ASYMMETRIC INFORMATION AND MARKET FAILURE IN BANK-NBFC CO-LENDING MODEL

{This Report submitted to the Indian Institute of Banking & Finance (IIBF), Mumbai for the Award of Diamond Jubilee & CH Bhabha Banking Overseas Research Fellowship (DJCHBBORF) 2020-21}

Committed to
professional excellence

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Date: 28 February 2023

SUPERVISOR'S CERTIFICATE

This is to certify that this Research Report entitled "*Asymmetric Information and Market Failure in Bank - NBFC Co-Lending Model*" has been prepared by Dr. Bibekananda Panda and submitted to the Indian Institute of Banking and Finance (IIBF), Mumbai for the award of the *Diamond Jubilee & C.H. Bhabha Banking Overseas Research Fellowship* (DJCHBBORF) for 2020-21, under my supervision. The research work done in this Report is Satisfactory and recommended for the Award. This Report or a part thereof has not been previously submitted to any other Institute/ University for any award/degree.

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DECLARATION

I, hereby declare that this project report titled, '***Asymmetric Information and Market Failure in Bank - NBFC Co-Lending Model***' is a bonafide and genuine research work carried out by me under the Diamond Jubilee and CH Bhabha Banking Overseas Research Fellowship 2020-21 of Indian Institute of Banking & Finance (IIBF), Mumbai. There is no violation of copy right. Indian Institute of Banking & Finance shall have the rights to preserve, use and disseminate this report in print or electronic format for academic/research purpose.

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List of Abbreviations

ANBC	Adjusted Net Bank Credit
API	Application Programming Interface
ASCB	All Schedule Commercial Bank
AUM	Asset Under Management
BC	Business Correspondent
BRE	Business Rule Engine
CAM	Credit Appraisal Memo
CBG	Compressed Biogas
CBS	Core Banking Solution
CDD	Customer Due Diligence
CEPC	Customer Education and Protection Cell
CEOBE	Credit Equivalent of Off-Balance sheet Exposures
CIBIL	Credit Information Bureau (India) Limited
CLM	Co-Lending Model
CP	Commercial Paper
CPC	Centralised Processing Cell
CPSE	Central Public Sector Enterprise
DRI	Differential Rate of Interest
EWS	Economically Weaker Section
FPC	Farmer Producer Cooperative
FPO	Farmer Producer Organization
FI	Financial Institutions
FI Index	Financial Inclusion Index
FLDG	First Loss Default Guarantee
FSS	Farmers' Service Societies
HFC	Housing Finance Company
IBPC	Inter-Bank Participation Certificates
IL&FS	Infrastructure Leasing & Financial Services
IRAC	Income Recognition and Asset Classification
IT	Information Technology
JLG	Joint Liability Group
JV	Joint Venture
KVI	Khadi and Village Industry
KYC	Know Your Customer
LIG	Low-Income Group
LAB	Local Area Bank
LMS	Loan Management System
MFI	Micro Finance Institution
MHP	Minimum Holding Period
MIG	Middle-Income Group
MSME	Micro, Small, and Medium Enterprise
MUDRA	Micro Units Development & Refinance Agency

NABARD	National Bank for Agriculture and Rural Development
NBFC	Non-Banking Financial Companies
NBFC-ND-SI	Non-Deposit-taking and Systemically Important NBFC
NGO	Non-Governmental Organization
NHB	National Housing Bank
NPA	Non-Performing Asset
NRLM	National Rural Livelihood Mission
NULM	National Urban Livelihood Mission
NWR	Negotiable Warehouse Receipts
PAN	Permanent Account Number
PACS	Primary Agricultural Credit Societies
PMJDY	Pradhan Mantri Jan-Dhan Yojana
PSB	Public Sector Bank
PSLC	Priority Sector Lending Certificates
PTC	Pass-Through Certificates
PvSB	Private Sector Bank
PSL	Priority Sector Lending
RBI	Reserve Bank of India
RCSA	Risk and Control Self-Assessment
RIB	Rural Infrastructure Bonds
RIDF	Rural Infrastructure Development Fund
ROE	Return On Equity
RRB	Regional Rural Bank
SCB	Schedule Commercial Bank
SC	Schedule Caste
SHG	Self-Help Groups
SOP	Standard Operating Procedure
SIDBI	Small Industries Development Bank of India
SMS	Specialised Mortgaged Stores
SRO	Self-Regulatory Organisation
SRMS	Scheme for Rehabilitation of Manual Scavengers
ST	Schedule Tribe
STP	Straight Through Processing
SFB	Small Finance Bank
SME	Small, and Medium Enterprises
SMF	Small and Marginal Farmers
TAT	Turn Around Time
TReDS	Trade Receivables Discounting System
UCB	Urban Co-operative Bank
UPI	Unified Payments Interface
USP	Unique Selling Proposition

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EXECUTIVE SUMMARY

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. The scheme has a lot of potential in the lending ecosystem since it combines the advantage of banks' low cost of funding with the agility and reduced cost of operations of NBFCs. As a result, the loan is affordable and accessible to the end user. It benefits the whole eco system as CLM allows banks to create priority sector assets through CLM partners without committing extra resources. Similarly, 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 recipient via the all-inclusive rate or weighted average blending rate which is close to the lending rate charged by the banks.

CLM assumes that there is a perfectly competitive credit market, and all lenders are equally informed about the borrowers, which is not practical in many relevant markets. Despite its inherent advantage, the CLM had a slow start. There are a few factors hindering the growth of the CLM in India. Apart from operational issues including IT system integration, development of a common credit policy, reconciling repayment schedules, bureau reporting, simultaneous credit risk assessment, hypothecation, servicing, and escrow management etc., one of the major hurdles for the CLM is the trust deficit between the lending partners which is limiting the product development. As trust deficit reduces the efficiency of the CLM, banks and NBFCs need to address the issue to make the CLM successful. While NBFCs are confident of their reliable customer selection and due diligence process, banks untrust NBFCs' borrower selection and credit assessment process due to various reasons. When the lending partners are a bank and an NBFC, the appraisal criteria are substantially different. Given the varying nature of assessment, a significant number of borrowers falls outside the credit sanction criteria.

With higher rejection rate, NBFCs are convinced that if they share sub-prime proposals with banks, there is high probability that banks will reject those. Hence, either by preference or by compulsion, subprime borrowers are solely financed by NBFCs. But the initial behaviour of the NBFCs in sharing high-risk proposals is anchored in the behaviour of banks and they follow stringent underwriting process. NBFCs are selective in choosing a borrower in CLM as the rigid process followed by banks ends up with a higher rejection rate. As both the lenders has

the options to underwrite separately, the customers' turnaround time (TAT) is also impacted. Furthermore, the amount of monitoring is greater when the bank is the primary lender.

Trust deficit among the lending partners might be getting triggered by the asymmetric information and ultimately leading to market failure. To understand the anomalies in the CLM ecosystem, the study aims at understanding the concerns of all stakeholders (Banks, NBFCs, and HFCs) on the issue of asymmetric information as a constraint in the CLM credit market growth. It also tries to assess whether the loan pricing of CLM by banks is competitive.

The current study is the first of its kind in the CLM in India. The literature on the subject is fairly limited due to its distinctiveness and timing. Apart from newspaper reports, there is little credible literature on the subject to date. Additionally, there is no publicly available statistics on CLM in India. Under such a scenario, the study is an honest attempt to understand the nuances of the CLM market through stakeholder interaction and feedback; hence the study is primary research in nature. A total of sixteen (16) banks (9 PSBs & 7 PvSBs) and twenty (20) NBFCs/ HFCs/ Fintech which are into the CLM business are surveyed for the study.

Summarising the feedback received from banks shows that the preferred CLM for banks is the one where NBFCs on-board the borrower and banks underwrite the loan later. The cash flow approach is the preferred appraisal method for banks. Banks find CLM riskier than their normal credit portfolio, and in the absence of CLM, banks do not entertain the same borrowers. Banks opine that in most of the cases the risk profiling of the CLM borrowers is not aligned with banks' credit policy. To hedge against risk, banks charge a higher premium upfront when pricing the CLM proposals. NBFCs are treating the CLM as a fair-weather partnership to survive from liquidity crunch and revert to their on-book lending as soon as the liquidity situation improves. Moreover, larger NBFCs are absent in the CLM. On an average, 24% of the CLM proposals are rejected by partner banks, and bank specific rejection rates widely vary from 10% to 45%. This is mainly as NBFCs are flexible compared to banks in their underwriting process. Additionally, the absence of the required documents as per banks' existing guidelines inflates the rejection rate under CLM.

The extra cost incurred in underwriting, loan servicing, towards risk premia, etc., inflate the blended rates most of the times but based on the risk profile and costs incurred, pricing is most competitive in CLM. Though banks charge high premium to CLM borrowers, those premiums are account specific based on the risk profiling and not generic. Banks are comfortable with NBFCs retaining a minimum of 20% of the loan share on their books. Credit rationalisation is a common phenomenon in CLM, and banks regularly persuade NBFCs to rationalise the quantum of credit. Even though the CLM has been in place for two and half years, banks and NBFCs often complain that the operational process has not yet been fully synchronised.

Summarising the feedback received from NBFCs/HFCs shows that NBFCs prefer the model where they onboard the borrower and banks underwrite later on. The preferred appraisal method for NBFCs is the cash flow approach, the same as for banks. Unlike banks, NBFCs find the CLM portfolio less risky. Activity-wise segregation shows that while underwriting and sanctioning are simultaneously undertaken by banks and NBFCs, post-sanctions, follow-up, and recovery are taken care of by NBFCs. Some of the banks have onboarded Fintech for their niche credit assessment technique and digital platform. The initial operational glitches are almost addressed, and both banks and NBFCs are quite comfortable with the process. However, it has always been a challenge when an NBFC ties-up with a new banking partner. On an average, it takes 1-2 quarters for the system to be fully integrated with a new partner. NBFC's decision of whether the borrower to be fully financed by NBFC or to be considered under CLM solely depends on the quantum of the credit. The USPs of NBFCs in CLM business are their robust credit appraisal mechanism, strong local footing, robust recovery mechanism and analytics-based credit assessment process, etc.

Due to the engagement of two or more very distinct lending organisations with diverse processes, policies, technology systems, and risk management practices, CLM provides some challenges. Integration of underwriting, disbursement, and collections processes has taken longer time and yet has failed to bridge all gaps. Greater co-ordination among lenders is required, including the seamless integration of their technological systems, not only to accomplish the CLM's objective but also to ensure a smooth customer experience. The platform integration eliminates the need for integration with Core Banking Solution (CBS) and each of the lender Loan Management System (LMS) programmes. Because the credit evaluation criteria for the bank and the originator are different, the underwriting policy must be digitised for a system-based review. Understanding the nuances of the CLM is crucial for the long-term sustainable credit growth in India.

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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CHAPTER I

INTRODUCTION, OBJECTIVES AND SCOPE OF THE STUDY

Introduction

The Co-Lending Model (CLM) brought forward by the Reserve Bank of India (RBI) in November 2020 enables banks to offer loans in collaboration with NBFCs to priority sector borrowers. The revised CLM also took forward the co-origination of loan scheme of RBI announced in September 2018 to address the liquidity issue post IL&FS crisis. The CLM has a lot of merit in the lending eco-system as it combines the low cost of funds of a bank with the agility and lower cost of operations of NBFCs. This makes the loan more affordable and accessible for the end user. The co-lending mechanism was devised by the RBI to ensure that low-cost funds from the banks are made available to NBFCs that work in the MSME (micro, small, and medium enterprises), EWS (economically weaker sections), LIG (low-income group), and MIG (middle-income group) categories, where banks are not keen to explore due to higher operating costs and credit risks.

CLM is envisioned as one of the important pillars for financial inclusion, which is a critical facilitator of inclusive and sustainable development for any nation. Financial inclusion has been a priority for the government, the RBI, and other authorities over the years, with a number of 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 financial institutions (FIs) are striving to close this gap by offering new payment products and tools that make formal credit more accessible. Formal credit was traditionally limited to financial items such as homes, vehicles, 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. As per the Global Findex Report (2021) by the World Bank, 78% of adults in India have an account (by themselves or together with someone else) at a bank or another type of financial institution, which is lower than some of their peers. The report also highlighted 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.

The RBI publishes the Financial Inclusion Index (FI Index) on a regular basis to evaluate the amount of financial inclusion in the country and estimate the broadening and deepening of financial inclusion. The index is based on 97 variables that indicate "access," or the supply of financial inclusion infrastructure, "use," or the demand for financial services, and "quality," or inequity in access and usage owing to a lack of financial knowledge and protection. By 2021, India has reached the halfway point, with the best access or supply of financial infrastructure and lagging in utilisation or demand to be financially involved. This is important in light of the ambitious objectives established by the National Strategy. The FI Index value has been rising, reaching 56.4 in March 2022, up from 53.9 in March 2021 and the highest ever since. There is significant improvement across all sub-indices.

As the Indian economy is evolving, for better proliferation of banking and financial services in remote rural areas, the priority sector rules have been amended from time to time to meet regional disparities in credit flow and meet national objectives. Banks and NBFCs are collaborating to increase the flow of credit to various key sectors by using their competitive advantages. The development of macroeconomic policies to increase credit flow to priority sectors has been a policy choice. Making priority sector lending a tool for banks to seize untapped business possibilities among the financially disadvantaged segments of society is very important. Developing policies to provide an optimal flow of credit to the MSME sector and addressing stress in MSMEs' accounts is also equally important and is given due consideration by the RBI and the government. To increase the flow of credit to individuals, self-help organisations, SC/ST persons, minority communities, etc., certain government-sponsored schemes are in place. A broad initiative is also implemented for easier access to credit and financial aid for farmers.

India has strong growth potential as a market for retail credit, and CLM was intended to benefit banks in creating priority sector assets through their co-lending partners without deploying additional resources. Similarly, NBFCs benefit from building a quality loan book without compromising their yields and profitability. 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 the remaining 20% from their own capital. This 80:20 ratio assures that the NBFC does not originate low-quality loans, since its 20% ownership will be impacted by losses from such origination.

This strategy ensures that all three parties—the borrower, the bank, and the NBFC—benefit. Borrowers receive funds at a lesser cost than they would have received from the NBFC on their own. The bank's money would be better deployed in the unserved and underserved sectors, and the NBFC would have a consistent flow of affordable and reliable finance. According to the RBI guidelines, a minimum of 20% of the credit risk through direct exposure must be held on the books of the NBFC till maturity, with the remainder held on the bank's books. At maturity, the bank and NBFC share the repayment or recovery of interest in proportion to their share of credit and interest. This joint origination enables banks to claim priority sector status for their portion of credit. Customers are serviced by NBFCs as a single point of contact, and a tripartite agreement is reached between customers, banks, and NBFCs.

1.2 Problem Statement

Apart from operational issues including IT system integration, development of a common credit policy, reconciling repayment schedules, bureau reporting, simultaneous credit risk assessment, hypothecation, servicing, and escrow management, etc., one of the major hurdles of the CLM is the trust deficit between the lenders, which is limiting the CLM market's development. By design, the sourcing of the CLM application rests upon NBFCs as they have the last mile reach. As both banks and NBFCs are operating in the same domain with almost similar business models, market failure due to a trust deficit is a major roadblock. Banks presume that the loan proposals shared by NBFCs are of poor quality, and NBFCs will self-finance the good-quality borrowers and prefer CLM for the less-creditworthy borrowers. As each loan proposal by default must go through two rounds of underwriting, a trust deficit hampers market growth.

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 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. Alternatively, banks add a premium to the interest rate, and hence high interest rates reflect the high costs of these activities. As banks prefer to grant loans returnable to them rather than high-yield loans (Stiglitz 1981), banks are moving towards credit rationing due to the presence of adverse selection problems. As trust deficit, which is the outcome of the asymmetric information, is reducing the efficiency of the CLM market, banks and NBFCs need to address the deficit to make the CLM effective.

1.3 Need of the Study and Key Questions

The CLM empowers multiple stakeholders in the lending ecosystem. While NBFCs and 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 against the liquidity crunch. Banks may benefit from accelerated creation of priority sector assets through their co-lending partners without deploying additional resources. On the other hand, NBFCs also benefit from building quality loan book without compromising their yields and profitability. In other words, co-lending, if implemented properly, can be a win-win proposition for all the stakeholders involved.

Despite the inherent advantages, the CLM is seen as having a slow start. There are a few factors hindering the growth of the new CLM market. 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.

1.4 Objectives of the Study

Given the inherent problem of the credit market and, moreover, the involvement of two sets of entities in lending activity, the trust deficit in the system, which is mainly due to asymmetric information, may lead to market failure.

The broad objectives of the study are the following:

I. To understand the concerns of all stakeholders (Banks, NBFCs, and HFCs) on the issue of asymmetric information as a constraint in the CLM credit market

II. To assess whether loan pricing of CLM assets by banks is competitive

III. To suggest policies for Banks, NBFCs, and the regulator for the smooth functioning and development of the CLM market.

1.5 Scope of the Study

The CLM is expected to leverage the comparative advantages of banks and NBFCs in a collaborative effort and improve the flow of credit to the unserved and underserved sectors of the economy. Deepening the understanding of the extent and effects of asymmetric information is key to the design of a regulatory framework that limits the negative consequences of asymmetric information. The presence of asymmetric information in the markets leads to incorrect pricing patterns and selections. An asymmetric information-intensive market progressively draws away from being effective and fully competitive.

The CLM argument is based on the assumption 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. Correspondingly, there is no clear evidence of the effects of the interaction of asymmetric information in the lending market. 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 indeed be discouraged from applying if they see the pricing is not aligned with their credit worthiness. For this reason, banks simply prefer to refuse loans. Minimizing asymmetric information is a critical measure for the CLM system to function smoothly in the Indian credit market.

India has strong growth potential as a market for retail credit. Urbanization, connectivity, and rising aspiration are adding more and more people in the formal financial network. CLM as a concept has a lot of merit in the lending eco-system of the country, as it combines the low cost of funds of a bank with the agility and lower cost of operations of an NBFC, thus making the loan more affordable and accessible for the end-user. Again, the whole idea of CLM is to improve the flow of credit to the unserved and underserved sectors of the economy and make funds available to the ultimate beneficiary at an affordable cost, considering the lower cost of funds from banks and the greater reach of the NBFCs. Banks will benefit from the accelerated creation of priority sector assets through their co-lending partners without deploying additional resources. On the other hand, NBFCs can benefit from building a quality loan book without compromising their yields and profitability. However, despite the inherent advantages, the CLM has not taken off. Though some of the constraints, including IT integration, reconciling repayment schedules, bureau reporting, simultaneous credit risk assessment, hypothecation, servicing, and escrow management, are somehow addressed by both the lenders, lack of trust among banks and NBFCs due to information asymmetry needs greater attention. If trust can be built between both the lenders, CLM may act as a very useful mechanism for financial inclusion in the country.

1.6 Research Methodology

The methodology followed in the study is based on primary research. As no secondary source of information about the CLM statistics is available for public consumption, either by the RBI or the lenders, the study had to settle for primary research only.

Research Design

- ✓ **Data collection:** The primary survey data is collected through personal, telephonic interviews, email, etc., both online and offline, using a structured questionnaire from a sample of banks, NBFCs, HFCs and Fintech platform providers across sectors and geographies.
- ✓ The questionnaires are designed in consultation with officers from Banks, NBFCs and academicians to cover all aspects of the CLM.

Sample Size:

Lending Entity	Sample Size
Banks	**16**
Public Sector Banks	9
Private Sector Banks	7
NBFCs/HFC	**20**
Fintech	**1**

Sampling

The study has followed probability sampling, i.e., clustered sampling. Sample units are well distributed across geographies and sectors. Questionnaires were administered both online and offline after an initial pilot survey and validation.

There is no separate vertical in PSBs which understand completely NBFCs' style of work. The co-lending department is aligned to the retail or NBFC alliance vertical of PSBs. The survey is administered among the Chairman/MD of the banks and NBFC business heads. However, in most of the cases, we are advised to talk to senior officials in charge of concerned CLM business units who have shared their feedback.

The responses received in the physical or telephonic interaction are also mixed in response to management cadre. Moreover, the respondents are the concerned officials of the banks who are dealing with the CLM business. In certain cases, the respondents are desk officers or the middle management.

As the survey was administered among the business heads of the Banks and NBFCs, we have only considered one feedback from each Bank/NBFC to avoid any ambiguity in the response.

1.7 Limitations of the Study

The research is the first of its kind on the CLM in India. The literature on the subject is fairly limited due to its distinctiveness and timing. However, apart from newspaper reports, there is very little credible literature on the subject to date.

Second, even though the idea has been around for more than two years (since November 2020), there is hardly any authentic information publicly available on co-lending business in India. NBFCs and Fintech platform providers are advertising inflated numbers to acquire market share and build business.

Under such scenario, it was difficult to conduct quantitative analysis in the absence of secondary data. The reluctance of all stakeholders, starting from the regulator (RBI) to commercial banks and NBFCs in sharing CLM data, is contrary to market discipline, and as a result, the research missed analysis on specific objectives. Nevertheless, as the industry matures, we believe that the regulator and its regulated entities (banks and NBFCs) will share co-lending data for public consumption.

1.8 Organization of the Study

The report is divided into seven chapters. ***Chapter I*** discusses the overview and objectives of the study, and ***Chapter II*** discusses relevant literature on co-lending, priority sectors, and credit market asymmetries. Priority sector lending overview is presented in ***Chapter III***, and ***Chapter IV*** covers details related to the CLM. Feedback and survey data analysis of banks and NBFCs is discussed in ***Chapter V***. ***Chapter VI*** concludes the study with policy suggestions.

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CHAPTER II

REVIEW OF LITERATURE

Introduction

A co-lending arrangement usually involves two or more parties coming together for a specific purpose or project. Such an arrangement allows them to use their respective strengths and capabilities for the benefit of the targeted sector. Co-lending allows for increased liquidity and credit penetration. The term “co-lending” is a broader concept and has its origin in the credit system since ages. However, the CLM of the RBI that has been the theme of this research is very new and has only come into play in November 2020.

In 2018, RBI rolled out guidelines for the co-origination of priority sector loans by scheduled commercial banks with non-banking financial companies that are non-deposit taking and systemically important (NBFC-ND-SIs). This emerged due to the liquidity crunch in the system post-IL&FS crisis. Later, in 2020, RBI rechristened the co-origination model as the co-lending model by allowing all NBFCs and HFCs to jointly lend to the priority sector along with commercial banks. The CLM had a lot of merit in the lending eco system. It was aimed at helping NBFCs increase their reach towards the growth of PSL sectors. It also aimed at helping MSMEs get access to formal low-cost credit. PSL sectors get banking facilities through NBFCs via various arrangements with commercial banks.

The CLM announced by the RBI in its November 5, 2020, circular RBI/2020-21/63 FIDD.CO. Plan.BC.No.8/04.09.01/2020-21 allows banks to extend loans to priority sector borrowers in partnership with NBFCs. The primary goal of this announcement was to improve collaboration between banks and NBFCs in areas of lending in the priority sector. The modified CLM carried out the RBI's co-origination loan scheme, which was notified in September 2018 via Circular No. FIDD.CO.Plan.BC/08/04.09.01/2018-19 dated September 21, 2018. The RBI's CLM notification intended to achieve efficient loan harmonisation across many sectors.

2.2 Literature on the Indian Co-Lending Model (CLM)

Karthik and Vinod (2021) have talked about the CLM and discussed why it has emerged as an important asset class in India. Defining co-lending, the authors have presented that, in simple terms, co-lending is a joint lending process involving two financial institutions. Discussing the benefits of the model, they took a deep dive into the current issues faced by both from an operational and technological aspect and the role played by fintech companies and third-party integrators in addressing some of these issues and aiding in the scale-up of this vertical. The authors have argued that platforms can establish the foundation for a seamless digital interaction between the lenders right from the origination, credit sanctioning, document verification, disbursement, and reporting stages. While presenting the suggestions, the authors argued that while banks have been relatively slow in adapting to the digital lending mode, the CLM can provide them with a strong boost. CLM and Business Correspondent (BC) models can aid banks in launching new products and expanding into new territories where they have a weaker presence. The authors have also recommended the entry of fintech players to optimise the market. The study has also recommended expanding the scope of the CLM to non-PSL sectors.

Sameera (2022) has discussed in her study the growing importance of co-lending in financial intermediation. She has presented in detail the role of government schemes to support MSMEs and the advantages of CLM. The study has shown that the CLM has the potential to bring about a significant change in priority sector lending (PSL). It has been observed that the large customer base and integration of technology of NBFCs, such that end users at remote places can take advantage of such schemes, combined with the robust financial backing of large institutions, may transform the lending and borrowing market in the priority sector. The study has highlighted that the Central Public Sector Enterprises (CPSEs) are not involved in any co-lending activities as of now. It has been recommended that the ways in which CPSEs contribute to co-lending in terms of financial intermediation be explored. If the CLM is implemented in the manner envisaged by the RBI, this may just prove to be the catalyst for the industries and in the uplifting of the priority sector from its economic hardships.

Swain (2002) empirically examined the hypothesis that household credit is rationed by the formal financial sector. This is based on the premise that all households have a positive desire for formal credit, and it is a less expensive source of borrowing. In his article, three distinct models were estimated to validate formal credit rationing. The first is a traditional credit-rationing model. The second model argues that the likelihood of borrowing from the formal sector is influenced simultaneously by credit demand and the bank's decision on access. Finally, the third model relaxes both assumptions, allowing the household to choose between formal and informal borrowing. Empirical findings demonstrate that access to the formal sector in rural credit markets is restricted, despite a considerable demand for loans. This shows that the formal sector in India retains a high level of effective credit restriction.

Sarma and Mehta (2014) analysed the applicability of two important microfinance models in the Indian microfinance market by incorporating contextual considerations as well as organisational aspects. Self-Help Groups (SHGs) supplement an area that has a greater number of NGOs and official financial institutions, as well as implementing organisations with a defined development mission that is not confined to microfinance. Whereas the SHG is a savings-led slow growth model that is unique to India, the Joint Liability Group (JLG) is a credit-led fast development model that is largely based on Bangladesh's Grameen model. According to the article, both models offer benefits based on external factors such as competitiveness and population homogeneity, among others. When aligned with organisational aspects such as culture and its strengths, leadership, and so on, both models live up to their full potential. A country like India is frequently plagued by a plethora of external forces, ranging from socially driven and stratified societal systems in rural parts to a monetarily motivated urban impoverished populace. This duality implies the presence of both models, which are tailored to the variety of the target demographic and the peculiarities of the implementing microfinance organization.

2.3 International Literature

Fotak and Lee (2020) discussed co-lending by private and government-owned banks. Under the "social" and "political" perspectives of government lending, it has examined the probable distortions to the lending syndicate's behaviour caused by the existence of a government co-lender. According to the authors, co-lending is frequently justified as a way to put market discipline on government-owned lenders, which, unlike private-sector firms, do not merely seek to maximise shareholder value. The research looked into how political distortions impact "mixed" syndicates that include both private and government-owned lenders. It was discovered that mixed syndicates make more loans to government-connected businesses than private syndicates. Moreover, loans from mixed syndicates have lower spreads, longer maturities, fewer collateral requirements, and fewer restrictions. When borrowers are "connected," terms are most favourable. Companies that borrow from mixed syndicates underperform in profitability and valuation in later years, implying that loans are distributed inefficiently. The research supports political distortions in mixed lending.

Studies argue that asymmetric information plays a key role in the failure of the lending market worldwide. An increase in adverse selection causes prices to increase (higher interest rate), quantities (quantity of credit offtake) to fall, and defaults to rise. Asymmetric information can lead to market failures such as credit rationing, inefficient provision, mispricing of risk, and market failure at the end.

Trovato and Alfo (2002) investigated the impact of governmental subsidies on the growth trajectory of Italian SMEs. Governmental subsidies to SMEs have frequently been utilized to promote economic growth in less developed regions. The major theoretical grounds for this intervention are based on the concept that public subsidies can remedy capital shortages caused by asymmetric knowledge. Public subsidies to rationed enterprises, according to Stiglitz and Weiss (1981), can lessen the informational gap, causing subsidized firms to reduce their financial restrictions and boost their investment levels. The results obtained by modelling leverage, performance, and investment behaviour in a panel of around 1,900 firms from 1989 to 1994 appear to validate the working hypotheses.

Crawford et al. (2015) have tested the consequences of asymmetric information and imperfect competition in the Italian market for small business lines of credit. The study argued that the degree of competition in local credit markets can have significant consequences on the equilibrium effects of an increase in adverse selection.

Sufi (2007) empirically explored the syndicated loan market, with an emphasis on how information asymmetry between lenders and borrowers influences syndicate structure. It was observed that when the information asymmetry between the borrower and lenders is potentially severe, participant lenders are closer to the borrower, both geographically and in terms of previous lending relationships.

Stiglitz and Weiss (1981) noted that sometimes banks reject to grant loans to applicants due to adverse selection and put forward the underlying causes as the fact that loan applicants with high-risk investments would apply for loans at high interest rates. Bester (1985) agreed with this opinion, provided that low-risk loan applicants walk off the market due to unreasonable pricing.

Jaffee and Stiglitz (1990) have discussed credit rationing. According to the authors, credit markets differ from traditional markets in two significant ways. First, in normal markets, which are the subject of traditional competition theory, a number of agents purchase and sell a homogenous product. Second, in typical markets, a product is delivered by a seller and paid for by a buyer at the same time. In attempting to apply the normal supply and demand model, which is not particularly applicable for the market for promises, credit allocation analysis might go off target. To supply credit in the United States, a complex, decentralised, and interconnected collection of financial markets, organisations, and instruments has arisen. Equity securities, on the other hand, are guarantees to return a certain percentage of a company's profits. Between loans and equity, a range of products, including convertible bonds and preferred shares, exist.

Parker (2003) investigated whether banks limit lending to emerging businesses and if government action is required. The assumption that they do has prompted government action in a variety of ways, including publicly funded loan guarantee systems in the United Kingdom and elsewhere. The study offered a review of contemporary credit rationing theory and evidence, concluding that the argument for credit rationing is weak. Theoretical arguments for or against credit rationing are ultimately inconclusive; thus, evidence is necessitated to resolve the problem. The evidence does not support the notion that credit rationing is a substantial or widespread phenomenon.

Overall, the negative consequence of asymmetric information in market failure is a broader concept in the financial world. Asymmetries can severely worsen lending conditions, and there is a need for additional policies to mitigate this market failure. This asymmetric information and trust deficit among groups of creditors may be hampering the newly devised CLM market's ability to penetrate in India.

2.4 Analysis of Panel Discussions on the Bank-NBFC Co-Lending Model

2.4.1 ET FinNext Submit 2022: Rise of the Co-Lending Model

Moderator:

Raman Aggarwal, Director, FIDC & Director, Paisalo Digital Ltd.

Panellists:

Monu Ratra, CEO & ED, IIFL Home Finance Ltd.

Pallavi Shrivastava, Co-Founder & Director, Progcap

Bhavin Patel, Co-Founder & CEO, LenDenClub

Anurag Sinha, Co-Founder & CEO, OneCard

Irfan Mohammed, CBO-Financial Services, CredAvenue Pvt. Ltd.

Is co-lending going to be the future of retail lending in India?

- Unanimously, yes
- As the recovery, follow-up, and other due diligence processes are passed to NBFCs, which they are best at, CLM is expected to have remarkable success in the coming days.

Which of these two approaches—on lending or the collaborative model of co-lending—is going to work?

- Co-lending is going to be a big hit because, in comparison to on-lending, where commercial banks have almost no control, in CLM banks share both risk and return, unlike on-lending. As the concept is new, banks are curious to know how their portfolios are going to behave.
- While on-lending reduces operational hazards, it stops to get scale. Again, on-lending is easier and faster, and the NBFC has full control over the credit policy. Co-lending is a long-term partnership where almost everything is supposed to be conducted jointly. Loan servicing and the longevity of the partnership are the crux of the CLM and will determine its viability.

How will the CLM flourish?

- There is both interest and intent from banks and NBFCs to collaborate. Even more surprisingly, the intent of PSBs is seen higher, which guarantees the success of CLM. NBFCs have expertise in delivering high-quality customer experience through technology, which will be important to CLM's success. Policy alignment between banks and NBFCs is must for its success.
- Transparency plays a significant role and needs to be managed on a real-time basis. NBFCs should give banks enough confidence that they are following the proper recovery process. The building blocks of the CLM should fall into place for its success through the penetration of technology and advanced analytics.
- Both banks and NBFCs should 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 systems in place, banks will be able to expand it.
- As the RBI is the common regulator for banks and NBFCs, it may ask banks to learn fast. Banks need to educate them on NBFC appraisal models and about their advanced analytics models. Banks to understand the underwriting process of NBFCs and trust them. Types of data points looked into by NBFCs, and the sophisticated valuation models are important to

be read by banks. Trust will be built in the system, after a couple of cycles subject to money comes back to banks.

What is the best bank-NBFC tie-ups?

There are four phases of bank-NBFC tie-ups in India. The key areas are:

- Co-origination
- On-lending
- Direct lending and
- Co-lending

Given the architecture, co-lending is considered the best among those because banks are concerned about the asset quality as they are underwriting each proposal themselves. Moreover, linking the co-lending to priority sectors has also become lucrative from the bank's perspective.

What are the challenges of the co-lending model?

- The first and foremost challenge is whether the information is flown in a transparent manner or not, and whether the books of both partners are talking in the same way or not.
- There is no separate vertical for PSBs which understand NBFCs' style of work. The co-lending department is also part of their retail vertical. As PSBs do not have specialised teams or professionals to understand and manage the CLM, they need to onboard specialists to understand the model.
- Sourcing and onboarding are the two most important parts of the CLM story. Again, along with onboarding and sourcing, the return of the money should be assured.
- NBFC are shadow banks and are asked to do what banks cannot. Now, through co-lending, banks are asked to do what they are shy of.
- There is a need for a common delinquency matrix through which both lenders can access the customer's profile.
- In most cases, NBFCs have their own proprietary scoring models, which they do not share with banks. This hampers trust between the two lenders.
- The model fails because banks are acting as big brothers. Banks opine that NBFCs have sourced the customer, and as a bank, they will do business in their way only. Fundamentally, it has to be collaborative, and a joint venture model is the best.
- The policy alignment and style of reading the CIBIL report are altogether very different for banks and NBFCs, which creates a lot of anomalies.

What is the scope of the CLM?

- CLM has tremendous scope in the Indian banking space.
- It may be extended to SFBs, foreign banks, RRBs, cooperative banks, etc., with certain limits to start with.
- Though banks are extremely interested, they are following a wait-and-watch strategy. Once the confidence is built, over the next couple of years, things will be aligned.

What should be the optimal Bank-NBFC ownership ratio in the CLM?

- The present 80:20 ratio is at a very comfortable level because it is flexible. The ultimate proportion may be left to market comfort.

2.4.2 ET BFSI Submit 2021: Convergence: The World of Hyper Personalization

Panel Discussion: "The Rise of Co-Lending: Pros and Cons for 2021"

Synopsis: Banks and NBFCs both vouched for CLM initially, but soon they realised that the collaboration was not easy. Both the entities have their different strategies. Since RBI has been supporting co-lending to cater to the huge demand for credit, it is critical to understand the pros and cons of the CLM.

Moderator:

Amol Dethe, Editor, ETBFSI

Panellists:

R Sridhar, Executive Vice Chairman and CEO, IndoStar Capital Finance Ltd

Rakesh Kaul, CEO, Clix Capital

Sashank Rishyasringa, Co-Founder & MD, Capital Float

Harshvardhan Lunia, Co-founder and CEO, Lendingkart

Viability of the co-lending model

- CLM is good for the NBFCs, those are finding it difficult to raise capital from the market. The model only works when there is a liquidity shortage. Given the rigidity on the banks' side, NBFCs hesitate to seek favour from banks.
- CLM is a fair-weather scheme for large NBFCs. Hardly any big NBFC is coming for co-lending. Again, it may not be the right model for all sectors of the economy.

Banks need to be liberal, and mutual trust between the lenders is important

- Banks have very little understanding of the unorganised sector where NBFCs excel. Banks find difficulty understanding NBFC models. The conventional appraisal methods and even rigidity in certain parameters on the bank's side are hindering the process flow. Decision-making in banks is bureaucratic, which NBFCs find tough to work with. The customer journey is also being impacted.
- In other countries, co-lending is popular in the form of securitization. Confidence of the banks about NBFCs underwriting is important. PSBs are keen but falter at the integration part, where fintech intervention is required.

Duplicity of process is to be avoided

- A series of duplications in the system is hampering the customer journey. Two entities are duplicating the work. It is a waste of resources.
- A strong digital platform is required. Technology will resolve the issue, as seamless integration of technology is required.
- There is also a need for service stags. The manual process is tough and repetitive, as both lenders operate under two sets of rules. Banks are wholesale financiers and are not so good at small value credit appraisals; they prefer NBFCs to follow their underwriting process. Banks often dictate the rules, using their dominating position due to their capital strength.
- As borrowers are of small value, credit assessment of each borrower for multiple times is expensive and can be avoided. Again, as digital lending may mess up the credit system, both lenders must ensure that the leverage of the customer does not go up.

2.4.3 ETBFSI Convergence: 2022

NBFCs CEOs Discussion: Electrifying Co-Lending

Synopsis: Several banks have entered into co-lending pacts with NBFCs, which are symbiotic relationships where banks can provide much of the capital and NBFCs the customer base. The session brainstormed how banks and NBFCs can better leverage their respective comparative advantages in a collaborative effort.

Moderator:

Amol Dethe, Editor, ETBFSI

Panellists:

Shachindra Nath, VC & MD, U GRO Capital

K. V. Srinivasan, ED and CEO, Profectus Capital

Vikrant Narang, Deputy CEO, Ambit Finvest

Mehernosh Tata, CEO, Edelweiss Retail Finance

How is the co-lending model shaping up in India?

- The co-lending model came out of a necessity for the system. Banks are short of the PSL target, and the return on rural infrastructure bonds (RIBs) is much lower. CLM is very profitable for banks and has a great future. CLM is still in infant stage and needs time to evolve.
- There are three important pillars of the CLM: origination, underwriting, and collection. These three important pillars need to be strong for CLM to succeed.
- Banks are good at taking deposits but bad at lending to the lower strata. However, the handshake between banks and NBFCs would address that concern.

For whom is it more beneficial?

- Unless it is a symbiotic relationship benefiting both parties, it is not going to work. It will be very profitable for NBFCs and also profitable for banks.
- NBFCs can be capital efficient and increase the quality of their portfolio. It will be very profitable for NBFCs as they will be amortising a higher fee on a small portion of capital.
- Banks go for prime lending. They share their assessment parameters in advance and define the assessment criteria as well. So, they make it clear about the processes of both.
- Banks will not target NBFC customers but will expand their distribution network.

How will the CLM model prosper?

- There are underwriting risks and integration challenges. That needs to be addressed. A lot of trust between both the lenders is required, which is missing. The system and documentation process are to be harmonized. Double underwriting is expensive and should be cut short.
- If one customer’s data is read in two different ways, it would remain very complicated. Banks are subject to IRAC norms compared to big NBFCs, which follow new Indian accounting standards. Due to different norms, NPA declaration, income recognition, and

amortisation of debt are all different. So, it becomes exceedingly difficult for both organizations. For a smooth process, systems need to be integrated.

- Executing nuances is important. Banks are pricing the risk upfront, which is positive. Trusting each stakeholder is important and aligning interests and considering it a joint venture are crucial. Friction needs to be cleared through building trust. NBFCs ability and nimbleness to adjust to banks policies is important as well.

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CHAPTER III

PRIORITY SECTOR LENDING IN INDIA

3.1 Evolution of Priority Sector Lending in India

The current framework of priority sector lending (PSL) in India dates back to 1967, when Morarji Desai, then Deputy Prime Minister and Minister of Finance, Government of India, stated in the Lok Sabha on December 14, 1967, that there had been persistent complaints that several priority sectors, such as agriculture, small-scale industries, and exports, had not received their fair share of bank credit. This appears to be the first time the phrase priority sector has been used. As a result, the concept of priority sector lending (PSL) was born.

Banking Laws (Amendment) Bill 1967, tabled in the Lok Sabha on December 23, 1967, introduced social control over banks. Banks were directed to align their activities with national objectives through social control. At a National Credit Council meeting in July 1968, it was stressed that commercial banks should boost their involvement in financing priority sectors such as agriculture and small-scale industries. Priority sector lending comprises only those sectors that have a substantial influence on vast portions of the population, the weaker sections, and sectors that are employment-intensive, such as agriculture and micro-and small enterprises.

3.2 List of Priority Sectors Identified in India

Since the introduction of the PSL guidelines, the list of sectors has undergone modifications on a few occasions based on macro-economic dynamics. To align it with emerging national priorities and bring a sharper focus on inclusive development, the RBI revised the PSL guidelines on September 4, 2020, by including bank finance to start-ups (up to Rs. 50 crore); loans to farmers for the installation of solar power plants for solarization of grid-connected agriculture pumps; and loans for the establishment of compressed biogas (CBG) plants. The following are the priority sector categories:

i. Agriculture
ii. Micro, small, and medium enterprises (MSMEs)
iii. Export Credit
iv. Education
v. Housing

vi. Social Infrastructure

vii. Renewable Energy

viii. Weaker Sections

ix. Others

3.3 Priority Sector Lending (PSL) Norms and Targets

PSL guidelines were implemented to support the weaker sections of society. All commercial banks, including Regional Rural Banks (RRB), Small Finance Banks (SFB), and Primary Urban Co-operative Banks (UCBs), are subjected to these provisions. For PSL categories, these institutions must lend 40% or more (depending on the lending institution category) of their entire loan book (as measured by adjusted net bank credit (ANBC) or credit equivalent of off-balance-sheet exposures (CEOBE), whichever is higher).

Priority Sector Lending by Banks
(As on March 31, 2022)

(Amount in ₹ crore)

Item	Target/ sub-target (per cent of ANBC/ CEOBE)	Public Sector Banks		Private Sector Banks		Foreign Banks^		Small Finance Banks		Scheduled Commercial Banks	
		Amount outstanding	Per cent of ANBC/ CEOBE	Amount outstanding	Per cent of ANBC/ CEOBE	Amount outstanding	Per cent of ANBC/ CEOBE	Amount outstanding	Per cent of ANBC/ CEOBE	Amount outstanding	Per cent of ANBC/ CEOBE
1	2	3	4	5	6	7	8	9	10	11	12
Total Priority Sector Advances	**40/75***	**2649179.95**	**42.90**	**1685805.56**	**43.71**	**208106.50**	**42.65**	**73505.52**	**85.08**	**4616597.54**	**43.52**
of which											
Total Agriculture	18.00	1182377.52	19.15	622339.14	16.14	48876.88	19.27	21361.96	24.73	1874955.50	18.07
Small and marginal farmers	9.00	648227.14	10.50	286829.08	7.44	26336.73	10.38	17274.46	20.00	978667.40	9.43
Non-corporate Individual Farmers#	12.73	924640.55	14.97	415711.15	10.78	33116.26	13.05	27619.46	31.97	1401087.42	13.51
Micro Enterprises	7.50	442596.73	7.17	318688.90	8.26	20524.93	8.09	23813.65	27.56	805624.21	7.77
Weaker Sections	11.00	827895.58	13.41	386742.30	10.03	30411.53	11.99	38345.20	44.38	1283394.62	12.37

Notes: 1. Amount outstanding and achievement percentage are based on the average achievement of banks for four quarters of the financial year.
2. *: Total priority sector lending target for Small Finance Banks was 75 per cent.
3. #: Target for non-corporate farmers is based on the system-wide average of the last three years' achievement. For FY 2021-22, the applicable system wide average figure was 12.73 percent.
4. ^: For foreign banks having less than 20 branches, only the total PSL target of 40 per cent is applicable.

Source: Priority Sector Returns submitted by banks.

Source: Report on Trend and Progress of Banking in India 2021-22

Bank category wise PSL targets are as follows;

Categories	Domestic Commercial Banks (excl. RRBs & SFBs) & Foreign Banks with 20 branches and above	Foreign Banks with less than 20 branches	Regional Rural Banks	Small Finance Banks
Total Priority Sector	40% of ANBC or CEOBE whichever is higher	40% of ANBC or CEOBE whichever is higher; out of which up to 32% can be in the form of lending to Exports and not less than 8% can be to any other priority sector	75% of ANBC or CEOBE whichever is higher; however, lending to Medium Enterprises, Social Infrastructure and Renewable Energy shall be reckoned for priority sector achievement only up to 15% of ANBC.	75% of ANBC or CEOBE whichever is higher
Agriculture	18% of ANBC or CEOBE, whichever is higher; out of which a target of 10% is prescribed for Small and Marginal Farmers (SMFs)	Not applicable	18% ANBC or CEOBE, whichever is higher; out of which a target of 10% is prescribed for SMFs	18% of ANBC or CEOBE, whichever is higher; out of which a target of 10% is prescribed for SMFs
Micro Enterprises	7.5% of ANBC or CEOBE, whichever is higher	Not applicable	7.5% of ANBC or CEOBE, whichever is higher	7.5% of ANBC or CEOBE, whichever is higher
Advances to Weaker Sections	12% of ANBC or CEOBE, whichever is higher	Not applicable	15% of ANBC or CEOBE, whichever is higher	12% of ANBC or CEOBE, whichever is higher
Source: Reserve Bank of India				

3.4 Categories under Priority Sector

The categories under the priority sector are as follows:

Agriculture

Farm Credit (Agriculture and Allied Activities), Agriculture Infrastructure, and Ancillary Activities forms agriculture lending. Loans to individual farmers (including Self-Help Groups or Joint Liability Groups) and Proprietorship businesses of farmers directly involved in agriculture and allied activities, such as dairy, fishery, animal husbandry, poultry, beekeeping, and sericulture, belong to this category. This includes crop loans, including loans for traditional/non-traditional farms, horticulture, and allied activities; medium and long-term loans for agriculture and allied activities (e.g. purchase of agricultural implements and machinery and developmental loans for allied activities); loans for pre and post-harvest activities, such as spraying, harvesting, grading, and transporting of their own farm produce; loans to distressed farmers indebted to non-institutional lenders; loans under the Kisan Credit Card Scheme; loans to small and marginal farmers for the purchase of agricultural land; loans against pledge/hypothecation of agricultural produce (including warehouse receipts) for a period not exceeding 12 months subject to a limit of Rs. 75 lakhs against negotiable warehouse receipts (NWRs) / electronic negotiable warehouse receipts (eNWRs) and Rs. 50 lakhs against warehouse receipts other than NWRs/eNWRs; credits to farmers for the installation of stand-alone Solar Agriculture Pumps and the solarisation of grid-connected Agriculture Pumps; and loans to farmers for the installation of solar power plants on barren/fallow land or in a stilt form on farmer-owned agriculture land. Finance to corporate farmers, Farmer Producer Organizations (FPOs) or Farmer Producer Cooperatives (FPCs), companies of individual farmers, partnership firms, and co-operatives of farmers engaged in agriculture and related activities, etc. come under farm credit.

Agriculture Infrastructure

Agriculture infrastructure loans are subject to a total sanctioned ceiling of Rs 100 crore per borrower from the banking system. Agriculture infrastructure includes the following: loans for the construction of storage facilities (warehouses, market yards, go-downs, and silos), including cold storage units and cold storage chains designed to store agricultural produce and products regardless of location; soil conservation and watershed development; plant tissue culture and agri-biotechnology, including seed production, bio-pesticides, bio-fertilisers, and vermicomposting; and loans for the construction of oil refineries.

Ancillary Services

Loans for ancillary services is subject to the following limits: loans up to Rs. 5 crores to farmer co-operative societies for the purchase of members' produce (not applicable to UCBs); loans up to Rs. 50 crores to start-ups, as defined by the Ministry of Commerce and Industry, Govt. of India, engaged in agriculture and allied services; and loans for food and agro-processing up to an aggregate sanctioned limit of Rs. 100 crore per borrower. Outstanding deposits with NABARD under the Rural Infrastructure Development Fund (RIDF) and other qualified funds due to a priority sector shortfall are part of ancillary services. The eligible activities under ancillary services include loans for the establishment of Agri-clinics and Agri-business centres; loans to Custom Service Units managed by individuals, institutions, or organisations who maintain a fleet of tractors, bulldozers, well-boring equipment, threshers, combines, etc., and undertake farm work for farmers on a contract basis; bank loans to Primary Agricultural Credit Societies (PACS), Farmers' Service Societies (FSS), and loans sanctioned by banks to MFIs for on-lending to agriculture sector as per the Master Directions of RBI; and loans sanctioned by banks to registered NBFCs (other than MFIs) as per the criteria stipulated in the Master Directions of RBI.

Small and Marginal Farmers (SMFs)

Small and marginal farmers include the following in the computation of achievement of the sub-target: farmers with a landholding of up to 1 hectare (Marginal Farmers); farmers with a landholding of more than 1 hectare and up to 2 hectares (Small Farmers); landless agricultural labourers, tenant farmers, oral lessees, and share-croppers whose share of landholding is within the limits prescribed for SMFs; loans to Self Help Groups (SHGs) or Joint Liability Groups (JLGs), i.e. groups of individual SMFs directly engaged in Agriculture and Allied Activities, provided banks maintain disaggregated data of such loans; loans up to Rs. 2 lakhs to individuals solely engaged in allied activities without any accompanying land holding criteria; and loans to Farmer Producer Organisations (FPOs)/FPCs of individual farmers and co-operatives of farmers directly engaged in agriculture and allied activities where the landholding share of SMFs is not less than 75%, subject to certain loan limits. UCBs are not authorised to lend to farmer cooperatives.

Lending by Banks to NBFCs and MFIs for On-lending in Agriculture

This includes bank credit extended to registered NBFC-MFIs and other MFIs (societies, trusts, etc.) that are members of RBI-recognized Self-Regulatory Organization (SRO) for the sector for on-lending to individuals and members of SHGs / JLGs who are eligible for priority sector advances under their respective agricultural categories, subject to certain conditions (not applicable to RRBs, UCBs, SFBs, and LABs (Local Area Banks)) and bank credit extended to registered NBFCs (other than MFIs) for on-lending for agriculture's ‘term lending' component up to Rs. 10 lakh per borrower, subject to certain criteria (not applicable to RRBs, UCBs, SFBs, and LABs).

Micro, Small and Medium Enterprises (MSMEs)

This covers MSMEs that are involved in the manufacture or production of goods in any way related to any of the industries listed in the First Schedule to the Industries (Development and Regulation) Act of 1951 or engaged in supplying or rendering any service or services. All bank loans to MSMEs that meet the aforementioned criteria are classified under PSL. Recourse factoring transactions conducted by banks that carry out the business of factoring departmentally when the 'assignor' is a micro, small, or medium enterprise would be eligible for MSME categorization on the reporting dates. Factoring transactions involving MSMEs that take place through the Trade Receivables Discounting System (TReDS) will also be eligible for priority sector classification. All loans to units in the Khadi and Village Industries (KVI) sector are eligible for classification under the priority sector's 7.5% sub-target.

Some of the other eligible priority sectors for lending to MSMEs include:

- Loans up to Rs. 50 crores to start-ups, as per the definition of the Ministry of Commerce and Industry, Government of India, that conform to the definition of MSME.
- Loans to entities involved in assisting the decentralised sector in the supply of inputs and marketing of the output of artisans, village, and cottage industries.
- Loans to co-operatives of producers in the decentralised sector, viz. artisans, village, and cottage industries.
- Loans sanctioned by banks to NBFC-MFIs and other MFIs (societies, trusts, etc.) that are members of the RBI-recognized SRO for the sector are for on-lending to the MSME sector.
- Loans to registered NBFCs (other than MFIs) for on-lending to micro and small enterprises
- Credit outstanding under general credit cards (including the Artisan Credit Card, Laghu Udyami Card, Swarojgar Credit Card, and Weaver’s Card, etc.) is in existence and caters to the non-farm entrepreneurial credit needs of individuals.
- Overdrafts to Pradhan Mantri Jan-Dhan Yojana (PMJDY) account holders as per the limits and conditions prescribed by the Department of Financial Services, Ministry of Finance, from time to time will qualify as achievement of the target for lending to microenterprises.

- Outstanding deposits with SIDBI and MUDRA Ltd. on account of the priority sector shortfall.

Export Credit

Export credits under the agriculture and MSME sectors are allowed to be classified as PSL in the respective categories, viz., agriculture and MSME. Export credit includes pre-shipment and post-shipment export credit (excluding off-balance sheet items) as defined in the Master Circular on Rupee and Foreign Currency Export Credit and Customer Service to Exporters issued by the Department of Regulation, RBI, vide DBR No.DIR.BC.14/04.02.002/2015-16 dated July 1, 2015, and updated from time to time.

Education

Loans to individuals for educational purposes, including vocational courses, not exceeding Rs. 20 lakhs will be considered as eligible for priority sector classification. Loans earlier sanctioned and currently classified as priority sector will continue till maturity.

Housing

Bank loans to the housing sector as per the limits prescribed below are eligible for priority sector classification:

- Loans to individuals up to Rs. 35 lakhs in metropolitan centres (with population of 10 lakh and above) and up to Rs. 25 lakhs in other centres are available for the purchase or construction of a dwelling unit per family, provided the overall cost of the dwelling unit in the metropolitan centre and at other centres does not exceed Rs. 45 lakh and Rs. 30 lakhs, respectively. Existing individual housing loans of UCBs presently classified under PSL will continue as PSL till maturity or repayment.
- Housing loans to banks' own employees will not be eligible for classification under the priority sector.
- Since housing loans that are backed by long-term bonds are exempt from ANBC, banks should not classify such loans under the priority sector. Investments made by UCBs in bonds issued by NHB or HUDCO on or after April 1, 2007, shall not be eligible for classification under the priority sector.
- Loans up to Rs. 10 lakhs in metropolitan centres and up to Rs. 6 lakhs in other centres for repairs to damaged dwelling units conforming to the overall cost of the dwelling unit under certain conditions.

- Bank loans to any governmental agency for the construction of dwelling units or for the slum clearance and rehabilitation of slum dwellers are subject to dwelling units with carpet areas of not more than 60 sq. m.
- Bank loans for affordable housing projects using at least 50% of the Floor Area Ratio (FAR) / Floor Space Index (FSI) for dwelling units with carpet areas of not more than 60 sq. m.
- Bank loans to HFCs (approved by NHB for their refinance) for on-lending, up to Rs. 20 lakhs for individual borrowers, for the purchase, construction, or reconstruction of individual dwelling units or for slum clearance and rehabilitation of slum dwellers, are subject to certain conditions.

Social Infrastructure

Bank loans to the social infrastructure sector are eligible for priority sector classification. These include bank loans up to a limit of Rs. 5 crore per borrower for setting up schools, drinking water facilities, and sanitation facilities, including the construction or refurbishment of household toilets and water improvements at the household level, etc., and loans up to a limit of Rs. 10 crore per borrower for building health care facilities, including those under 'Ayushman Bharat' in Tier II to Tier VI centres. In the case of UCBs, the above limits are applicable only in centres with a population of less than one lakh.

Renewable Energy

Bank loans up to a limit of Rs. 30 crores to borrowers for purposes like solar-based power generators, biomass-based power generators, windmills, micro-hydel plants, and non-conventional energy-based public utilities, viz., street lighting systems and remote village electrification, etc., will be eligible for priority sector classification. For individual households, the loan limit will be Rs 10 lakh per borrower.

Weaker Sections

Priority sector loans to the following borrowers are considered as lending under Weaker Sections category:

- Small and marginal farmers
- Artisans, village, and cottage industries where individual credit limits do not exceed Rs. 1 lakh

- Beneficiaries under government-sponsored schemes such as the National Rural Livelihood Mission (NRLM), the National Urban Livelihood Mission (NULM), and the Self Employment Scheme for Rehabilitation of Manual Scavengers (SRMS)
- Scheduled Castes and Scheduled Tribes
- Beneficiaries of the Differential Rate of Interest (DRI) Scheme
- Self-Help Groups
- Distressed farmers indebted to non-institutional lenders
- Distressed persons other than farmers, with loan amounts not exceeding Rs. 1 lakh per borrower, to prepay their debt to non-institutional lenders.
- Individual women beneficiaries up to Rs. 1 lakh per borrower. (For UCBs, existing loans to women will continue to be classified under weaker sections until their maturity or repayment.)
- Persons with disabilities
- Minority communities, as may be notified by the Government of India from time to time.
- Overdrafts availed of from time to time by PMJDY account holders as per the limits and conditions prescribed by the Department of Financial Services, Ministry of Finance, may be classified under Weaker Sections.

Others

The following loans, as per the prescribed limits, are eligible for priority sector classification:

- Loans provided directly by banks to individuals and individual members of SHG/JLG satisfying the criteria as prescribed in the Master Direction on Regulatory Framework for Microfinance Loans Directions, dated March 14, 2022
- Loans not exceeding Rs. 2 lakhs provided by banks to SHGs and JLGs for activities other than agriculture or MSME, viz., loans for meeting social needs, construction or repair of houses, construction of toilets, or any viable common activity started by SHGs
- Loans to distressed persons (other than distressed farmers indebted to non-institutional lenders) not exceeding Rs 1 lakh per borrower to prepay their debt to non-institutional lenders
- Loans sanctioned to state-sponsored organisations for scheduled castes and scheduled tribes for the specific purpose of purchase and supply of inputs and/or the marketing of the outputs of the beneficiaries of these organisations

- Loans up to Rs. 50 crores to start-ups, as per the definition of the Ministry of Commerce and Industry, Government of India, that are engaged in activities other than agriculture or MSME.

3.5 Alternative Avenues to Meet the Priority Sector Lending Target

Despite uniform regulatory requirements, banks have deviated from the regulatory target at times. Given the high PSL target, lending institutions are also allowed to meet the target through alternate routes, such as

- Inter-Bank Participation Certificates (IBPCs)
- Securitization of priority sector loans
- Depositing shortfalls in funds such as the Rural Infrastructure Development Fund (RIDF) and other funds with NABARD, NHB, SIDBI, and MUDRA Ltd.
- Trading in priority sector lending certificates (PSLCs) that was introduced in 2016 was a game changer since it permitted purchasing for shortfalls and selling for overachievement of PSL targets without transferring loan, cash flow, or risk
- Lending by commercial banks to NBFCs and small finance banks (SFBs) to NBFC-MFIs for the purpose of on-lending to priority sectors
- Co-lending arrangements

Hence, co-lending is the latest weapon of the RBI in supporting banks in meeting their PSL target and supporting inclusive growth in the economy. Hence, CLM has become a critical and profitable avenue for deployment of funds for banks in meeting the PSL target.

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CHAPTER IV

CO-LENDING MODEL (CLM)

4.1 Evolution of the Co-Lending Model (CLM)

The Co-lending Model (CLM), announced by the RBI vide Circular RBI/2020-21/63 FIDD.CO. Plan.BC.No.8/04.09.01/2020-21 on November 5, 2020, allows banks to extend loans to priority sector borrowers in partnership with NBFCs. The primary goal of this announcement was to improve collaboration between banks and NBFCs in areas of lending in the priority sector. The modified CLM carried out the RBI's co-origination loan plan, which was notified in September 2018 vide Circular No. FIDD.CO.Plan.BC/08/04.09.01/2018-19, dated September 21, 2018. The RBI's CLM notification intended to achieve efficient loan harmonisation across many sectors.

In India, the RBI has promoted on-lending by banks to NBFCs for providing loans to certain sectors. As per the RBI guidelines, banks can provide funds to registered NBFCs for on-lending to the priority sector categories of agriculture, housing, and micro-and small enterprises, subject to conditions. This is called the priority sector on-lending programme of NBFCs. CLM is very different from on-lending, as in on-lending, banks give funds to the NBFCs, and the latter deliver the loans to the ultimate weaker section beneficiary. Effectively, under the on-lending programme, NBFCs can make on-lending to the priority sector beneficiaries by using funds of the banks under the PSL programme.

The CLM has a lot of potential in the lending ecosystem since it combines the advantages of bank's low cost of funding with the agility and reduced cost of operations of NBFCs. As a result, the loan is more reasonable and accessible to the end user. India has a high potential for expansion as a retail credit market, and CLM would allow banks to create priority sector assets through co-lending partners without committing extra resources. Similarly, NBFCs gain from creating a high-quality loan book while maintaining their yields and profitability.

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. However, in the market, ‘co-lending’ refers to a partnership in which both parties participate in the loan. Otherwise, it resembles a business correspondent relationship rather than co-lending. If an NBFC wants to co-lend with a bank, it must have a minimum 20% stake in priority sector loans, according to RBI standards.

While large institutions may enjoy growth by using market instruments like bonds, CPs, and traditional banking channels, many MSMEs and MFIs have been unable to access these low-cost loan choices due to stringent due diligence, strict compliance, and the requirement for collateral. Lack of formal, low-cost finance presents a danger to the bottom line of these MSMEs. In the worst-case scenario, it may even drive them bankrupt. Over the years, NBFCs have honed their alternative due diligence methods, on-the-ground market penetration, and effective collection strategies. Despite their larger digital reach and more efficient operations, the cost of funding for NBFCs (as opposed to banks) remained expensive due to the intrinsic nature of their business.

To address these challenges, the RBI has introduced the idea of loan co-origination in August 2018, giving impetus to expand lending for priority sectors in terms of volume and competitive pricing. This model takes into account the lower interest rates provided by banks and the larger reach provided by NBFCs, lowering the combined cost of debt for the underserved. While revamping the earlier scheme to enhance credit facilities for the pandemic-hit priority sector, the RBI in 2020 permitted all scheduled commercial banks (except SFBs, RRBs, UCBs, and LABs) to co-lend with all registered non-bank financial companies (including housing finance companies) (as mentioned in PSL guidelines). For the sake of business continuity and ensuring an ongoing supply of credit to the priority sector, the RBI allowed banks to maintain current arrangements under previous co-origination norms until their board-approved co-lending policy is implemented.

4.2 Objectives of CLM

Co-lending is a mechanism devised by the RBI to ensure that low-cost funds from banks are made available to NBFCs that work in the MSME, EWS (economically weaker sections), LIG (low-income group), and MIG (middle-income group) categories, where banks are slightly hesitant to lend due to higher operating costs and credit risks. CLM's major goal is to increase credit flow to the unserved and underserved areas of the economy. CLM permits NBFCs to get low-cost capital from banks through a tie-up agreement while requiring them to contribute the remaining 20% from their own capital. This 80:20 ratio assures that the NBFC does not originate low-quality loans, since its 20% ownership will be impacted by losses from such origination.

This strategy ensures that all three parties—the borrower, the bank, and the NBFC—benefit. Borrowers receive funds at a lesser cost than they would have received from the NBFC on their own. The bank's money would be better deployed in the unserved and underserved sectors, and the NBFC would have a consistent flow of affordable and reliable finance. According to the RBI guidelines, a minimum of 20% of the credit risk through direct exposure must be held on the books of the NBFC till maturity, with the remainder held on the bank's books. At maturity, the bank and NBFC share the repayment or recovery of interest in proportion to their share of credit and interest. This joint origination enables banks to claim priority sector status for their portion of credit. Customers are serviced by NBFCs as a single point of contact, and a tripartite agreement is reached between customers, bank, and NBFC.

Some of the objectives of the CLM are:

Increase Collaboration: The RBI launched the co-lending scheme to foster cooperation between banks and NBFCs. Several objectives and targets of banks and NBFCs can be accomplished and harmonised through this CLM scheme. The RBI has introduced certain initiatives to enhance collaboration between NBFCs and banks, and when it comes to lending, CLM will improve the prospects of partnership.

Improve Flow of Credit: India is a huge country, with the underserved and rural sectors accounting for the majority of the population. The RBI launched CLM to assist the rural regions of society in getting a consistent supply of credit.

Sharing of Risks and Returns: Collaboration would entail not only the enhancement of lending methods and the development of technology but also the sharing of various types of risks and rewards between banks and NBFCs.

Making Funds Available: Typically, the rural sector finds it challenging to obtain credit from large public sector organisations and financial institutions. As a result, banks have partnered with NBFCs to service the rural sector. Because NBFCs primarily service the rural sector, banks would benefit from this collaboration as well.

4.3 Constructs of the CLM

While the co-origination model was first introduced by the RBI in August 2018, it underwent a revamp in November 2020 to deepen financial inclusion and make credit available at affordable rates. The RBI launched co-lending scheme in order to improve lending terms between banks and NBFCs. The CLM has the following attributes:

Parties involved: Banks are permitted to co-lend with NBFCs, including housing finance companies, based on a board approved master agreement between the two parties.

Master Agreement: A master agreement would be the type of contract or agreement entered into between the bank and the NBFC. This would have the characteristics of a master service agreement. According to the terms of the arrangement, the bank must retain a portion of the loans originated by the NBFC. These loans, however, are subject to rejection if they do not meet the due diligence standards of banks.

Loan Sanction: Banks shall co-lend with NBFCs under a CLM involving sharing of risks and rewards, ensuring appropriate alignment of respective business objectives as per mutual agreement, with the minimum share of the NBFC being 20%. Banks shall have two options for sanctioning loans under the CLM:

i) Irrevocable commitment on the part of the bank to book its share of individual loans as originated by NBFCs

ii) Discretionary arrangement on the part of the bank to take a portion of the loans originated by NBFCs. This should be done in compliance with the RBI guidelines on the transfer of assets through direct assignment.

The circular reads as

"The Master Agreement entered into with NBFCs for implementing the CLM may provide options of either mandatorily taking the bank's share of individual loans originated by the NBFCs on the bank's books or retaining the discretion to reject certain loans subject to its due diligence."

Compliance with Law: Any agreement between the bank and NBFC must meet the standards of the risk management guidelines and the code of conduct in financial services outsourcing. This policy was published in 2015 vide Reserve Bank of India Circular RBI/2014-15/497 DBR.No.BP.BC.76/21.04.158/2014-15.

KYC Directions: All loan agreements must comply with the RBI's KYC requirements. These instructions were released in 2016 as RBI/DBR/2015-16/18. Master Direction DBR. AML. BC.No.81/14.01.001/2015-16. Customer due diligence (CDD) must be performed in accordance with the aforementioned criteria. As a result, CLM strategy considers client due diligence.

Discretion of Banks: The bank's discretion in accepting loans originating from NBFCs is based on its prudence and independence. If the transaction is entered into the books, it will sometimes function in accordance with the terms of the agreement. If there is any type of loan transfer throughout this transaction, then compliance with the transfer must be maintained. This must be done in accordance with the instructions issued by the RBI. This would relate to Transactions Involving Asset Transfer by Direct Assignment of Cash Flows and the Underlying Securities issued vide RBI/2011-12/540 DBOD No. BP.BC-103/21.04.177/2011-12, May 2012. All of these transactions would operate independently, and such transactions would be exempted from the Minimum Holding Period (MHP).

Minimum Holding Period: The MHP would be applicable under the co-lending arrangement between the bank and the NBFC only if such requirements were pre-negotiated in the agreement. Apart from that, the agreement must include a back-to-back clause on the subject. All additional requirements relating to contract assignment must be met by the parties.

Systems: The banks and NBFCs have to ensure that there are effective systems in place to carry out measures on anti-money laundering and due diligence.

Promoter Groups: Banks are not permitted to participate in any other co-lending schemes where the NBFCs have direct control through a promoter group under this CLM.

Customers: When dealing with customers, NBFCs will negotiate the terms of the arrangement with them. As a result, NBFCs would be the point of contact for the agreement's provisions. In addition, the agreement must specify the duties and responsibilities of banks and NBFCs.

Customer Service: The NBFC shall serve as the customer's single point of contact and shall enter into a loan agreement with the borrower, which shall clearly state the terms of the arrangement as well as the roles and obligations of the NBFC and the Bank. All elements of the agreement must be communicated to customers in advance, and their explicit approval must be obtained. The existing customer service rules and Fair Practices Code, as well as the requirements imposed on the bank and NBFC therein, shall apply mutatis mutandis to loans made under arrangement. All appropriate RBI guidelines relating to customer service and customer care must be followed by NBFCs and banks. These criteria would apply to all agreements resulting from the CLM.

Consent: All information about the CLM must be disclosed to customers. Apart from this, each and every customer’s consent must be received for the agreement for the co-lending scheme.

Interest Chargeable: After mutual agreement between the bank and the NBFC, the borrower would be charged an interest rate. Interest rates must be computed in conformity with the requirements of the interest compliance provisions. While both lenders will effectively maintain the portion of the loan funded by them in their respective books of accounts, a unified statement is to be made available for the customer, and necessary integration arrangements will be made by the lenders.

Information Sharing and Data Protection: Under the CLM, NBFCs must ensure that a unified bank statement is prepared for customers. This statement must be shared with the bank. Besides, the CLM must conform to data protection rules.

Grievance Handling: There must be adequate mechanisms in place to manage any type of customer grievance. According to the CLM, the co-lenders must form a cell. All customer grievances must be handled efficiently and quickly. NBFCs must guarantee that any complaint is resolved within 30 days of the complaint date. If this cannot be settled between the co-lenders, the borrowers may file a complaint with the banking ombudsman or the NBFC ombudsman. Customers can also file complaints with the RBI's Customer Education and Protection Cell (CEPC).

Maintenance of Escrow Account: Under the CLM, all banks and NBFCs are required to keep separate accounts for each transaction. All reimbursements and payments will be routed through an escrow account. Banks must keep track of this account. This will reduce the amount of money mixed up. The terms and conditions of the master agreement will have rules related to appropriation. The NBFC should be able to generate a single unified statement of the customer, through appropriate information sharing arrangements with the bank.

Representations and Warranties: All agreements that incorporate the CLM's conditions will include representations and warranties. These representations and warranties must be made in accordance with the pre-negotiated terms and conditions between banks and NBFCs. All NBFCs participating in this co-lending arrangement will be accountable for the share reflected in the bank's books.

Recovery of Loans: The CLM have distinct processes for recovering debts from customers. Such recovery conditions must be mutually agreed upon by the customers.

Security: Terms related to the creation of security in the CLM have to be decided between the bank and the NBFC. In most cases, the NBFC shall arrange for the creation of security and charge as per mutually agreeable terms.

Asset Classification: The asset categorization guidelines must be followed by all co-lenders. This would also apply when co-lending partners are required to submit information to credit information companies.

Internal Audit: Any form of loan provided under the co-lending scheme must adhere to the internal and external audit guidelines established by the banks and NBFCs. For the same reason, compliance is mandatory.

Assignments of Loans: Any form of assignment to a third-party lender must be done with the approval of the other co-lenders.

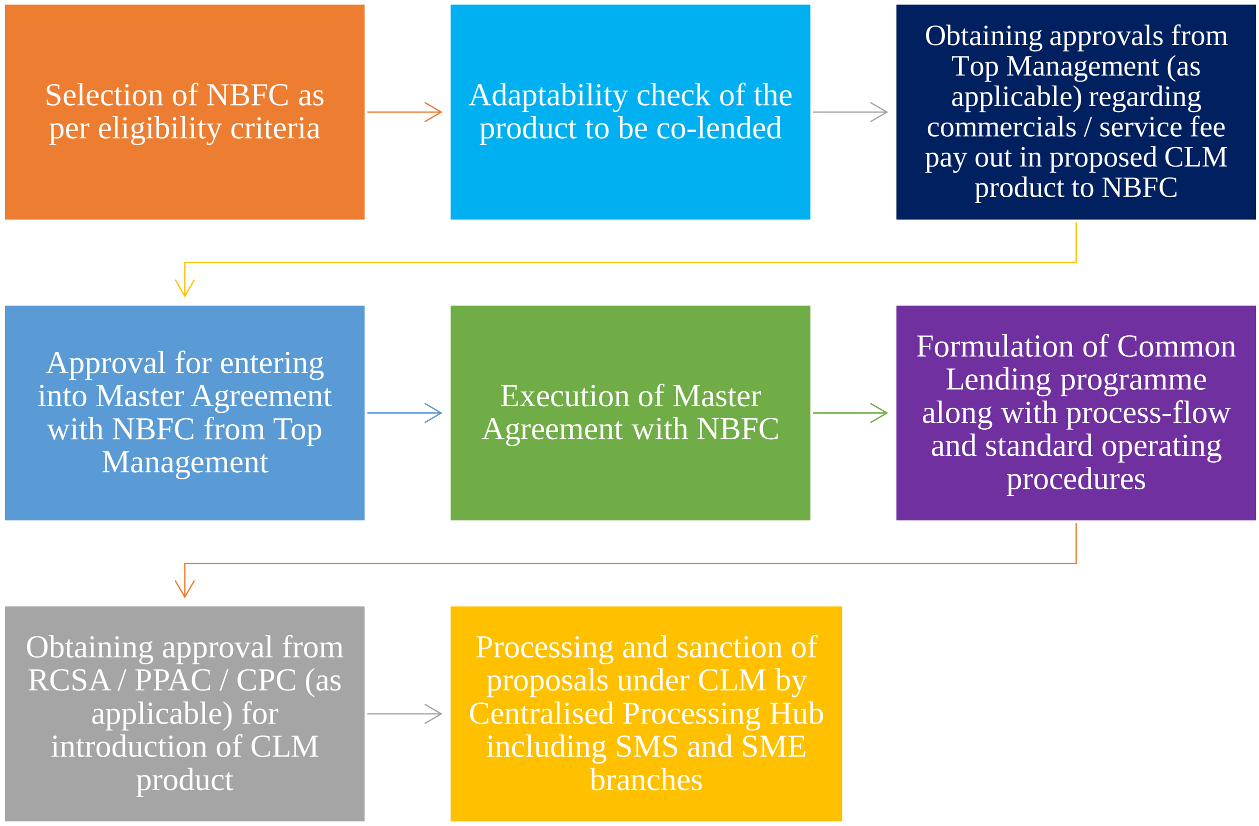
Business Continuity: The requirements of any co-lending agreement shall not interfere with the routine business conducted by banks and NBFCs with their customers. This arrangement must be made active until the debt is repaid. The co-lending scheme must remain operational until and unless it is terminated.

Cross-sell: Banks have the rights to cross sell its associates/ JV's products to the canvassed customers under the CLM.

Safe Custody of Documents: The documents under CLM may be kept in a third-party repository as mutually agreed upon, making it convenient for retrieval. However, the master agreement should, inter alia, contain the suitable clauses, including an indemnity clause, along with the right to retrieve the documents (jointly with the NBFC or individually by the bank, as applicable) from the third-party repository. Suitable clauses should be incorporated in the agreement to ensure that in the event of the liquidation of the NBFC, or if otherwise required by the bank, all the documents should be retrieved within a certain time frame.

Service Fee to NBFC: The bank will pay a service fee to the NBFC for the services provided, which include loan origination, administration, and recovery. The bank and NBFC shall have a flexible reimbursement process. The bank can either reimburse the NBFC for the services performed or incorporate them into the all-inclusive interest rate, which can be included in the master agreement between the bank and the NBFC.

4.4 CLM Process Flow of Commercial Banks



4.5 Co-Origination Model vis-à-vis Co-Lending Model

A close look at each of these RBI circulars reveals the differences between the two models. The CLM applies to banks and all registered NBFCs (including housing finance companies), whereas the previous model was limited to non-deposit-taking systemically significant NBFCs (NBFCs-ND-SI). Given the extent and reach of CLM, which applies to all registered NBFCs, the RBI has prohibited banks from co-lending with NBFCs affiliated with promoter groups in order to guarantee that CLM lending is transparent and at arms' length.

Co-origination Model vs. Co-Lending Model	
Co-origination Model (Sept 2018)	**Co-Lending Model (Nov 2020)**
• The co-origination system has been introduced by the RBI in response to the liquidity crisis at NBFCs in 2018. • It was targeted to enhance the credit flow to productive sectors.	• The primary focus of the revised scheme is to improve the flow of credit to the unserved and underserved sectors of the economy. • To make available funds to the ultimate beneficiary at an affordable cost

• As lenders are reluctant to increase their exposure directly to NBFCs, the co-origination route allows them to help the troubled sector get back on track with their lending business. • To provide a competitive edge for credit to the priority sector and to mitigate the challenges faced by the banks on priority sector loans	
• Joint contribution of credit at the facility level by both lenders as well as sharing of risks and rewards	• Joint contribution of credit at the facility level by both lenders as well as sharing of risks and rewards
• Only a few NBFC-ND-SI were allowed • HFCs were not allowed	• Banks are permitted to co-lend with all registered NBFCs (including HFCs) based on a prior agreement.
• Risk and reward sharing (with an NBFC share of at least 20%)	• Risk and reward sharing (with an NBFC share of at least 20%)
	• In the co-lending model, special attention is given to grievance redressal for borrowers. • Point of contact is NBFC only

4.6 Benefits of the CLM

The CLM enables traditional banks to lend larger sums of money while using the wider digital reach models. Banks have the capital, whereas NBFCs have the reach. A co-lending strategy is thus beneficial to both the lenders. This approach is effective because it employs strong technology to alleviate the operational issues that traditional lending models confront. A co-lending strategy has various advantages, including:

Lower Interest Rate: A variety of products may be served at lower interest rates to priority sector customers using the co-lending approach. The cost of obtaining customers has reduced significantly as a result of digital lending, which, when combined with the inexpensive cost of capital provided by banks, lowers the entire cost. Borrowers can benefit from the cost advantage.

Automated and paperless processes: From application to disbursement, the whole process is automated, allowing borrowers to access funds from the comfort of their own homes. Furthermore, new-age lenders have embraced e-KYC, and video KYC, which has further streamlined the procedure.

Improvement in Quality and Turnaround Time: Customers want credit to be available with a single click on simple, user-friendly smartphone apps. Improved service quality has emerged from the digitization of financial institutions. Robust technology has minimised the time taken to complete all processes, from application to disbursement and enables real-time service delivery. Customers benefit from CLM since it combines the best of both worlds: digital channels and physical branches.

Large Customer Base: Fintech firms are leveraging digital platforms to expand their access to potential customers, allowing them to meet the demands of borrowers beyond regional borders. Furthermore, a CLM provides funding to the economically disadvantaged stratum.

Benefits to Banks

- **Better Retail Growth:** The CLM's objective is to increase banks’ distribution bandwidth, which lead to more retail business. Because of the diversification benefits, low delinquency, and overall economies of scale, retail loan book expansion has been a significant emphasis area for most lenders. Co-lending provides significant growth momentum for the banks. Banks with effective CLM expertise could leverage CLM's potential in extending credit to non-PSL sectors.
- **Greater Reach:** NBFCs have a greater reach to the country's most remote areas, underserved target groups, and digitally underpenetrated areas. As a result of the CLM tie-up, banks have a larger pool of businesses and clients to lend to. As credit becomes increasingly formalized, an increasing number of customers who are new to the credit spectrum will join the formal financial network.
- **Better Customer Experience:** Customer centricity is at the heart of NBFC and Fintech business models. The contemporary partner of the bank in the arrangement manages entire customer management process of the CLM with its smooth and simple operations, which aids in future conversions and repeat loan prospects.
- **Skin in the-game:** Because NBFCs must also put up at least 20% of the capital, banks often feel relieved about the quality of customers routed to them, and so underwriting costs for the bank are substantially reduced.

- **Risk Management:** Banks profit from an increased sense of security and loss reduction as a result of the risk distribution between the two partners.
- **Diversification:** Banks split the risk with another lender instead of taking it fully on their books since the originator has skin in the game. In some circumstances, the originator extends a FLDG (First Loss Default Guarantee), boosting overall security.
- **Achieving PSL Target:** Banks are finding it simpler to meet PSL requirements. Banks need not to purchase PSL certificates and need not bear the whole risk of credit assessment for PSL borrowers.
- **Geographical Expansion:** Banks may easily expand to multiple geographies and strengthen ties with a larger number of originators, even if they have a limited or non-existent physical presence.
- **Cherry-picking Proposals:** Banks are empowered to be selective under CLM, sanctioning only proposals that fulfil their requirements. Banks are mindful when underwriting each proposal to ensure the quality of the CLM book.

Benefits to NBFCs

- **Faster Growth:** The more co-lending partnerships there are, better the growth. The fact that NBFCs do not have to fund 100% of the loan amount enables them to explore a broader range of concepts and target various customer and asset classes, which adds to their overall growth.
- **Low Interest Rates:** Banks have the advantage of having access to the inexpensive source of funding in the economy, which NBFCs do not have. However, under the CLM, NBFCs might benefit by extending loans at lower interest rates than they were charging earlier.
- **Credibility:** Through co-lending partnerships with large banks, new-age NBFCs aiming to enter the lending market. This will establish credibility for their brand in the eyes of customers.
- **Risk Management:** Because of the risk allocation between the two partners, with banks contributing the bulk of the capital, NBFCs can limit loan losses in the event of a bad debt.
- **Diversification of Customer Base:** As the total blended cost of capital is lower under co-lending arrangement, NBFCs will profit from the ability to cater to price sensitive consumer segment.
- **Sanctioning Big-Ticket Loans:** Due to the capital support from the partner bank, the NBFC would be able to underwrite larger ticket sizes.

- **New Product Addition:** Co-lending, in addition to standard products such as term loans and pass-through certificates (PTC), can serve as a new product in NBFC offerings.

Benefits to Borrowers

- **Better Customer Experience:** Fintech and NBFCs to ensure that the customer has a pleasant experience throughout the entire process in order to keep them for a long time and cross-sell financial services in the future.
- **Lower Interest Rates:** Customers do not have to pay exorbitant interest rates and will go through a smooth lending process, as banks are on board and blended rates are lower than the interest charged by the NBFCs. Borrowers now have access to low-cost finance that was previously inaccessible.
- **Underserved customers:** CLM is a good fit for traditionally credit-deprived communities in rural regions and individuals with less credit history. However, due to CLM, unserved and underserved customers receive recourses from banks, although indirectly.
- **Knowledge Dissemination:** NBFCs and Fintechs provide a personalised experience and go beyond by educating the ultimate customer about the terms and conditions of the lending contract, thereby helping to improve the financial literacy of underprivileged customers.
- **Single Point of Contact:** Borrowers will not have to deal with different lenders since the NBFC will oversee the entire procedure.

4.7 Opportunities and Hurdles in the CLM

Opportunities in the CLM

Underserved and Priority Sector Lending: Co-lending helps to increase liquidity and credit penetration in a number of underserved sectors. As a result, the number of first-time borrowers in India may grow, hence aiding to reduce the credit gap.

Partnership between banks and NBFCs: Banks and NBFCs both play critical roles in strengthening the system by supplying funds on a consistent basis to the appropriate customers and businesses. The co-lending strategy allows two economic pillars to collaborate and complement one another's skills.

Technological Interventions: Through several fintech-led technology interventions, the CLM offers the opportunity to transform the traditional lending business into a seamless experience for customers as well as banks.

Financial Inclusion: There is a major credit gap in categories such as small and medium firms, credit to lower and middle-income individuals, rural areas, and so on. If the CLM takes off and is properly implemented, it will ensure smooth credit distribution to the unserved and underserved. The co-lending strategy is one of the best methods to close the massive credit gap existing in India.

Hurdles in the CLM

CLM is an arrangement between two business entities which are operating though not exactly in the same credit space, but sometimes compete among themselves. In the last couple of years, some of these collaborations between banks and NBFCs did not take off. The main challenge that came up was the execution at the basic level. Due to the engagement of two or more very distinct corporate organisations with diverse processes, policies, technology systems, and risk management practices, co-lending presents certain challenges. Integration of underwriting, disbursement, and collection processes may take a long time and yet fail to bridge all gaps. Greater co-ordination among lenders is required, including the seamless integration of their technological systems, not only to accomplish the CLM's objective but also to ensure a smooth customer experience. To address the operational issues faced by CLM, financial institutions may require a specialised and advanced technology infrastructure.

Complexity of the Model: CLM requires banks to disclose their credit policies for offering such loans. Furthermore, banks and NBFCs must join into a master agreement covering loan servicing and customer service. There is also a sophisticated accounting system that must be established for the three components of CLM: 80%, 20%, and 100%. Separate accounts must be kept for the bank, NBFC, and borrower. This brings additional complexity.

Demand-Supply Mismatch in the PSL Segment: Banks typically fall short on the PSL target and thus rely on NBFCs to buy their assets. The supply of PSL loans by NBFCs is significantly lower than the demand, resulting in a lopsided commercial negotiation between banks and NBFCs in favour of NBFCs. Many other earnings are also retained by NBFCs in the form of processing fees, insurance commissions, additional interest charges, cheque bouncing charges, and penal interest.

Curious Case of Blended Cost of Fund and Rate of Interest: NBFCs state that they are concerned if banks would approve a particular loan originated by them for co-lending during the pool selection process and hence cannot pass on the advantage of the blended cost to the borrower at the time of origination. This is a major worry since the uncertainty undermines the regulator's goal of co-lending at reduced interest rates, which is reflected only after successful underwriting by the bank.

NBFC Customer Segment Does Not Overlap with Bank: The credit profiles of NBFC customers are riskier for banks, and so the possibility of larger credit losses cannot be ruled out. Banks also complain about their inability to endure increased loan losses. Banks know very little regarding the credit risk of NBFC borrowers.

Regulatory Compliances are Different for Banks and NBFCs: Since the regulatory mechanism for banks and NBFCs differ, there are concerns with KYC and collateral rules. These difficulties are big hurdles and limit the growth of the CLM market.

The solution to the above discussed issues will bring huge success to CLM in India.

4.8 CLM Operational Difficulties

Particulars	Challenges
Integration between lending partners' systems	• Banks and NBFCs are likely to use different Loan Origination Systems (LOS) and Loan Management Systems (LMS), resulting in a lengthy integration procedure. Furthermore, if a bank and an NBFC collaborate with several partners, the integration procedure is repetitious, making the entire process time-consuming.
Underwriting	• When the lending partners are a bank and an NBFC, the appraisal criteria are likely to be substantially different. Banks mostly depend on standard inspections such as financial statements, ITRs, and so on, but NBFCs are more adaptable and examine alternatives. • Given the varying nature of assessments, a significant number of borrowers may fall outside of the credit sanction criteria. This might undermine the goal of financial inclusion. • As both lenders must underwrite separately, the customer's turnaround time is likely to be impacted. Furthermore, as the primary lender is a bank, the amount of monitoring is likely to be greater.
Operations Management	• Alignment of various operational departments (business, credit, and operations) at both the originator and bank are difficult, significantly affecting turnaround time (TAT).

Reconciliation	• Reconciliation problems represent a significant difficulty in expanding the CLM. A few examples of instances in which reconciliation concerns emerge. • Receipt of disbursements: reconciliation of end-user expenditures (escrow account disbursals). If the lenders agree on a repayment strategy, the bank transfers money to the NBFC. • Collection apportionment schedule between interest, principal, and charges, as well as differences in apportionment technique between banks and NBFCs. • Reconciliation of escrow collection accounts, as well as escrow accounts split between the NBFC and bank.
Repayment Schedule	• There may be cases of variance in interest computation methodology across lending partners. For example, a bank computing interest on a 365-day basis, and an NBFC computing interest on a 360-day basis. Both parties' repayment schedules differ often. • In a co-lending agreement, an NBFC is often required to keep three repayment schedules (one for each lender's individual part of the loan and one for the total loan value) for reconciliation with lenders, customers, and internal records. • The upkeep and reconciliation of these three repayment plans are difficult.
Loan Servicing	• During loan servicing, each system may function differently under various payment scenarios, including prepayment, foreclosure, part payment, multiple overdue payments, etc. This is mainly due to dissimilar apportion logics, which may result in differences in the customer's outstanding balance and, as a result, incorrect bureau reporting.
Security Creation	• It is debatable whether to impose the fee on co-lenders at the point the transaction is initiated because the bank would be a co-lender and might choose to lend only to proposals that match their policy criteria.

4.9 Major CLM types

The CLM requires both banks and NBFCs to have a board-approved policy outlining the general framework on which they will participate in co-lending agreements. The policy must be consistent with the co-lending circular and may include rules pertaining to criteria for selecting a partner bank/NBFC, services covered by CLM, security creation and enforcement, and so on. The board-approved policy is a precursor to banks and NBFCs entering into a master co-lending arrangement. Such an arrangement either require banks to take their portion of the loans originated by NBFCs onto their books (non-discretionary model) or retain the discretion to reject certain applications after doing due diligence prior to taking the loans onto their books (discretionary model). Banks and NBFCs may also agree on the terms and conditions of the arrangement, specific product lines, areas of operation, different roles and responsibilities of banks and NBFCs, appropriation of funds between banks and NBFCs, a framework for loan monitoring and recovery, customer interface, and protection issues.

Taking guidance from the RBI notification, co-lending can take one of the two forms:

Discretionary Model

The model provides that the co-lender will have the discretion to take the loan onto its books after it has been originated by the NBFC, based on its due diligence. Banks retain the discretion to reject certain applications after doing due diligence prior to taking the loans onto their books. Under the Discretionary Model, banks have the right to refuse loans even after they have been originated by the partner NBFC.

Non-Discretionary Model

Where the co-lending arrangement contemplates the prior and irrevocable commitment of the other co-lender to take its portion of the loan on its books, i.e., banks to take their portion of the loans originated by NBFCs onto their books. Banks engage in the non-discretionary model upfront, i.e., at the time of loan origination.

Based on the approach, CLM can be classified as a joint lending and reimbursement approach or on a back-to-back basis.

Joint Lending

In joint lending, both lenders underwrite the customer, and the pay out to the final customer happens with the lenders' common consent. Documents to be signed with the customer are of a tri-party nature. The specific loan exposures for each of the partners are explicitly mentioned in the master agreement between the two lending partners. However, whether or not to proceed with the loan request is at the discretion of the bank.

Reimbursement Approach or Back-To-Back Basis

The minor lender or originator (NBFC) is in charge of initial underwriting and disbursement. These loans are forwarded to the major lender in accordance with the credit policy. Under this model, the legislation regulating direct assignment becomes valid, with the exception of the provision related to the minimum holding period. Co-lender may re-assign the loan only with the full approval of the other lender. Once the loans are approved, the major lender reimburses the minor lender for their portion of the loan amount. Between the major lender and the minor lender, a master service agreement is signed. Because of its operational convenience, market trends indicate that this model is the most widely used approach.

4.10 Blended/Weighted Average Interest Rate Calculation under CLM

The ultimate borrower may be charged an amount agreed upon by both the lenders, subject to the existing guidelines that apply to both. In the event of a fixed rate of interest, an all-inclusive rate is offered to the borrower based on the relevant interest rate and proportion of risk sharing. In case of a variable interest rate scenario, a weighted average of the benchmark interest rate in proportion to risk sharing is changed. The interest rate levied by the bank will be subject to the applicable interest rate on advances. Furthermore, NBFCs would be expected to follow credit pricing and other applicable lending rules for their loan commitments. The benefit of low-cost financing of banks and reduced cost of operations of NBFCs is passed on to the final recipient via the all-inclusive rate or weighted average rate. However, the breakdown of the all-inclusive interest rate, such as the rate charged by the bank and the rate charged by the NBFC, does not have to be reported to the borrower.

Scenario 1: Fixed Interest Rates

Blended Interest Rate Calculations	**Case I**	
	Bank	**NBFC**
Benchmark Interest Rate	8%	9%
Spread	2%	3%
Interest rate to customers	10% (A)	12% (B)
Loan contribution ratio	80% (C)	20% (D)
Blended interest rate (A*C) + (B*D) = E	10.40%	

Scenario 2: Floating Interest Rates

Change in the weighted average interest rate	Case II	
	Bank	**NBFC**
Benchmark Interest Rate	8% (A)	9% (B)
Loan contribution ratio	80% (C)	20% (D)
Weighted average benchmark interest rate (X = A*C + B*D)	**8.20%**	
Spread	2% (E)	3% (F)
Weighted Average Spread (Y = E*C+F*D)	2.20%	
Weighted Average interest rate offered to the customer at the time of disbursement (X + Y)	10.40%	
Change in Benchmark Rate	0% (F)	+1% (G)
Revised Weighted Average Benchmark Interest Rate X' = [(A+F)*C + (B+G)*D]	8.40%	
New Weighted Interest Rate (X' + Y)	10.60%	

4.11 Selected Bank-NBFC CLMs

A Few Selected Bank-NBFC CLM Tie-ups			
Sl. No.	**Bank**	**NBFC/HFC/Fintech**	**Sector**
1.	Bank of Baroda	U GRO Capital	SME
2.	IDBI Bank	U GRO Capital	SME
3.	Bank of India	MAS Financial Services	SME
4.	Yes Bank	PNB Housing Finance	Housing
5.	State Bank of India	Paisalo Digital	Agri
6.	Yes Bank	Indiabulls Housing Finance	Housing
7.	Yes Bank	PNB Housing Finance	Housing
8.	Central Bank of India	Indiabulls Housing Finance	Housing
9.	Central Banks of India	IIFL Home Finance	Housing
10.	Indian Bank	Indiabulls Housing Finance	Housing
11.	Indian Bank	IIFL Home Finance	Housing
12.	Punjab National Bank	IIFL Home Finance	Housing
13.	Punjab & Sind Bank	Indiabulls Home Finance	Housing

A Few Selected Bank-NBFC CLM Tie-ups			
Sl. No.	**Bank**	**NBFC/HFC/Fintech**	**Sector**
14.	State Bank of India	Vedika Credit Capital Limited	Agri
15.	State Bank of India	Save Microfinance Private Ltd.	Agri
16.	State Bank of India	Spice Money Ltd.	All
17.	State Bank of India	Nava Chetana Microfin Services	Agri
18.	State Bank of India	Uttrayan Financial Services	Agri
19.	State Bank of India	Inditrade Microfinance Pvt. Ltd.	Agri
20.	State Bank of India	Samunnati Financial Intermediation Services Pvt Ltd	Agri
21.	State Bank of India	Adani Capital Private Limited	Agri
22.	State Bank of India	Capri Global Capital Limited	SME
23.	State Bank of India	U Gro Capital Ltd.	SME
24.	State Bank of India	Edelweiss Housing Finance Limited	Housing
25.	State Bank of India	Cashpor Micro Credit	Agri
26.	State Bank of India	Midland Microfin Ltd.	Agri
27.	State Bank of India	Autotrac Finance Ltd.	Agri
28.	State Bank of India	Swaman Financial Services Pvt. Ltd.	Agri
29.	State Bank of India	Arth Micro finance	Agri
30.	State Bank of India	Avanti Finance Pvt. Ltd.	Agri
31.	State Bank of India	Unacco Financial Services	JLG
32.	State Bank of India	CreditAccess Grameen	JLG
33.	State Bank of India	Fusion Microfinance	JLG
34.	State Bank of India	Belstar Micro Finance Ltd.	SHG
35.	State Bank of India	Arohan Financial Services Ltd.	JLG
36.	State Bank of India	Janakalyan Financial Services	JLG
37.	State Bank of India	Humana Finserve	JLG
38.	State Bank of India	Buldana Urban Management Services	JLG
39.	State Bank of India	New Opportunity Consulting (NOCPL)	JLG/SHG
40.	State Bank of India	Adhikar Microfinance	JLG/SHG
41.	State Bank of India	Chaitanya India Fin Credit Pvt. Ltd.	JLG
42.	State Bank of India	Madura Microfinance	SHG
43.	State Bank of India	Magnot Consultancy Services Pvt. Ltd.	Gold
44.	State Bank of India	Drishtee Development and Communication Ltd.	All
45.	IndusInd Bank	Indel Money	JLG
46.	Karur Vysya Bank	Chola Financial Services	All
47.	State Bank of India	NICT Technology Pvt. Ltd.	All
48.	Indian Bank	Indiabulls Commercial Credit	SME

A Few Selected Bank-NBFC CLM Tie-ups			
Sl. No.	Bank	NBFC/HFC/Fintech	Sector
49.	State Bank of India	Vedika Credit Capital Ltd.	Agri
50.	Yes Bank	WheelsEMI	2-Wheeler
51.	State Bank of India	Vaya Finserve	SHG/JLG
52.	State Bank of India	Pahal Finance	JLG/SHG
53.	State Bank of India	Jagaran Microfin Pvt. Ltd.	JLG/SHG
54.	State Bank of India	Grameen Shakti Microfinance	JLG/SHG
55.	State Bank of India	MSM Microfinance	JLG/SHG
56.	State Bank of India	GU Finance	JLG/SHG
57.	State Bank of India	Disha India Micro Credit	JLG/SHG
58.	State Bank of India	Kamal Fincap	JLG/SHG
59.	State Bank of India	Taraashna Financial Services (Satin)	JLG/SHG
60.	State Bank of India	Arth Microfinance	JLG
61.	State Bank of India	Midland Microfin	JLG
62.	State Bank of India	Namra Finance	JLG
63.	State Bank of India	Navachetana Microfin Services	JLG
64.	State Bank of India	Avanti Finance	JLG/SHG
65.	State Bank of India	Red Craft Management Consultancy	All
66.	State Bank of India	Tru Cap Finance (formerly Dhanvarsha)	Gold
67.	State Bank of India	RupTok	Gold
68.	State Bank of India	India Gold	Gold
69.	State Bank of India	FIA Technology Services Pvt. Ltd.	All
70.	State Bank of India	Gram Tarang Inclusive Development Services Pvt. Ltd.	All
71.	State Bank of India	Dvara E-Registry	All

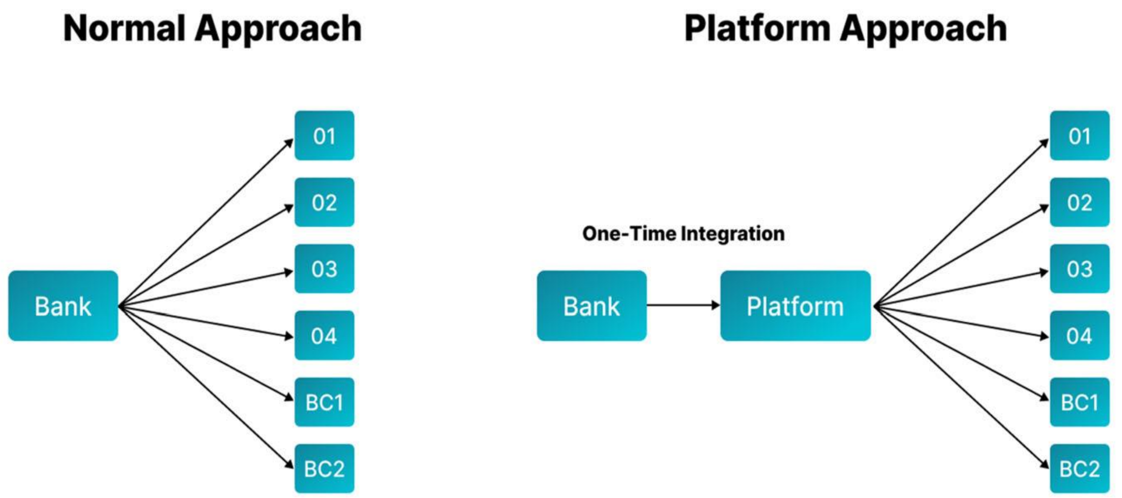
4.12 Role of Fintech in CLM Process Flow

Several Fintechs have been active in the CLM space to provide solutions to the banks and NBFCs at an operational level. From sourcing to underwriting to escrow management, services are taken care of by the Fintech platform providers. In the past few years, India's digital infrastructure has seen a slew of developments, including UPI, Digi-locker, e-KYC, e-Sign, account aggregators, and others, which have significantly increased the possibilities to success of CLM. However, the entire usefulness of CLM is dependent on elements such as improved credit profiling accuracy, reduced borrowing costs, shorter TATs, lower credit risk, greater operational flexibility, and more comfortable payback schedules, among others.

While lenders can set up the infrastructure for co-lending, integration issues and operational difficulties act as roadblocks, delaying the system's activation and subsequent scale-up. When a lender and an originator team up on a co-lending platform, it is best for both sides if they can establish regulations particular to their collaboration.

Fintech players are supporting banks and NBFCs through their sophisticated platforms. These platforms provide flexibility in terms of operations to both lenders. The platform's architecture backbone allows for a scalable plug-and-play solution for all lenders. Platforms lay the groundwork for a digitally seamless connection between lenders across the origination, credit sanctioning, document verification, disbursement, and reporting processes.

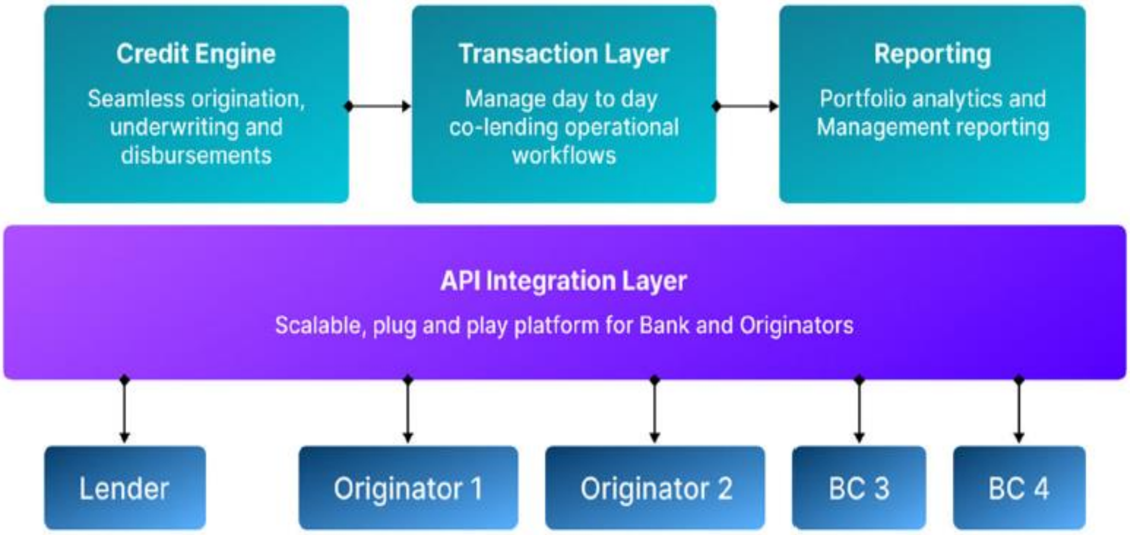
CLM platforms connect NBFCs and banks to disburse joint loans to borrowers. Fintech platforms provide quick loan discovery and seamless loan processing between NBFCs and banks. It also manages all the compliance and splitting requirements for the entire Co-lending ecosystem. The platform supports NBFCs being identified by banks in order to satisfy loan origination requirements. Furthermore, with a clear credit rating module and co-lending partners across many sectors, banks are using this platform to locate NBFCs that fit their parameters. Some of the other services provided by the Fintech in the CLM are seamless integration, alignment of originators' & lenders' credit appraisal, end-to-end operation, a complete portfolio management & monitoring solution, etc. A strong digital stack has the ability to assist co-lenders in developing a totally paperless process, which drastically reduces overall application processing time. The existing platform architecture of fintech is presented below.



Some of the services provided by fintech companies to banks and NBFCs include the following:

- One-time API integration to streamline data flow across numerous lending partners.
- Rich data analytics and reporting for a 360-degree perspective of the customer lifecycle journey.
- A workflow builder that allows to create extremely flexible and agile borrower journeys with just a few steps.
- Straight Through Processing (STP) for a completely automated, paperless journey
- Partner onboarding and management for a seamless co-lending experience
- Pre-screening functionality with checks such as Aadhar, PAN, CIBIL, Experian, and many others, and
- A robust debt recovery platform to minimise loan delinquencies and maximise collections.

The below picture shows the API-based architecture for quick integration with lending ecosystem enablers.



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CHAPTER V

SURVEY ANALYSIS: COMMERCIAL BANKS & NBFCS

The views of the Bank/NBFC/HFC/Fintech authorities were ascertained, and observations were recorded through an objective and subjective questionnaire. Apart from the structured questionnaire, the functionaries of the lending partners dealing with CLM were interviewed. The questionnaires are designed in consultation with officers from Banks, NBFCs and academicians to cover all aspects of the CLM. Feedback obtained through the questionnaire and informal interaction/interview method is analysed as follows:

5.1 Survey Analysis: Commercial Banks

5.1.1 Surveyed Commercial Banks

A total of sixteen (16) Banks which are into the CLM business, covering, nine (9) Public Sector Banks and seven (7) Private Sector Banks are surveyed for the study. Though every attempt is made in seeking the feedback of the banking universe, several banks have shown reluctancy in sharing the feedback on the CLM business.

Surveyed Banks	
Public Sector Banks	**Private Banks**
1. State Bank of India	10. HDFC Bank
2. Bank of Baroda	11. ICICI Bank
3. Central Bank of India	12. Kotak Mahindra Bank
4. Union Bank of India	13. Axis Bank
5. Punjab National Bank	14. Federal Bank
6. Bank of India	15. Yes Bank
7. Punjab and Sindh Bank	16. Karnataka Bank
8. Bank of Maharashtra	
9. Canara Bank	

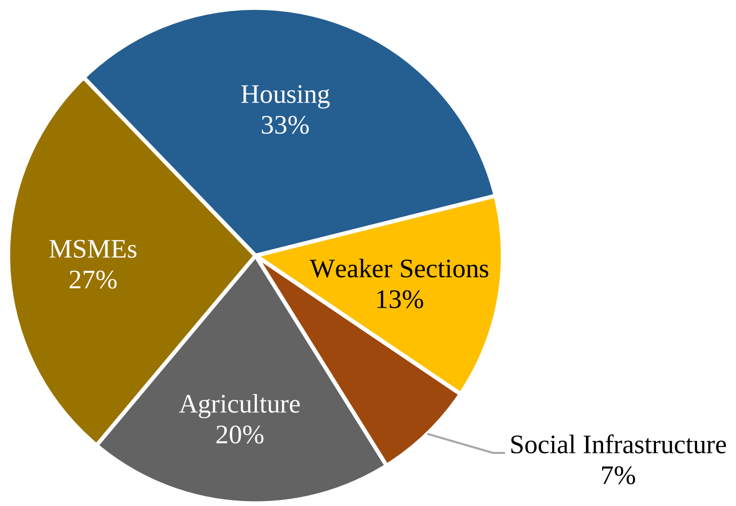
5.1.2 Number of CLM tie-up of Banks

It is observed that, on average, commercial banks have a tie-up with seven (7) NBFCs in CLM, where SBI leads with 15 tie-ups, followed by the Central Bank of India (11). Private banks have onboarded a relatively smaller number of NBFCs in CLM. HDFC Bank and ICICI Bank have onboarded one (1) and five (5) NBFCs in their co-lending businesses, respectively.

5.1.3 Preferred sub-sectors under Priority Sector for Co-Lending Tie-ups

Among the various sub-sectors under the priority sector domain (export credit, education, renewable energy, weaker sections, start-ups, social infrastructure, agriculture, MSMEs, and housing) where the CLM is allowed, as per the survey response, 33% of the CLM tie-ups are in the housing sector, followed by MSMEs (27%), and agriculture (20%). CLM tie-ups in weaker sections and social infrastructure were 13% and 7%, respectively. The dominance of CLM tie-ups in the housing sector is getting prominent and is seen as the most preferred CLM tie-up for banks.

Sub-sectors under Priority Sector for Co-Lending Tie-ups

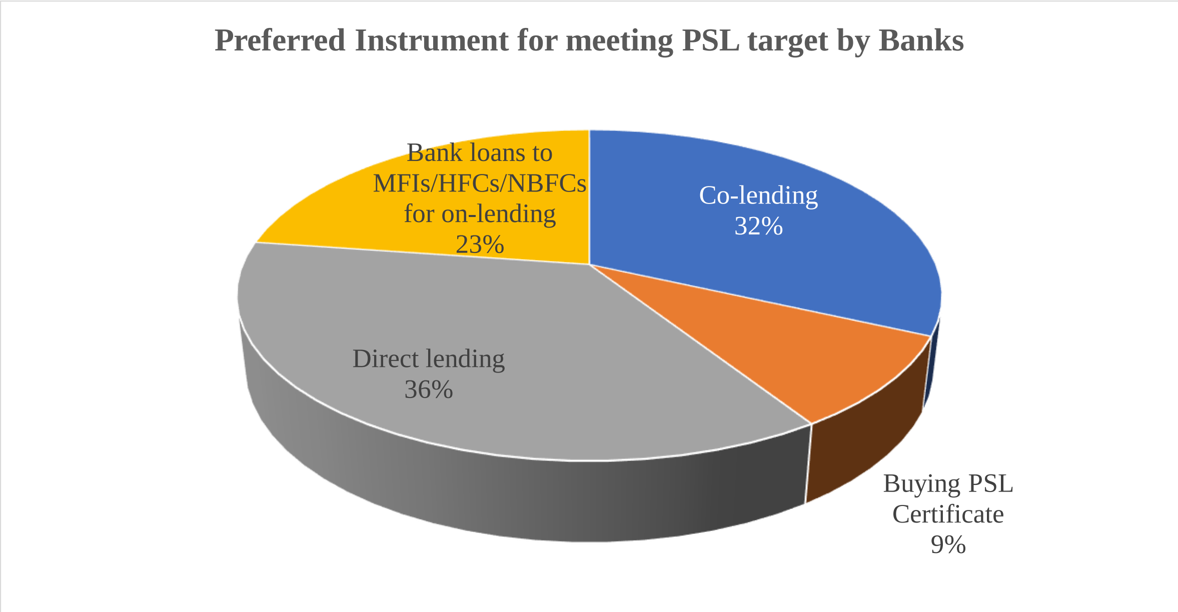


5.1.4 Preferred Instrument for Banks in Meeting PSL Target

As per the RBI guidelines, domestic commercial banks (excl. RRBs and SFBs) and foreign banks with 20 branches and above are to meet the target of 40% of ANBC or CEOBE, whichever is higher. There are various instruments available to banks to meet the PSL target. Those include investments by banks in securitization notes, transfers of assets through direct assignment or outright purchase, inter-bank participation certificates, priority sector lending certificates, bank loans to MFIs for on-lending, bank loans to NBFCs for on-lending, bank loans to HFCs for on-lending, and finally co-lending by banks and NBFCs.

Among the various options available to banks in meeting the PSL target, direct lending is seen as the most preferred instrument (36%), followed by co-lending (32%), and bank loans to

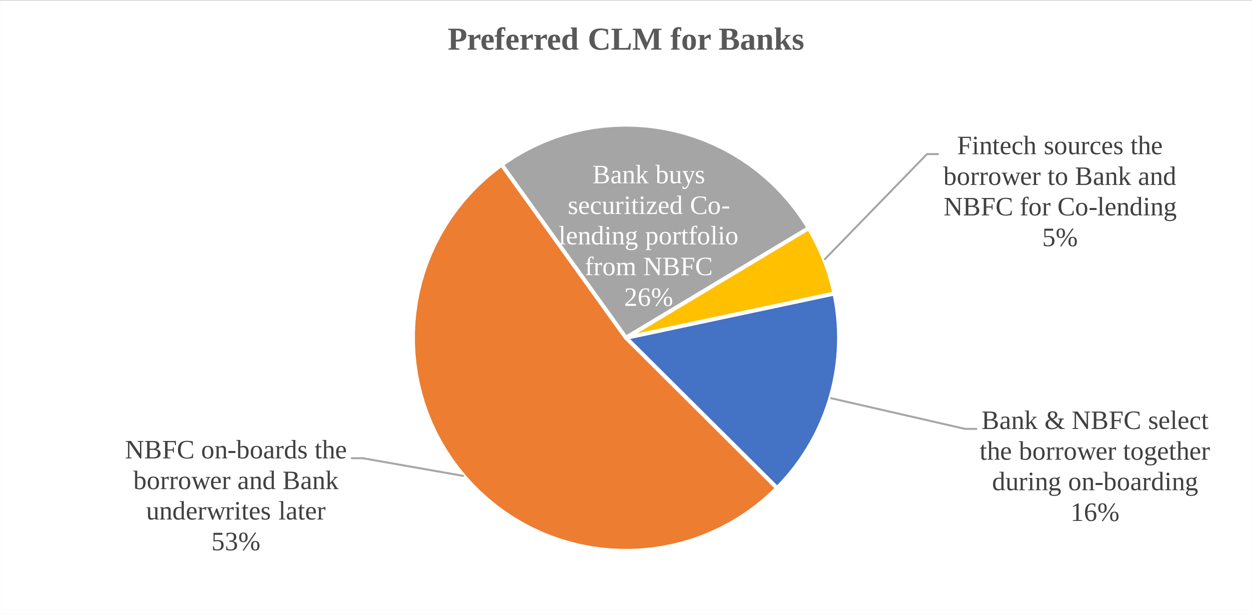
HFCs, NBFCs, and MFIs (23%). It is opined that buying PSL certificates is the least preferred instrument for meeting the PSL target of commercial banks. However, going forward, with the stabilisation of the CLM, we may see a shift in the behaviour of commercial banks in meeting the PSL target by focusing more on the CLM and reducing direct lending as well as lending to MFIs, HFCs, and NBFCs to meet the PSL target. Buying a PSL certificate is only treated as a last resort in meeting the PSL target.



5.1.5 Preferred CLM for Banks

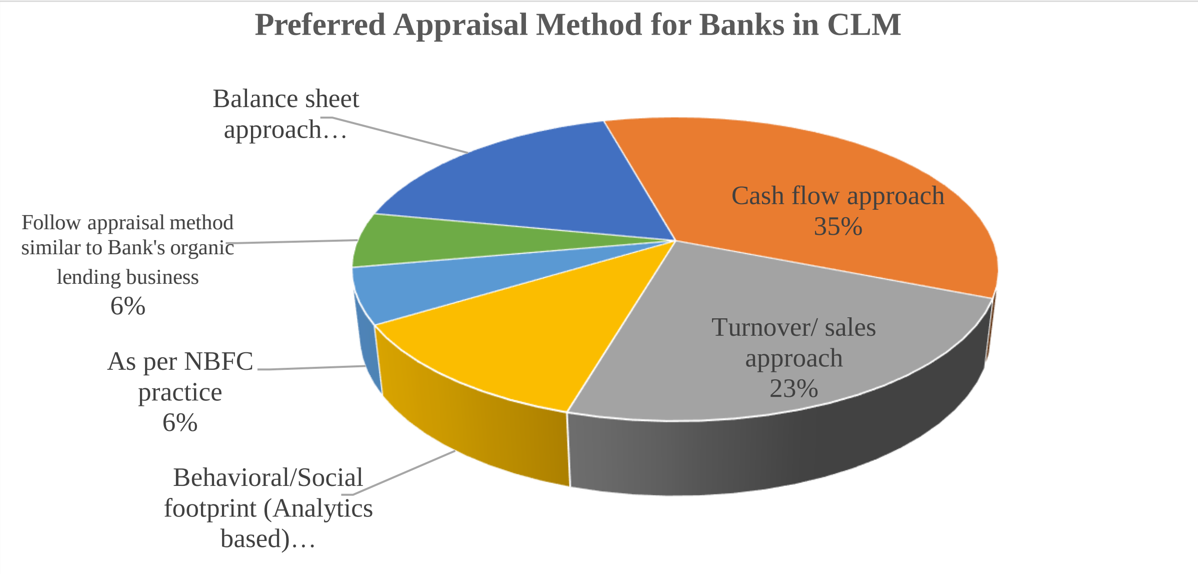
While assessing the preferred CLM option of banks, out of the four widely discussed models, the one where NBFCs onboard the borrower and banks underwrite the loan later is considered the most preferred model in the CLM. This is followed by the earlier practise of banks buying securitized co-lending portfolios from NBFCs. Bank & NBFC selecting the borrower together during on-boarding is opined as the third preferred model, followed by Fintech sources the borrower to bank and NBFC for co-lending.

As CLM can take one of the two forms: non-discretionary (where the co-lending arrangement contemplates the prior and irrevocable commitment of the other co-lender to take its portion of the loan on its books) or discretionary (where the other co-lender will have the discretion to take the loan on its books after the loan has been originated by the NBFC), based on their due diligence, banks are strategically shifting their preference from a non-discretionary to a discretionary CLM framework.



5.1.6 Preferred appraisal methods for banks in co-lending

In response to the question of the preferred appraisal methods for banks in CLM, the cash flow approach is voted as the most widely used appraisal method, followed by the turnover/sales approach. Balance sheet approach and behavioural/social footprint (analytics based) approach are considered as the third and fourth widely used method for CLM appraisal by banks.

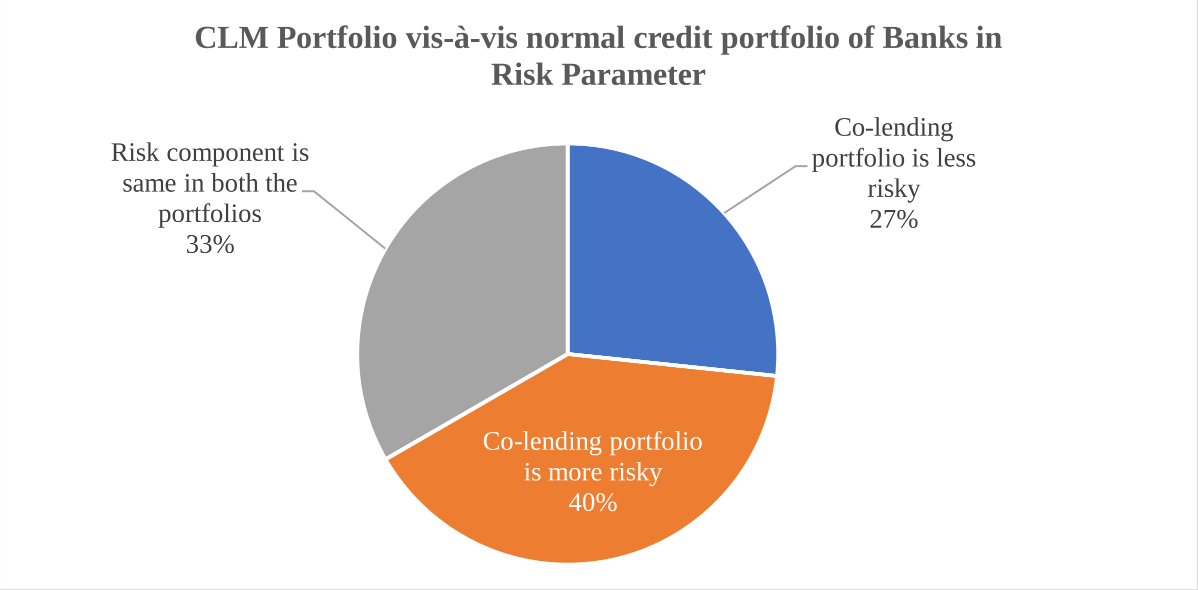


5.1.7 Average Blending Rate in the CLM Portfolio

As per the response received, the average blending rate in the CLM portfolio of commercial banks is reported at 10.95%, with the lowest being 9% and the highest being 15%. However, the yield to the bank depends on the asset class. Moreover, average yield is based on the weighted average rate of each segment of lending.

5.1.8 Co-lending Portfolio vis-à-vis Normal Credit Portfolio of Banks in Risk Parameters

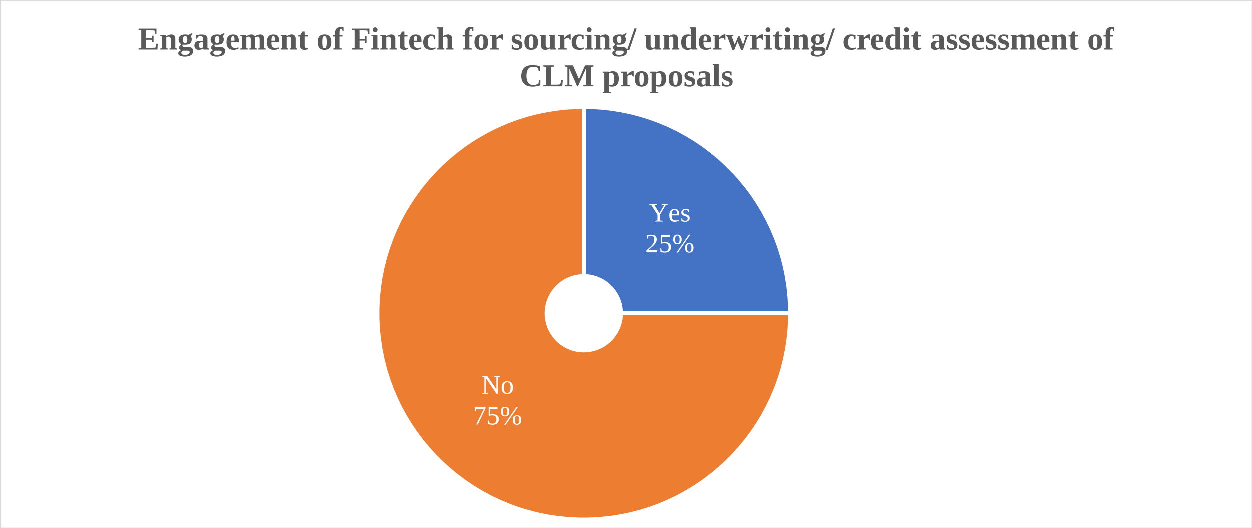
While assessing the CLM portfolio of commercial banks in terms of the risk parameter, 40% of respondents opined that the CLM portfolio is riskier than the normal credit portfolio of their bank. However, another 33% of respondents believed that the risk component is same in both portfolios, followed by another 27% who believed that the CLM portfolio is less risky. While sharing the reasons, it has been said that in the case of the non-discretionary model, CLM is considered to be riskier compared to the discretionary model.



5.1.9 Engagement of Fintech for Underwriting/Credit Assessment of CLM Proposals

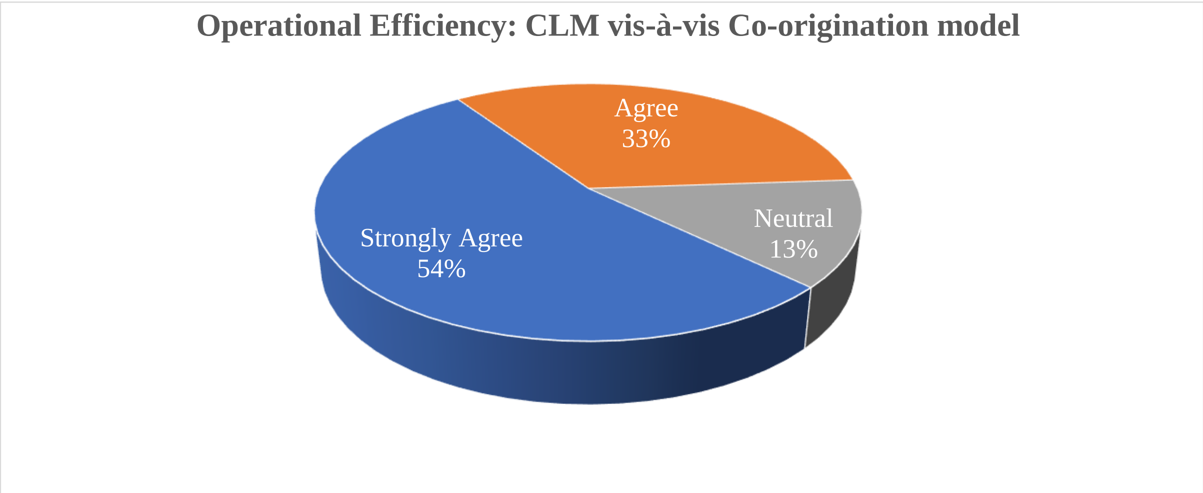
As most of the NBFC proposals do not fit into commercial banks' traditional credit appraisal process, a few commercial banks are engaging Fintech for sourcing/ underwriting/ credit assessment of CLM proposals. However, the ratio of such engagement is only 25%. Moreover, Fintech engagement is seen among both PSBs and private banks.

While understanding the reason and area for fintech tie-ups, it is observed that fintech engagement aims at sourcing, underwriting, collections, etc. Again, a few players have made arrangements for the sourcing of CLM proposals via Fintech, but it is still not considered as a broader strategy. Fintech engagement has also been attributed to some other angles, as some of the Fintech are subsidiaries of certain NBFCs, and hence the group company or parent company onboards the Fintech for sourcing and collection activities. In general, it has been said that the involvement of fintech in the co-lending space may rise in the coming days given the enablers provided by the fintechs.



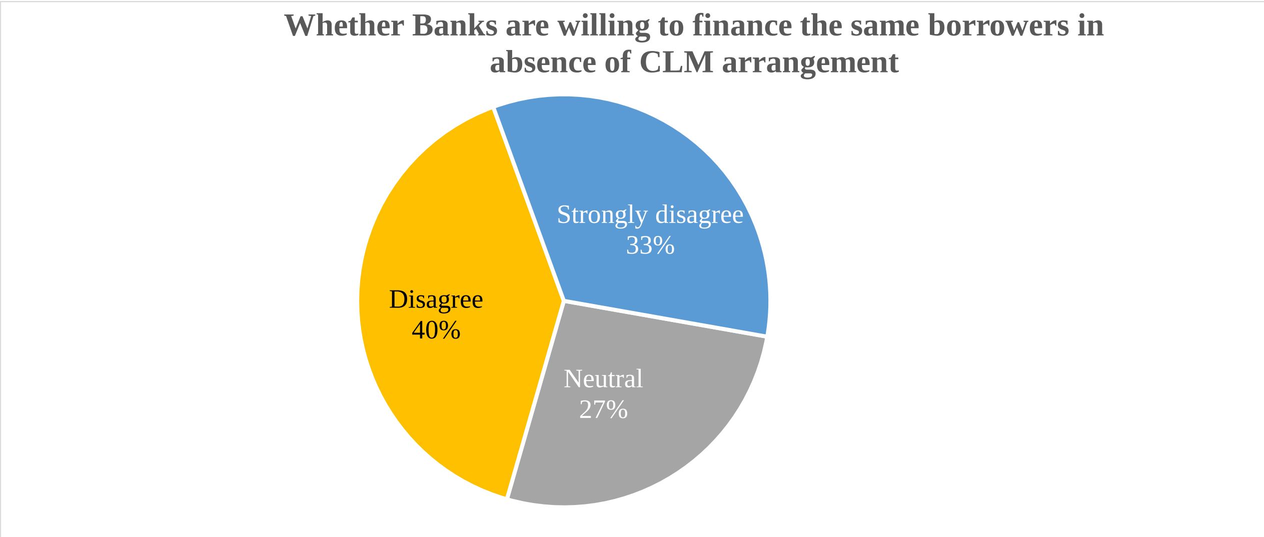
5.1.10 Operational efficiency: CLM vis-à-vis Co-origination Model

In comparison to the earlier model of co-origination, where only a few selected, systemically important non-banking financial companies (NBFC-ND-SIs) were permitted to co-lend with banks, 54% of respondents strongly agreed that CLM encompasses more operational efficiency compared to the earlier co-origination model, while another 33% agreed that CLM encompasses operational efficiency compared to the co-origination model. 77% of respondents opined that CLM encompasses more operational efficiency compared to co-origination model. 13% of respondents were neutral and chose not to comment, as a majority of those have not been to any NBFC tie-ups in the earlier co-origination model.



5.1.11 Whether banks prefer financing the same borrowers in the absence of a CLM arrangement

In response to the question of whether banks are willing to finance the same borrowers in the absence of CLM, the responses were in line with negation. Though only 27% were neutral and opined that their decision ultimately depends on borrowers' credit quality, another 73% opined that they would not finance the same borrowers in the absence of a CLM arrangement due to the increased risk profiling of the borrowers.



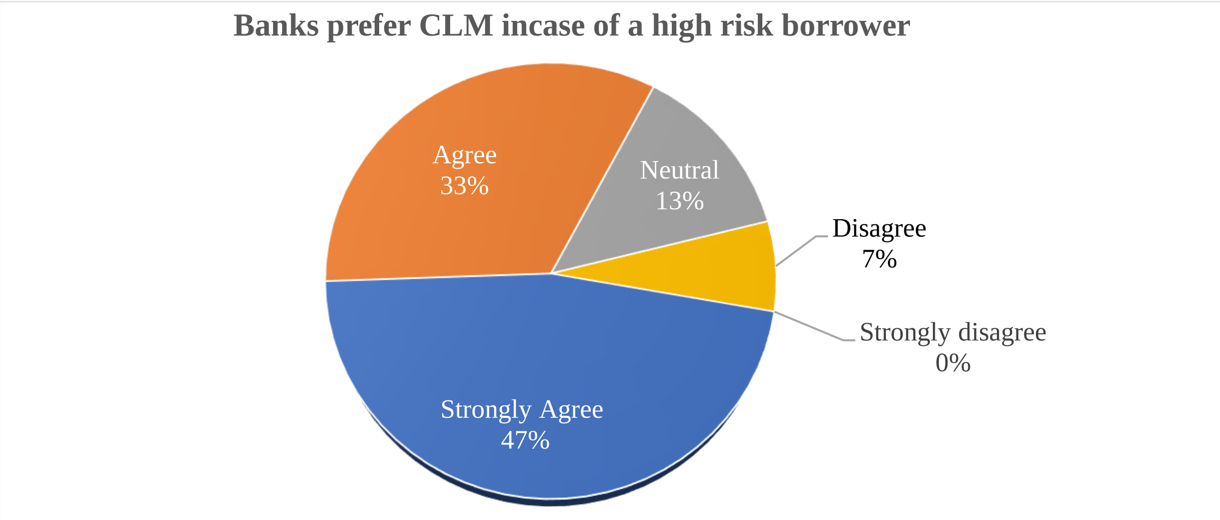
Some of the reasons for banks not to solely finance these CLM borrowers in the absence of a CLM arrangement are as follows:

- NBFCs have entered earlier unreached markets and created a niche for themselves. Even though these markets are riskier as per the banks' treatment, NBFCs manage them efficiently and differently than the other markets.
- NBFCs have been venturing into hitherto underserved markets, which may be risky but are managed differently and efficiently by them. Therefore, lending to these segments through joint participation is a preferred option for banks.
- In the credit ecosystem, diverse customers are served by diverse financial institutes. The NBFC customer segment is very different from that of banks. Synergizing on strengths could reduce eventual costs and default.
- The customer segments and geographies underwritten by banks generally are different from what is underwritten under CLM business.
- If the customer segment is at the same level and meets the policy requirements of the banks, then the banks may self-underwrite the same borrower.
- The NBFC's niche expertise in collections and underwriting certain niche customer segments helps banks rely on field investigation and customer interaction done by the NBFCs. As Banks do not have the mechanism to follow the process like NBFCs, refraining from this market is considered as better.
- The efficient collection mechanism of NBFCs gives a breather to banks, and without CLM, proposals are very risky, as hard recovery is prohibited for banks.

- The credit underwriting processes of banks and NBFCs are different. Hence, customer acceptance criteria are different, and what is best for NBFCs may not be so for banks.
- NBFCs have advanced credit appraisal tools. They compromise on borrowers' credit quality (CIBIL score) and are more concerned with margin, and the efficient collection mechanism is their strength, which is not possible for banks.
- Mostly subprime customers are assumed to be part of the pool; hence, they get rejected under the bank's credit assessment process.

5.1.12 Whether Banks prefer CLM in case of high-risk customer(s)

As most of the banks are of the opinion that the risk profile of CLM borrowers is not aligned with their credit policies, understanding the preferred model of banks for these high-risk sub-prime borrowers is important. While 80% of the respondents agreed that for high-risk sub-prime customer, CLM is their preferred model, 13% were neutral, followed by another 7% who disagreed, arguing that if the borrower is sub-prime, they would never extend credit, neither in direct lending nor in CLM.



While justifying their response, respondents have supported their response under the following points.

- Banks are in the CLM business to cater to the segments and geographies that are not covered under their direct business. Banks wish to explore opportunities in these customer segments through CLM only.
- CLM may allow banks to tap geographies or target customer segments where they are not operating currently and NBFCs are flourishing.
- Banks' reliance on credit assessment and the efficient collection mechanisms of NBFCs are the keys to dealing with high-risk borrowers.

- As the behaviour of these borrower segment differs from the bank's own book, banks underwrite higher risk under CLM than their own book, assuming that the delinquency might be on the higher side, which needs to be appropriately priced.

5.1.13 Banks' Opinion about the Scope of the CLM in India

While banks are asked to share their opinion about the scope of the CLM in India, almost all respondents have opined that they see tremendous scope for the CLM in the future. However, they have highlighted certain points to further CLM in India.

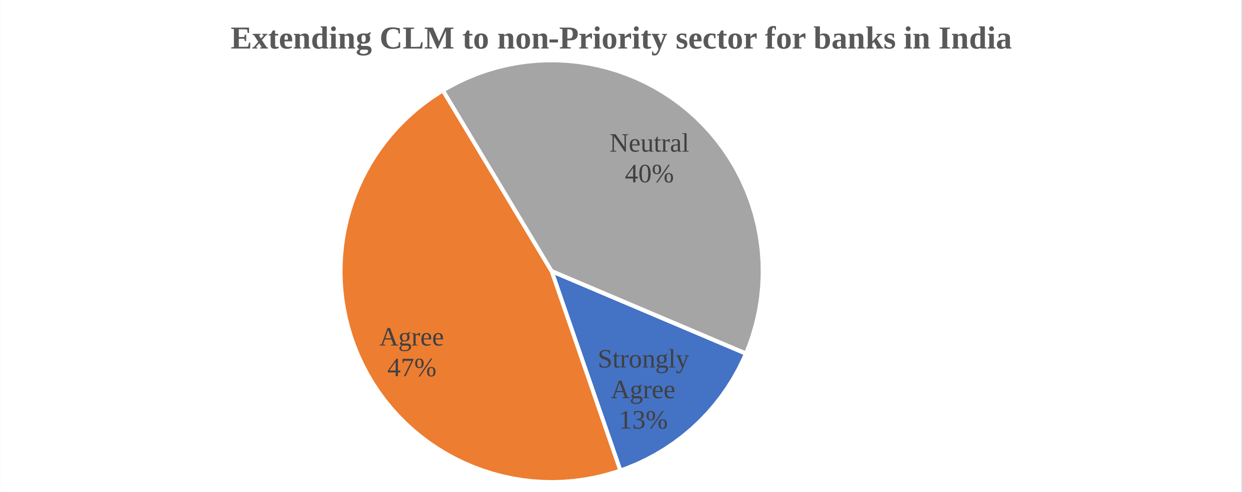
- The CLM might grow in the Indian market provided NBFCs start seeing the partnership as an ongoing and for the long-term. Banks have observed that NBFCs continue business under this arrangement temporarily when there is a liquidity crunch and revert to their on-book lending as soon as the liquidity situation improves.
- The scope of the CLM is based on the mutual needs of banks and NBFCs and is lucrative for those banks that are looking to explore newer markets which are already penetrated to some extent by NBFCs. At the same time, NBFCs willing to manage their available capital more efficiently can tap this market segment.
- The scope for middle-level NBFCs with a reasonable understanding of their markets who wish to increase their return on equity (ROE) through financial participation with banks is high.
- Most of the small and medium-sized NBFCs are coming forward for participation as they are capital-starved. The big NBFCs with strong capital base are least interested in the CLM.
- The CLM has enormous scope to grow in the coming days. But the model is still evolving and needs time to grow.
- Importantly, it is observed that the number of arrangements signed between banks and NBFCs is much higher than the actual number of arrangements that are operational. The regular attempt to accommodate the ineligible customers from the NBFC's side is restricting trust and leading to a higher rejection ratio.
- The ROE expectation for both NBFCs and banks for the portfolio built should be at par with the successful and sustainable relationship under the CLM. The normal trend is that the NBFC's ROE expectation is 2-2.5 times that of the banks.
- Currently, the mid-sized NBFCs are only looking at CLM as an opportunity to meet their regulatory requirements and always prefer to do business on their own.

- The underwriting practises and SOPs followed by the NBFCs are not at par with those of the banks, which carries a reputational risk. Without a common underwriting practice, the CLM may not prosper.
- Since banks are doing credit underwriting at a case-by-case basis and incurring additional operational expenses, the blended rates are getting higher. This is defying the objective of CLM, i.e., to pass on the advantage of the bank's lower cost of funds to priority sector borrowers.

Operational challenges are hampering the synchronisation processes between the partners. Until NBFC follows the similar SOP as the banks, CLM may not gain traction.

5.1.14 Extending the CLM to Non-Priority Sectors

While assessing the appetite for CLM from the banks' side, the survey sought bankers' opinion about extending the CLM to non-priority sectors. 60% of the respondents shared affirmative feedback, of which 13% strongly agreed. A big chunk of 40% of respondents were neutral, as the existing scheme is still evolving, and they are of the opinion that the NPA level of these loans may widen, further hampering the bank's commitment. Given the immense scope of retail credit for banks, CLM may be treated as a second choice.



5.1.15 Important Factors of Consideration for Banks while Pricing the CLM

As bankers are of the opinion that CLM is riskier compared to their normal credit portfolio, they charge a higher premium when pricing the CLM proposals. Some of the factors banks emphasise while pricing the CLM proposal are as follows:

- Risk premium
- Risk underwritten by the bank
- Service fee
- Track record of the NBFC
- Bank's cost of funds
- Credit manpower cost
- Operational cost
- Costs pertaining to audit
- Return requirement
- Underlying securities
- Past credit losses of NBFCs
- All other factors as per normal lending
- Business model of NBFCs
- Loan tenure
- NBFC's delinquency trend in the overall book & customer segment
- Net Credit Loss on the basis of CLM policy & customer segment

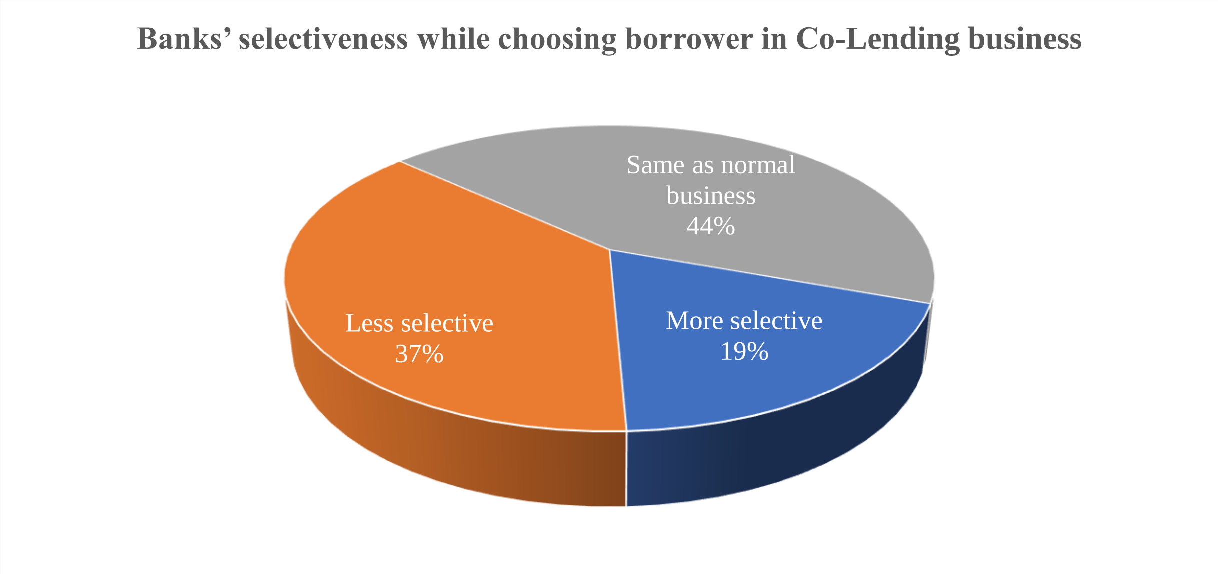
5.1.16 Activities and Respective Stakeholders in the CLM

As each CLM proposal goes through various stages of assessment, the study aimed to evaluate the activity segregation between banks and NBFCs in CLM. As per the respondents' opinions, underwriting and sanctioning are simultaneously undertaken by both banks and NBFCs, whereas post-sanctioning, follow-up, and recovery are handled by NBFCs.

Activity	Stakeholder(s)			
	Bank	**NBFC**	**NBFC & Bank Simultaneously**	**Bank & Fintech**
Borrower selection	-	80%	20%	-
Underwriting	-	-	95%	5%
Sanction	-	-	100%	-
Post sanction & follow up	-	90%	10%	-
Recovery	-	100%	-	-

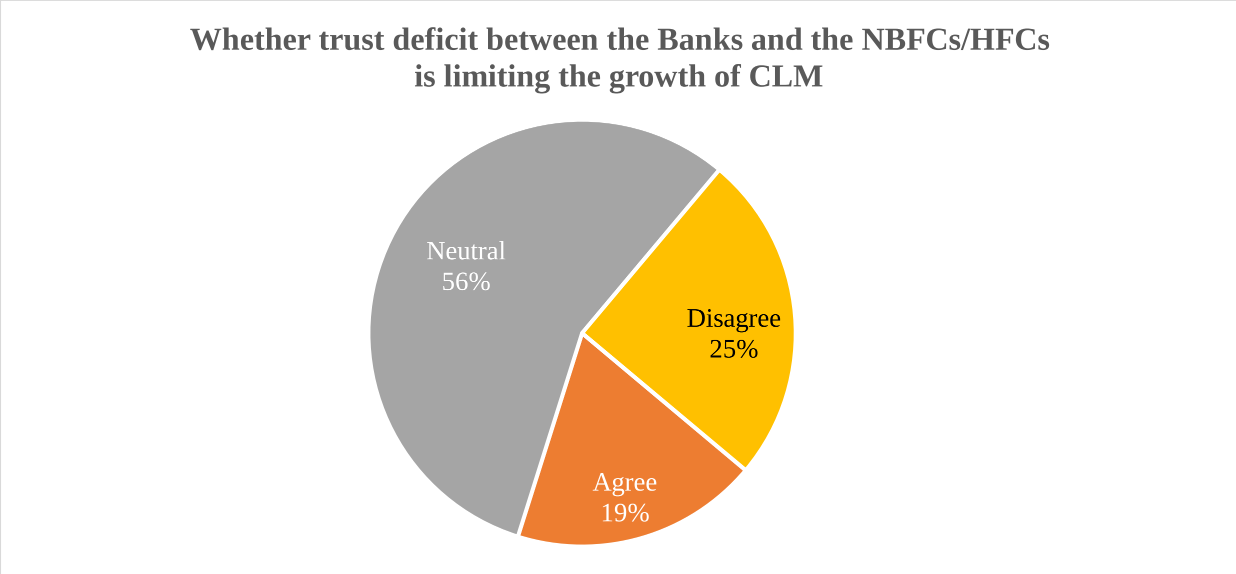
5.1.17 Banks' Selectiveness while Choosing Borrower in CLM

In response to the question of how selective banks are in choosing the CLM borrower, 44% of respondents opined that banks treat CLM proposals the same as normal business. However, another 37% opined that they are less selective as proposals are already sourced and underwritten by NBFCs/HFCs. Banks prefer to conduct due diligence as per the approved norms of the bank-NBFC agreement. Only 19% of the respondents opined that they are more selective because, given their experience, they find NBFCs' sharing proposals deviating from the agreed terms.



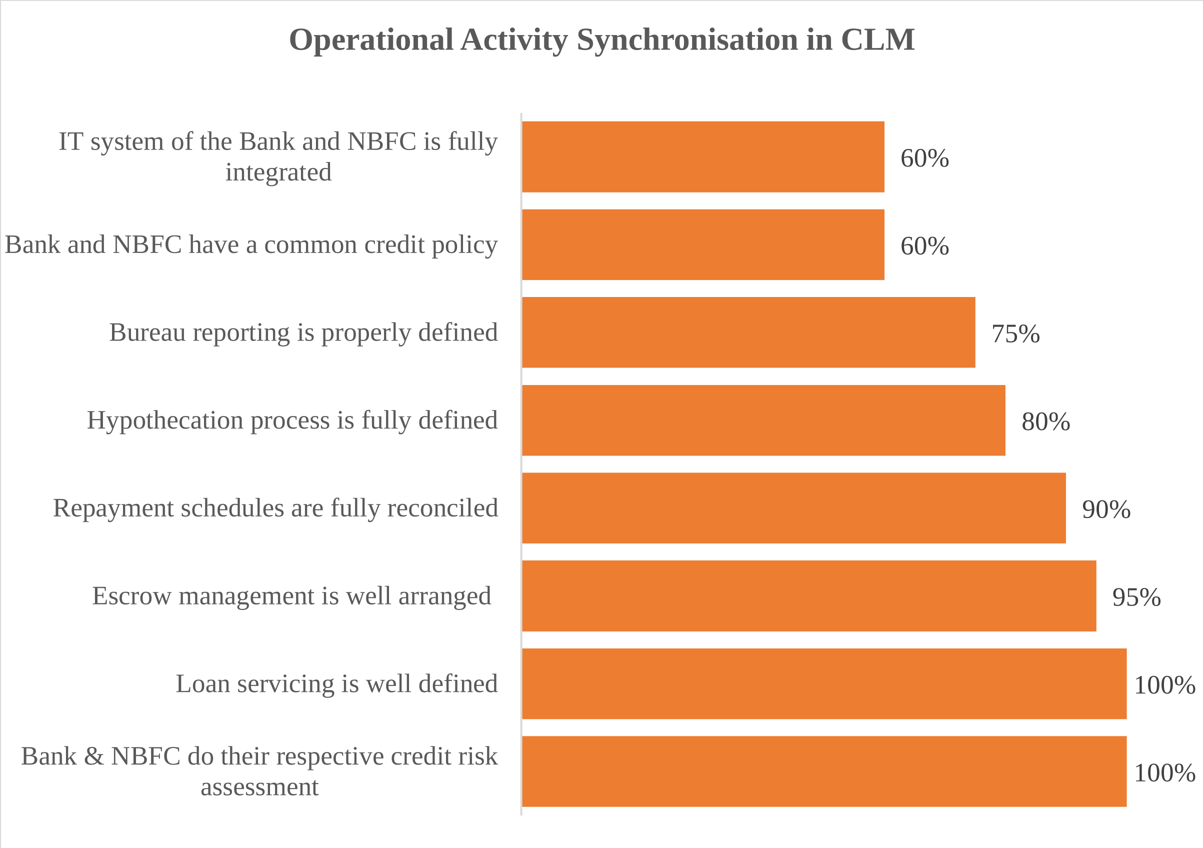
5.1.18 The Role of the Trust Deficit between Banks and NBFCs in the Growth of the CLM Market

In response to the question of whether the trust deficit between the banks and the NBFCs is limiting the growth of CLM, 56% of respondents have been neutral and have preferred not to comment on the same. The respondents are of the opinion that, as banks have the option to underwrite, they go by their credit assessment process. Proposals not fitting into bank's assessment are straightforwardly rejected, and there is no question of trust. Apart from CLM, in normal underwriting too, the decision is always based on credit assessment, so trusting NBFC/ HFC partner is immaterial. While 25% of respondents disagreed, the rest, 19%, agreed that the trust deficit between banks and NBFCs is hindering the growth of the CLM market. Hence, we have not received any clear communication regarding asymmetric information limiting the growth of the CLM market.



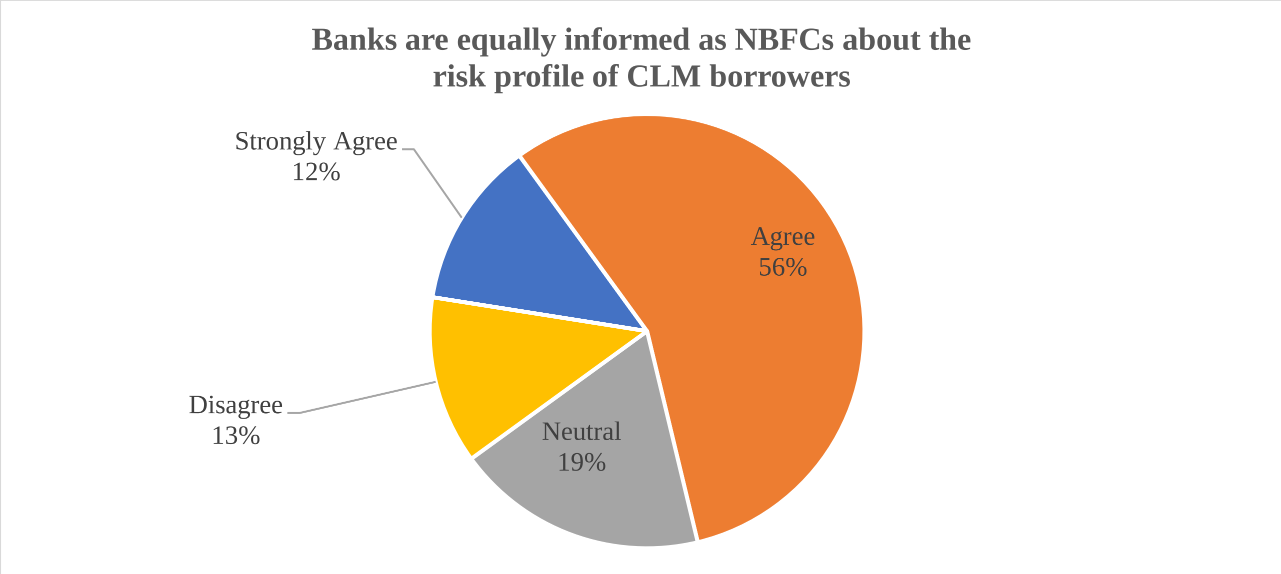
5.1.19 Facilities Stabilized at Operations Level Between Banks and NBFCs in CLM

Despite completing more than two years of implementation, banks as well as NBFCs often complain that the operational activities are yet to be fully synchronised among the participating lenders in connection to the CLM. The respondents have opined that the integration level of the IT systems of the banks and NBFCs and the development of a common credit policy are the two factors that are yet to be fully synchronised. Some of the other factors, including the reconciliation of the repayment schedules, the loan hypothecation process, bureau reporting, etc., are almost addressed.



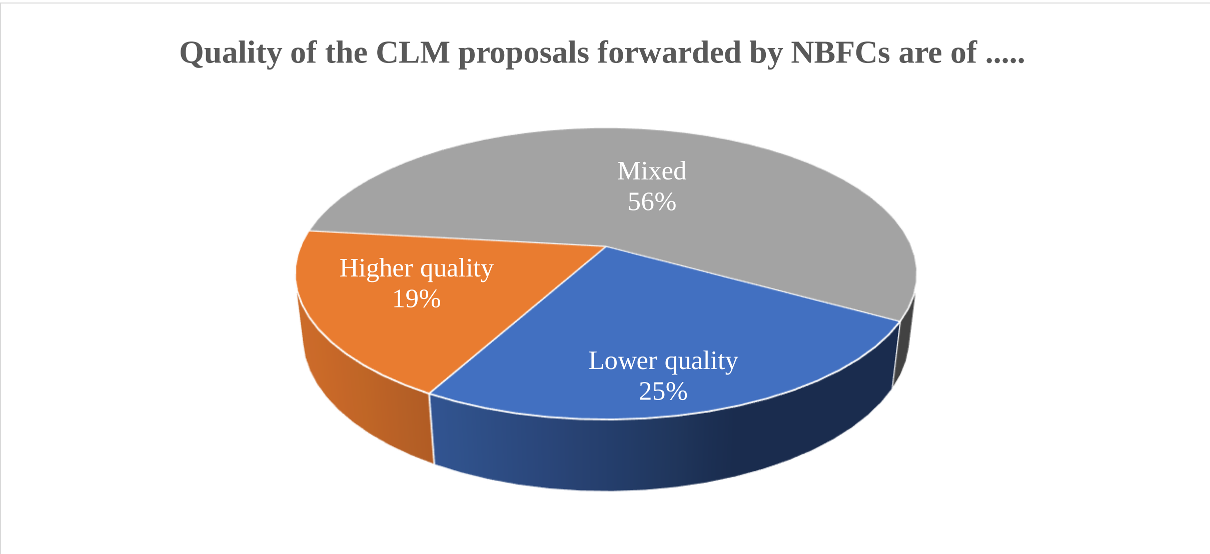
5.1.20 Banks are equally informed as NBFCs about the borrower's risk profile in CLM

While understanding the level of information banks have at their disposal regarding the risk profile of the borrowers, 68% of the respondents agreed that they are equally informed as NBFCs about the risk profile of the borrower in CLM. Most of the respondents opined that they hardly take decisions based on the NBFC's risk assessment of the borrower. Banks have their own underwriting process, which they follow. While 19% of the respondents did not comment, 13% disagreed saying that NBFCs having symmetric information about the risk profile of their customers. They opined that NBFCs do not share all negative information about the borrower’s profile out of fear of rejection.



5.1.21 Quality of the CLM proposals forwarded by NBFCs to Banks

While assessing the quality of the CLM proposals shared with banks by the NBFC partner, 56% of the respondents opined that the proposals are of mixed quality. While 25% of the respondents opined that the proposals are of lower quality, the rest, 19%, were of the opinion that CLM proposals are of higher quality. This hints that the quality of the proposals is a concern for banks because they consider the borrowers sourced by NBFCs are of subprime quality.



5.1.22 CLM Proposal Rejection Ratio by Banks

On an average, it is observed that 24% of the co-lending proposals are rejected by partner banks which are sourced by their CLM NBFC/HFC partner. Bank-specific rejection rates widely vary from 10% to 45%. The rejection rate for CLM proposals is on the higher side as NBFCs are flexible with their underwriting process whereas the banks follow stringent underwriting process. Also, the absence of required documents as per the banks' existing guidelines inflates the rejection rate under CLM.

Some of the primary reasons for rejection of CLM proposals, as mentioned by banks, are as follows:

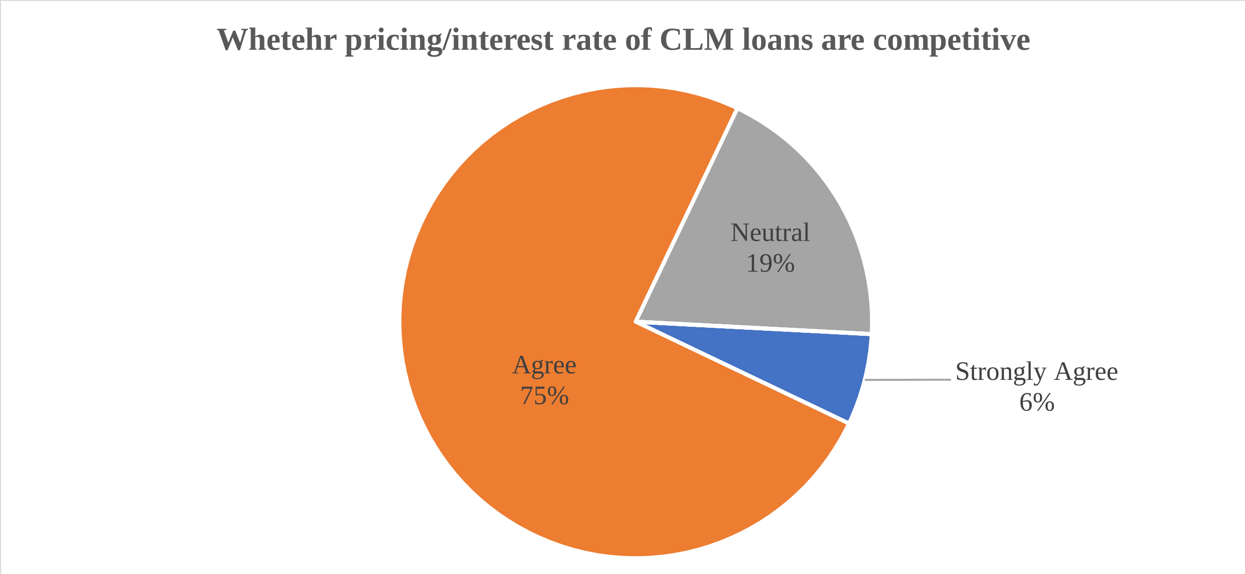
- The proposals submitted by NBFCs and HFCs are not as per mutually agreed-upon norms
- Most of the time, the borrower's CIBIL score is below the banks' minimum threshold
- Absence of Credit Appraisal Memo (CAM)
- NBFCs are not capturing the required information and documents in the proposal, like proper justification on previous defaults, supporting income, obligation documents, etc.
- Flexibility with respect to deviations from the policy

5.1.23 Ratio of CLM Proposals Underwritten by Banks

To understand the percentage of loan proposals underwritten by banks that are shared by NBFCs, we are told that banks are underwriting each individual loan proposal from their side. However, in cases of pool purchases, banks are not resorting to underwriting each individual loan proposal.

5.1.24 Pricing/ Interest Rate Competitiveness of the CLM Portfolio

While assessing whether information asymmetry is impacting the pricing of individual loans, 81% of respondents opined that pricing/ interest rates are competitive, while only 19% were neutral. Respondents opined that while pricing the CLM proposal, they take care of all additional costs involved, including underwriting costs, loan servicing costs, risk premia, etc. Therefore, the blended rates are sometimes inflated, but based on the risk profile and costs incurred, pricing is most competitive in CLM. Though Banks charge high premium to CLM borrowers, those premiums are account specific based on the risk profiling and not generic.

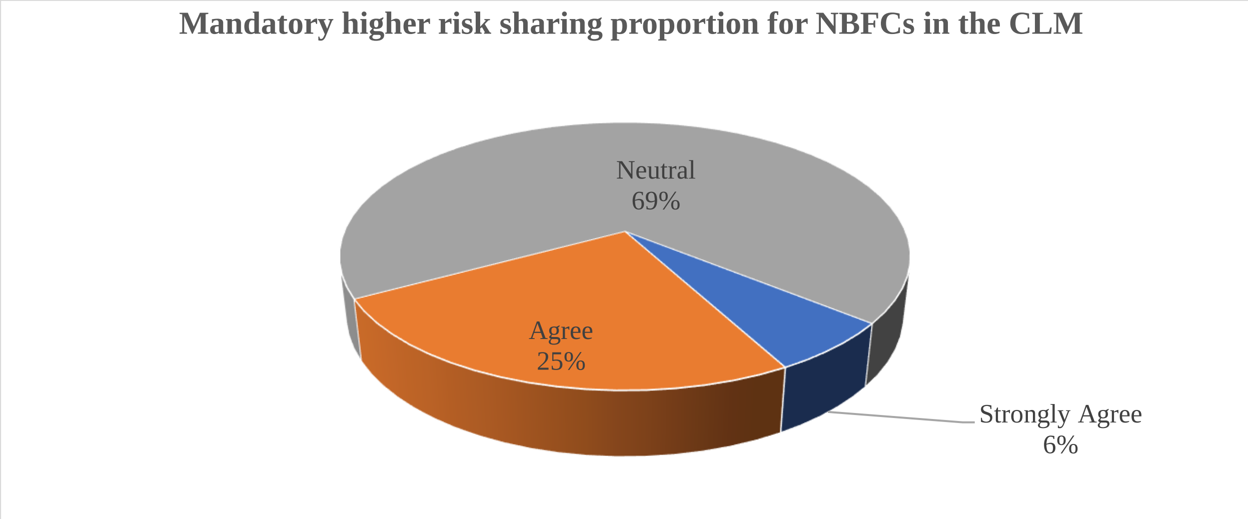


5.1.25 Whether Low-Risk Borrowers are Walking Away from the CLM Market Due to Higher Interest Rates

The blended interest rate under CLM is always higher than the interest rates charged by the banks. Hence, a prime customer would never prefer CLM compared to direct lending from the commercial banks, assuming that the borrower is well informed about the market and credit availability. Assuming a zero-sum game, there is a high probability that those customers leaving the CLM due to a higher interest rate must be getting served by commercial banks.

5.1.26 Requirement of Higher Risk Sharing by NBFCs in CLM

In connection to the concern that there should be higher risk sharing by NBFCs than its current minimum of 20%, we are told that banks always prefer that NBFCs share higher risk. Though the majority of respondents agreed that the current threshold of 20% is optimal for NBFCs, some banks have opined that the threshold could be increased to 30%. The majority opined that the banks are comfortable with NBFCs retaining at least 20% of the loan share on their books. However, the bank would be more comfortable if there is some sort of credit enhancement to protect against the higher credit risk and to bring more skin in the game for the originator. The thresholds can be linked to the products and their tenure.

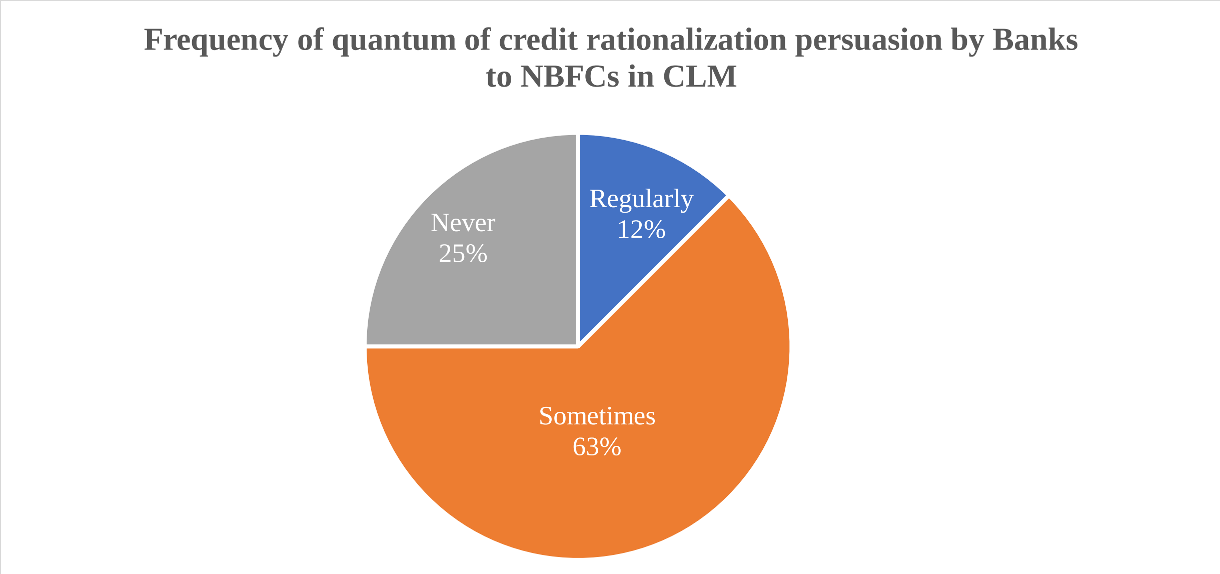


5.1.27 Lenders' Preference for Borrower Selection in CLM

As banks prefer to grant loans that are returnable to them rather than loans with high yields (Stiglitz 1981), banks always head towards credit rationing. Banks worry about the quality of borrower and hence adopt more stringent underwriting mechanism, leading to increased rejection of loan proposals. To validate the theory of Stiglitz (1981), we sought the opinion of banks to verify the types of borrowers they prefer: quality customers (loans are returnable) or high-yield customers (sub-prime customers). The respondents unanimously opined that they prefer quality borrowers (the loan is returnable) over high yield. Banks prefer quality customers who would repay the loans on time, and if there are quality customers in the affordable segment, they are willing to extend the partnership.

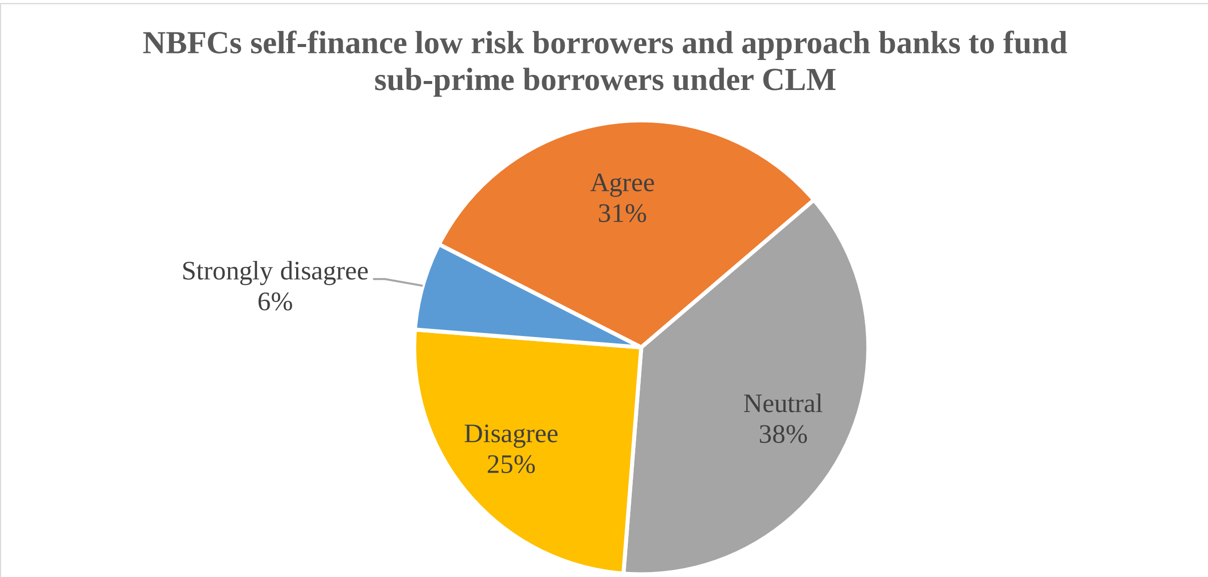
5.1.28 Credit Rationalization Persuasion by Banks

We understood that it is a common phenomenon that banks are regularly persuading NBFCs to rationalise the quantum of credit. While 63% of respondents opined that they indulge in the credit rationalisation persuasion sometimes, 12% of respondents informed us that they regularly peruse it, while another 25% never persuade the NBFC partner for credit rationalization. Instead of rationalization, they prefer not to extend the credit.



5.1.29 NBFCs Self-Finance Low Risk Borrowers and Approach Banks to Fund Sub-Prime Borrowers under CLM

To validate the asymmetric information hypothesis of whether NBFCs self-finance low-risk borrowers and approach banks to fund subprime borrowers under CLM arrangements, a query has been put forth, and surprisingly, it has been observed that an equal number of respondents are on both sides. 31% agreed, while another 31% disagreed that NBFCs should self-finance low-risk borrowers and approach banks to fund sub-prime borrowers under CLM. Another 38% were neutral and did not comment. We are told that though such events are suspected from banks side time to time, banks have no resource or practical arrangements to validate it. Moreover, a higher rejection rate in the initial period has also been a clear instruction to NBFCs for better quality proposal sharing next time.



5.1.30 At Which Stage, NBFC Partner Discloses the CLM Customer Details with the Banks

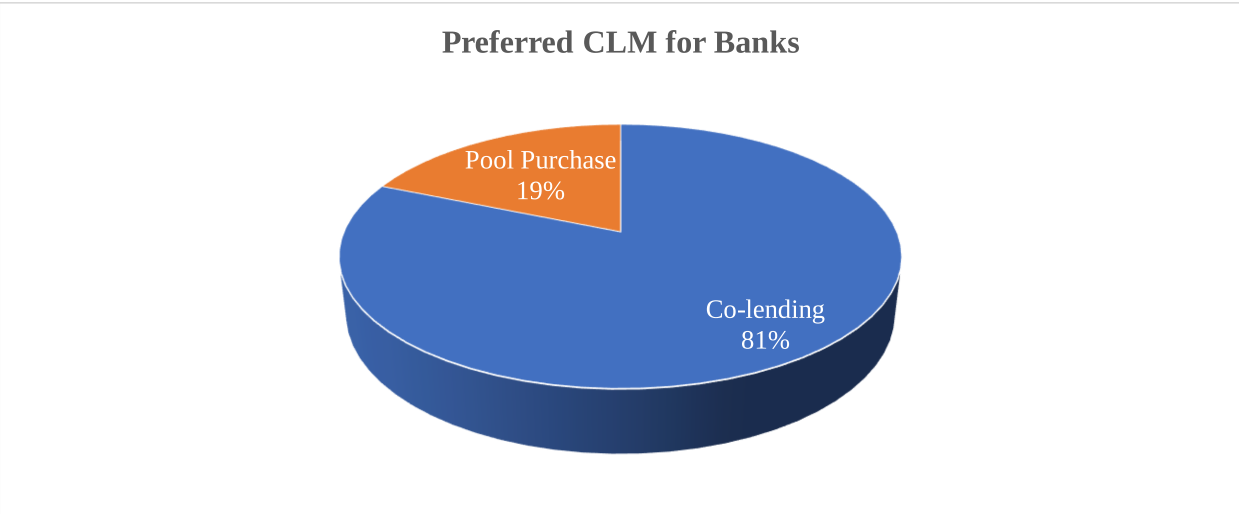
In response to the query, "At which stage does the NBFC partner discloses the CLM customer details to the banks?" 79% of the respondents opined that at the underwriting phase their NBFC partner discloses the borrower details. Another 14% opined that the NBFC discloses borrower details in the sanctioning phase and the borrower selection phase (7%). Again, the board-approved documents of most of the banks on CLM show that NBFCs must inform the borrower unambiguously about the CLM at the sourcing phase only.

5.1.31 Banks' Borrower Selection Criteria under CLM

In response to the question of borrower selection criteria by banks in the CLM, it is reported that banks select borrowers based on their risk profile. The borrower selection criteria and risk threshold differ for varied asset classes. Banks follow their in-house credit assessment process for borrower selection. Again, the borrower selection is as per mutually agreed parameters and based on compliance with the agreed product policy.

5.1.32 Preferred CLM for Banks

As we have observed, several banks are still into pull purchases rather than direct CLM. In understanding banks' preferred CLM, 81% opined that they prefer direct CLM, while another 19% are in favour of pool purchase.



Arguments in Favour of CLM are as follows:

- As individual accounts are opened under CLM, follow-up is proper, and due diligence is also done in every case.
- There is scope for enhanced underwriting.

- Product policies are approved in advance, and proposals are sourced in accordance with the same. Due diligence on each individual case is done at the time of sanction.

Arguments in Favour of Pool Purchase

- Under the CLM option, the process is cumbersome mainly in the absence of digital integration between the partners. Under pool purchase, the process is much more streamlined and provides operational flexibility to both partners, but the alliance between two totally different types of entities entails many different challenges and risks.
- Operational integration is easier for pool purchases.
- The lenders on record under CLM include both banks and NBFCs. Hence, banks are exposed to reputation risk in view of customer escalations, mis-selling, etc.

5.1.33 USP of Banks in CLM

The USPs of banks in the CLM business are:

- Some banks have a business rule engine (BRE)-based solution that is being used for financing joint lender group (JLG) members for agricultural and related activities.
- Lower cost of funds
- Lower capital constraints
- Well-defined internal processes
- A common lending programme agreed upon by banks and NBFCs
- Vast geographic presence across the country including rural areas, making it easy for the banks to understand the borrower profile of a specific geography
- Long history of understanding retail asset products considering banks' sizeable AUM
- Proactiveness of the management

5.2 Survey Analysis: NBFCs/HFCs/Fintech

The views of the NBFCs, HFCs, and Fintech officials were ascertained, and observations were recorded through objective and subjective questionnaires. Apart from structured questionnaire, the functionaries of the NBFCs, HFCs, and Fintechs dealing with CLM were interviewed both formally and informally. Feedback obtained through questionnaire and formal/ informal interaction are analysed as under:

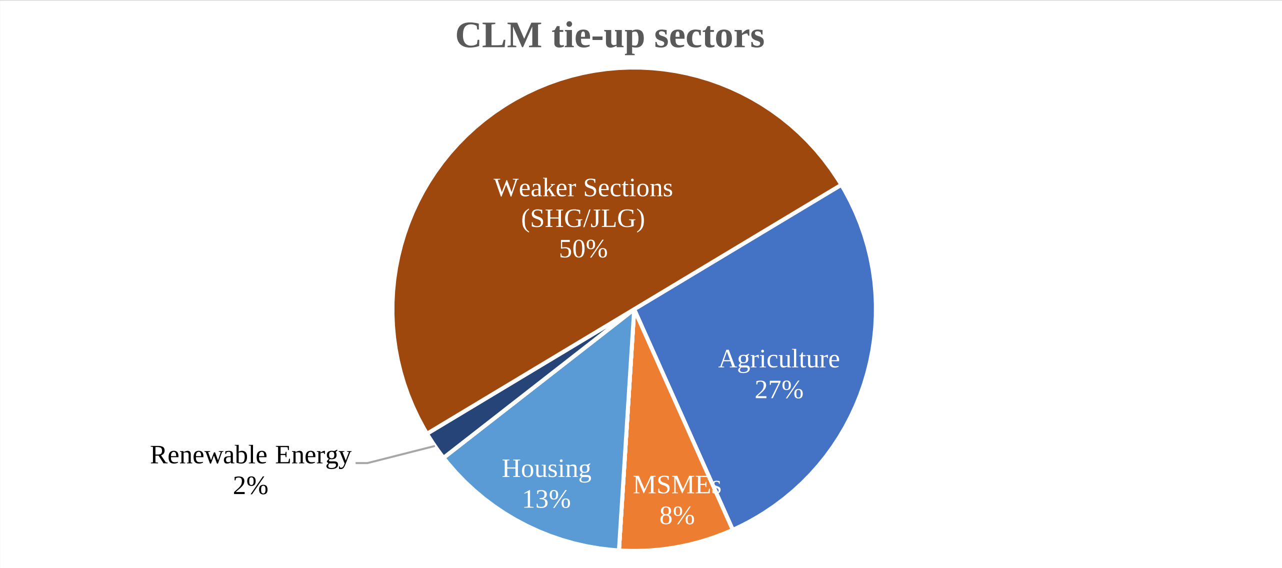
5.2.1 Surveyed NBFCs/HFCs/Fintech

A total of twenty (20) NBFCs/HFCs/Fintech which are into the CLM business are surveyed for the study. The list of surveyed entities is presented below.

Surveyed NBFCs/HFCs/Fintech	
NBFC/HFC/Fintech	**Sector of Operation**
1. Vedika Credit Capital Ltd.	Agri
2. Save Microfinance Private Ltd.	Agri
3. U Gro Capital Limited	SME
4. Uttrayan Financial Services Pvt. Ltd.	Agri
5. Kinara Capital Limited	SME
6. Paisalo Digital Ltd.	SME
7. Navachetana Microfin services Pvt. Ltd.	JLG
8. Credit Access Grameen Limited	JLG
9. Madura Microfinance Limited	SHG
10. Indel Money Limited	SME
11. Capri Global Capital Limited	SME
12. Arth Microfinance Limited	Agri
13. Edelweiss Housing Finance Limited	Housing
14. Adani Capital Pvt. Ltd.	Agri
15. Small Business Finance Limited	SME/Gold
16. Belstar Microfinance Ltd.	SHG
17. Disha India Micro Credit Limited	SHG/JLG
18. Vaya Finserv Pvt. Ltd.	SHG/JLG
19. Kamal Fincap Pvt. Ltd.	SHG / JLG
20. Yubi	Fintech

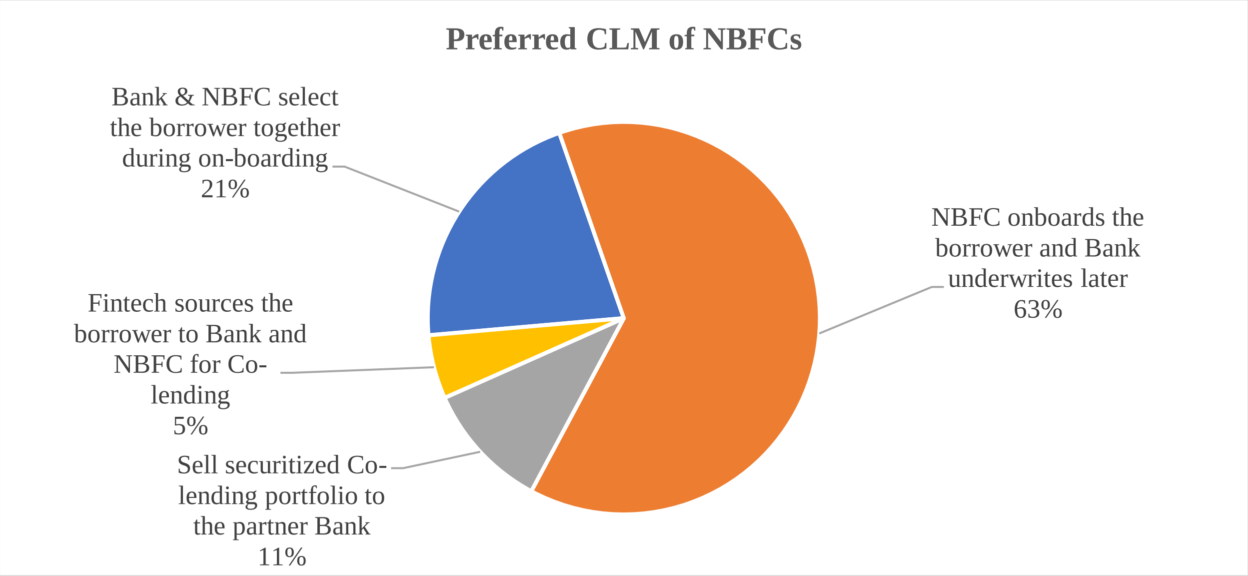
5.2.2 CLM Tie-Up Sectors by NBFCs

As per the feedback received, on average, each NBFC is having a tie-up with four (4) banks in the CLM business. Among the various sub-sectors under the priority sector (export credit, education, renewable energy, weaker sections, start-ups, social infrastructure, agriculture, MSMEs, and housing), as per the survey response, 50% of the CLM tie-ups are in the weaker section (SHG/JLG), followed by the agriculture sector (27%). CLM tie-ups in housing and MSME account for 13% and 8% shares, respectively. However, CLM tie-ups in renewable energy, export credit, start-ups, and social infrastructure are not prevalent as of now.



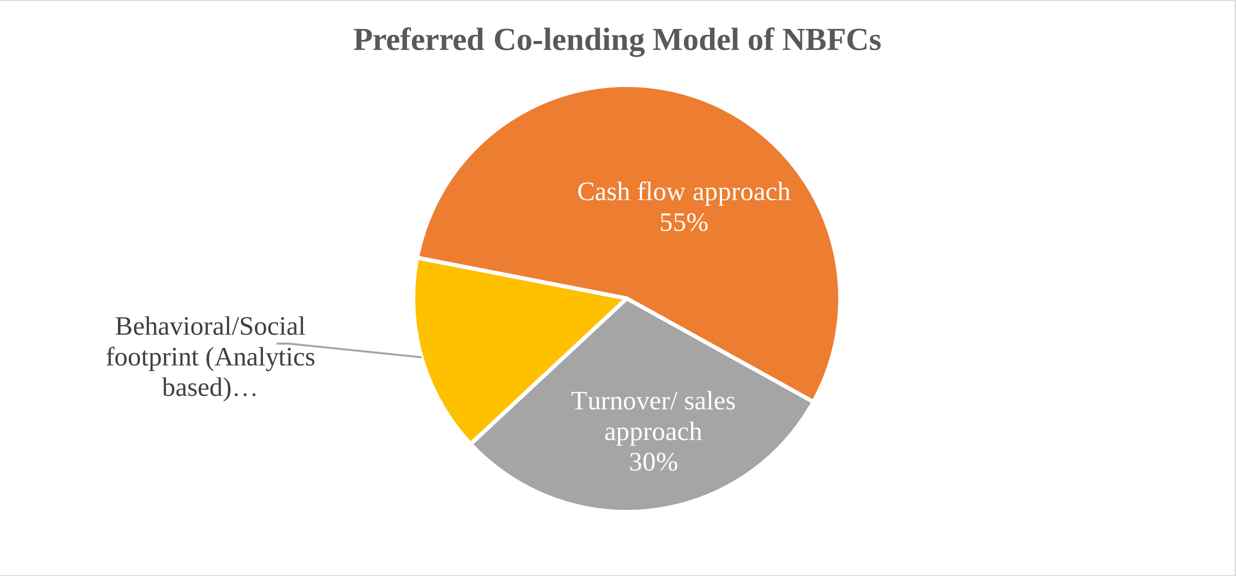
5.2.3 Preferred CLM of NBFCs

Among the available CLM options, it is seen that 63% of the NBFCs prefer the model where NBFC onboards the borrower and the bank underwrites later. This was followed by the model where banks and NBFCs select the borrower together during onboarding (21%). The earlier model of selling the securitized CLM portfolio to the partner bank is the third preferred model for NBFCs. Engaging Fintechs for sourcing the borrower to the bank and NBFC is opined as the fourth choice for NBFCs.



5.2.4 Preferred Appraisal Methods for NBFCs in the CLM

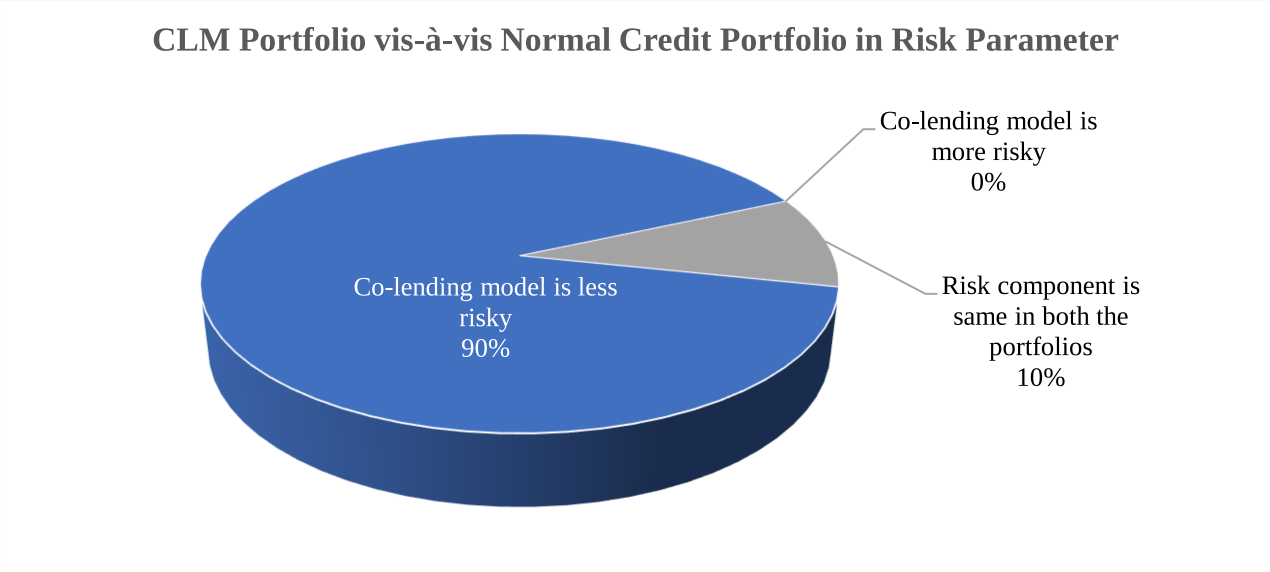
The preferred appraisal method for NBFCs in CLM is the cash flow approach (55%), followed by the turnover/sales approach (30%). Behavioural/social footprint (analytics based) approach is opined as the third widely used appraisal method among NBFCs in connection to CLM. This feedback is in line with the preferred appraisal method used by banks in the CLM.



5.2.5 CLM Portfolio vis-à-vis Normal Credit Portfolio of NBFCs in Risk Parameter

While seeking opinions about the risk profile of the CLM portfolio of NBFCs, 90% of respondents have opined that the CLM portfolio is less risky than their normal credit portfolio, and only 10% have opined that the risk component is the same in both the portfolios.

The treatment of 'risk' is very different for banks and NBFCs. While banks treat the CLM proposals as riskier, NBFCs see CLM proposals as less risky than their normal credit portfolio.



5.2.6 Activities and Respective Stakeholders in the CLM

While assessing the activity segregation between banks, NBFCs, and Fintech in CLM, we have observed that underwriting and sanctioning are simultaneously undertaken by banks and NBFCs, whereas post-sanctioning, follow-up, and recovery are taken care of by NBFCs.

Activity	Stakeholder			
	Bank	**NBFC**	**NBFC & Bank Simultaneously**	**Bank & Fintech**
Borrower selection	-	90%	10%	-
Underwriting	-	-	100%	-
Sanction	-	-	100%	-
Post sanction & follow up	-	100%	-	-
Recovery	-	100%	-	-

5.2.7 Fintech Engagement for Underwriting/Credit Assessment of CLM

As most of the NBFCs have their inhouse sophisticated credit assessment mechanism and reach to the last mile, they do not require the support of Fintech in the CLM business. However, it is observed that often banks are interested to partner Fintech in the CLM due to their niche credit assessment technique. The ratio of Fintech engagement is only 5% from NBFCs. Again, Fintech engagement has also been attributed to some other reason, as some of the Fintech are subsidiaries of certain NBFCs, and hence the group company or parent company onboards the Fintech for sourcing and other due diligence.

5.2.8 Operational Efficiency of CLM vis-à-vis the Earlier Co-Origination Model

In comparison to the earlier co-origination model, where only a few selected non-deposit-taking systemically important NBFCs (NBFC-ND-SIs) were permitted to co-originate loans with banks, 100 percent of respondents have opined that the CLM encompasses more operational efficiency compared to the earlier co-origination model. This is because of the flexibility of the new model and as it allows smaller, capital starved NBFCs to enter the market to co-lend.

5.2.9 Whether NBFCs prefer to finance the same borrowers in the absence of CLM

While NBFCs are asked whether they would prefer to finance the same borrowers in the absence of CLM, almost all NBFCs affirm. As per NBFCs' opinion, the reason they co-lend is that their capital base is small, and the blending rate under the CLM is the major attraction for customers. However, given a substantial capital base, NBFCs prefer to underwrite the same borrowers in the absence of CLM. Moreover, as per the existing practice, NBFCs underwrite the proposals fully, and banks join later for co-lending. Moreover, NBFCs are confident in their reliable customer selection and due diligence processes. Hence, NBFCs prefer to finance the same borrowers in the absence of a CLM arrangement as well.

5.2.10 Whether NBFCs prefer CLM for a high-risk borrower

In response to the question of whether NBFCs prefer CLM for high-risk borrowers, most of the respondents were neutral, followed by a small segment that denied it. The argument placed by NBFCs was that anyway the risk profile of the borrowers of NBFCs are always tilted upside. However, they have expertise in managing high risk. Some of the NBFCs opined that banks are selective with the whole CLM process, starting from the underwriting phase. Even though NBFCs share risky proposals with banks, there is a high probability that banks will reject them. Hence, either by preference or by compulsion, high-risk borrowers are mostly financed solely by NBFCs.

5.2.11 Scope of the Co-Lending Business Model in India

While assessing the scope of the CLM business model in India, we are told that the CLM has tremendous scope in India, and the regulator may extend the scope of the CLM model to non-priority sectors as well.

5.2.12 How selective are NBFCs when choosing a borrower in the CLM business?

NBFCs have shared that they are selective in choosing a borrower in the CLM business as the rigid process followed by banks ends up with a higher rejection ratio. Again, as every CLM partner bank has its own process and standards of underwriting, NBFCs are more selective when they share the CLM proposal with certain banking partners. We are told that certain partner banks are undertaking a very high level of scrutiny in CLM and are very rigid in certain aspects. It becomes difficult for NBFCs to convince their banking partners regarding the borrowers' potential as banks are only looking at their existing appraisal methods. Even if the borrower has a strong credit profile, if s/he under-scores in the banks' certain appraisal parameters, borrowers become ineligible to be a part of CLM.

5.2.13 Whether Trust Deficit Between the Banks and NBFCs is Limiting the Growth of CLM?

In response to the question of whether the trust deficit between the banks and the NBFCs is limiting the growth of the CLM market, the majority have opined in the affirmative. NBFCs claim that in many instances, banks are not happy with the quality of their proposals. Though NBFCs very much appreciate the credit profiles of the borrowers, banks reject those proposals based on their traditional appraisal techniques. Banks are rigid in taking deviations and demands everything in their way. As most of the proposals are getting financed initially by the NBFCs and banks are taking their portion by way of refinancing, it is getting tough for the NBFCs to meet banks' demands. NBFCs opined that given their limited manpower and banks' selective behaviour, NBFCs prefer to share good borrowers with banks so that the rejection rates are lower.

5.2.14. Facilities Stabilized at the Operations Level Between Banks and NBFCs in CLM

NBFCs opined that the initial operational glitches are no longer hurdles. Given more than two years of implementation, both the lenders are quite comfortable with the process. Almost all processes, starting from the integration of the IT systems of the bank and NBFC, rolling out a common credit policy, reconciling the repayment schedules, bureau reporting, credit risk assessment, hypothecation process, and escrow management, are now fully developed and stabilised with the existing partners. However, it has always been a challenge for the NBFC to tie up with a new banking partner. On average, it takes a minimum of 1-2 quarters for the system to be fully integrated.

5.2.15 Whether the Banking Partner of the NBFC is Equally Informed about the Risk Profile of The Borrower in CLM?

NBFCs have opined that they share all the available information with banks in advance as the due diligence process is to be undertaken by both the lending partners. Hiding information is not business supportive, as banks are rigid, and the board-approved agreement is particular about sharing customer information at the very first stage. NBFCs opined that they now understand the banks' underwriting requirements; hence, all available information about the customer's profile is shared with banks without any alteration. Apart from the information sharing by the NBFCs, banks have their own facilities, and some of the banks are taking the help of Fintech to do the credit appraisal. So, the risk profile is always clear to both the lending partners, but the perceived riskiness of the banks is higher compared to the NBFCs with respect to the CLM portfolio.

5.2.16 CLM Proposal Rejection Rate

The respondents opined that on average, 20% of the CLM proposals are rejected by partner banks, which are sourced by their NBFC or Fintech CLM partners. The rejection rate for CLM proposals is on the higher side as NBFCs are flexible with their underwriting process whereas the banks have a tight underwriting process. Also, the unavailability of required documents as per the banks' requirements further inflates the rejection rate under CLM. NBFCs argue that in several cases, the request of banks regarding the documentation is very tough, and NBFCs prefer banks to reject the proposal. The primary concern of the banks is related to the quantum of credit and credit score.

5.2.17 Pricing and Interest Rates of CLM Loans

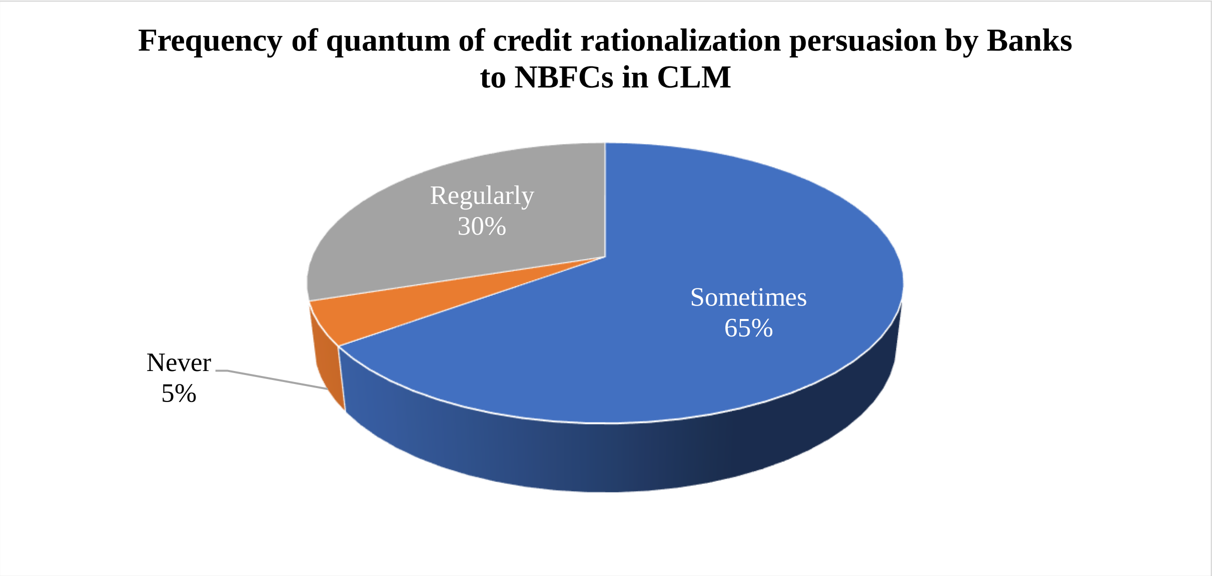
While understanding whether the pricing or interest rate of CLM loans are competitive, we have got very affirmative response. This is mainly because NBFCs' interest rates are always higher than that of banks. While 80% of the portfolio is held by the bank, the blended rate always comes closer to the bank's rate. Even though banks charge an additional risk premium, the rates are still competitive, as opined by NBFCs. The average blending rate, as told by the NBFCs, is nearly 17%. However, the blending rates again vary among categories, with the lowest for agriculture and the highest for MSMEs.

5.2.18 Does Partner Bank charge a high premium for CLM proposals compared to their normal customers?

Though we have not received any clear response to the question, NBFCs argue that they do not mind the higher interest rate as the blending rate is always lower than the rate charged by NBFCs. However, certain NBFCs believed that banks are adding high-risk premiums in certain cases, which is pushing the blending rate closer to the NBFCs' rate. In response to the question of whether low-risk borrowers are walking away from the CLM market due to a higher interest rate, NBFCs solely disagree. As customers are already financed by NBFCs, they do not have the choice to walk away. Only in case of the proposal falling under CLM, customer gets eligible for a lower blending rate.

5.2.19 Credit Rationalization Persuasion

65% of the NBFCs have opined that their banking partner persuades them to rationalise the quantum of credit to the borrower often, given that customer profiling does not fit into bank's appraisal process. As in most of the cases, banks takeover the respective share in the existing portfolio of NBFCs, credit rationalization is not effective. In that case, the bank either charges a higher premium or rejects the proposal. Another 30% of respondents opined that their partner bank always asks for credit rationalization.



5.2.20 In cases of tie-ups with multiple banking partners for CLM, whom does the NBFC approach first?

Under normal scenario, NBFCs prefer to do business with all partner banks, but when the question of first choice arises, NBFCs prefer lenient banking partner. Again, the choice also depends on the magnitude of business restrictions. This is one of the reasons why NBFCs prefer to have tie-ups with multiple banking partners in CLM.

5.2.21 At which stage do NBFCs inform the borrower regarding their CLM banking partner?

One of the important concerns in the model is whether the customer has the choice to go for a CLM or get fully financed from the NBFCs. Given the benefit of lower interest cost, it is always in the interest of the borrower that s/he gets financed under CLM. The next best option for the borrower is to get financed from a bank at a lower rate, but that is not feasible as the customer has already taken the credit from the NBFC. When NBFCs are asked about sharing information with customers regarding their CLM partnership and its low-interest benefit, we are told that NBFCs usually prefer to inform the borrower regarding their banking partner in CLM business at the sourcing phase. In fact, this has become one of the strategies for the NBFCs to attract customers. But they prefer to disclose the other uncertainties, like whether the partner bank agrees or not, only at the later phase.

5.2.22 NBFC's decision criteria for whether the borrower to be solely financed by the NBFC or to be financed under CLM

NBFCs opined that the decision of whether the borrower to be solely financed or to be financed under CLM solely depends on the quantum of the credit. NBFCs do not place much emphasis on the risk profile of the borrowers when choosing whether to fully finance or co-lend. Again, for the sake of time and cost savings, they hesitate to share proposals with banks if the risk profile of the customer is tilted upwards.

5.2.23 The USP of NBFCs in CLM

While sharing the USP of NBFCs in CLM business, we are told that the robust credit appraisal mechanism, strong local footing, robust recovery mechanism, and analytics-based credit assessment are some of the USPs of the NBFCs.

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CHAPTER VI

CONCLUSION AND POLICY SUGGESTIONS

6.1 Conclusion

The CLM that came into force in November 2020 allows banks to lend to priority sector borrowers in collaboration with NBFCs. The redesigned CLM integrated the RBI's co-origination loan scheme, which was launched in September 2018 to ease the liquidity crisis precipitated by the IL&FS crisis. The CLM has a lot of potential in the lending ecosystem since it combines the advantages of a bank's low cost of funding with the agility and reduced cost of operations of NBFCs. As a result, the loan is more reasonable and accessible to the end user. The RBI devised the CLM to ensure that low-cost funding from banks is made accessible to NBFCs that work in the MSME, EWS, LIG, and MIG segments, which banks are reluctant to explore due to higher operating costs and riskiness. India has a high potential for expansion as a retail credit market, and CLM allows banks to create priority sector assets through co-lending partners without committing extra resources. Similarly, 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 expected to be passed on to the final recipient via the all-inclusive rate/weighted average blending rate.

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.

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. The report also highlighted that only 13% of adults have borrowed money from a formal financial institution or used a mobile money account. As the Indian economy is evolving, for better proliferation of banking and financial services in remote rural areas, the priority sector rules have been amended from time to time to eliminate regional disparities in credit flow and meet national objectives. Banks and NBFCs are collaborating to increase the flow of credit to various key sectors by using their competitive advantages. 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. The policy must be consistent with RBI's co-lending circular and include rules pertaining to criteria for selecting a partner bank or NBFC, services covered by the CLM, security creation and enforcement, and so on. The board - approved policy is a precursor to banks and NBFCs entering into a master co-lending arrangement. Such an arrangement either require banks to take their portion of the loans originated by NBFCs on their books (non-discretionary model) or retain the discretion to reject certain applications after doing due diligence prior to taking the loans on their books (discretionary model). Banks and NBFCs may also agree on the terms and conditions of the arrangement, specific product lines, areas of operation, different roles and responsibilities of banks and NBFCs, appropriation of funds between banks and NBFCs, a framework for loan monitoring and recovery, customer interface, and protection issues.

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. Some of the opportunities of the CLM include bringing together banks and NBFCs, offering credit to the underserved and PSL sectors, and implementing fintech-led technology interventions that offer the opportunity to transform the traditional lending business into a seamless experience for customers as well as banks. Hence, CLM is one of the best methods to close the sizable credit gap existing in India.

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 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. Some of the 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.

CLM provides a unique opportunity for banks and NBFCs to work together to improve their approach to lending to priority sectors. The RBI circular cites CLM as an incentive to increase lending to the priority sector. The model offers an ideal opportunity for banks and NBFCs to overcome their impediments and collaborate on a platform that benefits everyone, including end-borrowers. Banks are proactively exploring CLM potential with NBFCs for financing farm mechanisation, warehouse receipt finance, farmer producer organisations (FPOs), and so on, in order to increase credit flow. As the economy completely recovers from pandemic shocks combined with pent-up demand, CLM will adapt and grow to meet the credit needs of the priority sectors. CLM and BC models together can help banks introduce new products and grow into new markets where they currently have a limited footprint.

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. Correspondingly, there is no clear evidence of the effects of the interaction of asymmetric information in the lending market. 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.

6.2 Research Findings

This study is the first of its kind in the CLM in India. The literature on the subject is fairly limited due to its distinctiveness and timing. However, apart from newspaper stories, there is very little credible literature on the subject to date. Second, despite the fact that the idea has been around for more than two years (since November 2020), there are no publicly available statistics on CLM in India. NBFCs and fintechs on the other hand, are releasing inflated numbers to acquire market share. Under such a scenario, it was difficult to conduct quantitative analysis in the absence of secondary data. The reluctance of all stakeholders, starting from the regulator to commercial banks and NBFCs, in sharing CLM related data has limited the scope of research to qualitative analysis only. Based on the feedback of the stakeholders, this study has deployed survey-based primary research analysis. Nevertheless, as the industry matures, we believe that the regulator and its regulated entities (banks and NBFCs) will share co-lending data for public consumption.

6.2.1 Research Findings: Banks

The views of the bank, NBFC, and fintech authorities were ascertained, and observations were recorded through an objective and subjective questionnaire. Apart from the structured questionnaire, the functionaries of the banks dealing with CLM were interviewed. Feedback obtained through a questionnaire and informal interaction, or interview methods is analysed. The questionnaires are designed in consultation with officers from Banks, NBFCs and academicians to cover all aspects of the CLM. For the analysis, a total of sixteen (16) banks which are into CLM business were surveyed, including nine (9) public sector banks and seven (7) private sector banks.

Banks prefer direct lending over collateralized lending among various options available to them in meeting their PSL target. Preferred CLM option for banks is the one where NBFCs onboard the borrower and banks underwrite later. The preferred appraisal method for banks in CLM is the cash flow approach. Banks feel that the CLM portfolio is riskier than their normal credit portfolio, and in the absence of CLM, banks will not finance the same borrowers. NBFCs have entered earlier unreached markets and created a niche for themselves. Even though these markets are riskier as per the banks' treatment, NBFCs manage them efficiently and differently than the other markets. Most of the banks are of the opinion that the risk profile of the CLM borrowers is not aligned with the bank's policy. As bankers are of the opinion that CLM is riskier compared to their normal credit portfolio, they charge a higher premium when pricing the CLM proposals.

As most of the NBFCs' proposals do not fit into commercial banks' traditional credit appraisal process, a few of the banks have engaged fintech for underwriting, sourcing, and collection efficiency. Banks believe that CLM encompasses greater operational efficiency compared to the earlier co-origination model, where only a few selected NBFCs-ND-SIs were permitted to co-lend with banks. Regarding the scope of the CLM in India, banks have opined that they see tremendous scope for the CLM in the future. The CLM might grow in the Indian market, provided the NBFCs start seeing the partnership as an ongoing and long-term. Banks opine that NBFCs start doing business under this arrangement temporarily when there is a liquidity crunch and revert to their on-book lending as soon as the liquidity situation improves.

As each CLM proposal goes through multiple stages of assessment, underwriting and sanction are simultaneously undertaken by both banks and NBFCs, whereas post-sanction follow-up and recovery are taken care of by NBFCs only. While responding to the query about whether the trust deficit between the banks and the NBFCs is limiting the growth of CLM, the respondents are of the opinion that banks do not trust NBFC credit assessments and go by their own credit assessment process when underwriting. Proposals not fitting the banks' assessment are rejected. While understanding the level of information banks have in their possession regarding the risk profile of the borrowers, majority of the respondents opined that NBFCs do not share all negative information about the borrower's profile out of fear of rejection. But, again, banks hardly take decisions based on the NBFCs' assessment report about the borrower. Banks have their own underwriting process, which they follow. Majority of the respondents have opined that the proposals shared by NBFCs are not of great quality. This hints that the quality of the proposals is a concern for banks because they consider the borrowers sourced by NBFCs to be subprime.

On average, 24% of the CLM proposals are rejected by partner banks, which are sourced by their partner NBFCs and HFCs. Bank-specific rejection rates widely vary from 10% to 45%. The rejection rate for CLM proposals is on the higher side as NBFCs are flexible with their underwriting process, whereas banks follow a stringent underwriting process. Also, the absence of required documents as per the banks' existing guidelines inflates the rejection rate under CLM. Banks prefer to underwrite each individual loan proposal from their side, but in the case of pool purchases, banks are not resorting to underwriting each individual loan proposal.

Banks are of the opinion that pricing/ interest rates are competitive in CLM. The extra costs in underwriting, loan servicing, risk premia, etc. sometimes inflate the blended rates, but based on the risk profile and costs incurred, pricing is most competitive in CLM. Banks charge a high premium to CLM borrowers, but those premiums are account-specific and based on the borrower's risk profile. The blended interest rate under CLM is always higher than the interest rates charged by the banks. Hence, a prime customer refers direct borrowing from commercial banks not co-lending, assuming that the borrower is well informed about the credit market and availability of credit.

In response to the question of whether NBFCs should share more capital than the current minimum of 20%, banks prefer NBFCs sharing more risk. Banks are comfortable with NBFCs retaining a minimum of 20% of the loan share in their books. However, the Banks to be more comfortable if there is some sort of credit enhancement to protect against the higher credit risk and to bring more skin in the game for the originator. The thresholds to be linked to the products and tenure of the product. It is observed that it is a common phenomenon that banks regularly persuade NBFCs to rationalise the quantum of credit.

To validate the assumption of asymmetric information hypothesis, whether NBFCs self-finance low risk borrowers and approach banks to fund sub-prime borrowers under CLM arrangement, banks share that though such events are suspected from banks side time to time, but banks have no resource or practical arrangements to validate it. Moreover, a higher rejection rate in the initial period has also been a clear direction to NBFCs for better customer sharing next time. Under CLM, banks select borrowers based on their risk profiles. The borrower selection criteria and risk threshold differ for different asset classes. Banks follow their in-house credit assessment process for borrower selection. Again, the borrower selection is as per mutually agreed parameters and based on compliance with the agreed product policy.

As it is observed, several banks are still into pull purchases rather than direct CLM. In understanding banks' preferred CLM, majority of the respondents opined that they prefer CLM. Those who prefer pool purchase are of the opinion that under the CLM, the process is cumbersome in the absence of digital integration between the partners. Under pool purchase, the process is much more streamlined and provides operational flexibility to both partners, but the alliance between totally different types of entities entails many different challenges. The USP of banks in the CLM business are the deployment of a business rule engine (BRE)-based solution, which is being used for financing joint lender group (JLG) members for agriculture and related activities. Some of the other USPs are the vast geographic presence across the country, including rural areas, making it easy for the banks to understand the borrower profile of a specific geography, well-defined internal processes, and a common lending programme agreed upon by banks and NBFCs.

Even though the CLM has been in place for two years, banks as well as NBFCs often complain that the operational process is yet to be fully synchronised among the participating lenders in connection to the CLM. The respondents have opined that the integration level of the IT systems of the banks and NBFCs and the development of a common credit policy are the two important factors those have yet to be fully synchronised. Some of the other factors, including reconciliation of the repayment schedules, loan hypothecation process, bureau reporting, etc., are almost addressed.

6.2.2 Research Findings: NBFCs/HFCs& Fintechs

A total of twenty (20) NBFCs/HFCs/Fintech which are into the CLM business are surveyed for the study. On average, NBFCs have a tie-up with four banks in the CLM business. Among the available CLM options, NBFCs prefer the model where NBFC onboards the borrower and the bank underwrites later. The preferred appraisal method for NBFCs in CLM is the cash flow approach, followed by the turnover and sales approach. This feedback is in line with the preferred appraisal method of banks in the CLM. In comparison to the earlier co-origination model, where only a few selected NBFC-ND-SIs were permitted to co-originate loans with banks, 100 percent of respondents have opined that the CLM encompasses more operational efficiency compared to the co-origination model. This is because of the flexibility of the CLM and the fact that it permits smaller, capital starved NBFCs to enter the market.

Majority of respondents have opined that the CLM portfolio is less risky than the normal credit portfolio of NBFCs. The treatment of ‘riskiness’ is very different for banks and NBFCs. While banks treat the CLM proposals as risky, NBFCs see the CLM proposals as less risky than their normal credit portfolio. While assessing the activity segregation between banks, NBFCs, and Fintech in CLM, we have observed that underwriting and sanctioning are simultaneously undertaken by banks and NBFCs, whereas post-sanctioning, follow-up, and recovery are taken care by NBFCs. As most of the NBFCs have their own sophisticated credit assessment process and reach the last mile, they do not require the support of Fintech in the CLM business. However, it is observed that often banks are interested to partner Fintech in the CLM due to their niche credit assessment technique. While assessing the scope of the CLM business model in India, we are told that the CLM has tremendous scope, and the regulator may extend the scope of the CLM model to non-priority sectors as well.

NBFCs have shared that they prefer to finance the same borrowers in the absence of CLM. As per NBFCs' opinions, the reason they co-lend is that their capital base is small, while the blending rate under the CLM is the major attraction for customers. However, given a substantial capital base, NBFCs would prefer to underwrite the same borrowers in the absence of CLM. Moreover, as per the existing system, NBFCs underwrite the proposals fully, and banks join later for co-lending. Moreover, NBFCs are confident of their reliable customer selection and due diligence processes. Hence, NBFCs prefer to fully finance the same borrowers in the absence of a CLM arrangement as well. Some of the NBFCs opined that the banks are very selective with the whole CLM process, starting from the underwriting phase. Even though NBFCs share risky proposals with banks, there is a high probability that banks reject them. Hence, either by preference or by compulsion, high risk borrowers are mostly financed solely by NBFCs.

NBFCs have shared that they are selective in choosing borrower in the CLM business because the rigid process followed by banks ends up with a higher rejection rate. Again, as every CLM partner bank has its own process and standards of underwriting, NBFCs are more selective when they share the CLM proposal with certain banking partners. We are told that certain partner banks are undertaking a very high level of scrutiny in CLM and are very rigid in certain aspects. It becomes difficult for NBFCs to convince their banking partners regarding the borrowers’ potential as banks are only looking at their existing appraisal methods. Even if the borrower has a strong credit profile, if s/he under-scores in the banks’ certain appraisal parameters, borrowers become ineligible. NBFCs claim that in many instances, banks are not happy with the quality of their proposals. Though NBFCs very much appreciate the credit profiles of the borrowers, banks outright reject those based on some traditional appraisal techniques. Banks are rigid in taking deviations and demands everything in their way.

As most of the proposals are getting financed initially by the NBFCs and banks are taking their portion by way of refinancing, it is getting tough for the NBFCs to meet banks' demand of documentation. Given their limited manpower and banks’ selective behaviour, NBFCs prefer to share good borrowers with banks so that the rejection rates will be lower. NBFCs opined that on average, 20% of the CLM proposals are rejected by partner banks that are sourced by their NBFC or Fintech CLM partner. The rejection rate for CLM proposals is on the higher side as NBFCs are flexible with their underwriting process whereas the banks have a tight underwriting process. Also, the unavailability of required documentation as per the banks' requirements further inflates the rejection rate under CLM. NBFCs argue that in several cases, the request of banks regarding the documentation is very tough, and NBFCs prefer banks to reject the proposal. The primary concern of the banks is related to the quantum of credit and the credit score.

NBFCs are of the opinion that the initial operational glitches are no longer hurdles. Given more than two years of implementation, both lenders are quite comfortable with the process. Almost all processes, starting with the integration of the IT systems of the bank and NBFC, rolling out a common credit policy for the bank and NBFC, reconciling the repayment schedules, bureau reporting, credit risk assessment, hypothecation process, and escrow management, are now fully developed and stabilised with the existing partners. However, it has always been a challenge while NBFC is having tie up with a new banking partner. On average, it takes a minimum 1-2 quarters for the system to be fully integrated with a new partner.

Regarding information sharing, NBFCs claim that they always share the available information with banks in advance as the due diligence process is to be undertaken by both the lending partners. Hiding information is not business supportive, as banks are rigid, and the board-approved agreement is particular about sharing customer information at the very first stage. NBFCs opine that as they understand the banks' underwriting requirements; hence, all available information about the customer's profile is shared with banks without any alteration. Apart from the information sharing by the NBFC, banks have their own facilities, and some of the banks are taking the help of Fintech to do the credit appraisal. So, the risk profile is always clear to both lenders, but the perceived riskiness of the borrowers as seen by banks is higher compared to the NBFCs with respect to the CLM portfolio.

The pricing/ interest rate of CLM loans is seen as competitive, as NBFCs' interest rates are always higher than banks. While 80% of the portfolio is held by the bank, the blended rate always comes closer to the bank's side. Even though banks charge an additional risk premium, the rates are still competitive, as opined by NBFCs. NBFCs argue that they do not mind the higher interest rate as the blending rate is always lower than the rate charged by NBFCs. However, certain NBFCs believe that banks are adding very high-risk premiums in certain cases, which is pushing the blending rate closer to the NBFCs' rate. As customers are already financed by NBFCs in CLM, there is no scope for them to walk away from the market. Only if the proposal becomes eligible under CLM does the customer get the benefit of a lower blending rate at a later stage. NBFCs are of the opinion that their banking partner persuades them to rationalize the quantum of credit to the borrower often. As in most of the cases, banks takeover the respective share in the existing portfolio of NBFCs, credit rationalization does not function well. In that case, the bank either charges a higher premium or rejects the proposal. NBFCs prefer to do business with all their partner banks, but when the question of the first choice comes, they prefer the more lenient banking partner. Again, the choice also depends on the magnitude of business restrictions. This is one of the reasons why NBFCs prefer to have tie-ups with multiple banking partners in CLM.

NBFCs opined that the decision of whether the borrower should be fully financed by NBFC or be considered under CLM solely depends on the quantum of the credit. NBFCs do not place much emphasis on the risk profile of the borrower when choosing whether to fully finance or co-lend. Again, for the sake of time and cost, they hesitate to share proposals with banks if the risk profile of the customer is tilted northward. The USP of NBFCs in the CLM business is their robust credit appraisal mechanism, strong local footing, robust recovery mechanism, analytics-based credit assessment, etc.

What we have observed in the process is that banks are limiting themselves to the MOU signing stage with NBFCs or a couple of tranches of assessments subsequently. Things are not moving thereafter. The CLM numbers floated in the market is having less substance. It is again supported by the fact that in FY22-23 PSBs have invested heavily on PSLCs. While CLM should be the most preferred option to meet PSL target, investing in PSLCs for meeting Priority Sector Lending target is not supporting the logic of sizable expansion in CLM business. SBI's investment in PSLCs jumped 46% YoY in FY23 to Rs. 2.02-lakh crore, similar is the case for PNB (Rs. 18,500 crore). During the study, it is observed that the numbers quoted by co-lending platform providers are having less substance. The quantum of deals and the numbers advertised by platform providers aiming at gaining business only.

6.3 Policy Suggestions

Despite CLM's inherent advantages, it had a slow start. There are few factors hindering the growth of the CLM market in India. Apart from operational issues including IT system integration, development of a common credit policy, reconciling repayment schedules, bureau reporting, simultaneous credit risk assessment, hypothecation, servicing, and escrow management, etc., one of the major hurdles for the CLM is a trust deficit, which is limiting market development. As the trust deficit reduces the efficiency of the CLM market, banks and NBFCs need to address it to make the CLM successful.

Due to engagement of two or more very distinct corporate organisations with diverse processes, policies, technology systems, and risk management practices, co-lending presents some challenges. Integration of underwriting, disbursement, and collections processes may take a long time and yet fail to bridge all gaps. Greater coordination among lenders is required, including the seamless integration of their technological systems, not only to accomplish the CLM's objective but also to ensure a smooth customer experience. To address the operational issues faced by CLM, financial institutions require a specialised and advanced technology infrastructure. Financial institutions must carefully assess whether their present technological arrangements can overcome the obstacles necessary to meet the unique requirements of the CLM.

6.3.1 Suggestions to Ease Operational Hurdles

- Banks argue that the underwriting practice and SOPs followed by the NBFCs are not at par with the banks to commensurate their reputation risk. Without a common underwriting practice, the CLM may not prosper. Hence, **developing a common underwriting practice is very important for both banks and NBFCs**.
- There are underwriting risks and integration challenges that need to be addressed. A lot of trust between both lenders is required, which is missing. **The system and documentation process need to be harmonized. Double underwriting is expensive and should be cut short.**
- As banks and NBFCs use different LOS and LMS, it results in a lengthy integration procedure. Furthermore, if a bank and NBFC collaborate with several partners, the integration procedure is repetitive, making the entire process time-consuming. **Lengthy integration procedures can be shortened by migrating lenders to a common fintech platform.** Third-party platforms provide scalable solutions in which integration is a one-time effort rather than being repeated for each new originator/lender collaboration. The platform integration eliminates the need for integration with CBS and each of the lender LMS programmes.
- When the lending partners are a bank and an NBFC, the appraisal criteria are likely to be substantially different. Given the varying nature of assessments, a significant number of borrowers may fall outside of the credit sanction criteria. This might undermine the goal of financial inclusion. As both lenders must underwrite separately, the customer's turnaround time is likely to be impacted. Furthermore, if the primary lender is a bank, the amount of monitoring is likely to be greater. Because the credit evaluation criteria for the bank and the originator are different, **the underwriting policies and rules must be digitised for a system-based review**. **A set credit policy agreed upon by both lenders can go a long**

way towards smoothing down the procedure. Underwriting from a major lender can help with faster choices, and a deviation matrix system can help with situations where there are policy mismatches. For a system-based assessment, the underwriting strategy must be digitalized.

- A series of duplications in the system is hindering the customer journey. The manual process is tough and repetitive, as both lenders operate under two sets of rules. **As loans are of small value, credit assessment of each borrower for multiple times is expensive and can be avoided with seamless integration of technology along with a strong digital platform that has end-to-end technology enabled.**
- Alignment of various operational departments (business, credit, and operations) at both the NBFC and bank is getting difficult, significantly affecting the TAT. **Developing a consistent SOP between the NBFC and the bank can aid in the reduction of TAT.**
- Reconciliation problems represent a significant difficulty in expanding the CLM. A few examples of instances in which reconciliation concerns emerge are, receipt of disbursements; collection apportionment schedule between interest, principal, and charges, as well as differences in apportionment technique between banks and NBFCs; reconciliation of escrow collection accounts, as well as escrow account split between NBFC and Bank etc. **A platform that aids in the coverage of reconciliation modules can enhance operational efficiency. Discussion with stakeholders when finalising the SOP might aid in reducing reconciliation challenges.**
- There may be cases of variance in the interest computation methodology across lending partners. For example, a bank would compute interest on a 365-day basis, and an NBFC would compute interest on a 360-day basis. Repayment schedules of both the lenders must be consistent. In CLM, an NBFC is often required to keep three repayment schedules (one for each lender's individual part of the loan and one for the total loan value) for reconciliation with lenders, customers, and internal records. **Upkeep and reconciliation of these three repayment plans are difficult. Developing a common reconciliation schedule from the initial phase can ease the process.**
- During loan servicing, each system functions differently under various payment scenarios, including prepayment, foreclosure, part payment, multiple overdue payments, etc. This is mainly due to dissimilar apportion logic, which may result in differences in the customer's outstanding balance and, as a result, incorrect bureau reporting of the customer. **Before the CLM tie-up, the lender and originator must agree on a proper split mechanism and interest calculation processes, as well as the alignment of apportioning logics under various scenarios.**

- It is debatable whether to impose the fee on co-lenders at the point the transaction is initiated because the bank would be a co-lender and might choose to lend only to proposals that match their policy criteria. **A security in favour of the NBFC can be created, and a master agreement with the bank can be executed to have a paripassu holding on the security. Alternatively, the charge-generating process must be altered to include the primary lender.**
- It becomes difficult for NBFCs to convince their banking partners regarding the borrowers' potential as banks are only looking at their existing appraisal methods. Even if the borrower has a strong credit profile, if s/he under-scores in the banks' certain appraisal parameters, borrowers become ineligible. **Developing a common credit policy or credit assessment can reduce the rejection rate.**
- **Both banks and NBFCs should 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 systems in place, banks will be able to expand it.
- Executing nuances is important. Banks are pricing the risk upfront, which is positive. Trusting each stakeholder is important and aligning interests and considering CLM as a joint venture is crucial. **Friction needs to be cleared through building trust.** NBFCs' ability and nimbleness to adjust to banks' policies is important as well.
- If a customer's data is read in two different ways, it is complicated. Banks are subject to IRAC norms compared to NBFCs, which follow new Indian accounting standards. Due to different norms, NPA declaration, income recognition, and amortisation of debt are all different. So, it becomes exceedingly difficult for both organizations. Hence, **there is need for a smooth process and systems to be integrated.**
- As most of the proposals are getting financed by the NBFCs initially and banks are taking their portion by way of refinancing, it is getting tough for the NBFCs to meet banks' demands at a later stage as customers even do not cooperate for additional papers. Given limited manpower and banks' selective behaviour, NBFCs find it difficult to onboard customers under CLM. **Developing a common assessment mechanism is very important.**
- Credit underwriting at banks' end entails operational expense at the bank level in addition to the operational expense incurred by the NBFC in underwriting the customer. This puts additional cost and higher blended rate. **Common platform for underwriting will make the CLM cost competitive.**

- There is a need for a common delinquency matrix through which both lenders can access the customer's profile. In most cases, NBFCs have their own proprietary scoring models, which they do not share with banks. This hampers trust between the two lenders. **The policy alignment and style of reading the CIBIL report being very different for banks and NBFCs, creates a lot of anomalies and lenders should come to single platform to overcome this crisis.**

6.3.2 Suggestions for Banks

- NBFCs claim that banks find it difficult to understand the nuances of CLM dynamics. **Banks may explore engaging guarantee companies in the MSME and home loan markets to confirm their appetite for risk for CLM with NBFCs. Those entities may be involved in accepting credit default guarantees until banks are ready to take on this risk on their own.**
- Banks **to ensure that the benefits of blended costs are effectively passed on to the customers in the case of pool purchases**.
- Banks **may explore onboarding Fintech for underwriting the proposals**. **This might reduce the cost of screening and allow for better appraisal using advanced analytics.**
- Banks are of the belief that NBFCs do not share all available information about their customers beforehand, mainly the negative ones. This might be getting anchored in Banks' behaviour**. As building mutual trust is very important, the board approved policy of banks to clearly highlight the same with certain stringent financial punitive rewards for the NBFCs in case of deviation. This may help banks trust the NBFC partner and restore mutual trust between the lenders.**

6.3.3 Suggestions for NBFCs

- NBFCs need to consider CLM as an ongoing, long-term partnership with banks. In several instances, it is observed that NBFCs start doing business under this arrangement temporarily, mainly during a liquidity crunch. They revert to their on-book lending as soon as the liquidity situation improves. The CLM will grow in the Indian market provided **NBFCs start seeing the partnership as an ongoing, long-term partnership**.
- **ROE expectation for both NBFCs and banks for the portfolio built need to be at par for a successful and sustainable relationship.** The same is not being observed, as the NBFC's ROE expectation is 2-2.5 times that of the bank's ROE.

- Banks argue that the underwriting practices and SOPs followed by the NBFCs are not at par with the bank to commensurate the reputation risk of the Bank. **Banks require NBFCs to have clear and defined commercials on CLM across the board. It is important that NBFCs create awareness among their field staff regarding the CLM. Transparency in information sharing for due diligence should be given due importance.**
- Transparency plays a significant role and needs to be managed on a real-time basis. **NBFCs should give banks enough confidence that they are following appropriate recovery process. The building blocks of the CLM should fall into place for its success through the penetration of technology and advanced analytics.**
- Banks' reliance on credit assessment and the efficient collection mechanisms of NBFCs are the keys to dealing with high-risk borrowers. Since banks are underwriting on a case-by-case basis and incurring additional operational expenses, the blended rates are getting closer to the NBFCs' side. This is defying the objective of the RBI, which is to pass on the advantage of the bank's lower cost of funds to priority sector borrowers. **It is important for NBFCs to maintain transparency in their appraisal process and to be confident in the outcome of their complex analytical underwriting models.**
- Because the collections are handled by the NBFC partner, there is a risk of commingling of funds, which need to be backed by cash collateral. **Collection practices of NBFCs to be aligned with banks to ensure any negative impact on bank's reputation.**
- Some of the primary reasons for the rejection of CLM proposals as mentioned by banks are, proposals submitted by NBFCs and HFCs are not as per mutually agreed norms. In most cases, the CIBIL score of the borrower is below the banks' minimum threshold, the credit appraisal memo (CAM) is missing, NBFCs are not capturing the required information and documents in the proposal, like proper justification on previous defaults, supporting income, obligation documents, etc.; flexibility with respect to deviations in the policy; Banks also claim that NBFCs do not share all negative information about the borrower's profile out of fear of rejection. **Before the belief gets anchored into the bank's behaviour, NBFCs need to address the trust gap.**

6.3.4 Suggestions for the Regulator

- There is a requirement for regulatory reforms to strengthen the existing CLM model. Given its scope, **CLM may be extended to non-PSL sectors**. **As CLM has tremendous scope in Indian banking, it may be extended to SFBs, foreign banks, RRBs, co-operative banks, etc. with certain limits to start with. A CLM arrangement for the non-PSL segment without a minimum holding period (MHP) may help the market grow.**

- **Direct Assignment guidelines need to be bought under CLM, for a sharp increase in the CLM volumes as the flow of credit to the end borrowers will be faster and enhance the liquidity in the market.** This will help NBFCs assign the loans immediately after disbursement. In the case of reimbursement, the law governing direct assignment becomes applicable, excluding the portion pertaining to the minimum holding period.
- To put skin in the game, **regulator may explore the possibilities of NBFCs providing protection to lenders in the form of a First Loss Default Guarantee (FLDG) as a market practise.**
- The CLM market's development is very skewed in India. Though not officially confirmed, during the survey, it was observed that the CLM portfolios of commercial banks were not commensurate with their shares in the Indian credit market. Some of the small banks have high value CLM portfolio, whereas some of the biggest lenders are lagging. **This might reflect certain anomaly in the CLM market, and the regulator needs to audit the existing CLM portfolio to find out whether the bulk of the portfolio of the small lenders is adhering to CLM discipline.**
- The transaction cost is based on state-wise stamping charges, which are higher in the case of mortgage loans. This results in a bunching of transactions rather than transactions at appropriate intervals, which should happen in 15 to 30 days. **The arrangement of a universal policy with due incentives may ease the process.**
- Hardly any big NBFC is coming for CLM. It is good for the NBFCs those are capital-starved and CLM augurs well in a liquidity shortage scenario. An appropriate policy for inviting large NBFCs to collaborate with banks is necessary. Additionally, the existing policy is silent about CLM arrangements between two NBFC partners. **Regulator may explore allowing two NBFCs to partner in CLM may help the market to penetrate further in remote rural areas.**
- **Elimination of regulatory arbitrage between banks and NBFCs and clarity on the applicability of norms (those applicable to banks or NBFCs) for the CLM are important.** In the event of a rating downgrade of the NBFC, a mechanism to pass on the excess interest spread collected by the NBFC to the bank might be necessary and justified as well.
- **A partner NBFC's share may be allowed for security creation in case of balance sheet lending. Collection efficiency is to be linked with the losses factored into the bank's pricing so that if the losses go beyond a threshold, the bank can curtail its financial risk. Upfronting of income may be allowed to the NBFCs with certain conditions.**

- The regulator may think of **bringing in a separate security trustee mechanism instead of the originator acting as the security trustee on behalf of both lenders**.
- RBI, being the common regulator for banks and NBFCs, **could create enabling infrastructure for banks to understand the appraisal models of NBFCs. This will build trust in the system. Types of data points investigated by NBFCs, and the sophisticated valuation models are important to be clear for banks. Trust will be built in the system, after a couple of cycles subject to money comes back to banks.**

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Annexure – I

Assessing the Efficacy of Bank-NBFC Co-Lending Model in Priority Sector Credit Creation

Madam/ Dear Sir,

I hope this email finds you well!

With an objective to improve the efficiency of the Bank-NBFC Co-Lending Market mechanism, the Indian Institute of Banking and Finance (IIBF) has awarded its prestigious Diamond Jubilee and CH Bhabha Banking Overseas Research Fellowship (DJCHBBORF) on thetopic "***Asymmetric Information and Market Failure in Bank - NBFC Co-lending Model***".

I, Dr. Bibekananda Panda, presently associated with State Bank of India as an Assistant General Manager (Economist) have been awarded this project. To come out with a practical implementable solution for the problem, I solicit your kind co-operation and request you to provide your valuable feedback by completing the questionnaire.

I am representing IIBF here, as a researcher.

Your feedback will be treated with utmost confidentiality and will be consumed for this research only.

Yours faithfully

Dr Bibekananda Panda
Assistant General Manager
(Economist)
State Bank of India
+91- 9167697370

1. Your Name

2. Name of your Organisation

3. Your Designation

4. Your Mobile number/Email address

5. Your Bank has tie-up with how many NBFCs for Co-lending?

6. The Co-lending tie-ups are in which of the sub-sectors under prioritysector?

- [ ] Agriculture
- [ ] Micro, Small and Medium Enterprises (MSMEs)
- [ ] Export Credit
- [ ] Education
- [ ] Housing
- [ ] Social Infrastructure
- [ ] Renewable Energy
- [ ] Weaker Sections
- [ ] Start-up
- [ ] Not Applicable
- [ ] Other

7. Which instrument do you prefer for meeting Priority Sector Lending (PSL) target?

- [ ] Co-lending
- [ ] Buying PSL Certificate
- [ ] Direct lending

8. Which of the Co-lending Models does your Bank practice?

- [ ] Bank & NBFC select the borrower together during on-boarding
- [ ] NBFC on-boards the borrower and Bank underwrites later
- [ ] Bank buys securitized Co-lending portfolio from NBFC
- [ ] Fintech sources the borrower to Bank and NBFC for Co-lending
- [ ] Other

9. Which of the following appraisal methods you prefer in Co-lending?

- [ ] Balance sheet approach
- [ ] Cash flow approach
- [ ] Turnover/ sales approach
- [ ] Behavioural/Social footprint (Analytics based)
- [ ] Other

10. What is the average blending rate in your Co-lending portfolio?

11. How do you rate the Co-lending portfolio vis-à-vis normal creditportfolio in risk parameters?

- ○ Co-lending portfolio is less risky
- ○ Co-lending portfolio is more risky
- ○ Risk component is same in both the portfolios
- ○ Other

12. Do you engage Fintech for underwriting/credit assessment of Co-lending?

- ○ Yes
- ○ No

13. What is the role of the Fintech which sources the Co-lending loanproposals to NBFCs and Banks?

14. Co-lending model encompasses more operational efficiency compared to the earlier co-origination model?

- Strongly Agree
- Agree
- Neutral
- Disagree
- Strongly disagree

15. You prefer finance to the same borrower in absence of Co-lending arrangement.

- Strongly Agree
- Agree
- Neutral
- Disagree
- Strongly disagree

16. Please enumerate the reasons for the above response.

17. You prefer Co-lending Model for a high-risk borrower

- Strongly Agree
- Agree

- Neutral
- Disagree
- Strongly disagree

18. Please give reasons for the above response.

19. How do you see the scope of the Co-lending business model in India?

20. Co-lending can be extended to non-Priority sector for banks in India.

- Strongly Agree
- Agree
- Neutral
- Disagree
- Strongly disagree

21. What are the factors you consider while pricing the Co-lending portfolio?

22. Who undertakes the following activities in the Co-lending Business?

	Bank	NBFC	Fintech	NBFC & Bank	NBFC & Fintech	Bank & Fintech

Borrower selection	◯	◯	◯	◯	◯	◯
Underwriting	◯	◯	◯	◯	◯	◯
Sanction	◯	◯	◯	◯	◯	◯
Post sanction & follow up	◯	◯	◯	◯	◯	◯
Recovery	◯	◯	◯	◯	◯	◯

23. How selective are you while choosing a borrower in Co-Lending business?

◯ More selective

◯ Less selective

◯ Same as normal business

◯ Other

24. What are the factors you consider while pricing your Co-lending portfolio?

25. Trust deficit between the Bank and the NBFC is limiting the growth of Co-lending market

◯ Strongly Agree

◯ Agree

◯ Neutral

◯ Disagree

◯ Strongly disagree

26. At operations level, kindly tick on the facilities that have stabilised in the Co-lending business model

- [ ] IT system of the Bank and NBFC is fully integrated
- [ ] Bank and NBFC have a common credit policy
- [ ] Repayment schedules are fully reconciled
- [ ] Bureau reporting is properly defined
- [ ] Bank & NBFC do their respective credit risk assessment
- [ ] Hypothecation process is fully defined
- [ ] Loan servicing is well defined
- [ ] Escrow management is well arranged
- [ ] Other

27. You are equally informed about the risk profile of the borrower as NBFC, in Co-lending business.

- ○ Strongly Agree
- ○ Agree
- ○ Neutral
- ○ Disagree
- ○ Strongly disagree

28. In terms of quality, the majority of the Co-lending loan proposals forwarded by NBFCs are of

- ○ Lower quality
- ○ Higher quality
- ○ Mixed
- ○ Other

29. On an average what is the percentage of Co-lending proposals rejected by you which are sourced by the partner NBFC/Fintech

30. What are the primary concerns for rejection of Co-lending proposals by your bank?

Kindly list out some of the frequently cited reasons for rejection of loan proposal by your bank

31. Is your Bank underwriting each individual loan proposal?

- Yes
- No
- Very few randomly
- Other

32. Pricing (interest rate) of Co-lending loans are competitive

- Strongly Agree
- Agree
- Neutral
- Disagree
- Strongly disagree

33. You charge high premium to Co-lending proposals compared to the normal customers

- Strongly Agree
- Agree
- Neutral
- Disagree
- Strongly disagree

34. A mandatory higher risk sharing proportion for NBFCs in the Co-Lending mechanism is required (at present it is 80:20)

◯ Strongly Agree

◯ Agree

◯ Neutral

◯ Disagree

◯ Strongly disagree

35. What should be the minimum risk threshold for NBFCs in the Co-lending model?
(at present it is 80:20)

36. As a lender, which type of borrower do you prefer in Co-lending business?

◯ Quality customers (loan is returnable)

◯ Sub-prime customers (those can be charged higher interest rates)

◯ Other

37. How often do you persuade your partner NBFC to rationalize thequantum of credit to the borrower?

◯ Regularly

◯ Sometimes

◯ Never

38. NBFCs self-finance low risk borrowers and approach banks to fund sub-prime borrowers under Co-lending

◯ Strongly Agree

◯ Agree

◯ Neutral

- Disagree
- Strongly disagree

39. Frequency of the rejection of the Co-lending proposals sourced by NBFCs/Fintech is high

- Strongly Agree
- Agree
- Neutral
- Disagree
- Strongly disagree

40. Low risk borrowers are walking away from the Co-lending market dueto higher interest rate

- Strongly Agree
- Agree
- Neutral
- Disagree
- Strongly disagree

41. At which stage, your NBFC partner discloses the Co-lending customer details with you?

- At sourcing phase
- Underwriting phase
- Sanctioning phase
- Borrower selection
- Does not disclose
- Other

42. On what criteria, you decide whether the borrower is to be financedunder Co-lending?

- Based on the risk profile of the borrower
- Based on the amount of loan
- Based on fund availability
- Other

43. Which of these options you prefer?

- Co-lending
- Pool Purchase

44. Please give reason for the above response.

45. What is your USP in Co-lending business?

46. What are your suggestions to partner NBFCs for making the model more efficient?

47. What changes (in product/process/pricing etc.) you recommend for the growth of the Co-lending market under the present regulatory environment?

48. Your policy suggestions for the regulator (RBI) to improve the Co-lending business environment

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Annexure - II

Assessing the Efficacy of Bank- NBFC Co-Lending Model in Priority Sector Credit Creation

Madam/ Dear Sir,

I hope this email finds you well!

With an objective to improve the efficiency of the Bank-NBFC Co-Lending Market mechanism, the Indian Institute of Banking and Finance (IIBF) has awarded its prestigious Diamond Jubilee and CH Bhabha Banking Overseas Research Fellowship (DJCHBBORF) on the topic "***Asymmetric Information and Market Failure in Bank - NBFC Co-lending Model***".

I, Dr. Bibekananda Panda, presently associated with State Bank of India as an Assistant General Manager (Economist) have been awarded this project. To come out with a practical implementable solution for the problem, I solicit your kind co-operation and request you to provide your valuable feedback by completing the questionnaire.

I am representing IIBF here, as a researcher.

Your feedback will be treated with utmost confidentiality and will be consumed for this research only.

Yours faithfully

Dr Bibekananda Panda
Assistant General Manager
(Economist)State Bank of India
+91- 9167697370

1. Your Name

2. Name of your Organisation

3. Your Designation

4. Your Mobile number/Email address

5. Are you aware that RBI has issued guidelines for Co-Lending by Banks and NBFCs to Priority Sector?

- ◯ Yes
- ◯ No

6. Your Organisation has tie-up with how many Banks for Co-lending?

7. The Co-lending tie-ups are in which of the sub-sectors

- ☐ Agriculture
- ☐ Micro, Small and Medium Enterprises (MSMEs)
- ☐ Export Credit
- ☐ Education
- ☐ Housing
- ☐ Social Infrastructure
- ☐ Renewable Energy
- ☐ Weaker Sections
- ☐ Start-up
- ☐ Not Applicable
- ☐ Other

8. Which of the Co-lending Models does your NBFC practice?

- ☐ Bank & NBFC select the borrower together during on-boarding
- ☐ NBFC onboards the borrower and Bank underwrites later
- ☐ Sell securitized Co-lending portfolio to the partner Bank
- ☐ Fintech sources the borrower to Bank and NBFC for Co-lending
- ☐ Other

9. Which of the following appraisal methods you prefer in Co-lending?

- ☐ Balance sheet approach
- ☐ Cash flow approach
- ☐ Turnover/ sales approach
- ☐ Behavioural/Social footprint (Analytics based)
- ☐ Other

10. How do you rate the Co-lending portfolio vis-à-vis normal credit portfolio in risk parameters?

- ○ Co-lending model is less risky
- ○ Co-lending model is more risky
- ○ Risk component is same in both the portfolios
- ○ Other

11. Who undertakes the following activities in the Co-lending Business?

	Bank	NBFC	Fintech	NBFC & Bank	NBFC & Fintech	Bank & Fintech
Borrower selection	○	○	○	○	○	○
Underwriting	○	○	○	○	○	○
Sanction	○	○	○	○	○	○
Post sanction & follow up	○	○	○	○	○	○
Recovery	○	○	○	○	○	○

12. Do you engage Fintech for underwriting/credit assessment in Co-lending?

○ Yes

○ No

13. What is the role of the Fintech which sources the Co-lending loan proposals to NBFCs and banks?

14. Co-lending model encompasses more operational efficiency compared to the earlier co-origination model?

- ◯ Strongly Agree
- ◯ Agree
- ◯ Neutral
- ◯ Disagree
- ◯ Strongly disagree

15. You prefer to finance the same borrower in the absence of Co-lending arrangement.

- ◯ Strongly Agree
- ◯ Agree
- ◯ Neutral
- ◯ Disagree
- ◯ Strongly disagree

16. Please enumerate the reason for the above response.

17. You prefer Co-lending Model for a high-risk borrower

- ◯ Strongly Agree
- ◯ Agree
- ◯ Neutral
- ◯ Disagree
- ◯ Strongly disagree

18. Please give reason for the above response.

19. How do you see the scope of the Co-lending business model in India?

20. Co-lending can be extended to non-Priority sector for banks

- ○ Strongly Agree
- ○ Agree
- ○ Neutral
- ○ Disagree
- ○ Strongly disagree

21. How selective are you while choosing a borrower in Co-Lending business?

- ○ More selective
- ○ Less selective
- ○ Same as normal business
- ○ Other

22. What are the factors you consider while pricing your Co-lending portfolio?

23. Trust deficit between the Bank and the NBFC is limiting the growth of Co-lending market

- ◯ Strongly Agree
- ◯ Agree
- ◯ Neutral
- ◯ Disagree
- ◯ Strongly disagree

24. At operations level, kindly tick on the facilities that have stabilised in the Co-lending business model

- ☐ IT system of the Bank and NBFC is fully integrated
- ☐ Bank and NBFC have a common credit policy
- ☐ Repayment schedules are fully reconciled
- ☐ Bureau reporting is properly defined
- ☐ Bank & NBFC do their respective credit risk assessment
- ☐ Hypothecation process is fully defined
- ☐ Loan servicing is well defined
- ☐ Escrow management is well arranged
- ☐ Other

25. Your banking partner is equally informed about the risk profile of the borrower in Co-lending business.

- ◯ Strongly Agree
- ◯ Agree
- ◯ Neutral
- ◯ Disagree
- ◯ Strongly disagree

26. On an average what is the percentage of Co-lending proposals that are rejected by your partner Bank?

27. What are the primary concerns of the partner Banks in rejection of Co-lending proposals?

28. Pricing (interest rate) of Co-lending loans are competitive

- Strongly Agree
- Agree
- Neutral
- Disagree
- Strongly disagree

29. What is the average blending rate in your Co-lending portfolio?

30. Your banking partner charges high premium to Co-lending proposals compared to their normal customers?

- Strongly Agree
- Agree
- Neutral
- Disagree
- Strongly disagree

31. How does your Banking partner justify the higher interest rate?

32. How often your partner bank persuades you to rationalize the quantum of credit to the borrower?

- Always
- Regularly
- Sometimes
- Never
- Other

33. In case of tie-ups with multiple banking partners for Co-lending, whom do you approach first and why?

34. Frequency of your Co-lending proposals getting rejected by your partner bank is high

- Strongly Agree
- Agree
- Neutral
- Disagree
- Strongly disagree

35. Low risk borrowers are walking away from the Co-lending market due to higher interest rate

- Strongly Agree
- Agree
- Neutral
- Disagree
- Strongly disagree

36. When do you inform the borrower regarding your banking partner in Co-lending business?

- ◯ At sourcing phase
- ◯ Underwriting phase
- ◯ Sanctioning phase
- ◯ Do not disclose
- ◯ Other

37. On what criteria, you decide whether the borrower is to be solely financed or to be financed under Co-lending?

- ◯ Based on the risk profile of the borrower
- ◯ Based on the quantum of loan
- ◯ Based on fund availability
- ◯ Other

38. What is your USP in Co-lending business?

39. What are your suggestions to partner banks for making the model more efficient?

40. What changes (in product/process/pricing etc.) you recommend for the growth of the Co-lending market under the present regulatory environment?

Your policy suggestions for the regulator (RBI) to improve the Co-lending business environment

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