

RBI DIRECTIONS ON PEER TO PEER LENDING PLATFORMS

1. INTRODUCTION

The Reserve Bank of India (the “RBI”), by way of a notification dated August 24, 2017¹, notified that a non-banking institution that carries on ‘the business of a peer to peer lending platform’ shall be a non-banking financial company (the “**Notification**”). The RBI has issued the Notification pursuant to Section 45-I(f)(iii) of the Reserve Bank of India Act, 1934 (the “**RBI Act**”), which confers power on the RBI to include any non-banking institution or class of such institutions within the definition of a ‘non-banking financial company’ (an “**NBFC**”), with the prior approval of the Central Government.

Subsequently, the RBI, on October 4, 2017, issued the Master Directions – Non-Banking Financial Company – Peer to Peer Lending Platform (Reserve Bank) Directions, 2017² (the “**P2P Directions**”), for compliance by every NBFC that carries on the business of a peer to peer lending platform (a “**P2P Lending Platform**”).

2. KEY PROVISIONS OF THE P2P DIRECTIONS

2.1 Applicability of the P2P Directions

The Notification defines ‘the business of a peer to peer lending platform’, as the business of providing under a contract, the *service of loan facilitation, via online medium or otherwise, to the participants who have entered into an arrangement with that platform* to lend on it or to avail of loan facilitation services provided by it.

Paragraph 2 of the P2P Directions provides that the P2P Directions will apply to every Non-Banking Financial Company – Peer to Peer Lending Platform (an “**NBFC-P2P**”). The P2P Directions define a ‘peer to peer lending platform’ as an intermediary providing the services of loan facilitation via online medium or otherwise, to ‘participants’. Paragraph 4(1)(iv) of the P2P Directions defines a ‘participant’ to mean a *person who has entered into an arrangement with an NBFC-P2P to lend on it or to avail of loan facilitation services* provided by it.

An NBFC-P2P is defined as a non-banking institution that carries on the business of a P2P Lending Platform. However, the P2P Directions clearly state that no non-banking institution other than a company will be permitted to undertake the business of a P2P Lending Platform. Under the P2P Directions, no NBFC-P2P can commence or carry on the business of a P2P Lending Platform without obtaining a certificate of registration from the RBI.

Further, Paragraph 6(3) of the P2P Directions provides that an NBFC-P2P shall not undertake any activity other than those stated in the P2P Directions.

Thus, it appears that the P2P Directions apply to any company which operates a platform, online or otherwise, for

¹ Notification No DNBR.045/CGM (CDS)-2017.

² RBI/DNBR/2017-18/57, Master Director DNBR (PD) 090/ 03.10.124/ 2017-18 (*Master Directions – Non-Banking Financial Company – Peer to Peer Lending Platform (Reserve Bank) Directions, 2017*) is available at <https://rbidocs.rbi.org.in/rdocs/notification/PDFs/MDP2PB9A1F7F3BDAC463EAF1EEE48A43F2F6C.PDF>.

facilitation of lending services, and such a company will have to apply for a certificate of registration under the P2P Directions. Further, upon registration, such a company will not be permitted to carry on any activity other than that of a P2P Lending Platform.

2.2 Scope of Activities of an NBFC-P2P

Paragraph 6 of the P2P Directions lists out the functions and activities that an NBFC-P2P shall and shall not carry out. Some of the significant functions that an NBFC-P2P shall undertake are as follows:

- (a) to act as an intermediary providing an online marketplace or platform to the participants;
- (b) to ensure adherence to legal requirements applicable to the participants as prescribed under relevant laws;
- (c) to undertake due diligence on the participants;
- (d) to undertake credit assessment and risk profiling of the borrowers and disclose to the prospective lenders;
- (e) to undertake documentation of loan agreements and other related documents;
- (f) to provide assistance in disbursement and repayment of loan amount;
- (g) to render services for recovery of loans originated on the platform.

Some of the activities that an NBFC-P2P shall not specifically undertake are as follows:

- (a) raise deposits;
- (b) provide any credit enhancement or credit guarantee;
- (c) facilitate or permit any secured lending linked to its platform;
- (d) hold, on its own balance sheet, funds received from lenders for lending, or funds received from borrowers for servicing loans;
- (e) cross sell any product except for loan specific insurance products;
- (f) permit international flow of funds.

2.3 Prudential Norms

The P2P Directions list out the following prudential norms with respect to NBFC-P2Ps:

- (a) NBFC-P2P shall maintain a Leverage Ratio not exceeding 2 (two). 'Leverage Ratio' is defined as the Total Outside Liabilities divided by Owned Funds, of the NBFC-P2P.
- (b) The aggregate exposure of a lender to all borrowers at any point of time, across all P2Ps, shall be subject to a cap of INR 10,00,000 (Indian Rupees ten lakhs);
- (c) The aggregate loans taken by a borrower at any point of time, across all P2Ps, shall be subject to a cap of INR 10,00,000 (Indian Rupees ten lakhs);
- (d) The exposure of a single lender to the same borrower, across all P2Ps, shall not exceed INR 50,000 (Indian

Rupees fifty thousand);

- (e) The maturity of the loans shall not exceed 36 (thirty six) months.

P2Ps are required to obtain a certificate from borrowers and lenders certifying their respective adherence to the above limits.

2.4 Funds Transfer Mechanism

The P2P Directions propose an escrow account mechanism for fund transfers between participants. There shall be at least 2 (two) escrow accounts – one for funds received from lenders and pending disbursement, and the other for collections from borrowers. The escrow accounts will have to be operated by a trustee, who will mandatorily be promoted by the bank maintaining the escrow accounts. All fund transfers will have to be through and from bank accounts and cash transactions are strictly prohibited.

The P2P Directions also describe a mechanism that may be adopted by NBFC-P2Ps for operation of escrow accounts. As per the prescribed mechanism, the trustee will be required to operate the escrow accounts only on the basis of instructions received from the lenders and borrowers. The NBFC-P2P will only act as a marketplace for exchange of information and instructions between the trustee, lenders and borrowers and may be provided 'view only' access to escrow accounts for monitoring and reporting purposes.

2.5 Obligations of an NBFC-P2P

The P2P Directions set out operational guidelines to be followed by NBFC-P2Ps, some of which are as follows:

- (a) disclosure of prescribed details about the borrower to the lender, and about the lender to the borrower (excluding personal identity and contact details, in case of disclosure made to the borrower);
- (b) public disclosure of the methodology of, and the factors considered for, credit assessment, portfolio performance, including share of non-performing assets and broad business model;
- (c) become a member of all credit information companies and submit data to them;
- (d) have a fair practices code approved by the board;
- (e) have a board approved policy to address participant grievances;
- (f) have a board approved business continuity plan in place for safekeeping of information and documents, and servicing of loans for full tenure in case of closure of platform;
- (g) ensure compliance with the Master Directions on Information Technology Framework for the NBFC Sector;
- (h) conduct of information system audit of internal systems and processes once in 2 (two) years and submit the report to the Regional Office of the Department of Non-Banking Supervision, RBI.

2.6 Reporting Requirements

Prior written permission of the RBI will be required for the following:

- (a) any allotment of shares which will take the aggregate holding of an individual or group to 26% (twenty six percent) or more of the paid up capital of the NBFC-P2P;

- (b) any takeover or acquisition of control of an NBFC-P2P, which may or may not result in change of management;
- (c) any change in the shareholding of an NBFC-P2P, which would result in acquisition by or transfer of shareholding to any entity, of 26% (twenty six percent) or more of the paid up equity share capital of the NBFC-P2P;
- (d) any change in the management of an NBFC-P2P which would result in change in more than 30% (thirty percent) of the directors (excluding independent directors);
- (e) any change in the shareholding that will give the acquirer a right to nominate a director.

Further, a public notice of at least 30 (thirty) days is required to be given before effecting the sale of, or transfer of ownership by, sale of shares, or transfer of control of an NBFC-P2P.

Additionally, there are other regular reporting requirements, including, quarterly statements with loan details, leverage ratio, amounts in escrow accounts, change in addresses of directors and auditors and other related information.

3. **INDUSLAW VIEW**

Companies operating P2P Lending Platforms have, for long, been functioning in an unregulated space, on the basis that their primary business was that of an information technology service provider. The P2P Directions, however, introduce substantial obligations for NBFCs, including the onerous requirement to due diligence participants and ensure compliance with applicable law.

Ever since the RBI issued the Consultation Paper on Peer to Peer Lending in April 2016³ (the “P2P Consultation Paper”), most stakeholders in the sector of peer-to-peer lending had been awaiting guidelines from the RBI and the P2P Directions set out a number of requirements that will require further clarification.

In particular, the P2P Directions raise certain queries regarding what the RBI seeks to regulate:

- (a) *Do the P2P Lending Platforms have to fulfil the 50-50 test issued by the RBI to fall within the purview of the P2P Directions?*

The P2P Directions state that the directions apply to every NBFC that carries on the business of a peer to peer lending platform. This implies that only NBFCs fall within the purview of the P2P Directions.

The RBI has, by way of a press release dated April 8, 1999, clarified that a company has to fulfil the 50-50 test to qualify as a non-banking financial company, that is, its financial assets must be more than 50% (fifty percent) of its total assets and its income from financial assets must be more than 50% (fifty percent) of its gross income. However, a P2P Lending Platform does not and in fact, cannot have any financial assets, as it cannot lend on its own.

In this respect, the RBI needs to clarify whether the 50-50 test is applicable to P2P Lending Platforms that are regulated by the P2P Directions.

- (b) *Who can be ‘participants’ in an NBFC-P2P?*

The P2P Directions do not provide any clarity on whether the term ‘person’ as used in the definition of ‘participant’

³ Consultation Paper on Peer-to-Peer Lending is available at <https://rbidocs.rbi.org.in/rdocs/content/pdfs/CPERR280416.pdf>.

includes both individuals and legal entities.

While explaining the concept of peer-to-peer lending in the P2P Consultation Paper, the RBI mentions that the borrower may be an individual or a legal person requiring a loan. However, no such clarity is forthcoming, either in the P2P Consultation Paper, the Notification or the P2P Directions, with respect to who may be a lender on an NBFC-P2P. From a plain reading of the P2P Directions and in the absence of clarity from the RBI, it appears that if a platform facilitates lending transactions between borrowers and lenders, whether individuals or legal entities (including banks and other financial institutions), such a platform will fall within the purview of the P2P Directions.

Banks and other financial institutions are sufficiently regulated under RBI's regulatory framework and are required to comply with all laws applicable to them; this onus cannot be moved to third parties such as NBFC-P2Ps under the RBI's existing regulatory framework. However, if the intent of the RBI is to regulate lending by banks and other financial institutions, then the P2P Directions seem restrictive from a business perspective in light of the prudential norms. If lenders include banks and other financial institutions, then the exposure limits of lenders also seem too low.

In this regard, it is interesting to note that with the P2P Directions permitting any person (including individuals) to lend, the applicability of the Money Lenders' Act enacted in several states to such lenders is not clear. The RBI should use this opportunity to clarify the applicability of Money Lenders' Acts across states.

(c) *What constitutes 'secured lending' and 'clean loans'?*

Paragraph 6(1)(v) of the P2P Directions provides that an NBFC-P2P shall not facilitate or permit any secured lending linked to its platform. It clarifies that only clean loans will be permitted.

The P2P Directions do not clarify the meaning of the term 'secured lending'. While explaining the operational business models of P2P lending in India, the P2P Consultation Paper, mentions that P2P Lending Platforms usually facilitate collection of post-dated cheques from the borrower in the name of the lender as a proxy for repayment of loan.

There are several judicial precedents noting that collection of post-dated cheques for repayment of loan does not make the underlying loan a secured loan. The P2P Consultation Paper appears to support this view. There needs to be express clarity on whether collection of post-dated cheques for repayment of loan is permissible.

Further, the rationale of the RBI behind prohibiting facilitation of secured lending is unclear, more so, if the intent is to regulate lending amongst individuals.

Further, the prohibition on providing credit enhancement or guarantee also brings into question business structures such as first loss default guarantee that are adopted by P2P Lending Platforms to provide comfort to individual lenders.

The P2P Directions are severely restrictive from a business perspective: for instance, the obligation on the NBFC-P2Ps to ensure that participants on the platforms adhere to laws applicable to them, prohibiting participants from cross selling or carrying on any other activity will require substantial resources to discharge. Further, with several dos and don'ts imposed on NBFC-P2Ps, the revenue streams of NBFC-P2Ps become restricted.

The rationale behind the leverage ratio is also unclear considering the P2P Directions have made it clear that NBFC-P2Ps shall not lend on their own.

Additionally, the mandate of escrow mechanism for fund transfer may prove to be onerous from an operational perspective to NBFC-P2Ps, in addition to increasing the costs for such NBFC-P2Ps.

NBFC-P2Ps are also required to make several public disclosures on their websites. One such disclosure is providing an 'overview of credit assessment/score methodology and factors considered'. The extent of this information that NBFC-P2Ps are required to disclose is not clear. Considering that P2P Lending Platforms invest significant time and money in the development of intellectual property, if NBFC-P2Ps are required to disclose such information in great detail, it may compromise their confidential information and intellectual property rights guaranteed under law.

However, considering the restrictive and regulated nature of the P2P Directions, it is interesting to note that the RBI is silent on the interest rates that may be charged on the loans facilitated through NBFC-P2Ps.

The P2P Directions do not prescribe any penalty for non-compliance with the P2P Directions. However, since the P2P Directions have been issued by the RBI under the powers conferred under the RBI Act, the penalties under Chapter V of the RBI Act may be applicable to any non-compliance or breach of the P2P Directions.

Despite the unanswered queries and the restrictive conditions, the P2P Directions have at least set out a specific framework governing P2P Lending Platforms and seeks transparency. Further, with the requirement for NBFC-P2Ps to register as credit information companies, obtaining credit reports of borrowers and reporting defaults, just got easier for NBFC-P2Ps.

From an FDI perspective, the P2P Directions also provide much needed clarity, as it was always unclear whether P2P Lending Platforms fall under the head of 'Other Financial Services' under the FDI Policy. With NBFC-P2Ps now being regulated by the RBI, they fall under the automatic route of investment under the FDI Policy.

Given that the P2P Directions provide only 3 (three) months to existing companies undertaking the business of P2P Lending Platforms to apply for registration as an NBFC-P2P, there is an expectation from the RBI to issue clarifications at the earliest. We will wait to see how the interpretation of the P2P Directions evolves and provide an update as issues find resolution.

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