11. TRAVERSING THE CO-LENDING REGULATORY LABYRINTH: A PATHWAY FOR NON-PRIORITY SECTOR FINANCING IN INDIA

Saumya Verma[*]

Abstract

This paper investigates the regulatory structure that governs co-lending in India, with a specific emphasis on funding outside of the priority sector. This study examines the rules and monitoring processes of the Reserve Bank of India (RBI) and the difficulties encountered by co-lenders in adhering to sector-specific laws, risk management standards, and data sharing procedures. The research emphasises the potential benefits of co-lending strategies in facilitating increased access to finance for non-priority industries. Collaborative lending agreements may boost financial inclusion and stimulate economic development in different sectors by using the combined skills of banks and NBFCs, as well as their strong risk management experience. Efficient risk mitigation measures and effective cooperation among many lenders are essential. The paper also investigates techniques for harmonising risk preferences, standardising rules, and building robust data exchange platforms to guarantee seamless execution of co-lending programmes. The research highlights the need of having precise laws, ongoing monitoring, and prompt revisions to effectively respond to changing market dynamics and overcome obstacles. Through astutely manoeuvring regulations and cultivating fruitful partnerships, stakeholders can seize the abundant opportunities offered by co-lending collaborations. This will facilitate efforts to promote financial inclusion, foster entrepreneurial growth, and contribute to sustainable economic advancement in different sectors of the country's economy.

Keywords: 'NBFCs', 'Co-Lending', 'Non-Priority Sector', 'Scheduled Banks', 'RBI Guidelines', 'Regulation of NBFCs'.

1. INTRODUCTION

[*] Saumya Verma is an Assistant Professor of Law at Presidency University, Bengaluru

The non-priority industries include manufacturing, services, infrastructure, trade, and other commercial activities that make a substantial contribution to the Gross Domestic Product of the Country, employment generation, and overall economic progression.[1] In India, there has been a surge in the expansion of new commercial ventures, startups, and small and medium-sized businesses in the non-priority sector.[2] However, several organisations face trials in securing finances from banks on account of subjects such as inadequate surety, credit history,etc. Fortifying these non-priority industries is central for creating an atmosphere that endorses entrepreneurship and produces employment. Areas such as infrastructure development, real estate, and manufacturing are critical in enabling India's move towards becoming the third-largest economy in the world.[3]

Collaborative lending is a worldwide practice in which firms work together to generate assets, liabilities, carry out operations, or engage in enterprises.[4] This may include the participation of many lenders or borrowers, each driven by distinct objectives. Lenders may choose to participate in a loan for many reasons, such as the amount of the loan, limitations on their exposure, the need for effective risk management, varying ability to originate loans, or varied degrees of association with the borrower base.[5] Borrowers have the option to either distribute responsibility or use the loan depending on their own requirements. The concept is seen as the progressive stage of comparable methods of lender collaboration, such as loan sales, loan assignments, or securitisation.[6]

The Indian government and regulatory agencies have been investigating innovative lending strategies and encouraging partnerships between banks and non-banking

[1]Rajat Dhawan and Suvojoy Sengupta, 'A New Growth Formula for Manufacturing in India' (*Mckinsey & Company*, 30 October 2020) <https://www.mckinsey.com/industries/industrials-and-electronics/our-insights/a-new-growth-formula-for-manufacturing-in-india> accessed 14 August 2024.
[2]Ministry of Skill Development and Entrepreneurship, 'Government Initiatives to Promote Startups across the Country: Role of Startups in Economic Development' (*PIB Delhi*, 29 July 2024) <https://pib.gov.in/PressReleasePage.aspx?PRID=2038380> accessed 14 August 2024.
[3]Benjamin Laker, 'India Will Grow To Become The World's Third-Largest Economy By 2027' (*Forbes*, 23 February 2024) <https://www.forbes.com/sites/benjaminlaker/2024/02/23/india-to-become-third-largest-economy-by-2027-implications-for-leaders/> accessed 14 August 2024.
[4]Maitreesh Ghatak and Timothy W. Guinnane, 'The Economics of Lending with Joint Liability: Theory and Practice' (1999) 60(1) *Journal of Development Economics* 195, 228.
[5]Troy Segal, 'Syndicated Loan: What It Is, How It Works, and Examples' (*Investopedia*, 2024) <https://www.investopedia.com/terms/s/syndicatedloan.asp> accessed 12 August 2024.
[6] ibid.

financial businesses (NBFCs).[7] Co-lending partnerships have gained popularity as an efficient method to meet the financial requirements of non-priority industries.[8] These agreements include collaboration between banks and NBFCs to provide loans. Co-lending models have the capacity to extend their services to areas and sectors that are currently lacking access, such as small and medium companies (SMEs) or firms located in rural and semi-urban regions.[9] Co-lending may facilitate financial inclusion and stimulate economic progress in different regions by combining resources and expanding outreach initiatives.[10]

2. THE CO-LENDING LANDSCAPE

Co-lending is a collaborative network of lenders in which two or more lenders join forces to provide a loan. The legal status of co-lending is determined by explicit conditions included in either the credit agreement or a separate co-lender agreement.[11] The connection among creditors is recognised by a contract, for instance, an agreement among the creditors or the co-borrowers. On the other hand, the loan agreement defines the relationship between the co-borrowers and the primary borrower..[12] The legal relationship between the colenders is determined by the principles and regulations of contract law.[13] Co-lending may be categorised as either limited purpose partnerships or protem joint ventures when two lenders agree to collaborate in originating and participating in lending activities together.[14] When two co-lenders provide a lending facility, the arrangement between them and the borrower might be considered a loan agreement. Nevertheless, because there are two lenders involved in the lending process,

[7]ASSOCHAM, India, 'Non-Banking Finance Companies: The Changing Landscape' (*PwC*, 2016) <https://www.pwc.in/assets/pdfs/publications/2016/non-banking-finance-companies-the-changing-landscape.pdf> accessed 12 August 2024.

[8]'The next Wave of Co-Lending Partnerships' (*Financial Express*, 2024) <https://www.financialexpress.com/opinion/the-next-wave-of-co-lending-partnerships/3436234/> accessed 12 August 2024.

[9]Bibekananda Panda, 'Asymmetric Information and Market Failure in Bank-NBFC Co-Lending Model' (Indian Institute of Banking & Finance (IIBF), Mumbai 2023).

[10]'Co-Lending: Understand How It Is the Future of Lending' (*Finverv*, 18 October 2023) <https://www.finverv.com/posts/co-lending-future-of-lending/> accessed 12 August 2024.

[11]Ishpreet Gandhi and Armaan Joshi, 'What Is Co-Lending and How Does It Work?' (*Forbes*, 17 April 2022) <https://www.forbes.com/advisor/in/business-loan/what-is-co-lending/> accessed 12 August 2024.

[12]'Borrower Considerations in Multiple Lender Transactions' (*Morris, Manning & Martin, LLP*, 2022).

[13]'CO-LENDING: Lenders' Collaboration to Extend Lending Outreach and Capabilities' (n 8).

[14]Bibekananda Panda (n 11).

the borrower is obligated to make commitments to both of them. The legal rights of any lender are regulated by the laws pertaining to “joint promissees”.[15] In India, the Indian Contract Act of 1872 addresses joint rights as outlined in section 452 of the Act. Co-lending is a legal arrangement that combines elements of partnership law, lending law, and joint contract law.[16]

In the co-lending arrangement, two businesses collaborate and form a partnership through an intercreditor agreement to provide loans together to borrowers. The collaboration might include numerous banks, non-banking financial companies (NBFCs), or a mix of both.[17] The two lenders mutually agree to provide a loan to the borrower in a predetermined proportion, with one lender serving as a representative for both parties. The two co-lenders may have different projected interest rates, but they both agree on a blended interest rate. This blended rate is calculated by taking the weighted average of the differential interest rates and the respective shares of the two lenders in the principal amount.

All important terms and conditions under the CLM arrangement are encompassed in a jointly consented contract that is legally signed by both the creditors and the borrowers. The Reserve Bank of India (RBI) published a notice on November 5, 2020, labelled as ‘Joint Lending by Banks and NBFCs to the Priority Sector’.[18] The notification provided an apprise to the joint loan origination policy that was first introduced in the year of 2018.[19] Such arrangement characteristically comprises a capital apportionment ratio of 80-20, whereby non-banking financial institutions guarantee at least of 20% financing throughout the loan.

[15]Suhasini Kamble, ‘A Primer on Devolution of Joint Rights’ (*ipleaders*, 9 April 2021) <https://blog.ipleaders.in/primer-devolution-joint-rights/> accessed 12 August 2024.
[16]ibid.
[17]Timothy Lopes, ‘Modes of Collaboration between Banks and NBFC’s’ (*Vinod Kothari Consultants*, 2019) <https://vinodkothari.com/wp-content/uploads/2019/09/Modes-of-Collaboration-between-Banks-NBFCs.pdf> accessed 12 August 2024.
[18]‘Co-Lending by Banks and NBFCs to Priority Sector (RBI/2020-21/63, FIDD.CO.Plan. BC.No.8/04.09.01/2020-21)’ (*Reserve Bank of India*, 5 November 2020).
[19]Reserve Bank of India, ‘Co-Origination of Loans by Banks and NBFCs for Lending to Priority Sector, (RBI/2018-19/49, FIDD.CO.Plan.BC.08/04.09.01/2018-19)’ (21 September 2018).

Joint underwriting is a collaborative process that involves several parties working together to ensure thorough examination and verification.[20] The risk-return split is computed, with both parties jointly assuming the risk and sharing the reward. The ultimate interest rate imposed on clients is often a composite interest rate, situated between the separate interest rates levied by the bank and the NBFC.[21] The NBFC is accountable for sourcing, customer experience and management, product innovations, efficient paperwork, and fast turnaround time, while banks are responsible for acquiring capital and building trust. Both the NBFC and the partner bank conduct risk assessment, while the NBFC is responsible for loan origination for consumers.[22]

An NBFC carries out loan origination tasks using co-lending software and evaluates the potential customer, then refers them to the partner bank.[23] The NBFC also independently conducts requirement analysis and risk assessment, and finally assesses the creditworthiness of the client.[24] Once all the mandatory standards are complied with, then the NBFCs and banks may begin with a tripartite agreement with the borrowers. Several financial establishments internationally, such as banks, credit unions, internet lenders, etc. have implemented co-lending. NBFCs, every so often, team up with more than a few banks to dispense money via diverse channels.[25] By increasing the possibilities of loan acceptance and reducing interest rates, the shared risk leads to favourable outcomes.

3. REGULATION OF CO-LENDING IN INDIA

Chapter III B of the Reserve Bank of India Act, 1934 confers upon the RBI the power to supervise and control non-banking financial companies that fall within the purview of RBI.[26] Dealings include a variety of entities such as instalment businesses, leasing

[20] 'What Is Co-Lending?' (n 19).
[21] ibid.
[22] Reserve Bank of India, 'Co-Origination of Loans by Banks and NBFCs for Lending to Priority Sector, (RBI/2018-19/49, FIDD.CO.Plan.BC.08/04.09.01/2018-19)' (21 September 2018).
[23] Jayashiri Ramanathan, 'What Is Co-Lending and How Will NBFCs Benefit from It?' (*CloudBankin*, 2024) <https://cloudbankin.com/blog/loan-management/what-is-co-lending-and-how-will-nbfcs-benefit-from-it/> accessed 12 August 2024.
[24] 'Pioneers of Change: Building Resilient NBFCs Powering Innovation and Change for an Inclusive and Sustainable Future' (*PwC*, April 2024) <https://www.pwc.in/assets/pdfs/pioneers-of-change-building-resilient-nbfcs-final.pdf> accessed 12 August 2024.
[25] 'Analysis of NBFC Sector and Select Asset Classes' (*Northern Arc Capital Limited*, December 2023) <https://www.northernarc.com/assets/uploads/pdf/Industry-Report.pdf> accessed 12 August 2024.
[26] The Reserve Bank of India Act 1934.

companies, home financing firms, lending companies, investment companies, and many more. RBI is the only governing authority for NBFCs, and these entities are exempted from the State Money Lenders Act.[27] Earlier, the National Housing Bank used to control Housing Finance Companies (HFCs). Now, RBI governs them in compliance with Sections 29A to 52A of the National Housing Banks Act, 1987, as amended by the Finance (No. 2) Act, 2019.[28] RBI has established an inclusive set of rules that takes in all regulatory factors, i.e. registration, prudential standards, standards for taking public deposits, capital adequacy, and limits of investment.[29] Since January 2016, the RBI has been releasing Master Directions that consolidate instructions on rules and regulations established by the Reserve Bank under several Acts, including banking concerns and foreign currency operations.[30] The rules approved by the Reserve Bank of India (RBI) have statutory authority and may be viewed as legally obligatory. Non-banking financial firms that are involved in manufacturing, mining, trade, and other similar activities are not bound by regulations framed by the RBI. However, the actions of NBFCs are overseen by the Companies Act, 2013.[31] Unlike traditional financial institutions, Non-Banking Financial Companies are exempted from the duty of giving in to any report to the RBI about the public deposits they receive. Co-Lending is a legally binding agreement that combines the basics of partnership, lending regulations, and joint contracts.[32]

This entails a collaboration between two co-lenders for a commercial venture, with the borrower making commitments to both co-lenders. The responsibilities of the borrower are regulated by collective agreements.[33] The Indian Contract Act does not explicitly include joint lending, but it does have Section 43 - Joint and Several Liability Provision,

[27]'Law Overview: Non-Banking Financial Companies (NBFCs)' (*Taxmann*, 27 January 2023) <https://www.taxmann.com/post/blog/non-banking-financial-companies-nbfcs> accessed 13 August 2024.
[28]ibid.
[29]ibid.
[30]ibid.
[31]The Companies Act 2013.
[32]'The Law of Co-Lending' (*Vinod Kothari Consultants*, 2023) <https://vinodkothari.com/wp-content/uploads/2023/11/The-Law-of-Co-lending.pdf> accessed 13 August 2024.
[33]'Co-Lending by NBFCs' (*AZB & Partners*, 20 July 2022) <https://www.azbpartners.com/bank/co-lending-by-nbfcs/> accessed 13 August 2024.

which deals with joint liability.[34] This provision holds many parties accountable for a single obligation, hence making joint lending relevant to banks and NBFCs.

In the case of '*Govindlal Bhikulal Maheshwari v Firm Thakurdas Bhallabhadas and ors.*', the Bombay High Court provided an explanation regarding section 45 of the Contract Act.[35] This section consists of two parts: the first part determines who has the right to claim performance when there are multiple promisees, and the second part determines who has the right to claim performance in the event of the death of any of the promisees. The established legal position is that both parties have the right to demand and enforce the execution of a commitment, such as a loan, together. However, this joint right may be exercised by one of the parties or a third party if they have been appointed as an agent. Given the widespread occurrence of mortgage rights being granted to several mortgagees, various legal cases support the notion that mortgages cannot be divided and that the debt is considered as one entity. In the case of '*Adiveppa Channappa Kittur versus Rachappa Balappa Hosmane*', the Bombay High Court defined a mortgage as a contractual agreement where the mortgagors typically agree to return a consolidated amount to the lender or lenders.[36][37] In the event of failure, this consolidated amount is obtained by the sale of the security.

The Bombay High Court, in the aforementioned case, established the rights of a co-mortgagee, affirming that a sole co-mortgagee lacks the authority to independently initiate legal action to reclaim the total mortgage sum or their respective portion.[38] This is due to the indivisible nature of the mortgage. With the intention of ensuring fairness, it is required to take detailed measures in the law that outline the allocation of revenues from the mortgage sale among all parties involved. When co-lending, both co-lenders have the authority to take legal action against the borrower jointly.[39] However, it is permissible for the co-lenders to select one of themselves or a third party as a servicer

[34]Indian Contract Act 1872, s 43.
[35]*Govindlal Bhikulal Maheshwari v Firm Thakurdas Bhallabhadas* AIR 1959 Bom 58
[36]'The Law of Co-Lending' (n 53).
[37]*Adiveppa Channappa Kittur v Rachappa Balappa Hosmane* AIR 1933 Bom 361
[38]ibid.
[39]'Co-Lending by NBFCs' (n 54).

without any issues. In the event that the borrower faces legal action, both co-lenders must jointly file the case.[40]

The co-originating of loans was assumed by the Reserve Bank of India on September 21, 2018.[41] The concept of co-lending permits an alliance among banks and non-banking financial companies in the priority sector banking. However, after the RBI guidelines of 2020, co-lending is being considered in the non-priority sector as well. This concept permitted all designated commercial banks, with the exception of Regional Rural Banks and Small Finance Banks, to collaborate in originating loans for the purpose of generating priority sector assets. In this paradigm, the bank may assert its priority sector status for the portion of credit it provides while participating in the co-origination arrangement. Nevertheless, it is essential that the bank's priority sector assets be always non-recourse to the NBFC. Foreign banks may only provide loans under the co-origination framework provided the loans meet the criteria for being priority sector assets. The Reserve Bank of India introduced regulations on November 5, 2020, pertaining to collaborative lending among banks and NBFCS and the required credit strategy for the same. According to the RBI, the CLM model is to boost the user-friendliness of credit and ensure the availability of funds at a fair expense, bearing in mind the reduced cost of funds from banks and widespread reach of NBFCs. The CLM provides advantages for end-borrowers, including enhanced quality and efficiency, rapid loan distribution, reduced interest rates, and a substantial client base.[42]

The Reserve Bank of India has provided the lending banks more independence in their operations and authorised their observance of regulatory guidelines for outsourcing and Know Your Customer (KYC) procedures. Banks have been empowered to take part in collaborative lending endeavours with any officially recognised non-banking financial company, including housing finance companies. As per RBI regulations, banks must uphold a minimum of 20% of the loan amount in their financial accounts. For organisations, both in the banking and non-banking financial sectors, to be granted access to the co-lending model, they must develop and widely exhibit rules on their web pages

[40]'CO-LENDING: Lenders' Collaboration to Extend Lending Outreach and Capabilities' (n 8).
[41] Reserve Bank of India (n 23).
[42]'Co-Lending by NBFCs' (n 54).

that these have been approved by regulatory authorities. A Master Agreement may be established between the two partner institutions, enabling banks to include particular loans originating by NBFCs in their portfolios or maintain the authority to decline certain loans.[43] The Reserve Bank of India (RBI) allows banks to assert their priority sector status in relation to their portion of credit while participating in the Credit Linked Capital Subsidy Scheme (CLCSS) and complying with the specified requirements.[44] The Digital Lending Guidelines mention that co-lending arrangements would be regulated by the existing instructions outlined in the Circular on Co-lending by Banks and NBFCs to Priority Sector of November 5, 2020, together with other relevant instructions.[45]

4. SUGGESTIONS & CONCLUSION

Banks and NBFCs collaborating with borrowers in the non-priority sector may face considerable challenges in sticking to Know Your Customer (KYC) and Anti-Money Laundering (AML) regulations.[46] The regulatory basis governing non-priority sectors is prone to frequent amendments, with alterations to law, rules, and administrative requirements. Smaller banks or non-banking financing firms (NBFCs) may have limitations in terms of capital, such as a scarcity of compliance personnel, technical know-how, or specialised knowledge. Such limitations might hamper their capacity to deal with compliance risks while engaging in co-lending activities in the non-priority sector. In order to confront these problems, co-lenders should give importance to generating a robust legal framework, sponsoring efficient communication and cooperation, using technology to exchange and oversee data, and dependably enhancing their sector know-how and risk management skills.[47]

A better understanding of terms among banks and non-banking finance firms (NBFCs) is important for the success of collaborative lending arrangements, especially in the non-priority sector. In order to accomplish this objective, banks and non-banking finance

[43] 'Master Circular - Bank Finance to Non-Banking Financial Companies (NBFCs)' (*Reserve Bank of India*, 2 July 2012) <https://www.rbi.org.in/commonperson/english/Scripts/Notification.aspx?Id=1087> accessed 13 August 2024.
[44] Reserve Bank of India (n 23).
[45] 'CO-LENDING: Lenders' Collaboration to Extend Lending Outreach and Capabilities' (n 8).
[46] Bibekananda Panda (n 11).
[47] Aathira Varier (n 34).

firms (NBFCs) should establish clear-cut and definite roles and obligations by way of a comprehensive agreement that should describe the procedures for loan commencement, valuation, disbursement, regulation, and prospecting.[48] Such agreements should also provide obvious risk-sharing methods that would safeguard a crystal clear and jointly agreed-upon approach for handling credit risk. In order to increase the advantages of collaborative lending agreements, banks and NBFCs should give precedence to using their respective strong points. NBFCs should possess advanced risk management schemes, a robust financial standing, and the competence to get cost-effective funding. Also, non-banking financial companies (NBFCs) should provide specialised information, transparency, and strong customer bonds in non-priority sectors.[49]

Co-lending arrangement among the banks and NBFCs in the Indian financial system offers beneficial fiscal access to non-priority industries. The Reserve Bank of India has recognised a solid regulatory basis for co-lending, though there are still complications in adhering to such regulations, appraising perils, data exchange, and analysing the regulatory basis for co-lending. In order to effectively confront the aforementioned barriers, it is decisive to have an inclusive policy framework for co-lending that could cover its basic concepts, the risks associated, and trustworthy means of data sharing. The integration of banks' risk management skills with the specialised knowledge of NBFCs may establish a lending environment specifically designed for non-priority industries.[50] Technological progress and digital platforms have the potential to enhance compliance procedures, facilitate seamless data sharing, and enhance operational effectiveness in co-lending collaborations.[51]

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[48]'Unveiling the Significance of CLM 1 and CLM 2 in Co-Lending Dynamics: Transforming Financial Collaborations' (n 45).

[49]'NBFCs at the Forefront – Bridging the Gap with Innovation and Technology' (*Elets Technomedia Pvt Ltd*, 2023) <https://bfsi.eletsonline.com/nbfcs-at-the-forefront-bridging-the-gap-with-innovation-and-technology/> accessed 13 August 2024.

[50]K. Srinivasa Rao, 'Strengthening Risk-Management Capabilities in the Financial Sector' (*Ideas for India*, 2021) <https://www.ideasforindia.in/topics/money-finance/strengthening-risk-management-capabilities-in-the-financial-sector.html> accessed 13 August 2024.

[51]Dinesh Sharma, 'NBFCs and Compliance: The Role of Technology and Collaboration' (28 April 2024) <https://www.linkedin.com/pulse/nbfcs-compliance-role-technology-collaboration-dr-dinesh-sharma-rvevc/> accessed 13 August 2024.

Regulatory authorities should actively intervene in addressing doubts, providing explicit instructions, and establishing a conducive climate for the growth of co-lending.[52] Engaging in regular dialogues with industry stakeholders, maintaining a continuous monitoring process, and promptly updating regulatory frameworks helps effectively tackle possible challenges. For co-lending to prosper, it is crucial to have a cooperative attitude from all stakeholders, such as lenders, regulators, legislators, and industry groups.[53]

[52]NBFC Advisor, 'Understanding the NBFC Co-Lending Model and Opportunities' (10 April 2024) <https://www.linkedin.com/pulse/understanding-nbfc-co-lending-model-opportunities-nbfc-advisor-2jjdc/> accessed 13 August 2024.

[53]'Building the NBFC of the Future - A Scalable and Profitable Model' (*PwC*, 2018) <https://www.pwc.in/assets/pdfs/publications/2018/building-the-nbfc-of-the-future.pdf> accessed 13 August 2024.