THE INVISIBLE BACKBONE: RE-EVALUATING THE ROLE AND LEGAL ARCHITECTURE OF NBFCS IN THE INDIAN FINANCIAL MATRIX

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ABSTRACT

In the year 2026, the Indian financial system has undergone considerable transformations, with the NBFC sector having crossed the mark of ₹50 lakh crore ($600 billion+) in Assets Under Management (AUM), and becoming the chief means of providing credit financing for the bottom-of-the-pyramid economy of India. In the course of developing from the "shadow banking" sphere into the central pillar of credit creation in India, the NBFC sector reached an outstanding level of market share (approximately 18-19% of credit in the country). From this standpoint, the present paper pursues an exhaustive approach in discussing the crucial part of NBFCs in assisting India in achieving the ambitious aim of reaching a GDP of $7 trillion by the year 2030. In particular, this paper examines the development of the Scale-Based Regulation (SBR) framework in the period of 2025-2026 and its success in reconciling the prudential needs of systemically significant non-banks and the interests of commercial banks. The "Unregistered Type I" category of firms, introduced in early 2026, deserves special mention. The research conducted from a critical perspective achieves a convergence of laws relating to the banking sector and NBFCs with respect to NPA criteria (harmonization of the 90-day norm) and capital adequacy criteria. The justification for the above-stated analysis in the study is that the convergence, as stated above, has reduced the “contagion risk” in the sector. Furthermore, this study provides global comparative analysis of the “Prudential” approach followed by India as opposed to the market-led approach of the U.S. and the outcome-led approach of the UK. From the critical analysis of trends prevailing in Co-lending 2.0, Digital Credit Intelligence, and Infrastructure Financing, it can be inferred that Indian NBFCs have taken the lead globally in striking a delicate balance between financial aggressiveness and regulation, and serving as an “Invisible Backbone” for the Indian economy.

I. Introduction: The Origin of the Concept of the Shadow Banks

Paul McCulley's 2007 article popularized the term "shadow banks".[1] "Shadow banks" referred to any financial intermediary not under the impact of the monetary policy of the central bank as well as not covered by its financial guarantee system. The financial intermediaries had developed a quite dubious reputation among the general population due to the secretive nature and high risks connected with the shadow banking operations. Nevertheless, having considered the current financial environment at the beginning of 2026, it becomes clear that the shadow banking concept has become rather outdated while discussing India's case. The Indian NBFCs do not operate in the shadows anymore; they have turned into transparently regulated entities.

At the moment, India's NBFCs make up about 19-20% of the total credit portfolio in India with the assets under management reaching the ₹50 lakh crore ($600 billion+) benchmark. There can hardly be any doubts as to the reasons behind such success of the Indian NBFCs as this achievement could have been reached thanks to more than one decade of RBI's work on bringing non-bank regulation in line with commercial banking regulation while preserving its flexibility.

The Indian NBFC industry has witnessed four different phases, and these are:

1. Primitive Phase (Prior to 1990s): The Period of Unorganized Financial Intermediation

Prior to the 1990 period, there was an unorganized phase when the companies engaged in hire-purchase operations, chits, and Nidhis were prevalent in the country's financial landscape. These finance companies were subject to little regulation because they fell within the jurisdiction of the Companies Act[2] and the administrative oversight of the Ministry of Corporate Affairs (MCA). These companies were important sources of financing for people who lacked access to banking services.

2. Epoch of Growth Through Reform (1998-2018): The Era of Specialist Lenders

As a consequence of the 1998 RBI amendment laws[3], the central bank gained unprecedented power over the sector; licensing along with the introduction of mandatory minimum net-owned

[1]Paul McCulley, Managing Director, PIMCO, *Takahe Down: The Rise of Shadow Banking,* Remarks at the PIMCO Global Central Bank Investment Forum (2007)
[2]Companies Act, No. 1 of 1956, INDIA CODE (1956).
[3]Reserve Bank of India (Amendment) Act, No. 23 of 1997, INDIA CODE (1997).

funds was introduced. This was the era when big NBFCs called 'National Champions' made their mark; they specialized in niche lending such as loans on used cars, gold lending, and micro-lending. The specialist lenders knew the area well and could collect money much better than banks. However, at the same time, "regulatory arbitrage" prevailed and massive NBFCs thrived on commercial paper financing.

3. The Crisis & Consequences Era (2018-2021): After the IL&FS and DHFL Funding Crunch

The wave set off by the failure of companies such as IL&FS in 2018 and the collapse of DHFL in 2019 became the “Lehman moment” for India’s NBFCs. The liquidity crunch led to the recognition of the need for a fresh assessment of the manner in which the sector could be sustained. There was a realization that shadow banking had to accept the reality that they were an integral part of the financial system. At this stage came the Liquidity Coverage Ratio (LCR).[4]

4. The Resilience & Convergence Phase (2021-2026): The Age of Scale-Based Regulation

In this age, the concept of Scale-Based Regulation (SBR) has reached its peak, through phased implementation from 2022 to 2025.[5] In terms of legislation, the legal distinction between a big NBFC and a banking institution has become increasingly blurred. In light of the emergence of the new category of “Upper Layer” (NBFC-UL), the top 20 systematically important NBFCs will now have to abide by the capital adequacy requirements as well as the guidelines on corporate governance, which are comparable to those followed by commercial banks.

Moreover, there are the amendments in the RBI Directions in February 2026, leading to the new category of “Unregistered Type I.” [6] Hence, it can be argued that it can be considered a “regulatory safety valve,” in the sense that these specific low-risk entities are exempt from mandatory registration requirement under Section 45-IA of the RBI Act, 1934.

Accordingly, it can be argued that the regulatory framework governing NBFCs in India is not just a safety brake that kicks off when there is any trouble. Instead, it is an advanced system

[4]Liquidity Risk Management Framework for Non-Banking Financial Companies and Core Investment Companies, RBI/2019-20/88 (Nov. 4, 2019).
[5]Scale Based Regulation (SBR): A revised Regulatory Framework for NBFCs, RBI/2021-22/112 (Oct 22,2021).
[6]Team Finserv, *Uneasy Ease: RBI Prposes Exemption in Approval Model for Type I NBFC*, Vinod Kothari Consultants (Feb. 10, 2026).

that has been designed not only to ensure financial stability but also to promote innovation, which is the hallmark of NBFCs without stifling them in the process. With India aiming to attain a $7 trillion economy, it is important to assess whether NBFCs can fund MSMEs, environmental enterprises, and rural clients through the complex legal framework.

By analysing the differences between the "Market-driven American Model" and the "Innovative British Model," we hope to underscore the importance of following the "Middle Path" of India by other emerging nations across the globe.

II. Functional Pillars: The Role of NBFCs in 2026

In the intricate network of the financial system of India, NBFCs have not only been able to move away from being seen as "alternative lenders" but have also emerged as specialized sources of credit for the economy. While commercial banks have been doing the job of "general practitioners" in providing deposit collection and general bank activities for firms and people alike, the NBFCs have become "specialized surgeons," operating in certain niche areas using sector-specific knowledge and highly localized evaluations, surpassing the automatic evaluations conducted by the giant banks.

The functional pillars of NBFCs by the year 2025-26 have been built on four vital financial sectors:

1. Specialized Asset Financing and the Dominance in the Used-Vehicle Market

Commercial banks have had the dominant share of the prime lending market for new passenger cars and the NBFCs have gained dominance in the Used-Vehicle & CE Finance industry. One could add that this particular sector was previously seen as an area of "chaos," but is now relevant to the Indian economy.

The NBFCs rely on highly localized networks wherein a process of boots-on-the-ground intelligence helps estimate the residual value of used commercial vehicles such as trucks, tractors, and three-wheelers. Bank-based lending institutions see such assets as "un-bankable" and high-risk ventures due to their complicated nature. Conversely, the NBFCs can determine whether it would be profitable to sell a seven-year-old truck in a tier 3 town.

This forms the foundation upon which the growth of logistics industries in India is based since they form the required foundation for the development of the e-commerce and agriculture logistics industry. The flexibility of financing via NBFCs is crucial in ensuring that the "last mile delivery" services offered by the logistics infrastructure of India are adequate, considering that small firms will not be able to improve their transport infrastructure without financing.

2. Bridging MSME Credit Gap via Micro LAP Programmes

Although they are still considered to be the second biggest employers of labour after the agricultural sector, MSMEs in India are currently facing a credit gap in excess of ₹25 trillion. The gap has been reduced through the programmes introduced by NBFCs in terms of the Micro LAP schemes in which loans in the amount of up to ₹10 lakh are made available to clients, whereas, the banks would not have offered such loans because of their relatively high operating costs. At present, the participation ratio of the NBFCs in the Micro-LAP category stands at about 45%.[7]

This is because the NBFCs have the capability of identifying where exactly they should fit into the prevailing scenario. The next innovative service offered by the NBFCs is "Triangulated Underwriting". Loan applications without an income tax return are bound to be rejected by the banks, but then NBFCs have introduced heterogeneity including GST, electricity bills, and UPI payments.

Alternative security is the second innovative service offered by the NBFCs, utilizing assets such as Abadi Deh land or land with possessory titles. This innovative service enables the NBFCs to make sure that the micro-entrepreneurs use their dead assets i.e., land for security in business.

3. Gold Loans – Economic Safety Valve

No exaggeration here: the most effective type of loans in 2025-2026 are gold ones. The reason lies in two factors – the increasing value of the precious metal worldwide and the tendency towards obtaining the necessary finances via borrowing.

These kinds of gold loan companies may be called the final chance for the new economy developed on the basis of the current pandemic. First and foremost, they do not have

[7]Reserve Bank of India, ANNUAL REPORT 2024-25, at 142 (2025).

mismatched terms, meaning there are no risks of liquidity problems that might lead to the insolvency of the corporation. The implemented regulatory framework, including the 75% LTV ratio regulated by the RBI[8], turned out to be quite effective, as even under the circumstances of volatility and a fall in the price of gold, the mentioned 25% margin guarantees the overcollateralization of NBFCs' positions, making the NPA ratio of this product consistently lower than that of other types of retail credit.

The elimination of the lending scheme utilized by the unregulated money lenders allowed for introducing laws that could cut the costs of liquidity for ordinary citizens and take advantage of their idle gold assets.

4. Infrastructure and Green Finance: The Trigger for the Future

The fourth pillar will become the relevance of the Infrastructure Financing Company (NBFC-IFC) by 2026. Being in such a hurry to enter the "Net Zero" stage, India is finding NBFC-IFCs useful as financiers of "Green Finance." The problem is that banks have an asset-liability mismatch (ALM) issue since the projects of the infrastructural finance get completed in 20 years compared to bank deposits' validity of three years. NBFC-IFCs are uniquely positioned since they have the opportunity to finance such projects using long-term debentures and ECBs for solar power parks, wind plants, and green hydrogen zones.[9]

III. The Legal and Regulatory Structure (2025-2026)

The legal and regulatory system of the NBFC industry can be considered an "invisible backbone," which is needed for stable economic development. Historically, this sector benefited greatly from regulatory arbitrage and functioning on the basis of low capital adequacy ratio requirements, and laxer asset classification guidelines. However, after liquidity issues emerged in the post-2018 period, it became necessary to take into account a new approach to the legal framework. From the perspective of a new approach, the key element of the contemporary framework is Scale-Based Regulation (SBR). Having been introduced completely at the end of 2025, SBR implies the shift from "entity-based" towards "activity/risk-based" oversight and, hence, ensures that the more extensive the NBFC becomes,

[8]Loans against Pledge of Gold Ornaments and Jewellery, RBI/2013-14/435 (Jan. 8, 2014).
[9]Master Direction-External Commercial Borrowings, Trade Credits and Structured Obligations, RBI/FED/2018-19/67 (updated Mar. 2016).

the higher legal obligations it must meet.

1. Four-Level Supervision Pyramid

In particular, the use of the "proportionality principle" is characteristic of the current approach to the regulation of NBFCs by RBI.[10] This principle implies that the higher the entity is, the more thorough the supervision process must be. It ensures no excessive burden for small businesses but allows large businesses to receive the same "bank-like treatment."

a. Base Layer (NBFC-BL): The Cornerstone of Inclusion

i. Scope/Description: NBFCs which do not take deposits and have an asset base not exceeding ₹1,000 crore belong to this category. Additionally, this category covers P2P lending entities, AA, and debt-focused NOFHCs.

ii. 2026 "Unregistered Type I" Age: One major milestone happened in 2026 when "Unregistered Type I" category was introduced as a part of the efforts made to streamline processes for "de-bureaucracy". Hence, this development has made the process of doing business much easier and simpler for conglomerates of India.

b. The Middle Layer (NBFC-ML): The Credit Engines

i. Scope and Description: It acts as the "growth engine" in the pyramid framework and comprises all deposit-taking NBFCs (NBFC-D) regardless of their size and all non-deposit-taking NBFCs having assets above ₹1,000 crores.

ii. Prudential Stringency: In this scenario, there are more stringent legal regulations. There is the need for at least a CRAR of 15%. [11]This ensures that the buffer is capable of absorbing losses. In addition, from 2026, the 'Fit and Proper' criteria have become very strict regarding board members. This includes having special sub-committees for Risk Management and Audit. It also ensures that the role of Chief Compliance Officer (CCO) is appointed in mandatory terms.

[10]Res. Bank of India, Scale Based Regulation (SBR): A revised Regulatory Framework for NBFCs, RBI/2021-22/112 (Oct 22,2021).
[11]*Id.* at ¶ 3.2.1 (setting capital requirements of the Middle Layer).

c. Upper Layer (NBFC-UL): The Systemic Giants

i. Extent of Coverage and Meaning: The Upper Layer comprises exclusively the top 15 to 20 NBFCs in the country (such as Bajaj Finance, Tata Capital and Cholamandalam). These entities are categorized on the basis of their size, leverage and liquidity risk using the complicated 'Parametric Scoring' system.

ii. Legal Convergence: While these entities may technically be referred to as 'Shadow Banks', they are 'banks in disguise'. Before the end of 2025-26, all organizations falling under the umbrella of NBFC-UL would have to compulsorily list themselves in the stock market. In addition, they are supposed to fulfil the CET1 (Common Equity Tier 1) ratio of 9%, similar to the Basel III rules applicable to normal banks.[12]

d. The Top Layer (NBFC-TL): The Strategic Reserve

i. The "Sword of Damocles": This is a "contingency layer" that at present time (early 2026) is still empty.[13] It serves as a "holding cell" for any Upper Layer entity that is considered as an extremely idiosyncratic risk to the whole Indian financial system. Being assigned to this layer, any NBFC will be subjected to an intensified supervision regime that may be referred to as being placed "under the regulatory microscope" as a way to avoid a possible Lehman-style disaster.

ii. The Bar Raiser (NOF): In order to limit new entries to those who have a serious capital and are likely to conduct "a fair play," the NOF minimum requirement has been increased to ₹10 crore and made permanent for new registrations. Thus, any "shell NBFC" may not appear in India; besides, each registered entity should possess some degree of "skin-in-the-game" to defend interests of creditors.

iii. The Digital Lending Obligations: The current legislation also embraces digital lending requirements contained in 2025 Digital Lending Guidelines. Now the “Lending Service Providers” (LSPs) have to show a clear “KFS Menu” and give a 24-hour cooling off period.

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[12]Res. Bank of India, Master Direction-Reserve Bank of India (Non-Banking Financial Company-Scale Based Regulation) Directions, 2023, RBI/DoR/2023-24/106 (updated as of 2026).
[13]See Res. Bank of India*, supra* note 9, at ¶ 2.4 (defining the top Layer as ideally empty unless systematic risk is identified by the RBI).

IV. Case Study: Shriram Finance's Transition to the NBFC Upper Layer (2024-2026)

1. The Background

By early 2024, the merger dust had already settled for what was one of the most significant mergers seen in Indian financial market landscape. Shriram transport Finance and Shriram City Union Finance had merged to create Shriram Finance Limited (SFL).[14]

Shriram Finance Limited had crossed an Asset under management (AUM) of Rs. 2.43 lakh crore (around $ 29 billion) as of mid-2024. This made SFL no more a mere "truck financer." Instead, it was a sprawling giant. But its size also compelled it to compulsorily move into Upper Layer (NBFC-UL) category under the Scale Based Regulation (SBR) system.

2. The Conflict

The move from being a traditional NBFC to an NBFC-UL was more than a rebranding effort, it was a structural overhaul. The primary conflict arose from the 90-day Non-Performing Asset Recognition Norm.[15]

Historically, Shriram's core customers were single truck owners and small farmers who operated on seasonal cash flow. A poor agricultural season or transporters' strike could result in delayed payments of over 90 days despite the fact that such a borrower would still be able to repay his loans.

The Legal Obligation: As an NBFC-UL, Shriram had to comply with banking regulations and treat any overdue account as NPA after 90 days. The implication of such requirement was that it would lead to inflated bad loan ratios and increased "provisioning," which reduces bottom-line profit levels.

3. The Turning Point

In order to pass the Upper Layer examination while retaining its connection with the village economy, Shriram took a three-fold approach during 2024-2025:

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[14]Shriram Finance Ltd., Annual Report 2023-24, at 12-15 (2024).
[15]Res. Bank of India, Master Directions- Reserve Bank of India (Non-Banking Financial Company-Scale Based Regulation) Directions, 2023, RBI/DoR/2023-24/106, § (updated as of 2026).

Prediction through Risk Analysis: SFL moved away from purely relationship-based lending. By 2025, they integrated satellite data and rural Mandi (market) pricing trends into their underwriting models to predict when a farmer's cash flow might dip before a payment was missed.

The Social Finance Buffer: SFL doubled down on the Social Finance Framework. During 2025 alone, they invested over Rs. 15,000 crores in social loans, which allowed them to obtain cheaper international funding(such as the $76 million co-financing deal with DEG and Citi in March 2026) aimed at rural development.[16]

Governance Transformation: SFL tightened its internal controls, achieving 100% board attendance in ESG and regulatory training sessions by 2024-25 fiscal year, indicating to the RBI that they were ready for the responsibilities of a systematically important institution.

4. The Resolution: Resilience in Numbers

By the second quarter of FY 2026 (ended late 2025), the results of transition were clear:

a. Growth: Income grew to Rs. 11,912 crores, representing a growth of 18%.

b. Profitability: Gross profit grew to Rs. 2,314 crores, showing that despite the increased regulation, profits were not affected adversely.

c. Market Confidence: SFL's stock became a "multibagger" for many, delivering a 72% return during 2025 as investors realized that the company could maintain its high-yield lending while keeping the "bank-like" discipline demanded by the RBI.

5. Key Takeaways

a. Scale as a Double-Edged Sword: While size brought SFL lower borrowing costs, it also brought the high level of regulatory oversight in India.

b. Tech as a Bridge: Technology allowed SFL to translate the "unstructured" financial lives of rural Indians into the "structured" data required by modern regulators.

[16]Shriram Finance secures USD 76 Million co-financing for economic inclusion & rural development, Econ. Times (Mar. 04, 2026).

c. Governance if the New Alpha: In the year 2026, Shriram Finance showed that for an NBFC, Compliance equals Capital. The strict adherence to NBFC-UL norms made it the "gold standard" for foreign institutional investment.

V. A Comparative Study

The Indian NBFC model doesn't really have a twin. Though NBFCs are treated as a unique category under Indian laws, countries like the US and the UK regulate similar entities under a general concept called non-bank financial intermediation or shadow banking without having a statutory category for them. To see why it's built the way it is, we have to look at how these countries handle their "Shadow Banking" players.

1. The United States

In the US, the non-bank world is a playground for investment banks, hedge funds, and mortgage specialists.

How they work: A defining feature of the U.S. system particularly in the pre-2008 era is the "originate to distribute" model. Under this framework, financial institutions originate loans (such as mortgages) and subsequently securitise them, selling the resulting instruments to investors in capital markets.[17] This model enhances liquidity but also disperses credit risk across the financial system.

The Legal Side: Unlike India's "one-stop-shop" oversight by the RBI, the US system is a bit of jigsaw puzzle, split between the "Securities and Exchange Commission" (SEC), the "Federal Reserve System" (FED), and the "Consumer Financial Protection Bureau" (CFPB). The whole focus is on market liquidity. If investors stop buying that debt, the lenders collapse exactly like we saw during the 2008 subprime mess.

2. The United Kingdom

The UK has carved out a space as the global capital for Fintech and Peer-to-Peer (P2P) lending.

How they work: In the UK, companies make use of "Open Banking," established via the Payment Services Regulations 2017 (which incorporated the standards of the Revised Payment

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[17]See Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report 42-45 (2011)

Services Directive). This framework allows regulated businesses to access banking data of customers (with their consent) using APIs, which helps them perform credit scoring based on the information accessed, and design personalized products, without the need for substantial balance sheets.

The Legal Side: The main regulator The Financial Conduct Authority (FCA), utilizes "Outcome-Based Regulation." Instead of being fixated only on ensuring adequate capitalisation, the FCA focuses largely on consumer protection and behaviour in the market. In particular, this is evident from the "Customer Duty" framework of the FCA, where companies are required to ensure that the products offered have proper value and suitability.[18]

Even though prudential regulation cannot be neglected (mainly for significant firms by the Prudential Regulation Authority), the general approach towards the regulatory policy is based on innovation and consumer protection.

3. Comparison matrix

FEATURE	**INDIA**	**UNITED STATES**	**UNITED KINGDOM**
REGULATORY AUTHORITY	Single (RBI)	Multiple (SEC, FED, FDIC)	FCA
FUNDING SOURCE	Bank Loans & NCDs	Repo & Capital Markets	Private Equity & Crowdsourcing
CAPITAL ADEQUACY	Very High (15%)	Variable/Risk-Based	Innovation-Friendly
PRIMARY GOAL	Inclusion & Stability	Liquidity & Returns	Competition & Conduct

VI. Critical Challenges : The Road to 2030

Even with all the progress we've seen by 2026, the sector isn't out of the woods. There are three big hurdles that could make or break the next few years:

[18] Fin. Conduct Auth., PS22/9: A New Consumer Duty (2022) (UK).

1. The Funding Loop: NBFCs still get about 40% of their money from banks. If the big banks catch a cold, the NBFCs get the flu. We desperately need a deeper corporate bond market so these companies can be more efficiently capitalized.

2. Digital Scams: As lending moves to apps, the risks are shifting. AI-driven "Deepfake" fraud represents the new frontier. The legal definitions of digital lending from a few years ago are already starting to feel dusty and need constant updates to keep up with hackers.

3. The Regulatory Squeeze: There's a real worry that we've made the rules too stiff. If an NBFC is forced to act exactly like a bank but isn't allowed to take low-cost deposits, their margins are significantly compressed. We don't want "zombie" companies that are safe but too broke to actually innovate.

VII. Conclusion: The "Middle Path"

The Indian NBFC sector of 2026 is essentially a success story of the "Middle Path." We managed to avoid the wild, de-regulated volatility of the US and the purely conduct heavy approach of the UK.

By using Scale-Based Regulation, India has built a system where the rules actually match the risk. The bigger you are, the more you're watched. These companies have proved they aren't just "shadows" anymore; they are the ones reaching the farmers, truckers, and small-town entrepreneurs whom the big banks wouldn't touch for decades.

As India pushes toward that 7 Trillion Dollar milestone, this "Invisible Backbone" has to stay in peak condition, strong enough to carry the country's weight, but flexible enough to keep us moving forward.