CAFRAL Raises Concerns Over NBFC and Digital Lending Practices

For Prelims: **Reserve Bank of India**, **Non-Banking Finance Companies**, Centre for Advanced Financial Research and Learning, **Monetary policy**, **Companies Act, 1956**, **Deposit Insurance and Credit Guarantee Corporation**

For Mains: Burning Issues Related to Banking Sector, Difference in NBFC and Banks.

Source: IE

Why in News?

The **Centre for Advanced Financial Research and Learning (CAFRAL),** a research body set up by the **Reserve Bank of India (RBI),** has highlighted a growing risk in **bank financing for Non-Banking Finance Companies (NBFCs)** and identifies potential dangers in the digital lending landscape.

- Also, CAFRAL also warned about **fake/illegitimate lending apps** gathering personal data, posing potential misuse and safety risks for users.

What are the Major Concerns Raised by CAFRAL?

- **Interdependency Risks in NBFC Sector:**
    - **CAFRAL** observed that **banks mostly lend to bigger NBFCs, leading to increased cross-lending** within the NBFC sector.
        - This creates a network of inter-dependencies and contagion channels that can amplify shocks and transmit them across the system.
    - For example, the **default of IL&FS in 2018 and DHFL collapse in June 2019, triggered a liquidity crisis and a loss of confidence in the NBFC sector,** affecting the asset quality and profitability of banks that had lent to them.
- **Impact of Contractionary Monetary Policy on NBFCs:**
    - CAFRAL also found that **contractionary monetary policy leads to risk build-up in NBFCs' portfolios**.
    - When the **RBI tightens the policy rate,** NBFCs face higher borrowing costs and lower profitability.
        - To maintain their margins, **they tend to shift their lending to riskier segments such as unsecured loans,** subprime borrowers, etc. They also increase their **exposure to capital markets by investing in equities and mutual funds.**
        - These strategies expose them to **higher credit risk, market risk, and liquidity risk,** which can affect their solvency and stability.
- **Warnings About Illicit Lending Apps and Fintech Impact:**
    - It also warns about **fake/illegal digital lending apps,** pretending to be **legitimate** and gathering personal data for potential misuse.
    - Users can not easily verify the legality of these apps. There are concerns about **potential losses from online lending** affecting traditional banking if linkages between these

sectors grow stronger.
    - These apps often **request extensive personal information**, posing risks to consumer safety and privacy, although some data may be genuinely necessary.
    - FinTech has increased product diversity, with **around 1100 lending apps available** for Indian Android users across 80 app stores.

Note: Digital lending refers to the **process of providing loans or credit to individuals or businesses through online platforms or digital channels** without the need for traditional physical documentation or in-person interactions.

What are NBFCs?

- **About:**
    - An **NBFC, registered under the Companies Act, 1956,** engages in various financial activities such as loans, investments in securities, leasing, insurance.
    - It excludes institutions whose **primary business falls under agriculture, industry, goods trading, services, or immovable property trading**.
- **Criteria:**
    - When over **50% of a company's assets are financial assets** and **more than 50% of its income is derived from these financial assets,** it indicates the company's primary involvement in financial activities.
        - Companies meeting both criteria are registered as NBFCs by the RBI.
        - The **Reserve Bank has been given the powers under the RBI Act 1934** to register, lay down policy, issue directions, inspect, regulate, supervise and exercise surveillance over these NBFCs.

Note: Companies primarily engaged in areas like **agriculture, industry, goods trading, services, or real estate** would not be regulated by the RBI, even if they conduct some financial activities. **This exclusion is determined using the '50-50 test'.**

- **Exemptions From Registration with RBI:**
    - Under **Section 45-IA of the RBI Act, 1934**, an NBFC must obtain a registration certificate from the RBI and maintain Net Owned Funds of ₹25 lakhs (₹Two crore since April 1999) to operate as a non-banking financial institution.
    - However, certain categories of NBFCs regulated by other authorities, such as **SEBI-registered Venture Capital Funds, Merchant Banking, and Stock broking companies,** are exempt from RBI registration.
- **Difference in NBFC and Banks:**
    - **NBFCs are restricted from accepting demand deposits** from the public, unlike banks, which commonly accept these types of deposits that can be withdrawn on demand without prior notice.
    - Unlike banks, **NBFCs do not form part of the payment and settlement system.** They are unable to issue cheques drawn on themselves, a standard practice offered by banks.
    - Unlike banks, the **deposit insurance facility provided by institutions like the Deposit Insurance and Credit Guarantee Corporation** is **not available to depositors of NBFCs**.
        - In case of bank failures, this insurance offers protection to depositors, but it does not extend to NBFC depositors.
- **Funding:**
    - NBFCs primarily finance their operations through a **mix of market borrowing and bank loans**.

Way Forward

- **Monitoring the Inter-linkages and Spillovers:** The RBI and other regulators need

to **strengthen monitoring the inter-linkages and spillovers between NBFCs and banks**, as well as within the NBFC sector, using various tools such as **network analysis, stress testing, early warning indicators, etc.**
    - They also need to coordinate and cooperate with each other to ensure effective information sharing and crisis management.
- **Risk Management and Governance:** Strengthening risk management practices to identify, assess, and mitigate potential risks in NBFCs effectively.
    - **Enhancing corporate governance** and regulatory oversight to ensure **sound decision-making and transparency.**
- **Regulatory Surveillance of Digital Lending: Strengthening regulatory oversight over digital lending applications to ensure compliance with consumer protection laws and data privacy regulations.**
    - Implementing clear guidelines to **verify the legality and authenticity of lending apps.**

UPSC Civil Services Examination, Previous Year Question (PYQ)

Prelims

Q. With reference to the Non-banking Financial Companies (NBFCs) in India, consider the following statements: (2010)

1. They cannot engage in the acquisition of securities issued by the government.
2. They cannot accept demand deposits like Savings Account.

Which of the statements given above is/are correct?

(a) 1 only

(b) 2 only

(c) Both 1 and 2

(d) Neither 1 nor 2

Ans: (b)
