Co-lending in India: Tracing the evolution of a collaborative lending framework

MSC
MicroSave Consulting

Authored by:

Dhawal Mehra

Dhawal Mehra is a Senior Manager in the Banking, Financial Services, and Insurance (BFSI) capability at MSC (MicroSave Consulting). His experience spans micro, small, and medium enterprises (MSMEs) and retail lending, within public-sector banking and FinTech-linked platforms. He brings expertise in credit appraisal, portfolio monitoring, and digital operations. Dhawal holds a Master of Business Administration (MBA) degree from IE Business School, Madrid, Spain.

Mini Niraj Kumar

Mini Niraj Kumar is an Associate in the Catalytic Finance SPG at MSC (MicroSave Consulting). She supports projects across climate finance, micro, small, and medium enterprise (MSME) development, environmental, social, and governance (ESG) compliance, institutional strengthening, and product development. She brings expertise in conducting market research, undertaking institutional assessments, and facilitating stakeholder engagement. She holds a master's degree in forestry management from the Indian Institute of Forest Management (IIFM), Bhopal, India.

Niyanta Desai

Niyanta Desai is an Associate in the Banking, Financial Services, and Insurance (BFSI) capability at MSC (MicroSave Consulting). Her experience spans financial inclusion research, insurance, market diagnostics, micro, small, and medium enterprises (MSMEs) lending, impact assessments, and capacity building. She has worked closely with public and private stakeholders to inform program strategy and implementation. Niyanta holds a master's degree in economics, with a specialization in international trade, from the Indian Institute of Foreign Trade, New Delhi, India.

Introduction

How did co-lending evolve from a policy initiative into a mainstream lending model? What role has regulation played in shaping the way institutions collaborate to expand access to credit?

In the first policy brief in this series, we explored the fundamentals of co-lending: what it is, how it works, the roles of participating lenders, and how it differs from other collaborative lending models. We also examined how co-lending enables regulated entities (REs) to combine complementary strengths, creating a more efficient mechanism for delivering formal credit to underserved borrowers. However, understanding the operational mechanics of co-lending tells only part of the story. Equally important is understanding how the regulatory framework has evolved to support the model's growth and development.

Unlike many lending structures that emerged organically through market practice, the co-lending arrangement (CLA) in India has been carefully shaped through successive regulatory interventions by the Reserve Bank of India (RBI). Over the last several years, the RBI has progressively refined the framework, moving from the introduction of co-origination for priority sector lending (PSL) to a comprehensive, principle-based framework for collaborative lending between REs. Each regulatory milestone has reflected changing market realities, technological advancements, supervisory experience, and the growing need to expand formal credit while preserving financial stability and consumer protection.

Today, CLA is no longer merely a mechanism for banks to meet Priority Sector Lending (PSL) targets; it has evolved into a strategic model for expanding and strengthening credit delivery. The model enables banks, non-banking financial companies (NBFCs), and other REs to reach and serve a wider range of borrowers. It also enables them to share risks, responsibilities, and expertise.

In this policy brief, we trace the regulatory evolution of co-lending in India. We begin with the policy context that necessitated the RBI intervention and then examine the Co-origination Guidelines of 2018. We also cover the co-lending model (CLM) introduced in 2020, subsequent refinements to the framework, and the RBI's CLA Directions, 2025. Further, we examine the changes introduced at each stage, the rationale for those changes, and how they collectively transformed co-lending into a cornerstone of India's collaborative lending ecosystem.

Why India needed a regulatory framework for co-lending

PSL has long been one of the RBI's principal policy instruments to promote financial inclusion. Under the PSL framework, banks must allocate a prescribed proportion of their Adjusted Net Bank Credit (ANBC) to sectors important to India's socio-economic growth and inclusive economic development. These sectors include agriculture, micro, small, and medium enterprises (MSMEs), housing, education, renewable energy, and other underserved segments. For most domestic commercial banks, the overall target is 40% of ANBC or Credit Equivalent of Off-Balance Sheet Exposure (CEOBSE), whichever is higher.

Essentially, PSL operates on a demand-side logic, which does not necessarily address the supply-side constraints. For example, lending to an informal small farmer or a micro-enterprise differs operationally from lending to a large, formally documented business. The latter typically has audited financial statements, a documented credit history, and collateral that make credit assessment easier and monitoring less risky. Banks, therefore, prefer to lend to formal borrowers, regardless of their PSL targets.

Recognizing these differences, the RBI introduced the Priority Sector Lending Certificate (PSLC) mechanism in 2016. Under this framework, banks that exceed their prescribed PSL targets can monetize their surplus by selling their PSL certificates to banks that fall short, without transferring the underlying loan assets.

The PSLC market has grown substantially. Total trading volume of PSLC reached INR 12.2 trillion in FY25, compared to INR 1.8 trillion in FY18. Large PSLC trading volumes indicate that some organizations are better equipped than others to serve last-mile credit needs, as they consistently surpass their PSL targets. Unfortunately, these organizations are often not the ones with large balance sheets and lower-cost funds. Instead, they tend to be institutions that have developed effective models for serving underserved borrowers, while many banks remain constrained by traditional operating models. As a result, while PSLC helps banks meet their PSL shortfalls, it does little to expand the size of the credit pie.

> What is important to remember is that the challenge arises not from the absence of capital, but rather from the efficient delivery of capital at the last mile.

Co-lending offers a solution. It enables traditional financial institutions to meet their PSL targets by deploying capital on the ground rather than relying on the purchase of PSLCs. It enables commercial banks to contribute their deep balance-sheet capacity and low-cost capital, while non-banking financial companies (NBFCs) and FinTechs leverage their specialized underwriting, local agility, and last-mile distribution networks.

Although collaborative lending has long existed in the form of consortium and syndicated lending for large corporate exposures, its use for retail loan pools is more recent. The rise in digital lending and FinTech platforms has contributed to this shift. The term “co-lending” gained traction specifically in the context of retail credit, where two or more lenders jointly originate and fund a loan from inception.

However, allowing two regulated institutions to participate in the same loan creates a new regulatory problem and opens a host of questions:

1. How should two regulated institutions participate in the same loan without diluting accountability?
2. Who is responsible for credit assessment?
3. How are risk and rewards shared?
4. How is the loan serviced and monitored?
5. How is the borrower charged?
6. How are customer grievances handled?

These questions are particularly important when one institution performs activities on behalf of another. Collaboration cannot dilute a regulated entity’s responsibility for functions that remain subject to regulatory requirements. As co-lending emerged as a new model in finance, it became important to establish a clear regulatory framework to bring it within the regulatory perimeter and ensure the safety of borrowers and lenders alike.

The Co-origination Framework of 2018 was the RBI’s first formal attempt to establish this regulatory architecture. The policy objectives behind the RBI’s intervention were multifaceted:

- Expand financial inclusion by combining banks’ low-cost funding with NBFCs’ last-mile reach to serve underserved and priority-sector borrowers;

- Lower borrowing costs by blending the funding advantages of banks with the origination capabilities of NBFCs;
- Introduce prudential safeguards, such as minimum risk retention, uniform asset classification, and clear governance, to prevent regulatory arbitrage and ensure sound risk management.

Thus, co-lending arrangements in India emerged as a hybrid model that combines the strengths of both worlds. While NBFCs gain access to lower-cost funding, co-lending helps banks tap underserved markets. Rather than a zero-sum game, both parties stand to gain as they compete for the same role.

Co-origination of loans by banks and NBFCs for lending to the priority sector, 2018

Prior to 2018, banks and NBFCs could lend, partner, assign assets, and outsource specific tasks. They were not operating in a regulatory vacuum. The RBI's first formal step toward a co-lending framework came with the introduction of the Co-origination of Loans by Banks and NBFCs for Lending to the Priority Sector guidelines on 21st September 2018. As India's first formal regulatory framework governing co-lending, it sought to improve credit flow to the priority sector and prescribed several key features:

- The model was restricted to PSL;
- It applied only to scheduled commercial banks, excluding regional rural banks (RRBs), small finance banks (SFBs), local area banks (LABs), and urban co-operative banks (UCBs), which partnered with registered NBFCs;
- The framework allowed banks to partner with non-deposit-taking, systemically important NBFCs (NBFC-ND-SIs) for the joint origination of priority-sector loans;
- NBFCs had to retain at least 20% of each loan, while banks could finance up to 80%. This requirement ensured that both institutions retained meaningful economic exposure throughout the loan lifecycle;
- NBFCs could source and service loans, but both institutions had to agree on a common credit policy. They also had to share the risks and rewards associated with each loan.

The 20:80 risk-sharing requirement was particularly significant. The RBI required the originating institution to retain meaningful exposure rather than immediately transfer the associated credit risk, thereby ensuring it retained meaningful skin in the game. This alignment of incentives reduced the risk of weak underwriting standards. It also encouraged both institutions to maintain portfolio quality throughout the loan lifecycle.

Beyond PSL compliance, the framework marked a broader shift in regulatory philosophy. Instead of expecting every institution to independently develop end-to-end lending capabilities, the RBI recognized that institutions could generate greater value by focusing on their respective comparative advantages. This approach reduced the need for every institution to develop end-to-end lending capabilities independently. Instead, institutions could focus on their core strengths and collaborate through structured partnerships.

However, despite its innovative design, the co-origination framework witnessed relatively modest adoption in its initial years for several reasons:

- Since the framework entailed joint credit assessment, both lenders had to evaluate every individual borrower before disbursement. Each loan application, therefore, had to clear two separate credit processes, two documentation standards, two approval hierarchies, and two internal timelines. For high-volume, small-ticket lending, the framework was designed to enable, but what emerged was a structural contradiction. The model demanded operational agility, but its own rules made it operationally rigid;

- Participation was restricted to NBFC-ND-SIs, which were the largest and most capitalized non-bank lenders in the country. This restriction inadvertently excluded the institutions that most needed access to cheaper bank capital. Smaller, more locally embedded NBFCs with genuine last-mile reach in agriculture and MSME lending remained outside the framework;
- Guidance was limited on governance arrangements, customer grievance redressal, accounting treatment, recovery responsibilities, and dispute resolution mechanisms. As more institutions considered co-lending partnerships, the absence of detailed operational standards became increasingly apparent.

These early experiences demonstrated that collaborative lending required more than risk-sharing. What it required was a comprehensive governance framework to support long-term institutional partnerships.

The CLM: RBI Guidelines, 2020

Building on the lessons from the co-origination framework, the RBI introduced the Co-Lending by Banks and NBFCs to the Priority Sector on 5th November 2020, which replaced the earlier co-origination guidelines of 2018. The underlying objective remained unchanged: to combine banks' low-cost capital with NBFCs' specialized distribution capabilities. The revised framework substantially strengthened the governance architecture surrounding collaborative lending. The framework also changed the eligibility criteria, the credit assessment logic, the fund-sharing structure, and the operational model.

The revised framework brought about several significant changes, including:

- **Expanded eligibility:** Extended participation from only NBFC-ND-SIs to all registered NBFCs, including housing finance companies (HFCs).
- **Broader scope:** Continued to cover PSL while permitting co-lending for non-priority sector loans under institutions' Board-approved policies, subject to applicable prudential regulations.
- **Two operating models:** Introduced CLM 1, based on a prior irrevocable commitment by the bank to fund eligible loans, and CLM 2, where the bank could exercise discretion before taking loans onto its books.
- **Governance framework:** Mandated Board-approved policies and a Master Agreement specifying underwriting standards, operational responsibilities, servicing arrangements, and risk-sharing mechanisms.
- **Risk retention:** Required NBFCs to retain a minimum 20% exposure in every co-lent loan, ensuring continued alignment of incentives.
- **Regulatory compliance:** Reinforced compliance with know your customer (KYC), outsourcing, customer protection, audit, and priority sector classification requirements.

The framework remained confined to bank-NBFC partnerships and excluded other REs such as RRBs, SFBs, and cooperative banks. There were also concerns regarding inadequate disclosures, higher effective borrower rates, and NBFCs acting primarily as originators with minimal balance-sheet exposure.

The evolution of the co-lending models (CLMs)

Although the RBI introduced the framework simply as a Co-Lending Model (CLM), industry participants soon started to distinguish between two operational structures under the guidelines. These operating structures were referred to as CLM 1 and CLM 2, respectively. These terms are widely used in banking parlance, but they do not appear in the RBI's regulatory notifications. The emergence of CLM 1 and CLM 2 reflected the industry's attempt to categorize two distinct operational approaches under the 2020 framework.

> The distinction between CLM 1 and CLM 2 centers on the timing of the bank's participation in the loan and the manner in which credit exposure is assumed.

Under CLM 1, the bank entered into an irrevocable prior commitment to acquire its agreed share of every eligible loan originated by the NBFC. Consequently, both lenders assumed credit exposure from origination and shared risks and rewards throughout the loan lifecycle. Operationally, this model remained closest to the RBI's original co-lending philosophy. Both lenders participated jointly, aligned their incentives, and held the credit asset simultaneously. The arrangement promoted greater transparency and ensured that both institutions maintained a long-term interest in borrower performance.

Recognizing that such simultaneous participation could sometimes delay loan processing, the RBI also permitted a more flexible operational approach. Under what was later designated as CLM 2, the NBFC originated and initially disbursed the loan from its own balance sheet. The bank could then acquire its agreed share after conducting independent due diligence. This structure reduced operational friction because loan origination could proceed without concurrent approval from the financing bank. As a result, CLM 2 became particularly attractive for large-scale digital credit partnerships, where speed and operational efficiency were paramount.

However, the flexibility offered by CLM 2 also introduced conceptual and regulatory challenges. The bank participated only after loan origination, making the arrangement akin to a direct assignment (DA) transaction. Instead of jointly originating credit, the bank effectively acquired an existing loan from the NBFC. This blurred the distinction between collaborative lending and loan transfer. Industry experts argued that this discretionary acquisition model diluted the defining feature of co-lending, "simultaneous risk participation." It also created uncertainty about the true regulatory nature of these transactions.

The coexistence of CLM 1 and CLM 2 also produced considerable variation in market practices. Individual banks interpreted operational responsibilities differently, negotiated bespoke Master Agreements, and adopted institution-specific approaches to credit appraisal, customer servicing, loan booking, and technology integration. While this flexibility encouraged innovation and accelerated adoption, it also reduced standardization across the ecosystem and made regulatory oversight and consistent treatment of borrowers more challenging.

Operational refinements in the CLM

The revisions introduced during 2021-2022 sought to address supervisory concerns about inconsistent practices among co-lending partners, particularly regarding fund-flow mechanisms, escrow arrangements, and asset-classification norms. They also sought to align co-lending with the RBI's broader digital lending and outsourcing guidelines issued during this period. The RBI did not issue a new "CLM 2" circular in 2022. Instead, it refined and clarified the 2020 CLM through supervisory guidance notes, frequently asked questions (FAQs), and clarifications. These measures addressed operational ambiguities and strengthened safeguards around fund flows, third-party fees, and borrower disclosures. These refinements preserved the core CLM architecture but embedded stricter operational requirements. These included mandatory escrow accounts for disbursements and repayments, as well as clearer timelines for loan-share transfers between partners. They also aligned co-lending with the Key Fact Statement (KFS) norms for transparent disclosure of interest rates and fees. The 2022 refinements also aligned co-lending with the RBI's Digital Lending Guidelines. These guidelines introduced stricter norms for lending service providers (LSPs), data privacy, borrower consent, and permissible fee structures. Together, these refinements closed operational loopholes and significantly reduced the scope for regulatory arbitrage.

The Co-Lending Arrangements (CLA) Directions, 2025

In April 2025, the RBI issued draft CLA Directions for public consultation. After stakeholder feedback, the final Reserve Bank of India (Co-Lending Arrangements) Directions, 2025 were issued on 6th August 2025, effective from 1st January 2026. The 2020 circular was formally repealed. The CLM 2 model was also removed, leaving co-lending under the ambit of CLM 1.

This revised policy broadened the lending scope beyond priority sectors, invited broader institutional participation, and eliminated previous ambiguities with a highly structured, standardized framework.

Key change	What changed?	Why it matters
Expanded scope	The co-lending framework extends beyond PSL to a wider range of loan segments and eligible REs.	Enables broader adoption of co-lending across products and customer segments.
Standardized risk sharing	Both lending partners must retain a minimum 10% share of every co-lent loan, down from 20%.	Aligns incentives and ensures that both institutions maintain exposure throughout the loan lifecycle.
Default loss guarantee (DLG)	Originating REs may provide a DLG of up to 5% of the outstanding portfolio, subject to RBI conditions.	Strengthens confidence between lending partners while maintaining prudent risk management.

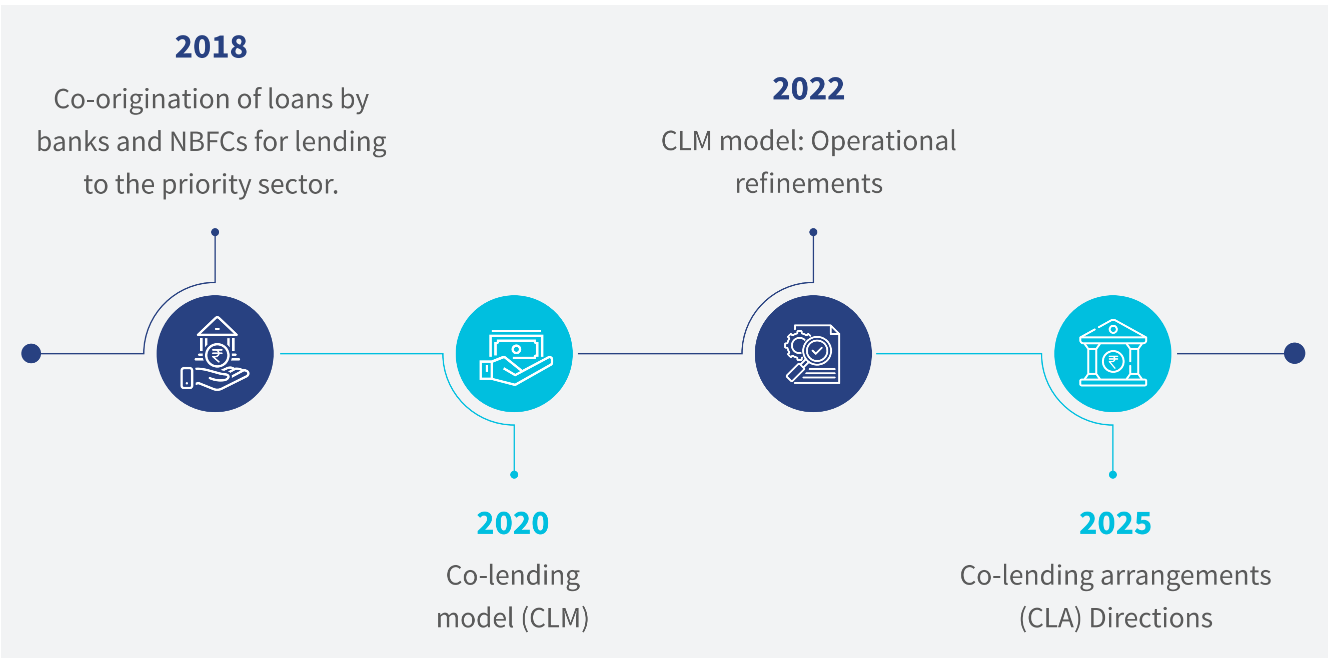
Key change	What changed?	Why it matters
Borrower-level asset classification	Both partners must maintain consistent Special Mention Account (SMA) and Non-Performing Asset (NPA) classification for the same borrower.	Improves transparency, regulatory consistency, and portfolio monitoring.
Governance and customer protection	The framework requires a mandatory Master Agreement, escrow-based fund flows, KFS, blended pricing, and a single customer interface.	Promotes operational clarity, transparency, and better customer experience.

However, in November 2025, the RBI withdrew the standalone CLA framework and replaced it with the Reserve Bank of India (All-India Financial Institutions – Transfer and Distribution of Credit Risk) Directions, 2025. The rationale was broader than co-lending itself. The RBI recognized that regulated institutions use several mechanisms to transfer and distribute credit risk, including loan transfers and co-lending, and sought to bring these arrangements within a single, comprehensive, and self-contained regulatory framework rather than regulate them through separate directions. Co-lending was consequently retained as a distinct component of the new framework, but was positioned alongside other forms of credit-risk transfer and distribution.

The bottom line is that the 2025 Directions strengthen governance, harmonize operational practices, and expand the framework's applicability. Together, these changes reposition co-lending beyond its original PSL-oriented design toward a broader and more standardized model of collaborative lending and lay the foundation for wider adoption of co-lending across India's financial ecosystem.

Regulatory journey of co-lending in India

India's co-lending regulatory framework has evolved through key milestones set by the RBI. These changes have created a more structured, transparent, and scalable model for collaborative lending.



Product categories and ticket sizes

Unlike the earlier priority-sector-only framework, the 2025 Directions apply to both secured and unsecured loan portfolios without product-level restrictions. This marks a significant shift from a model historically associated with agriculture, MSMEs, and affordable housing.

However, ticket-size requirements continue under the PSL framework when REs seek PSL classification for their co-lent share. CLAs that do not seek PSL classification are not subject to these specific ticket-size caps. Instead, they follow each RE's Board-approved credit policy.

Customer segments

The RBI has historically framed co-lending as a way to extend "credit at an affordable cost." The model combines banks' lower cost of funds with NBFCs' wider reach. Historically, the model has served:

- MSMEs and small businesses, particularly those without an extensive banking relationship;
- Small and marginal farmers, and agri-allied borrowers;
- New-to-credit and thin-file borrowers in semi-urban and rural geographies;
- Affordable housing borrowers.

Under the 2025 Directions, the broader scope allows the model to serve any borrower category that an RE's credit policy supports. However, the model's core value proposition remains strongest for underserved segments that require deeper reach and more specialized credit assessment.

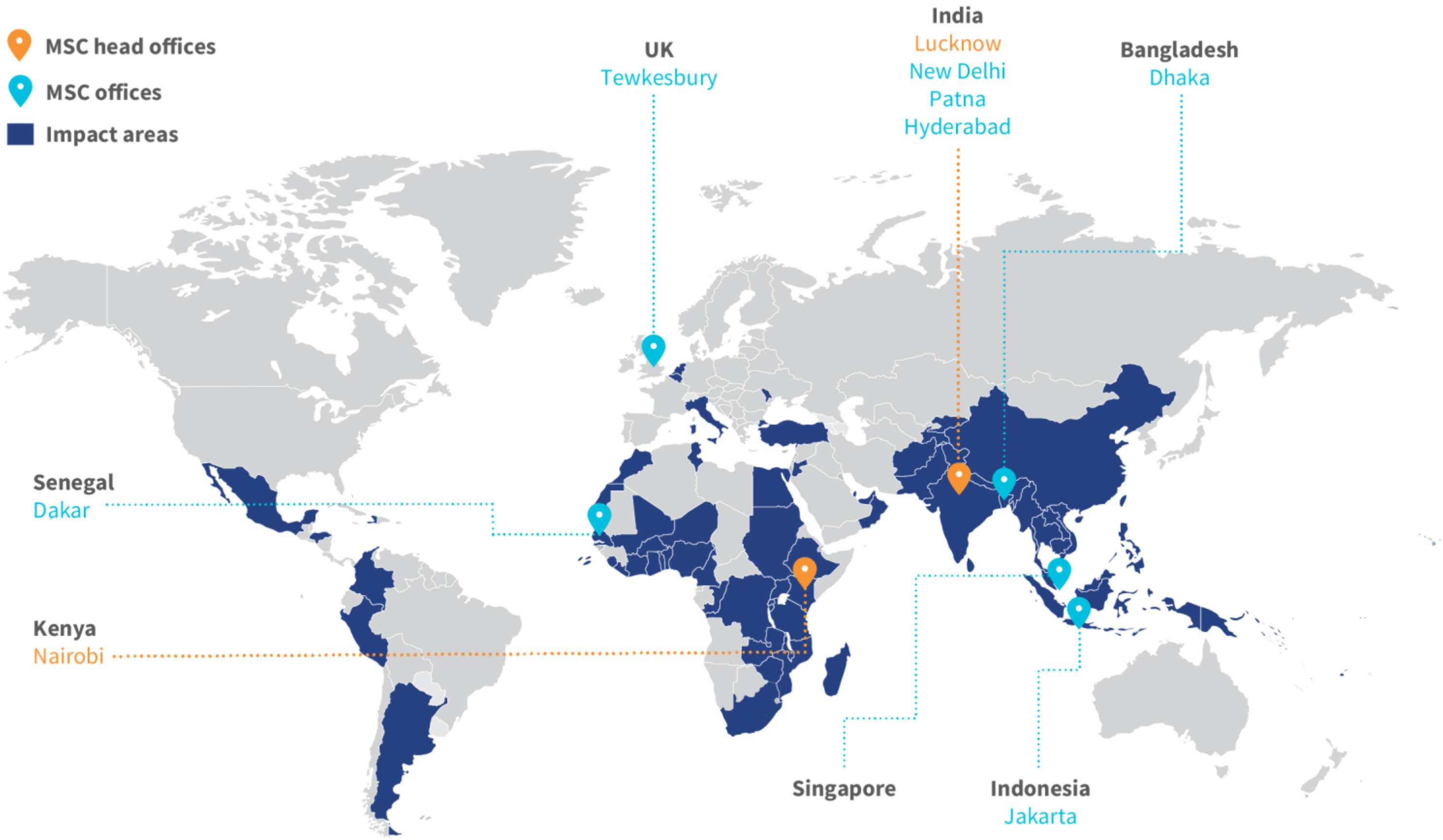
Conclusion

The evolution of India's co-lending framework reflects a broader shift in regulatory thinking. It has moved from treating collaborative lending as a niche PSL mechanism to recognizing it as a scalable architecture for credit delivery. Through successive reforms, the RBI has strengthened governance, aligned incentives, expanded institutional participation, and created a framework for collaboration among diverse REs. The framework also balances innovation with prudential oversight, which supports broader and more sustainable credit delivery.

Yet regulations are only the starting point. Their significance lies in how they reshape the flow of credit on the ground. The framework may now be in place, but its real promise is only beginning to unfold.

In the final brief in this series, we move from policy to practice by examining the implementation of this framework through the SIDBI–RRB CLA. We explore how collaborative lending is helping RRBs diversify their portfolios, deepen their footprint among rural MSMEs, and serve these businesses with greater ambition. More importantly, we explore what happens when a regulatory framework designed for collaboration is put to work, and what that could mean for the future of rural MSME finance in India.

MSC
MicroSave Consulting



Asia head office

28/35, Ground Floor, Princeton Business Park, 16 Ashok Marg,
Lucknow, Uttar Pradesh, India 226001
Tel : +91-522-228-8783 | Fax : +91-522-406-3773

Africa head office

Landmark Plaza, 5th Floor, Argwings Kodhek Road
P.O. Box 76436, Yaya 00508, Nairobi, Kenya
Tel: +254-20-272-4801/272-4806

Email: info@microsave.net | Website: www.microsave.net