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# The Role of CIBIL And Credit Rating Agencies in Mitigating Adverse Selection in India’s Credit Markets

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***Abstract*—Adverse selection is a crucial challenge faced in the Indian credit markets, which may cause inefficient credit allocation and increase financial risk. Thus, by realizing this problem in the Indian credit markets, the issue of adverse selection is mitigated by credit rating agencies such as CRISIL and ICRA and credit information companies such as TransUnion CIBIL, Equifax, etc., which thoroughly check the creditworthiness of individuals, companies and businesses by assigning them various ratings and scores, which provide a smooth way for efficient credit allocation thereby, reducing the risk of adverse selection due to information asymmetry. The following work will examine the problem and factors of adverse selection in credit markets due to information asymmetry and analyse the steps taken by credit information companies like TransUnion CIBIL and credit rating agencies (CRAs) in addressing the problem of adverse selection in India’s credit markets. Such institutions play an essential role in overcoming the barrier of asymmetric information to achieve efficient credit allocation, reducing the risk of adverse selection in the market.**

***Index Terms*—Adverse Selection, Credit Rating, Credit Score, CIBIL, CRISIL, Information Asymmetry.**

## I INTRODUCTION

A series of definitions for a clear understanding is required before analysing the role of Credit information companies and credit rating agencies in mitigating the problem of adverse selection in the Indian credit markets.

## II INFORMATION ASYMMETRY

In simple terms, Information asymmetry refers to a situation in which one participant in a legitimate transaction possesses more important information than the opposing party involved in the transaction. In the context of the Indian credit markets, Information asymmetry occurs when the borrowers in the transaction have more information about their worthiness than their creditors, increasing the risk for the creditors for the efficient allocation of funds. For example, outside investors never get more information than insiders This results in insufficient information being gathered by one party compared to the other. Thus, in a company, the shareholder has more information than that of the bondholder of the companyADVERSE SELECTION

In Economic terms, Adverse selection is the consequence/result of Information asymmetry due to the hold of better information by one party compared to the other party in a transaction. With respect to Indian credit markets, due to the insufficiency of data gathered by one party, i.e. the lenders in this case, there occurs a high risk in the allocation of funds as the borrowers of the funds have more information about their worthiness for the repayment of the loan. Since the creditors/lenders would not know the borrower's creditworthiness, this causes an adverse selection. Addressing the problem of adverse selection in the Indian credit markets is crucial for ensuring better financial decisions, lower-risk lending practices, and the borrowers' creditworthiness.

## III CREDIT INFORMATION COMPANIES

Credit information companies are those organizations that analyse the creditworthiness of individuals and businesses by assigning them credit scores based on their ability to repay a loan. The rating is usually done in a three-digit format between 300-900, where a higher rating like 700-900 indicates a higher worthiness of the borrower to repay the loan, whereas a lower score like 200-350 indicates a lower chance of worthiness for the repayment of the loan by the borrower. The score is assigned by calculating the previous financial position and records. Credit scores assigned are merely considered only as an assurance given. The Reserve Bank of India (RBI) regulates all credit information companies in India. Among the credit information companies, TransUnion CIBIL is the most recognised CIC in the Indian credit markets.

## IV CREDIT RATING AGENCIES

Credit rating agencies are those organisations that assess the creditworthiness of companies, businesses and even the government. The ratings they assign help the creditors know the company's ability to repay the loan, reducing the risk of the creditors making financial decisions. The rating is usually done in alphabetical order, such as AAA, AA, A, BBB, etc., where AAA indicates a higher credit rating of the company or a firm and a lower rating, such as CCC or C- means a higher risk in lending money to a company or firm as its creditworthiness is lower. There are many credit rating agencies in India, such as CRISIL, ICRA, CARE, etc.; credit rating can also be assigned to governments where it assesses the government's creditworthiness for its ability to repay the loan. In the Indian credit market, credit rating agencies are managed and regulated by the Securities and Exchange Board of India (SEBI).

The term credit means granting a loan by the creditor to the borrower/debtor, for which the debtor does not repay it to the creditor immediately and makes arrangements for repayment after some time.

Credit markets generally refer to a well-structured system where investors, individuals, businesses and governments borrow and lend money. The key participants in credit markets include formal organizations such as banks, MFIs and NBFCs, which are regulated by the RBI and SEBI and informal organisations such as moneylenders and unauthorised lenders.

India, home to 1.4 billion people, boasts the largest and most intricate credit market. Due to its complex structure, there is a risk of adverse selection in the market; adverse selection in the credit market occurs when lenders face difficulties distinguishing between high-risk and low-risk borrowers due to the barrier of information asymmetry. Economists believe that the existence of information asymmetry hinders the functioning of a market and can lead to what is known as market failure. In a credit market, the borrowers always have more information about their financial stance, whereas the other party has been denied the same, i.e. the lenders. The lenders in a credit market are unaware of the borrower's financial creditworthiness, increasing the risk of their decision to finance their customers. This leads to the misallocation of funds in the market due to a lack of information on the lender's side.

The problem of adverse selection in the credit market can be well understood by the following case studies, where adverse selection was the primary problem in the credit market.

## V THE SUBPRIME MORTGAGE CRISIS - FOREIGN CASE STUDY

The Subprime Mortage Crisis was a financial catastrophe between 2007 - 2010 due to the collapse of the

U.S. housing bubble. Subprime mortgages were loans granted to debtors with insufficient credit history, making them high-risk borrowers. The crisis caused a global financial crisis. From 2000 to 2001, the Federal Reserve, the central bank of the U.S., lowered the interest rate due to a low recession to benefit the economy. Lowering the interest rate made borrowing money from the banks cheaper, and loans were then granted at lower interest rates to customers with good credit histories. Subsequently, banks also started to grant loans to high-risk borrowers with a bad credit history but at a higher interest rate. Due to this, people began to purchase houses, which eventually increased the rate of houses. Further, when the prices of the homes ceased to rise and started to fall, the borrowers of the mortgages could not sell their homes at a higher price to repay the loan and, thus, failed to repay the loan. When they stopped repaying, the borrowers caused a massive loss for the Mortgage-backed securities (MBS), which caused a considerable loss to the banks. For example, Lehman Brothers, a top-tier bank, went bankrupt due to these losses. Further, the catastrophe also resulted in the stock market crash, the failure of businesses, and many people losing jobs. This crisis in the U.S. can be seen through the lens of the adverse selection theory of economics. The lenders, i.e. the Banks, lacked information about the high-risk borrowers and their creditworthiness and started lending them at higher interest rates. Due to the lack of information regarding the distinguishing between high-risk and low-risk borrowers, the banks started lending more to high-risk borrowers with a low ability to repay the loan. Thus, when the prices of the houses began falling, the borrowers could not sell their homes at reasonable rates to pay back the debt. Therefore, the borrowers failed to repay the loans, causing considerable bank losses.

## VI THE MICROFINANCE CRISIS IN ANDHRA PRADESH - INDIAN CASE STUDY

The 2010 financial crisis in Andhra Pradesh was a financial blight in the microfinance sector. The Microfinance Institutions started lending out loans on a large scale, which increased the debt of the borrowers as they began to take loans multiple times from a widespread source. As the debtor the borrowers increased, the loan repayment risk drastically increased, making the borrowers unable to repay the loan. Thus, the borrowers failed to repay the loans. Further, the situation worsened as the risk of the repayment of the loans increased, and the MFIs started to implement unusual methods for the recovery of loans by using techniques such as harassment and shaming them in public. As a result, this caused distress in the borrowers, and almost 75 people in Andhra Pradesh committed suicide. The Andhra Pradesh microfinance crisis led to various consequences that affected both the borrowers and the MFIs in terms of suicides done by the borrowers due to the unethical means of loan recovery methods and the increased debts, which caused significant losses to the MFIs.

The microfinance crisis in Andhra Pradesh can be effectively linked to the concept of adverse selection in economics, which is characterized by one party having less information than the other party in a transaction. In this crisis, the rapid lending of loans to the borrowers on a large scale increased the borrowers' debts, resulting in the non-repayment of the loans they took. This can be considered a classic example of outcomes from the adverse selection in the credit market. The lenders in this case, i.e. the MFIs, were unaware of the creditworthiness of the borrowers, which led to the granting of the loans to high-risk borrowers who then failed to repay the loan due to increased debts. Further, unethical methods for recovery also contributed to this crisis.

Therefore, in conclusion, the above two case studies, from both foreign and domestic, provide a comprehensive view of the problem of adverse selection in the credit market, highlighting the consequences of lending to a high-risk borrower in a credit market.

The problem of adverse selection in the Indian Credit market is a pertinent issue that leads to the inefficient allocation of funds to high-risk borrowers, causing market failure. The problems that are caused need to be addressed through efficient methods and means for better functioning and risk-free financial decisions of the credit market in India. Given the same, the functions of credit information companies like TransUnion CIBIL and credit rating agencies like CRISIL, ICRA, etc, play a role in addressing the problem of adverse selection in the Indian credit market. These institutions' varied functions are vital in vindicating the effects of adverse selection in the Indian credit market.

## VII TRANSUNION CIBIL (CREDIT INFORMATION BUREAU (INDIA) LIMITED)

The CIBIL is the first Indian credit information company to collect financial reports from banks and individuals. The report collected by these companies is the credit information report, which is further used in generating a credit score that determines an individual's/company's creditworthiness. Credit scores provided to individuals or companies are usually three-digit numbers ranging between 300-900, which shows the ability of a borrower to repay the loan. To illustrate, if a borrower's credit score is about 250 to 350 or 400, the borrower's creditworthiness is very low. Therefore, he is a high-risk borrower who is unlikely to be able to repay the loan. Similarly, if the borrower’s credit score ranges from 700 to 750 or 800, his creditworthiness is very high, making him a low-risk borrower likely to repay the loan.

Regarding the problem of adverse selection, credit scores assigned by these companies significantly reduce the risk of misallocating funds in the credit market. This role by the CICs, therefore, mitigates the problem of adverse selection in the Indian credit market, where it distinguishes between the high-risk borrowers and low-risk borrowers of the funds, making an efficient way for the lenders to allocate the funds to the borrowing party. Furthermore, the credit score assigned to the borrowers also reduces the existing barrier of information asymmetry, which provides an advantageous transaction to the borrowing party. Thus, this again highlights the importance of CICs mitigating the burden of adverse selection in Indin credit markets.

Additionally, to reduce the risk of adverse selection in the credit market, the lenders provide loans at a lower interest rate to borrowers who have high credit scores (700-850) and charge a high rate of interest to borrowers with low credit scores (250-350/400). As a result, the borrowers with high credit scores get incentivised, which makes them take more loans as the lenders have complete trust in such borrowers due to their high credit scores. In contrast, borrowers with a lower credit score and high interest rates are charged, making them opt not to take loans anymore due to their inefficiency in repaying the loan. This phenomenon is done by lenders and is termed risk-based pricing.

Risk-based pricing can only be done when the lenders know the borrowers' credit scores; these are assigned through CICs, including TransUnion CIBIL, Equifax, etc. Thus, credit information companies like TransUnion CIBIL are vital in mitigating the risk-averse selection in the Indian credit market.

Thus, to conclude, these are the roles opted for by credit information companies like TransUnion CIBIL, Equifax, and so on to mitigate the risk of adverse selection in the Indian credit market. The roles include assigning credit scores, reducing information asymmetry, and Risk-based pricing, which the lender should duly perform.

## VIII CREDIT RATING AGENCIES

As previously noted, credit rating agencies evaluate the creditworthiness of corporations, businesses, and even governmental entities. Similar to the CICs, credit rating agencies are assigned to allocate ratings to companies and corporations. Unlike credit information companies, credit rating agencies also assign ratings to the governments to. The credit rating and the credit scores assigned are not the same, although both are assigned to check the creditworthiness of the borrowers. The credit scores the CICs assigns is a three-digit numeric code, whereas a credit rating assigned to the borrowers by the CRAs is a three-digit alphabetic code such as AAA, BBB, etc. In the ratings assigned by the CRAs in alphabetical order, AAA indicates a higher creditworthiness of the borrowers, which means that the borrower is at lower risk and ratings such as CCC, -CC indicates which is a lower credit rating indicates a lower creditworthiness of the borrower which means that the borrower is at higher risk of default. These ratings done by credit rating agencies help lenders know the actual risk and potential of the borrowers, which makes the lender effectively allocate funds to the borrower by knowing their ability to repay the loan. Thus, with the help of these ratings, the problem of adverse selection in the Indian credit market can be minimised.

In addition to the previous role of credit ratings by the CRAs, the ratings assigned also impact the information asymmetry between the two parties, i.e., the lenders and the borrowers. Earlier, the informational gap between the two parties was an additional set of advantages to the borrowing party as the borrowers knew exactly about their creditworthiness and ability to repay the loan. Due to the allocation of ratings to the borrowers, the lenders could now realise the genuine risk of granting loans to the borrowers. They could now allocate funds more efficiently as the informational gap between the parties ceased to exist. As mentioned earlier, adverse selection results from information asymmetry between the transacting parties. Since the ratings assigned to the borrowers ceased, the information gap between the parties exists, and the risk of adverse selection is also reduced.

Thus, this highlights the importance of credit rating agencies in addressing the problem of information asymmetry and adverse selection in Indian credit markets.

Further, due to the ratings assigned by the CRAs, financial institutions that act as lenders can differentiate between high-risk and low-risk borrowers. This helps the lending party grant loans and incentives to lower-risk borrowers likely to repay the loan. This also encourages lenders to penalise high-risk borrowers by charging higher interest rates, which defenestrates the high-risk borrowers' ability to take regular loans.

Thus, these are the various methods used by credit rating agencies to mitigate the problem of adverse selection in the Indian credit market, which helps in increasing the transparency between the parties in a transaction and further helps them to be efficient in the allocation of the funds to the borrowers thereby reducing the risk of improper lending and financial decisions in the credit market.

The establishment of legislative enactments also contributes to the mitigation of such problems in the Indian credit markets. In India, legislation such as the SARFAESI Act of 2002 helps the banks recover the loans granted to the borrowers. Similarly, various other acts, such as the Reserve Bank of India Act of 1934, The Banking Regulation Act of 1949, and The Insolvency and Bankruptcy Code of 2016, contribute to the same.

## IX CONCLUSION

Thus, in conclusion, this paper dealt with the basics of the Indian credit market, portraying essential definitions. The economic theory of adverse selection and information asymmetry is the major problem that is attached to the Indian credit market, which results in wrongful financial decisions in the credit markets, which further results in their declination. To showcase the same, two real-life case studies from foreign and domestic have been comprehensively analysed to show the consequences of adverse selection in the financial markets, which was caused by the informational gap that existed between the transacting parties; this gap in economic terms is known as the information asymmetry were the availability of information in one transacting party is not as same as the other thereby risking the decisions made which is known as the adverse selection. Further, to conclude, the paper then highlights the roles of Credit Information Companies (CICs) such as TransUnion CIBIL and Credit Rating agencies in resolving the problem of adverse selection in the Indian credit market and also throw light on the various legislative enactments that address the same.

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