Co-lending and Default Loss Guarantees

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VINOD KOTHARI CONSULTANTS

Vinod Kothari
Vinod Kothari Consultants P. Ltd

Kolkata:
B-42, Metropolitan Cooperative Housing Society,
Kolkata- 700
Phone: 033 45017864/ 23233742
Email: info@vinodkothari.com

New Delhi:
Nukleus, 501 & 501A, 5th Floor, Salcon Rasvilas, District Centre, Saket, Delhi 110017
Phone: 011 41315340
Email: delhi@vinodkothari.com

Mumbai:
403-406, Shreyas Chambers
175, D N Road, Fort
Mumbai
Phone: 022 2261 4021/ 40056953
Email: bombay@vinodkothari.com

Bangalore:
4, Union Street, Infantry Rd,
Shivaji Nagar,
Bengaluru- 560 001
Phone: 022 2261 4021
Email: bengaluru@vinodkothari.com

Website: www.vinodkothari.com

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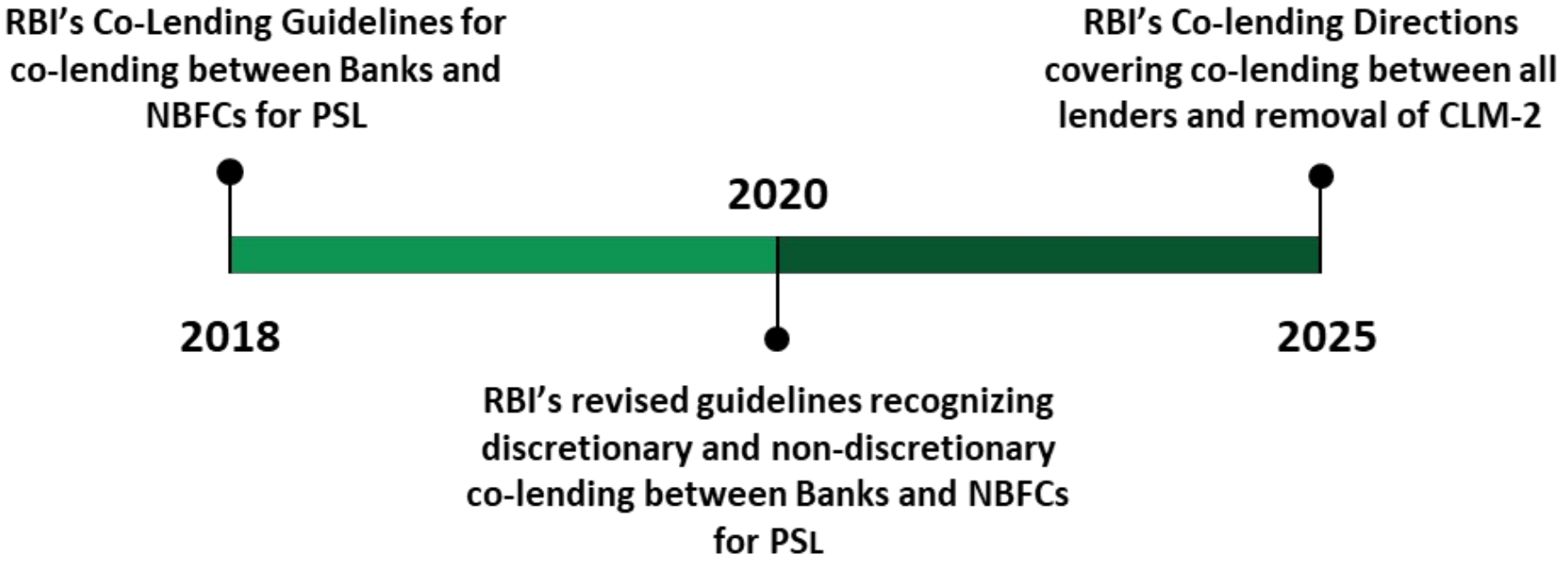
Evolution of the Co-Lending Framework



Applicability, Grandfathering Clause, Early Adoption

Applicability	To be applicable from January 01, 2026.
Early Adoption	Early adoption permitted Existing or new arrangements till the effective date to be covered by the 2020 Circular

What does this mean?

1. New disbursements till Effective Date?
2. New disbursements under existing arrangement even after Effective Date?
3. New arrangements before Effective Date, but disbursements after Effective Date?

Co-lending versus loan sourcing

	Co-lending	**Loan sourcing and servicing**
Need for regulated lender	Needs to be a regulated lender	No need to be regulated lender
Stake in the loan	At least 10%	None
Nature of income	Interest on loan share + fees	Sourcing/servicing fees
Skin-in-the-game	Share in the loan + DLG (digital as well as non-digital loans)	DLG (in case of digital loans)
Charging of fees from customer	Can charge fees from customer	Cannot charge fees from customer

Co-lending versus loan transfers or TLE

	Co-lending	**Transfer of Loan Exposures**
Need for regulated lender	Both parties need to be REs	Both parties need to REs
Stake in the loan	At least 10%	May be 0% if full DD done
Nature of income	Interest on loan share + fees	Sourcing/servicing fees + gain on sale + differential fee
Skin-in-the-game	Share in the loan + DLG (digital as well as non-digital loans)	Retention of pari passu stake
Charging of fees from customer	Can charge fees from customer	Not applicable
Gain on sale	As there is no transfer, no question	As there is transfer, gain on sale usually comes upfront
Credit enhancement	5% DLG may be provided	No credit enhancement

Snapshot of the Changes 1/2

Key Changes

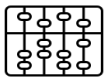
Bye-Bye CLM-2 - Discretionary Co-lending not allowed;
"cherry-picking" arrangements would henceforth be squarely as per the TLE Directions (MHP etc.)

Operational Time Period- 15 days' time is given for completing the transfer, it does not seem to be giving a discretion to the buyer to not buy the share.

Minimum Risk Requirements - 10% by each co-lender

Customer Onboarding- Partner RE may rely on originating RE for customer identification and KYC

Default Loss Guarantee - 5% permitted by originating RE
(*subordination or waiver or deferral of servicing fees will not be allowed*)



Gain on sale again: The final Directions have added words in previous para "if applicable".

Snapshot of the Changes 2/2

Key Changes

	**Website disclosure**: A list of all active CLA partners, blended rate no more required to be disclosed
	**Financial Disclosure:** To be done on quarterly/annual basis, as applicable to the concerned REs-earlier being on a quarterly basis
	**Change in customer interface**: Prior intimation to the customer in case of change in interface
	**Real-time information sharing-** Share "latest by end of next working day" for asset classification changes
	**NPA/SMA classification-** Huge operational challenge, as one lender treating an asset as SMA/NPA will lead to the other lender also adhering to the same
	**Reporting to Credit Bureaus**- CIC reporting for respective share, multiple reporting by each lender may create operational challenge.

Time period for transfer

- The time period of 15 days under para 22
  - provided to ensure that the respective shares of the REs are reflected in the books of both REs without delay after disbursement by the originating RE to the borrower.
  - not for application of discretion or cherry picking; it is for the logistics of ensuring the funds transfer, and the onboarding of the borrower in the books of the Funding RE
  - not for deciding the loans to be considered for co-lending; instead it is only providing a reasonable window for the purpose of reflecting the loans in the books of the respective co-lender.

Extract of provision

22. The CLA shall ensure that the respective shares of the REs are reflected in the books of both REs without delay after disbursement by the originating RE to the borrower, in any case not later than 15 calendar days from the date of disbursement.

Gain on sale: profit recognition

- Draft Directions mentioned that gain on sale can be recognised, though there were no provisions for discretionary co-lending.
- The final Directions retain the para, with the added words "if applicable".
- A pre-agreed co-lending is not a case of "transfer", and hence, the question of gain on sale does not arise.

Extract of provision

16. NBFCs shall adhere to the applicable accounting standards, while booking of unrealised profit under CLAs, if applicable. However, such profits, shall be deducted from CET 1 capital or net owned funds for meeting regulatory capital adequacy requirement till the maturity of such loans.

Escrow Mechanism - does co lending have to be prefunded?

- All transactions (disbursements / repayments) to be routed through an escrow account to be maintained with a bank (which could also be one of the REs involved in CLA).
- Escrow arrangement must be governed by a formal Escrow Agreement, which clearly specifies the manner of appropriation between the originating and partner REs.
  - In practice, the escrow mechanism typically adopts a "maker-checker" format to ensure dual control and reduce the risk of operational or financial errors.
- Ideally the funding lender should transfer the amount as and when the loans are disbursed.
  - However, transferring funds on a real time basis might lead to operational difficulties, hence, the partners may agree on periodic fund transfers by the funding co-lender based on the extent of disbursements done by the originating co-lender during that period.
- It is also fine if the originating co-lender disburses the whole amount and then claims a reimbursement from the funding co-lender, provided the reimbursement happens as soon as practicable.

Extract of provision

26. All transactions (disbursements / repayments) between the REs, as well as with the borrower, shall be routed through an escrow account maintained with a bank (which could also be one of the REs involved in CLA). The agreement shall clearly specify the manner of appropriation between the originating and partner REs.

Manner of fee/revenue raising by the originating RE

- The commercial construct of every CLA is:
  - A particular rate of interest to the Funding RE
  - A significantly higher rate of interest to the Originating RE
- So how does the Originating RE make his rate of return?
  - (i) Higher share in the interest rates
  - (ii) Sharing or substantially claiming all of the other charges paid by the borrower, such as processing fees
  - (iii) Service charges paid by the Funding RE
- What is this service charge? There is an explicit reference in Para 20 to fees/charges for "lending services".
- From the language of the regulation, it seems that the Funding RE may provide some fees too:
  - (i) However, the payment of these fees will be serve as a credit enhancement

Extract of provision

20. As part of the credit policy, the RE shall lay down the objective criteria for fees/ charges payable for lending services, depending upon relevant factors such as the nature of service provided, quantum of loan, etc. Such fees/ charges shall not involve, directly or indirectly, any element of credit enhancement/ default loss guarantee unless permitted otherwise.

Blended Rate of Interest

- The borrower shall be charged a blended rate of interest, which shall be computed based on ROI of the Originating RE and the Funding RE, as per respective Interest Rate Policy, on the respective share in the loan.
- Interest rate policy of the Funding RE: The Interest Rate may take into consideration, the following:
  - (i) the interest rate for the loan product in question, determined in accordance with its Policy, and
  - (ii) a mark-up on account of servicing or other charges payable to the sourcing co-lender, along with applicable GST, as incremented by the loss of ITC thereon.
- Interest rate policy of the Sourcing RE: The Interest Rate expected may take into consideration:
  - (i) the interest rate for the loan product in question, determined in accordance with the Policy, and
  - (ii) a leveraged mark-up on account of sourcing, servicing and other functions performed by Sourcing RE. The leverage factor shall be given by the proportion of the Funding RE's share, and the Sourcing RE's share in the co-lending transaction.

Extract of provision

17. Specifically, the final interest rate charged to the borrower shall be the blended interest rate which is calculated as an average rate of interest derived from the interest rates charged by respective REs, as per their internal lending policies and risk profile of the same or similar borrower, weighted by the proportionate funding share of concerned REs under CLA.

Sale of shares by the Co-lenders

- Assignment of a share in a loan - only with the consent of the other party.
- Natural for Partner RE to retain a right to transfer his share in the loan - which is both major, as also not necessarily linked with servicing obligations.
- Partner RE may define, through the co-lending agreement, the right to sell, securitise, or encumber his share.
- For the Originating RE , the Partner RE would have taken exposure relying on the strengths of the Originating RE.
- Arrangement may put a bar on the right of the originating RE to sell, securitise or encumber his share.
- Either of the parties can only sell the share only in compliance with the TLE Directions.

Type of co-lending partner	Permissibility to transfer the share
By Originating RE	Can be transferred to the Partner RE through TLE transaction subject to compliance of TLE directions including MHP requirements. Minimum retention required under CLM would no longer apply as the Partner RE becomes a sole lender.
By Partner RE	Partner RE is permitted to transfer its portion of loan under the TLE transaction, subject to compliance of MHP based on tenure of loan

Manner of accounting

- There are no specific guidelines for accounting of co-lending transactions; instead, the established accounting norms applicable to financial instruments and transactions are to be extended to co-lending transactions.
- Recognition of Co-Lending Exposure as Financial Asset
  - Co-lending, in its purest form, grants each co-lender the right to receive cash flows for their corresponding exposure to the borrower.
  - Simultaneously, the borrower bears a legal obligation to provide cash.
  - Consequently, in a standard co-lending setup, each co-lender is expected to recognise and classify their respective exposure as a financial asset.
- Treatment of Differential Interest Income
  - Co-lenders are often engaged in various activities, such as loan servicing, customer onboarding, and providing a customer interface. Therefore, the sharing of interest is typically determined based on each co-lender's involvement in both pre and post-disbursal activities.
  - Given the varying roles of different co-lenders in the arrangement, the rates of return within the loans may be distributed differently among co-lenders. Hence, the excess interest earned, is not in respect to service provided by one co-lender to another, rather differential income, which retains its original characteristic as an interest income, and shall be accounted for accordingly.

Asset Classification

- **Borrower level classification by both the REs:**
  - Para 33 of the present Directions provides that REs shall apply a borrower-level asset classification for their respective exposures to a borrower under CLA.
- **Matching of SMA/ NPA classification**
  - If either of the REs classifies its exposure to a borrower under CLA as SMA / NPA on account of default in the CLA exposure, the same classification shall be applicable to the exposure of the other RE to the borrower under CLA.

Extract of provision

33. REs shall apply a borrower-level asset classification for their respective exposures to a borrower under CLA, implying that if either of the REs classifies its exposure to a borrower under CLA as SMA / NPA on account of default in the CLA exposure, the same classification shall be applicable to the exposure of the other RE to the borrower under CLA. REs shall put in place a robust mechanism for sharing relevant information in this regard on a near-real time basis, and in any case latest by end of the next working day.

Issuance of KFS

- **Key Facts Statement:**
  - The requirement to provide a KFS was initially introduced for digital lending arrangements and was later extended in case of retail and MSME term loans. Now extends to all co-lending transactions.
  - To be issued by the Originating RE, specifying the name of Partner RE and blended ROI.

Extract of provision

14. All required details of CLA shall be disclosed appropriately to the concerned borrower as laid down under RBI Circular on 'Key Facts Statement (KFS) for Loans & Advances' dated April 15, 2024 as amended from time to time.

Disclosure and Reporting

Website

- List of all active CLA partners.
- The draft guidelines required the blended rate of interest to also be disclosed. However, the same is not required to be disclosed under the present Directions.
- Co-lending policy, if any

Notes to Accounts

Details of CLA-

- quantum of CLAs,
- weighted average rate of interest,
- fees charged / paid,
- broad sectors in which CLA was made,
- performance of loans under CLA,
- details related to default loss guarantee, if any

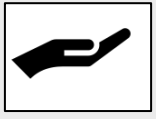
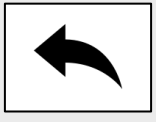
Customer

Any subsequent change in customer interface shall only be done after prior intimation to the borrower.

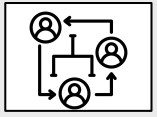
CIC

Para 31 of the present Directions clarifies that each RE shall adhere to the extant requirements of reporting to CICs for their share of the loan account.

Key Clauses for Intercreditor Agreement

	Clauses	
1		Intent of the parties and legal nature of the arrangement
2		Key commercial terms- tenure, exposure, representations and warranties
3		Servicing of function, collections and distribution of cash flows and expenses;
4		Underwriting standards to be followed, manner of rejection of certain loans not meeting the underwriting criteria
5		Transfer of funding share (entirely pre-funded, partially prefunded, reimbursed to Originating RE);
6		Event of Default, consequences of termination of arrangement;

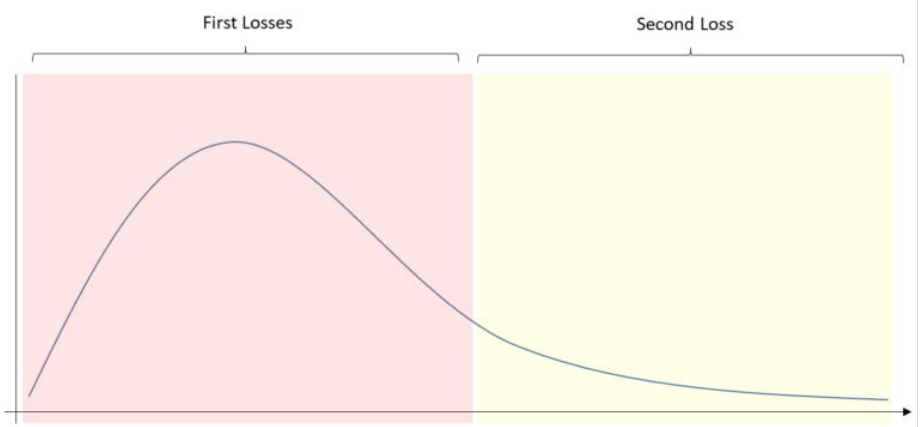
Key Clauses for Intercreditor Agreement

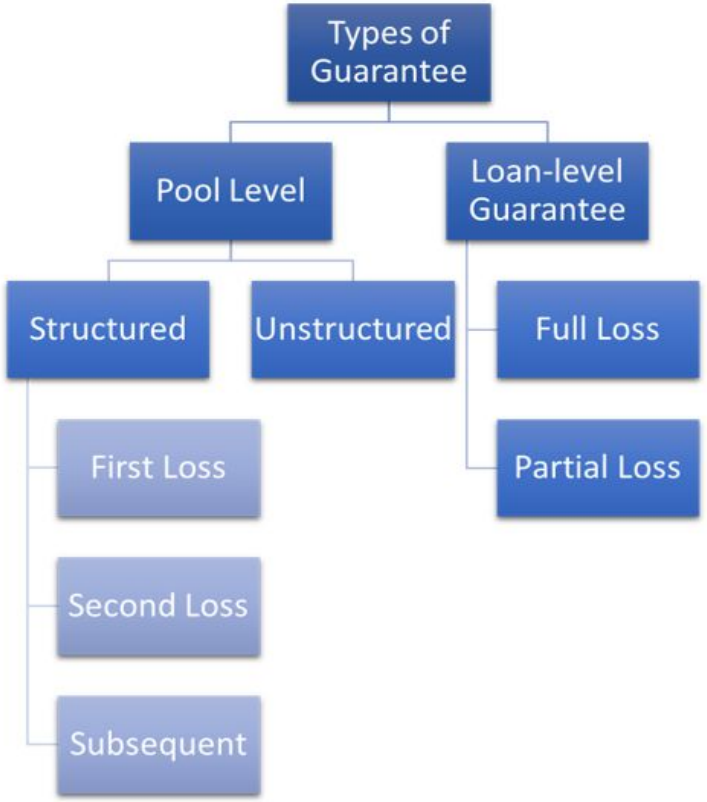
		Clauses
7		Decisions on restructuring, prepayment, etc, securitisation or partial assignment by either party
8		Criteria of selection of borrowers; Product lines and area of operation;
9		Fees payable for lending services, if any;
10		Roles and responsibilities of each co-lending partner;
11		Time frame for exchanging critical information;
12		Grievance redressal mechanism and Customer interface and customer protection issues

Default Loss Guarantee

Structured Default Guarantees

- What exactly are structured default guarantees?
  - A pool level guarantee where the exposure is capped
  - Common usage is "first loss default guarantee" (FLDG), which implies that there is a second layer of credit support too
  - In many cases, there was a 100% guarantee – unstructured guarantee





Restrictions on Structured Default Guarantees

- Under the DL Guidelines, it was mentioned that FLDGs arrangements are treated akin to "Synthetic Securitisation"
- Synthetic Securitisation is not permitted under SSA Directions
- Synthetic securitisation is a structure whereby instead of transferring a pool of loans, the risk of the pool is transferred.
- No reason to apply the regulations to loan-specific guarantees, commonly provided in the form of bank guarantee.
- Are mezzanine or second loss support permitted?
- Can co-lender provide guarantees?
  - Yes, under the Co-lending Directions, 2025

- Why is a structured default guarantee akin to securitisation?
  - In a typical securitisation, the originator has exposure to risks and rewards
  - Originator provides first layer of credit risk support
  - Originator takes the excess spread (IO strip)
- The so-called FLDG model virtually does the same thing:
  - Originator takes first loss
  - Originator sweeps the IO strip, as the servicing fees typically ensure a threshold rate
- Hence, arrangement is substantively similar to a securitisation transaction, minus the legal assignment

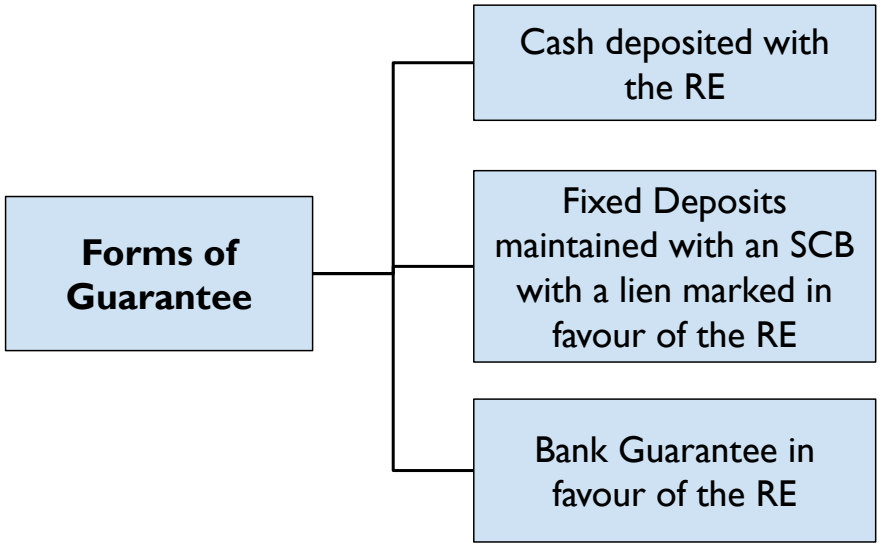
Understanding the DLG Guidelines

- RBI on June 8, 2023, took the first step in recognising first loss default guarantees ('FLDG'), provided by regulated or non-regulated entities, subject to restrictions
  - A contractual arrangement, called by whatever name, between the Regulated Entity (RE) and an entity meeting the criteria laid down at para 3 of these guidelines, 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.

- Basic questions around the DLG Structure:
  - Is the DLG allowed only in case of digital lending?
  - Has non-digital lending been omitted from dispensation?
  - Will it be a loan by loan or portfolio level guarantee?
  - Can the DLG be replenished or reinstated?
  - Can it be explicit as well as implicit guarantee?

DLG Structure

- Eligibility of Guarantor
- LSP or other RE with which it has entered into an outsourcing (LSP) arrangement
- Must be a company under the Companies Act, 2013
- DLG Agreement
- DLG arrangements should be backed by an explicit contract that shall at least contain the following -
  - Extent of DLG cover
  - Form in which DLG cover is to be maintained with the RE
  - Timeline for DLG invocation
  - Disclosure requirements with respect to information to be published on the LSP's website
- Tenure of DLG
- DLG agreements shall remain in force for shall not less than the longest tenor of the loan in the underlying loan portfolio
- Limit or capping of DLG cover
- Total amount of DLG cover on any outstanding portfolio shall not exceed 5% of the amount of that loan portfolio



Concept of Implicit Guarantee

- Not explicitly provided in the form of a guarantee
  - However, shall not be an informal arrangement
  - Should be a contractual arrangement
- All condition of DLG shall be applicable such as capping, eligibility of guarantor
  - However, question of maintaining it in the form of cash deposit or fixed deposit may not arise
- The DLG can be a mix of explicit and implicit support, within the limit of 5%

- Which of these are implicit guarantee?
- Subordination of servicing fees
- Sourcing agent compensates the lender for referring a loan that does not meet prescribed underwriting standards
- Payment of servicing fees that is linked to performance- scalar fee arrangement

Computation of 5% limit

- Computed on the value of loans disbursed within a particular cohort
  - Static pool based:
    - All disbursements within a time frame
    - All disbursements upto an amount
  - Dynamic pool-based
- The 5% limit shall be applied on the original principal of loans covered by the guarantee
- The guarantee is the extent of risk taken by the guarantor, but the exposure of the guarantor is on the entire principal amount
  - The exposure continues till the principal is fully repaid
- Since the guarantee is pre-funded, if there is a mismatch between the amount of funding and the maximum guarantee, the guarantor's risk is still limited to 5% of principal

- Invocation of DLG
  - To be utilised on "defaults", as defined between the parties
    - EMIs, or
    - the full value of defaulted loans
  - If the guarantee has been utilised against default, there is no question of replenishment of the guarantee
- Guaranteed amount comes down in two ways-
  - Either basis utilisation for meeting defaults; or
  - When the POS on the guaranteed pool has dropped below the value of the unutilised guarantee

Actionables for DLG Provider and Beneficiary

LSP providing DLG

- Must be incorporated as a company under the Companies Act, 2013,
- Provide a declaration certified by its statutory auditor on
  - the aggregate DLG amount outstanding,
  - the number of REs and the respective number of portfolios against which DLG has been provided,
  - past default rates on similar portfolios, and
  - such other information to satisfy the lender that it would be able to honour the DLG commitment
- Publish on their website the total number of portfolios and the respective amount of each portfolio on which DLG has been offered

NBFC/Bank availing DLG

- Put in place a Board approved Policy
- Ensure NPA classification as per the extant asset classification and provisioning norms irrespective of any DLG cover available at the portfolio level
- Amount of DLG invoked shall not be set off against the underlying individual loans
- Share the recovery, if any, from the loans on which DLG has been invoked and realised, with the DLG provider as per the terms of the contract.

Actionables for DLG Provider and Beneficiary

DLG Provider

- Treatment of financial guarantees under IndAS:
- Initial recognition: financial guarantee is a liability, and hence, has to be initially measured at fair value:
  - Fair value of expected losses, minus present value of guarantee fee
- Subsequent measurement:
  - Higher of initial value, and expected credit losses
- Hence, guarantee fee can be taken as income only if it exceeds the fair value of the guarantee

Beneficiary

- The amount recovered shall be set off from the expected credit losses
- However, difference in accounting treatment and the NPA/capital requirements,
  - NPA recognition shall continue in the books of the lender
  - Similarly, capital requirements will also remain unaffected