

SERIES:

SHADOW BANKING, SHAKY FOUNDATIONS:

THE NBFC GOVERNANCE DILEMMA

PART - A



SERIES : SHADOW BANKING, SHAKY FOUNDATIONS: THE NBFC GOVERNANCE DILEMMA !

In India, Non-Banking Financial Companies (“NBFCs”) emerged during the 1960s to cater to the needs of individuals and businesses, seeking alternative financing options. Given the prevailing economic conditions at the time, NBFCs had a modest beginning and initially did not have a significant impact on the financial system. Consequently, due to their limited scope, there were not many regulatory guidelines governing their operations.

However, between the 1980s and 1990s, NBFCs witnessed rapid growth, with their numbers increasing from around 7,000 in 1981 to nearly 30,000 by 1992. The economic liberalization of 1991 further accelerated this trend, as businesses’ financial needs surged. As NBFCs expanded in the number and size, it became increasingly difficult for the Reserve Bank of India (“RBI”) to regulate them effectively.

In response, the RBI Act, 1934 was significantly amended in January 1997 to protect depositors’ interests and ensure the sector’s sound governance. Since, then the legal and regulatory landscape for NBFCs in India is continuously evolving. The Scale-Based Regulatory framework (“SBR Framework”) issued in January, 2021, is the most recent and significant step taken by the RBI for NBFC supervision, post failures of giants like IL&FS, DHFL.

Currently, as per the data released by RBI on May 9, 2025, the number of registered NBFCs stands at 9,291 only. Needless to say, apart from the registered NBFCs, there are still countless registered businesses operating as non-registered NBFCs. However, this steep decline in the number of registered NBFCs despite the sector’s asset base growth with CAGR of 18.76% should be a topic for discussion.

This contraction has majorly happened due to a sharp rise in the cancellation of Certificates of Registration, driven by stricter entry norms and compliance requirements, which many entities failed to meet.

BEFORE GOING INTO THE LEGAL INTRICACIES OF THE GOVERNANCE STRUCTURE FOR NBFCs, IT IS IMPORTANT TO BRIEFLY LOOK AT THE EVOLUTION OF LEGAL AND REGULATORY FRAMEWORK:

1970-1980

- Minimal regulation, NBFCs operated with limited RBI oversight.

1990-1997

- Changes to RBI Act, 1934 and amendment of Chapter III-B, III-C and V to incorporate NBFC prudential norms.

2000s

- Prudential Norms Revised.
- Classification of NBFC into SI, NSI, D, ND.
- ALM guidelines issued.

2014-18

- NOF increased to 2 Cr
- Introduction of Ind AS to NBFCs
- Increased scrutiny for liquidity Risk

Post 2019

- NBFC Scale based Regulations 2021.
- Digital Lending Guidelines, 2025.

REGULATING NBFCs: IS IT ACTUALLY A GOVERNANCE NIGHTMARE ?

As per a recent Report dated **April 11, 2025** by Fintech Association for Consumer Empowerment (a recognised Self-regulatory Organisation), summary of penal actions against banks and NBFC during FY **2024-25** by RBI is as follows :

Entities	No. of Penal Actions	Amount of Penal Actions (in INR Lacs) No. of Penal Actions
Banks	30	2676.80
NBFC	48	573.30
Total	79	3291.5

As per the aforesaid Report, the analysis suggests that the penal actions were taken for a wide variety of reasons, majorly including non-compliance with KYC norms, Fair Practices Code, Corporate governance, digital lending guidelines, reporting, interest rate, and conduct in outsourcing etc.

The above penal actions clearly indicate towards leakages in the compliance and governance structures of the NBFCs. However, the concern arises when these compliance gaps turn into major fraud instances like IL&FS and DHFL, costing the public funds, depositors, customers and the entire economy.

IL&FS and DHFL FRAUDS DECODED:

The IL&FS group operated over **200** subsidiaries with a debt exposure of approx **Rs 94,000 Crs**

June 2018: IL&FS defaulted for the first time on repayment of commercial paper and inter corporate deposit worth **INR 450 crores** and ICRA downgraded the ratings

July & August 2018 : Group's Founder and Chairman Ravi Parthasarathy resigns citing health reasons and the subsidiaries continued to report multiple loan defaults.

August 2018 A forensic Report revealed money laundering of over **Rs. 6,500 crores**. NCLT ordered government to assume control and constitute a new board under the chairmanship of Mr. Uday Kotak and five other new board members.

Major Revelations: a) Non- Disclosure of bad loans; b) negligent management decisions; c) Serious Lapses by the Auditors (Deloitte and KPMG); d) Poor Fund Management; e) unethical accounting practices; f) Evergreening of loans.

September, 2018 SEBI, RBI, MCA, SFIO, ED initiates investigations and special audits.

Impact of IL&FS Crisis:

- i. **Erosion of Confidence:** Investor trust in NBFCs declined sharply, affecting capital inflows and market sentiment.
- ii. **Market Sell-Off:** Panic selling in NBFC stocks and mutual funds led to a ₹8.48 lacs crore loss in investor wealth.
- iii. **Liquidity Shock:** The default triggered a liquidity crunch, tightening credit across the financial system.
- iv. **Macroeconomic Pressure:** The crisis widened the fiscal deficit, impacting inflation, currency stability, and growth.
- v. **Stalled Projects:** Key infrastructure projects collapsed due to halted funding, hampering sectoral progress.

DHFL Fraud:

DHFL a prominent player in housing finance sector took loans from consortium of banks for approx. Rs. 96,000 Crs.

May 2020: A financial scam to the tune of more than Rs 31,000 crore, was unearthed. Promoters: Kapil and Dheeraj Wadhawan were arrested by CBI.

Between 2017-2017: DHFL promoters, Kapil and Dheeraj Wadhawan, allegedly established 87 shell companies and created over 2.6 lakh fictitious home loan accounts.

Revelations: a) Systematic manipulation of loan disbursements; b) Over Rs, 11,000 Crs transferred to these 87 shell companies; c) fictitious virtual Bandra Branch was used to disburse these funds; d) funds were used by the promoters; political funding.

May 2019: DHFL began defaulting on its debt obligations and media reports regarding irregularities in loan disbursal floated.

November 2019: RBI, superseded DHFL's board due to governance concerns and payment defaults and ordered a Special Audit

Impact of DHFL Crisis:

i. Severely eroded the financial ecosystem's integrity. Loans disbursed to shell or fraudulent entities failed to return either principal or interest, resulting in a surge in Non-Performing Assets (NPAs). This crippled DHFL's lending capacity, ultimately triggering a liquidity crisis.

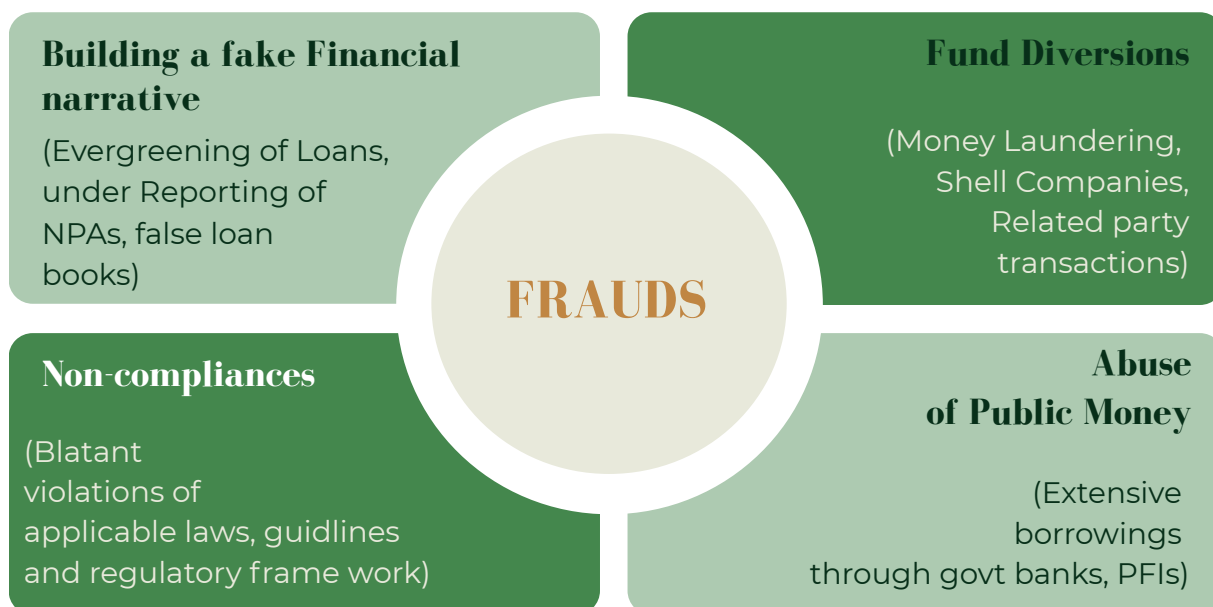
ii. Public Funds were systematically siphoned off and round-tripped to the Wadhawan family through a web of dubious companies, masquerading actions. These funds were allegedly used to acquire assets abroad and evade taxes, undermining economic stability and governance norms.

iii. Significant blow to public confidence in NBFCs and banks: The scale of the fraud exposed major lapses in oversight and due diligence. Moreover, it had political ramifications—allegations emerged that stolen funds were funnelled into companies in Gujarat and Karnataka under the guise of election-related schemes, further deepening the scandal.



The IL&FS and DHFL frauds revealed significant lapses in corporate governance, financial oversight, and regulatory enforcement within India's financial sector. IL&FS's collapse due to excessive debt and opaque lending practices, and DHFL's diversion of funds through fictitious entities, collectively underscored systemic vulnerabilities. These cases highlight the critical need for stronger regulatory frameworks, enhanced transparency, and robust risk management to ensure financial stability and protect stakeholder interests.

COMMON FRAUDULENT PRACTICES OBSERVED ACROSS THE NBFC SECTORS:



SCALE BASED REGULATIONS: A CRITICAL ANALYSIS

The SBR Framework, unveiled by the Reserve Bank of India in **January 2021**, represents a pivotal advancement in the regulatory landscape governing NBFCs. It marks a deliberate departure from the conventional one-size-fits-all approach, embracing instead a nuanced, risk-sensitive model of supervision.

This strategic shift clearly driven by the recognition that while NBFCs play a vital role in financial inclusion, their unchecked growth and inadequate oversight as exposed by failures like IL&FS, DHFL, and others pose serious systemic threats.

SBR Framework has introduced a more comprehensive and layered structure based on the size, complexity, and systemic importance posed by different NBFCs, classifying them into four layers:

Top Layer (This will ideally remain empty, NBFCs shall move to the Top Layer from the Upper Layer at RBI's direction based on substantial risk).

Upper Layer (NBFCs which are specifically identified by RBI as based on a set of parameters and scoring methodology)

Mid Layer (All Deposit taking, Non-Deposit taking AB>**1000 Crs**, NBFCs: SPD, IDF, CIC, HFC, IFC)

Base Layer (Non Deposit AB>**1000 Crs**; NBFC-P2P, NBFC-AA, NOFHC, NBFC not availing public funds/customer Interface)

By categorizing NBFCs into regulatory layers based on size, complexity, and systemic importance, RBI has made an effort to align regulatory intensity with risk exposure. This is not only prudent but necessary, given the increasing interconnectedness between NBFCs, banks, mutual funds, and capital markets

However, while the framework is structurally sound, its success lies in the effective execution. The challenges that lay ahead of its execution are as follows:

Transparency:

Reliance on RBI's discretion for determining the Upper and Top Layer will consequently raise questions about transparency, objectivity, and potential regulatory unpredictability and risk of arbitrariness.

High Compliance Cost:

The compliance expectations, particularly for mid-sized NBFCs in the Middle Layer irrespective of their asset size, may unintentionally result in higher operational costs, reducing their ability to compete or expand into underserved regions.

Risk of Regulatory Arbitrage:

NBFCs may attempt to limit asset growth or change business models to avoid moving into a higher tier with tighter norms. This may undermine the spirit of the framework and may create blind spots in risk oversight.



Lack of Global Precedents:

While aligned with principles of proportionate regulation, the SBR Framework is relatively unique. Most countries (e.g., U.S., EU) use activity-based regulations or focus only on systemically important institutions. India's tiered approach, though innovative, lacks global benchmarking, making cross-border supervision and harmonization harder.

While the SBR Framework is a timely and visionary reform, its long-term effectiveness will depend on how well it is executed and can adapt to a dynamic financial environment. It must evolve as a living regulatory system i.e. responsive, inclusive, and robust which is capable of not just preventing future failures, but also fostering a healthy, transparent, and inclusive NBFC sector that can serve as a strong pillar of India's financial system.

We will be presenting our detailed analysis on the SBR Framework and the road ahead in upcoming Part-B of this Series.

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Latest Awards and Recognitions

RS&I Resight (RSG India)

IBLJ A List
A List (2023-2024)

ALB India Law Awards 2025
Notable Firm (2024)

Legal 500
Private Equity (including Venture Capital) - Tier 5 (2025)

IFLR1000 (34th Edition) 2024

1. Rajesh Begur B Ranking: Leading Lawyer – Highly Regarded
2. Firm Ranking: Recommended Firm
3. Southern Asia, Australasia and Central Asia Ranking: Highly Regarded

Corporate INTL Global Awards

Cross Border Private Equity Transactions Law Firm of the Year in India - 2025

Forbes India – Legal Powerlist 2023

Top Law Firm (above 10 years' experience)

Asia Law 2022

Notable Firm – Private Equity, Investment Funds, Banking and Finance, Corporate and M&A

Global Law Expert 2021

Cross Border Private Equity Transactions Law Firm of the year

RSG Consulting 2019

Top 40 Indian Law Firm

