Co-origination in Lending: The Way Forward

In recent past with Asset Liability Management (ALM) and Liquidity crisis hovering over NBFCs, Co-origination in lending also called Co-lending is next big wave for lending market. By explanation, Co-lending is when Banks and NBFCs come together to disburse loans. It is a win-win situation for Banks and NBFCs, wherein Banks can disburse substantial funds and NBFCs can leverage their penetration and reach to the unbanked geographical areas of the country. Banks have challenge in reaching the last mile customer in rural areas and this gap is potentially filled by NBFCs, as they have their foot prints in the interior parts of rural India. Risk assessment play vital role in such arrangements of Co-lending as it needs to be crafted jointly to meet the compliance requirements of Banks and NBFCs. Let us dive deep into various dynamics of Co-lending. Read on…

Key Challenges faced today
Current situation and challenges faced by NBFCs and Banks in the lending space

Table 1
Table 1 above, represents challenge encountered by Banks, NBFCs and Customers in today’s finance market wherein aspirations are growing at individual and corporate levels.

With above challenges being inevitable Co-lending is next big step in collaboration between Banks and NBFCs. It is a partnership which symbolises productive transformation of weakness into potential area of growth which benefits the end customers. Currently, NBFC struggling with access to funds and Banks sitting on liquidity, makes a perfect match for both the entities to join hands and leverage this opportunity. With credit squash for NBFCs Co-
lending comes as a big prospect to grow linearly.

Considering the end customers for whom access to loans was a big challenge will be able to fulfil their personal needs and dreams.

**Key characteristics of the Co-lending arrangement for Banks and NBFCs:**

- **Team Structure:** Banks and NBFCs need to identify alliance team to deal with Co-lending operations. This will include drafting of policy, procedures and agreements to endure complete compliance as per RBI guidelines. The team needs to have experts from business, credit, risk, operations, legal and collections to ensure that all the dynamics of loan cycle are covered. Both Banks and NBFCs need to mindfully craft the team composition to reap the benefits of Co-lending considering this as a long term partnership.

- **Sourcing:** End customer sourcing will be the key aspect which will be taken care by NBFCs due to their sheer geographical reach. Having said that NBFCs carry the weight of sourcing right type of customers from credit and risk management point of view. Now with internet availability across India, sourcing customer through digital channel will lead to smooth process flow and quick disbursement of loans.

- **Underwriting:** Banks and NBFCs should independently access the risks and prices their part of exposure. Fintech companies plays vital role in determining credit assessment for the end customer who are specially new to credit and availing loans for the first time. Since these type of customers have no credit bureau data, assessing their risk profile should be thought innovatively and leveraging technology through fintech players.

- **Operations:** Defining pre-sanction and post-sanction documentation as part of co-lending arrangements for end customer is important to avoid ambiguity and compliance issues. Banks and NBFCs should comply with RBI requirements from documentation perspective during the loan journey of the customer. Banks and NBFCs should jointly draft operational manual so that there is complete transparency between both the entities.

- **Collections:** NBFCs expertise can be utilised for collection operations. Technology solutions like early warning signals can be embedded to have proactive actions towards potential customers who will default. Banks and NBFCs need to independently maintain NPA (Non-Performing Assets) provisioning in their respective books of accounts.

**Essential Features of Co-origination model between Banks and NBFCs**

**Sharing of Risk and Rewards:** Minimum 20% of the credit risk by way of direct exposure shall be on NBFC’s books till maturity and the balance will be on bank’s books. The NBFC shall 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.

**Interest Rate:** NBFC would have the flexibility to price their part of the exposure, while bank shall price its part of the exposure in a manner found fit as per their respective risk appetite/ assessment of the borrower and the RBI regulations issued from time to time. An indicative illustration for arriving at the single blended/ weighted average rate is detailed in Annex1. However, notwithstanding the charging of a single blended/ weighted average rate of interest from the borrower, the repayment/recovery of interest shall be shared between the bank and the NBFC in proportion to their share of credit and interest.
Know Your Customer (KYC): The co-originating lenders shall adhere to applicable KYC/AML guidelines, as prescribed by Department of Banking Regulation (DBR)/Department of Non-Banking Regulation (DNBR) and may also be guided by Para 14 of Master Directions on KYC, issued by DBR.

Loan Sanction: The NBFC shall recommend to the Bank proposals as found relevant for joint lending. The lenders shall be entitled to independently assess the risks and requirements of the applicant borrowers. The loan agreement would be tripartite in nature, wherein, both the Bank and the NBFC shall be parties as lenders to the loan agreement with the customer.

Common Account: The Bank and the NBFC shall open an escrow type common account for pooling respective loan contributions for disbursal as well as to appropriate loan repayments from borrowers, without holding the funds for usage of float. Regarding 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.

Monitoring & Recovery: Both lenders shall create the framework for day to day monitoring and recovery of the loan, as mutually agreed upon.

Security and Charge Creation: The lenders shall arrange for creation of security and charge as per mutually agreeable terms.

Provisioning/Reporting Requirement: Each of the lenders shall follow its independent provisioning requirements including declaration of account as NPA, as per the regulatory guidelines respectively applicable to each of them. Each of the lenders shall carry out their respective reporting requirements including reporting to Credit Information Companies, under respectively applicable law and regulations for their portion of lending.

Assignment/Change in Loan Limits: Any assignment of loans by any of the lenders can be done only with the mutual consent of both the lenders. Further, any change in loan limit of the co-originated facility can be done only with the mutual consent of both the lenders.

Grievance Redressal: It shall be the responsibility of the NBFC to explain to end borrower regarding the difference between products offered through the co-origination model as compared to its own products. The front-ending lender will be primarily responsible for providing the required customer service and grievance redressal to the borrower. However, any complaint registered by a borrower with the NBFC and/or bank shall also be shared with the bank/ NBFC and in case, the complaint is not resolved within 30 days, the borrower would have the option to escalate the same with concerned Banking Ombudsman/ Ombudsman for NBFCs.

Business Continuity Plan: Both the bank and the NBFC shall formulate a business continuity plan to ensure uninterrupted service to the borrowers till repayment of the loans under the co-origination agreement.

Annex 1 - Indicative Illustration for calculation of Blended/Weighted Average Interest Rate

Scenario 1: Fixed interest rates

Customers are offered fixed interest rate throughout life of loan.

<table>
<thead>
<tr>
<th>Blended interest rate calculations</th>
<th>Example 1</th>
<th>Example 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank</td>
<td>8%</td>
<td>8%</td>
</tr>
<tr>
<td>NBFC</td>
<td>9%</td>
<td>9%</td>
</tr>
<tr>
<td>Benchmark Interest Rate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Spread</td>
<td>2%</td>
<td>2%</td>
</tr>
<tr>
<td>Interest rate to consumer</td>
<td>10% (A)</td>
<td>10% (A)</td>
</tr>
<tr>
<td>Loan contribution ratio</td>
<td>80% (C)</td>
<td>70% (C)</td>
</tr>
<tr>
<td>Blended interest rate</td>
<td>10.40%</td>
<td>10.60%</td>
</tr>
<tr>
<td>(A<em>C)+(B</em>D)=E</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
## Scenario 2: Floating interest rates

<table>
<thead>
<tr>
<th>Change in Weighted Average interest rate</th>
<th>Example 1</th>
<th>Example 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benchmark Interest Rate (A)</td>
<td>Bank 8%</td>
<td>Bank 8%</td>
</tr>
<tr>
<td>Loan contribution ratio (C)</td>
<td>NBFC 9%</td>
<td>NBFC 9%</td>
</tr>
<tr>
<td>Weighted Average Benchmark Interest Rate (X = A<em>C + B</em>D)</td>
<td>8.20%</td>
<td>8.30%</td>
</tr>
<tr>
<td>Spread (E)</td>
<td>Bank 2%</td>
<td>Bank 2%</td>
</tr>
<tr>
<td>Weighted Average Spread (Y = E<em>C+F</em>D)</td>
<td>NBFC 3%</td>
<td>NBFC 3%</td>
</tr>
<tr>
<td>Weighted Average Interest rate offered to customer at the time of disbursement (X + Y)</td>
<td>10.40%</td>
<td>10.60%</td>
</tr>
<tr>
<td>Change in Benchmark Rate (F)</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Revised Weighted Average Benchmark Interest Rate (X' = [(A+F)*C + (B+G)*D])</td>
<td>8.40</td>
<td>8.60</td>
</tr>
<tr>
<td>New Weighted Interest Rate (X' + Y)</td>
<td>10.60%</td>
<td>10.90%</td>
</tr>
</tbody>
</table>

Note: The above illustration is only indicative in nature and is not mandatory. However, irrespective of the methodology employed by the lenders to arrive at the blended interest rate, it is envisaged that the benefit of low-cost funds from banks and lower cost of operations of NBFC is passed on to the ultimate beneficiary.

### Other Charges

Any other applicable charges will be decided mutually between co-originating lenders and communicated to the customer.

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### With both Bank and NBFC eyeing potential growth & survival opportunity, Co-lending partnerships are here to stay

Below is the key advantage for Co-lending for Banks and NBFCs:
- Increase customer reach
- Tap new customer segments
- Lower cost of customer acquisition
- Provide competitive credit to priority sector and meet regulatory requirements
- Access to latest technologies
- Create customized offerings
- Utilize NBFC’s expertise in sourcing & recovery
- Lower interest rates
- Easy access to loans
- Promote financial inclusion in the society
- Customized loans which are fit for purpose
- Get rid of the liquidity crunch
- Increase AUM without funding related challenges
- Survive the NBFC crisis
- Shared risks throughout the loan lifecycle
- Meeting priority sector lending target given by RBI

### Role of Technology – Enabling Operations, Improving Customer Experience in Co-lending

It is very important to understand technology changes which needs to be adopted by Banks and NBFCs to make this arrangement a big success. The complex nature of arrangements suggested by Co-lending guidelines makes Banks, NBFCs and technology solutions
providers to come up with innovative software solutions for smooth operational process to be governed.

Furthermore, in this digital era financial service industry is undergoing major innovative disruption in the areas such as multi payment modes, eKYC, chat bots, predictive analysis due to data analytics, real time credit scoring etc.

**Digital Customer experience:**

It is important that end customer encounters seamless digital workflow to process his loan application. Providing omni channel customer experience is one of the imperative aspects in today’s digital era. Getting the data validated from source system e.g. PAN number from NSDL, GST details from GSTIN, Bank statement analysis through fintech services providers will mitigate risk and give smooth experience to end customer who is need of loan.

**Integration between core systems:**

This simply means that there needs to be robust middleware engine which should be able to integrate data between Banks and NBFCs. Since Co-lending will be usually a retail loan with high volume the integration layer should be adequately sized. Use of robust centralized middleware systems to enable communications and information sharing between bank and NBFCs would be imperative part of the whole eco-system. The integration layer should be flexible enough to make the changes for integration with any third-party system considering the frequent changes financial industry is going through.

**Data Maintenance:**

The data base used to manage customer data needs to be secured as per the latest security guidelines suggested by RBI from time to time. Cyber security impacts the business and could have very high reputational risk for both Banks and NBFCs. Since there is confidential customer data it is vital that data maintenance is done adequately to avoid data breaches. Data maintenance review should be jointly conducted by Banks and NBFCs as regular intervals and it should not be annual activity just for tick in the box.

**Escrow Management:**

Enablement of Escrow account management with automated reporting to build trust between the Banks and NBFCs. Both the entities would like to have online reconciliation mechanism with zero items pending to be unreconciled.

**Regulatory and Internal reporting:**

MIS to senior management of Banks and NBFCs is vital for them to make strategic decisions on how the portfolio is behaving, what are the customer behaviour trends shaping up, geographical insight of portfolio behaviour and other tactical areas which will facilitate them to take decisions as part of their day to day business activities.

Implementation of reporting tools which ensure meeting regulatory requirements and timely production & consolidation of financial statements and reports by adopting data policies, procedures and standards in the most efficient method.

**Bureau reporting:**

Technology system should be robust enough to ensure correctness of bureau reporting as per the data requirement standard of credit bureaus. If the mandatory data required by bureau is not captured in source system, there is high chances of rejection of data by bureau which is not an efficient way to design any technology solutions.

**Co-lending as forthcoming model – Beginning of new partnership between Banks and NBFCs**

MSME (Micro small and medium enterprises) and SME (Small and medium enterprises) sector always had challenge of access to fund to meet their business requirements but with challenges comes opportunities. Co-lending is a partnership model wherein Banks and NBFCs will jointly collaborate to meet the funding requirements of MSME and SME. Most of these tier 3 and tier 4 entrepreneurs do not
have a formal document which will facilitate Banks and NBFCs to do their income assessment. This pushes fintech companies to come up with innovate credit assessment model for “New to Credit” (NTC) customers which can be leveraged by Banks and NBFCs as part of their co-lending model. This initiative by RBI will enhance the credit flow to productive sectors which will drive consumption demand and set the wheel of Indian economy rolling at a faster speed. The liability side of balance sheet for banks was executed by government through JAN DHAN YOJNA wherein rural population were guided to open bank accounts. Co-lending will take care of asset side of balance sheet for Banks and NBFCs to tap the market which has huge potential to grow exponentially for next two decades.

The Co-lending guidelines introduced by RBI has challenged the existing traditional model of lending market. It has opened avenues for Banks, NBFCs and Technology service providers on how to work in a collaborative method so that each entity reap the advantage and shares the risk associated. Banks and NBFCs will have to enter in tri-partite agreement with each borrower and will have to open escrow account to screen movement of funds as part of this partnership/collaboration. Both the entities will be required to do significant ground work before the flight takes off. The credit assessment parameters would be required to mutually agreed upon to ensure efficient risk assessment of the customer.

This model will reach the pinnacle in next two to four years with more and more innovations coming within the model itself. It is rightly said that “Change is the only constant” and Co-lending is one of the key changes in the lending model which is going to stay for long term.

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Illustrative flow diagram for Co-lending process:

Source: RBI/2018-19/49 FIDD.CO.Plan.BC.08/04.09.01/2018-19

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For detailed information, refer to the source: RBI/2018-19/49 FIDD.CO.Plan.BC.08/04.09.01/2018-19.