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Co-origination of loans in India: Impact and analysis

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Abstract

'Co-origination of loan' is a scheme based on joint participation by Banks and NBFCs which appears to bring about win-win situation for all parties concerned namely; Banks & NBFCs on the one hand and Priority sector borrowers on the other hand. This was all the more warranted when economic growth rate has declined below 5%, credit rate and exports have also gone down drastically whereas inflation and unemployment are on the rise. Global scenario is gloomy and therefore not supportive in any manner to spur growth, demand for consumption and exports. However, Indian economy is witnessing both cyclical and structural forces working against accelerating the growth. Even savings and investment growth have moderated to a large extent. In such a scenario, even within the priority sector, MSMEs have great potential to grow faster even in the short run as compared to large scale enterprises. In fact, it is imperative for the Government, Banks and NBFCs to collaborate with each other so as to promote growth in MSME sector which in the process would help in creating more employment for the masses leading to increased purchasing power in the hands of people while containing inflation.

In the above backdrop and to achieve country's aspirations for a double-digit growth, it is crucial that the potential of MSME sector is optimised. But, ease of credit access to MSME's is difficult as, PSB's which are offering credit at lower prices are not able to timely deliver credit and NBFC's which are quick in delivery of credit, are offering the same at high rates and liquidity crunch. This in turn has eroded the profitability of MSMEs and impaired their growth. In order to mitigate this imbalance, RBI has come up with the concept of 'co-origination' in September, 2018. In this concept, NBFCs and Banks share the percentage of the loan provided with a pricing blend by which the effective RoI is reasonable for the borrower. In this paper we will study the impact of 'co-origination' on Banks/Financial Institutions, borrowers and economy as a whole.

Keywords: MSME, NBFC, Priority Sector Lending, Co-origination, Financial Inclusion

Introduction

Reserve Bank of India by its Circular dated September, 21 2018 laid down the frame work with specific guidelines to carry out the unique model of co-origination of loans by Banks and NBFCs for lending to priority sector. Earlier, Banks and NBFCs have been mainly advancing loans to priority sector independently. Following the collapse of IL&FS more than a year back NBFCs access to credit has gone down sharply. Banks are also now reluctant to provide NBFCs with adequate funds at reasonable rates which have adversely affected their ability to give advances to MSME sector. It is significant to note here that barring a few large and highly rated NBFCs all others are starved of (available) funds for lending purposes. As distinct from this practice, with this innovative way of co-origination of loans to priority sector (mainly consisting of small and medium enterprises) both banks and NBFCs are required to formulate policy to coordinate, synergize on certain issues including interest rate to be charged and then they have to collectively sanction and disburse loans to priority sector.

This innovative model appears to be derived from the concept of public private partnership which is undoubtedly necessitated by the fact that there is a liquidity crisis at NBFCs as well as low level of credit disbursement to priority sector by Banks. As a result, NBFCs have been going on a low scale of business. This scheme for priority sector lending where partnership dynamic between the two sets of lenders would be such that loans would be originated by NBFC with a minimum exposure of 20% and Banks would fund the rest of the loan with pre-agreed rates of lending by the two players. As per the norms issued by RBI in September 2018, the arrangement should involve sharing of risks and rewards between Banks and NBFCs, with the later taking minimum of 20 percent credit risk by way of direct

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rewards between Banks and NBFCs, with the later taking minimum of 20 percent credit risk by way of direct exposure.

It's a pioneering concept which can alleviate a lot many problems faced by MSMEs, Banks and FIs. Yet providing adequate and timely finance at reasonable rate of interest to the units is the target. As we further study its impact in Indian context, it would be significant to note, how with the course of gathering momentum of co-origination of loan model, it would be imperative for RBI to amend the guidelines which are silent on the various issues like tax benefits and involvement of multiple Banks and/or NBFCs for giving combined effect to extend credit dispensation in a single arrangement.

Essential features of Co-Origination of Loans:

- (i) It is basically a scheme for priority sector lending where partnership dynamics between the two categories of lenders namely Banks and NBFCs excluding Non-Deposit taking – Systemically Important (NBFC-ND-SI) would be involved for sharing of risk and rewards. As per RBI guidelines NBFCs with a minimum direct exposure of 20% and with the maximum of 80% by Banks are required to finance to especially micro, small & medium enterprises on mutually agreed rates of lending. In addition, they can also levy applicable charges mutually decided by them.
- (ii) The NBFCs shall have to give an undertaking to the Bank that its contribution towards the loan amount is not funded out of borrowing from the co-originating Bank or any other group company of the partner Bank.
- (iii) NBFC would have the flexibility to price their part of the exposure while Banks shall price their part of the exposure in a manner found fit as per their respective risk assessment and the RBI regulations issued from time to time.
- (iv) It is incumbent upon the NBFC to make recommendation to the Bank proposals as found relevant for joint lending. The Lenders shall be authorized to independently assess the risks and requirements of applicant borrowers. The loan agreement would be tripartite in nature.
- (v) The Bank and NBFC shall open an escrow type common account for pooling respective loan contributions for appropriate loan repayments/collections from borrowers without holding the funds of usage of float. In case of loan balances, the NBFC/ Bank shall maintain individual borrower's accounts and should also be able to generate and share a single unified statement to the Customer through appropriate sharing of required information with the Bank/NBFC.
- (vi) Both lenders shall create the framework for day to day monitoring and recovery of the loan as mutually agreed upon.
- (vii) Any assignment of loans by any of the lenders can be done only on the mutual consent of both the lenders. The applicable provisioning requirements shall be followed by each of the co-lenders.
- (viii) Banks can claim priority sector status in respect of its

shares of credit advanced to borrowers.

- (ix) NBFCs shall be first responsible for any grievance redressal and also to explain to the borrower regarding the difference between the products offered through the co-origination model as compared to its own products. Any complaint has to be resolved within 30 days and incase not resolved the borrower would have the option to approach Banking / NBFCs Ombudsman.

Literature Review

For banks to participate in NBFC-originated loans there have been several lending models. Apart from direct funding by banks to eligible MFIs, various forms of co-lending have also been explored. Direct assignment and securitization largely owe their volumes to PSL requirements. The Business Correspondent (BC) model also, to an extent, has been responsible for supplying PSLs to banks through NBFC machinery. NBFCs are not new to co-origination model as they have been partnering with Banks in various forms for loan origination. The only difference is that there used to be some form of loss-sharing arrangement, which is not permitted under the current RBI guidelines dated 21.09.2018.

In furtherance to the aforesaid press release, RBI on September 21, 2018 issued the guidelines which allow Schedule Commercial Banks (excluding Regional Rural Banks and small finance banks) to co-originate loans with Systemically Important Non-Deposit taking NBFCs (NBFC-ND-SI) for fulfilling their mandatory priority sector lending requirement. The RBI has prescribed that the 'Co-origination Model' should involve sharing of risks and rewards between the Bank and the NBFC for ensuring appropriate alignment of respective business objectives, as per the mutually decided agreement between the Bank and the NBFC.

NBFCs are primarily dependent on debt markets, bank loans and securitisation (also to Banks) to meet their funding requirement. They saw an enormous decline in credit growth and a liquidity crunch following the collapse of IL & FS and DHFL about a year ago. Hence, they have been facing difficulties in accessing funds to lend at reasonable costs, which in turn is translating into high interest rates for their borrowers. Only large and highly rated NBFCs have access to the debt markets where conditions are not currently favourable. Public sector Banks, especially under the PCA framework, are reaching the single borrower and hence overall NBFC sector is unable to meet their funding requirements. Many NBFCs, especially mid-sized, therefore are facing funding challenges which is constraining their growth opportunities. Additionally, the rising interest rate scenario means an increase in the borrowing cost of the NBFCs.

Also, co-origination mechanism gives Banking sector another avenue to meet their Priority Sector Lending (PSL) requirements which includes Securitisation, Priority Sector Lending Certificates (PSLCs), apart from direct lending. In addition to that, motivation for the Bankers to lend to the MSME segment would probably come from relatively poor return on their advances to the large corporate and also the recent regulatory guidelines restricting Banks' exposures to single borrowers or borrowers in the same corporate group.

With the rise in competition, stressed margins and evolving customer demands, Banks have also been seeking newer avenues to grow faster and tap new customer segments. As large Banks, despite having big branch networks, may not be able to reach certain locations, where the NBFCs have a strong presence. NBFCs have better understanding at the ground level because they are available till the last mile and with co-origination Banks can supplement their resources.

Under the said model, any assignment of loans by any of the lenders can be done only with the mutual consent of both the lenders. The applicable provisioning requirements shall be followed by each of the co-lenders and it shall be the responsibility of the NBFC first for any grievance redressal. Both the lenders will explain to the borrower regarding the difference between products offered through the co-origination model as compared to its own products.

Both need to work on a mutually acceptable sourcing and credit policy which must be also be approved by their Boards. They will need to enter into a tri-partite agreement with each borrower and have a separate account to monitor the funds movement under this model. Also, the NBFC will have to give an undertaking to the Bank that its contribution towards the loan amount is not funded out of borrowing from the co-originating Bank or any other group company of the partner Bank.

Entering into co-origination arrangement shall provide a competitive edge for credit to the priority sector and to mitigate the challenges faced by the Banks on priority sector loans. Since, it's a nascent concept in India, its impact and further analysis will enhance our understanding of the same as so far it has not been completely absorbed by the Indian financial sector.

Objective of study

To identify and understand the effect of 'co-origination of Loans' on Government, Banks and NBFCs on growth of MSMEs in India.

Research Methodology

Research methodology is a blueprint which gives right direction for conducting the research study. Methodology gives a direction to the researcher about formulating research design, research participants, sample and sampling techniques, hypothesis design, instruments, methods of data collection and data analysis procedures. On the basis of research design and research process, researcher tries to solve the specific problem. According to Zikmund (1984), the degree of uncertainty about the research problem determines the research methodology.

This research paper is based on secondary data and data collected from the relevant RBI and Government Publications, various journals, newspapers and websites. Researcher tries to check out the impact of Government Banks (PSUs) and NBFCs on growth of MSMEs in India. The study focuses attention on the method of financing to MSMEs and their success, if the scheme is rolled out in an appropriate manner.

Role and Impact of Co-origination of Loans in growth of MSMEs in India

While large banks despite having big branch network are constrained to reach certain locations, a large number of

NBFCs have a strong presence more particularly in smaller cities and towns and they have also a better understanding about prospective borrowers at ground level it would be worth considering adopting this unique model.

The co-origination mechanism as introduced by the Reserve Bank of India would give the banking sector (excluding RRBs and small finance Banks) another avenue to meet their priority sector lending requirements. Priority sector inter alia consists of mainly agriculture and allied activities, fisheries, horticulture, cottage industries and micro, small and medium industries. It is significant to highlight the fact that Banks have been expected to achieve the target of 18% of the net Bank credit; they have never met the target set for them in the past. Hardly around 15% of the total net Bank Credit kept on flowing into the priority sector even micro, small and medium enterprises was unable to access loans from Banks due to a variety of reasons such as geographical location or lower credit scores. Loans which were sanctioned and given by Banks to the MSMEs were found to be inadequate for most of the time and hence MSMEs were forced to turn to the unorganized financial sector to raise loans at much higher cost which intern made them less competitive in the market.

Thus, this model is expected to overcome weaknesses of both Banks and NBFCs respectively and would help increase investments as well as asset creation in Priority Sector of the economy. It is noteworthy to underline that this new co-origination scheme is also aimed at mitigating the aforesaid problems faced by MSMEs. However, credit flow would certainly increase to this sub-sector provided problems and various issues are taken into account and they are resolved on time.

Availability of funds in the hands of moderately rated NBFCs is obviously a core issue here which needs to be dealt with at war footing. The new co-origination lending system in the wake of the financial crunch at Non-Banking Finance Companies is set to enhance the credit flow to productive sectors. Policy emphasis is on long term structural reforms rather than incentives that are short term.

RBI seeks to provide a competitive edge for credit to the priority sector and mitigate the challenges faced by the Banks on priority sector loans. NBFCs operate on low cost infrastructures and have wider geographical as well as customer outreach.

An example of the implementation of the co-origination so far are as follows:

- (i) In April, SBI announced tie-up with PAISALO Digital for disbursement of loans with ticket size of Rs 10,000 to Rs 2 lakh in agriculture and small and medium enterprises. The NBFC has operations in Uttar Pradesh, Maharashtra, Himachal Pradesh, Gujarat, Rajasthan, Delhi, Haryana, Punjab, Uttarakhand and Bihar.

The evolving partnerships would soon test the potential of this model. If the partners are successfully able to streamline the operational challenges and technology challenges, there is slight reason to believe that the partnerships could also become a key lever for business expansion in other segments.

Co-origination represents an alternate business model that is asset light and creates a sustainable revenue model through NIM (net interest margin) and fee income. Due to blending of interest rates between the two lenders, there is no notional

loss in yield on advance to either Bank's or NBFC's thereby protecting their margins.

Advantages to Banks:

- (i) Banks can claim (Priority Sector Lending) PSL status for Loans financed under Co-origination model as discussed above.
- (ii) The Guidelines rule out maintenance of any float or funding pool which means, at the time of funding, the funds must be allocated between the Bank and the NBFC in their agreed ratio, such that neither party uses the funds belonging to the other. Thus, averting the risk for both.
- (iii) There is a revision of single and group borrower exposure limit for Banks. An overall ceiling on exposure of an entity to the Banking system has been mandated. As per RBI Circular, RBI/2015-16/70 DBR.No.Dir.BC.12 /13.03.00/2015-16 dated July 1, 2015, 'The exposure ceiling limits would be 15 percent of capital funds in case of a single borrower and 40 percent of capital funds in the case of a borrower group. The capital funds for the purpose will comprise of Tier I and Tier II capital as defined under capital adequacy standards.' Co-origination will provide a good avenue to Banks to expand their portfolio and diversify their risk.
- (iv) The advanced digitised platforms of NBFC's can be used by Banks for effective monitoring of assets where they can also mine customer and transaction data. Co-origination is an opportunity for the Banks because they can make use of certain significant capabilities of NBFCs like monitoring small-ticket loans, automated under-writing and efficient collection systems.

Advantages to NBFC's

- (i) Moderately rated NBFC's which face difficulty in raising funds can use this channel to increase their book size. It will omit the occurrence of funding related challenges or capital constraints. Though the major component of loan is of Banks, Co-origination will help the troubled NBFC sector get back on track with the lending processes after the slump.

Co-origination may mitigate the risk factor and asset-liability mismatches in NBFCs books' as NBFCs are not allowed to take Bank's contribution towards the loan amount to MSME from the co-originating Bank or any other group company of the partner Bank under this model. Thus, unlike previous times, NBFCs working with this model of finance, cannot multiple-finance or re-finance on single asset or have huge exposure on single borrower mitigating the risk of asset liability mismatches.

Advantages to the Borrower: Co-origination of loans between Banks and NBFCs will ensure last-mile connectivity between Banks and MSMEs in the areas where they are inaccessible. Borrowers who are unable to access loans from Banks due to reasons such as:

- (i) geographic location
- (ii) lower credit scores
- (iii) information asymmetry

have to turn to the unorganized financial sector for taking loans at much higher costs, which reduces their profit margins. Due to notional decrease in profit margins, MSMEs take a comparatively longer time to expand and most of them yield to non-performing asset class in Bank's books. Co-origination model will help MSMEs in this aspect as NBFC will take care of the collection of required information and Banks will finance depending upon their cost-to-serve to borrower and borrowers' creditworthiness. With favourable ecosystem in the manufacturing/services sector, MSMEs can pave way for fulfilling entrepreneurial ambitions.

Advantages to the Economy: Since the MSMEs fall mainly under the informal and unorganised sector, this step may help in formalization of MSMEs, reducing information asymmetry and thereby stimulating the growth of MSMEs and in turn the economy and in the process be able to generate significant levels of employment. This may also decrease the rate of rejection of loan applications by Banks and boost up the credit sentiment and credit growth in the economy.

Also, the goal of Financial Inclusion can be achieved through synergistic efforts between the mainstream financial entities and other players like MFIs, Fintech etc. as they play a complementary role in supporting Financial Institutions.

This would also have positive effect on savings and investment growth rate which off late have shown a negative trend in the economy.

Risk involved in co-origination model for Banks:

Operationally, it is quite likely that the co-origination model will throw on Banks a far more cumbersome documentation and monitoring requirement than direct assignments. Hence, all eyes will be on whether the instant Guidelines are seen as permitting credit enhancement for the Bank in form of subordination of the NBFC's share.

Risk involved in co-origination model for the borrower:

Lending is a manual process till now and borrowers may have to deal with huge documents and documentation. Fear of data duplication and compliance issues may be high.

Risks involved in co-origination model for Economy and NBFCs:

The key issue for NBFCs is solvency and the way forward will be decided by how these companies do the asset liability management. It may be noted that asset liability mismatches were a fundamental flaw which led to the issues in the sector.

In the past years with the enactment of the Recovery of Debts due to Banks and Financial Institutions Act, 1993 popularly known as the 'DRT Act' and also the Securitization Act (SARFAESI Act), it was only the Banks and statutory Financial Institutions such as ICICI, IDBI, LIC, IDFC and other like statutory financial institutions which were allowed to approach DRT (Debt Recovery Tribunals) for purposes of recovery of their bad debts and for adjudication of ancillary matters relating to recovery of loans and interest thereon. While DRT was a forum available to Banks and statutory Financial Institutions, the smaller NBFC entities were required to approach Civil

Court for all matters related to recovery of their NPAs. This judicial process before the Courts was much more time consuming vis-à-vis the more straightforward process adopted by the DRTs established under the DRT Act. This is also the forum for recovery proceedings under the SARFAESI Act whereby Banks and Financial Institutions have been provided with sweeping powers of attachment and sale of secured assets of defaulters. As a result of non-availability of a speedier forum for adjudication i.e. DRTs, the recovery process of NPAs of NBFCs was adversely affected and their performance was also badly hit. This was the case, despite NBFCs having various advantages over Banking companies in terms of higher penetration and better understanding of the micro and small finance requirements of businesses in semi-urban and rural areas. These impediments in the growth of NBFCs have been sought to be removed by bringing them within the jurisdiction of the DRT & SARFAESI Acts, and thereby allowing them to utilize the forum of DRT for their requirements of enforcement of security interest and recovery of bad loans. Keeping this end in view, the government sometime in 2016 allowed NBFCs having loan book of at least Rs. 500 crores and recovery amount /case value above Rs. 1 crore to approach DRT for adjudication of their debt recovery matters.

Conclusion and Suggestions

Although the aforesaid model of credit delivery system has been brought into focus for more than a year back, this model is still at nascent stage for reasons not far to seek. It is also true that earlier in the past a joint participation of Banks and NBFCs in various forms for loan origination existed. But this model of co-origination of loans to MSMEs now being a recognized model by the RBI is likely to be beneficial to all the three parties involved.

Especially in a situation where a large number of MSMEs operate in unorganized sector it is not easy to collect & collate financial and other relevant information regarding such MSMEs. It is also important to bear in mind that each enterprise being unique in its business and style of functioning, differs from any other enterprise. Thus, this sort of information asymmetry makes things all the more difficult for any lending institution to arrive at any kind of realistic financial assessment. Moreover, it also becomes an uphill task for any lending institution to assess performance of these entities in terms of gauging viability of their projects and future prospects. However, the presence of NBFCs in small towns and cities would help them to effectively and efficiently serve prospective borrowers. Besides this, due to the edge and advantage which NBFCs have it will be convenient and relatively easy for them to evaluate the financial strength and weaknesses associated with MSME borrowers which will eventually facilitate the process of recovery of loans advanced to them. Whereas, Banks are in a position to provide a large portion of loans required by small and medium enterprises, they would have to take more responsibility with regard to adequate and timely loan dispensation and recovery thereof as compared to NBFCs who are already facing difficulty in raising funds and expanding their portfolio.

Based on our analysis, our suggestions to further improve the scope of co-origination model in Indian context are as

follows:

- (i) Ambiguity on whether more than one Bank or NBFC be involved in a single arrangement is still there in the co-origination model as guidelines are not very clear on this aspect. Assuming that there can be multiple Banks or NBFCs in an arrangement, if there are multiple NBFCs involved, in such a case, whether minimum credit risk retention requirement of 20% by the NBFC shall be considered on individual basis or collective basis is yet to be determined. Similarly, if multiple Banks are there in the loan delivery system to a unit of MSME, a total of maximum 80% shall be considered on individual basis or collective basis. Clarity on this part will increase the scope of implementation and success of the model.
- (ii) Reduction in corporate income tax from the present rate of 30 per cent may be substantially reduced to less than 25 per cent which is the present rate applicable to large corporate entities.
- (iii) In case of Start-up enterprises tax holidays have already been given. On similar lines they (MSMEs under co-origination model) may also be given tax holidays for some time so as to stimulate their expansion in terms of increased savings and improved financial condition. MSME sector needs to be incentivised through fiscal measures and other provisions of the economic policy. MSME sector deserves further consideration for rebates on GST so as to make goods and services more competitive in the market. This would help MSMEs to achieve their break-even earlier than projected, helping them with increase in margins and eventually supporting them in expanding.
- (iv) Besides NBFCs, scope of co-origination model should be further extended to various Government Agencies like REC, IFCI, PFC etc. This would increase the reach of the model and bring about the desired effect in the economy. SIDBI has already started the process of implementation of the said model.
- (v) The priority sector assets on the Bank's books should at all times be without recourse to the NBFC. However, there is no explicit bar on any additional credit enhancement that can be provided by the NBFC under the arrangement.
- (vi) The eligibility threshold for approaching DRT (as stated in point 6.7) should be reduced to make many more NBFCs eligible to take advantages of DRT and SARFAESI Acts and avail benefits of speedier recovery of loans. This will facilitate and expedite loan recovery of NBFCs making them financially stronger with greater funds at their disposal. This is intended to have a positive impact on their financial performance which in turn would also hopefully lead to greater lending by them paving the way for higher growth rate in the economy.
- (vii) Financial institutions need to carefully evaluate if their current technology systems are capable of handling the challenges posed by the unique requirements of this arrangement.

Co-origination will necessitate significant groundwork from both the Bank and the NBFC before it takes off. As financial institutions are gearing up to capitalize on the Co-

origination opportunity there is a need for greater collaboration between the involved financial institutions, including the seamless integration of their systems and procedures, not only to meet the goals of the program but also to provide a smooth customer experience.

Recommendations

The study will improve our understanding of implementation of this concept and will help Policy makers/Banks/Financial Institutions to work on suggested parameters for successful optimisation of this model.

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