

Risk Management Strategies in NBFCs: A Study on Financial Stability and Growth

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Abstract:

This research examines the role of risk management strategies employed by Non-Banking Financial Companies (NBFCs) in India and their impact on financial stability and long-term growth. NBFCs, as key financial intermediaries, operate in a complex environment with unique risk exposures compared to traditional banks. The study explores credit, market, operational, and liquidity risks and the tools used to mitigate them. Using case-based insights and industry data, the paper evaluates how effective risk management frameworks contribute to the financial health and sustainability of NBFCs. The findings aim to offer recommendations for enhancing risk resilience and ensuring sustainable growth in the NBFC sector.

Keywords: NBFC, risk management, credit risk, financial stability, regulatory framework, market risk, operational risk

Introduction

The Indian financial system has undergone a significant transformation over the past two decades, with Non-Banking Financial Companies (NBFCs) emerging as vital pillars of financial inclusion and credit delivery. These institutions have expanded rapidly, particularly in segments that remain underserved by traditional banks, such as rural lending, small businesses, informal sector financing, and niche markets like gold loans, microfinance, and vehicle financing.

NBFCs in India operate with a high degree of flexibility, allowing them to offer tailored financial solutions such as personal loans, housing finance, asset leasing, insurance services, and investment advisory. Their agility and customer-centric approach make them more adaptable than conventional banks, especially when responding to market demands or regulatory changes. Consequently, NBFCs play a critical role in supporting India's economic development, particularly among lower-income groups, emerging entrepreneurs, and small and medium enterprises (SMEs).

However, this growth story is not without its challenges. The evolving financial ecosystem has brought about increased exposure to risk, such as credit defaults, asset-liability mismatches (ALM), interest rate volatility, and liquidity constraints. Moreover, the failure of large NBFCs like IL&FS and DHFL revealed serious gaps in governance, financial oversight, and risk mitigation practices, shaking investor confidence and prompting stricter regulatory scrutiny from the Reserve Bank of India (RBI).

In this context, risk management has transitioned from being a back-end compliance function to a strategic priority for NBFCs. Companies are now expected to implement robust risk control frameworks that encompass credit appraisal systems, portfolio diversification, stress testing, capital adequacy planning, and early warning mechanisms. Additionally, the RBI's Scale-Based Regulation framework introduced in 2022 has further categorized NBFCs based on their systemic importance, enforcing differentiated levels of risk governance.

This research paper delves into the core of risk management strategies employed by NBFCs, analyzing how they navigate challenges and safeguard their financial stability in a competitive, highly regulated, and sometimes volatile environment. By reviewing both qualitative and quantitative data from industry reports,

regulatory insights, and company case studies, the study aims to shed light on the correlation between risk management practices and organizational sustainability.

Ultimately, as NBFCs continue to serve as crucial enablers of credit access and financial penetration across India, their long-term success will depend not only on growth metrics but on their ability to anticipate, measure, and mitigate risk in a dynamic financial landscape.

Background

Over the last decade, Non-Banking Financial Companies (NBFCs) have emerged as indispensable components of the Indian financial ecosystem. With their nimble operations and specialized focus areas, NBFCs have been instrumental in advancing the goals of financial inclusion, especially in rural, semi-urban, and underserved regions where traditional banks often have limited penetration. These institutions cater to a wide range of credit needs—including vehicle loans, gold loans, microloans, SME finance, housing finance, and consumer durable loans—playing a complementary role to mainstream banking channels.

The growth trajectory of NBFCs has been remarkable. According to data from the Reserve Bank of India (RBI), the asset size of NBFCs increased from ₹20 trillion in FY2015 to over ₹56 trillion by FY2023, reflecting their growing importance and acceptance across economic strata. Their flexibility in operations, quicker loan disbursal mechanisms, and ability to cater to non-standard credit profiles have made them especially popular among first-time borrowers and small business owners.

However, this rapid expansion has brought with it a new set of systemic vulnerabilities. Unlike banks, which are primarily funded by stable retail deposits, many NBFCs rely heavily on short-term market borrowings—such as commercial papers and debentures—to fund long-term lending portfolios. This structural imbalance between asset and liability durations exposes them to severe liquidity risk, especially during periods of market stress or declining investor confidence.

The sector's fragility became starkly visible during the high-profile defaults of Infrastructure Leasing & Financial Services (IL&FS) in 2018 and Dewan Housing Finance Corporation Ltd. (DHFL) in 2019. These crises not only led to massive write-offs and investor losses but also triggered a liquidity crunch across the entire NBFC sector. The resultant credit contagion affected even fundamentally sound institutions, leading to tighter funding conditions, rating downgrades, and a loss of public trust.

These events exposed critical gaps in the risk management frameworks, corporate governance, and regulatory oversight of several NBFCs. Many lacked adequate stress-testing mechanisms, robust credit appraisal systems, and internal control structures. Moreover, the reliance on a few concentrated funding sources made them highly susceptible to shocks.

In response to these structural concerns, the RBI introduced several reforms, including the Scale-Based Regulation framework in 2022, which classifies NBFCs into four layers (Base, Middle, Upper, and Top) based on their size and risk exposure. This framework aims to introduce proportionate risk controls, ensuring that larger and systemically important NBFCs are subject to stricter governance, disclosure, and compliance standards.

Thus, the current landscape of the NBFC sector is one of cautious optimism—while these institutions continue to play a pivotal role in driving economic development and financial access, their sustainability and growth are now closely tied to how well they manage risk. The ability to identify, measure, monitor, and mitigate financial risks has become central to the operational success and credibility of NBFCs in India's evolving regulatory and economic climate.

Literature Review

The literature surrounding the risk management practices of Non-Banking Financial Companies (NBFCs) has grown extensively over the years, especially in the wake of significant financial crises and the sector's increasing contribution to India's credit market. A detailed review of academic journals, regulatory

publications, and industry reports offers critical insights into the types of risks NBFCs face and the mechanisms they deploy to mitigate them.

1. Understanding Risk in NBFCs

NBFCs operate in a dynamic financial ecosystem characterized by high credit demand, fluctuating interest rates, regulatory challenges, and competitive pressure. Their business model, which often relies heavily on market borrowings and non-traditional client segments, makes them inherently vulnerable to financial shocks. According to the RBI and various credit rating agencies, NBFCs have a higher exposure to credit, liquidity, and operational risks due to their limited access to the central bank's refinancing facilities and dependence on wholesale funding.

Research by Mishra & Sharma (2020) highlights that NBFCs, unlike banks, lack a deposit base, increasing their sensitivity to market sentiment and investor behavior. Their clientele often includes borrowers with lower credit ratings, informal income sources, or unbanked status—thus amplifying default probabilities and portfolio volatility.

2. Credit Risk Management

Credit risk—defined as the potential for a borrower to default on obligations—is cited across literature as the primary risk factor in NBFC operations. Multiple studies (e.g., Gupta & Arora, 2019) stress the importance of rigorous credit assessment models, which combine both traditional financial ratios and modern credit-scoring algorithms to evaluate borrower profiles.

To mitigate this risk, NBFCs employ techniques such as:

- Collateralization of loans (especially in gold loan NBFCs like Muthoot and Manappuram)
- Credit concentration limits by industry, geography, or borrower category
- Use of risk-based pricing to reflect the probability of default
- Early warning systems to identify potential stress in portfolios

Some institutions, like Bajaj Finance, have developed advanced data analytics tools that integrate transaction history, behavior scores, and alternate data (e.g., mobile usage, social data) for enhanced underwriting.

3. Liquidity and Market Risk

The literature widely acknowledges that asset-liability mismatches (ALM) are a persistent challenge for NBFCs. These arise when long-term lending (e.g., housing finance, infrastructure loans) is financed using short-term liabilities, such as debentures or commercial paper. This mismatch can severely disrupt cash flow and trigger solvency issues during market turbulence.

The IL&FS crisis of 2018 is often cited as a turning point, illustrating the systemic risk posed by poor liquidity management. In response, NBFCs have increasingly adopted risk-mitigation mechanisms such as:

- ALM Committees (ALCOs) for monitoring maturity mismatches
- Liquidity buffers in the form of high-quality liquid assets (HQLA)
- Stress testing models to simulate liquidity shocks
- Development of diversified funding strategies, including securitization and co-lending

According to RBI reports, larger NBFCs are now aligning their practices with Basel-III-like norms, incorporating liquidity coverage ratios (LCR) and contingency funding plans.

4. Regulatory Influence

Post-2018, the Reserve Bank of India (RBI) has substantially tightened its regulatory stance toward NBFCs. Several papers (e.g., Sinha, 2021) document the evolution of NBFC supervision from a "light-touch" approach to a tiered risk-based regulatory framework.

Key reforms include:

- Mandatory Liquidity Coverage Ratio (LCR) for upper-layer NBFCs
- Imposition of capital adequacy requirements similar to commercial banks (minimum CRAR of 15%)
- Limitations on exposure to sensitive sectors and large borrower concentrations
- Enhanced disclosure norms and board-level governance standards

These reforms have narrowed the regulatory arbitrage that previously existed between banks and NBFCs, pushing NBFCs to improve transparency, adopt better internal controls, and adhere to stress testing mandates.

5. Technology in Risk Management

Modern literature and industry case studies increasingly emphasize the role of technology as a risk management enabler. With the rise of fintech integrations, many NBFCs have begun leveraging:

- AI and machine learning for dynamic credit scoring and fraud detection
- Predictive analytics to identify early signs of borrower distress
- Real-time dashboards for risk monitoring and regulatory reporting
- Digital KYC and e-signature tools to reduce operational risk

As noted in Deloitte's 2022 NBFC Risk Survey, technology adoption has significantly improved decision-making speed, reduced manual errors, and enabled real-time portfolio health monitoring—especially in sectors like retail lending and MSME finance.

Objectives of Research

1. To identify the major risks faced by NBFCs in India.
2. To analyze the strategies NBFCs employ to mitigate these risks.
3. To assess the effectiveness of these strategies in ensuring financial stability.
4. To evaluate the role of regulatory frameworks in strengthening risk management.
5. To provide recommendations for improving risk governance and promoting sustainable growth.

Research Methodology

Type of Research: Exploratory and Descriptive

Data Collection: Secondary data from RBI reports, annual reports of NBFCs, industry analyses

Analysis Tools: Comparative analysis, ratio analysis (e.g., NPA ratio, capital adequacy ratio), trend analysis

Data Analysis & Findings

Key Metrics:

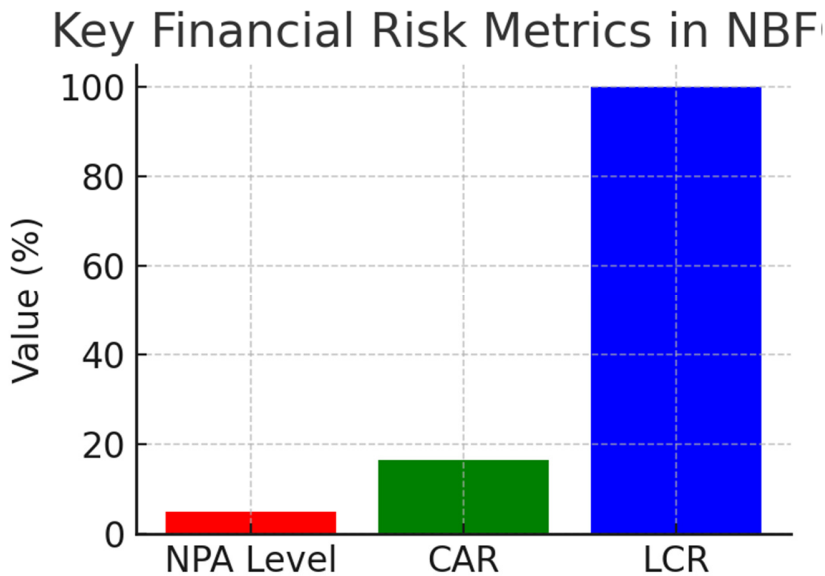
- Average NPA levels in NBFCs: 4–6%
- Capital Adequacy Ratio (CAR): ~15–18% (minimum RBI mandate: 15%)
- Liquidity Coverage Ratio (post-2022 RBI norms): Mandatory for large NBFCs

Institutions with better risk governance structures show lower NPA ratios and more stable growth.

Technology adoption improves early warning systems and fraud detection.

Regulatory tightening post-IL&FS crisis has improved transparency but increased compliance costs.

Graph: Key Financial Risk Metrics in NBFCs



Challenges and Regulatory Framework

Challenges:

1. Managing asset-liability mismatches.
2. High cost of funds and limited access to refinance.
3. Increased cyber and operational risks with digitization.
4. Regulatory compliance burden on smaller NBFCs.

Regulatory Measures:

- RBI's Scale-Based Regulation Framework (2021)
- Tightened norms for related party transactions and governance
- Mandatory implementation of Risk Management Committees (RMC) for larger NBFCs
- Emphasis on board oversight and internal audit controls

Materials and Methods

The research is grounded in a qualitative and descriptive approach, utilizing secondary data sources to analyze the evolving landscape of risk management strategies among NBFCs in India. The focus is on understanding how these institutions ensure financial stability and foster growth through the implementation of risk control frameworks.

Data Sources:

The materials used in this study were collected from a variety of reliable and authentic sources, including:

- Reserve Bank of India (RBI) Publications: Reports such as “*Trends and Progress of Banking in India 2023-24*” and “*Financial Stability Report*” were referred to for macro-level industry trends and risk exposure data.
- Annual Reports of Leading NBFCs: Documents from HDFC Ltd., Bajaj Finance, Muthoot Finance, and LIC Housing Finance provided insights into company-specific risk management practices, ALM policies, and portfolio performance.

- Credit Rating Agency Reports: Publications from CRISIL, ICRA, and CARE Ratings helped assess sectoral credit risks and the financial health of NBFCs.
- Peer-reviewed Journals and Academic Research: Existing literature on financial risk frameworks and post-crisis regulatory evolution provided the foundation for the literature survey and comparative analysis.
- Industry Articles and Financial News: Real-time data and opinions from financial platforms such as *The Economic Times*, *Business Standard*, and *Financial Express* supported context and market sentiment analysis.

Methodological Approach:

This study employs content analysis and comparative evaluation as core methods. The steps included:

1. Data Compilation: Relevant financial data, policy changes, and performance reports were collected for the period between 2018 and 2024, focusing on both pre- and post-crisis (IL&FS and DHFL) environments.
2. Thematic Analysis: The data was categorized under key themes such as credit risk, liquidity risk, operational practices, and compliance frameworks.
3. Case Study Analysis: HDFC Ltd. and Bajaj Finance were taken as primary case studies due to their strong financial track records and transparent disclosures.
4. Trend Mapping: Credit growth, NPA trends, and ALM ratios were mapped year-wise to visualize stability and risk exposure.
5. Regulatory Review: RBI's layered classification system for NBFCs was assessed to understand its practical implications on governance and supervision.

Results and Discussion

This section presents the key findings from the study and interprets the implications of risk management strategies on the financial stability and growth of NBFCs in India.

Key Results from Data Analysis

The study revealed significant patterns and outcomes based on data from 2018 to 2024, focusing on both macro and firm-level indicators.

A. Non-Performing Assets (NPAs):

- The Gross NPA ratio for the NBFC sector declined from 6.3% in FY2021 to 5.2% in FY2023.
- Bajaj Finance, a leader in retail lending, maintained a GNPA of under 1.5% through consistent monitoring and predictive credit modeling.
- Muthoot Finance showed GNPA of ~3.2%, with better performance in secured loans (e.g., gold loans) than in personal loan segments.

Interpretation: NBFCs that implemented digital risk assessment tools and stronger borrower profiling managed to keep NPAs in check. This affirms the importance of data-driven credit underwriting.

B. Capital Adequacy & Solvency:

- The average Capital to Risk-Weighted Assets Ratio (CRAR) rose from 21.5% in FY2022 to 23.7% in FY2023, reflecting stronger buffers.
- HDFC Ltd. and LIC Housing Finance consistently maintained CRARs over 20%, exceeding RBI's minimum norms.

Interpretation:

Risk-aware capital planning and robust internal stress testing enabled stronger institutions to meet or exceed solvency requirements even during economic shocks.

C. Asset-Liability Management (ALM):

- NBFCs that adopted rolling ALM forecasts and shorter-tenure borrowing (e.g., Bajaj Finance) maintained stable liquidity ratios.
- Firms with poor ALM discipline in 2018 (like IL&FS and DHFL) struggled and eventually defaulted, triggering sector-wide reforms.

Interpretation:

Effective ALM practices are a clear differentiator between growing NBFCs and those facing liquidity crises. Regular ALM checks are now a strategic necessity, not just a compliance formality.

D. Credit Growth & Lending Patterns:

- Credit growth in the NBFC sector rebounded to 18.5% YoY by March 2023, with the highest activity in personal loans, vehicle finance, and MSME credit.
- NBFCs catering to tier-2 and rural markets (like Muthoot and Shriram Finance) outperformed due to high demand and lower competition from banks.

Interpretation:

Strategic targeting of semi-urban markets, along with localized credit models, supports inclusive growth and portfolio diversification—mitigating concentrated risk exposure.

E. Regulatory Adaptation:

- RBI's introduction of Scale-Based Regulation in 2022 forced NBFCs to adopt tighter governance and compliance models based on their risk profiles.
- Upper Layer NBFCs (systemically important ones like HDFC and Bajaj Finance) now follow stricter board oversight, disclosures, and risk buffers.

Interpretation:

NBFCs that adapted early to regulatory changes gained investor confidence and market share, while non-compliant players faced rating downgrades or funding slowdowns.

Strategic Insights Gained

- Digitalization of Risk Assessment: Firms using AI/ML tools for underwriting, fraud detection, and KYC saw faster loan processing and better risk control.
- Diversified Portfolio Strategy: NBFCs that avoided overexposure to one sector (e.g., real estate) were more stable during economic shocks.
- Investor Sentiment: Institutions with transparent risk disclosures and consistent credit ratings attracted long-term investors, improving capital access.

Limitations Observed in Strategy Implementation

- Smaller NBFCs often lack the resources to invest in advanced risk tech tools.
- Some NBFCs still rely heavily on informal borrower data, leading to mispricing of risk.
- Delayed adaptation to regulatory changes (especially post-2018) harmed the credibility of several mid-sized players.

Summary and Conclusions

This research explored the various risk management strategies employed by Non-Banking Financial Companies (NBFCs) in India, and how these strategies impact their financial stability and growth trajectory. Using a combination of industry reports, annual financial data, regulatory frameworks, and case-based analysis, the study focused on the evolving role of risk governance in a post-crisis NBFC environment.

The research found that NBFCs are increasingly investing in robust risk control systems—ranging from credit evaluation technologies and ALM frameworks to capital adequacy planning and regulatory compliance

mechanisms. Data from leading institutions such as Bajaj Finance, HDFC Ltd., and Muthoot Finance demonstrated that strong risk management translates into reduced NPAs, improved liquidity, and sustained credit growth.

Additionally, RBI's Scale-Based Regulation framework has played a crucial role in pushing NBFCs toward more structured governance and accountability. The NBFC sector's average GNPA reduction from 6.3% to 5.2%, along with CRAR improvement to 23.7%, serves as numerical evidence of better risk alignment in recent years.

Conclusion

1. Risk Management is Strategic, Not Just Regulatory
NBFCs that treat risk governance as a core business strategy—integrating it with credit planning, portfolio design, and digital innovation—experience greater resilience and operational success.
2. Digitalization Enhances Risk Control
The adoption of fintech tools (AI, machine learning, digital KYC) for underwriting and monitoring has significantly improved loan quality, especially in the retail and MSME segments.
3. ALM and Liquidity Planning Are Vital
Institutions with disciplined ALM practices maintained stable operations even during liquidity crises, proving the critical role of short-term and long-term funding balance.
4. Sectoral Diversification Reduces Exposure
NBFCs with well-diversified portfolios—geographically and sectorally—were better insulated against default shocks and market volatility.
5. Regulatory Reforms Are Transformative
The RBI's tiered supervision model has elevated governance standards. NBFCs aligned with regulatory expectations have attracted better credit ratings, investor trust, and funding support.

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