Risks in Indias Shadow Banking Analysing Business Models, Fund Diversion, and Warning Signals in NBFCs

This case study examines the Non Banking Financial Company sector in India, highlighting its critical role in economic growth and financial inclusion. While the NBFC sector has immense growth potential, it also faces significant challenges that require analysis beyond the quantitative ratings provided by credit agencies. Through an in-depth exploration of NBFC business models, this case identifies high-risk areas within the sector, such as fund diversion tactics and complex inter-group lending structures that obscure transparency. Additionally, issues related to corporate governance, liquidity crunches, and regulatory actions reflect structural weaknesses that could have broader implications for India’s financial system. This study proposes a framework for assessing NBFC financial health, emphasizing the analysis of business model, identification of early warning signals, such as liquidity mismatches and unusual fund transfers, to strengthen credit appraisal processes.

Cover Page

Title of the Case Study	Risks in India's Shadow Banking: Analysing Business Models, Fund Diversion, and Warning Signals in NBFCs
Theme of the Case Study	Improving credit assessment, collections, and debt solutions to reduce losses
Name of the Author	Vineet Kumar Jain
Designation (Present)	Assistant General Manager
Employer (Present)	Bank of Baroda
Mobile number	08285361206
Email address	vineet.jain104@gmail.com
Qualification/s	MBA (MDI Gurgaon), B.Tech (NIT Bhopal), CAIIB, Certified Bank Trainer (IIBF/NIBM). PG Diploma in training and development (ISTD) etc.
Any other information	He has worked in the Apex training establishment of Bank of Baroda for four years and has trained more than 5000 employees in various areas of banking. He has written several case studies and articles. He has received various awards from RBI, NIBM, IIBF for his case studies. He has also represented bank in various seminars. He has worked as Head of SME loan Factory and Branch Head of large branches. He has also worked in international business branch, large corporate branch and Risk Management department of the bank.

Abstract

Risks in India's Shadow Banking: Analyzing Business Models, Fund Diversion, and Warning Signals in NBFCs

Stressed Assets poses a significant challenge for banks, as maintaining asset quality and recovering overdue loans is crucial. The wholesale segment contributes significant share of stressed assets, with loans to the NBFC sector representing one of the most substantial portfolios in this segment.

This case study examines the Non-Banking Financial Company (NBFC) sector in India, highlighting its critical role in economic growth and financial inclusion. While the NBFC sector has immense growth potential, it also faces significant challenges that require analysis beyond the quantitative ratings provided by credit agencies. Through an in-depth exploration of NBFC business models, this case identifies high-risk areas within the sector, such as fund diversion tactics and complex inter-group lending structures that obscure transparency. Additionally, issues related to corporate governance, liquidity crunches, and regulatory actions reflect structural weaknesses that could have broader implications for India's financial system. This study proposes a framework for assessing NBFC financial health, emphasizing the analysis of business model, identification of early warning signals, such as liquidity mismatches and unusual fund transfers, to strengthen credit appraisal processes.

In the evolving regulatory landscape, where the Reserve Bank of India (RBI) has tightened supervision on NBFCs to address systemic risks, this case study underscores the importance of aligning business practices with regulatory expectations. By integrating these warning signals into credit appraisals, lenders can proactively address potential risks, thereby enhancing asset quality and supporting sustainable business growth of the banks in the sector.

Risks in India’s Shadow Banking: Analyzing Business Models, Fund Diversion, and Warning Signals in NBFCs

I. INTRODUCTION

The Annual General Meeting of XYZ Bank Ltd was being held and discussion on final results and future course of action of bank was going on. Mr. Anupam, MD & CEO of XYZ Bank Ltd was attending to the queries of shareholders. While replying to the query related to credit quality issues in the bank’s NBFC portfolio, he mentioned – “Bank is having very good risk appraisal system and monitoring mechanism for evaluating the business model of NBFCs.” He also mentioned – “Bank is regularly monitoring the rating profile of the customers of NBFCs availing loan facilities from our bank and our NPAs in this segment will not increase beyond current level.” This statement was highly appreciated by shareholders as well as media.

Mr. Anupam however knew that NBFC portfolio was one of the major loan portfolios of the Bank and balance outstanding in NBFC sector was more than 10% of Global Exposure of the Bank. He also knew that this sector was facing multiple issues including regulatory actions. He was aware that at the time of announcement of half yearly/ yearly result of the bank, everybody was going to focus on the stress figures in NBFC portfolio. Hence after returning from Annual General Meeting, he immediately asked for the list of stressed accounts in NBFC sector. While going through the list of accounts, he found that no major slippage was expected in NBFC portfolio of the bank.

II. HALF YEARLY RESULTS: SURPRISES SURPRISE AGAIN

It was the month of September. Mr. Anupam was listening to prime-time news on a business news channel. There was news that Balcon Capital India Private Limited (Balcon Capital) had defaulted on an interest repayment of Rs. 19 crores. He immediately called GM (NBFC) and asked him to give the full details of Balcon Capital. GM (NBFC) informed that this account was rated very high internally as well as externally (AA rated account) and total exposure was approximately Rs. 300 crores. Mr Anupam was furious. He immediately asked for the list of stressed accounts. He was surprised to see that many “out of the blue” entries were there in the list. Mr. Anupam remembered his promise to shareholders that stress level in NBFC segment would not increase beyond current level. He decided to assign this task to

Mr. Atul. He was General Manager (Large corporate Banking) and had experience of working in credit domain for more than 30 years.

Mr. Anupam made his point very clear to Mr. Atul – "Atul, I have made a promise to our shareholders. I know that it is very challenging task but I am sure that you will prove me right. I don't want any surprises in our yearly results. Make sure that we detect any potential slippage well before time and take corrective action before it turns into stressed account."

III. STRATEGY

Mr. Atul knew that macro-economic factors were changing drastically and many accounts could come under stress. First, he decided to understand the NBFC sector and its growth potential. He was convinced that there was huge opportunity of business growth in this sector. There was a need to identify right accounts based on right parameters.

Now he decided to understand the existing process of appraisal for NBFC sector and started with Balcon Capital. He observed that there was overemphasis on the fact that it was sponsored by a clutch of marquee shareholders namely Clearwater Capital Partners, Abu Dhabi Investment Council and Varde Partners Global Investment Giants and also on the fact that it was rated as AA by different rating agencies and had very low DE ratio. He found that the business model of Balcon Capital was highly concentrated towards asset backed senior secured lending in the Real Estate sector, majorly concentrated to -7- Metros & urban cities (Details as per Annexure -1).

After going through the proposal, he made following observations to his team members – "To survive and grow, any business must have some core competence. Any NBFC, which is funding to real estate sector or any other sector and competing with other financial institutions e.g. banks, should have niche market segment and expertise in that segment. I don't see any such thing in the case of Balcon Capital. This NBFC has funded those real estate projects, which were rejected by our bank or other banks. It charged higher interest rate and offered long moratorium period to increase their book size. It seems a typical strategy for showing higher profitability and attracting higher valuation from prospective investors." He was very clear and said that if there was any liquidity issue, then we could help but if the business model was flawed then bank could not throw good money after bad money.

He emphasized - "Our credit assessment should include many important points e.g. evaluation of NBFC's internal processes; funding norms (repayment schedule including moratorium, rate of interest charged etc.); rating parameters and criterion for accepting prospective borrower; rating profile of their portfolio; number of times their risk management committee has met in the last financial year and initiatives taken for building risk culture in the organization; robustness of their system and possibility of manual intervention in reporting of data; provisioning norms (e.g. based on Expected Credit Loss or standardized provisioning matrix); corporate governance standards of large customers of these NBFCs etc.”

He decided to identify the financial as well as non-financial parameters for better understanding and evaluation of NBFC sector. He started brainstorming with his team. Finally, they were able to find some risk areas for better understanding of companies operating in NBFC sector. The team identified following areas

- **Operational risk management practices** – it covered various aspects e.g. Fraud, Money Laundering, IT, Cyber Threat, Corporate Governance Issues, Reputational Risk etc. To analyse operational risk management practices was most crucial as this area was completely ignored. At the time of brainstorming, team discussed many examples. One example was related with checking of their IT system. It was discussed that if the system was developed in-house then company could manipulate many things including asset qualification and NPA figures. Other example was related to hiring of unethical employees. Complete team was sacked by one NBFC and this team was recruited by some other NBFC. Based on this discussion, he asked his team members to look for symptoms e.g.

    - ✓ Loan repayment from unknown sources / through cash transaction
    - ✓ DSA/ Internal employees committing frauds
    - ✓ IT/ Cyber security risk
    - ✓ Inaccurate submission of numbers and figures
    - ✓ Organisational reporting structure
    - ✓ Absence of risk registry/ key risk indicator
    - ✓ RCSA conducted or not etc.

- **Credit risk management practices** – It covered aspects e.g. credit policy and its components; frequency of updating of policy; discretionary power given to various executives; power for deviation and concession; rating system; risk-based pricing; exposure norms; methods for calculation of expected loss and unexpected loss; segregation of sales, collection and credit function; system to capture early warning signals etc. Here also examples where violation of exposure norms caused failure of bank/ NBFCs etc. were discussed. Based on this discussion, he asked his team members to look for symptoms e.g.

- ✓ Rating of borrowers of NBFC
- ✓ Ticket size of loans
- ✓ Loan book growth in last three years
- ✓ Concentration in any particular industry/ geography etc.
- ✓ Availability of board approved policy for credit decision making
- ✓ Meetings of various subcommittee (risk management committee, audit committee) of the board in a year
- ✓ Covenant monitoring system present or not
- ✓ Cash flow trapping used as risk mitigation tools
- ✓ Physical inspection policy of the NBFC
- ✓ "Name lending" present or not etc.

Other than this managing liquidity risk was also very important for NBFC sector.

Now, he decided to implement these checkpoints immediately for any fresh sanction and review of existing accounts. When he used this method in Balcon Capital, he found that many such risks were there in this account.

- ✓ Highly concentrated and unseasoned lending book.
- ✓ Operating performance remains vulnerable to slippages on its sizeable single-borrower exposures
- ✓ Exponential growth in loan book especially in the last few years.
- ✓ Original shareholders were trying to exit the company since last one year.
- ✓ Key management people were from Mumbai only and they had completed their graduation from Mumbai University.
- ✓ There were only -2- Risk committee meeting in the whole year
- ✓ Funded real estate projects at higher interest rate with long moratorium. Some of these projects were rejected by banks from their own risk analysis perspective etc.

IV. HITTING THE BULL'S EYE

Mr. Atul was happy that he was able to identify the right parameters and quality of new accounts was improved significantly. But still he was worried about large scale fund diversion from NBFC sector to other group companies. He decided to find out warning signals and modus operandi. He studied about various NBFC accounts. Based on this analysis, he found out some interesting checkpoint

- ✓ Whenever there is complex structure, always look for consolidated financials and look for detailed audit report of other companies
- ✓ Check the position of operating profit versus debt
- ✓ Source of profitability – whether it is by upfronting processing fees and higher interest rate
- ✓ If there is intergroup transaction then find out reason for each transaction
- ✓ SPV should not lend to other companies.
- ✓ Personal net worth of Chief Executives and trend of that net worth
- ✓ Corporate governance should be very high in case executives are from particular back ground (politically connected, big tycoons on board for no reason etc.)
- ✓ Adverse news in the market especially whistle blower complaint
- ✓ "BOX System" – to hide related party transactions and to divert money etc.

These methods worked very well and now the officers were able to ring fence the cash flow. Covenants were suitably revised and close monitoring of identified accounts helped to safeguard bank's interest. In many accounts "Debt swap" was done. Finally, the hard work of Mr Atul was showing results and this time there was no surprise stressed account.

V. CONCLUSION

Mr. Atul was convinced with former RBI Governor's statement – "Promoters do not have a divine right to stay in charge regardless of how badly they mismanage an enterprise, nor do they have the right to use the banking system to recapitalize their failed ventures."

Once the stress was identified, he immediately acted to recover bank's money. It was his proactiveness that he was able to identify good assets in all existing NBFC accounts and got bank's money back. The team was jubilant but Mr. Atul was not the one to rest on his laurels. He congratulated his team and motivated them – "This is just the beginning. There is a huge transformation going on in NBFC sector. Tomorrow risk may emerge due to charging of excess rate of interest, which may be assessed by checking ROA or there may be risk of money laundering due to cash disbursement / repayments. The basic idea is to understand their business model and core competence, understand and evaluate the risk properly and use suitable covenants."

Suggested Questions for Discussion

- What is the growth potential of the NBFC sector in India, and how can XYZ Bank identify prospective borrowers within this sector?
- How might the "Box System" contribute to fund diversion in NBFC accounts, and what warning signals should XYZ Bank look for to detect such activities?
- How have recent regulatory actions impacted NBFCs, and what potential weaknesses or vulnerabilities can XYZ Bank identify in the NBFC business model?
- What are the primary risks associated with lending to NBFCs, such as operational and credit risk? What additional checkpoints should be developed to mitigate these risks effectively?

Annexure 1

M/s. Balcon Capital India Private Limited (Balcon)

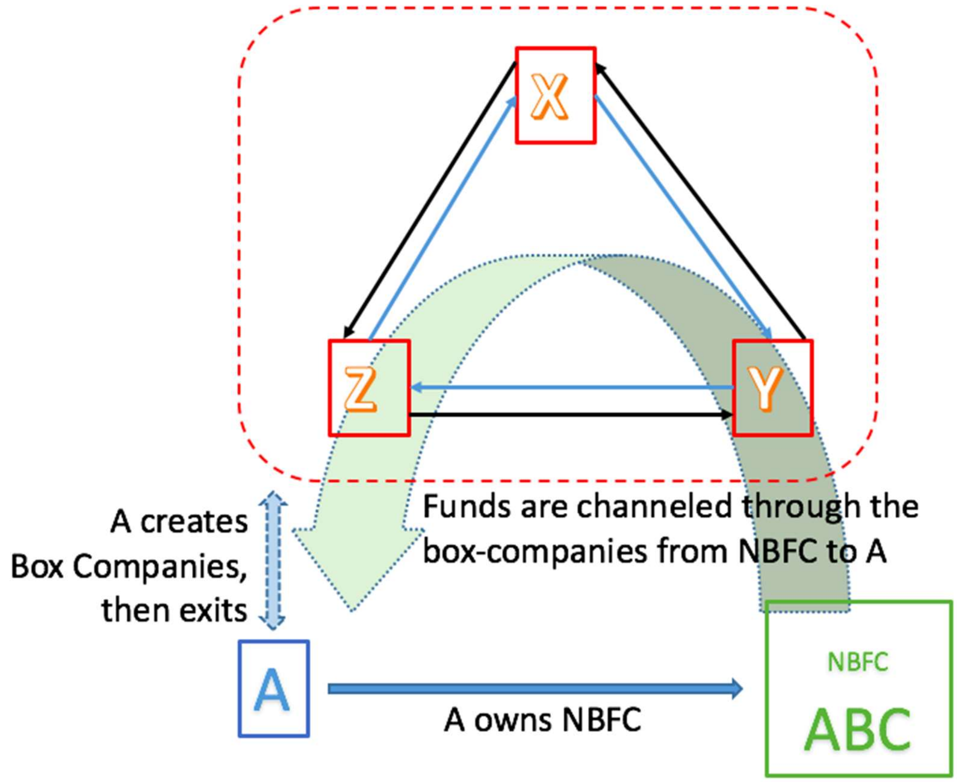
- Balcon Capital India Pvt. Ltd was a Non Deposit Systematically Important Non-Banking Finance Company (NBFC-ND-SI).
- Company was a 100% owned subsidiary of India Credit Pte Limited which was in turn had been sponsored/promoted by clutch of marquee shareholders namely Clearwater Capital Partners, Abu Dhabi Investment Council and Varde Partners.
- The sponsor shareholders had infused $300 mn (Approx. INR 2,000 crores) as equity capital plus reserves in the Company which made Balcon among the largest capitalised foreign owned NBFC in Real Estate sector.
- Strategically, Balcon's initial portfolio growth was entirely funded out of net worth with Nil Bank Borrowings and thereafter debt was raised to fund its expansion.
- Balcon is primarily focussed on lending to the real estate sector in India across Tier-1 cities which included -7- cities.
- Though the Company was largely in the onward lending business to the real estate sector, Company mitigated the risk by maintaining overall security cover (i.e. 1.5x), structured transactions such that to provide financial closure for the projects. Moreover, the company was having professionals on board having rich experience in the sector as well.
- The Company was having adequate capital buffer with Capital Adequacy Ratio of 59.46% and DE Ratio (TOL/TNW) of 0.83:1 time.
- Loans of the Company were underwritten by maintaining an overall security cover of at least 1.5x. In addition, Balcon took additional security by way of pari passu or second charge of additional projects, pledge of shares etc.
- The Company achieved revenue of Rs 513.44 Crore & NPAT of Rs 270.82 Crore in last financial year.
- The Company's AUM growth was more than 5 times in last one year. The asset quality of the company was satisfactory with gross and net NPA as Nil. However

there was a restructured asset of Rs 146.41 Crore in the Loan portfolio reported in Audit Report of the Company.

- Long term debt program of the company had been assigned a rating of AA.
- Company planned to disburse Rs 3699 Crore during the current financial year which was to be met by the raising funds through Term Loan / NCDs.
- The Company was availing Term Loan/ WCDL from 8 Banks.

Annexure 2

Box System



Source - https://www.linkedin.com/pulse/box-firms-system-channel-funds-prasun-banerjee/

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Teaching Note

I. Learning Objectives

1. Understand the role and significance of the NBFC sector within India's financial landscape.
2. Analyze how the "Box System" and other tactics may be used for fund diversion within NBFCs and recognize signs of manipulation.
3. Examine how regulatory changes by the RBI affect NBFC operations, identify emerging vulnerabilities, and evaluate structural risks in NBFC business models..
4. To Develop assessment framework for key risks associated with lending to NBFCs and establish comprehensive checkpoints that enhance risk assessment and safeguard asset quality.

II. Suggested Reading

1. https://www.northernarc.com/assets/uploads/pdf/Industry-Report.pdf
2. https://www.careratings.com/uploads/newsfiles/1723195327_NBFC-Navigating%20growth%20amidst%20regulatory%20changes.pdf
3. https://www.moneylife.in/article/dhfl-and-reliance-capital-used-the-box-system-to-avoid-disclosure-says-redd-report/57392.html
4. https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12735&Mode=0
5. https://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=58921
6. https://www.sa-dhan.net/quarterly-mf-report/
7. https://www.business-standard.com/economy/news/micro-lenders-sro-calls-for-capping-roa-at-4-124102201165_1.html

III. Teaching Plan

Start with an introductory discussion to engage students on key issues:

- **Questions to ask:**
  - What is the role of NBFCs in the financial sector?

- What are the potential growth opportunities for NBFCs and their value to banks?

- **Explanation:** Discuss the importance of NBFCs in expanding financial services to underserved regions and sectors. Explore the types of NBFCs and their unique roles in financial inclusion. Different type of NBFCs can also be explained as explained in reading 1.

  Reference that can be used – Suggested reading 1 and 2 can be used for reference and data. Reading 1 explains in detail about NBFC sector.

(Expected time: 30 minutes)

Now answer of question can be given - What is the growth potential of the NBFC sector in India, and how can XYZ Bank identify prospective borrowers within this sector?
Answer – Emphasize the sector's high growth potential, especially in consumer and MSME lending. Highlight that XYZ Bank should focus on NBFCs aligned with its risk profile, avoiding partnerships where loan rejections indicate incompatible risk standards. It should be highlighted that if some loan is rejected by XYZ bank then the target of NBFC should not be that segment (for example if all rejected real estate loans of our bank are sanctioned by NBFCs then that NBFC is not our target customer)

Open discussion – Box structure

Reading 3 can be discussed in detail and facilitator can share experience on possible method of fund diversion. Here following pointers given in case can be discussed in detail

- ✓ Whenever there is complex structure, always look for consolidated financials and look for detailed audit report of other companies
- ✓ Check the position of operating profit versus debt
- ✓ Source of profitability – whether it is by upfronting processing fees and higher interest rate
- ✓ If there is intergroup transaction then find out reason for each transaction
- ✓ SPV should not lend to other companies.
- ✓ Personal net worth of Chief Executives and trend of that net worth

- ✓ Corporate governance should be very high in case executives are from particular back ground (politically connected, big tycoons on board for no reason etc.)
- ✓ Adverse news in the market especially whistle blower complaint
- ✓ "BOX System" – to hide related party transactions and to divert money etc.

(Expected time: 15 minutes)

Now answer of question can be given - How might the "Box System" contribute to fund diversion in NBFC accounts, and what warning signals should XYZ Bank look for to detect such activities?

Answer – Discuss how promoters might use the "Box System" to divert funds. Highlight key warning signals like cross-shareholdings, unusual transactions, and inconsistent reporting.

Recent regulatory actions on NBFCs and assessing business model

- **Question to Ask:**
  What recent regulatory actions have been taken by the RBI on NBFCs, and how might these affect NBFCs' business models?"– Reading 4, 5 and other news item can be discussed.
- **Explanation:** Discuss regulatory updates, using Readings 4, 5, and 6 as references, covering issues such as compliance requirements, restrictions on high-risk lending, and market conduct standards. Highlight the implications for NBFCs in specific sectors, such as gold loan NBFCs and microfinance institutions (MFIs), and discuss the SRO recommendation to cap the ROA at 4% (Reading 7).
  Here it should be highlighted to asses potential risk because of business model adopted by NBFCs. It can be violation of regulatory guidelines or unfair practices also.

  Now answer of question can be given - How have recent regulatory actions impacted NBFCs, and what potential weaknesses or vulnerabilities can XYZ Bank identify in the NBFC business model?

  Answer – Explain that regulatory actions often require NBFCs to stop business until irregularities are corrected. Business should be analysed from different perspectives.

Even high return is also a risk as these may come from chasing high-risk assets or regulatory non-compliance.

(Expected time: 30 minutes)

Establishing comprehensive checkpoints that enhance risk assessment and safeguard asset quality

Group activity – Case Analysis and Decision-Making

- **Activity Setup:** Assign case on different NBFCs (e.g., Bajaj Housing, Hero Financial, L&T Finance) and divide students into groups. Each group analyzes an NBFC to decide whether XYZ Bank should lend to it, focusing on operational, credit, and compliance risks.
- **Task:** Groups present their analysis. The class then discusses their findings and facilitator will add value. Example – Facilitator can highlight the issue of CIBIL rating (bank will sanction loan to those borrowers who have CIBIL score of 700 and above but NBFC may be accepting 500 score. So, this should also be checked etc.)

Now all the checkpoints developed in the case can be discussed and explained for answering last question.

(Expected time: 75 minutes)
