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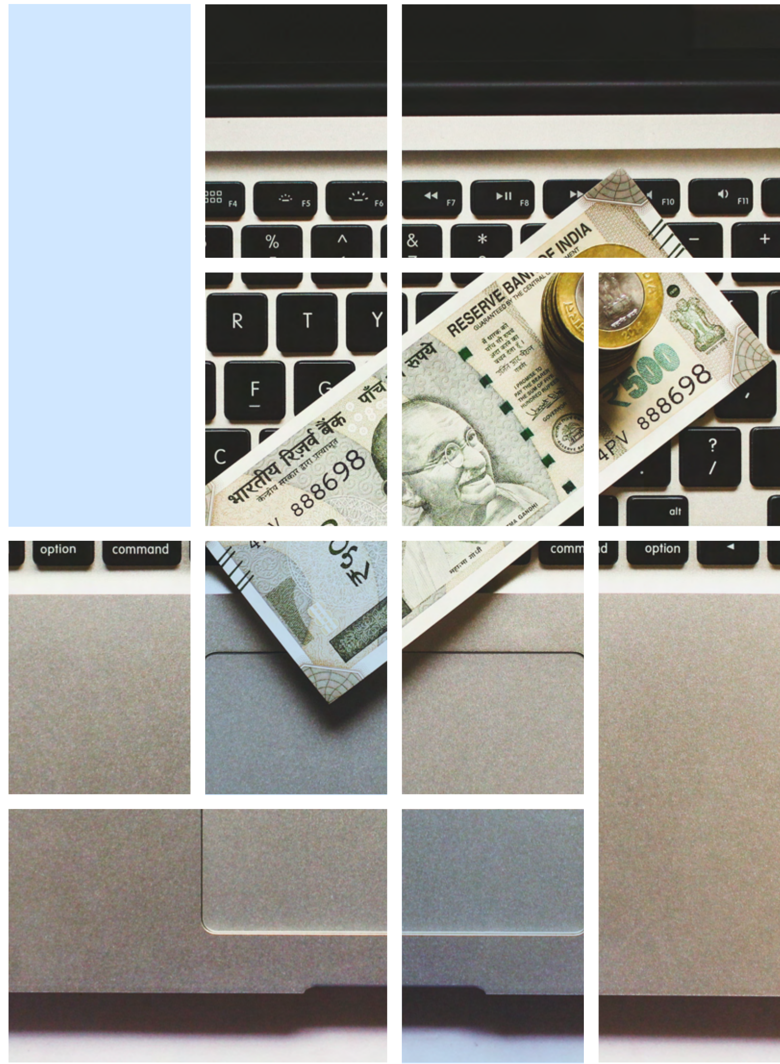

A comprehensive guide to co-lending

Decoding the theory and practice of bank-NBFC partnerships

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What is co-lending?

Co-lending is the joint origination, underwriting, servicing and disbursal of a loan by two or more lenders. The concept has been around for a long time both in India and abroad. Now, the Reserve Bank of India has orchestrated a policy under which banks and non-banking financial companies (NBFCs) come together to service priority sector lending.

The idea behind such a structure is to bring together the best that banks and NBFCs have to offer. The long-term objective, however, is to reduce the end interest rate for borrowers. They have been borrowing at rates between 18 and 24%, and co-lending could bring this down to as low as 8 percent.

NBFCs have proven their ability to reach the last mile – thanks to local expertise, specialised knowledge, and efficient credit distribution systems. But they incur a massively high cost of funds – and this is a major impediment affecting their profitability.
Banks, on the other hand, are sitting on a mountain of cash. And the bulk of it is passed on to financial intermediaries such as NBFCs, MFIs, and housing finance companies for onward lending.
This essentially means that NBFCs do all the hard work of originating, underwriting, processing, disbursing, and monitoring loans to the bottom of the pyramid, while banks earn a fat interest for enabling access to funds.
This is a rather inadequate approach. Hence, in the spirit of Ricardian economics, RBI devised a policy that would incentivise both banks and NBFCs to leverage each other's comparative advantages.
Banks' access to cheap funding and NBFCs' impeccable credit distribution model – combine the two forces, and you have what RBI calls the co-lending model (CLM).

How does co-lending work?

One may think there's nothing baffling about two lenders coming together to provide credit – the bank funds 80% of the loan while the NBFC funds 20% – sounds rather simple. What's more, banks can grow their loan book, NBFCs' liquidity problem is solved, and credit reaches the ultimate beneficiaries at an affordable price. What's even better, CLM loans are considered part of priority sector lending (PSL), thus co-lending will save banks the struggle of meeting PSL targets.

Indeed, it looks like a package deal. Except that the devil is in the details.

Banks and NBFCs are two very different entities; getting them on the same page is easier said than done. Let's understand why.

Under the CLM, banks have two options for sanctioning loans

A) Non-discretionary arrangement i.e., an irrevocable commitment on part of the bank to take into books its share of individual loans as originated by NBFCs

B) Discretionary arrangement on part of the bank to take a portion of the loans originated by NBFCs

Co-lending models

Option A requires high-level coordination between the bank and the NBFC, wherein the two entities jointly originate, jointly underwrite, and jointly sanction loans. This is not easy. Imagine banks and NBFCs having to align on some 10,000 parameters to disburse a loan of ₹1,00,000. The collaboration challenge is massive and may seem insurmountable.

In comparison, Option B seems less arduous operationally, as NBFCs can single-handedly originate, sanction, and disburse loans and later sell them to the bank.

Key takeaways:

- In the co-lending model, banks fund 80% of the loans and NBFCs fund 20%. Banks and NBFCs can partner to co-lend in two ways
- First, banks commit to take on their share of individual loans originated by NBFCs.
- Second, banks exercise their discretion to take on a portion of loans originated by NBFCs.

Simple in theory, complex in practice

The coming together of banks and NBFCs is much like an arranged marriage. While both parties may have willingly entered the union, they are quick to realise that it's a balancing act.

"Much like marriage, co-lending is a daily challenge. Banks and NBFCs operate on different systems, divergent underwriting processes, and distinct parameters. For the partnership to stand a chance, banks and NBFCs must be prepared for constant reconciliation of their distinct personalities, traits, and dispositions."

Integrating the two systems to arrive at a common ground is no mean feat — for the intricacies make a complex web.

Here's how convoluted it can get – let's assume that a bank and an NBFC engage in non-discretionary CLM (Option A). Now, one would assume that once the two parties have arrived at a predetermined lending policy, no matter how complex that process may have been, things will flow smoothly thereafter. Except that it doesn't. The bank will still have to involve itself in the daily lending activities of its partner NBFC, as RBI does not allow banks to completely outsource core functions such as loan sanctioning.

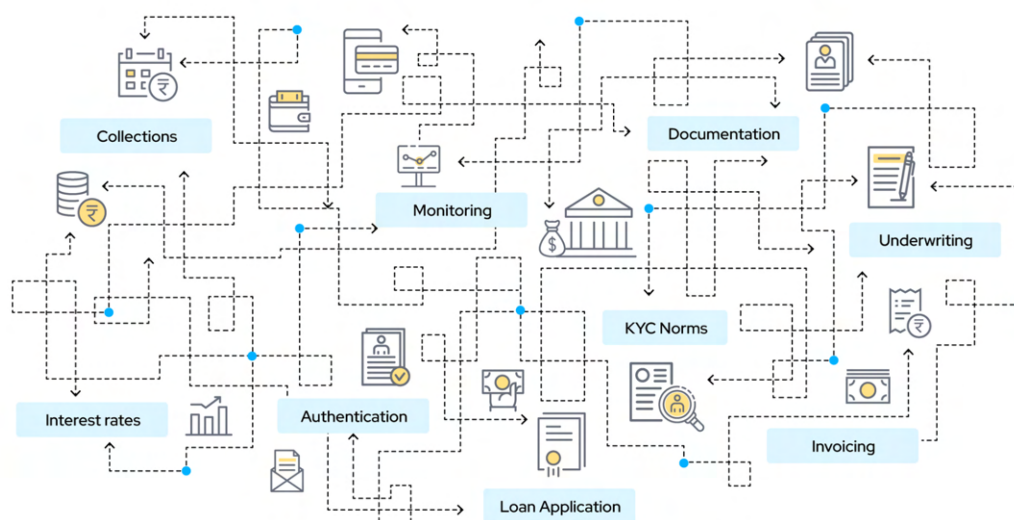
Now consider Option B. The bank can accept or reject the portfolio of loans after checking for compliance. In effect, this gives banks veto powers to reject applications from borrowers originated by the NBFC if they do not meet their own due diligence.

Moreover, lenders are required to report to credit information companies and maintain separate asset classification requirements. As a result, a borrower deemed 'good' in one player's books could easily fail the other's credit checks.

Things get far more complicated as you delve deeper. Banks and NBFCs must enter a master agreement before disbursing loans, which among other things, will include the all-inclusive interest rates, framework for monitoring and recovering loans. Moreover, if the CML agreement between the two falls through, there must be a business continuity plan to keep serving the borrower until the loan is repaid.

Here's another example. Each loan application requires the NBFC and the bank to agree on what

Co-lending maze



type of interest rate must be charged – floating or fixed. Once this hurdle has been jumped, the bank decides on one interest rate and the NBFC on another, based on individual risk appetites for their respective shares of the loan exposure.

Should they decide on a floating interest rate, a weighted average of the benchmark interest rates in proportion to the respective loan contribution has to be calculated. Should they choose a fixed interest rate, a final blended rate is arrived at. The complexity is dizzying.

The final consumer only cares about what he/she will have to pay at the end of the day. But it takes much meandering to arrive at a final interest rate under this model.

There are numerous facets that must reconcile, align, and integrate – ranging from the broad lending policy to the minutiae such as KYC norms and security creation to reporting, documentation, and internal audits. Such compatibility is not easy to achieve.

Clearly, RBI has blessed this union expecting it to be one soul in two bodies. That leads us to the question, is the co-lending model doomed from the start?

Key takeaways:

- Banks are not allowed to outsource core lending functions like loan sanctioning, meaning that they must be involved in the day-to-day operations of partner NBFCs.
- Under the discretionary model, banks can effectively veto borrowers nurtured by the NBFC.
- The partner banks and NBFCs may have completely different processes and parameters based on which they arrive at an interest rate. Agreeing on the type and amount of interest rate for each loan is complex.
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- Banks and NBFCs must ensure that their incompatible KYC norms, reporting and documentation must align.

How FinTechs can foster trust

Banks and NBFCs are increasingly realising that great improvements invariably involve cooperation. However, currently, the information silos and integration challenges make tie-ups between banks and NBFCs tricky. For such a collaborative lending model to work, trust and commitment between banks and NBFCs are of the utmost importance.

Banks and NBFCs should be able to coordinate and talk to each other real-time. Here's where FinTechs come in. They can deploy a well-architected network of APIs that centralises stakeholder communication in one easy-to-use platform.

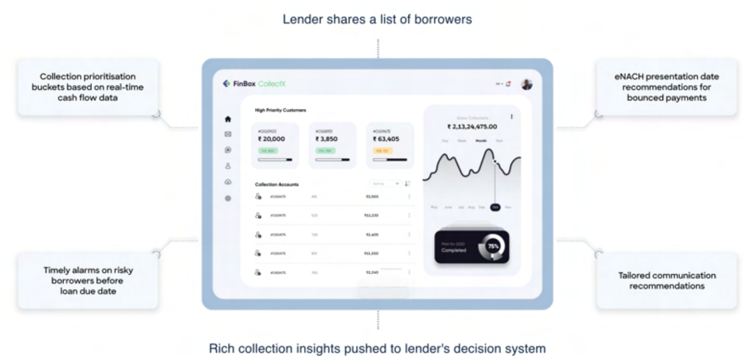
This way, with a couple of API pull requests, lenders should be able to post their respective exposures in their books. A common dashboard can offer all stakeholders a full view of the escrow account through which loans are to be routed. Hence, each party can access a single source of truth.

Additionally, FinTechs can fully code and automate the performance of jointly originated loans. However, the extent to which this can be done depends on the facility agreement and the software. A short low-value facility agreement with little optionality will be easier to code and automate. On the other hand, a long, high-value co-lending facility agreement, running to hundreds of pages, with complex clauses and many negotiated (i.e. non-standard) terms will, of course, be much harder.

The digital future of co-originated loans rests on smart contracts. Their ability to automate data

and payment flows enable lenders to provide more efficient loan servicing and superior customer experience. For instance, if the borrower submits an electronic request to utilise a portion of an active credit line, a smart contract-based facility agreement can check if the request complies with the outlined terms and execute instructions, all with zero human intervention. Having said that, in the case of credit lines, interest rates tend to be variable, and therefore the smart contract may require data on benchmark rates from an external source to be able to assign the interest rate and complete the task.

Evidently, there is plenty of room for a well-crafted end-to-end technology solution to take over the space. After all, a global market estimated at $4.6 trillion p.a is there for the taking. With predefined workflows, in-app communication tools, and process automation, technology can overcome the myriad barriers CLM raises. A single platform that navigates the maze to finally present a single loan agreement is the future we are gravitating towards.



Improve collections with FinBox CollectX

FinBox's credit intelligence models are trained on India's largest new-to-credit customer base and factor in over 5,000 unique parameters to generate a confidence score for lenders to work with.

Our platform-first, API-driven lending stack can help banks and NBFCs arrive at a common ground to decide on policies and frameworks that can make CML successful. FinBox makes it a matter of a few minutes to assess a potential borrower and underwrite risks.

Disbursing loans is just the beginning, it's the collections that make the entire lending business tricky. Our intelligent default prediction engine alerts the lender to borrowers' financial activity right before a repayment due date, flagging the likelihood of a default. This helps lenders monitor risky accounts more closely and adopt soft tactics to ensure the repayment schedules stay on track. CollectX – our proprietary collections engine – has helped leading lenders stem delinquencies by

The bottom line

All said and done, the co-lending space ought to be founded on trust. Banks and NBFCs have to meet halfway to make co-lending a reality. It's becoming clearer by the day that co-lending cannot work unless it's founded on relationships. However, fintechs can trigger cooperation and collaboration between these two entities that see eye to eye on hardly anything.

Author's Bio

Anna Catherine,
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Anna is a content specialist at FinBox who tells FinTech stories that drive insights using data, narrative, and visuals. Prior to FinBox, she was with a communication agency where she worked on a range of branding activities such as positioning, conceptualisation, and writing for some leading brands - Mercedes-Benz Research and Development India, Lenovo, Shell, and Toyota KiNTO, to name a few. She holds an honours degree in Economics and a post-graduate degree in International Relations.

Rajat Deshpande
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LinkedIn profile

Rajat is a FinTech specialist and a startup enthusiast who started FinBox alog with his Co-Founders with a mission tp lay out digital infrastructure for alternate finance solutions. Under his leadership, FinBox has built multiple products in the Embedded Finance and Big Data credit analytics spaces. FinBox has anabled over 16million lending decisions in India and SE Asia. In his prior stints, Rajat was associated with the global consulting firm ZS, Citigroup and GoPigeon Logistics as Head of product. He holds a Dual (BTech+MTech) degree in Mechanical Engineering from IIT, Bombay.

At FinBox we are building the Embedded Credit Infrastructure of the future. We provide full-stack API and SDKs for businesses to embed credit products into the platforms, and connect them with a diverse network of lenders.

Reach out to us and empower your customers with in-context credit through a simple, yet powerful integration.

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