PALAQ VORA
JAGDISH KAISARE

Anagram Partners

palaq.v@anagrampartners.in
jagdish.k@anagrampartners.in

If you have any questions regarding the matters discussed in this publication, please contact the attorney(s) listed above or call your regular contact at Anagram.

"NBFCs will be central to India's journey towards becoming a Viksit Bharat (developed nation) by 2047"[1]

– Nirmala Sitharaman

Introduction

India's financial landscape is dynamically evolving, with NBFCs playing an increasingly pivotal role. NBFCs are formally recognized by the Reserve Bank of India ("**RBI**") as an important constituent of the nation's financial system.[2] These agile credit intermediaries are crucial for bridging financing gaps and delivering last-mile credit to vast segments of the unbanked and underbanked population, making them indispensable to the nation's economic progress.

This essential role has fueled unprecedented growth within the NBFC sector. Propelled by India's escalating credit demands, the sector has demonstrated a robust 14%[3] compounded annual growth rate ("**CAGR**"), with assets under management ("**AUM**") soaring to an impressive $510 billion by FY24[4]. Yet, amidst such expansion, NBFCs continually grapple with the challenge of securing adequate and diverse funding, often competing directly with banks, their primary capital source. Recognizing such reliance, the RBI has not only underscored NBFCs' importance in domestic credit intermediation but also strongly advocated for diversifying their funding sources as a crucial risk mitigation strategy.[5] This very need for a broader capital base has ignited substantial interest from institutional investors, evident in the remarkable INR 88,708 crores of private equity and venture capital funding attracted by NBFCs across 162 deals between 2020 and H1 2024.[6] Crucially, this growth has thrived under a regulatory framework known for its flexible and facilitative stance.

Existing Regulatory Framework and Proposed Shift

Currently, India's regulatory framework for NBFCs has been characterized by its flexible and facilitative approach, allowing participants autonomy within stipulated regulations. This design has favoured market-driven investments. For instance, it imposes no explicit ceilings on aggregate shareholding across

1 *NBFCs key to Viksit Bharat, must ensure transparent, fair lending: FM | Today News*
2 'Report on Trend and Progress of Banking in India 2023-24' by Reserve Bank of India.
3 *Declining bank deposits raise concerns about NBFC's fund raising capacity: Report - The Economic Times.*
4 *NBFCs will continue to grow at a faster pace, have grown above India's GDP historically: Report | IBEF*
5 'Report on Trend and Progress of Banking in India 2023-24' by Reserve Bank of India.
6 'Report on Private Equity-Venture Capital in Financial Services & Fintech' by Reserve Bank Innovation Hub.

multiple NBFCs, nor does it provide for conditional approvals based on existing portfolios or stakes in competing entities, or impose an embargo on observer appointments to portfolio company boards. This pragmatic stance has long been a cornerstone of fostering a dynamic financial ecosystem.

However, a discernible shift now appears on the horizon. Recent credible reports suggest a potential RBI re-calibration, marked by prescriptive directives departing from established norms. In a notable instance, a conditional approval for an institutional investor's transaction with a housing finance NBFC reportedly mandated the investor dilute its existing shareholding in a portfolio company from 23% to 20% or below, prior to undertaking the acquisition of a competing housing finance NBFC ("**Divestiture Directive**").[7] Concurrently, reports indicate the RBI has instructed NBFCs to cause the resignation of '*observers*' appointed by institutional investors to their boards.[8] Such an approach, if indicative of a new policy direction, risks introducing significant regulatory uncertainty, potentially stifling the sector's growth and ultimately diminishing India's appeal for long-term institutional capital.

Reconsidering Restrictions on Multi-NBFC Investments

The RBI's calibrated regulatory framework for NBFCs, the Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023 ("**NBFC Regulations**"), is premised on the principle of proportionality – regulating financial entities based on their perceived risk and operational scale. The NBFC Regulations categorize NBFCs into four layers and prescribes prudential and governance norms tailored to their systemic risk profiles.

Crucially, the NBFC Regulations already require NBFCs belonging to a common "Group" or floated by common "Promoters" to be evaluated on a "consolidated" basis to determine their categorization, inherently providing mechanisms for group-level oversight to mitigate risks associated with cross holdings.[9] Further, any acquisition of control or significant investment in an NBFC mandates prior written RBI permission.[10] The application process requires detailed information, enabling the RBI to evaluate the source of funds and the acquirer's background, thus ensuring robust oversight.[11]

While the precise rationale behind the RBI's reported Divestiture Directive remains unclear, it appears to "unproportionately" steer the regulatory regime towards an "intervention" model, potentially limiting an institutional investor's participation to substantially only one NBFC within a segment. This seems aimed at preventing perceived systemic risks from "conflict of interests" and "cross-contamination". However, strategic or significant investment in multiple NBFCs does not inherently lead to systemic risks or conflicts of interest that cannot be effectively managed through existing or enhanced prudential and governance norms.

Advantages of Diversified Holdings and Robust Safeguards

Consolidating related or competing NBFCs within an institutional investor's portfolio enhances value creation and fosters market and product expansion. This strategic arrangement leverages shared technological infrastructure, centralized risk management, and collective customer acquisition, leading to economies of scale and operational efficiencies. It also facilitates cross-learning, resource optimization, improved governance, and innovation. Diversified holdings allow for cross-selling complementary products, strengthening vendor negotiating

7 *RBI asks Warburg Pincus to reduce stake in Home First Finance before Shriram Housing deal: Report*

8 *RBI's directors cut: NBFCs told to oust PE, VC observers - The Economic Times*

9 Regulation 2.8 of NBFC Regulations.

10 Regulation 42.1 of NBFC Regulations.

11 Regulation 42.2 of NBFC Regulations.

power, aiding talent attraction, and positioning the investor as a sector consolidation catalyst. Ultimately, these arrangements bolster individual NBFC growth, enhance portfolio resilience, maximize investor returns, and support market development.

Moreover, the NBFC Regulations already include comprehensive measures to prevent unjust distribution of cash, cross-contamination, and systemic risk, rendering ad-hoc restrictions on multiple investments (such as Divestiture Directives) largely unnecessary. Some of these measures are:

- ***NOFHC Regulations:*** NBFCs held by Non-Operative Financial Holding Companies ("**NOFHC**") are prohibited from having exposure (credit and investments) to the Promoter/Promoter Group entities or associated persons, mitigating intra-group contagion risks;[12]
- ***Concentration Norms:*** RBI prescribes specific concentration norms and sectoral exposure limits for NBFCs, directly addressing concentration risk and preventing excessive exposure within a "Group" structure;[13]
- ***AIF Investment Restrictions:*** Restrictions on NBFC investments in Alternative Investment Funds ("**AIFs**") with '*downstream investment*' in their debtor companies address potential conflicts and promote arm's length transactions;[14]
- ***Dividend Distribution Requirements:*** Stringent eligibility conditions and prudential requirements for dividend declaration ensure that financial distributions are based on sound financial health;[15] and
- ***Risk Management Committee:*** NBFCs must constitute a risk management committee for evaluating overall risks, including liquidity risks.[16]

Critical Role of Equity Capital and Observer Appointment

NBFCs' prevailing high dependence on debt financing poses systemic risks, especially during economic stress. In stark contrast to debt, equity capital imposes no consistent repayment obligations; rather, it significantly strengthens capital buffers, improves capital adequacy ratios, and provides an essential cushion against unforeseen losses. Restrictions on strategic investments and case-by-case scrutiny create regulatory uncertainty, deterring long-term commitments and disincentivize institutional investors, including foreign capital, from participating in the high-growth NBFC sector. The undesirable consequence could be capital scarcity, compelling NBFCs to assume greater systemic risks by relying disproportionately on borrowings.

A related concern has emerged regarding RBI's recent directions to certain NBFCs to request "observers" appointed by institutional investors to become directors on their board. The RBI's rationale is that observers avoid civil or criminal liability for fraud, fund diversions, and governance lapses, despite attending board meetings and conveying investor views without legal obligations of a director.[17] However, observers typically serve as oversight mechanisms for institutional investors, especially in growth-stage NBFCs. It is commercially beneficial for these investors to appoint observers for strategic oversight without necessarily participating at a director-level decision-making stage, before potentially transitioning to a directorship.

12 Regulation 32 of NBFC Regulations.
13 Regulations 32A, 91, 110, of NBFC Regulations.
14 Regulation 32C of NBFC Regulations.
15 Regulation 33 of NBFC Regulations.
16 Regulation 39 of NBFC Regulations.
17 *RBI's directors cut: NBFCs told to oust PE, VC observers - The Economic Times*

Moreover, even if institutional investors must appoint only directors, such directors are liable only for acts that occurred with their knowledge, attributable through board processes, and with their consent or connivance, or where they had not acted diligently.[18] Additionally, it is noteworthy that the NBFC Regulations holistically include robust measures to detect fraud, prevent fund diversion, and address governance lapses, thereby rendering the rationale behind the RBI's observer-related directions somewhat indistinct.

Paving the Path Forward: Recommendations for a Resilient NBFC Future

To sustain the crucial role played by NBFCs in India's financial system and effectively bridge the financing gaps, securing diverse and long-term equity capital is not merely beneficial – it is an absolute necessity. The RBI stands at a pivotal juncture, where its regulatory decisions regarding strategic investments in multiple NBFCs and engagement of observers will shape the sector's trajectory. To ensure that the future is robust and prosperous, the RBI is encouraged to adopt the following strategic adjustments to its regulatory philosophy:

Permit Diversified Investments

The RBI should permit strategic investments by institutional investors in two or more NBFCs, irrespective of whether they are related, competing, or operating in different segments. This progressive approach promotes healthy competition, and fosters innovation. The RBI should refrain from adopting an interventionist approach when evaluating prior approval applications for acquisitions or significant investments, allowing market dynamics to play a more prominent role, guided by clear, pre-defined prudential norms rather than subjective, case-by-case restrictions.

Leverage Consolidated Supervision

The RBI should leverage the existing NBFC Regulations, which already evaluates NBFCs on a "consolidated basis," for effective oversight. This can be achieved by:

- ***Scope of Group and Promoter:*** Expanding and refining the definition of "Group" and "Promoter/Promoter Group" to address complex ownership structures or significant influence not "technically" falling under existing legal / accounting definitions;
- ***Enhanced Reporting:*** Mandating consolidated financial statements beyond aggregating assets for layer classification, providing a holistic view of the Group's financial health, leverage, and risk exposure. This should couple with (i) specific, granular reporting for all intra-Group transactions; and (ii) consolidated risk management reporting – elucidating Group-wide exposure to specific sectors / geographies or borrowers, liquidity positions, operational risks and governance mechanisms;
- ***Supervisory Engagements:*** For Groups reaching systemic importance, considering (i) frequent supervisory interactions and Group-level stress testing; and (ii) mandating higher capital adequacy ratios or liquidity buffers aimed at absorbing potential Group-level shocks; and
- ***Fit & Proper Criteria:*** Extending the "fit and proper" criteria to Group-level management to ensure that the overall leadership spearheading the Group is sound.

18 Section 149 of the Companies Act, 2013

Maintain Proportionality

The principle of proportionality should continue to apply, ensuring regulation degree is commensurate with the actual risk posed by the entity or Group, without unduly stifling vital investment or the sector's growth potential. Over-regulation of entities not posing significant systemic risks can be counterproductive, leading to inefficiencies and reduced financial access.

Clarify Observer Role and Liability

The RBI should clarify its stance on observer appointments, acknowledging their distinct role and the existing legal framework regarding director liabilities. Reconciling regulatory expectations with current legal frameworks governing director liabilities is essential. Mandating observers' transition to directorship where oversight suffices can create unnecessary administrative burdens, increase perceived investor liabilities, and deter strategic oversight.

Regulatory approach that leans towards undue restriction, marked by ambiguous approvals and deviations from established oversight mechanisms, risks undermining investor confidence and curtailing essential capital flows. Such an approach could inadvertently push NBFCs towards a disproportionate reliance on debt, introducing the very systemic vulnerabilities the RBI seeks to prevent.

The path forward is clear. By championing a policy that actively encourages, rather than constrains strategic investments across the NBFC landscape, and by judiciously leveraging its robust, existing framework for consolidated and risk-proportionate supervision, the RBI can truly unlock the sector's vast potential. This requires intelligent oversight that discerns genuine systemic risk from mere perceived conflicts. The choice is for a thriving, capital-rich NBFC ecosystem ready to propel India into its next era of prosperity. A clear, consistent, and confidence-inspiring regulatory framework is not merely beneficial; it is the fundamental cornerstone for ensuring the NBFC sector remains a formidable force for prosperity and inclusion across India.

anagrampartners

Mumbai | Delhi

Follow us for more
anagrampartners.in

0802—2025