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Pooling of funds: RBI's Co-Lending Model for Priority Sector

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ABSTRACT

Based on input from concerned stakeholders and aiming to maximize the strengths of both banks and NBFCs, the Reserve Bank of India (RBI) introduced a model to facilitate better credit flow to underserved sectors of the economy. This model, known as the 'Co-lending model', aims to make funds more readily available to the end recipient at a lower cost by combining the resources of banks and NBFCs. This partnership provides a commendable solution for mid-sized and smaller NBFCs that are often in need of funds. Co-lending has become a popular choice for banks and borrowers due to cost advantages, improved clientele quality, transparency, seamless digital/cashless processes, and diversification. This article provides an overview of various aspects of the model, from its origin to future prospects, including its advantages, disadvantages, market size over the past 5 years, and the role of third parties in ensuring a smooth onboarding process. Despite initial challenges, the model has been well-received by stakeholders and promises a bright future.

Key Words: *financial institutions, flow of funds, central banking, credit, nbfi, banks*

Introduction

On August 1, 2018, the Reserve Bank of India (RBI) issued a press release introducing a co-origination model for banks and non-banking financial companies (NBFCs). The purpose of this model is to support the credit needs of high-risk priority sectors such as agriculture, export credit, social infrastructure, renewable energy, housing, education, and MSMEs. The RBI stated that scheduled commercial banks (excluding Regional Rural Banks and Small Finance Banks) can collaborate with Non-Banking Financial Companies - Non-Deposit taking-Systemically Important (NBFC-ND-SIs) to create eligible priority sector assets. This collaboration involves joint contribution of credit by both lenders at the facility level and entails sharing of risks and rewards to ensure alignment of respective business objectives. According to the RBI, priority sectors are vital for the nation's growth, and this model aims to facilitate lending to these sectors even if they are considered high-risk by providing a mutually beneficial arrangement for banks and NBFCs.

The Reserve Bank of India (RBI) has renamed the model as ***the "Co-lending Model (CLM)***" to enhance its operational flexibility. This move aims to improve the flow of credit to the underserved and unserved sectors of the economy, making funds more accessible and affordable to the end beneficiaries. The decision to rechristen the model was based on feedback

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from various stakeholders and is intended to better utilize the strengths of both banks and NBFCs through collaboration. Banks and NBFCs are currently adhering to the latest RBI co-lending guidelines outlined in the circular dated November 5th, 2020 (RBI - Notifications, 2020).

1. Guidelines

1.1. Scope

According to RBI regulations, banks are allowed to collaborate with registered NBFCs, including Housing Finance Companies (HFCs), to provide loans based on a pre-existing agreement. This partnership is set up as an 80:20 arrangement, with banks and NBFCs sharing both the risks and rewards. Both banks and NBFCs are required to conduct proper due diligence and assess the risk before granting the loan. However, a third party may conduct the Know Your Customer (KYC) due diligence, as long as it is not based in a high-risk country, as defined by the RBI. Banks are required to adhere to the RBI's 2012 revised guidelines for securitization transactions circular (RBI - Notifications, 2012). The Minimum Holding Period (MHP) exemption is only applicable when the banks and NBFCs have a prior agreement that includes a back-to-back basis clause and complies with all other conditions outlined in the guidelines for direct assignment. Lastly, NBFCs within the promoter's group are not allowed to co-lend with the banks.

1.2. Customer related issues

Since the NBFC is the sole point of contact for consumers, it is necessary to have an agreement outlining the obligations of each party. The borrower will be evaluated at an all-inclusive interest rate agreed upon by the bank and the NBFC. In order to generate the customer's account statement, the NBFC must have sufficient data. The NBFC and banks may enter into information-sharing agreements for this purpose. To address any grievances the borrower may have, the NBFC must ensure that a grievance redressal mechanism is in place. For loans made under the agreement, the current customer service and fair practices code standards, as well as the duties placed upon the banks and NBFCs, are applicable.

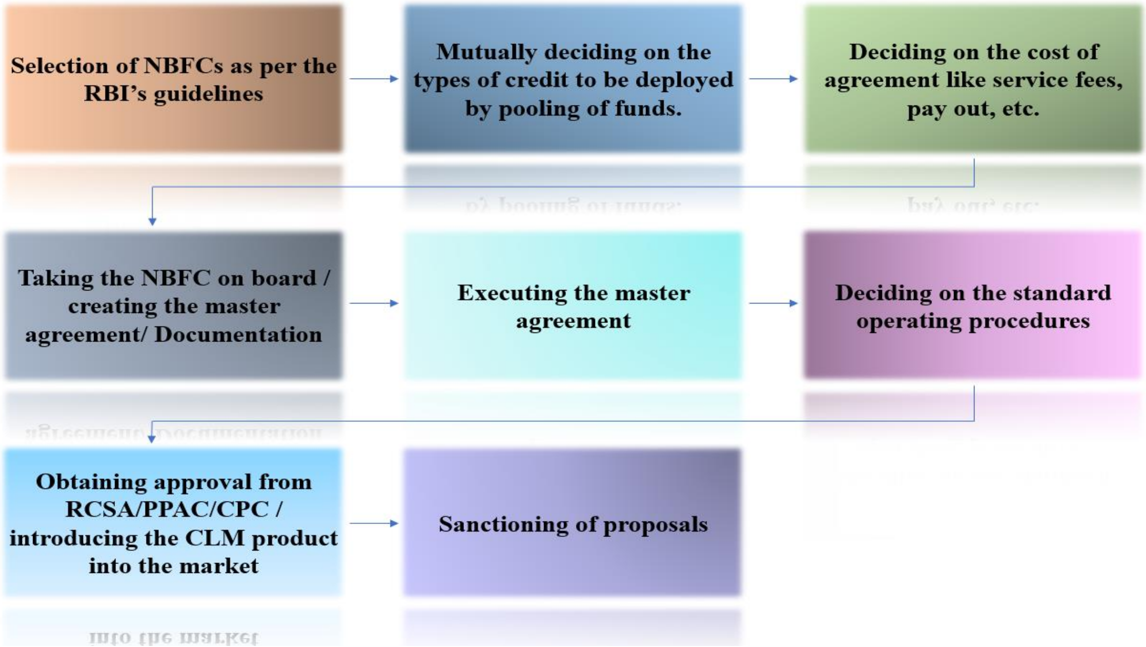
1.3. Other operational Issues

The co-lending banks and NBFCs must each maintain individual borrower accounts for their respective exposures. However, all transactions (disbursements/repayments) between the banks and NBFCs related to the co-lending model must be routed through an **escrow account** maintained with the banks, in order to avoid mingling of funds. The structure for tracking and recovering the loan, as well as the specifics of the security and fees, will be decided between the bank and NBFC. Any third-party involvement requires the consent of both the NBFC and the bank. To ensure that borrowers receive continuous service even after the co-lending arrangement between the co-lenders is terminated, the NBFC and the bank must agree on a **business continuity** strategy.

Co-lending is not a new concept; it has occurred in the past, where banks used to lend together for project financing. For NBFCs, this is excellent news since it allows them to take on larger projects with the help of partner banks. The goal of co-lending is to provide credit at a lower cost through NBFCs in priority segments like MSMEs, alternative investment funds (AIFs), and granular assets space in all geographies.

Though banks have their own challenges, combined Banks and NBFCs both have their strengths. Both are good at sourcing borrowers and maintaining excellent asset quality. NBFCs are always in need of funds and this marriage (co-lending) between the two is a commendable step taken by the RBI. Going ahead, we are likely to see a lot more collaborative lending happening in the future.

Figure 1: Process of Co-lending[2]



Source: Infomerics Economic Research

The banks and NBFCs can collaborate in various ways, such as co-origination of loans, on-lending, securitization, and more, to gain a competitive edge. Through these methods, banks aim to align their interests with NBFCs and expand market credit.

"Effective from November 16, 2023, the Reserve Bank increased the risk weights on loans by SCBs to NBFCs by 25 percentage points (over and above the risk weight associated with the given external rating) in all cases where the extant risk weight as per external rating of NBFCs is below 100 per cent. Going forward, NBFCs need to diversify and look beyond banks for their funding requirements" (RBI - Notifications, 2023). Considering this recent increase in risk weights for bank lending to NBFCs, the following are the implications:

- NBFCs giving out unsecured loans (per cent exposure of NBFCs to unsecured loans) were the most affected. The reason is the higher dependence on banks than the money market.

- NBFC became more cautious in maintaining their margins and was bound to set aside more capital. Banks, though, were not much affected as they already kept much more capital adequacy than the prescribed capital by RBI.

- Consumption was to be affected, making this step long overdue, as the risk weights were reduced after the pandemic to increase public demand.

- Fin-Techs were advised to slow down on giving out loans via phones.

- Banks would put more trust in the A-rated NBFCs than the AAA-rated NBFCs as the gap between the risks from the two types was reduced. Also, margins are higher in lending to A-rated NBFCs.

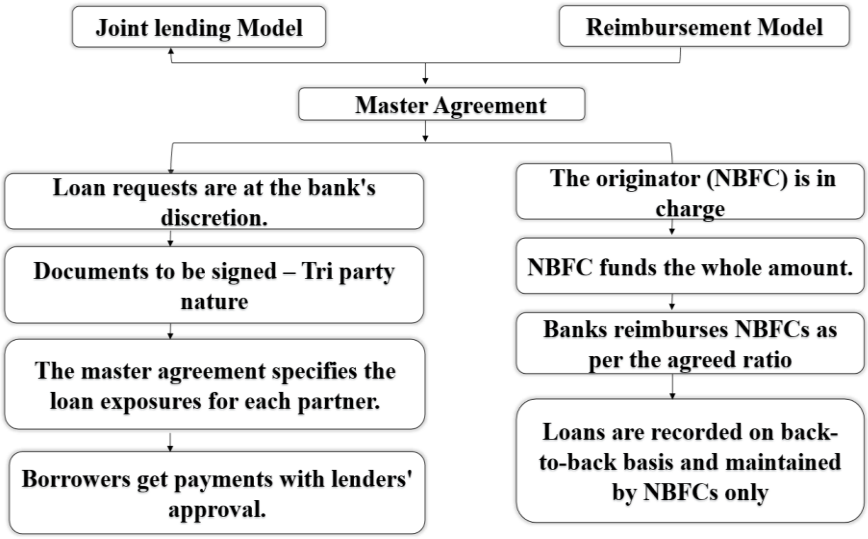
2. This process is designed on basis of the bank's perspective.

Traditionally, NBFCs and banks were mostly connected via the on-lending method, where the NBFCs receive funding from the banks and then distribute the loans to the less prosperous beneficiaries. While on-lending has its own advantages and it does reduce the operational hassles as it is much easier to just borrow and lend in a single step, instead of setting up the partnerships, creating a co-lending structure, and maintaining the serviceability, it does not seem feasible for all the NBFCs as the format of on-lending is not much scalable and has its own challenges.

2. Modes of Co-lending

Based on methodology, the co-lending model can be of two types as explained below:

Figure 2: Types of co-lending.



Source: Infomerics Economic Research

In the Joint lending model, banks can choose to reject loans even after they have been initiated by the partner NBFC. In the reimbursement (non-discretionary) model, the co-lending agreement documents the bank's commitment to record its share of the loan on its books, which originates through NBFCs (Panda, B. 2023).

3. Market outlook

The co-lending business is gaining popularity among banks. The top banks in India, namely State Bank of India (SBI) and Bank of Baroda (BOB), reported a co-lending amount of over ₹ 25000 crores in the fiscal year 2023, compared to just ₹ 5000 crores the year before (Shukla, 2023). The co-lending market is projected to triple, with banks and NBFCs expected to sign agreements totaling ₹ 1 trillion in the current financial year.

Table 1: Gross Value of Co-lending Transactions		
Financial Year	**Yubi -platform**	**SBI + BOB (combined)**

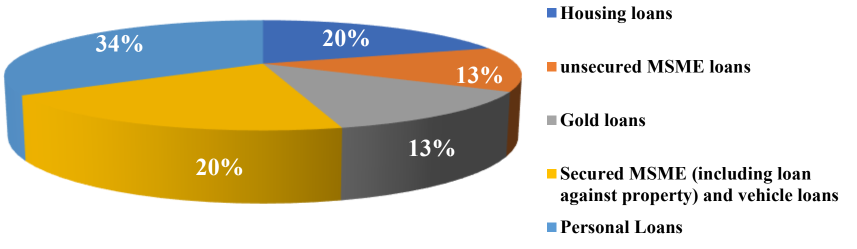
FY22	₹ 3000 cr.	₹ 5000 cr.
FY23	₹ 9000 cr.	₹ 25000 cr.
Y-o-Y (%)	200%	400%

Source: Media sources.

Several public sector banks, including SBI, BOB, PNB, Central Bank of India, and BOI, have co-lending agreements with NBFCs, as per Yubi's records. In Q4 FY21, co-lending disbursements were at ₹643 crores, which increased to ₹2901 crores in Q4 FY22 (Maity, S. 2023).

According to a CRISIL ratings study based on 100 NBFCs, which represent over 90% of the sector's assets under management, the co-lending AUM of NBFCs is close to ₹1 lakh crore after more than 5 years since the model came into existence. The study also details the share of credit deployments in various segments in the co-lending books of the sample selected by the rating agency.

Figure 3: Share (%) credit deployment in the NBFCs' AUM



Source: Based on the Crisil survey

Yubi Co. Lend has been the leading co-lending technology platform for originators and lenders since its official launch in Oct 2019. Yubi is the world's first unified credit platform (as it claims), and with the assistance of banks in forming partnerships with NBFCs, FinTech, HFCs, and other financial institutions that have a wider client base, this platform has been able to facilitate the financial inclusion of the priority sector. As per this platform, the following is the trend:

- As of September 2022, the platform registered close to ₹ 10,000+ Crores worth of loan disbursements, 54 lakhs transactions, 55 new clients, and the co-lending loan book grew at an average of 30 per cent month on month (M-o-M).
- On the platform, the consumer sector contributed around 60 percent (the majority), as against 14.4 percent of loans against property (LAP), 9.4 percent of small and medium enterprises (SME-secured), 6.5 percent of SME-unsecured, 6.5 percent for two-wheelers, and 3.9 percent for credit lines in the co-lending.
- Maharashtra led the list of states with 12 percent of the total loans disbursed throughout the year. Karnataka and Tami Nadu came in second and third, respectively, with almost 20 percent of the total loans disbursed. Over 74 percent of loans have been

disbursed to borrowers in Tier 2 and Tier 3 cities who previously had limited access to loans.

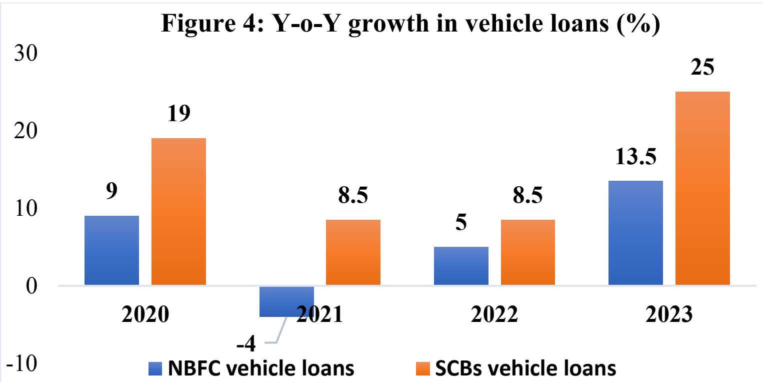
- The total volume of transactions increased 16 times from the first half of FY23, which shows the increased popularity of the co-lending model amongst the parties concerned. The platform saw a 250 percent growth year over year in terms of gross transaction volume, having recorded over 3.5 million transactions in FY23.

These numbers are based on a single digital platform and other recent reports/claims made in the news. They merely represent the actual number and are expected to grow at a fast clip.

Co-lending structures first appeared in priority-sector lending (PSL) but quickly extended to non-PSL. Digital lending was the catalyst for the co-lending boom. Through these platforms and models, digital lending firms could locate, attract, and turn over a significant number of small borrowers.

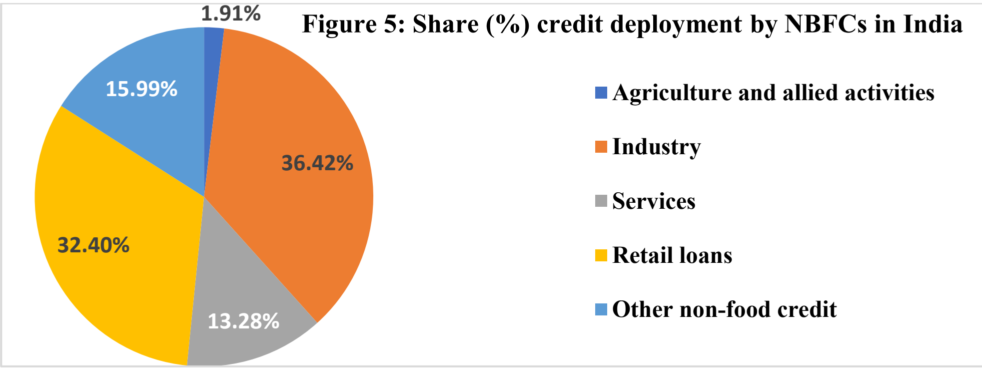
4. The priority sector

All priority sector advancements increased by 10.8 per cent in 2022-23, with private sector banks seeing the most significant rise (15.7 per cent). By contrast, PSBs lending to the priority sector increased by 7.1 per cent. Co-lending is gaining popularity in the retail segment, specifically in home loans, two-wheeler loans, commercial vehicle loans, microfinance loans, and gold loans. In 2022-23, NBFC credit to the vehicles segment rose by double digits as it emerged from the challenges of the pandemic. Banks' vehicle credit fell for two years straight but got better at 25 per cent y-o-y at the end of Marchend of March 2023 (RBI - Publications 2023).



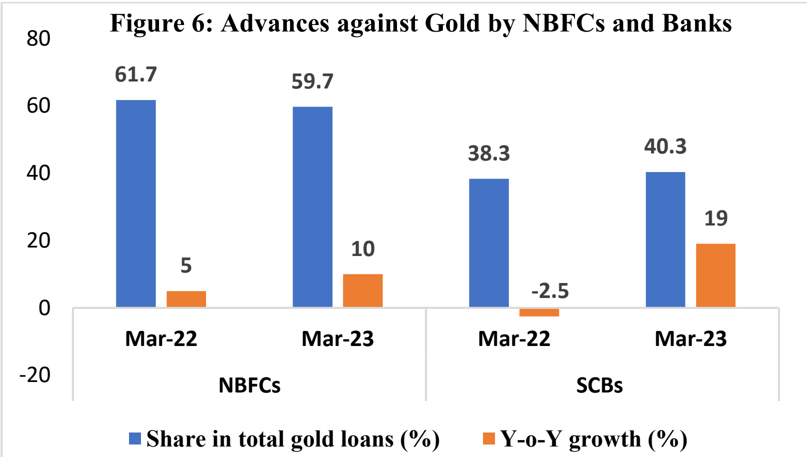
Source: CMIE database and RBI.

Banks' credit disbursements in the agriculture category procured through digital channels increased 8x in Q4 FY22 over Q4 FY21, demonstrating the tremendous growth in partnership-based sourcing (Maity, S. 2023). In 2022-23, NBFC credit to the services sector expanded, driven by transport operators and retail trade (RBI - Publications 2023). For agricultural and allied activities, credit growth was in double digits. Of the' current credit book of NBFCs, Industry accounts for the highest of about 36 per cent, followed by retail loans of 32.4 per cent. The agricultural category accounts for the lowest of all the sectors.



Source: RBI

In the gold loan segment, banks and NBFCs are collaborating more and more to take advantage of the synergies that come from co-lending. NBFCs are still a popular choice for this segment, with a share of almost 60 percent compared to SCBs' share of almost 40 percent in the total advances given against gold.



Source: RBI

About 69 per cent of MSMEs were unable to survive for more than three months in 2020, as their capacity fell from 75 per cent to 13 per cent. The RBI permitted banks to co-lend with NBFCs this particular year. This case included an 80/20 cash distribution, with banks contributing the bulk of the funds. This agreement makes the lending procedure for MSMEs and emerging enterprises simpler. For MSMEs to expand and thrive, timely and sufficient financial access is vital. Indian banks have been advised to increase loans to micro and small businesses by 20 per cent annually.[1] A significant obstacle MSMEs encountered was insufficient financing availability resulting from lack of data, lack of integrating digital platforms for smooth workflow, and non-formal business practices. Comparing Q1 FY23 to Q1 FY22, E2E[2] Digital lending is expanding. Seven out of 12 banks offer E2E digital loans to MSMEs and retailers, resulting in 40x and 2x growth in the particular sector.

[1] As per the recommendations of the Prime Minister's Task Force on Micro, Small and Medium Enterprises (MSMEs) (Chairman: Shri T.K.A.Nair, Principal Secretary, Government of India) constituted by the Government of India.

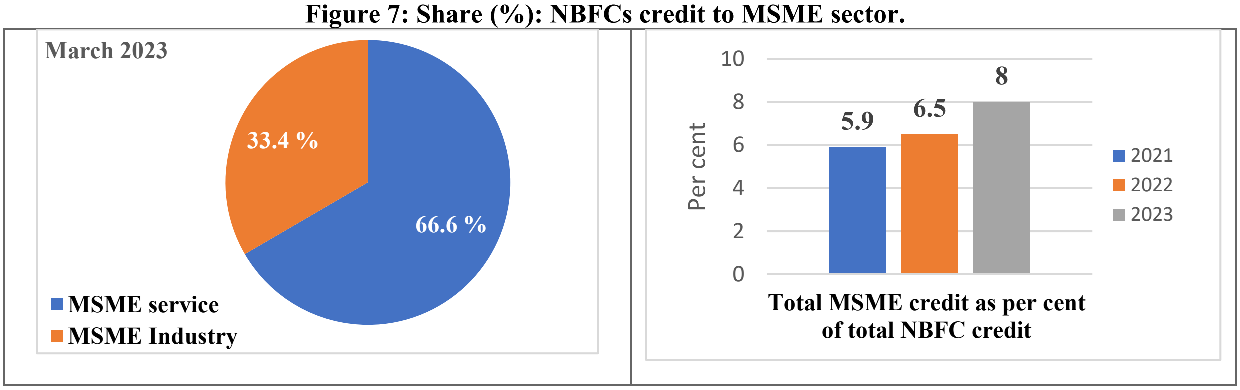
[2] The previously fragmented and partially manual processes evolve into a unified procedure with an end-to-end lending platform. The lending process has become fully streamlined, from automated loan origination and credit risk decision-making to compliance and disbursement

Table 2: Credit to the MSME sector				
Years	NBFCs credit to MSME (₹)	Banks credit to MSMEs (₹)	Y-o-Y Growth in NBFC credit (%)	Y-o-Y Growth in Banks credit (%)
2021-22	617400	8,665,880	21.20%	12.70%
2022-23	917060	9,736,908	42.40%	12.40%
Source: RBI and CMIE database.				

MSMEs' key digitized journeys include Mudra loans, MSME renewals, working capital upgrades, etc. The recent MSME Pulse Report showed that the demand for commercial loans witnessed a 33 percent growth year over year from January to March 2023.

As per the report on Trends and Progress of Banking in India by the RBI 2022-23, NBFCs' credit growth to the MSME sector was over three times that of banks, thanks to their ability to provide personalized financing solutions. The co-lending framework for priority sector lending has also expedited the flow of credit from NBFCs to the MSME sector, taking advantage of banks' low financing costs and NBFCs' wider reach (RBI - Publications 2023). NBFC credit to MSME saw a massive growth of 42.4 per cent y-o-y as compared to a marginally decreased credit growth by banks, i.e., from 12.7 per cent y-o-y to 12.4 per cent y-o-y (see table 2). Total MSME credit as per cent of total NBFC credit increased from 6.5 per cent to 8 per cent in 2023 (see figure 7).

Figure 7: Share (%): NBFCs credit to MSME sector.



Source: RBI.

Further growth will be supported by the government's focus on India's economic growth, infrastructure projects like Pradhan Mantri Awas Yojana (Urban) Mission, which will further lead to increased share of MSME and home loans in the co-lending books. Whereas, taking into consideration the increased risk weights and by generating employment in industries including semiconductors, aviation, railroads, renewable energy, and electric vehicles, etc., in an effort to alleviate dissatisfaction about unemployment rates, the share of personal loans could decline in the next fiscal.

5. Partnerships

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Globally, banks remain net borrowers from NBFCs, whereas in India, the situation is entirely opposite: banks are net lenders to NBFCs. Interconnectedness has decreased in other countries vis-à-vis India. The direct interconnectedness of NBFCs with banks has been rising in India due to higher bank borrowings (Financial Stability Board, 2022).

As per the Chief Business Officer at Yubi, 18 co-lending partnerships were recorded only in the second half of FY23, and Yubi recorded 8 of them, including banks, NBFCs, and other financial institutions like SBI, Axis Bank, Karnataka Bank, Axio, Lendingkart, and UGro Capital, among others (Shukla, P. 2023).

The co-lending transactions got a boost after the change in the guidelines in November 2020. In the new norms, banks got autonomy (ETBFSI, 2021). Some meaningful co-lending partnerships that happened recently are as follows:

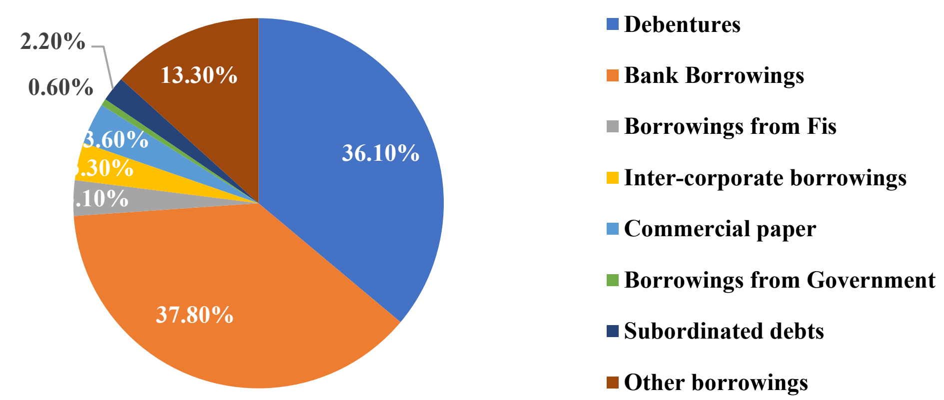
- Bank of Baroda has created an end-to-end digital platform to ink such tie-ups. It already has ties with Paisalo Digital and U-Gro Capital (Shukla, 2023). In 2022, Clix Capital partnered with the Bank of Baroda to disburse loans in the healthcare equipment space (BoB, 2022). In April 2023, the Bank already made four tie-ups, and three were in the pipeline. In addition to the healthcare sector, the Bank of Baroda has also disbursed loans for solar rooftop projects.
- In 2022, SBI made ties with five housing finance companies: PNB Housing Finance, IIFL Home Finance, Shriram Housing Finance, Edelweiss Housing Finance, and Capri Global Housing Finance. The co-lending agreement was made with Adani Capital to help farmers purchase tractors. In November 2023, SBI went into a co-lending agreement with Mahindra Finance, part of the Mahindra Group for Mahindra finance customers, to unlock the potential of Priority Sector Lending (Panda, B. 2023).
- In case of MSME loan disbursals, in 2021-22, the Central Bank of India and U GRO Capital finalized an agreement to disburse MSME loans worth ₹ 1000 crore. SBI has joined hands with Adani Capital for co-lending to farmers, Capri Global Capital has partnered with the State Bank of India for co-lending to MSMEs, and UCO Bank has entered a co-lending agreement with Aadhar Housing Finances (ETBFSI, 2021).
- The NBFC, namely M/s. Capri Global Capital Ltd has entered co-lending alliances with State Bank of India (SBI) (Business Standard, 2022), Union Bank of India (Union Bank of India, n.d.), Central Bank of India (CBI, 2023), and Punjab & Sind Bank (Statesman News Service, 2022) for MSME loans.
- Private sector banks like Axis Bank partnered with Shriram Housing, AutoTrac Finance, and ITC to grow their rural and semi-urban loan books.

Such cases can easily be increased, but our thesis is that these are not one-off alliances but a part of the inexorable pattern of rising co-lending between banks and NBFCs.

5.1. Source of funding

Over the last five fiscals, bank loans to NBFCs logged a compound annual growth rate (CAGR) of 18 per cent and stood at ₹ 13 trillion as of March 2023, against ₹ 64 billion as of March 2023. There are four ways by which banks are connected to NBFCs, i.e., co-origination, on-lending, direct lending, and co-lending (Panda, B. 2023). NBFCs finance their activities largely through borrowings from markets and banks. By the end of March 2023, bank borrowings had surpassed debentures as the primary funding source for NBFCs. Bank borrowings continue to expand rapidly as of the end of September 2023. Co-lending will increase in popularity in the upcoming fiscal year as NBFCs search for other funding sources to serve the retail market.

Figure 8: NBFCs' source of Funds



Source: RBI

6. FinTechs

With increasing innovation in fintech and artificial intelligence, the expansion of finance alternatives in unexpected ways is inevitable. The positive thing here is that there is both intent and interest coming from banks, fintech, NBFCs, HFCs, etc. The only issue we can find is the trust deficit between the banks and NBFCs, which limits a fintech platform's ability to catch up with the rest of the operations. Despite RBI's reluctance, multiple fintech companies like CRED and Jupiter have persuaded RBI to provide them with an NBFC license.

However, obstacles, such as operational challenges and integration problems,, impede the system's activation and consequent scaling up. Fintechs via UPI, Digi-locker, e-KYC, e-Sign, account aggregators, and others bridge the gap between Banks and NBFCs and borrowers. Improved credit profile accuracy, cheaper borrowing costs, shorter turnaround time (TAT), decreased credit risk, more operational flexibility, and more convenient repayment schedules are some factors that make co-lending a beneficial tool overall.

These fintech companies' services to Banks and NBFCs include automated paperless transactions, one-time API integration to organize the data across concerned parties, seamless lender onboarding, and a strong loan recovery manifesto (Panda, B. 2023).

Finally, there is a need for alignment between the mindsets of banks and NBFCs/fintech solely to enhance customer satisfaction via technologically advanced tools. Banks need to see customers as joint customers and ensure that they are equally responsible for seamless service, while NBFCs need to maintain regulatory norms.

The fundamental concept of NBFC-to-Bank co-lending is based on the difference in funds availability and expenses between the two parties. The same is true for many types of NBFCs- large and small- new and experienced. What is important here to note is that expanding on more NBFC-to-NBFC co-lending partnerships will result in more efficient and significant capital flows for MSMEs. While RBI guidelines specify bank-NBFC partnerships only, there is nothing to prevent two NBFCs from collaborating.

7. Advantages

The co-lending provides cost advantages to the NBFCs as raising funds through the money market is always 20 to 50 bps more expensive. As NBFCs must also put up at least 20 percent of the capital, banks often feel relieved about the quality of customers routed to them, and so underwriting costs for the bank get substantially reduced (Panda, B. 2023).

The core of both NBFC and Fintech business models is customer centricity. Through its efficient and straightforward operations, the bank's modern partner oversees the co-lending model's complete customer management process, assisting in future conversions and repeat loan possibilities.

With co-lending, banks can now diversify into new product segments like underwriting, which would eliminate capital constraints or funding-related issues, and the open structure will encourage the healthy expansion of priority sector loans carried out by NBFCs.

8. Disadvantages

The growing interconnectedness can also amplify systemic risks during periods of stress. When the digital lending (DL) guidelines (RBI—Notifications, 2022) were introduced, the market was somewhat disrupted since they prohibited the use of fabricated structures, which were quite common at the time. However, the DL guidelines have enabling provisions for co-lending structures that use digital lending as a mode of co-lending.

In the words of Late Pillarisetti Satish, former Executive Director of the Sa-Dhan, "Banks have the money, NBFCs have people on the ground. A marriage makes sense. But the key question is, why would a bank share a good borrower with an NBFC?" Banks are cautious in getting into a co-lending partnership. For example, Canara Bank still follows an approach that only engages in secured loans and establishes a stress-trigger threshold (Moneycontrol, 2021). There needs to be a better match between policies provided by Banks and NBFCs regarding risk assessment and underwriting. In February 2023, SBI conducted a study (primary research) based on stakeholder interaction and feedback. The results showed that the lack of trust among the lending partners might be triggered by the asymmetric information (Panda, B. 2023). The co-lenders should have mutual regard for knowledge of the participating institution.

The co-lending model suffers from a phenomenon known as the ‘slower execution timeline’. Quickening this process is manifestly essential now (Shukla, P. 2023). Some PSBs are creating their digital platform to integrate all their co-lending transactions with their partners.

To date, more comprehensive and systematic data is needed regarding the co-lending model's effectiveness. Apart from newspaper articles and paid reports, there needs to be more literature on the subject. This absence of data leaves stakeholders like regulators, rating agencies, and financial institutions with limited information about the model's modus operandi. We expect the RBI and co-lending platform will soon produce the appropriate amount of data for the past five or six years to better understand the model and the various underlying issues.

Banks that are into co-lending have yet to progress as they assume that they are superior lenders, and the NBFCs should follow them blindly and adopt their due diligence practices. In case the MSMEs are enjoying credit limits under the CGTMSE cover, Banks are reluctant to go for the co-lending option because only some of the NBFCs may have the guaranteed institution cover that is sharable. Co-lending is often exercised as an option for working capital credit, not for a composite loan or term lending to manufacturing enterprises.

9. Conclusion – Way forward

Co-lending businesses are familiar with this and still need to be more organized. The Indian SME market is expected to be worth US$ 300–400 billion by 2025, co-lending is the way to go in order to ensure credit access to these growing enterprises and, as a result, aim to unlock a trillion-dollar opportunity in terms of digital lending (Niyogin Fintech, 2023). The Government of India has long placed financial inclusion at the top of its priority list. Therefore, the government has taken several steps to broaden the scope of cooperation between banks and NBFCs. The easing of domain regulations will likely broaden banks' customer base, provide NBFCs with more money, and help them overcome their ongoing liquidity issue. Thus, the debate demonstrates that, despite numerous teething issues, the potential is enormous, the possibilities are unlimited, and the future is promising.

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