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REGULATION OF NBFCs IN INDIA: EVOLVING LEGAL FRAMEWORK AND REGULATORY CHALLENGES

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ABSTRACT

The regulation of non-banking financial companies (NBFCs) in India has undergone a structural transformation over the last decade, moving from a light-touch, entity-based licensing regime under Chapter III-B of the Reserve Bank of India Act, 1934 to a graduated, risk-calibrated architecture built on the Reserve Bank's Scale Based Regulation (SBR) framework. The collapse of Infrastructure Leasing & Financial Services in 2018 and the subsequent resolution of Dewan Housing Finance Corporation exposed the systemic consequences of a sector that had grown large and deeply interconnected with banks while remaining materially under-regulated. The legislative and regulatory response has been substantial: enhanced supervisory powers under the Finance (No. 2) Act, 2019, the extension of the Insolvency and Bankruptcy Code to financial service providers, the four-layered SBR framework of 2021, a Prompt Corrective Action regime, consolidated Digital Lending Directions, and, most recently, a proportionality-driven recalibration exempting small, non-public-funded NBFCs from registration. This paper examines that trajectory doctrinally, argues that the Indian framework has largely closed the regulatory arbitrage gap between banks and NBFCs, and contends that the residual regulatory challenge is no longer under-regulation but policy cyclicality, supervisory capacity, and bank-NBFC interconnectedness. It concludes that predictability of prudential policy, statutory articulation of the SBR layers, and a resolution framework tailored to non-deposit-taking NBFCs are the reforms India now requires, rather than further layers of prescriptive rulemaking.

KEYWORDS

Non-Banking Financial Companies; Scale Based Regulation; Reserve Bank of India; Digital Lending; Financial Stability.

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I. INTRODUCTION AND RESEARCH PROBLEM

NBFCs occupy a constitutionally and functionally distinctive space in Indian finance. They are creatures of Chapter III-B of the Reserve Bank of India Act, 1934, which the Supreme Court has described as a complete code governing their registration and prudential supervision.[1] In *Nedumpilli Finance Company Ltd v State of Kerala*, the Court held that State money-lending enactments have no application to NBFCs registered with the Reserve Bank, since the field of borrower protection stands subsumed within Chapter III-B.[2] The consequence is that the entire regulatory burden for a sector supplying credit equivalent to roughly a quarter of scheduled commercial bank credit rests on a single regulator acting through subordinate instruments.

That concentration of regulatory responsibility is the source of the research problem. For decades, NBFC regulation was calibrated to the fiction that entities not accepting public deposits posed little systemic risk. The 2018 default of Infrastructure Leasing & Financial Services falsified that assumption: a wholesale, non-deposit-taking group triggered a liquidity contraction across the sector. The regulatory architecture that has been erected since is dense, but it has been built almost entirely through circulars and master directions rather than statute, and it has oscillated in tightness within short intervals. The problem this paper investigates is whether the current framework is optimally designed — whether its stringency is matched by predictability, statutory grounding and supervisory capacity.

II. RESEARCH OBJECTIVES

(i) To trace the evolution of the legal framework governing NBFCs in India from entity-based licensing to scale-based regulation.

(ii) To evaluate the adequacy of the Reserve Bank's supervisory and resolution powers following the Finance (No. 2) Act, 2019 and the extension of the Insolvency and Bankruptcy Code to financial service providers.

(iii) To assess whether the 2025-26 proportionality reforms represent a coherent recalibration or an ad hoc retreat.

(iv) To identify the principal residual regulatory challenges and propose targeted reforms.

[1]Reserve Bank of India Act 1934, ch IIIB (ss 45-I to 45-QB), governing the registration, prudential supervision and resolution of non-banking financial companies.

[2]Nedumpilli Finance Company Ltd v State of Kerala, 2022 LiveLaw (SC) 464 (judgment dated 10 May 2022); see also Vinod Kothari Consultants, 'State Moneylending Laws Do Not Apply to NBFCs, Holds SC '(16 May 2022).

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III. RESEARCH QUESTIONS

(1) Has the Scale Based Regulation framework effectively eliminated regulatory arbitrage between banks and NBFCs?

(2) Are the Reserve Bank's present supervisory and resolution powers over NBFCs legally sufficient and institutionally exercisable?

(3) Does the reliance on subordinate legislation rather than statute compromise regulatory certainty for NBFCs?

(4) What is the appropriate regulatory response to bank-NBFC interconnectedness and rapid unsecured retail credit growth?

IV. RESEARCH HYPOTHESES

H1: The Scale Based Regulation framework has substantially narrowed regulatory arbitrage between banks and NBFCs, but has achieved this through activity-neutral prescription rather than genuinely risk-differentiated supervision.

H2: The principal residual threat to NBFC-sector stability is not under-regulation but regulatory cyclicality and bank-NBFC interconnectedness.

H3: The proportionality reforms of 2025-26 improve compliance efficiency for small NBFCs without materially increasing systemic risk, because the exempted class is defined by the absence of public funds and customer interface.

V. RESEARCH METHODOLOGY

This paper adopts a doctrinal and analytical methodology. Primary sources comprise the Reserve Bank of India Act, 1934, the Insolvency and Bankruptcy Code, 2016 and the rules framed thereunder, the Reserve Bank's circulars, master directions and statutory reports, and the judgment of the Supreme Court in Nedumpilli Finance. Secondary sources comprise analyses published by established law firms, peer-reviewed and edited legal blogs, and reporting in financial newspapers of record. The study is qualitative and interpretive; no empirical or survey data was independently generated. Every factual and regulatory assertion has been verified against at least one identified source, and where sources diverge on the status of an instrument, the position reflected in the Reserve Bank's own published directions has been preferred.

VI. LITERATURE REVIEW

The literature on Indian NBFC regulation is largely practitioner-generated and broadly welcoming of the post-2018 tightening. Arora and Mitra characterise the SBR framework as a pragmatic response to the unchecked growth of NBFCs in size, number and interconnectivity, while cautioning that transition periods must be long enough to permit orderly compliance.[3] Commentary on the Prompt Corrective Action framework similarly treats its extension to NBFCs as a necessary parity measure, noting the exclusion of government NBFCs, housing finance companies and primary dealers from its scope.[4]

On digital lending, the analysis published on IndiaCorpLaw treats the Reserve Bank of India (Digital Lending) Directions, 2025 as a material upgrade that produces regulatory certainty by consolidating the 2022 guidelines and the default loss guarantee circular into a single instrument.[5] Vinod Kothari Consultants' analysis of *Nedumpilli* emphasises the occupied-field reasoning and its extension to State enactments generally.[6] More recent commentary from Khaitan & Co reads the 2026 registration exemptions as a deliberate lightening of touch at the base of the sector rather than a weakening of prudential resolve.[7]

What the literature does not adequately address is the cost of regulatory volatility. Financial journalism has been more candid here: reporting in *Business Standard* following the February 2025 relief noted that unsecured lending had grown at a compounded rate of 22 to 25 per cent and that unhedged foreign currency borrowing by NBFCs posed a distinct exposure, concluding that shadow-bank risk persisted notwithstanding regulatory easing.[8] This paper seeks to fill that analytical gap.

VII. RESEARCH AND ANALYSIS

A. From Entity-Based Licensing to Scale Based Regulation

The pre-2019 framework rested on registration under section 45-IA and a binary distinction between deposit-taking and non-deposit-taking NBFCs. The Finance (No. 2) Act, 2019 dismantled that minimalism: it amended section 45-IA and inserted sections 41-D, 45-IE, 45-

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[3]Nishtha Arora and Soumyajit Mitra, 'Scale-Based Regulation for NBFCs – A Pragmatic Approach '*India Business Law Journal* (law.asia).
[4]'NBFCs Are Now Subject to Prompt Corrective Action '*India Business Law Journal* (law.asia); 'RBI Introduces Tough PCA Framework for Large NBFCs, Effective October 2022 '*Business Standard* (14 December 2021).
[5]'RBI's Revised Digital Lending Guidelines: Strengthening Guardrails in an Evolving Ecosystem '*IndiaCorpLaw* (19 July 2025), on the Reserve Bank of India (Digital Lending) Directions 2025 dated 8 May 2025.
[6]Vinod Kothari Consultants (n 2).
[7]Khaitan & Co, *A Lighter Touch? RBI's Proposed Recalibration of NBFC Regulation* (23 February 2026); 'RBI Amendments 2026: A New Category for NBFC Registration and Exemptions '*The Legal 500* (2026).
[8]'Waiting for a Fair Wind: Shadow Bank Risks Persist Despite RBI Relief '*Business Standard* (9 March 2025).

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MAA and 45-NAA, empowering the Reserve Bank to remove directors, supersede boards for up to five years and appoint an administrator, debar auditors, and require group-level financial disclosure.[9] In parallel, the Insolvency and Bankruptcy (Insolvency and Liquidation Proceedings of Financial Service Providers and Application to Adjudicating Authority) Rules, 2019, notified under section 227 of the Code, extended insolvency resolution to NBFCs with assets of INR 500 crore or more.[10] Dewan Housing Finance Corporation became the first such referral within days of notification.[11]

The Scale Based Regulation circular of 22 October 2021, operative from 1 October 2022 and consolidated in the Master Direction of 19 October 2023, completed the transition by sorting NBFCs into base, middle, upper and top layers, with regulatory intensity rising with each tier.[12] The framework is now restated in the Reserve Bank of India (Non-Banking Financial Companies – Registration, Exemptions and Framework for Scale Based Regulation) Directions, 2025 of 28 November 2025.[13] The Upper Layer, comprising seventeen entities in the list published on 7 August 2026, attracts bank-like obligations including mandatory listing within three years of identification.[14]

B. Supervisory Escalation: Prompt Corrective Action

The Prompt Corrective Action framework notified on 14 December 2021 and effective from 1 October 2022 introduced rule-based supervisory escalation, keyed principally to net non-performing asset thresholds of 6 to 9 per cent, 9 to 12 per cent and above 12 per cent, with mandatory restrictions on dividends and pressure for promoter equity infusion at the first level, escalating to branch and capital expenditure restrictions thereafter.[15] The exclusion of government NBFCs is analytically indefensible: several of the largest entities by asset size are

[9]Shardul Amarchand Mangaldas & Co, *Amendments to RBI Act, 1934 to Give Greater Control Over NBFCs* (2019), on ch VI of the Finance (No 2) Act 2019 (in force 9 August 2019), amending s 45-IA and inserting ss 41-D, 45-IE, 45-MAA and 45-NAA.

[10]Insolvency and Bankruptcy (Insolvency and Liquidation Proceedings of Financial Service Providers and Application to Adjudicating Authority) Rules 2019, notified 15 November 2019 under s 227 of the Insolvency and Bankruptcy Code 2016, extended to NBFCs with asset size of INR 500 crore or more on 18 November 2019. See 'NBFCs and Other Financial Service Providers Now under IBC '*IndiaCorpLaw* (23 November 2019).

[11]Ibid. The RBI superseded the board of Dewan Housing Finance Corporation Ltd on 21 November 2019, the first such referral of a financial service provider.

[12]Khaitan & Co, *New NBFC Regulatory Regime: Scale Based Regulation Directions 2023* (Ergo, 2023), recording the Scale Based Regulation circular dated 22 October 2021, effective 1 October 2022, and the Master Direction – RBI (Non-Banking Financial Company – Scale Based Regulation) Directions 2023 dated 19 October 2023.

[13]Reserve Bank of India, *Reserve Bank of India (Non-Banking Financial Companies – Registration, Exemptions and Framework for Scale Based Regulation) Directions 2025* (28 November 2025, updated 1 July 2026).

[14]The RBI released its list of 17 NBFCs in the Upper Layer on 7 August 2026; identified entities face enhanced regulation for a minimum of five years and mandatory listing within three years of identification.

[15]India Business Law Journal and Business Standard (n 4).

government-owned, and the systemic consequences of their distress would not be mitigated by their ownership.

C. Conduct Regulation and the Digital Lending Turn

The Reserve Bank of India (Digital Lending) Directions, 2025 of 8 May 2025 consolidated the 2022 digital lending guidelines and the 2023 default loss guarantee circular, capping default loss guarantee arrangements at five per cent of the underlying portfolio, mandating reporting of digital lending applications, requiring pre-notification before recovery agent contact, and obliging repatriation and deletion of offshore-processed borrower data within twenty-four hours.[16] This is a significant doctrinal development: it marks the Reserve Bank's decisive move from prudential regulation of NBFCs into conduct and data-protection regulation of their outsourced ecosystem, an area that overlaps with the Digital Personal Data Protection Act, 2023 without any formal coordination mechanism between the two regimes.

D. Cyclicality and the 2025-26 Recalibration

In November 2023 the Reserve Bank raised risk weights on consumer credit and imposed a 25 percentage point surcharge on bank exposures to NBFCs. On 25 February 2025 it reversed both, restoring the microfinance risk weight from 125 to 100 per cent and withdrawing the NBFC surcharge with effect from 1 April 2025.[17] The Amendment Directions of 2026, effective 1 April 2026, went further, creating a class of unregistered Type I NBFCs with assets below INR 1,000 crore that neither avail public funds nor maintain customer interface, with a de-registration window closing on 30 September 2026.[18][19]

These measures are individually defensible. Taken together they reveal a regulator adjusting the prudential dial within a fifteen-month cycle. For an NBFC planning a three to five year capital raise, that volatility is itself a risk factor, and it is one the framework does not acknowledge. Hypothesis H2 is accordingly supported: the sector's vulnerability lies less in insufficient rules than in the unpredictability of their calibration.

[16] IndiaCorpLaw (n 5).
[17] Khaitan & Co, *RBI Eases Risk Weight on Consumer Credit and Bank Loan: Relief for NBFCs and Microfinance Institutions* (2025), on RBI circulars DOR.STR.REC.61/21.06.001/2024-25 and DOR.CRE.REC.63/21.06.001/2024-25, both dated 25 February 2025, the NBFC relief taking effect 1 April 2025.
[18] Khaitan & Co and The Legal 500 (n 7).
[19] Reserve Bank of India (n 13). The de-registration window under the Amendment Directions 2026 closes on 30 September 2026, applications being made through the PRAVAAH portal.

E. Interconnectedness as the Unaddressed Systemic Risk

The Reserve Bank's own data record NBFC credit growth of 19.4 per cent and a capital-to-risk-weighted-assets ratio of 25.9 per cent, with the sector supplying credit equivalent to about a quarter of scheduled commercial bank credit.[20] The Financial Stability Report of June 2026 finds the sector well-capitalised and profitable, yet flags growing interconnectedness among banks, NBFCs and other financial institutions as a channel for transmitting shocks in periods of stress.[21] Layered rulebooks do not address a transmission channel; consolidated supervision and stress testing do. Hypothesis H1 is therefore only partly borne out: arbitrage has narrowed, but the SBR layers are calibrated to size rather than to the density of an entity's linkages with the banking system.

VIII. SUGGESTIONS AND RECOMMENDATIONS

First, the Scale Based Regulation framework should be given statutory anchorage. Its layers, criteria and consequences presently rest on subordinate instruments amendable at will; incorporating the layer structure and the criteria for Upper Layer identification into Chapter III-B would confer the predictability that a capital-intensive sector requires without diminishing regulatory flexibility on prudential detail.

Second, the Reserve Bank should adopt and publish a counter-cyclical policy protocol for risk weights and exposure norms, specifying the indicators that will trigger tightening and easing and a minimum notice period for changes. Rule-based cyclicality is legitimate; discretionary oscillation is not.

Third, the Prompt Corrective Action framework should be extended to government-owned NBFCs. Systemic risk is a function of balance sheet and linkage, not of shareholding, and several government NBFCs now sit in the Upper Layer.

Fourth, supervisory attention should shift from entity size to interconnectedness. An interconnectedness metric — capturing bank borrowings, co-lending exposures and unhedged foreign currency liabilities — should supplement asset size in Upper Layer identification, and periodic sectoral stress tests should be published.

Fifth, the resolution architecture requires completion. The 2019 Rules apply to NBFCs above INR 500 crore in assets and route them through the Insolvency and Bankruptcy Code with the

[20]Reserve Bank of India, *Report on Trend and Progress of Banking in India 2024-25* (December 2025), reporting NBFC credit growth of 19.4 per cent, a capital-to-risk-weighted-assets ratio of 25.9 per cent, and NBFC credit equivalent to roughly a quarter of scheduled commercial bank credit.

[21]Reserve Bank of India, *Financial Stability Report* (June 2026, released 30 June 2026), as reported in *Business Today* (30 June 2026).

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Reserve Bank as gatekeeper; below that threshold there is no bespoke resolution route at all. A graduated resolution framework, and a formal coordination mechanism between the Digital Lending Directions and the Digital Personal Data Protection Act, 2023, would close the two most conspicuous gaps.[22]

IX. CONCLUSION

India's NBFC framework has matured from permissive registration into a graduated, supervisorily intense regime, and the constitutional position established in *Nedumpilli* makes that regime exclusive.[23] The tightening was warranted and its results are visible in capital and asset quality metrics. But regulatory maturity is not merely a function of stringency. The framework's remaining weaknesses are its statutory thinness, the cyclicality of its prudential calibration, its blind spot for interconnectedness, and its incomplete resolution architecture. Convergence with banking norms is defensible where risks converge; it becomes counterproductive where it extinguishes the operational flexibility that allowed NBFCs to serve borrowers whom banks do not reach.[24] The reform India now needs is predictability and supervisory depth, not additional layers of prescription.[25]

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