DEMYSTIFYING SHADOW BANKS AS A SUBSTITUTE TO THE BANKING SECTOR: A CRITICAL STUDY

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ABSTRACT: *Although there have been prodigious studies about various aspects of the banking industry, minimal efforts have been taken to intrinsically study the NBFC sector and document the structural issues they face. This paper examines the historical development of the NBFCs in India, their role in credit supply, potential triggers for the 2018 financial crisis, and the successive formulation of the 2022 Regulation. It attempts to comprehend the benefits and drawbacks of NBFCs' business models, as well as the factors that led to their recent rapid growth and difficulties. The latter part of the paper seeks to evaluate the emergence of Fintech companies as prominent players within the Indian financial system alongside NBFCs and its subsequent impact on the credit landscape. Given the growing importance of NBFCs as a significant contributor to expanding India's monetary base, there is a substantial academic and research interest in their origins, development, and performance.*

Keywords: - *NBFCs, Financial inclusion, Systemic effect, Asset mismatch, Credit regulations.*

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I. INTRODUCTION

The advancement of the Indian economy is sustained by increasing the flow of credit, which could be primarily attributable to investments in the private sector. Owing to the 1991 Liberalization, Privatization, and Globalization (‘**LPG**’) reforms, there has been an influx in credit availability to the Indian economy.[1] For a long period of time, banks accounted for a predominant share of credit within the economy in comparison to other Non-Banking financial companies ('**NBFCs**'). Post the Fiscal year 2014, this trend underwent a significant shift due to the burgeoning NPA within the balance sheet of the banks, after which banks restricted the accessibility of credit to the public.[2] The consequent deficiency of credit was primarily compensated by NBFCs, who then emerged as key players within the financial sector.[3] Over time, Non-Banking financial institutions have broadened their scope, technological complexities, asset expansion as well as diversification in the range of products and services offered.[4] NBFCs are incorporated under the Companies Act of 1956. They are companies that carry out financial operations without holding a banking license. The history of NBFCs in India can be traced back to Muthoot Fincorp Ltd in the late 1880s when they started as a small lending company in Kerala.[5] These non-banking companies started as a humble supplement to Banks in the early 1960s. There has been a commendable growth of NBFCs in the last decade, therefore necessitating the regulation of these companies. To objectively examine how these companies operate, it is essential to comprehend the differences and similarities between NBFCs and banking institutions, with an emphasis on the regulatory framework and operational practices they are subject to.

The acceptance of deposits is where these two organizations primarily diverge. Demand deposits cannot be accepted by an NBFC, and expressly they cannot hold a savings account. Only NBFCs with specific Reserve Bank of India ('**RBI**') authorization and grade categorization are allowed to accept time deposits. On the other hand, banks can accept both

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[1] Subhomoy Bhattacharjee, *How WB, IMF got India to adopt reforms in 1991,* THE INDIAN EXPRESS (Nov. 12, 2022), https://indianexpress.com/article/news-archive/web/how-wb-imf-got-india-to-adopt-reforms-in-1991/.
[2] Sunainaa Chadha, *Gross NPAs of the public sector banks doubles in the last seven years*, THE TIMES OF INDIA (Dec. 16, 2021) https://timesofindia.indiatimes.com/business/india-business/gross-npas-of-public-sector-banks-double-in-last-seven-years-sbi-tops-list/articleshow/88316357.cms.
[3] Gautam Rohidekar, *NBFC Regulation: Mistakes of the Past and Challenges of the Future,* 10 STUDENT ADV 26, 27 (1998).
[4] THE WORLD BANK, https://www.worldbank.org/en/publication/gfdr/gfdr-2016/background/nonbank-financial-institution (Nov 16, 2022).
[5] Rajiv Singh, *The other Muthoot: True blue heirs*, FORBES INDIA (Nov. 14, 2022), https://www.forbesindia.com/article/boardroom/the-other-muthoot-true-blue-heirs/51265/1.

time and demand deposits, which in turn gives them an upper hand in terms of accepting deposits. In addition to this, NBFCs are not permitted to provide all the transaction services which are provided by banks, such as issuing Demand Draft, cheques, and facilitating Fund transfers. It can be thus construed that they do not form a part of payment and settlement systems. Furthermore, they are not entitled to maintain a current account as opposed to banking companies.[6] Lastly and most importantly, Deposit Insurance and Credit Guarantee Corporation ('**DICGC**') provides insurance facilities to depositors in the case of banks, whereas this privilege is not extended to depositors of the NBFCs.

Another area of focus extends to the scope and application of the Insolvency and Bankruptcy code 2016 on these institutions. Matters such as bankruptcy, liquidation, and winding up of NBFC are governed by the provisions of this code, whereas banks are excluded from the ambit of the same. This is mainly because banks are considered to be the backbone of the economy, hence matters such as winding-up have grave implications for the financial stability of the country. Thus, independent legislations exist to separately govern banking and nonbanking entities. Amalgamation, Winding up, and liquidation of Banks, in instances of violation of the rules and regulations laid by RBI, and failure in meeting prescribed obligations such as repayment of public debts, are governed by sections 36 / 36AA /36AE /36AF /36AG /37 /38 of Banking Regulation Act 1941.[7] Section 270 of the Companies Act 2013 deals with the winding up of a company, either voluntarily or by an order of the National Company Law Tribunal.[8] Since NBFC is recognized as a company, the aforementioned provision will be applicable. Interestingly, IBC invests rights to both debtors and creditors to file petitions to scrutinize insolvency resolutions. If the same is made applicable in cases of banking institutions, the public depositors, who are the creditors, will be empowered with the same rights which in turn would be detrimental to the aims and objectives of the RBI, as the chances for banks to get wound up as an alternative to reconstruction or rectification increases.

Since NBFCs are not allowed to undertake all of the bank's services, they are categorized into distinct categories to make it easier for them to operate. The different types of NBFCs are Asset Finance companies, Loan companies, Mortgage Guarantee companies, Investment companies, Core Investment companies, Infrastructure finance companies, Microfinance companies, and

[6] R. Kannan ET. AL, Non-Banking Financial Companies role in India's development, 84 (2019).
[7] Banking Regulation Act 1949, §36, 36AA, 36AE, 36AF, 36AG, 37, 38, No. 10, Acts of Parliament, 1949(India).
[8] The Companies Act, 2013, §270, No. 18, Act of Parliament, 2013(India).

housing finance companies.[9] The rise in these financial institutions' importance in the economy motivated the RBI to frame more rules and regulations in order to contain the systemic risks that could be possibly caused by them. RBI recognizes that NBFCs cater to specific sectors and geographies and that their distinctiveness must be safeguarded to guarantee that their activities in the line of credit remain flexible.[10]

There have been profound ramifications of the Russian War on the NBFC Sector. Russia is India's 25th largest trading partner with the export of mobile phones, pharmaceuticals, import of crude oil, diamonds, and coal. Russia is the second largest oil producer, which mainly sells crude oil to European refineries, and the largest supplier of natural gas to Europe which accounts for almost 35%. At the Onset of the Russia-Ukraine War, the demand for crude oil in Russia increased, and which furthered price of crude oil. Although Russia is not the sole source from which India purchases crude oil, the others countries on which India is dependent for the same are supplied by Russia itself. Products that are directly tied to crude oil account for 9% of the wholesale price index. An increase in the price of crude oil will spurs inflation in the economy because manufacturers and other intermediaries use petroleum products. International trade will also be impacted by the war as aviation fuel prices will also spike.[11] Since the import and export of goods will determine the value of the Indian currency, increased import expenditure will decrease the value of the Indian currency. Therefore, RBI should take necessary steps to accommodate this situation by providing substitutes for petroleum products like ethanol and dependence on electrical vehicles.[12]

II. THE 2018 IL&FS CRISIS AND ITS SYSTEMIC IMPACT ON NBFCS.

In India, a crisis was developing when Infrastructure leasing and financial services limited ('**IL&FS**') failed to make payments to its creditors in 2018, which coincided with the celebration of the tenth anniversary of the fall of Lehman Brothers, a vital element in the 2008 recession.[13] IL&FS Ltd is a holding company of the IL&FS group which has more than twenty-four direct subsidiaries and more than 135 indirect subsidiaries. Infrastructure, finance, and environmental services comprise the firm's core business sectors. The business owed more than

[9] RESERVE BANK OF INDIA, https://www.rbi.org.in/Scripts/FAQView.aspx?Id=92 (Nov. 11, 2022).
[10] *Nedumpilli Finance Co. Ltd. v. State of Kerala and Anr.*, (2022) 7 SCC 394.
[11] RESERVE BANK OF INDIA, https://m.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=1208, (Jun 30, 2022).
[12] RESERVE BANK OF INDIA, https://www.rbi.org.in/Scripts/BS_ViewBulletin.aspx?Id=21204, (Aug 18, 2022).
[13] Hans Tjio, *Securities and Financial Services Regulation*, 16 SALANNREV 615, 615-619 (2015).

91,000 crores in debt, and its debt-to-equity ratio exceeded 18, which was inimical.[14] Due to underperformance, the firm was unable to pay off its long-term and short-term loans in accordance with the terms previously agreed upon. As a result, other IL&FS group companies also fell behind on payments, which caused a significant decline in the share price on the stock market. With the approval of the National Company Law Tribunal (**'NCLT'**), the central government made the decision to replace the Board of Directors under Sections 241 and 242 of the Companies Act 2013.[15][16] It removed 12 of the existing board members and appointed Uday Kotak, Vineet Nayyar, GN Bajpai, GC Chaturvedi, Malini Shankar, and Nanda Kishor as six newly elected members. Uday Kotak, the managing director of Kotak Bank, presided over the board.[17] This kind of rescue effort is being conducted by the central government for the first time after Satyam computer's scam.

Investors will be eager to participate in these debt products because the credit rating agency gave the firm a AAA credit rating for the debt instruments issued, making them the highest-rated instruments on the market.[18] IL&FS received loans from banks and NBFCs in the form of money market instruments, with bank loans being long-term and NBFC loans being short-term, respectively. Commercial paper, intercorporate deposits, repo rates, and reverse repo rates are some examples of money market instruments. They are given out for periods of time shorter than a year. The loans were provided on a short-term basis, and the NBFCs wanted payback. However, IL&FS invested the funds in term infrastructure projects, which led to an assets-liability mismatch and payment default.[19]

One of the financial institutions that did not get its repayments was SIDBI, which prompted the institution to approach the central bank of India. Due to the default in payment, there was a sudden downgrade in the credit rating of the company. The reduction of credit rating resulted in the sale of these debt Instruments at heavily discounted rates, and the stock market took a hit of more than 1000 points. The default of payments by a mammoth company like IL&FS made a dent in the confidence of the investors and not only caused the investors to withdraw their money from the Debt market but also from the equity market and caused turmoil in both markets. The genesis of this issue started way back when the credit-rated agency gave AAA

[14] Tanya Rathod ET. AL., *Analysis of Indian Laws in the Wake of IL&FS Crisis*, 3.2 JCLG 218, 222 (2020).
[15] *Supra* Note 8, §241.
[16] *Id* §242.
[17] *Supra* note 14, 231.
[18] *Id*, 224.
[19] Jayshree P. Upadhyay, *Inside the audit lapses that led to IL&FS crisis*, (May 21, 2019), https://www.livemint.com/companies/news/inside-the-audit-lapses-that-led-to-il-fs-crisis-1558456079750.html.

ratings for these debt instruments issued by the company as well as its subsidiaries. If the company whose debt instruments were given the highest rating in the market fails to repay its debt, investors will not rely on the ratings given by the credit rating agency and will withdraw their shares from the market because there is no guarantee that a company which has BBB credit rating will honour its debt obligations and thereby affected the corporate Debt market, the aftermath of the situation caused other market players to pay high-interest rates on commercial paper as well as in the debenture market.[20] In addition, NBFCs lacked adequate funding since investors lost faith in them as a result of IL&FS's status as an NBFC. The RBI increased banks' lending credit to these entities from 10% to 15% in an effort to increase credit availability and help to stabilize the market.

The Ministry of Corporate Affairs included NBFCs under the scope of the IBC, 2016, and granted them a moratorium period during which no action could have been taken against them.[21]

Looking back upon the 2018 financial crisis, there were a number of beneficial effects on the economy. NBFCs and the credit rating agency came into the limelight, and as a result, there is more transparency. The RBI, being one of the finest banking regulators in the world, helped in containing the situation, and IL&FS, with its new Board of Directors, was able to recover more than 90% of its debts and is expected to cover all before 2023.[22] Because NBFCs and banks are intertwined, as well as, considering that these financial institutions receive the majority of bank loans, any impact on NBFCs will have an impact on the economy as a whole. For example, in 2018, the IL&FS crisis caused shadow bank transactions to decline, which in turn led to a decline in the infrastructure and transportation industries.[23] Majority of the consumers in this sector rely on credit from these financial institutions since they are granted more easily.

III. NBFC 2022 AMENDED FRAMEWORK.

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[20] Shilpy Sinha, *IL&FS fiasco: Why rating agencies need a reform*, (Oct 26, 2018), https://economictimes.indiatimes.com/industry/banking/finance/ilfs-fiasco-why-rating-agencies-need-a-reform/articleshow/66340528.cms?from=mdr.

[21] Anisha Shroff ET. AL., *NBFCs brought under purview of insolvency code,* (Jan. 20, 2022), https://law.asia/NBFCs-purview-insolvency-code/.

[22] Press Trust of India,*Govt reshuffles IL&FS board; Rajan becomes non-executive chairman, Business Standard* (Sept. 27, 2022).

[23] Beena Parmar, *Debt and defaults: What happened to IL&FS?* (Sept. 14, 2018) https://www.moneycontrol.com/news/business/companies/debt-and-defaults-what-happened-to-ilfs-2952381.html.

On 22nd January 2021, the RBI published a discussion paper for public comments with the title "Revised Regulatory Framework for NBFCs - A Scale-based Approach. "Upon the inputs received from the discussion paper, the central bank decided to bring a new scale-based regulatory system. Section I of this regulation classifies NBFCs into four categories on the basis of their size, risks involved and activities performed, namely Base layer (**'NBFC-BL**'), middle layer (**'NBFC-ML'**), the upper layer (**'NBFC-UL'**), and the top layer (**'NBFC-TL'**).[24] The 2018 NCLT crisis is one of the reasons for the enactment of the 2022 regulation. The primary classification of NBFCs will be the aforementioned NBFC-BL and NBFC-ML. The NBFC-UL and NBFC-TL are rather subjective categories, and the RBI has the sole discretion to assign NBFCs in these categories. Being placed in the top layer category requires receiving RBI clearance based on a predetermined set of rules, and there is no minimum number needed for it. These categories frequently include one or more of the top 10 NBFCs. Because they are run by the government, NBFCs that are owned by the government will not be classified. These categories frequently include one or more of the top 10 NBFCs. Because they are run by the government, NBFCs that are owned by the government will not be classified. [25] The top layer is nearly identical to the upper layer and should be left vacant, but if the RBI determines that the NBFC's systemic risk is rising, the top layer will be converted from the upper layer. The Net owned fund (**'NOF'**) was also altered by the modification.

The amendment also made changes regarding the NOF. All types of these Financial Institutions must expand their NOF, which were established at 2 crores, to 10 crores by 2027, which would lead to an expansion of the sale and purchase market of NBFCs.[26] These categories frequently include one or more of the top 10 NBFCs. Because they are run by the government, NBFCs that are owned by the government will not be classified. Further Non-performing assets (**'NPA'**) norms were amended. For an asset to be considered NPA, the default made should be for more than 180 days. This has to be eventually reduced to 150 days, 120 days, and 90 days by 2024, 2025, and 2026 respectively. The amount of NPAs in the economy will rise as a result of this. This can be beneficial or detrimental to the economy. Detrimental because the increase in NPAs will lower the credit scores leading to a reduction in the economy's ability to obtain credit, and beneficial because NPAs can be recovered much more quickly with the help of the

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[24] *Revised Regulatory Framework for NBFCs - A Scale-based Approach*, RESERVE BANK OF INDIA - Publications (Nov. 18, 2022), https://www.rbi.org.in/Scripts/PublicationsView.aspx?id=20316.
[25] Siddhi Anand, *Revised Regulatory Framework for NBFCs- A Scale-Based Approach*, TAXGURU, 7-8 (2021), https://taxguru.in/rbi/revised-regulatory-framework-NBFCs-scale-based-approach.html.
[26] *Supra* Note 9.

Debt Recovery Tribunal (**'DRT'**).[27] Another provision that this amendment brought about was regarding the board of directors. NBFCs should have at least one member with experience in the banking or Non-banking Financial sector.[28] The newly amended regulation made it compulsory for even non-systemically important NBFCs to have a Risk Management Committee. For a company to be included as systemically important it should have an asset size of more than 500 crores.[29] This would help the RBI to regulate NBFCs in a much more efficient manner. NBFCs uses prudence while dealing with their directors, senior officers, or any other associated parties in transactions or loans. This is performed to alleviate any corruption or bias. An increase in the document disclosure in Related Party Transactions makes this easier.[30] Section 2(76) of the Companies Act defines Related Parties.[31] The third change is in relation to Key Managerial Persons (**'KMPs'**). The Companies Act defines a KMP in Section 2(51).[32] Prior to the aforementioned amendment, a KMP of one company could hold an office in any other company (including an NBFC) as a Key Managerial Person. This is now forbidden. Existing KMPs have been given a transition period of two years. Additionally, a new position has been created by the framework, called the Chief Compliance Officer, who will act as an independent internal auditor.[33]

Furthermore, other changes brought by the aforementioned regulation are on the basis of:

- **Household Income Cap**: Prior to the amendment, the cap was 1,20,000/- and 2,00,000/- in the case of rural and urban areas, respectively, but now it has been increased to 3,00,000/-,[34]
- **Indebtedness:** The initial cap was 1, 25,000/- excluding the loans taken for educational and medical expenses, but now the loan can be granted up to 50% of the annual income of a household. To substantiate further, if a household has an annual income of 5,00,000/-, then 2,50,000 is the Indebtedness cap. If an NBFC had already lent 2,40,000, then the balance of money which could be availed by any other financial institution is 10,000/-. This amount is called the residual Indebtedness lim.[35]

[27] *Supra* Note 24.
[28] *Id.*
[29] *Id.*
[30] *Id.*
[31] *Supra* Note 8, §2(76).
[32] *Id*, §2(51).
[33] RESERVE BANK OF INDIA, https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=12290&Mode=0 (Nov 18, 2022).
[34] *Supra* Note 24.
[35] *Supra* Note 24.

- **Loan pricing:** Earlier, there was capping on loan pricing, but it has been removed, and the price will be fixed on the basis of competitiveness, which is one of the major advantages brought to the NBFCs by the amendment.[36]
- **Penalty charges:** NBFCs were not allowed to charge penalty even when customers made default or what so ever the situation may be. As per the amendment, delay payment penalty can be now imposed.[37]
- **Qualifying Asset:** Up until the new regulation NBFCs were required to keep 85% of its net assets as qualifying assets however these thresholds were not applicable to any other entities like the banks. This threshold has been reduced to 75%.[38]
- **Registration:** Non-profit NBFCs having an asset size of more than 100 crores are required to be registered and need to adhere to the guidelines and norms.[39]

All these measures were brought in order to bring regulation in the functioning of NBFCs and to bring clarity amongst all the players on the field. The impact of this regulation will definitely increase the profit margins of NBFCs due to various factors like the removal of the cap on loan pricing and the permission to charge penalty charges. The old regulation caused problems relating to operational feasibility, those borrowers who were considered to be earning too much (above the house hold income cap) in the perspective of NBFCs, were considered earning too little to be covered by banks, and hence they were unserved. With the amended regulation took care of this discrepancy which will bring financial inclusion in the economy.

IV. BENEFITS OF NBFC AND FINTECH PARTNERSHIP

Fintech companies, as the name suggests, are a combination of two words - Finance and technology. It aims at redefining the financial sector through the incorporation of technological innovation, multiformity in the products and services offered to the common public, and upgrading existing business models. It can be construed as the utilization of Information technology by the finance sector.

The principal difference between NBFCs and Fintech companies is in terms of the functions it undertakes. NBFCs aims at providing credit, and financial assistance to customers whereas

[36] *Id.*
[37] *Id.*
[38] *Id.*
[39] *Id*

Fintech companies, which comprise a particular segment of NBFCs, focus explicitly on expanding efficacy and accessibility in customer service.[40]

NBFC is fundamental for credit outreach and partnership with the Fintech Companies can spur a revolution within the credit market system. Credit should be made accessible to the underserved in order to boost the economy, even though the majority of individuals cannot enter the mainstream due to a lack of capital. There is a lot of possibility for credit development and increased financial inclusion if the last mile is covered through the partnership model.[41] The pandemic has facilitated an increased partnership between the two entities. With NBFC'S model of decision-making (guidelines for asset-liability mismatch promulgated by the RBI for all financial institutions irrespective of whether they accept public deposits or not)[42] and Fintech companies' model of payment, the costs for customer acquisition and on boarding can be significantly reduced as credit can be dispersed within a span of a few minutes (low manual operational costs).

The benefit of this partnership is to cater to customers in different geographies, especially ones in rural areas. The partnership follows a first loan default guarantee scheme, where a Fintech company and a regulated entity (**'RE'**), such as banks or NBFCs, enter into an agreement, whereby the Fintech Company pays, the regulated entity to some extent, in cases of default by the borrower.[43] The Co-lending model between NBFCs and Fintech partners is viable in this age of collaboration over competition. It stipulates sourcing the loan at a specified proportion (the ideal ratio is 80:20). Co-lending necessitates an NBFC license for the Fintech companies. If a Fintech company does not have an NBFC license, then the Co-lending ratio would equate to 100:0. This denotes that a loan entirely or partly can originate from a Fintech partner, but 100 percent of the loan is written off in the balance sheets of the NBFC.[44]

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[40] 'Fintech and NBFCs partnership can bring credit revolution in the country': PayPoint India MD Ketan Doshi at ASSOCHAM 8th National E-Summit, (Dec 31, 2022) https://www.business-standard.com/content/press-releases-ani/fintech-and-NBFCs-partnership-can-bring-credit-revolution-in-the-country-paypoint-india-md-ketan-doshi-at-assocham-8th-national-e-summit-121123100356_1.html.

[41] Prabhakar, Tarunima and Weber, Steven, *Alternative Lending in a Digital Age: A Comparative Case Study in Regulation Across India and the United States,* (May 19, 2020). Available at SSRN: https://ssrn.com/abstract=3956623 or http://dx.doi.org/10.2139/ssrn.3956623.

[42] RESERVE BANK OF INDIA, https://rbi.org.in/scripts/PublicationsView.aspx?id=20941 (Dec 28, 2021).

[43] Subrata Panda, *Digital lending norms: Fintech firms seek clarity on RBI's FLDG stance*, Business Standard (Saturday, Nov 19, 2022), https://www.business-standard.com/article/finance/digital-lending-norms-fintech-firms-seek-clarity-on-rbi-s-fldg-stance-122090601207_1.html.

[44] Ishpreet Gandhi, Armaan Joshi,What Is Co-Lending And How Does It Work?, Forbes ADVISOR, https://www.forbes.com/advisor/in/business-loans/what-is-co-lending/ (Apr 17, 2022); Nidhi S Chugh, *With co-lending partnerships on rise, credit flow to enhance: Experts*, ETBFSI.com (April 05, 2022), https://bfsi.economictimes.indiatimes.com/news/NBFC/with-co-lending-partnerships-on-rise-credit-flow-to-enhance-experts/90638462.

The unique ability of Fintech partners is related to their distribution, deeper understanding of customers, and embedment into various other forms of ecosystems (payments ecosystem, e-commerce). NBFCs are limited to the extent of their own distribution, whereas Fintech companies help enhance distribution reach to serve multiple customer segments.[45] Notably, there has been an expansion of business in the Indian banking sector in the last few years,[46] but when analysed deeper, it can be found that the majority of the expansion is concentrated on the top 10% of the customers (constituting the top pyramid). This includes clients who own multiple credit cards and those who get multiple calls for bank loans. Others are not included in that top period because they do not have access to any form of formal credit from banks or other financial institutions. This can be linked to several factors, including a lack of data typically used for underwriting, accessibility issues, and banks' comfortability with providing high-ticket loans. This demonstrates that the possibility of credit innovation is sluggish. The necessity for the sector to be formalized is crucial because India accounts for the largest informal lending market. New age data can be used to collect digital footprints,[47] underwrite them, and understand the profile of the customers approaching the institutions.

To start a lending business, there are four broad pillars, first is Customer acquisition or sourcing, followed by underwriting, collection, and lastly, creation of capital.[48] There are different challenges with each of these parameters. Customer acquisition is presumed to be a herculean task because it is challenging to reach particular population segments, particularly those in rural areas, and inform them about the availability of small amounts of credit that can be accessed solely through mobile phones for medical and other emergencies. Since the market has become digitally literate, making on boarding customers is made simple. (That enables Fintech companies to become 100% digital). Underwriting and collections are sectors that need to be built eventually, during the course of time. It requires the need to build algorithms, create new data points, and test them across various cycles. Due to covid and other events that have

[45] Rajeev Tomar, *Finance Industry Transitioning To A New Era Of FinTech – NBFC Collaborations,BUSINESSWORLD,* (November 19, 2022), https://www.businessworld.in/article/Finance-Industry-Transitioning-To-A-New-Era-Of-FinTech-NBFC-Collaborations/26-10-2021-409870/.

[46] RESERVE BANK OF INDIA, https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=1209 (June 30,2022).

[47] THE ECONOMIC TIMES, https://economictimes.indiatimes.com//markets/stocks/news/learn-with-etmarkets-why-a-digital-footprint-is-crucial/articleshow/53924552.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst (Aug 30, 2016).

[48] BUSINESS STANDARD, https://www.business-standard.com/content/press-releases-ani/fintech-and-NBFCs-partnership-can-bring-credit-revolution-in-the-country-paypoint-india-md-ketan-doshi-at-assocham-8th-national-e-summit-121123100356_1.html (Dec 31, 2021).

occurred in the past few months, trust in the co-lending model has been generated as various transactions have been made possible in reality and not just at the superficial level. Capital Acquisition also requires reliance on various sources such as banks, and debt instruments and there are various procedural formalities that need to be followed.[49]

Reserve Bank of India V. Peerless General Finance and Investment Co. Ltd.[50] is a landmark judgment that dealt with the regulation of NBFCs in the country. In this case, the Supreme Court reiterated the power that RBI holds in monitoring this country's financial system. Under Section 45K and 45L of the RBI Act,[51] the RBI can collect information regarding deposits, including interest rates, and give directions on the same from NBFCs and financial institutions. The Supreme Court, while upholding this power, held that NBFCs are recognised regulated entities.

A. WORKING OF AN NBFC-FINTECH-BASED PARTNERSHIP

Fintech have the capacity to focus on specific niche segments, which could be demography, profession, or geography related. Traditionally when it comes to unsecured personal loans banks and NBFCs have relied on civil data, and bank statements, as the primary way of underwriting. This becomes a bottleneck for the economy, as India is home to one of the largest unorganized, semi-formal sectors in the economy, and reliance on these variables will lead to the exclusion of a large segment of potential customers since they might not have access to these data.

Banks will take a longer time, owing to the regulatory framework, to experiment with the tons of data captured in SMS and other forms of transactions. NBFCs are more forthcoming in this regard, whereas Fintech can go two steps forward in acquiring the data owing to their technological prowess, to address the market gaps in the economy.[52] Each entity can focus on each of their specialty and create an environment of coexistence within the financial sphere. The relationship between a Bank, an NBFC, and a Fintech company is symbiotic in nature. MSMEs, businesses run by women entrepreneurs, or in smaller locations, with minimal capital,

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[49] Neel Juriasingani, *The opportunities & challenges for NBFCs catering to New to Credit Customers*, BFSI (Apr 14, 2020), https://bfsi.economictimes.indiatimes.com/blogs/the-opportunities-challenges-for-NBFCs-catering-to-new-to-credit-customers/4163.
[50] Reserve Bank of India V. Peerless General Finance (1992) SCC (2) 343
[51] The Reserve Bank of India Act, 1963, §45J, §45K No. 55, Act of Parliament, 1963(India).
[52] Antonio Garcia Pascual, Fabio Natalucci, *Fast-Moving FinTech Poses Challenge for Regulators,* IMF Blog (April 13, 2022), https://www.imf.org/en/Blogs/Articles/2022/04/13/blog041322-sm2022-gfsr-ch3.

remain the focus segments of the partnership since these units contribute to the country's GDP and create employment opportunities.[53]

If the partnership does not exist, there would be a sequential flow of capital. Banks will lend to an NBFC at a specific interest rate, and NBFC will further lend to a Fintech company with an increased margin. After the partnership, the credit flow structure takes a shift. Customers can directly acquire loans from banks or NBFCs.[54] The movement of capital will be reduced to two stages, so the margin loaded at every stage is reduced. Hence the cost of capital will decline and this benefit will be passed out to the customer. Fintech, apart from being a sourcing channel concentrates on new age kinds of business models (FLDG, AI-MI, Peer to Peer Lending, Payment Gateways, and Digital Models),[55] which is anchored on the concept of digitization. Due to this, they will be able to source loans at a lower cost in comparison to NBFC, since the cost of capital would lessen, a phenomenon which will encourage people to approach a Fintech based company. Organizations like Facebook are also partnering with NBFCs to channelize their data.

The Reserve Bank of India Act of 1934 regulates all NBFCs. As per the regulations, any organization facilitating Fintech services in India will have to be registered with RBI. Certificate of Registration from RBI is pre-requisite for NBFC for initiating Fintech business in India.

B. BREACH OF PRIVACY

This partnership is not entirely fool proof. Fintech heavily relies on technology and they amass sensitive and personal data of the customers. With access to such information, they become custodians or owners of such data, which is being given access by them. Whether the information is private or public in nature, these organizations are now responsible for preserving it, and this cannot be compromised.[56] Different systems and procedures must be implemented by the Fintech companies in order to guarantee confidentiality. Any violation of

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[53] Mr Marko Carevic; Col. Sarpreet Benipal; Mr Mahesh Thakkar; Mr Sanjeev Goel, (Jan. 9, 2020), *Session 1 — Can NBFCs fulfill India's Financial Inclusion goals? SCC Online.*

[54] RESERVE BANK OF INDIA, https://www.rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?Id=11920 (June 24, 2020).

[55] Ayushi Doegar, *10 Innovative Fintech Business Models,* MOBCODER, (October 7, 2021), https://mobcoder.com/blog/fintech-business-models/.

[56] Wanbil W. Lee, DBA, FBCS, FHKCS, FHKIE, FIMA, Wolfgang Zankl, Ph.D. and Henry Chang, CISM, CIPT, CISSP, DBA, FBCS, *An Ethical Approach to Data Privacy Protection*, Volume 6, ISACA Journal (2016), https://www.isaca.org/resources/isaca-journal/issues/2016/volume-6/an-ethical-approach-to-data-privacy-protection.

privacy by the company would be in contravention of the terms and conditions of the contractual relationship, which governs the distribution and use of sensitive data between two parties. In the event that sensitive personal information is handled carelessly and someone suffers an unforeseen loss, Section 43A of the Information Technology Act, 2000 provides for payment of compensation by a body corporate.[57] According to section 72A of the Act, the intentional, knowing publication of information without the person's consent and in violation of the essentials of a valid contract, is now additionally punishable by up to three years in prison and a fine.[58] Fintech companies need to ensure data protection in order to encourage customer participation. This can be achieved by setting up an Incident Reporting Framework where instances of cyber threats and attacks can be reported, creating audit and quality management mechanisms where vulnerabilities within the system can be assessed or catered to, and most importantly adherence to the safe transaction principles which is mainly availability, confidentiality, and integrity. The only thing that regulators can do is adopt a practical strategy by creating credible cyber-attack scenarios and evaluating the defences put in place by digital firms. The fact that ongoing financial innovation is continually creating new avenues for assault makes this effort even more challenging.[59] The only way the regulators can hope to successfully carry out their duties is by gaining in-depth knowledge in this area. As per the RBI guidelines, every regulated entity should have a nodal officer to deal with grievances and redressal in relation to the operation of Fintech companies. The borrower has the option to file a complaint through the Complaint Management System portal under the Reserve Bank-Integrated Ombudsman Scheme, in cases where complaints made by the borrower against the lender or the Lending Service Provider ('**LSP**') employed by the lender are not resolved by them within the allotted time frame which is currently 30 days.[60]

V. CONCLUSION

In developing nations like India, where access to financing by banks remains difficult for a sizable portion of the population, NBFCs play a significant role. Other developing nations can learn a lot from the development of NBFCs in India and the crisis of 2018. Ultimately, capital (both equity and debt) must practice the required restraint, and capital providers must be more selective when supporting NBFCs. NBFCs can access finances more easily and with greater

[57] The Information Technology Act, 2000, No. 21 OF 2000, § 43A.
[58] *Id,* § 72A.
[59] Reserve Bank of India, https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=12382&Mode=0, (September 02, 2022).
[60] Team Finserv, *RBI Regulations on Digital Lending, VINOD KOTHARI CONSULTANTS, (August 10, 2022)*

flexibility. They have been making significant contributions to key industries including infrastructure and the automobile industry, which are regarded as the engine of the nation's economic expansion and progress. It is recommended that the regulatory bodies analyse, recognize, and oversee the impact of NBFCs' risk-taking activities on their financial performance. They should also scrutinize or verify rigorously, and enforce new rules and regulations for their better and efficient performance, which can result in the development of the sectors of the economy in a good and profitable way.