

Role of Asymmetric Information in Limiting the Bank-NBFC Co-Lending Model in India

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Introduction

The Co-Lending Model (CLM) that came into force in November 2020 allows banks to lend to priority sector borrowers in collaboration with Non-Banking Financial Companies (NBFCs). The revised CLM carries forward the Reserve Bank of India's (RBI) earlier co-origination loan scheme, which was launched in September 2018 to ease the liquidity crunch triggered by the IL&FS crisis. CLM is envisioned as one of the important pillars for financial inclusion which is a critical facilitator of inclusive and sustainable development. CLM is a joint lending procedure that involves two financial institutions. One is a major lending institution, such as a bank, while the other is a smaller NBFC.

Benefits of CLM

The CLM empowers multiple stakeholders in the lending ecosystem. While NBFCs and Housing Finance Companies (HFCs) can leverage their strong presence in local markets, commercial banks have the availability of low-cost funds for credit disbursal. This becomes even more relevant in the scenario where many NBFCs and HFCs are battling for funds. NBFCs gain from creating a high-quality loan book while maintaining their yields and profitability. The benefit of low cost of financing from banks and reduced cost of operations of NBFCs is passed on to the final borrower via the all-inclusive rate or weighted average blending rate which is close to the lending rate charged by the banks. In other words, co-lending, if implemented properly, can be a win-win proposition for all the stakeholders involved.

Blended Interest Rate Calculations	Bank	NBFC
Benchmark Interest Rate	8%	12%
Spread	2%	3%
Interest rate to customers	10% (A)	15% (B)
CLM Loan contribution ratio	80% (C)	20% (D)
Blended interest rate $(A * C) + (B * D) = E$	11%	

Some of the benefits of CLM to banks include, better retail business growth; greater reach to the country's most remote areas with a larger pool of businesses and clients to lend to; better customer experience leading to future conversions and repeat loan prospects; skin in-the-game as NBFCs must invest a minimum 20% of the capital; better risk management; better diversification as banks can split the risk with another lender instead of taking it fully; achieving priority sector lending (PSL) target with no additional capital; easily expanding to multiple geographies and strengthening ties with a larger number of originators; and finally, cherry-picking loan proposals that fulfil banks' requirements.

NBFCs are expected to benefit tremendously from the CLM arrangement. They may experience faster growth with no additional capital; better quality loan book; lower interest rates than competitors; association with large banks establishes credibility for their brand in the eyes of customers; better risk management and limited loan losses in the event of a bad debt; diversification of customer base; sanctioning big-ticket loans; new product addition; higher non-interest income etc.

Benefits of CLM to customers include better customer experience as NBFCs are the only nodal point of contact; low interest rate due to the blending method; better customer education and knowledge dissemination; single point of contact and smooth process; availability of credit to underserved customers etc. Hence, CLM provides a unique opportunity for banks and NBFCs to work together to improve their approach to lending to priority sectors.

Why CLM may be a game changer?

As per the Global Findex Report 2021 by the World Bank Group, 78% of adults in India have an account (by themselves or together with someone else) at a bank or another type of financial institution. This is much lower than some of its peers. Again, the report says that only 13% of adults have borrowed money from a formal financial institution or used a mobile money account. This shows that access to credit is yet to be formalised in India, and the CLM can play a big role in deepening financial inclusion in the country. CLM's major goal is to increase credit flow to unserved and underserved areas of the economy. It permits NBFCs to get low-cost capital from banks through a tie-up agreement while requiring them to contribute a minimum of 20% of their own capital. This 80:20 ratio assures that the NBFCs do not originate low-quality loans, since their 20% ownership will be impacted by losses from such origination.

CLM requires both banks and NBFCs to have their board-approved policy outlining the general framework on which they will participate into co-lending agreements. NBFCs commonly have a wider target audience for loans because of their customer-centric approach and the surge in

social media and digital acquisition of prospective customers. Nevertheless, they lack inexpensive access to significant capital to provide loans to their clients. Banks, on the other hand, have a large pool of assets available to be spent on the correct set of customers; nevertheless, their customer acquisition strategy is out of sync with digital penetration, and they largely rely on offline acquisition tactics.

CLM enables banks and NBFCs to collaborate under a single lender's umbrella and harness their unique synergies to provide a holistic experience to all stakeholders in the arrangement. Hence, CLM is one of the best methods to close the sizable credit gap existing in India.

Constraints

Despite the inherent advantages, the CLM is having a slow start. Due to the engagement of two or more very distinct lending organisations with diverse processes, policies, technology systems, and risk management practices, CLM presents some challenges.

Some of the initial constraints obstructing deepening of CLM were, IT system integration, development a common credit policy, reconciling repayment schedules, bureau reporting, simultaneous credit risk assessment, hypothecation, servicing, and escrow management etc., Apart from operational issues, one of the major hurdles of the CLM is the trust deficit, which is limiting the market's development. Asymmetric information reduces the efficiency of CLM market and its development. While the CLM assumes that NBFCs and banks will complement each other in supporting credit for the less creditworthy, the inherited flaw in the model needs to be addressed for the market to penetrate. As both lenders (Banks and NBFCs) operate in the same domain with almost similar business models, the possibility of market failure due to a trust deficit is a major roadblock. As per design, the sourcing of the application rests on NBFCs, as they have last-mile reach. Banks believe that the loan proposals shared by NBFCs are of low quality which is aptly described as 'Lemons' by George Akerlof (Akerlof 1970) in his seminal work.

Banks prefer to sanction loans returnable to them rather than high-yield loans (Stiglitz 1981), which is the preference of NBFCs; therefore, banks head towards credit rationing due to the presence of adverse selection problems. As the CLM credit market is affected by imperfections due to the presence of asymmetric information, banks lack the necessary information to set the price of loans that reflect the borrowers' riskiness. Banks always worry about quality borrower, which leads them to adopt more stringent underwriting mechanisms and frequent rejection of loan proposals. As banks fail to distinguish good borrowers from bad borrowers, they assume every borrower is a lemon. Hence, they charge a premium for the increased cost of screening

safe applicants from risky applicants and for monitoring borrowers' actions; ultimately, banks pass on the additional transaction costs to borrowers; or they might add a premium to the interest rate, and hence high interest rates may reflect the high costs of these activities.

Asymmetric Information

The CLM argument assumes that there is a perfectly competitive credit market, and all lenders are equally informed about the borrower, which is not practical in many relevant markets. As banks consider every proposal to be a lemon, they keep charging higher spreads on those loans. On the other hand, charging a higher interest rate might have a negative effect on the banks' profit, as it might induce self-selection of risky borrowers. Safe borrowers might get discouraged from applying if they see the pricing is not aligned with their credit worthiness. For this reason, banks simply prefer to refuse credit. Minimizing asymmetric information is critical for the CLM system to function smoothly in the Indian credit market.

Banks are concerned about the quality of the borrower and hence adopt more stringent underwriting mechanisms, leading to the rejection of quite a good number of loan proposals sourced by NBFCs. As banks fail to distinguish good borrowers from bad borrowers, they assume every borrower a lemon. Hence, they charge a premium for the increased cost of screening safe applicants from risky applicants and for monitoring borrowers' actions. Ultimately, banks pass on the additional transaction costs to borrowers. Alternatively, banks add a premium to the interest rate, and hence high interest rates reflect the high costs of these activities. This is the theme of the current research that aims to find out whether asymmetric information is limiting the growth of the CLM in India.

Conclusion

CLM is envisioned as one of the important pillars for financial inclusion, which is a critical facilitator for inclusive and sustainable development. This has been a priority for the government and the RBI over the years, with several initiatives taken and substantial progress achieved. India is one of the world's fastest-growing economies, yet there is a large gap in access to formal credit, particularly when compared to other developed economies. Banks and other FIs are striving to close this gap by offering new financial products and tools that make formal credit more accessible, which was traditionally limited to financial products such as home, vehicle, and personal loans. Banks and FIs, on the other hand, have lately shifted their emphasis to these unserved segments with sophisticated products developed in collaboration with Fintech and primarily backed by digital channels.

Both banks and NBFCs need to consider CLM as a joint venture. There should be a common journey and long-term vision. Once the credit quality is established, and it is demonstrated that CLM can bring the money back with robust system in place, banks will welcome it. Banks are pricing the risk upfront which is positive. Trusting each stakeholder is important and aligning interests and considering it as a joint venture is crucial. Frictions need to be minimized through building trust. NBFCs' ability and nimbleness to adjust to banks' policies is important as well. CLM provides a unique opportunity for banks and NBFCs to work together to improve their approach to lending to priority sectors. It has tremendous scope, and the regulator may extend the scope of the CLM model to non-priority sectors as well.

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