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First Loss Default Guarantee for Fintechs

Why in news?

The Reserve Bank of India (RBI) has allowed First Loss Default Guarantee (FLDG) for fintech Lending Service Providers (LSP).

What is an FLDG arrangement?

- Default loss guarantee (DLG) is also known as First Loss Default Guarantee (FLDG).
- First loss default guarantee (FLDG) is a lending model between banks or non-banking finance companies (Regulated Entities) and lending service providers (fintech firms).
- In FLDG arrangement, the initial hit on a default is taken by a third party such as fintech firm that originated the loan.
- The fintech player (LSP) compensates lenders if the borrower defaults up to a certain threshold of the loan portfolio.

How do FLDG work?

- The LSP provides first loss guarantee up to a pre-decided percentage of loans generated by it.
- The loan portfolio backed by FLDG is similar to the off-balance sheet portfolio of the LSP.
- The lender do not partake in any lending process but the nominal loans sit in the balance sheet of the lender.
- But the credit risk is borne by the LSP without having to maintain any regulatory capital.

From the perspective of the fintechs, offering FLDG acts as a demonstration of its underwriting skills.

Why do we need FDLG?

- To avoid 'synthetic securitisation' as it is prohibited by the RBI.
- REs were hesitant to lend through fintechs without commitment towards loan loss.
- Fintech industry's business is affected by RE's hesitancy.

From the perspective of the lender, FLDG ensures the platform's skin in the business.

What did the RBI say on FDLG?

- The RBI has released a circular clearly specifying details on scope, eligibility, structure, form, cap, disclosure requirements, and exceptions.
- **Conditions -** A Regulated Entity (RE) can enter into DLG arrangements only with an LSP or other REs 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.
- The total amount of DLG cover on any outstanding portfolio does not exceed 5% of the amount of that loan portfolio.
- The guarantee is accepted by the bank only in the form of a cash deposit, or fixed deposits in a bank.

What are the benefits of FDLG?

- Facilitates orderly development of the digital lending ecosystem and boosts fintech activity in the financial sector.
- Enhances credit penetration through digital space.
- Facilitate entry of small and medium fintechs into the digital lending space in partnerships with banks or NBFCs.
- The guidelines facilitates all players to participate in an effective and transparent manner.

Quick Facts

- **Regulated Entity (RE) -** All Commercial Banks (including Small Finance Banks), Co-operative Banks and Non-Banking Financial Companies (NBFC) as per RBI.
- **Lending Service Providers (LSP) -** Fintech players who use technology platforms in the lending space.
- They are agents of a bank or NBFC who carry out one or more of a lender's functions.
- The functions include customer acquisition, underwriting support, pricing support, disbursement, monitoring and recovery of specific loan on behalf of REs.
- **Underwriting -** It is the process through which an individual or institution takes on financial risk for a fee.
- **Synthetic Securitisation -** 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.
- In this, the credit risk of the portfolio remains on the balance sheet of the lender.

References

1. IE - RBI permits loan default guarantee in digital lending
2. Business Line - First Loss Default Guarantee for fintech lenders