Reimagining rural MSME finance: How collaborative lending strengthens India’s regional rural banks

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How can India unlock the full potential of the millions of businesses that operate beyond its metropolitan centers? What will it take to ensure that rural entrepreneurs can access the credit they need to grow and create jobs?

The answer lies with rural and semi-urban micro, small, and medium enterprises (MSMEs). MSMEs operate across these regions, and generate employment, strengthen local value chains, and contribute significantly to regional economic development. The sector contributes 30.1% of India's GDP, 35.4% of manufacturing output, and 45.73% of total exports. It employs roughly 280 million people.

Addressing this credit gap requires institutions to combine their strengths. Co-lending has emerged as an important response by bringing together the complementary capabilities of regulated entities (REs). Banks provide low-cost capital and robust risk management systems. Non-banking financial companies (NBFCs) provide specialized underwriting expertise and last-mile outreach. Together, they can expand access to credit.

As discussed in the previous policy briefs in this series, the Reserve Bank of India's (RBI) co-lending arrangements (CLA) Directions, 2025 provide a comprehensive regulatory framework for partnerships among eligible regulated entities. However, regional rural banks (RRBs) remain outside the general scope of these Directions.

Instead, they operate under a distinct regulatory arrangement. Under a special regulatory arrangement approved by the RBI, RRBs can enter into co-lending arrangements only with the Small Industries Development Bank of India (SIDBI). This creates a unique institutional model to strengthen MSME finance.

Through this model, SIDBI and RRBs jointly extend MSME credit. SIDBI contributes domain expertise and digital capabilities, while RRBs provide their extensive branch network and local reach.

The untapped strength of India's RRBs

Few institutions possess the reach and community presence of India's RRBs. RRBs have long served as the backbone of rural banking. They have a network of 22,207 branches across 26 states and 3 union territories. Nearly 92% of these branches are in rural and semi-urban areas. RRBs, therefore, serve as a primary financial link for millions of rural citizens and help bridge the rural credit gap through community trust and local connectivity.

Built on decades of community trust and local connectivity, RRBs have traditionally played a pivotal role in supporting agricultural credit and rural livelihoods. Their understanding of local economies, close customer engagement, and widespread branch presence give them a unique position to extend formal financial services to underserved communities.

However, despite this unmatched reach, a historical paradox remains. While RRBs' total outstanding loans grew to INR 5.2 trillion (approximately USD 55 billion), their MSME portfolio stood at only INR 0.57 trillion (approximately USD 6 billion). In contrast, credit flows remained heavily concentrated in the agri sector. RRBs disbursed INR 2.5 trillion (~USD 26 billion) in total agricultural credit.

Recognizing this opportunity, the Government of India (GoI) and the RBI have consistently emphasized stronger MSME finance through existing rural financial institutions. The broader vision goes beyond greater credit availability. It seeks to transform RRBs into digitally enabled financial institutions that offer diverse credit products, improve customer experience, and support rural entrepreneurship through modern credit delivery mechanisms.

From exclusion to opportunity: The evolution of co-lending for RRBs

The integration of RRBs into the collaborative lending ecosystem was gradual.

The initial barrier

When the RBI formalized the co-lending model (CLM) in 2020, it sought to boost credit flow to underserved sectors. However, RRBs remained largely outside the general framework. All-India Financial Institutions (AIFIs), including the Small Industries Development Bank of India (SIDBI), also remained outside the framework. The original model covered only partnerships between scheduled commercial banks and NBFCs. The CLA Directions, 2025, effective 1st January 2026, broadened the framework to include AIFIs such as SIDBI, the National Bank for Agriculture and Rural Development (NABARD), and the National Housing Bank (NHB). The Directions also established a more standardized governance framework for collaborative lending. However, RRBs continued to remain outside the general co-lending framework.

The strategic pivot: The SIDBI exception

The RBI introduced a special authorization for SIDBI, the national apex institution for MSME development, in recognition of the role that RRBs play in rural industrialization. This exception allowed SIDBI to enter into CLAs with RRBs. It positioned RRBs as vital originating partners for rural enterprises. The partnership addresses the institutional mismatch by combining the strengths of both institutions. RRBs provide extensive local presence and strong customer relationships, while SIDBI provides specialized underwriting expertise and low-cost capital. RRBs can diversify their portfolios by mapping branches to MSME clusters and introducing customized loan products. SIDBI acts as a market maker and risk-sharing partner.

From vision to reality: How MSC is supporting the co-lending journey

A co-lending framework can deliver meaningful outcomes only when participating institutions have the right processes, capabilities, and digital infrastructure. The translation of the regulatory vision into operations, therefore, requires sustained institutional strengthening alongside technology adoption. The support has focused on three complementary pillars.

- **Supporting the strengthening of institutional and operational readiness.** MSC (MicroSave Consulting) has worked with participating institutions to standardize operational processes and refine digital workflows. It has strengthened loan origination and monitoring systems and developed robust credit appraisal frameworks. The support also includes refining the business rule engine (BRE) logic and strengthening the loan origination and monitoring processes. It also covers standard operating procedures to improve consistency across institutions.

- **Building institutional capabilities.** Technology alone cannot transform lending practices without investment in people. Through continuous implementation support, pilot support, and knowledge sharing, credit teams and field staff have strengthened their understanding of MSME lending. They have also developed stronger skills in digital credit assessment, portfolio monitoring, and collaborative lending processes. The MSC team has developed training materials that provide RRB staff with clear operational guidance. These materials also give borrowers a clear understanding of the co-lending process and documentation requirements. Together, these resources support a smoother and more transparent borrowing experience. This focus on capacity building has enabled institutions to develop internal expertise that extends beyond the pilot phase.

- **Supporting continuous implementation and learning.** Institutional transformation is an iterative process. Throughout implementation, participating institutions have received operational guidance and case-level observations.
- The support also covers management information systems (MIS), dashboard development, process refinement, and continuous feedback. This approach has helped institutions strengthen their operational capabilities. It has also created a scalable, replicable model to expand access to productive credit for rural and semi-urban enterprises.

Rather than introduce a parallel lending framework, the initiative strengthens existing institutions. It enables them to adopt co-lending through standardized, technology-enabled, and sustainable processes.

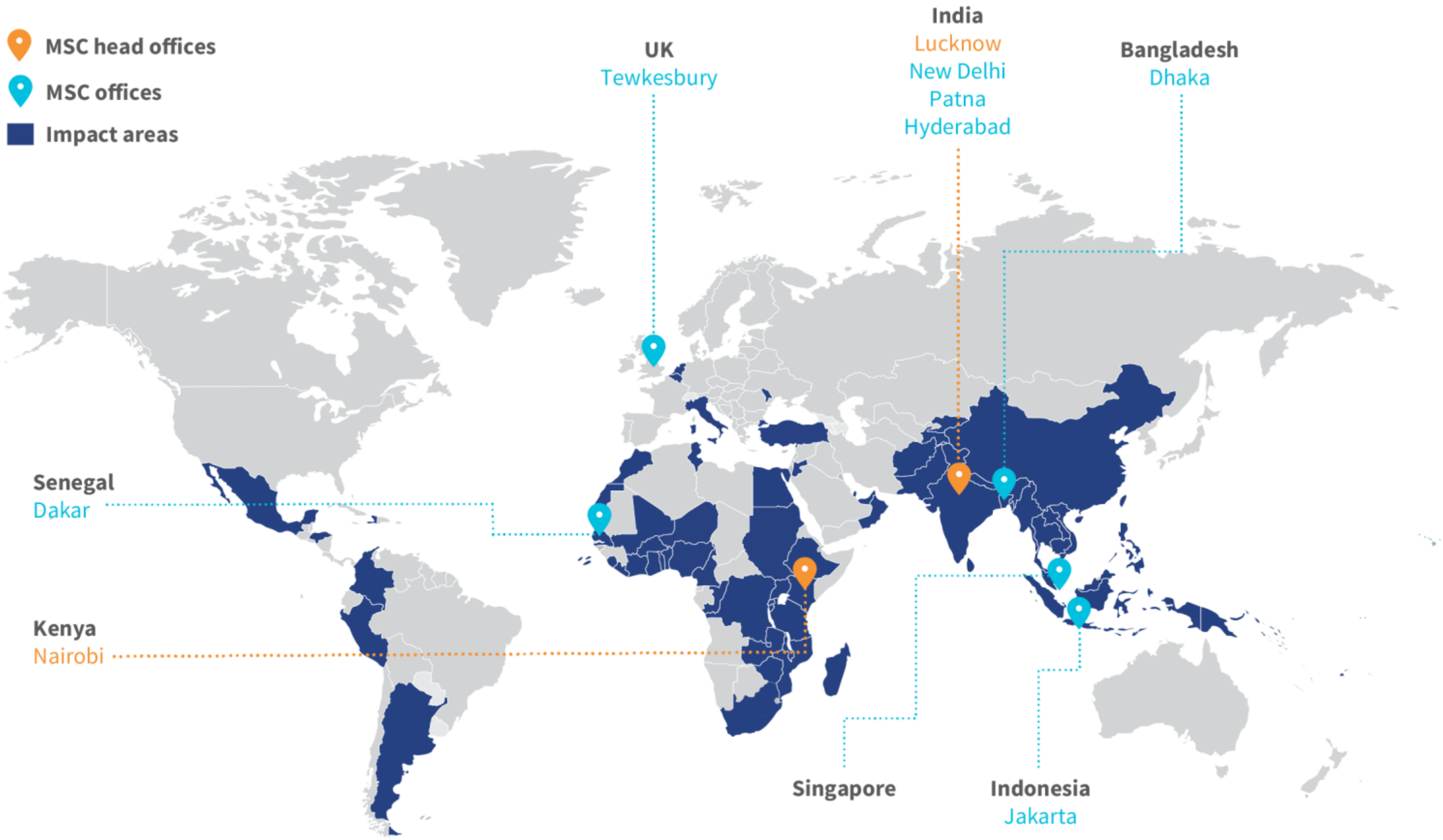
The road ahead: Building a scalable rural credit ecosystem

The true value of collaborative lending extends far beyond faster loan processing and digital workflows. Its greatest strength lies in combining institutions with complementary capabilities. Together, these institutions can deliver formal credit more efficiently, responsibly, and at a much larger scale.

By combining the extensive reach of RRBs with the MSME expertise, digital capabilities, and risk-sharing support of an apex financial institution, the model strengthens rural credit delivery. MSC's technical assistance has enhanced institutional capacity through improved credit processes, digital enablement, staff training, and implementation support. This support has enabled faster and more transparent lending for borrowers. It has also improved operational efficiency, governance, and MSME financing capabilities among participating institutions.

As more institutions adopt co-lending and strengthen their digital and operational capabilities, this model can reshape rural credit delivery in India. More importantly, it demonstrates that meaningful financial inclusion requires more than access to capital. It also requires strong partnerships, technology-enabled processes, and capable institutions. These elements can help institutions serve the evolving needs of rural entrepreneurs.

The true legacy of this transformation lies in its sustainability. CLAs strengthen existing institutions rather than creating temporary and parallel channels. They can reshape rural credit delivery by embedding stronger capabilities in digital underwriting, agile credit processing, and risk management within RRBs. Continuous technical assistance, operational guidance, and capacity building can help establish a scalable model for rural credit delivery. For millions of micro and small entrepreneurs across rural India, this transformation offers more than streamlined loan approvals. It can create a responsive and efficient financial ecosystem that supports enterprise growth, strengthens livelihoods, and contributes to India's rural economy.



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