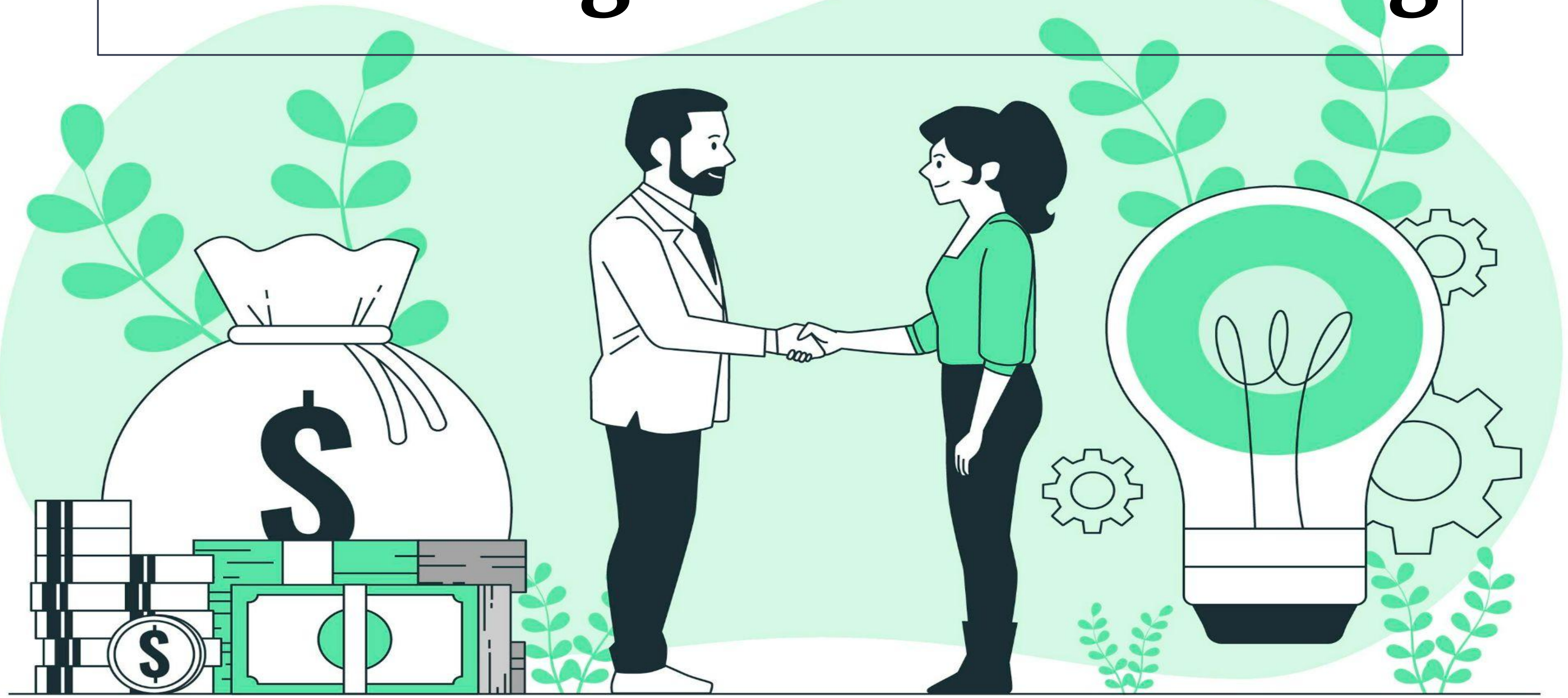
Co-Lending and Loan Sourcing



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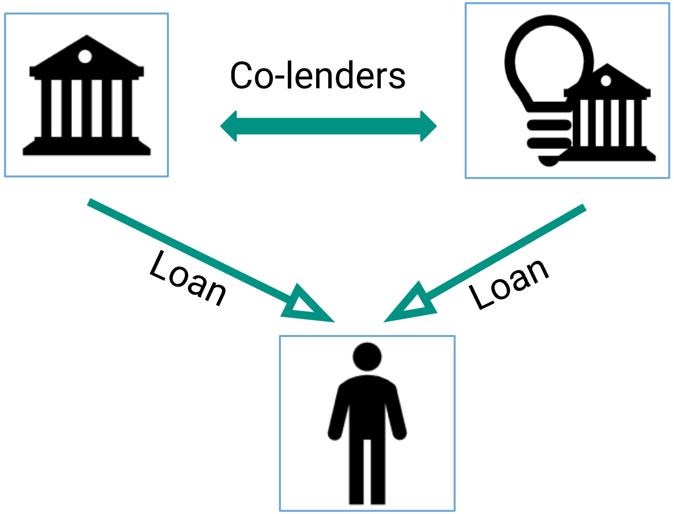
01

What do you mean by co-lending ?

Co-lending

Co-lending is the coming together of entities for the purpose of giving out loans to the borrowers.

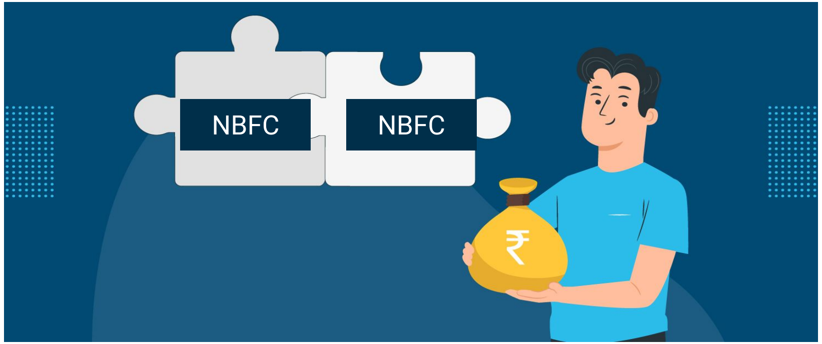
This arrangement therefore allows the lenders to make joint contribution of credit at the facility level and at the same time share the risks and rewards.



Relationship between the co-lenders and sharing of risks and rewards

- The relationship between both the lenders is defined by a ‘contract’ between them (inter-creditor or co-lender agreement).
- While the relationship between the co-lenders and the borrower is defined by a ‘loan agreement’ between them.
- The legal nature of the relationship between the co-lenders is defined by the Contract act.
- Sharing of risks and rewards are an important feature of a co-lending arrangement.
- In view of the differential role of the different co-lenders in the arrangement, the rates of return in the loan(s) may be shared differently by the co-lenders.

Co-lending



Purpose and types

- RBI has explicit guidelines for co-lending between Banks and NBFCs.
- The guidelines were enacted with a view to improve credit facilities to unserved and underserved sector of the economy and make available funds to the ultimate beneficiary at an affordable cost, considering the lower cost of funds from banks and greater reach of the NBFCs.
- However, co-lending between two NBFCs shall also follow the said guidelines.

Loans can be given for

Priority Sector (PSL)

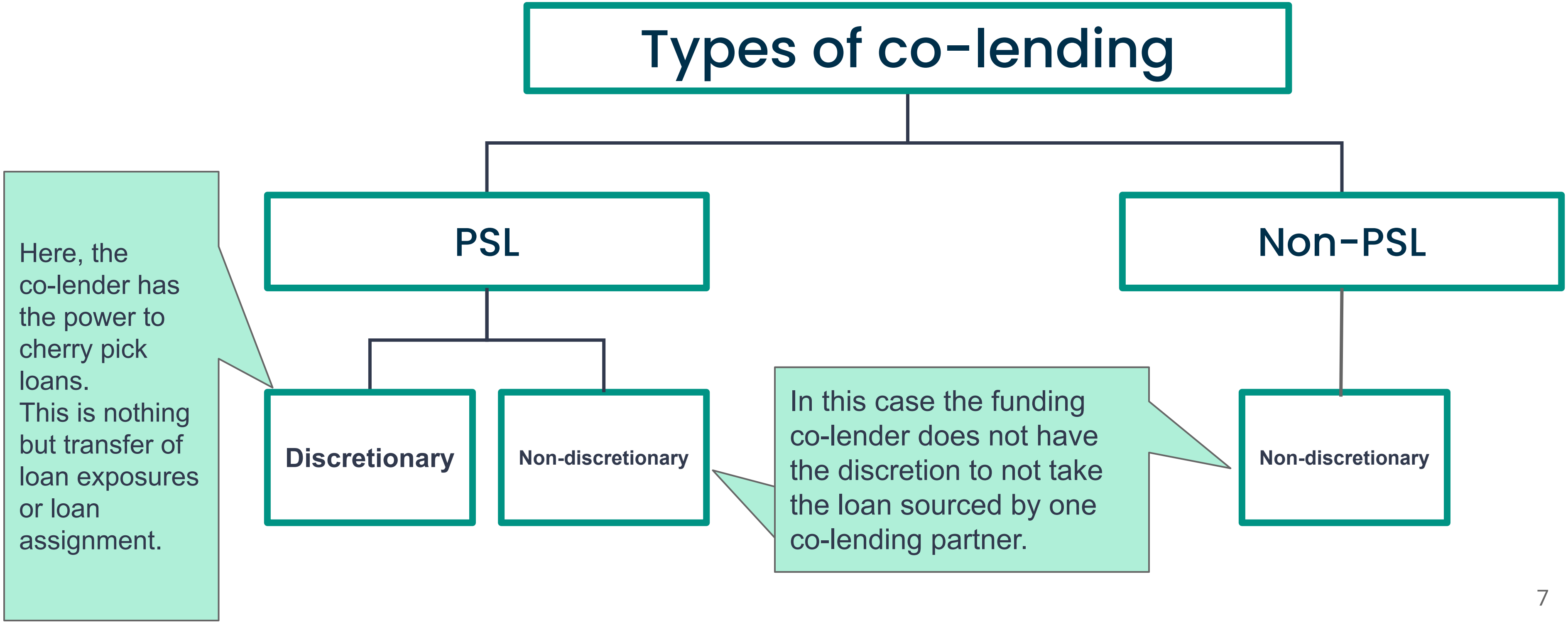
- Agriculture
- MSME
- Khadi and village industry sector
- Education
- Housing
- Social Infrastructure
- Renewable energy
- Export credit
- Factoring transactions
- Others

Non-priority Sector (Non-PSL)

Economic Rationale for Co-lending

- ❏ The economic rationale for co-lending models is to enable the co-lenders to exploit their differential abilities.
- ❏ Again, the co-lending model of RBI talks about co-lending between banks and NBFCs.
- ❏ This mechanism ensures a win-win situation for all three parties – borrower, bank and NBFC. Borrowers get the funds at a lower cost than what would have got on a standalone basis from the NBFC. The Bank would get better deployment of their funds in the unserved and underserved sector, and the NBFC would have a steady flow of economical and reliable source of funding.

Discretionary and non-discretionary co-lending



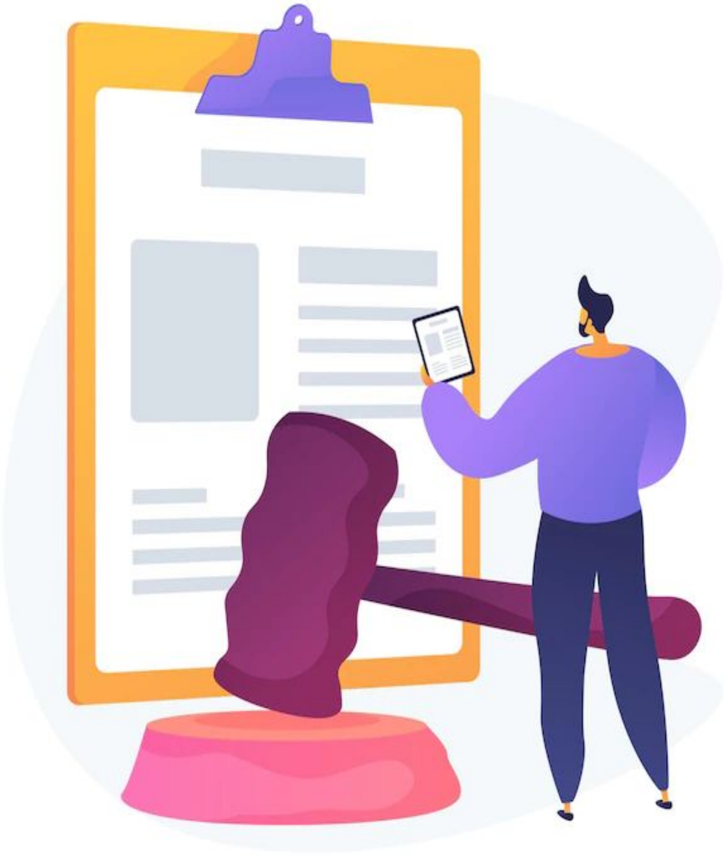
Co-lending and Transfer of loan exposure

What is transfer of loan exposure ?

- The expression means transfer of economic interest of the transferor in the loan exposure.
- Even if some of the portion of the economic interest in the loan exposure is retained by the transferor, the risk and rewards associated with the portion transferred is clearly demarcated and separated in favour of the transferee.
- The TLE Directions also call for a minimum holding period that is the minimum time for which the transferor should hold the loans before transferring them.

Can a co-lender transfer his share in the shared loan to a third party ?

The relationship between the two co-lenders is based on mutual trust just like in a partnership or joint venture arrangement.
Therefore transfer of loan exposures should happen only with the concurrence of the other co-lender.
Accordingly, the intercreditor agreement must govern such transfers to third parties.
This is a very critical aspect specially in case it is the sourcing-cum-servicing lender who desires to transfer his exposure, as the funding co-lender would have relied on the strengths of the former.



02

What does the regulations say ?

RBI Circular on Co-Lending by Banks and NBFCs to Priority Sector

Minimum retention of 20% by the NBFC

Co-lending arrangement with NBFC belonging to promoter group : not allowed

Loan agreement containing :
- Features of the loans
- Roles and responsibilities of each party

All inclusive interest rate agreed by both the lenders

Grievance redressal

Escrow account

Recovery and security

Assignment of loan to third parties

03

What is Loan Sourcing ?

Loan Sourcing

Sourcing Partner

Entity having network of persons in need of financial assistance but is not in a position to lend.

The sourcing partner does everything from collecting the loan application to forwarding the same to the the borrowers

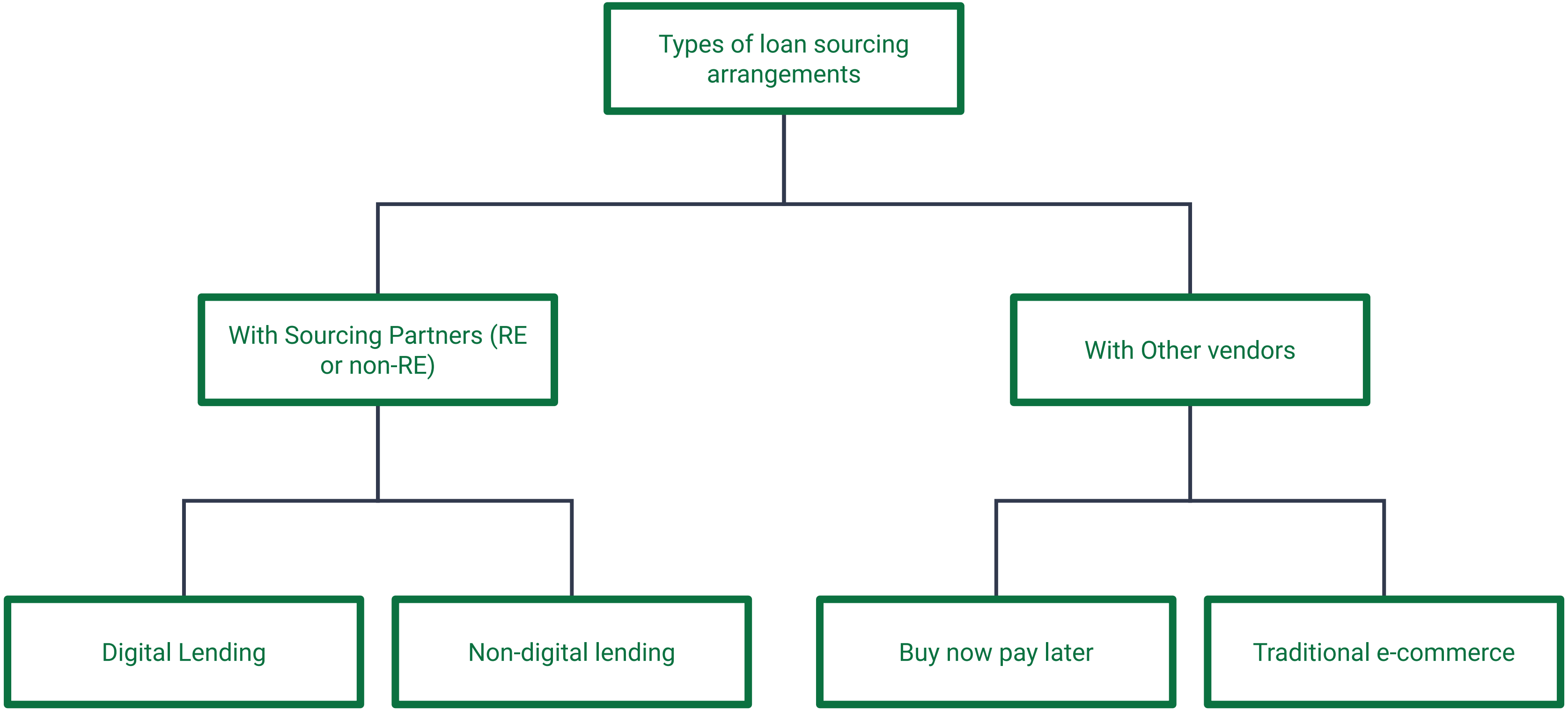
Forwards the loan application

The funding partner after doing its own credit checks approves the loan.

Entity having strong funding abilities.

Funding Partner

Types of loan sourcing arrangements



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Can one co-lender provide a default loss guarantee to the other ?

Default loss Guarantee

Let's assume there is a loan pool of 100 Cr. The guarantor guarantees the pool subject to a limit of 10 Cr. This means that all the losses upto Rs. 10 Cr will be incurred by the guarantor. The same is referred to a default loss guarantee.

On the surface of it, it might seems that the guarantee is only for Rs. 10 Cr but it actually covers all the loans in the pool.

Can a co-lender give such a guarantee to the other co-lender ?

RBI Guidelines on Default Loss Guarantee (DLG) in Digital Lending

- RBI has issued guidelines on default loss guarantee which allows Regulated Entities (RE) to enter into such DLG arrangements with Lending service provider or with other REs appointed as a LSP.
- It further states that the total amount of DLG cover on any outstanding portfolio which is specified upfront shall not exceed five per cent of the amount of that loan portfolio.
- It also mandates putting in place a board approved policy before entering into such DLG arrangements.

- The RBI guidelines only permit the REs to enter into DLG arrangements with their LSPs or with those REs with whom they have a co-lending arrangement.
- In the case of a co-lending there is no outsourcing agreement.
- Accordingly, the co-lending is not a outsourcing arrangement but is rather a shared lending arrangement.
- A co-lender cannot be said to be an agent of the other co-lender.

Therefore, a co-lender cannot provide DLG to the other co-lender.

However, nothing prevents the co-lenders from obtaining a guarantee from a third party who is engaged by them as a LSP.

05

How is co-lending changing the credit landscape in India ?

- ➔ According to reports the size of co-lending market in India crossed Rs. 10,000 crores as on September, 2022. These, however, are the numbers for co-lending done only through a fintech platform.
- ➔ More recent reports suggest co-lending has crossed the Rs. 25,000 crores mark in FY23, highlighting a more than fourfold increase from FY22 numbers.
- ➔ However, these reports take into account only co-lending between Banks and NBFCs and the actual numbers should be much higher.
- ➔ Although RBI guidelines only spoke about PSL, the practice spread to Non-PSL too.
- ➔ Digital lending platforms were capable of capturing a large number of borrowers but lacked funding capabilities.
- ➔ This funding need was satisfied by NBFCs which had sufficient funds to lend.
- ➔ Thus, there was a proliferation of co-lending arrangements between banks and digital lenders, NBFCs and digital lenders, etc.

Thank you