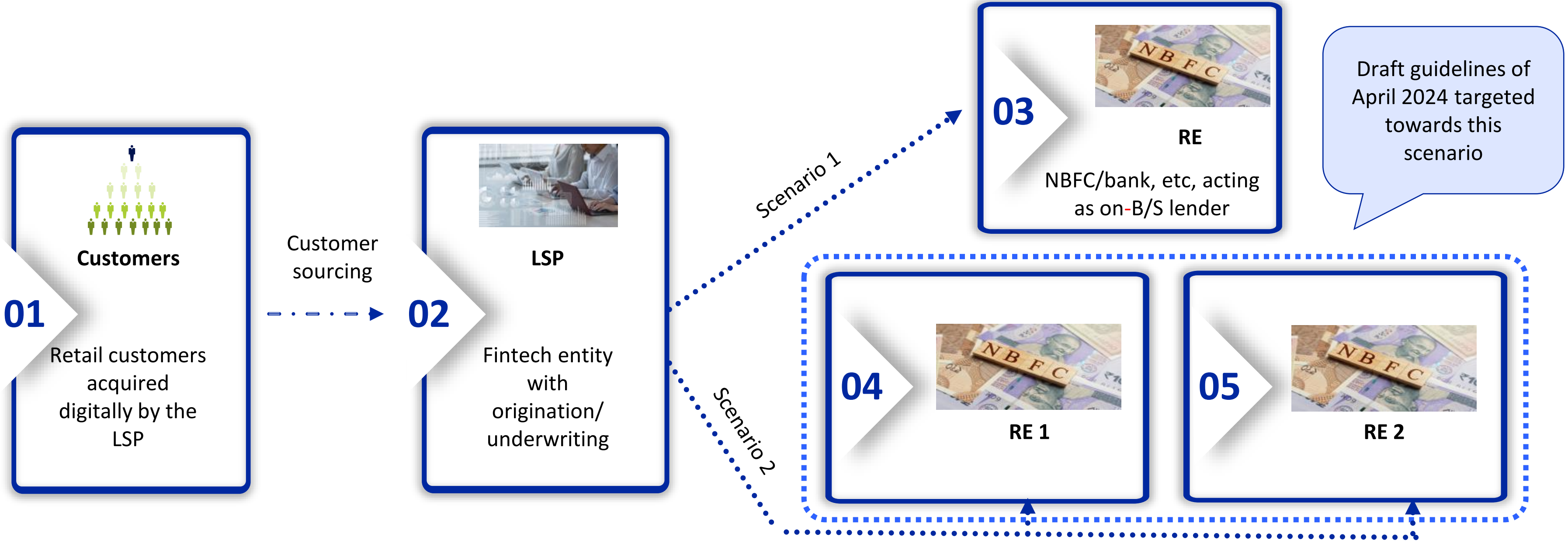
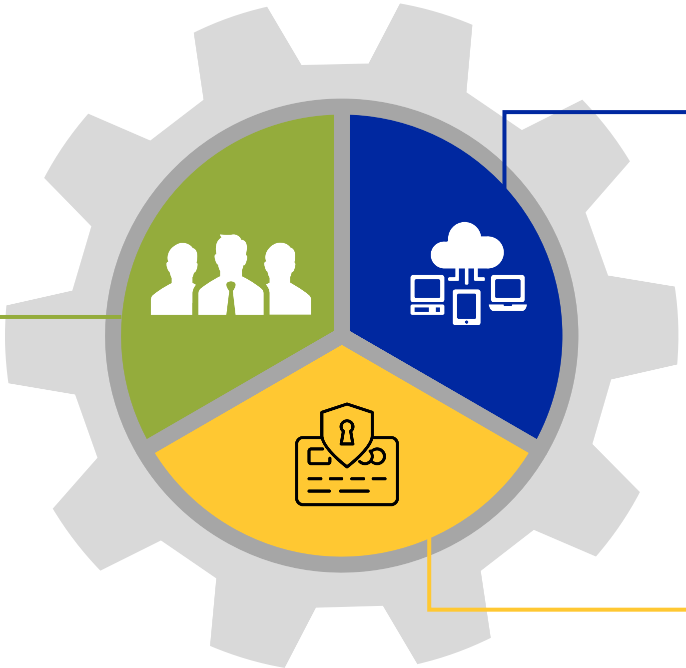


- The RBI has defined digital lending as a remote and automated lending process, largely through the use of seamless digital technologies for customer acquisition, credit assessment, loan approval, disbursement, recovery and the associated customer service. The phrase 'largely by use of seamless digital technologies' has been used in the digital lending definition to accord operational flexibility to the regulated entities (REs) in digital lending. Therefore, even if some physical interface with customer is present, the lending will still fall under the definition of digital lending.
- The DLG guidelines of June 08, 2023, are applicable only for lending activities operating within the scope of the above definition.

Digital lending – A look at existing guidelines

Customer protection & conduct issues

- Direct disbursement into bank account of borrower
- Direct loan servicing, repayment, etc, into bank account of balance sheet lender, which is an RE
- Standard definition of annual percentage rate (APR)
- Key fact statement to include APR, recovery mechanism, cooling-off period
- Enhanced due diligence of LSPs by lenders and periodic review of conduct



Technology and data requirements

- Clear policy on storage of data , location of data servers in India, etc
- Collection, usage and sharing of data with third parties
- Comprehensive privacy policy

Regulatory framework

- Compulsory reporting to credit information companies
- FLDGs, which were previously under examination, are currently addressed by the June 2023 guidelines

Key proposals under the draft guidelines of April 2024

Proposed changes to improve transparency for end-borrowers; long-term positive impact on the industry

All available loan offers to be shown to borrower

The digital view to give details to enable the borrower to make a fair comparison between various offers

This is could turn out to be favourable for lenders who have a having strong brand presence/ recall vis-a-vis other lenders, in cases where the loan terms are not different

Consistent approach to be followed by LSP to ascertain willingness

LSP to display unbiased content and not directly/indirectly promote or push a product of a particular RE

Key points from FAQs issued by the RBI on DLG guidelines

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DLG portfolio to be specified upfront	▪ The portfolio over which DLG can be offered shall consist of identifiable and measurable loan assets which have been sanctioned (the 'DLG set'). This portfolio will remain fixed for the purpose of DLG cover. ▪ Thus, issuers will not have the option to replace contracts in the event of delinquencies etc.
Calculation of DLG cap	▪ The cap is applicable on the total amount disbursed out of the DLG set. Thus, the DLG cover could remain dynamic based on the disbursement in relation to the defined DLG set. ▪ The capital and funding requirement for entities extending DLG would go up as DLG would have to be provided on the disbursed loan amount and the same would have to be retained for the tenor of the loans.
Replenishment of DLG	▪ The DLG amount, once invoked by the RE, cannot be reinstated, even if the loan in lieu of which it is invoked get recovered subsequently. This shall result in an increase in the reported NPAs and consequently the provisions by the lenders. This could, therefore, lead to a lowering in LSP incomes to compensate the REs. At present, DLG can be invoked once an account becomes delinquent.
Treatment of DLG in case of RE, for capital purposes	▪ An RE providing DLG shall deduct the full amount of the DLG, which is outstanding from its capital. Thus, the capital ratios of DLG providers will be impacted.
Other clarifications	▪ REs acting as DLG providers shall also put in place board-approved policies as a prudent measure. ▪ DLG is not permitted on loans arranged on NBFC-P2P platforms, credit cards and revolving credit facilities offered through the digital lending channel

Trends in digital lending

Growth | Digital lenders expected to move to a relatively slower lane

Exhibit: AUM growth

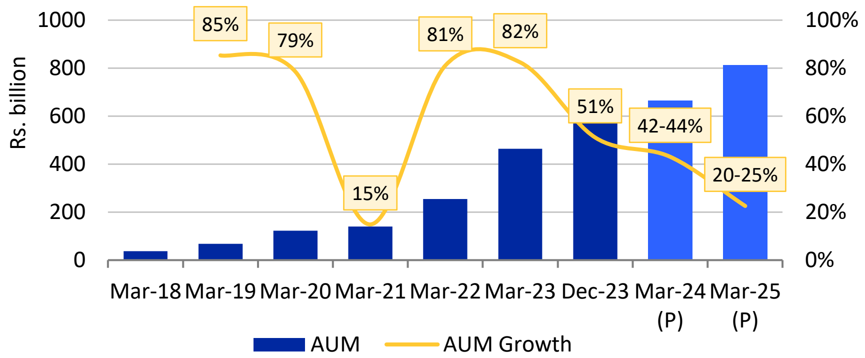
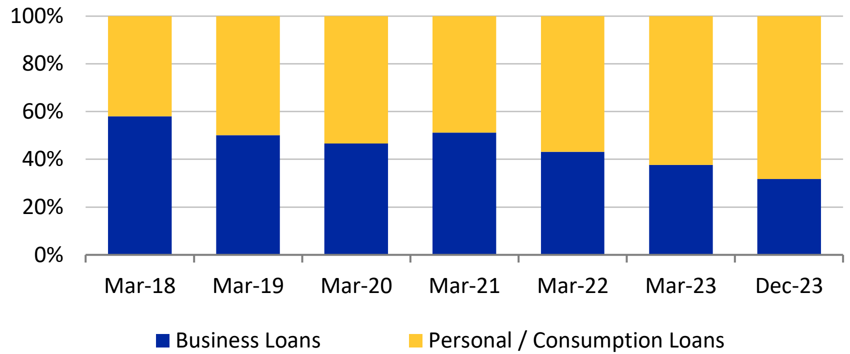


Exhibit: Segment-wise distribution of AUM

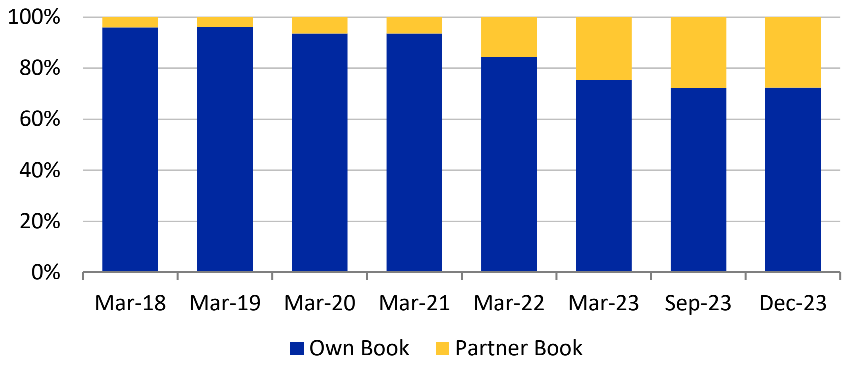


Source: Based on sample set, ICRA Research; AUM pertains to the loans of the digital lending NBFCs and the loans originated through the same digital mode for the partner NBFCs/banks

- Starting from a small base, digital lenders have seen exponential expansion over the last few years. The Covid-19 pandemic was a dampener for this segment in FY2021. However, digital lenders were able to recover much faster than other segments, enabled by their inherently lower requirement for physical contact with customers, quick and technology-enabled processes, etc.
- Over the past five years, digital lenders have expanded their portfolio of consumer and business loans at a robust pace. However, the AUM growth in the consumer loans space was significantly higher at a CAGR of ~70% during this period compared to ~40% for business loans. As a result, consumer loans accounted for more than two-thirds of the digital lending AUM as of December 2023.
- ICRA expects the AUM growth to slow down as tightening funding and capital conditions kick in. As per ICRA's estimates, AUM growth in FY2024 was around 42-44% YoY, which would slow down further to 20-25% YoY in FY2025.

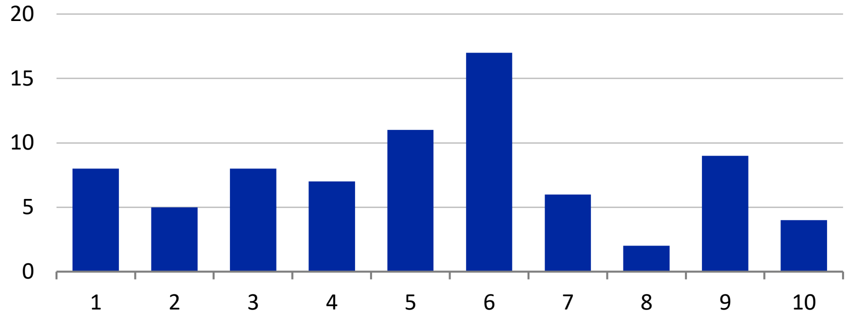
Growth | Strengthening of partnerships crucial for sustaining expansion

Exhibit: AUM distribution trend



Source: Based on sample set, ICRA Research

Exhibit: Number of partners in sample set



Source: ICRA Research; out of the sample set of 13 entities, 3 entities did not have any co-lending partners; details for the balance 10 entities is provided in this chart; details as of date

- Given the start-up nature of digital lenders and their modest balance sheets, funding high growth rates is a key constraint. Digital lenders have developed various innovative partnership models, whereby they partner with larger NBFCs or banks for AUM growth by leveraging the partner balance sheets.
- These partnerships have also been beneficial for larger NBFCs and banks, which previously had a limited presence in the segments targeted by digital lenders. Further, it provides these larger partners the option to quickly adjust their exposure to digital lenders or renegotiate the revenue sharing arrangements, in case the risk perception changes based on the asset quality and consumer behaviour, as was seen in a few cases last year.
- Nevertheless, the share of such off-balance sheet (off-b/s) partnership-based AUM growth has been steadily increasing over the last few years; currently, around 30% of the AUM is funded via partner book. Additionally, with the regulator increasing constraints on direct lending by banks to NBFCs in the form of higher risk weights, it is likely that digital lenders would have to rely more on partnerships as a sustainable avenue for their AUM growth. This would necessitate a sustained track record of stable business model with the key risks under control, which shall incentivise further expansion of these partnerships.

Asset Quality | Loan losses remain elevated; further increase expected in near term

Exhibit: 90+ dpd

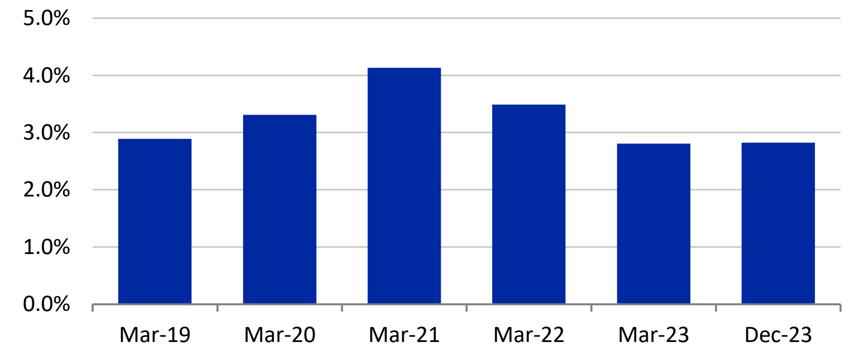
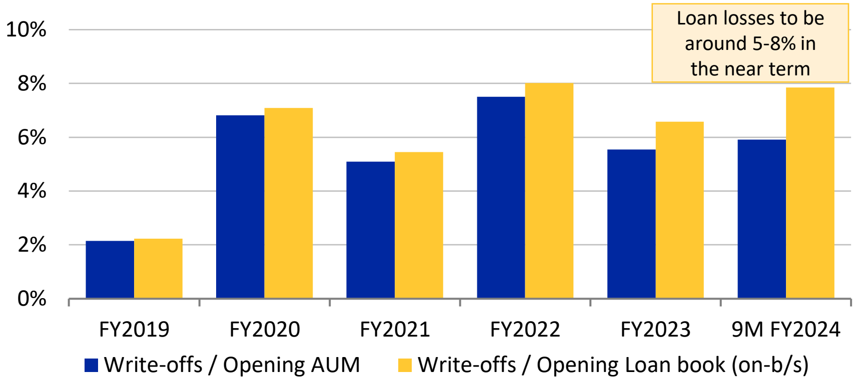


Exhibit: Write-offs (% of opening AUM vis-à-vis on-b/s loan portfolio)



Source: Based on sample set, ICRA Research

- Given the modest credit risk profiles of the target consumer segment as well as the pandemic-related impact, digital lenders had faced elevated delinquencies and write-offs over the last few years. Underwriting would remain key as digital lenders have limited field presence and the collection infrastructure is in the scale-up mode at present.
- Delinquencies have remained range-bound, but elevated, as entities have been prudent in writing off loans (typically within 180-360 days) within accelerated timeframes, considering the customer segment and the absence of a physical collection infrastructure.
- Loan losses had increased steeply during the pandemic, but had declined in FY2023, by when the impact of the pandemic was largely absorbed. However, some deterioration was witnessed again in 9M FY2024. The asset quality implications of borrower overleveraging have started becoming more visible for smaller-ticket consumer credit, credit cards, etc. Thus, the loan loss risk in this segment has also increased. ICRA expects the loan losses for digital lenders in the range of ~5-8% on a cohort basis in the near term.

Capitalisation | Leverage under control; access to adequate funding key for growth

Exhibit: Capital infusion as % of outstanding net worth

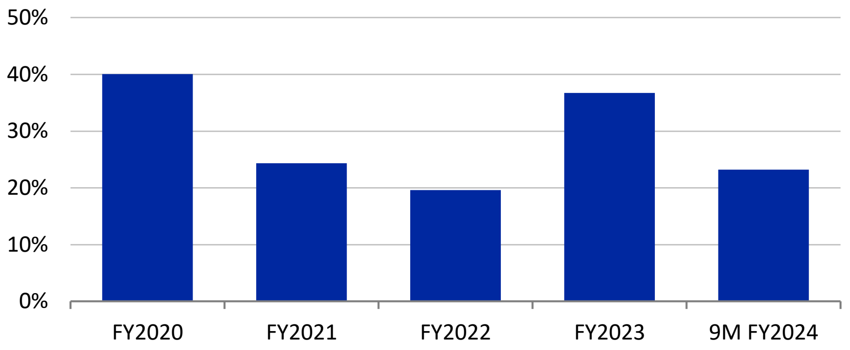
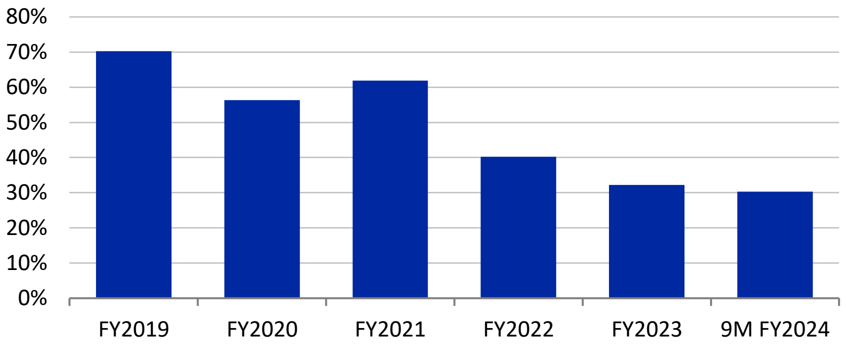


Exhibit: Net worth as % of AUM



Source: Based on sample set, ICRA Research

- Digital lenders have largely relied on equity funding support from investors to fund their strong growth in the past. This has been especially critical as internal accruals have remained weak. Typical lenders to this segment would be NBFCs, high net worth individuals (HNIs), smaller banks, etc. Managing AUM growth via partnerships has been key for the growth in the recent past.
- However, as lenders have slowly gained confidence on the back of improving track record in this segment, their exposure in this segment has also steadily increased. This has supported a steady increase in leverage for this segment, over the last three years. However, the impact of regulatory tightening on funding to the NBFCs from banks remains to be seen in the near term.
- ICRA expects the capital and funding requirement for entities extending DLG to go up as the latter would have to be provided on the disbursed loan amount and it would have to be retained for the tenor of the loan. Further, the entire DLG would be knocked off for capital for capital adequacy computation.

List of ICRA-rated digital lenders

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S. No.	Name	Rating Outstanding
1	**Akara Capital Advisors Private Limited**	[ICRA]BBB (Stable) / [ICRA]A3+
2	**Bhanix Finance and Investment Limited**	[ICRA]BBB (Stable) / [ICRA]A3+
3	**DMI Finance Private Limited**	[ICRA]AA (Stable) / [ICRA]A1+
4	**Hiveloop Capital Private Limited**	[ICRA]BBB- (Stable) / [ICRA]A3
5	**Kinara Capital Private Limited**	[ICRA]BBB (Positive) / [ICRA]A3+
6	**Lendingkart Finance Limited**	[ICRA]BBB+ (Stable) / [ICRA]A2
7	**NeoGrowth Credit Private Limited**	[ICRA]BBB+ (Stable) / [ICRA]A2
8	**Oxyzo Financial Services Private Limited**	[ICRA]A+ (Stable) / [ICRA]A1+
9	**WheelsEMI Private Limited**	[ICRA]BBB (Stable)

Source: ICRA Research

Recap: Recommendations for DLGs in June 2023 circular – I

Key highlights	Guideline recommendations
Eligibility as DLG provider	▪ DLG can be provided by LSPs or other REs acting as LSPs, with which relevant outsourcing agreements have been entered into. LSPs should be companies incorporated under the Companies Act, 2013.
Cap on DLG	▪ While there was no explicit restriction on this previously, the June 2023 guideline has introduced a cap of 5% of the loan portfolio outstanding. ▪ This facilitates risk sharing as opposed to the prevalent practice where some of the transactions are guaranteed up to 100% of the exposure.
Implicit/performance-based guarantees	▪ All arrangements which are not structured as a guarantee but are linked to the performance of the loan portfolio and provide credit risk relief to the RE would be treated as implicit guarantee. Implicit guarantees would be treated on a par with DLGs and the total cap of 5% on the DLGs would accordingly be applicable to them as well. ▪ However, further clarity is required on the treatment of performance-related payouts from the RE to the loan servicer.
Documentation	▪ DLG agreements are required to be documented through explicit legally enforceable contractual agreements. ▪ Ex-post modifications to the terms of DLGs would not be possible, enabling true risk sharing.
Types of DLG	▪ DLGs can be provided only in the form of cash deposits, lien-marked FDs in scheduled commercial banks or through BGs. As such, DLGs in the form of corporate guarantees (CGs), which is the current industry practice, can no longer be used. Further, invocation risk w.r.t. cash/FD/BG is likely to be lower than CGs. ▪ This is likely to result in a negative carry/incremental operating costs depending on the form in which the DLG is provided.

Recap: Recommendations for DLGs in June 2023 circular – II

Key highlights	Guideline recommendations
Invocation of DLG	▪ While there was no time limit previously, the current guidelines state that DLGs have to be invoked within a maximum overdue period of 120 days. ▪ This is expected to result in prompt invocation of DLGs, going forward, as opposed to the previous practice of the negotiated settlement of DLGs w.r.t. the non-performing assets (NPAs).
Tenor of DLG	▪ The tenor of the DLG cannot be lower than the longest tenor of the loan in the underlying loan portfolio. There is no option for DLGs to fall off after a certain initial period.
NPA recognition	▪ NPA recognition and classification would be the responsibility of the RE, as per the extant asset classification and provision norms (IRAC norms). For the calculation of NPA as per IRAC norms, the invoked DLG cannot be set off against the underlying NPAs. Corresponding provisioning should also be carried on the entire quantum of NPA without any set-off against the DLG. ▪ However, as per IND-AS, ICRA expects that the DLG cover would reduce the provision requirements.
Disclosure requirements	▪ The RE shall have a mechanism to ensure that the LSPs with which it has DLG arrangements shall publish on their websites the total number of portfolios and the respective amount of each portfolio on which a DLG has been offered. This is expected to lead to better transparency at the industry level on the usage of DLGs in digital lending transactions. ▪ This disclosure is not expected to be intrusive as the DLG guidelines have provided a level-playing field to all participants. Further, the disclosures pertain only to aggregate-level information and not to specific loans.

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Thank You!