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# LANDSCAPE OF DIGITAL LENDING IN INDIA



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## PREFACE

In ever evolving landscape of digital lending in India, staying abreast of regulatory guidelines is essential for both financial institutions and borrowers alike. To address this need and provide comprehensive insights into the regulatory framework governing digital lending practices, we have prepared a booklet based on the guidelines issued by the Reserve Bank of India (RBI).

At ELP, we are committed to keeping pace with the dynamic regulatory landscape in banking and finance to ensure our clients receive the most up-to-date and relevant guidance. Our dedicated team of legal experts closely tracks changes in legislation, guidelines, and policies issued by regulatory. By staying at the forefront of regulatory updates, we are able to anticipate emerging trends, assess potential implications, and advise our clients on proactive compliance measures and strategic opportunities.

With this booklet we have tried to cover a wide spectrum of issues and guidelines pertinent to digital lending in India. The booklet offers a detailed exploration of the regulatory landscape, encompassing key aspects such as data protection, consumer rights, transparency, and compliance requirements mandated by the RBI. By synthesizing and organizing the RBI guidelines into an accessible format, this booklet aims to empower stakeholders in the digital lending ecosystem, including banks, non-banking financial institutions, fintech firms, and borrowers, with a clear understanding of their rights, obligations, and best practices.

However, we would like to add that this booklet is intended solely for informational purposes and does not constitute legal advice or professional guidance. While every effort has been made to ensure the accuracy and completeness of the information contained herein, readers are advised to consult qualified legal or financial professionals before making any decisions or taking any actions based on the content of this booklet. The views and opinions expressed in this booklet are those of the authors and do not necessarily reflect the official policies or positions of any regulatory authority or financial institution. The authors and ELP disclaim any liability for errors, omissions, or damages arising from the use of or reliance on the information provided herein.

This booklet serves as an indispensable resource, providing valuable insights and guidance to foster responsible and sustainable digital lending practices in India.

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## LIST OF RBI CIRCULARS AND GUIDELINES

- **RBI Working Group Recommendations (November 2021):** Recommendations formulated by the Working Group set up by the Reserve Bank of India (RBI) in January 2021 to assess the digital lending landscape and propose regulatory interventions.
- **RBI Comprehensive Guidelines on Digital Lending (September 2, 2022):** Comprehensive guidelines issued by RBI to govern digital lending activities by regulated entities (REs) in India. These guidelines cover various aspects such as engagement of service providers, credit appraisal, data privacy, transparent processes and grievance redressal mechanisms.
- **RBI Guidelines on First Loss Default Guarantee (FLDG) Arrangements (June 8, 2023):** Guidelines issued by RBI specifically addressing First Loss Default Guarantee (FLDG) arrangements in digital lending. These guidelines aim to enhance transparency, fairness and risk management in digital lending activities.
- **RBI Frequently Asked Questions (FAQs) to Digital Lending Guidelines (February 15, 2023):** FAQs published by RBI to provide clarity and guidance on the interpretation and implementation of the digital lending guidelines issued on September 2, 2022.
- **RBI Guidelines on Outsourcing of Financial Services (November 3, 2006):** Guidelines issued by RBI on managing risks and code of conduct in outsourcing of financial services by banks. These guidelines apply to regulated entities engaging in outsourcing arrangements, including digital lending activities.
- **RBI Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021 (September 24, 2021):** Master direction issued by RBI on securitisation of standard assets, containing provisions relevant to First Loss Default Guarantee (FLDG) arrangements in digital lending.
- **Key Facts Statement (KFS) and disclosure of Annual Percentage Rate (APR)-** Circular on ‘Display of information by banks’ dated January 22, 2015; paragraph 6 of Master Direction on ‘Regulatory Framework for Microfinance Loans’ dated March 14, 2022; and paragraph 5 of ‘Guidelines on Digital Lending’ dated September 2, 2022.
- **Key Facts Statement (KFS) and disclosure of Annual Percentage Rate (APR -** to enhance transparency and reduce information asymmetry on financial products being offered by different regulated entities – Circular Number-RBI/2024-25/18 DOR.STR.REC.13/13.03.00/2024-25 dated April 15, 2024.

### **TIMELINE FOR THE IMPLEMENTATION OF THE RECOMMENDATIONS RELATED TO DIGITAL LENDING, INCLUDING THE RELEASE OF GUIDELINES AND SUBSEQUENT UPDATES OR CLARIFICATIONS:**

- **January 2021:** Reserve Bank of India (RBI) sets up a Working Group to assess the digital lending landscape and formulate recommendations to address emerging challenges and opportunities.
- **November 2021:** The Working Group releases its recommendations, outlining key areas for regulatory intervention and proposing guidelines to govern digital lending activities.
- **August 2022:** RBI releases the implementation plan for the Working Group's recommendations, detailing the timeline and process for rolling out the regulatory framework for digital lending.
- **September 2, 2022:** Comprehensive guidelines on digital lending by regulated entities (REs) in India are issued by RBI. These guidelines cover various aspects such as engagement of service providers, credit appraisal, data privacy, transparent processes, and grievance redressal mechanisms.

- **November 30, 2022:** Deadline for regulated entities to implement adequate systems and processes to ensure compliance with the new guidelines for both existing and new digital loans.
- **June 8, 2023:** RBI issues additional guidelines specifically addressing First Loss Default Guarantee (FLDG) arrangements in digital lending. These guidelines aim to further enhance transparency, fairness, and risk management in digital lending activities.
- **February 15, 2023:** RBI publishes Frequently Asked Questions (FAQs) to provide clarity and guidance on the interpretation and implementation of the digital lending guidelines issued on September 2, 2022.
- **June 8, 2023:** Additional guidelines are released, specifically focusing on FLDG arrangements in digital lending. These guidelines provide further clarity on the arrangements between regulated entities (REs) and other lending service providers (LSPs) or outsourcing entities.
- **October 1, 2024:** REs to put in place the necessary systems and processes to implement the Key Facts Statement (KFS) and disclosure of Annual Percentage Rate (APR) at the earliest. In any case, all new retail and MSME term loans sanctioned on or after October 1, 2024, including fresh loans to existing customers, shall comply with these guidelines in letter and spirit without any exception. During the interregnum, the relevant provisions on 'KFS/Factsheet' under the extant guidelines shall continue to remain applicable, including the 'Guidelines on Digital Lending', the Master Direction on 'Regulatory Framework for Microfinance Loans', and the circular on 'Display of Information by Banks'.
- **Ongoing:** RBI continues to monitor the implementation of the digital lending guidelines and may issue further updates, clarifications, or amendments as necessary to address evolving challenges and ensure effective regulation of the digital lending ecosystem.



## INTRODUCTION

### DIGITAL LANDSCAPE IN INDIA: INSIGHTS FROM RBI STUDY

A recent study conducted by the Reserve Bank of India (RBI) in December 2022 sheds light on the evolving digital landscape in India and its implications for the economy, particularly in the realm of digital lending. The study utilizes national input-output statistics to measure the size of India's digital economy and its interaction with traditional sectors.

#### **Key Findings:**

- **Growth of the Digital Economy:**
  - The core digital economy, estimated to be 5.40% of India's overall Gross Value Added (GVA) in 2014, witnessed significant growth, contributing to 8.5% of the GVA by 2019. This growth, exceeding 15% annually, outpaced the overall economy's growth rate by 2.4 times.
  - The study highlights the importance of policies such as Make in India and Production-Linked Incentive (PLI) schemes to incentivize domestic production and foster innovation, thereby enhancing the digital economy's growth.
- **Employment Dynamics:**
  - Employment estimates indicate that around 4.9 million individuals were employed in the core digital sector, while approximately 62.4 million workers were employed in sectors experiencing digital disruption.
  - The study underscores the need for digital literacy and skill development initiatives to prepare the workforce for the evolving demands of the digital economy.
- **Implications for Digital Lending:** The study's findings underscore the growing importance of the digital economy in India and its impact on various sectors, including lending. As the digital landscape continues to evolve, policymakers and financial institutions need to adapt by embracing digital innovations, enhancing digital literacy and fostering a conducive regulatory environment. Moreover, initiatives aimed at promoting domestic production and skill development will play a crucial role in harnessing the full potential of the digital economy and driving sustainable economic growth.

### DIGITAL LENDING LANDSCAPE IN INDIA:

In recent years, the landscape of lending in India has undergone a significant transformation propelled by advancements in technology and evolving regulatory frameworks. The rise of digital lending platforms has revolutionized the borrowing experience, offering convenience, accessibility and speed to borrowers across diverse segments of society. However, alongside this digital revolution comes the imperative to ensure transparency, fairness, and consumer protection within the digital lending ecosystem. Recognizing this imperative, regulatory authorities have introduced a series of guidelines aimed at fostering responsible lending practices, enhancing transparency, and safeguarding the interests of borrowers. In this context, it becomes essential to examine the combined impact of these guidelines on the digital lending space in India, both from policy and operational perspectives.

As digital lending platforms proliferate, offering unprecedented access to credit, regulatory authorities are doubling down on efforts to ensure transparency, fairness and consumer protection. The introduction of unified regulatory frameworks, enhanced disclosure requirements and measures to promote innovation and financial inclusion signify a concerted effort to strike a balance between fostering financial innovation and safeguarding consumer interests.

In this booklet, we delve into the combined effect of these guidelines on the digital lending space in India, examining the implications for lending bodies and financial institutions from both policy and operational standpoints. By navigating these changes effectively, stakeholders can contribute to the emergence of a more inclusive, transparent, and resilient digital lending ecosystem in India.

## RBI REGULATORY REGIME ON DIGITAL LANSCAPE

RBI set up a Working Group in January 2021 which released its recommendations in November 2021. The Implementation of the Recommendations was released in August 2022, and on September 2, 2022. This was followed up with the Guidelines dated 8th June 2023 (RBI Guidelines) as regards FLDG arrangements. The Guidelines have been issued under the Banking Regulation Act, 1949, the Reserve Bank of India Act, 1934, the National Housing Bank Act, 1987, the Factoring Regulation Act, 2011 and the Credit Information Companies (Regulation) Act, 2005. Subsequent to this, the RBI published Frequently Asked Questions (FAQs) pertaining to the guidelines on February 15, 2023. This was succeeded by the issuance of guidelines on First Loss Default Guarantee (FLDG) arrangements on June 8, 2023, and further instructions regarding the Key Facts Statement (KFS) and the disclosure of the Annual Percentage Rate (APR) on April 15, 2024. RBI September 02, 2022 Comprehensive Guidelines now govern Digital Lending by the Regulated Entities (REs) in India. These Guidelines address a wide range of issues ranging from engagement of services of Service providers, credit appraisal, data privacy, maintenance of transparent process and systems, reporting and grievance redressal mechanism. These guidelines also apply to the 'existing customers availing fresh loans' and to 'new customers getting onboarded' from September 02, 2022 onwards. Lenders were given a time frame up to November 30, 2022, to put in place adequate systems and processes to ensure that 'existing digital loans' are in compliance with these guidelines in both letter and spirit. These Guidelines are applicable to all Commercial Banks, Primary (Urban) Co-operative Banks, State Co-operative Banks, District Central Co-operative Banks; and Non-Banking Financial Companies (including Housing Finance Companies).

The RBI Guidelines, dated June 8, 2023 (RBI Guidelines) as regards FLDG arrangements, were made effective from the date of the circular viz 8th June 2023. The Guidelines cover the arrangements between REs and other LSPs (who are not REs). The Guidelines also cover an outsourcing arrangement between two REs. Accordingly, all existing new arrangements between REs will need to be evaluated. The onus of compliance with Guidelines relating to providing loans to customers including maintaining necessary technology infrastructure will be on the REs. However, since the arrangements get reflected in the form of agreements and RBI Guidelines have been acknowledged as having a force of law, compliance requirements need to be ensured by both parties.

RBI has on April 15, 2024, also issued **guidelines on Key Facts Statement (KFS) for Loans & Advances** to enhance transparency and reduce information asymmetry in financial products offered by RE's, empowering borrowers to make informed decisions. These guidelines provide for the following:

- **Mandatory Provision of KFS:** REs must provide KFS to prospective borrowers in a standardized format, explaining its contents and obtaining acknowledgment from the borrower.
  - **Validity Period:** KFS should have a validity period of at least three working days for loans with a tenor of seven days or more and one working day for loans with a tenor of less than seven days.
  - **Inclusion in KFS:** KFS should include a computation sheet of APR and the loan amortization schedule. Charges recovered from third-party service providers shall also form part of APR and be disclosed separately.
  - **Explicit Consent for Additional Charges:** Any fees or charges not mentioned in the KFS cannot be levied without explicit consent from the borrower.
  - **Summary Box:** KFS should be included as a summary box exhibited as part of the loan agreement.
  - **Exemptions:** Credit card receivables are exempted from these provisions.
  - **Applicability and Commencement:** REs must implement the guidelines for all new retail and MSME term loans sanctioned on or after October 1, 2024. Relevant provisions under existing guidelines shall remain applicable during the interim period.



## EFFECT OF THE CURRENT GUIDELINES ON DIGITAL LENDING SPACE IN INDIA

An overview of the impact of the RBI Guidelines on the digital lending ecosystem in India is given below:

### **Policy Perspective:**

- **Enhanced Transparency and Customer Protection:** The guidelines focus on enhancing transparency in the digital lending space, ensuring that borrowers have access to comprehensive information on loan products and lenders.
- This emphasis on transparency not only empowers borrowers to make informed decisions but also fosters trust in the digital lending ecosystem.

### **Regulatory Standardization:**

- The unified regulatory framework for connected lending and web-aggregation of loan products aims to standardize regulations across all regulated entities.
- Standardization promotes consistency and fairness in lending practices, reducing the risk of moral hazard issues and ensuring an arm's length relationship between lenders and borrowers.
- **Promotion of Innovation and Financial Inclusion:** Measures such as increasing the UPI transaction limit for specified categories and enhancing e-Mandates aim to promote innovation and expand financial inclusion.
- By facilitating higher transaction limits and simplifying processes, these measures encourage the adoption of digital payment systems and lending services, especially in sectors like healthcare and education.

### **Operational Perspective:**

- **Adoption of Technology Standards:** Lending bodies and financial institutions need to adopt technology standards and cybersecurity measures prescribed by regulatory authorities.
- Compliance with these standards ensures the security and integrity of financial data, safeguarding against cyber threats and enhancing customer trust.
- **Enhanced Customer Communication and Disclosure:** Lending service providers (LSPs) must ensure transparent communication with borrowers, providing clear and comprehensive information about loan offers, terms, and conditions.
- Implementing standardized Key Fact Statements (KFS) and disclosure practices helps borrowers understand the cost and implications of loans, promoting responsible borrowing.
- **Robust Grievance Redressal Mechanisms:**
  - Establishing robust grievance redressal mechanisms, including designated nodal officers and complaint management systems is essential for addressing borrower concerns promptly and effectively.
  - Clear communication channels and timely resolution of grievances enhance customer satisfaction and trust in digital lending platforms.
- **Compliance with Data Privacy and Storage Requirements:** Lending entities must comply with data privacy regulations and ensure secure storage of customer data, especially in light of the proposed establishment of a Fintech Repository.
- Adhering to guidelines on data collection, usage and sharing helps protect borrower privacy and builds confidence in digital lending platforms.

The combined effect of these guidelines on the digital lending space in India reflects a concerted effort to promote transparency, customer protection, and innovation. Lending bodies and financial institutions must adapt their policies and operations to comply with regulatory standards, prioritize customer communication and disclosure, establish robust grievance redressal mechanisms, and ensure compliance with data privacy requirements.

## EFFECT OF THE RBI GUIDELINES ON DIGITAL LENDING IN NUTSHELL

S. NO	SERVICES	EFFECT OF RBI GUIDELINES
1	<b>Eligibility</b>	<p>As per the RBI Guidelines, the service provider must be a loan service provider (LSP).</p> <p>This would include not only the LSP but also other outsourcing agents of LSP.</p> <p>The LSP must have the financial strength to meet the guaranteed commitment which needs to be supported by an auditor certificate.</p>
2	<b>Outsourcing of financial services</b>	<ul style="list-style-type: none"> <li>▪ Permitted subject to RBI Guidelines as specified in the Annexures.</li> <li>▪ Outsourcing within Group allowed with relaxed conditions.</li> <li>▪ Core financial activities/management function cannot be outsourced.</li> <li>▪ Outsourcing of recovery function allowed subject to adherence to the RBI Guidelines.</li> </ul>
3	<b>FLDG /DLG Arrangements</b>	Only with Regulated Entities subject to RBI Guidelines
4	<b>Over -all Limit on FLDG</b>	<p>DLG should not exceed 5% of the amount of that “loan portfolio”. Any implicit/indirect support provided by LSP shall be taken into account in calculating this cap. The beneficiary of DLG must be a regulated entity (RE).</p> <p>DLG may be only in one or more of the following forms –</p> <ul style="list-style-type: none"> <li>▪ Cash deposited with the RE;</li> <li>▪ Fixed Deposits maintained with a Scheduled Commercial Bank with a lien marked in favour of the RE;</li> <li>▪ Bank Guarantee in favour of the RE.</li> </ul>
5	<b>Utilization of FD amount</b>	<p>Utilization of FD amount may be mutually decided with REs and accrued interest may also be considered to calculate the value of 5%.</p> <p>DLG can be given at the portfolio level and loan-by-loan guarantees are not allowed.</p> <p>The RBI Guidelines require that DLG may remain with the lender till the full discharge of the loans forming part of portfolio and will continue to come down on the basis of utilization of the said guarantee for meeting defaults.</p>

6	<b>Synthetic Lending</b>	No allowed in any form.
7	<b>Key Facts Statement (KFS)</b>	RBI has on 15 <sup>th</sup> April 2024, also issued guidelines on Key Facts Statement (KFS) for Loans & Advances to enhance transparency and reduce information asymmetry in financial products offered by regulated entities, empowering borrowers to make informed decision.
	<b>Implementation</b>	REs must implement the guidelines for all new retail and MSME term loans sanctioned on or after October 1, 2024. Relevant provisions under existing guidelines shall remain applicable during the interim period.

## UNDERSTANDING THE DIGITAL LENDING

### RELEVANT DEFINITIONS FOR UNDERSTANDING DIGITAL LENDING:

- **Annual Percentage Rate (APR):** Annual cost of credit to the borrower, including interest rate and associated charges.
- **Digital Lending:** A remote and automated lending process, largely by use of seamless digital technologies for customer acquisition, credit assessment, loan approval, disbursement, recovery and associated customer service.
- **Digital Lending Apps/Platforms (DLAs):** Mobile and web-based applications with user interface that facilitate digital lending services. DLAs will include apps of the Regulated Entities (REs) as well as those operated by Lending Service Providers (LSPs) engaged by REs for extending any credit facilitation services in conformity with extant outsourcing guidelines issued by the Reserve Bank.
- **Equated Periodic Instalment (EPI):** Fixed repayments including principal and interest components at periodic interval. 'Continuing basis' includes agreements for a limited period.
- **Key Facts Statement (KFS):** Statement of key facts in simple language provided to borrowers in a standardized format.
- **Lending Service Provider (LSP):** 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.
- **Regulated Entities (REs):** All Commercial Banks, Primary (Urban) Co-operative Banks, State Co-operative Banks, District Central Co-operative Banks; and Non-Banking Financial Companies (including Housing Finance Companies) regulated by any of the financial sector regulators.
- **"Systemically important non-deposit taking non-banking financial company"**, means a non-banking financial company not accepting / holding public deposits and having total assets of ₹500 crore and above as shown in the last audited balance sheet.
- **'Outsourcing' NBFC's** use of a third party (either an affiliated entity within a corporate group or an entity that is external to the corporate group) to perform activities on a continuing basis that would normally be undertaken by the NBFC itself, now or in the Key Facts- legally significant and deterministic facts in a loan agreement.

### BACKGROUND

In July 2022, India's NITI Ayog released its report titled "DIGITAL BANKS A Proposal for Licensing & Regulatory Regime for India"<sup>1</sup>. Earlier in 2017, the RBI issued Master Directions - Non-Banking Financial Company – Peer to Peer Lending Platform (Reserve Bank) Directions, 2017.

Building on the above, the RBI, on September 2, 2022, issued guidelines for digital lending applicable to all Commercial Banks, Primary (Urban) Co-operative Banks, State Co-operative Banks, District Central Co-operative Banks; and Non-Banking Financial Companies (including Housing Finance Companies).

### WHAT IS DIGITAL LENDING (DL)

There is no single universally accepted definition available for this – the obvious reason is that the field is still evolving, with newer methods being deployed in light of new technological advancements. However, based on its features, 'digital lending' can be defined as a platform-based seamless lending process which uses digital technologies for the

<sup>1</sup> [https://www.niti.gov.in/sites/default/files/2022-07/DigitalBanking07202022\\_compressed.pdf](https://www.niti.gov.in/sites/default/files/2022-07/DigitalBanking07202022_compressed.pdf)

entire process of credit dispensation including credit assessment, loan approval, documentation, disbursement, loan repayment, and customer service. Majorly, DL takes two forms - (i) Balance Sheet Lending (BSL) and (ii) Market Place Lending (MPL).

RBI guidelines define **Balance Sheet Lending (BSL)** as “Financial service involving extension of monetary loans, where the lender retains the loan and associated credit risk of the loan on its own balance sheet” and Balance Sheet Lenders as ‘Lenders who undertake balance sheet lending’.

On the other hand, **Market Place Lending (MPL)** is a platform which connects lenders with borrowers/customers and investors who may buy or invest in such loans/ lend to such borrowers. These MPL are also known as Market Place Aggregators (MPAs) and is P2P.

There are other practices including ‘Rent a NBFC’. This arrangement used “First Loss Default Guarantee (FLDG)” to share credit risk without having to maintain any regulatory capital.

## GUIDELINES ON DIGITAL LENDING

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On September 2, 2022, the RBI issued Comprehensive Guidelines to govern Digital Lending by REs in India. These Guidelines address a wide range of issues ranging from engagement of service providers, credit appraisal, data privacy, maintenance of transparent process and systems, reporting and a grievance redressal mechanism.

## APPLICABILITY OF THE GUIDELINES

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These guidelines apply to all Commercial Banks, Primary (Urban) Co-operative Banks, State Co-operative Banks, District Central Co-operative Banks; and Non-Banking Financial Companies (including Housing Finance Companies).

**These guidelines also apply to the ‘existing customers availing fresh loans’** and to ‘new customers getting onboarded’ from September 2, 2022 onwards. However, lenders were provided time till November 30, 2022, to put adequate systems and processes in place to ensure that ‘existing digital loans’ are also in compliance with these guidelines in both letter and spirit.

## SCOPE OF THE GUIDELINES

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The Guidelines covers three specific areas of:

- Customer Protection and Conduct requirements
- Technology and Data Requirement and
- Regulatory Framework.

These guidelines allow outsourcing arrangements by REs with a Lending Service Provider (LSP)/ Digital Lending App (DLA) but the onus of compliance with RBI guidelines will remain with the REs.

## TYPE OF LENDING ALLOWED:

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The Guidelines basically allow **only Balance Sheet type of lending**. All loan servicing, repayment etc. need to be in the RE’s bank account without any pass-through account/ pool account of any third party.

**Disbursements would** need to be made into the bank account of the borrower except for disbursements covered exclusively under statutory or regulatory requirements for specific end use, or into the bank account of the end-beneficiary. No third- third-party account disbursement is allowed, including the accounts of LSPs and their DLAs.

Co-lending arrangements are allowed as per the RBI guidelines in Circular dated November 05, 2020<sup>2</sup>

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<sup>2</sup> Co-lending arrangements shall be governed by the extant instructions as laid down in the Circular on Co-lending by Banks and NBFCs to Priority Sector dated November 05, 2020.



## **OUTSOURCING ARRANGEMENTS:**

Outsourcing of various functions such as customer acquisition, underwriting support, pricing support, servicing, monitoring, recovery of specific loan or loan portfolio are allowed. REs are required to comply with RBI guidelines on outsourcing of various functions. As per “Guidelines on Managing Risks and Code of Conduct in Outsourcing of Financial Services by banks” dated November 3, 2006, banks are required to have a comprehensive board approved outsourcing policy. Offshore outsourcing is permitted subject to strict compliance of the regulatory requirements and only in jurisdictions upholding confidentiality clauses and agreements. However, banks are prohibited from outsourcing core management functions including Internal Audit, Compliance function and decision-making functions like determining compliance with KYC norms for opening deposit accounts, sanction for loans (including retail loans) and management of investment portfolio. Agreement with such an LSP should cover all requirements as specified by RBI in the above-mentioned circular.

Before engaging services of an LSP/DLA, REs need to conduct enhanced due diligence covering its technical abilities, data privacy policies and storage systems, fairness in conduct with borrowers and ability to comply with regulations and statutes etc. Periodic reviews are also required.

## **LOSS SHARING ARRANGEMENT IN CASE OF DEFAULT:**

First Loss Default Guarantee (FLDG/DLG) is allowed subject to compliance of certain conditions.

“First loss facility” means the first level of financial support provided by the originator or a third party to improve the creditworthiness under which the provider of the facility bears part or all of the risks associated with the assets.

FLDG is permitted subject to adherence to the provisions of the Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021 dated September 24, 2021, especially, synthetic securitization contained in Para (6)(c).

FDLG/DLG should not exceed 5% of the amount of that “loan portfolio”. Any implicit/indirect support provided by LSP shall be considered in calculating this cap. The beneficiary of DLG must be a RE. DLG may be only in one or more of the following forms –

- Cash deposited with the RE;
- Fixed Deposits maintained with a Scheduled Commercial Bank with a lien marked in favour of the RE;
- Bank Guarantee in favour of the RE.

The utilization of FD amount may be mutually decided with REs and accrued interest may also be considered to calculate the value of 5%. DLG can be given at the portfolio level and loan-by-loan guarantees are not allowed. The RBI Guidelines require that DLG may remain with the lender till the full discharge of the loans forming part of portfolio. It will continue to come down on the basis of utilization of the said guarantee for meeting defaults.

**Synthetic Securitization:** According to the guidelines, lenders, including overseas branches of Indian banks, are prohibited from engaging in synthetic securitization. This type of securitization involves the transfer of credit risk associated with an underlying pool of exposures, either wholly or partially. It typically uses credit derivatives or guarantees to hedge the credit risk of a portfolio that continues to reside on the lender's balance sheet. **FLDG provider should ensure that the following conditions are fulfilled, failing which, the credit enhancement provider will be required to hold capital equal to the full value of the securitized assets:**

- Entities providing such facilities must be regulated by at least one financial sector regulator.
- The facility should be distinct from other facilities and documented separately from any other facility provided by the facility provider.
- The nature, purpose, extent of the facility and all required standards of performance should be clearly specified in a written agreement to be executed at the time of originating the transaction and disclosed in the offer document.

- The facility should be on an *'arm's length basis'* on market terms and conditions and subjected to the facility provider's normal credit approval and review process.
- Payment of any fee or other income for the facility is not subordinated or subject to deferral or waiver.
- The facility should be limited to a specified amount and duration. The duration of the facility should be limited to the earlier of the dates on which (i) all claims connected with the securitization notes issued by the SPE are paid out; or (ii) the facility provider's obligations in relation to such facility are otherwise terminated.
- There should not be any recourse to the facility provider beyond the fixed contractual obligations and the facility provider should not bear any recurring expenses of the securitization.

## REQUIREMENTS TO BE COMPLIED WITH BY RES FOR DIGITAL LENDING

In the light of the RBI Guidelines, REs are required to ensure the following in connection with their digital lending processes:

- No automatic increase in credit limit unless explicit consent of borrower is taken on record for each such increase.
- Annual Percentage Rate (APR) - APR which should be an all-inclusive cost of digital loans should be disclosed upfront by REs and shall also be a part of the Key Fact Statement.
- Key Fact Statement (KFS) is to be sent to the borrower before the execution of the contract as per the format provided in Annex-II to the RBI circular dated September 02, 2022 and April 15, 2024.
- Fees, charges, etc. of LSPs are to be directly paid by RE and cannot be charged by LSP to the borrower.
- The penal interest/charges levied, if any, shall be based on the outstanding amount of the loan. Rate of such penal charges need to be disclosed upfront on an annualized basis to the borrower in the Key Fact Statement (KFS).
- Digitally signed documents (Digitally signed means a document signed using digital signature) viz., KFS, summary of loan product, sanction letter, terms and conditions, account statements, privacy policies of the LSPs/DLAs with respect to borrowers' data, etc. should automatically flow to the borrowers on their registered and verified email/SMS upon execution of the loan contract/ transactions.
- Details of the LSP (including any change), acting as recovery agent and authorized to approach the borrower for recovery, need to be disclosed to the Borrower along with sanction.
- The cooling off period for exit will be as per the Board approved policy of the RE which should not be less than three days for loans having tenor of seven days or more and one day for loans having tenor of less than seven days.
- Borrowers should be given an option to exit a digital loan by paying the principal and the proportionate APR without any penalty during this period.
- Beyond the above, pre-payment charges can be levied as per extant RBI guidelines.
- Reporting to Credit Information Companies (CICs) is to be ensured by REs as per extant RBI Guidelines<sup>3</sup> irrespective of its nature/ tenor of the loan.
- Extension of structured digital lending products by REs and/or LSPs engaged by REs over a merchant platform involving short term, unsecured/ secured credits, or deferred payments, need also to be reported to CICs by the REs.
- REs shall ensure that LSPs, if any, associated with such deferred payment credit products shall abide by the extant outsourcing guidelines issued by the Reserve Bank and be guided by these guidelines.
- A list of their DLAs, LSPs engaged with the details of the activities for which they have been engaged, should be displayed on the website of REs.
  - DLAs or DLAs of their LSPs at the on-boarding/sign-up stage of the borrower should prominently display information relating to the product features, loan limit and cost, etc. Further, there should be links to the REs' website where further detailed information about the loan products, the lender, the LSP, particulars of customer care, link to Sachet Portal, privacy policies, etc. can be accessed by the borrowers.

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<sup>3</sup> As per the provisions of the Credit Information Companies (CIC) (Regulation) Act, 2005; CIC Rules, 2006; CIC Regulations, 2006

- It shall be ensured that all such details are available at a prominent single place on the website for ease of accessibility.
- REs and LSPs should name a nodal grievance redressal officer to deal with FinTech/ digital lending related complaints/ issues raised by borrowers/complaints against their respective DLAs. Contact details of grievance redressal officers shall be prominently displayed on the websites of the RE, its LSPs and on DLAs and also in the KFS provided to the borrower.
  - Further, the facility of lodging a complaint shall also be made available on the DLA and on the websites.
  - Responsibility of grievance redressal shall continue to remain with the RE. Such complaints should be resolved within 30 days. Thereafter the Complaint can be lodged on the Complaint Management System (CMS) portal under the Reserve Bank-Integrated Ombudsman Scheme.
- Collection of data by DLAs and DLAs of their LSPs should be need-based and with prior and explicit consent of the borrower having audit trail.
  - No access to mobile phone resources like file and media, contact list, call logs, telephony functions, etc. except for the purpose of on-boarding/ KYC requirements with the explicit consent of the borrower.
  - Borrowers should be provided an option to give or deny consent for use of specific data, restrict disclosure to third parties, data retention, revoke consent already granted to collect personal data and if required, make the app delete/ forget the data.
  - The purpose of obtaining borrowers' consent needs to be disclosed at each stage of interface with the borrowers.
  - Explicit consent of the borrower needs to be taken before sharing personal information with any third party, save and except the data required under the statutory or regulatory requirements.
  - No personal information of borrowers could be stored save and except some basic minimal data (viz., name, address, contact details of the customer, etc.) that may be required to carry out their operations.
- The responsibility regarding data privacy and security of the customer's personal information will be that of the RE:
  - Clear Policy guidelines regarding the storage of customer data including the type of data that can be stored, the length of time for which data can be stored, restrictions on the use of data, data destruction protocol, standards for handling security breach, etc., need to be put in place by REs and also disclosed by DLAs of the REs and of the LSP engaged by the RE. This should be displayed prominently on their website and the apps at all times.
  - No biometric data be stored/ collected in the systems associated with the DLA of REs/ their LSPs, unless allowed under extant statutory guidelines.
  - All data need to be stored only in servers located within India, while ensuring compliance with statutory obligations/ regulatory instructions.
  - Comprehensive privacy policy: REs/DLAs/LPS should have a comprehensive privacy policy compliant with applicable laws, associated regulations and RBI guidelines and for accessing and collection of personal information of borrowers, DLAs of REs/LSPs should make the comprehensive privacy policy available publicly.
  - Details of third parties (where applicable) allowed to collect personal information through the DLA shall also be disclosed in the privacy policy.
- REs and the LSPs need to comply with various technology standards/ requirements on cybersecurity stipulated by RBI and other agencies, or as may be specified from time to time, for undertaking digital lending.
- **Based on the guidelines on Key Facts Statement (KFS)**, players in the lending industry need to take the following steps:

- **Standardized KFS Format:** Develop a standardized format for the Key Facts Statement (KFS) that includes all the legally significant and deterministic facts of a loan agreement, presented in simple language.
- **System Implementation:** Put in place necessary systems and processes to ensure the generation and provision of KFS to all prospective borrowers.
- **Content Explanation:** Train staff to explain the contents of the KFS to borrowers and ensure that borrowers acknowledge their understanding of the statement.
- **Validity Period Compliance:** Ensure that the KFS provided to borrowers has a validity period as per the guidelines, allowing borrowers sufficient time to review and agree to the loan terms.
- **APR Computation:** Develop a computation sheet for the Annual Percentage Rate (APR) and include it in the KFS, incorporating all charges associated with the credit facility.
- **Charge Disclosure:** Disclose all charges recovered from borrowers, including those on behalf of third-party service providers, separately in the KFS.
- **Consent for Additional Charges:** Obtain explicit consent from borrowers for any fees or charges not mentioned in the KFS before levying them during the loan term.
- **Summary Box Inclusion:** Ensure that the KFS is included as a summary box exhibited as part of the loan agreement for easy reference by borrowers.
- **Implementation Timeline:** Plan and execute the necessary changes to comply with the guidelines for all new retail and MSME term loans sanctioned on or after October 1, 2024.

## CHECKLIST FOR DIGITAL LENDING

- Formulate Policies (if not already in place) for outsourcing and engagement of LSP/DLAs, Collection and Privacy of Data, FLDs arrangements, Grievance Redressal mechanism etc. in line with RBI Guidelines (Annexure).
- Design loan products suited for DL, including costing and mechanism for appraisal and disbursement.
- Devise standard terms and conditions suited for DL to take care of compliance of such conditions by the borrower.
- Put in place a system of execution of security documents in digitized format.
- Devise suitable formats of security documents suited for DL on a digitized platform and related compliances and perfection of charges.
- Verification and compliance of eKYC norms.
- Service Level Agreement to take care of the RBI Guidelines. It should have standard clauses as specified in Annexure.
- Supervision and Risk Assessment Mechanism is put in place as per Annexure.
- Fair Practice Code incorporating RBI Guidelines (Annexure) is put in place.
- Grievance Redressal is put in place incorporating RBI Guidelines – Annexure.
- Data Protection Mechanism is put in place.
- A board approved Code of conduct for DSA/ DMA/ Recovery Agents and obtain their undertaking to abide by the code.
- Recovery Agents should adhere to extant instructions on the Fair Practices Code for NBFCs as also their own code for collection of dues and repossession of security.



## DATA PRIVACY AND SECURITY

### DATA PRIVACY AND SECURITY REQUIREMENTS:

In the digital lending ecosystem, data privacy and security are of utmost importance to protect sensitive customer information from unauthorized access, misuse, or breaches. Financial institutions, including digital lenders, have a responsibility to adhere to stringent data privacy regulations and implement robust security measures to safeguard customer data throughout its lifecycle.

### RESPONSIBILITIES OF FINANCIAL INSTITUTIONS:

- **Compliance with Regulatory Standards:** Financial institutions must comply with relevant regulatory standards and guidelines governing data privacy and security, such as those issued by the RBI and other regulatory authorities. This includes adherence to data protection laws, industry best practices and international standards for information security.
- **Secure Storage and Handling:** Financial institutions are responsible for securely storing and handling customer data, both during transit and while at rest. This involves implementing encryption, access controls, and authentication mechanisms to prevent unauthorized access or data breaches. Additionally, data should be stored in secure facilities and protected against physical threats, such as theft or damage.
- **Data Minimization and Purpose Limitation:** Financial institutions should practice data minimization by collecting only the necessary information required for legitimate business purposes. They should also adhere to the principle of purpose limitation, ensuring that customer data is used only for specified and lawful purposes and not retained longer than necessary.
- **Consent Management:** Financial institutions must obtain explicit consent from customers before collecting, processing, or sharing their personal data. Consent should be informed, specific, and revocable and customers should have the option to opt-out of certain data processing activities.
- **Transparency and Disclosure:** Financial institutions should maintain transparency in their data processing practices and provide clear and concise disclosures to customers regarding the collection, use, and sharing of their personal information. This includes informing customers on the types of data collected, the purposes for which it is used and any third parties with whom it may be shared.
- **Grievance Redressal Mechanisms:** Financial institutions should establish robust grievance redressal mechanisms to address customer concerns related to data privacy and security. This includes, providing channels for customers to lodge complaints, escalating unresolved issues and ensuring timely resolution of grievances in accordance with regulatory requirements.

### IMPORTANCE OF CLEAR POLICY GUIDELINES AND DISCLOSURE PRACTICES

Clear policy guidelines and disclosure practices play a crucial role in ensuring data protection within the digital lending ecosystem. Transparent and clear policies regarding data privacy and security demonstrate the institution's commitment to protecting customer interests. This builds trust and confidence among customers, encouraging them to engage with the institution and share their personal information.

- **Empower Informed Decision-Making:** Clear disclosures enable customers to make informed decisions about the use of their personal data. By understanding how their information will be used and protected, customers can assess the risks and benefits of engaging with the institution and exercise their rights accordingly.
- **Facilitate Regulatory Compliance:** Clear policy guidelines and disclosure practices facilitate regulatory compliance by ensuring that financial institutions adhere to applicable laws and regulations governing data privacy and security. This reduces the risk of non-compliance and potential regulatory sanctions.

- **Mitigate Legal and Reputational Risks:** Transparent data handling practices help financial institutions mitigate legal and reputational risks associated with data breaches or privacy violations. By proactively disclosing their data protection measures and respecting customer privacy preferences, institutions can demonstrate accountability and minimize the likelihood of adverse legal or reputational consequences.

# TECHNOLOGICAL STANDARDS AND CYBERSECURITY MEASURES & ENSURING THE SECURITY AND INTEGRITY OF DIGITAL LENDING PROCESSES

## TECHNOLOGICAL STANDARDS

- **Encryption:** Financial institutions are required to implement strong encryption algorithms to secure data in transit and at rest, ensuring that it remains unreadable to unauthorized parties.
- **Access Controls:** Regulatory guidelines emphasize the implementation of access controls to restrict unauthorized access to sensitive systems and data. This includes user authentication mechanisms, role-based access controls and multi-factor authentication to verify the identity of users accessing the system.
- **Secure Development Practices:** Financial institutions are required to follow secure software development practices, such as incorporating security controls into the design and development process of digital lending platforms. This includes conducting security assessments, code reviews and penetration testing to identify and mitigate potential vulnerabilities.
- **Network Security:** Regulatory authorities may require financial institutions to implement robust network security measures, such as firewalls, intrusion detection systems, and network segmentation to protect against unauthorized access and cyber threats.
- **Data Privacy Regulations:** Compliance with data privacy regulations, such as the General Data Protection Regulation (GDPR) or the Personal Data Protection Act in India, is essential. Financial institutions must ensure that customer data is collected, processed, and stored in accordance with legal requirements, including obtaining explicit consent for data processing activities.

## CYBERSECURITY MEASURES

- **Continuous Monitoring:** Financial institutions need to implement continuous monitoring mechanisms to detect and respond to security incidents in real-time. This includes the use of security information and event management (SIEM) systems, intrusion detection systems, and threat intelligence feeds to identify and mitigate potential threats.
- **Vulnerability Management:** Regular vulnerability assessments and patch management practices are essential to identify and remediate security vulnerabilities in digital lending platforms and associated systems. Financial institutions need to conduct periodic vulnerability scans and apply security patches promptly to mitigate the risk of exploitation by threat actors.
- **Incident Response Plans:** Financial institutions also need to develop and maintain incident response plans to effectively respond to security incidents, such as data breaches or cyber-attacks. These plans outline the steps to be taken in the event of a security incident, including incident detection, containment, eradication, recovery and post-incident analysis.
- **Employee Training and Awareness:** Training employees on cybersecurity best practices and raising awareness about emerging threats are critical components of a comprehensive cybersecurity strategy.
- **Third-Party Risk Management:** Financial institutions should also assess and manage the cybersecurity risks associated with third-party vendors, including digital lending platform providers and service providers. This involves conducting due diligence assessments, reviewing security controls and contractual agreements to ensure that third parties adhere to security standards and regulatory requirements.

Players in the digital lending space need to implement these technological standards and cybersecurity measures through a combination of technical controls, policies, procedures and employee training programs. They invest in robust

cybersecurity technologies, such as next-generation firewalls, endpoint protection solutions and security analytics platforms to protect digital lending platforms from cyber threats.

By prioritizing technological standards and cybersecurity measures, financial institutions can safeguard the security and integrity of digital lending processes, protect customer data and maintain trust and confidence in the digital lending ecosystem. In summary, financial institutions must prioritize data privacy and security by implementing robust policies, procedures, and technical controls. Clear policy guidelines and disclosure practices are essential tools for ensuring data protection, building customer trust and maintaining regulatory compliance within the digital lending ecosystem.

## PROVISIONS OF THE INFORMATION TECHNOLOGY ACT, 2000 & DIGITAL PERSONAL DATA PROTECTION (DPDP) ACT OF 2023

From a digital lending perspective, several key points related to cyber law, particularly the provisions of the Information Technology Act, 2000 and Digital Personal Data Protection (DPDP) Act of 2023 are crucial to understand. Following are some important provisions:

### **Information Technology Act, 2000 (IT Act)**

The Information Technology Act of 2000, amended in 2008, establishes liability for negligence in handling sensitive personal data under Section 43A. This provision mandates reasonable security practices and procedures for bodies corporate dealing with sensitive information, with penalties for wrongful loss or damage. Additionally, Section 72A prescribes penalties for unauthorized disclosure of personal data without consent. The IT Act, was landmark legislation aimed at providing legal recognition for electronic transactions and facilitating e-governance. However, its relevance to digital lending primarily lies in the provisions related to data protection and cybersecurity.

- **Data Protection:** The IT Act, laid the foundation for data protection in India. Section 43A imposes liability on corporates for negligence in implementing reasonable security practices leading to data breaches, with provisions for compensation to affected individuals. This section is pertinent for digital lending platforms as they handle sensitive personal data, such as financial information.
- **Cybercrimes:** The IT Act, also addresses cybercrimes, including hacking, identity theft, and phishing, which pose significant risks to digital lending platforms and their customers. Sections 65 to 78 outline various offences and penalties for cybercrimes, ensuring a legal framework to combat online fraud and unauthorized access to financial data.
- **Subsequent Amendments:** The IT Act underwent amendments in 2008 to enhance its effectiveness in addressing emerging challenges in the digital space. These amendments primarily focused on strengthening cybersecurity measures and updating penalties for cybercrimes. However, the core principles related to data protection remained largely unchanged.

### **SOME OF THE IMPORTANT PROVISIONS OF IT ACT**

- **Section 43 (Penalty and compensation for damage to computer, computer system, etc.):** This section is relevant to digital lending platforms as it deals with unauthorized access, computer damage, and data theft. For digital lenders, ensuring the security and integrity of customer data is paramount to comply with this provision. Any unauthorized access or data breach can lead to legal liabilities and penalties.
- **Section 66 (Computer related offences):** Digital lending platforms must be aware of cybercrimes outlined in Section 66, such as hacking, identity theft, and cyber fraud. Implementing robust cybersecurity measures and fraud detection mechanisms is essential to mitigate the risk of such cybercrimes.
- **Section 69 (Power to issue directions for interception or monitoring or decryption of any information through any computer resource):** This provision grants authority to the Government to intercept, monitor and decrypt information for national security purposes. While this is primarily related to national security concerns, digital lending platforms must ensure compliance with lawful interception requests and protect customer data from unauthorized access.
- **Section 70 (Protected system):** Section 70 emphasizes the importance of safeguarding essential services and national interests. Digital lending platforms may fall under the category of critical information infrastructure, especially considering the sensitive financial data they handle. Therefore, they must adopt robust security measures to protect against cyber threats.

## DIGITAL PERSONAL DATA PROTECTION (DPDP) ACT OF 2023:

Digital Personal Data Protection (DPDP) Act of 2023, represents a significant advancement in personal data protection, as compared to the limited provisions of the IT Act. Inspired by global frameworks like GDPR, the DPDP Act introduces comprehensive regulations applicable to digital lending platforms. It defines key entities such as Data Fiduciaries and Data Principals and sets forth exceptions for governmental bodies.

### Key Aspects of DPDP Act:

- **Applicability:** The Act extends beyond territorial boundaries, applicable to organizations processing personal data in connection with Indian individuals, regardless of location.
- **Bodies Formed:** Clear definitions are provided for entities involved in data processing, distinguishing roles such as Data Fiduciaries, Data Principals, and Data Processors. Exceptions: Limited exceptions are allowed in the interest of national security and public order.
- **Lawful Processing:** Consent is paramount for lawful processing, and Data Fiduciaries must identify legitimate grounds for data processing.
- **Data Subject Rights:** Data Principals are granted rights such as access, erasure, and objection, with corresponding obligations for Data Fiduciaries.

### Key Principles of Data Protection:

The DPDP Act, in its definition of personal data under Section 2(t), elucidates it as any data identifying an individual. This encompasses a broad spectrum of information ranging from basic identifiers like name and location to more intricate facets such as economic, cultural, and physical attributes.

The DPDP Act espouses key principles integral to data protection, echoing global standards. These principles encompass:

- **Data Minimization:** Advocating for minimal data collection, the Act emphasizes gathering only requisite information, enhancing trust between data collectors and individuals.
- **Valid Consent:** Central to data collection, consent must be explicit, informed, and freely given, underscoring transparency and user autonomy.
- **Lawful Data Collection:** Data collection must align with legal and ethical standards, fostering fair practices and preventing discrimination.
- **Accuracy:** Ensuring the accuracy and reliability of data is paramount, requiring data controllers to maintain up-to-date and verifiable information.
- **Limitations on Data Storage:** Data should only be retained for necessary durations, safeguarding against unauthorized access and misuse.
- **Confidentiality:** Upholding confidentiality, data must be stored and transferred securely, mitigating risks of breaches and unauthorized access.
- **Accountability:** Imposing obligations on data fiduciaries, accountability ensures the establishment of robust governance frameworks and grievance redressal mechanisms.

**Rights of Data Principals:** Empowering individuals, the DPDP Act enshrines various rights for data principals, including:

- **Right to Information:** Individuals have the right to be informed about data collection, processing, and storage, enhancing transparency and user control.
- **Right to Access:** Data principals can access their personal data and obtain copies, ensuring accuracy and accountability.



- **Right to Rectify Information:** Individuals have the right to correct inaccurate or outdated data, enhancing data accuracy and reliability.
- **Right to Be Forgotten:** Individuals can request deletion of personal data no longer necessary for processing, aligning with the principle of data minimization.
- **Right to Data Portability:** Individuals can request their data in a portable format for transfer, promoting user control and interoperability.
- **Right to Object to Data Processing:** Individuals can object to data processing under legitimate grounds, bolstering user autonomy and control over personal data.
- **Data Protection Impact Assessment (DPIA):** Organizations must conduct DPIAs for activities posing high privacy risks, fostering proactive risk mitigation.
- **Right to Lodge Complaint:** Individuals can lodge complaints with the Data Protection Board, ensuring recourse for data breaches and non-compliance.

**Obligations and Responsibilities of Data Fiduciary:** Data fiduciaries play a pivotal role in ensuring compliance with data protection standards. Their obligations include:

- **Engagement of Data Processors:** Data fiduciaries may engage data processors for processing personal data, ensuring adherence to legal provisions.
- **Ensuring Data Accuracy:** Fiduciaries must ensure data completeness, accuracy, and consistency, upholding data quality and reliability.
- **Adopting Technical Measures:** Implementing technical and organizational measures, fiduciaries safeguard personal data against breaches and unauthorized access.
- **Data Breach Notification:** Fiduciaries must notify the Board and data principals of any data breaches, ensuring timely remedial measures and accountability.
- **Data Retention:** Data fiduciaries must delete data upon withdrawal of consent or fulfillment of processing purposes, adhering to data minimization principles.
- **Appointment of Data Protection Officer:** Significant data fiduciaries must appoint data protection officers and undertake periodic audits, ensuring compliance and accountability.

**Grounds for Data Collection:** The DPDP Act provides two primary grounds for lawful data processing: consent and legitimate use. Consent must be explicit, informed, and for specified purposes, ensuring user autonomy. Legitimate use encompasses various scenarios, including legal obligations, state functions, and emergency situations, ensuring a balance between privacy rights and public interest.

In the digital lending landscape, adherence to data protection laws, especially the DPDP Act of 2023, is essential to safeguard personal data and uphold individuals' rights. Understanding the legal framework and compliance requirements is essential for digital lenders to operate securely within the regulatory environment. Furthermore, landmark cases under the IT Act, such as *Shreya Singhal v. Union of India* and *Google v. Visaka Industries*, offer valuable precedents for interpreting legal liabilities and responsibilities, particularly regarding content moderation and intermediary liability. Digital lending platforms can draw lessons from these cases to navigate legal challenges effectively and ensure compliance with cyber laws.

**In addition to the RBI Regulations, IT Act, 2000, and DPDP Act 2023, there are several other relevant enactments, schemes, and compliance guidelines that digital lending platforms need to adhere to in India. Some of the other related enactments are:**

- **Consumer Protection Act, 2019:** This Act provides guidelines for protecting consumers' interests against unfair trade practices, including those in the digital lending sector. It ensures fair practices in contracts, transactions, and services offered to consumers.

- **Credit Information Companies (Regulation) Act, 2005:** This Act regulates credit information companies (CICs) that collect and maintain credit information of individuals and businesses. Digital lending platforms often rely on data from CICs to assess borrowers' creditworthiness.
- **Information Technology (Reasonable Security Practices and Procedures and Sensitive Personal Data or Information) Rules, 2011:** These rules under the IT Act, 2000, provide guidelines for the collection, storage, and transfer of sensitive personal data or information by body corporates. Although the DPDP Act, 2023, supersedes these rules, they still provide important benchmarks for data protection practices.
- **Foreign Exchange Management Act (FEMA), 1999:** FEMA regulates foreign exchange transactions in India. Digital lending platforms engaging in cross-border transactions or receiving foreign investments need to comply with FEMA regulations.
- **Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002:** This Act allows financial institutions to enforce security interests in assets to recover non-performing assets. Digital lending platforms dealing with asset-backed lending need to be aware of SARFAESI provisions.
- **Income Tax Act, 1961:** Digital lending platforms are subject to taxation laws governing their income, profits, and transactions. Compliance with tax regulations is crucial to avoid legal penalties and ensure transparency in financial operations.
- **Pradhan Mantri Mudra Yojana (PMMY):** PMMY is a Government scheme aimed at providing financial support to micro-enterprises through various financial institutions, including digital lending platforms. Compliance with PMMY guidelines may be required for platforms facilitating microloans.
- **Fair Practices Code (FPC):** RBI mandates that all non-banking financial companies (NBFCs), including digital lending platforms, follow the Fair Practices Code in their operations. FPC outlines ethical and transparent practices in lending, including disclosure of terms and conditions, fair treatment of customers, and grievance redressal mechanisms.
- **Prevention of Money Laundering Act (PMLA), 2002:** PMLA aims to prevent money laundering and the financing of terrorism. Digital lending platforms are required to implement robust customer due diligence (CDD) measures, maintain transaction records and report suspicious transactions to authorities as per PMLA provisions.
- **National Automated Clearing House (NACH):** NACH is a centralized payment system introduced by the NPCI for facilitating interbank, high-volume, electronic transactions that are repetitive and periodic in nature. Digital lending platforms often utilize NACH for loan repayments and disbursements, necessitating compliance with NACH guidelines.

## WAY AHEAD

The future outlook for digital lending in India is promising, driven by various factors including technological advancements, regulatory developments and evolving consumer preferences. Here are some insights into the potential opportunities and challenges for the growth of the digital lending ecosystem:

### OPPORTUNITIES:

- **Technological Advancements:** Continued advancements in technology, such as artificial intelligence (AI), machine learning (ML), and blockchain, are expected to streamline digital lending processes further. These technologies can improve credit assessment, risk management, and customer experience, leading to more efficient and accurate lending decisions.
- **Financial Inclusion:** Digital lending has the potential to bridge the gap between traditional banking services and underserved populations, including those in rural and remote areas. By leveraging mobile technology and alternative data sources, digital lenders can reach previously excluded segments of the population and provide access to credit.
- **Customized Lending Solutions:** Digital lending platforms can leverage data analytics to offer personalized loan products tailored to individual borrower needs. This customization can enhance customer satisfaction and loyalty while mitigating risks for lenders by better aligning loan terms with borrower repayment capabilities.
- **Regulatory Support:** Regulatory bodies like the Reserve Bank of India are actively working to create a conducive environment for digital lending while ensuring consumer protection and financial stability. Clear guidelines and regulations provide certainty for lenders and foster trust among borrowers, encouraging further innovation and investment in the sector.
- **Partnerships and Collaborations:** Digital lenders can explore partnerships with fintech startups, traditional financial institutions, and e-commerce platforms to expand their reach and offer complementary services. Collaborations can lead to innovative loan products, improved distribution channels, and enhanced customer acquisition strategies.

### CHALLENGES

- **Data Privacy and Security:** With the increasing digitization of financial transactions, ensuring the privacy and security of customer data becomes paramount. Digital lenders must invest in robust cybersecurity measures and comply with stringent data protection regulations to safeguard sensitive information from unauthorized access or breaches.
- **Credit Risk Management:** While alternative data sources and advanced analytics can enhance credit assessment processes, they also present challenges in managing credit risk effectively. Digital lenders must strike a balance between leveraging innovative data sources and maintaining prudent underwriting standards to avoid excessive risk exposure.
- **Digital Literacy and Awareness:** Despite the growing adoption of digital financial services, a significant portion of the population remains underbanked or unbanked, often due to lack of awareness or digital literacy. Digital lenders need to invest in educational initiatives to empower consumers with the knowledge and skills required to access and use digital lending products responsibly.
- **Regulatory Compliance Burden:** While regulatory frameworks aim to promote responsible lending practices and protect consumer interests, compliance requirements can impose significant operational burdens and costs on digital lenders, particularly smaller players. Striking the right balance between regulatory compliance and business growth remains a challenge for the industry.
- **Market Saturation and Competition:** As the digital lending market matures, competition among players intensifies, leading to potential margin pressures and commoditization of loan products. To differentiate themselves, digital

lenders must focus on innovation, customer-centricity and operational efficiency to maintain a competitive edge in the crowded marketplace.

Overall, while digital lending in India presents significant opportunities for growth and financial inclusion, addressing key challenges related to data privacy, credit risk management, regulatory compliance, and market competition will be essential for sustainable success in the long term. By navigating these challenges effectively, digital lenders can unlock the full potential of the digital lending ecosystem and contribute to India's economic development.

## STEPS FOR FINTECHS AND LENDING INSTITUTIONS

- **Comprehensive Compliance Review:** Conduct a thorough review of existing policies and procedures to ensure alignment with the updated RBI Guidelines on digital lending and FLDG arrangements.
- **Enhanced Transparency Measures:** Implement transparent disclosure practices regarding loan terms, conditions and FLDG arrangements, adhering to RBI standards.
- **Technology Infrastructure Upgrade:** Invest in robust technology infrastructure to support compliance with cybersecurity and data privacy regulations outlined in the guidelines.
- **Staff Training:** Provide regular training sessions to staff and lending partners to ensure understanding and compliance with updated policies and regulations.
- **Strengthened Customer Communication:** Enhance customer communication channels to facilitate transparent and timely communication regarding loan terms, grievances, and redressal mechanisms.
- **Adoption of DLG Guidelines:** Ensure adherence to the DLG guidelines, including the assessment of LSPs' financial strength, compliance with caps and utilization of guarantees.
- **Take steps to comply with the requirements of RBI circular of 15<sup>th</sup> April 2024,** on Key Facts Statement (KFS) for Loans & Advances to enhance transparency and reduce information asymmetry in financial products offered by regulated entities, empowering borrowers to make informed decisions.
- **Regular Monitoring and Reporting:** Establish mechanisms for ongoing monitoring, reporting and internal audits to ensure continued compliance with regulatory requirements.
- **Collaboration with Regulators:** Foster collaborative relationships with regulators and industry stakeholders to address any emerging challenges and contribute to the development of a conducive regulatory environment.

By adopting these steps, fintech and lending institutions can navigate the evolving regulatory landscape, enhance transparency and compliance and uphold consumer protection standards in the digital lending ecosystem.

## CONCLUSION

The RBI has thus, established comprehensive guidelines on digital lending, effective from 2nd September 2022. In addition to the existing guidelines, the RBI has set forth additional regulations regarding digital lending guarantees (DLG) effective from 2nd September 2022. DLG providers, designated as LSPs, must demonstrate financial strength to meet guaranteed commitments, as supported by auditor certification and also ensure compliance of the requirements relating to Key Facts Statement (KFS) for Loans & Advances.

Fintech and Lending Institutions need to conduct a thorough review of their policies and procedures to ensure alignment with the updated RBI Guidelines on digital lending and FLDG arrangements. Implement transparent disclosure practices regarding loan terms, conditions, and FLDG arrangements, adhering to RBI standards. They also need to invest in robust technology infrastructure to support compliance with cybersecurity and data privacy regulations outlined in the guidelines. Establish mechanisms for ongoing monitoring, reporting, and internal audits to ensure continued compliance with regulatory requirements. By formulating and implementing these steps, players in the lending industry can comply with the RBI guidelines on Key Facts Statement (KFS) and empower borrowers to make informed financial decisions.



## ANNEXURES

### EXCERPTS FROM RBI GUIDELINES

#### **Fair Practices Code for applicable NBFC Applicable NBFCs having customer interface**

- Applications for loans and their processing
  - All communications to the borrower shall be in the vernacular language or a language as understood by the borrower.
  - Loan application forms shall include necessary information which affects the interest of the borrower, so that a meaningful comparison with the terms and conditions offered by other NBFCs can be made and informed decision can be taken by the borrower. The loan application form shall indicate the documents required to be submitted with the application form.
  - Applicable NBFCs shall devise a system of giving acknowledgement for receipt of all loan applications. Preferably, the time frame within which loan applications will be disposed of shall also be indicated in the acknowledgement.
- Loan appraisal and terms/conditions
  - NBFCs shall convey in writing to the borrower in the vernacular language as understood by the borrower by means of sanction letter or otherwise, the amount of loan sanctioned along with the terms and conditions including annualised rate of interest and method of application thereof and keep the acceptance of these terms and conditions by the borrower on its record.
  - NBFCs shall mention the penal interest charged for late repayment in bold in the loan agreement.
  - NBFCs, shall furnish a copy of the loan agreement as understood by the borrower along with a copy each of all enclosures quoted in the loan agreement to all the borrowers at the time of sanction / disbursement of loans.
- Disbursement of loans including changes in terms and conditions
  - NBFCs shall give notice to the borrower in the vernacular language or a language as understood by the borrower of any change in the terms and conditions including disbursement schedule, interest rates, service charges, prepayment charges etc.
  - NBFCs shall also ensure that changes in interest rates and charges are affected only prospectively. A suitable condition in this regard must be incorporated in the loan agreement.
- Decision to recall/ accelerate payment or performance under the agreement shall be in consonance with the loan agreement.
  - NBFCs shall release all securities on repayment of all dues or on realisation of the outstanding amount of loan subject to any legitimate right or lien for any other claim they may have against borrower.
  - If such right of set off is to be exercised, the borrower shall be given notice about the same with full particulars about the remaining claims and the conditions under which applicable NBFCs are entitled to retain the securities till the relevant claim is settled/ paid.
- General Guidelines:

- NBFCs shall refrain from interference in the affairs of the borrower except for the purposes provided in the terms and conditions of the loan agreement (unless information, not earlier disclosed by the borrower, has been noticed).
- In case of receipt of request from the borrower for transfer of borrowal account, the consent or otherwise i.e., objection of the applicable NBFC, if any, shall be conveyed within 21 days from the date of receipt of request. Such transfer shall be as per transparent contractual terms in consonance with law.
- In the matter of recovery of loans, an applicable NBFC shall not resort to undue harassment viz., persistently bothering the borrowers at odd hours, use muscle power for recovery of loans etc.
  - NBFC shall ensure that the staff are adequately trained to deal with the customers in an appropriate manner.
  - As a measure of customer protection and also in order to bring in uniformity with regard to prepayment of various loans by borrowers of banks and NBFCs, applicable NBFCs shall not charge foreclosure charges/ prepayment penalties on any floating rate term loan sanctioned for purposes other than business to individual borrowers, with or without co-obligant(s).
- Repossession of vehicles financed by applicable NBFCs
  - NBFCs must have a built-in re-possession clause in the contract/loan agreement with the borrower which must be legally enforceable.
  - To ensure transparency, the terms and conditions of the contract/loan agreement shall also contain provisions regarding:
    - notice period before taking possession;
    - circumstances under which the notice period can be waived;
    - the procedure for taking possession of the security;
    - a provision regarding final chance to be given to the borrower for repayment of loan before the sale / auction of the property;
    - the procedure for giving repossession to the borrower; and
    - the procedure for sale / auction of the property.
  - A copy of such terms and conditions must be made available to the borrower.
  - Applicable NBFCs shall invariably furnish a copy of the loan agreement along with a copy each of all enclosures quoted in the loan agreement to all the borrowers at the time of sanction/ disbursement of loans, which forms a key component of such contracts/ loan agreements.
- Language and mode of communicating Fair Practice Code Fair Practices Code (which shall preferably be in the vernacular language or a language as understood by the borrower) based on the guidelines outlined hereinabove shall be put in place by all applicable NBFCs having customer interface with the approval of their Boards.
- NBFCs have the freedom of drafting the Fair Practices Code, enhancing the scope of the guidelines but in no way sacrificing the spirit underlying the above guidelines. The same shall be put up on their website, if any, for the information of various stakeholders.
- Interest Rate Model
  - The Board of each applicable NBFC shall adopt an interest rate model taking into account relevant factors such as cost of funds, margin and risk premium and determine the rate of interest to be charged for loans and advances.

- The rate of interest and the approach for gradations of risk and rationale for charging different rate of interest to different categories of borrowers shall be disclosed to the borrower or customer in the application form and communicated explicitly in the sanction letter.
- The rates of interest and the approach for gradation of risks shall also be made available on the website of the companies or published in the relevant newspapers.
- The information published in the website or otherwise published shall be updated whenever there is a change in the rates of interest.
- The rate of interest must be annualised rate so that the borrower is aware of the exact rates that would be charged to the account.

### Responsibility of Board of Directors

- NBFCs shall also lay down the appropriate grievance redressal mechanism within the organization.
- Such a mechanism shall ensure that all disputes arising out of the decisions of lending institutions' functionaries are heard and disposed of at least at the next higher level.
- The Board of Directors shall also provide for periodical review of the compliance of the Fair Practices Code and the functioning of the grievances redressal mechanism at various levels of management.
- A consolidated report of such reviews shall be submitted to the Board at regular intervals, as may be prescribed by it.
- The Board of the NBFC, or a Committee of the Board to which powers have been delegated shall be responsible inter alia for the following:
  - Approving a framework to evaluate the risks and materiality of all existing and prospective outsourcing and the policies that apply to such arrangements;
  - Laying down appropriate approval authorities for outsourcing depending on risks and materiality;
  - Setting up suitable administrative framework of senior management for the purpose of these directions;
  - Undertaking regular review of outsourcing strategies and arrangements for their continued relevance, and safety and soundness and
  - Deciding on business activities of a material nature to be outsourced, and approving such arrangements.
  - The NBFC shall have in place a **management structure to monitor and control its outsourcing activities**. It shall ensure that outsourcing agreements with the service provider contain provisions to address their monitoring and control of outsourced activities.

### Grievance Redressal Officer

- At the operational level, all applicable NBFCs shall display the following information prominently, for the benefit of their customers, at their branches/ places where business is transacted:
  - the name and contact details (Telephone / Mobile nos. as also email address) of the Grievance Redressal Officer who can be approached by the public for resolution of complaints against the Company.
  - If the complaint / dispute is not redressed within a period of one month, the customer may appeal to the Officer-in-Charge of the Regional Office of Department of Supervision of the Bank (with complete contact details), under whose jurisdiction the registered office of the applicable NBFC falls.

- Reserve Bank – Integrated Ombudsman Scheme, 2021 NBFCs covered under the Reserve Bank – Integrated Ombudsman Scheme, 2021 shall appoint Principal Nodal Officer in accordance with directions provided under the said Scheme.

#### **Guidelines on Digital Lending**

- NBFCs shall also comply with the instructions contained in circular on ‘Guidelines on Digital Lending’ dated September 02, 2022, as amended from time to time.
- Loans Sourced by NBFCs over Digital Lending Platforms:
  - Adherence to Fair Practices Code and Outsourcing Guidelines
  - NBFCs, irrespective of whether they lend through their own digital lending platform or through an outsourced lending platform, must adhere to the Fair Practices Code guidelines in letter and spirit.
  - They must also meticulously follow regulatory instructions on outsourcing of financial services and IT services.
  - Outsourcing of any activity by NBFCs does not diminish their obligations, as the onus of compliance with regulatory instructions rests solely with them.
  - Wherever NBFCs engage digital lending platforms as their agents to source borrowers and/ or to recover dues, they must follow the following instructions: (a) Names of digital lending platforms engaged as agents shall be disclosed on the website of NBFCs
- Digital lending platforms engaged as agents shall be directed to disclose upfront to the customer, the name of the NBFC on whose behalf they are interacting with him.
- Immediately after sanction but before execution of the loan agreement, the sanction letter shall be issued to the borrower on the letter head of the NBFC concerned.
- A copy of the loan agreement along with a copy each of all enclosures quoted in the loan agreement shall be furnished to all borrowers at the time of sanction/ disbursement of loans.
- Effective oversight and monitoring shall be ensured over the digital lending platforms engaged by the NBFCs.
- Adequate efforts shall be made towards creation of awareness about the grievance redressal mechanism.

#### **Technical Specifications for all participants of the Account Aggregator ecosystem**

- The NBFC-Account Aggregator (AA) consolidates financial information, of a customer held with different financial entities, spread across financial sector regulators adopting different IT systems and interfaces.
- Reserve Bank Information Technology Private Limited (ReBIT), has framed specifications and published the same on its website ([www.rebit.org.in](http://www.rebit.org.in)).
- NBFCs acting either as Financial Information Providers (FIP) or Financial Information Users (FIU) are expected to adopt the technical specifications published by ReBIT, as updated from time to time.
- Clear policy guidelines regarding the storage of customer data including the type of data that can be held, the length of time data can be held, restrictions on the use of data, data destruction protocol, standards for handling security breach, etc., shall also be disclosed by DLAs prominently on their website and app at all times.

No biometric data should be stored/ collected in the systems associated with the DLA of REs/ their LSPs, unless allowed under extant statutory guidelines.

## EXCERPTS FROM THE RBI HARMONISED INSTRUCTIONS ON KEY FACTS STATEMENT (KFS) FOR LOANS & ADVANCES- CIRCULAR OF APRIL 15, 2024

**Reference:** Key Facts Statement (KFS) and disclosure of Annual Percentage Rate (APR) as contained in paragraph 2 of Circular on 'Display of information by banks' dated January 22, 2015; paragraph 6 of Master Direction on 'Regulatory Framework for Microfinance Loans' dated March 14, 2022; and paragraph 5 of 'Guidelines on Digital Lending' dated September 2, 2022.

- The harmonised instructions shall be applicable in cases of all retail and MSME term loan products extended by all regulated entities (REs).
- For the purpose of this circular, following terms have been defined:
  - Key Facts of a loan agreement between an RE/a group of REs and a borrower are legally significant and deterministic facts that satisfy basic information required to assist the borrower in taking an informed financial decision.
  - Key Facts Statement (KFS) is a statement of key facts of a loan agreement, in simple and easier to understand language, provided to the borrower in a standardised format.
  - Annual Percentage Rate (APR) is the annual cost of credit to the borrower which includes interest rate and all other charges associated with the credit facility.
  - Equated Periodic Instalment (EPI) is an equated or fixed amount of repayments, consisting of both the principal and interest components, to be paid by a borrower towards repayment of a loan at periodic intervals for a fixed number of such intervals; and which result in complete amortisation of the loan. EPIs at monthly intervals are called EMIs.
  - Other words and expressions not defined above, but used in this circular, shall have the same meaning as assigned to them under the Master Direction on Interest Rate on Advances (2016) as updated from time to time or any other relevant regulation issued by the Reserve Bank.
- REs shall provide a KFS to all prospective borrowers to help them take an informed view before executing the loan contract, as per the standardised format given in the Annex A. The KFS shall be written in a language understood by such borrowers. Contents of KFS shall be explained to the borrower and an acknowledgement shall be obtained that he/she has understood the same.
- KFS shall be provided with a unique proposal number and shall have a validity period of at least three working days for loans having tenor of seven days or more, and a validity period of one working day for loans having tenor of less than seven days.
- Explanation: Validity period refers to the period available to the borrower, after being provided the KFS by the RE, to agree to the terms of the loan. The RE shall be bound by the terms of the loan indicated in the KFS, if agreed to by the borrower during the validity period.
- The KFS shall also include a computation sheet of annual percentage rate (APR), and the amortisation schedule of the loan over the loan tenor. APR will include all charges which are levied by the RE. Illustrative examples of calculation of APR and disclosure of repayment schedule for a hypothetical loan are given in Annex B and C respectively.
- Charges recovered from the borrowers by the REs on behalf of third-party service providers on actual basis, such as insurance charges, legal charges etc., shall also form part of the APR and shall be disclosed separately. In all cases

wherever the RE is involved in recovering such charges, the receipts and related documents shall be provided to the borrower for each payment, within a reasonable time.

- Any fees, charges, etc. which are not mentioned in the KFS, cannot be charged by the REs to the borrower at any stage during the term of the loan, without explicit consent of the borrower.
- The KFS shall also be included as a summary box to be exhibited as part of the loan agreement.
- Exemptions: Credit card receivables are exempted from the provisions contained under this circular.
- Applicability and Commencement: REs shall put in place the necessary systems and processes to implement the above guidelines at the earliest. In any case, all new retail and MSME term loans sanctioned on or after October 1, 2024, including fresh loans to existing customers, shall comply with the above guidelines in letter and spirit without any exception. During the interregnum, the relevant provisions on 'KFS/Factsheet' under the extant guidelines shall continue to remain applicable, including the 'Guidelines on Digital Lending', the Master Direction on 'Regulatory Framework for Microfinance Loans', and the circular on 'Display of Information by Banks'.



## EXCERPTS FROM THE RBI DIRECTIONS ON MANAGING RISKS AND CODE OF CONDUCT IN OUTSOURCING OF FINANCIAL SERVICES

- Typically outsourced financial services include applications processing (loan origination, credit card), document processing, marketing and research, supervision of loans, data processing and back office related activities, besides others.
- Some key risks in outsourcing are Strategic Risk, Reputation Risk, Compliance Risk, Operational Risk, Legal Risk, Exit Strategy Risk, Counterparty Risk, Country Risk, Contractual Risk, Access Risk, Concentration and Systemic Risk.
- The failure of a service provider in providing a specified service, a breach in security/ confidentiality, or non-compliance with legal and regulatory requirements by the service provider can lead to financial losses or loss of reputation for the NBFC and could also lead to systemic risks.
- The service provider may either be a member of the group/ conglomerate to which the NBFC belongs, or an unrelated party.
- **The underlying principles behind the RBI directions are that the regulated entity shall ensure that outsourcing arrangements neither diminish its ability to fulfil its obligations to customers and RBI nor impede effective supervision by RBI.**
- NBFCs, therefore, have to take steps to ensure that the service provider employs the same high standard of care in performing the services as is expected to be employed by the NBFCs, if the activities were conducted within the NBFCs and not outsourced.
- **Accordingly, NBFCs shall not engage in outsourcing that would result in their internal control, business conduct or reputation being compromised or weakened.**
- NBFCs which desire to outsource financial services would not require prior approval from RBI. However, such arrangements would be subject to on-site/ off- site monitoring and inspection/ scrutiny by RBI.
- In regard to outsourced services relating to credit cards, RBI's detailed instructions contained in its circular on credit card activities vide DBOD.FSD.BC.49/24.01.011/2005-06 dated November 21, 2005 would be applicable.
- **Activities that shall not be outsourced NBFCs** which choose to outsource financial services shall, however, **not outsource core management functions including Internal Audit, Strategic and Compliance functions and decision-making functions such as determining compliance with KYC norms for opening deposit accounts, according sanction for loans (including retail loans) and management of investment portfolio.**
- However, for NBFCs in a group/ conglomerate, these functions may be outsourced within the group subject to compliance with instructions.
- Further, while internal audit function itself is a management process, the internal auditors can be on contract.
- **Material Outsourcing**
  - Material outsourcing arrangements are those which, if disrupted, have the potential to significantly impact the business operations, reputation, profitability or customer service.
  - Materiality of outsourcing would be based on:

- the level of importance to the NBFC of the activity being outsourced as well as the significance of the risk posed by the same;
  - the potential impact of the outsourcing on the NBFC on various parameters such as earnings, solvency, liquidity, funding capital and risk profile;
  - the likely impact on the NBFC's reputation and brand value, and ability to achieve its business objectives, strategy and plans, should the service provider fail to perform the service;
  - the cost of the outsourcing as a proportion of total operating costs of the NBFC;
  - the aggregate exposure to that particular service provider, in cases where the NBFC outsources various functions to the same service provider and
  - the significance of activities outsourced in context of customer service and protection.
- **NBFC's role and Regulatory and Supervisory Requirements**
    - The outsourcing of any activity by NBFC does not diminish its obligations, and those of its Board and senior management, who have the ultimate responsibility for the outsourced activity.
    - NBFCs would therefore be responsible for the actions of their service provider including Direct Sales Agents/ Direct Marketing Agents and recovery agents and the confidentiality of information pertaining to the customers that is available with the service provider. NBFCs shall retain ultimate control of the outsourced activity.
    - It is imperative for the NBFC, when performing its due diligence in relation to outsourcing, to consider all relevant laws, regulations, guidelines and conditions of approval, licensing or registration.
    - Outsourcing arrangements shall not affect the rights of a customer against the NBFC, including the ability of the customer to obtain redress as applicable under relevant laws.
    - In cases where the customers are required to deal with the service providers in the process of dealing with the NBFC, **NBFCs shall incorporate a clause in the relative product literature/ brochures, etc., stating that they may use the services of agents in sales/ marketing etc. of the products. The role of agents may be indicated in broad terms.**
    - The service provider shall not impede or interfere with the ability of the NBFC to effectively oversee and manage its activities nor shall it impede the Reserve Bank of India in carrying out its supervisory functions and objectives.
    - **NBFCs need to have a robust grievance redress mechanism**, which in no way shall be compromised on account of outsourcing.
    - The service provider, if not a group company of the NBFC, shall not be owned or controlled by any director of the NBFC or their relatives; these terms have the same meaning as assigned under Companies Act, 2013.
  - **Risk Management practices for Outsourced Financial Services**
    - NBFC intending to outsource any of its financial activities shall put in place a comprehensive outsourcing policy, approved by its Board, which incorporates, inter alia, criteria for selection of such activities as well as service providers, delegation of authority depending on risks and materiality and systems to monitor and review the operations of these activities.
  - **Role of the Board and Senior Management**
    - The Board of the NBFC, or a Committee of the Board to which powers have been delegated shall be responsible inter alia for the following:

- Approving a framework to evaluate the risks and materiality of all existing and prospective outsourcing and the policies that apply to such arrangements;
  - Laying down appropriate approval authorities for outsourcing depending on risks and materiality;
  - Setting up suitable administrative framework of senior management for the purpose of these directions;
  - Undertaking regular review of outsourcing strategies and arrangements for their continued relevance, and safety and soundness and
  - Deciding on business activities of a material nature to be outsourced, and approving such arrangements.
- **Responsibilities of the Senior Management**
    - Evaluating the risks and materiality of all existing and prospective outsourcing, based on the framework approved by the Board;
    - developing and implementing sound and prudent outsourcing policies and procedures commensurate with the nature, scope and complexity of the outsourcing activity;
    - reviewing periodically the effectiveness of policies and procedures;
    - communicating information pertaining to material outsourcing risks to the Board in a timely manner;
    - ensuring that contingency plans, based on realistic and probable disruptive scenarios, are in place and tested;
    - ensuring that there is independent review and audit for compliance with set policies and
    - undertaking periodic review of outsourcing arrangements to identify new material outsourcing risks as they arise
- **Evaluation of the Risks**
    - The NBFCs shall evaluate and guard against the following risks in outsourcing:
    - **Strategic Risk** – Where the service provider conducts business on its own behalf, inconsistent with the overall strategic goals of the NBFC.
    - **Reputation Risk** – Where the service provided is poor and customer interaction is not consistent with the overall standards expected of the NBFC.
    - **Compliance Risk** – Where privacy, consumer and prudential laws are not adequately complied with by the service provider.
    - **Operational Risk**- Arising out of technology failure, fraud, error, inadequate financial capacity to fulfil obligations and/ or to provide remedies.
    - **Legal Risk**– Where the NBFC is subjected to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements due to omissions and commissions of the service provider.
    - **Exit Strategy Risk**– Where the NBFC is over-reliant on one firm, the loss of relevant skills in the NBFC itself preventing it from bringing the activity back in-house and where NBFC has entered into contracts that make speedy exits prohibitively expensive.
    - **Counter party Risk**– Where there is inappropriate underwriting or credit assessments. viii. **Contractual Risk**– Where the NBFC may not have the ability to enforce the contract.
    - **Concentration and Systemic Risk**– Where the overall industry has considerable exposure to one service provider and hence the NBFC may lack control over the service provider.

- **Country Risk**– Due to the political, social or legal climate creating added risk.
- **Evaluating the Capability of the Service Provider**
  - In considering or renewing an outsourcing arrangement, appropriate due diligence shall be performed to assess the capability of the service provider to comply with obligations in the outsourcing agreement.
  - Due diligence shall take into consideration qualitative and quantitative, financial, operational and reputational factors.
  - NBFCs shall consider whether the service providers' systems are compatible with their own and also whether their standards of performance including in the area of customer service are acceptable to it.
  - NBFCs shall also consider, while evaluating the capability of the service provider, issues relating to undue concentration of outsourcing arrangements with a single service provider.
  - Where possible, the NBFC shall obtain independent reviews and market feedback on the service provider to supplement its own findings.
  - Due diligence shall involve an evaluation of all available information about the service provider, including but not limited to the following:
    - Past experience and competence to implement and support the proposed activity over the contracted period;
    - Financial soundness and ability to service commitments even under adverse conditions;
    - Business reputation and culture, compliance, complaints and outstanding or potential litigation;
    - Security and internal control, audit coverage, reporting and monitoring environment, business continuity management and v. ensuring due diligence by service provider of its employees.
- **The Outsourcing Agreement**
  - The terms and conditions governing the contract between the NBFC and the service provider shall be carefully defined in written agreements and vetted by NBFC's legal counsel on their legal effect and enforceability.
  - Every such agreement shall address the risks and risk mitigation strategies.
  - The agreement shall be sufficiently flexible to allow the NBFC to retain an appropriate level of control over the outsourcing and the right to intervene with appropriate measures to meet legal and regulatory obligations.
  - The agreement shall also bring out the nature of legal relationship between the parties - i.e. whether agent, principal or otherwise.
  - Some of the key provisions of the contract shall be the following:
    - The contract shall clearly define what activities are going to be outsourced including appropriate service and performance standards;
    - The NBFC must ensure it has the ability to access all books, records and information relevant to the outsourced activity available with the service provider;
    - The contract shall provide for continuous monitoring and assessment by the NBFC of the service provider so that any necessary corrective measure can be taken immediately;
    - A termination clause and minimum period to execute a termination provision, if deemed necessary, shall be included;

- Controls to ensure customer data confidentiality and service providers' liability in case of breach of security and leakage of confidential customer related information shall be incorporated;
- There must be contingency plans to ensure business continuity; vii. the contract shall provide for the prior approval/ consent by the NBFC of the use of subcontractors by the service provider for all or part of an outsourced activity;
- It shall provide the NBFC with the right to conduct audits on the service provider whether by its internal or external auditors, or by agents appointed to act on its behalf and to obtain copies of any audit or review reports and findings made on the service provider in conjunction with the services performed for the NBFC;
- Outsourcing agreements shall include clauses to allow the Reserve Bank of India or persons authorised by it to access the NBFC's documents, records of transactions, and other necessary information given to, stored or processed by the service provider within a reasonable time;
- Outsourcing agreement shall also include a clause to recognise the right of the Reserve Bank to cause an inspection to be made of a service provider of an NBFC and its books and account by one or more of its officers or employees or other persons;
- The outsourcing agreement shall also provide that confidentiality of customer's information shall be maintained even after the contract expires or gets terminated and
- The NBFC shall have necessary provisions to ensure that the service provider preserves documents as required by law and take suitable steps to ensure that its interests are protected in this regard even post termination of the services

#### ■ Confidentiality and Security

- NBFC shall seek to ensure the preservation and protection of the security and confidentiality of customer information in the custody or possession of the service provider.
- Access to customer information by staff of the service provider shall be on 'need to know' basis i.e., limited to those areas where the information is required in order to perform the outsourced function.
- NBFC shall ensure that the service provider is able to isolate and clearly identify the NBFC's customer information, documents, records and assets to protect the confidentiality of the information. In instances, where service provider acts as an outsourcing agent for multiple NBFCs, care shall be taken to build strong safeguards so that there is no comingling of information / documents, records and assets.
- NBFC shall review and monitor the security practices and control processes of the service provider on a regular basis and require the service provider to disclose security breaches.
- NBFC shall immediately notify RBI in the event of any breach of security and leakage of confidential customer related information. In these eventualities, the NBFC would be liable to its customers for any damages.

#### ■ Responsibilities of Direct Sales Agents (DSA)/ Direct Marketing Agents (DMA)/ Recovery Agents

- NBFCs shall ensure that the DSA/ DMA/ Recovery Agents are properly trained to handle their responsibilities with care and sensitivity, particularly aspects such as soliciting customers, hours of calling, privacy of customer information and conveying the correct terms and conditions of the products on offer, etc.
- NBFCs shall put in place a board approved Code of conduct for DSA/ DMA/ Recovery Agents, and obtain their undertaking to abide by the code. In addition, Recovery Agents shall adhere to extant instructions on Fair Practices Code for NBFCs as also their own code for collection of dues and repossession of security.



- It is essential that the Recovery Agents refrain from action that could damage the integrity and reputation of the NBFC and that they observe strict customer confidentiality.
- NBFC and their agents shall not resort to intimidation or harassment of any kind, either verbal or physical, against any person in their debt collection efforts, including acts intended to humiliate publicly or intrude upon the privacy of the debtors' family members, referees and friends, sending inappropriate messages either on mobile or through social media, making threatening and/or anonymous calls, persistently calling the borrower and/ or calling the borrower before 8:00 a.m. and after 7:00 p.m. for recovery of overdue loans, making false and misleading representations, etc.
- **Business Continuity and Management of Disaster Recovery Plan**
  - NBFC shall require its service providers to develop and establish a robust framework for documenting, maintaining and testing business continuity and recovery procedures. NBFCs need to ensure that the service provider periodically tests the Business Continuity and Recovery Plan and may also consider occasional joint testing and recovery exercises with its service provider.
  - In order to mitigate the risk of unexpected termination of the outsourcing agreement or liquidation of the service provider, NBFCs shall retain an appropriate level of control over their outsourcing and the right to intervene with appropriate measures to continue its business operations in such cases without incurring prohibitive expenses and without any break in the operations of the NBFC and its services to the customers.
  - In establishing a viable contingency plan, NBFCs shall consider the availability of alternative service providers or the possibility of bringing the outsourced activity back in-house in an emergency and the costs, time and resources that would be involved.
  - Outsourcing often leads to the sharing of facilities operated by the service provider.
  - The NBFC shall ensure that service providers are able to isolate the NBFC's information, documents and records, and other assets. This is to ensure that in appropriate situations, all documents, records of transactions and information given to the service provider, and assets of the NBFC, can be removed from the possession of the service provider in order to continue its business operations, or deleted, destroyed or rendered unusable.
- **Monitoring and Control of Outsourced Activities**
  - The NBFC shall have in place a management structure to monitor and control its outsourcing activities. It shall ensure that outsourcing agreements with the service provider contain provisions to address their monitoring and control of outsourced activities.
  - A central record of all material outsourcing that is readily accessible for review by the Board and senior management of the NBFC shall be maintained. The records shall be updated promptly and half yearly reviews shall be placed before the Board or Risk Management Committee.
  - Regular audits by either the internal auditors or external auditors of the NBFC shall assess the adequacy of the risk management practices adopted in overseeing and managing the outsourcing arrangement, the NBFC's compliance with its risk management framework and the requirements of these directions.
  - NBFCs shall at least on an annual basis, review the financial and operational condition of the service provider to assess its ability to continue to meet its outsourcing obligations. Such due diligence reviews, which can be based on all available information about the service provider shall highlight any deterioration or breach in performance standards, confidentiality and security, and in business continuity preparedness.
  - In the event of termination of the outsourcing agreement for any reason in cases where the service provider deals with the customers, the same shall be publicized by displaying at a prominent place in the branch, posting



it on the website, and informing the customers so as to ensure that the customers do not continue to deal with the service provider.

- NBFCs shall ensure that reconciliation of transactions between the NBFC and the service provider (and/ or its sub-contractor), are carried out in a timely manner.
- An ageing analysis of entries pending reconciliation with outsourced vendors shall be placed before the Audit Committee of the Board (ACB) and NBFCs shall make efforts to reduce the old outstanding items therein at the earliest.
- A robust system of internal audit of all outsourced activities shall also be put in place and monitored by the ACB of the NBFC.

#### ■ **Redress of Grievances related to Outsourced Services**

- NBFCs shall constitute Grievance Redressal Machinery as contained in RBI's circular on Grievance Redressal Mechanism vide DNBS. CC. PD. No. 320/03. 10. 01/2012-13 dated February 18, 2013.
- At the operational level, all NBFCs shall display the name and contact details (Telephone/ Mobile nos. as also email address) of the Grievance Redressal Officer prominently at their branches/ places where business is transacted.
- The designated officer shall ensure that genuine grievances of customers are redressed promptly without involving delay.
- It shall be clearly indicated that NBFCs' Grievance Redressal Machinery will also deal with the issue relating to services provided by the outsourced agency.
- Generally, a time limit of 30 days may be given to the customers for preferring their complaints/ grievances.
- The grievance redressal procedure of the NBFC and the time frame fixed for responding to the complaints shall be placed on the NBFC's website.

#### ■ **Reporting of transactions to FIU or other competent authorities**

- NBFCs would be responsible for making Currency Transactions Reports and Suspicious Transactions Reports to FIU or any other competent authority in respect of the NBFCs' customer related activities carried out by the service providers.
- REs to ensure that any lending done through DLAs is reported to CICs irrespective of its nature/ tenor. ii) Extension of new digital lending products by REs over a merchant platform involving short term, unsecured/ secured credits or deferred payments need to be reported to credit bureaus by the REs. REs shall ensure that LSPs, if any, associated with such deferred payment credit products shall abide by the extant outsourcing guidelines issued by the RBI.

#### ■ **Outsourcing within a Group/ Conglomerate**

- In a group structure, NBFCs may have back-office and service arrangements/ agreements with group entities e.g. sharing of premises, legal and other professional services, hardware and software applications, centralize back-office functions, outsourcing certain financial services to other group entities, etc.
- Before entering into such arrangements with group entities, NBFCs shall have a Board approved policy and also service level agreements/ arrangements with their group entities, which shall also cover demarcation of sharing resources i.e. premises, personnel, etc.

- Moreover the customers shall be informed specifically about the company which is actually offering the product/ service, wherever there are multiple group entities involved or any cross selling observed.
- NBFCs shall ensure that these:
  - are appropriately documented in written agreements with details like scope of services, charges for the services and maintaining confidentiality of the customer's data;
  - do not lead to any confusion to the customers on whose products/ services they are availing by clear physical demarcation of the space where the activities of the NBFC and those of its other group entities are undertaken;
  - do not compromise the ability to identify and manage risk of the NBFC on a stand-alone basis;
  - do not prevent the RBI from being able to obtain information required for the supervision of the NBFC or pertaining to the group as a whole; and
  - incorporate a clause under the written agreements that there is a clear obligation for any service provider to comply with directions given by the RBI in relation to the activities of the NBFC.
  - REs may capture the economic profile of the borrowers (age, occupation, income etc) before extending any loans over DLAs, with a view to assess the borrower's creditworthiness in an auditable way.
- NBFCs shall ensure that their ability to carry out their operations in a sound fashion would not be affected if premises or other services (such as IT systems, support staff) provided by the group entities become unavailable.
- If the premises of the NBFC are shared with the group entities for the purpose of cross-selling, NBFCs shall take measures to ensure that the entity's identification is distinctly visible and clear to the customers.
- The marketing brochure used by the group entity and verbal communication by its staff/ agent in the NBFCs premises shall mention nature of arrangement of the entity with the NBFC so that the customers are clear on the seller of the product.
- NBFCs shall not publish any advertisement or enter into any agreement stating or suggesting or giving tacit impression that they are in any way responsible for the obligations of its group entities.
- The risk management practices expected to be adopted by an NBFC while outsourcing to a related party (i.e. party within the Group/ Conglomerate) would be identical.

#### ▪ **Off-shore outsourcing of Financial Services**

The engagement of service providers in a foreign country exposes an NBFC to country risk -economic, social and political conditions and events in a foreign country that may adversely affect the NBFC.

- Such conditions and events could prevent the service provider from carrying out the terms of its agreement with the NBFC.
- To manage the country risk involve in such outsourcing activities, the NBFC shall take into account and closely monitor government policies and political, social, economic and legal conditions in countries where the service provider is based, both during the risk assessment process and on a continuous basis, and establish sound procedures for dealing with country risk problems.
- This includes having appropriate contingency and exit strategies.
- In principle, arrangements shall only be entered into with parties operating in jurisdictions generally upholding confidentiality clauses and agreements.

- The governing law of the arrangement shall also be clearly specified.
- The activities outsourced outside India shall be conducted in a manner so as not to hinder efforts to supervise or reconstruct the India activities of the NBFC in a timely manner.
- As regards the off-shore outsourcing of financial services relating to Indian Operations, NBFCs shall additionally ensure that
  - Where the off-shore service provider is a regulated entity, the relevant off-shore regulator will neither obstruct the arrangement nor object to RBI inspection visits/ visits of NBFCs internal and external auditors.
  - The availability of records to management and the RBI will withstand the liquidation of either the offshore custodian or the NBFC in India.
  - The regulatory authority of the offshore location does not have access to the data relating to Indian operations of the NBFC simply on the ground that the processing is being undertaken there (not applicable if off shore processing is done in the home country of the NBFC).
  - **The jurisdiction of the courts in the off shore location where data is maintained does not extend to the operations of the NBFC in India on the strength of the fact that the data is being processed there even though the actual transactions are undertaken in India and**
  - All original records continue to be maintained in India.
- **Some of the matter still under Consideration but needs to be taken into consideration for devising lending facilities**
  - REs have been advised to ensure that financial products involving contractual agreement, in which a third party guarantees to compensate up to a certain percentage of default in a loan portfolio of the RE, shall adhere to the extant guidelines laid down in Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021 dated September 24, 2021. Boards of REs shall ensure that the extant regulatory instructions are complied with in both letter and spirit.
  - Regulatory framework for web-aggregator of loan products to be framed.
  - RBI to lay down baseline technology standards for DLAs which will include:
    - Secure application logic i.e. technical specifications of the DLA to ensure security of applications running on mobile phones, proper authentication, input validation, clear access rules, measures to ensure protection of sensitive data, etc.
    - Keeping auditable log of every action that user performs along with their IP address and device information
    - Monitoring of transactions being undertaken through DLA
    - Multi-step approval for critical activities undertaken on the DLA
  - DLAs should mandatorily reflect these standards in the terms of service.
  - Further it should be ensured that apps have specific technological safeguards to prevent frauds like sanction of loans on stolen identity, data breaches, etc
  - REs to ensure that the algorithm used for underwriting is based on extensive, accurate and diverse data to rule out any prejudices. Further algorithm should be auditable to point out minimum underwriting standards and potential discrimination factors used in determining credit availability and pricing. ii) Digital lenders should adopt ethical AI which focuses on protecting customer interest, promotes transparency, inclusion, impartiality, responsibility, reliability, security and privacy.

- REs to ensure measures related to data privacy and security at the end of SMS gateways/ SMS service providers before onboarding them.
- Legal & Institutional Framework
- A Self-Regulatory Organisation (“SRO”) covering REs and DLAs/LSPs in the digital lending ecosystem is proposed to be set up which will take up following:
  - framing a code of conduct for recovery
  - framing a model standardised LSP agreement for balance sheet lenders
  - to put in place a Code of Conduct for responsible advertising and marketing standards, to be adopted by all the DLAs.
  - frame institutional mechanism for training and accreditation of recovery agents in consultation with RBI.
  - maintaining ‘negative list’ of LSPs which are non-compliant with regulatory and statutory provisions, engaged in unfair practices including but not limited to use of false statements, harassment, unauthorized sharing of credit information, etc.
- REs are required to report LSPs engaged in unfair practices or in breach of regulatory norms to SRO for inclusion in negative list.
- DLAs are required to adopt responsible advertising and marketing standards and should refrain from making misleading claims.

We hope you have found this information useful. For any queries/clarifications please write to us at [insights@elp-in.com](mailto:insights@elp-in.com) or write to our authors:

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