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The Role of Non-Banking Financial Companies in Financial System and Economic Growth in India

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ABSTRACT

Non-Banking Financial Companies (NBFCs) have emerged as key players in India's evolving financial system, serving sectors and regions inadequately reached by traditional banking institutions. This paper explores the multifaceted roles of NBFCs in promoting financial inclusion, supporting economic development, and filling the credit gaps in vital segments such as MSMEs, infrastructure, housing, and consumer finance. Through their innovative lending models and flexible operations, NBFCs have contributed significantly to capital formation, employment generation, and entrepreneurship. The study, based entirely on secondary data from authoritative sources like RBI reports, Economic Surveys, and CRISIL analyses, provides a comprehensive examination of the sector's structural framework, sectoral contributions, and regulatory environment. It highlights key policy reforms, including the RBI's Scale-Based Regulation (SBR) framework, which aims to enhance financial stability and accountability in the NBFC ecosystem. Despite facing challenges related to liquidity, asset quality, governance, and digital risks, NBFCs hold strong potential to complement the banking sector and contribute to India's inclusive and sustainable growth. The paper concludes with practical policy suggestions to strengthen their role in the formal financial architecture.

1. Introduction

The Indian financial system has undergone significant transformation over the past few decades, evolving into a multifaceted structure that supports investment, consumption, and economic expansion. While scheduled commercial banks have remained the cornerstone of this system, a parallel financial network has grown in both relevance and scale comprising Non-Banking Financial Companies (NBFCs). These institutions have played a pivotal role in delivering financial services to sectors and regions that often remain underserved by conventional banks. NBFCs offer a broad range of financial products including loans and advances, asset financing, hire-purchase, leasing, investment in securities, and microcredit. Their ability to design flexible lending models, offer customized solutions, and extend credit swiftly has allowed them to penetrate markets where formal banking infrastructure is limited or absent. This responsiveness to local financial needs has made NBFCs essential players in advancing financial inclusion and fostering entrepreneurial activity, particularly in rural and semi-urban areas. In the context of economic development, NBFCs have been instrumental in supporting Micro, Small, and Medium Enterprises (MSMEs), infrastructure projects, housing finance, vehicle financing, and consumer lending. Their contributions not only facilitate job creation and capital formation but also generate demand in allied sectors. By bridging the credit gap, NBFCs have supported inclusive growth and played a complementary role to traditional banks. However, this growth trajectory has not been without concerns. Several systemic vulnerabilities have emerged in recent years, including liquidity mismatches, governance deficiencies, and concentration of credit risk. High-profile financial failures have highlighted the need for stricter supervision and policy oversight. Recognizing these risks, the Reserve Bank of India (RBI) has introduced a series of regulatory reforms, including the Scale-Based Regulation (SBR) framework in 2021, aimed at enhancing financial discipline, improving transparency, and safeguarding public trust. This study investigates the evolving role of NBFCs in India's financial ecosystem, with a specific focus on their structural features, economic contributions, regulatory environment, and future potential. It aims to provide an in-depth understanding of how NBFCs function as financial intermediaries, the sectors they serve, and the macroeconomic impact of their operations. Furthermore, it seeks to identify the risks confronting the sector and evaluate the effectiveness of ongoing policy reforms.

The paper is organized as follows: Section 2 provides a review of relevant literature. Section 3 outlines the research methodology and data sources. Section 4 discusses the functional roles of NBFCs within India's financial system. Section 5 examines their contribution to economic growth. Section 6 addresses existing challenges and regulatory concerns. Section 7 explores recent reforms and future directions, while Section 8 concludes with key findings and policy recommendations.

2. Literature Review

The role of NBFCs in India has become increasingly significant, especially after the liberalization reforms and subsequent financial inclusion initiatives. A growing body of literature recognizes NBFCs as alternative credit institutions that have helped bridge gaps left by formal banks, particularly in financing MSMEs, low-income households, and rural borrowers.

According to Kumar and Singh (2020), NBFCs are more flexible in their lending operations than commercial banks and play a vital role in serving the informal sector. Similarly, Kaur and Kapoor (2021) found that NBFCs have demonstrated higher efficiency in reaching underserved urban and semi-urban borrowers, providing quicker credit disbursement through innovative lending models. These findings are supported by Mehta and Rajput (2022), who emphasize the ability of NBFCs to cater to self-employed individuals and micro-businesses with tailored products and simplified processes. On the regulatory front, several studies have highlighted the challenges NBFCs face in maintaining financial discipline. Sharma (2023) discusses the aftermath of the IL&FS crisis, suggesting that weak corporate governance and asset-liability mismatches created systemic risks. The introduction of the Scale-Based Regulation (SBR) by the Reserve Bank of India in 2021 has been a key reform in this regard. Gupta and Bansal (2021) argue that while SBR has improved regulatory clarity, many medium-sized NBFCs still lack internal risk control systems to align with RBI expectations. The link between NBFCs and financial inclusion has been widely researched. RBI's Financial Stability Reports (2021–2023) consistently acknowledge that NBFCs have expanded credit outreach in rural areas. Studies by Mukherjee and Roy (2022) and Narayan and Patel (2024) highlight that NBFCs have enabled access to finance for first-time borrowers, including women entrepreneurs and small farmers.

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These companies have introduced doorstep loan services and used alternate credit scores, which has empowered credit-deprived populations to participate in the economy.

Another significant area of research is the digital transformation of NBFCs. Das and Malhotra (2022) found that the adoption of digital platforms allowed NBFCs to maintain credit operations even during the COVID-19 pandemic. Their integration of mobile apps, e-KYC, and digital loan underwriting has improved efficiency and reduced transaction costs. However, Narayan and Patel (2024) caution that digital NBFCs need stronger cybersecurity protocols and regulatory oversight to manage rising technology-driven risks. A macroeconomic perspective is provided by Ahmed and Farooq (2023), who used econometric models to show a positive correlation between NBFC credit and regional economic growth. Rajan and Sehgal (2023) further elaborate on NBFCs' contribution to job creation through MSME lending. Their study estimates that over 40 million jobs are indirectly supported by NBFC-financed enterprises, making them significant players in employment generation. In a similar vein, Banerjee and Kulkarni (2020) argue that NBFCs have played an indirect role in infrastructure financing by targeting logistics, transportation, and urban housing segments.

Despite these contributions, challenges remain. Reddy and Srinivas (2020) and Sinha and Das (2021) raise concerns about liquidity stress caused by over-dependence on short-term borrowings. ICRA and CRISIL (2021–2023) also note that credit risk in unsecured lending has risen sharply. These studies call for stronger capital adequacy and liquidity coverage frameworks. Furthermore, the lack of long-term refinancing sources has restricted the ability of NBFCs to finance capital-intensive sectors.

Emerging themes such as ESG compliance and green finance are also gaining ground. Ghosh and Barman (2024) observe that a few NBFCs have begun lending for clean energy projects and electric mobility, although this remains an evolving segment. Rao and Rani (2021) argue that there is a need for structured ESG frameworks for NBFCs to align with India's climate and sustainability goals. While existing literature offers rich insights into the operational and financial contributions of NBFCs, certain gaps persist. First, there is limited longitudinal research connecting NBFC credit flows with national macroeconomic indicators like GDP, industrial output, and employment. Second, while the SBR framework is widely acknowledged, empirical studies evaluating its effectiveness across NBFC categories (base, middle, upper layers) are still lacking. Third, very few studies examine the risks emerging from digital NBFCs and the long-term impact of fintech integration. Lastly, there is inadequate exploration of how NBFC-bank partnerships (e.g., co-lending models) are altering credit delivery frameworks.

This study seeks to fill these gaps by offering a comprehensive and updated analysis of NBFCs in India—covering their structural evolution, regulatory environment, financial outreach, and broader economic impact. The objective is to enhance academic understanding and offer practical recommendations for policymakers, regulators, and industry stakeholders.

3. Research Methodology

This study follows a descriptive and analytical research approach based entirely on secondary data. The analysis relies on authoritative sources such as Reserve Bank of India (RBI) reports, Economic Surveys (2020–2024), Ministry of Finance publications, industry reports from CRISIL and ICRA, and peer-reviewed journal articles from Scopus-indexed databases. Key themes explored include the sectoral contribution of NBFCs, their role in financial inclusion, regulatory developments such as the Scale-Based Regulation (SBR) framework, and risks related to liquidity and governance. A qualitative content analysis method is employed to identify trends and extract insights from official documents and research literature. Comparative assessment is also used to distinguish the performance of NBFCs from that of traditional banking institutions. While the study offers a comprehensive understanding of NBFCs' macroeconomic role, it is limited by the absence of primary data and the rapidly evolving nature of the financial sector. Nonetheless, the methodology ensures academic rigor, policy relevance, and adequate coverage of recent developments shaping India's NBFC landscape.

4. Role of NBFCs in India's Financial System

NBFCs have evolved as vital institutions within India's financial system, especially in bridging the gap between formal banking structures and credit-deficient segments. Unlike banks, NBFCs do not have the authority to accept demand deposits, yet they perform essential functions in credit distribution, resource mobilization, and financial innovation. Their agility, customized lending approaches, and reach beyond metropolitan areas enable them to fulfill the diverse credit needs of individuals and enterprises, particularly those outside the purview of traditional banking. NBFCs are categorized by the Reserve Bank of India based on their operational focus and asset composition. These include Loan Companies (LCs), Investment Companies (ICs), Infrastructure Finance Companies (IFCs), Asset Finance Companies (AFCs), Microfinance Institutions (MFIs), and Housing Finance Companies (HFCs). Each classification caters to a specific financial segment. For example, Asset Finance Companies focus on leasing and equipment finance, while MFIs support small-scale borrowers in rural economies. This structural diversity ensures that NBFCs collectively cover a wide spectrum of financial needs across demographic and sectoral boundaries. The operational models of NBFCs differ substantially from conventional banks. Their credit delivery is typically characterized by lower documentation requirements, faster processing, and flexible repayment schedules. These advantages stem from the use of alternative credit assessment tools, including transaction histories, utility payment data, and behavioral analytics. Digital NBFCs and fintech-led platforms have further enhanced accessibility by enabling paperless applications, automated approvals, and app-based disbursements. These innovations have brought formal finance closer to small borrowers, daily-wage earners, and self-employed individuals who often lack collateral or credit scores.

NBFCs also play a strategic role in extending credit to underserved regions. Their presence in Tier II and Tier III towns, as well as in remote rural areas, has allowed them to reach customer segments that remain under banked. Unlike banks that are guided by stringent compliance protocols and high operational thresholds, NBFCs are often more responsive to local financial needs. Microfinance-focused NBFCs, in particular, have empowered women-led households and rural microenterprises by offering doorstep financial services and group-based lending models that promote repayment discipline and community accountability. In terms of credit volume, NBFCs have emerged as significant contributors to India’s overall lending activity. According to RBI data, NBFCs account for approximately one-fourth of total financial sector credit, with notable presence in consumer loans, vehicle financing, SME credit, and affordable housing. Their growth has been particularly notable in sectors where banks maintain a conservative stance. Furthermore, NBFCs have supported credit flow during periods of stress, such as the

COVID-19 pandemic, when they continued to disburse working capital to micro and small businesses and helped maintain liquidity in the informal economy. The function of NBFCs goes beyond credit provision. They also contribute to financial deepening by encouraging savings through investment products, supporting asset creation, and enhancing entrepreneurial opportunities. Their partnership with banks under co-lending frameworks has facilitated wider credit distribution while mitigating default risks. This hybrid model has allowed formal financial institutions to leverage NBFCs' local knowledge and delivery capacity without compromising regulatory safeguards.

5. NBFCs and Economic Growth

NBFCs have become integral to India's economic development by enhancing credit availability across sectors that are often under-served by traditional banks. Their ability to deliver flexible, quick, and targeted financial solutions has helped bridge the credit gap in key areas such as MSMEs, retail lending, infrastructure, and rural finance. Through their sector-specific models, NBFCs have enabled greater financial inclusion, supported employment, and contributed significantly to national output. The **Micro, Small and Medium Enterprises (MSME)** sector, which contributes nearly **30% of India's GDP** and employs over **110 million people** (Ministry of MSME, 2023), remains heavily reliant on NBFCs due to limited access to formal bank finance. According to the International Finance Corporation (IFC, 2022), the credit gap in the MSME sector is estimated at around **USD 300 billion**, much of which is filled by NBFCs through collateral-light lending and digital outreach. As per the **Reserve Bank of India's Financial Stability Report (2023)**, NBFCs accounted for approximately **25% of the total credit** extended by financial institutions. The **Asset Under Management (AUM)** of NBFCs crossed **₹35 lakh crore** in FY 2023, growing at a **Compound Annual Growth Rate (CAGR) of 14.2%** over the past five years. This growth reflects the increasing demand for alternative lending in emerging segments such as personal finance, gold loans, vehicle financing, and affordable housing.

Table 5.1: Sector-wise Credit Deployment by NBFCs (FY 2023)

Sector	**Share of NBFC Credit (%)**	**Year-on-Year Growth (%)**	**Economic Impact**
MSMEs	27%	18.4%	Enterprise expansion and job creation
Vehicle Finance	21%	12.3%	Transport sector growth and mobility infrastructure
Consumer Loans	19%	15.6%	Boost in private consumption
Infrastructure & Equipment	11%	9.7%	Capital investment and productivity enhancement
Affordable Housing	8%	10.8%	Urban development and real estate expansion
Gold Loans & Others	14%	16.9%	Rural liquidity and informal sector credit access

Source: RBI Financial Stability Report 2023; CRISIL Ratings Report 2023

NBFCs also contribute to **employment generation** both directly, through organizational staffing, and indirectly, by financing self-employment and small-scale enterprises. For instance, NBFC-financed MSMEs have been found to support over **40 million livelihoods** (Rajan & Sehgal, 2023). In rural and semi-urban areas, NBFC-MFIs provide group-based loans that empower women, small farmers, and artisans, contributing to inclusive and sustainable development.

During periods of financial stress, such as the **COVID-19 pandemic**, NBFCs demonstrated resilience by continuing credit disbursement where banks slowed operations. Their decentralized structure, localized operations, and technology-driven platforms enabled continued support to small traders, informal workers, and households, stabilizing consumption and micro-business activity during economic disruptions. Moreover, the emergence of **co-lending partnerships** between NBFCs and commercial banks has improved credit outreach in priority sectors. This collaborative model helps combine the formal credit strength of banks with the ground-level network and customer relationships of NBFCs, thereby improving risk-sharing and financial penetration.

6. Challenges and Regulatory Issues in the NBFC Sector

While NBFCs have emerged as critical players in India's financial landscape, their rapid growth has exposed a number of structural and regulatory vulnerabilities. These challenges have gained greater attention in recent years, particularly after high-profile defaults and liquidity crises that raised concerns about systemic risk, investor confidence, and regulatory adequacy.

6.1 Liquidity and Solvency Risks

One of the most pressing challenges in the NBFC sector is the persistent mismatch between the asset and liability profiles of many firms. Unlike banks, NBFCs rely heavily on short-term borrowings to fund long-term lending portfolios, especially in infrastructure, real estate, and asset-backed financing. This structural imbalance was starkly exposed during the **IL&FS crisis in 2018** and the **DHFL default in 2019**, which triggered a sector-wide credit freeze and investor panic. These events revealed the fragility of liquidity management practices in large NBFCs and highlighted the need for better asset-liability management (ALM) oversight and contingency funding buffers.

6.2 Regulatory Arbitrage and Shadow Banking Risks

Another major concern is the regulatory arbitrage that exists between NBFCs and traditional banks. NBFCs operate under relatively relaxed capital adequacy norms, provisioning requirements, and liquidity coverage ratios. While this flexibility has allowed them to grow and innovate, it has also led to excessive risk-taking in some cases. The phenomenon of **shadow banking**, where NBFCs operate like quasi-banks without being subject to the same prudential norms, poses risks to financial stability. This has led policymakers to call for a level playing field in regulation, especially for systemically important NBFCs whose failure could disrupt broader financial markets.

6.3 Rising Non-Performing Assets (NPAs)

Asset quality deterioration is another growing concern. In the wake of economic disruptions such as the COVID-19 pandemic, many NBFCs have witnessed a spike in delinquencies and restructured accounts. According to the **RBI's Financial Stability Report (2023),** the gross NPA ratio for the NBFC sector stood at **5.8%,** with elevated stress in segments such as SME loans, unsecured personal credit, and vehicle finance. Smaller NBFCs with limited risk assessment capabilities and over-concentration in high-risk geographies are particularly vulnerable. Additionally, delays in collections, inadequate credit appraisal systems, and high dependency on informal income assessments further exacerbate credit risk.

6.4 Governance and Risk Management Gaps

The governance structures in several NBFCs, particularly smaller and mid-sized ones, have been found lacking in terms of board independence, transparency, and internal control mechanisms. Weak internal audits, related-party transactions, and misaligned incentive structures contribute to poor decision-making and financial misreporting. These governance failures undermine investor trust and compromise the long-term sustainability of NBFCs.

6.5 Scale-Based Regulatory Framework (SBR)

In response to these challenges, the Reserve Bank of India introduced the **Scale-Based Regulation (SBR) Framework** in October 2021. This framework categorizes NBFCs into four layers—**Base, Middle, Upper, and Top**—based on their size, risk exposure, and systemic importance. Larger NBFCs in the **Upper Layer** are now subject to more stringent norms akin to banks, including tighter capital requirements, governance standards, and disclosure obligations. The SBR approach aims to move away from one-size-fits-all regulation and impose proportionate oversight based on potential impact on financial stability. While this reform has been widely welcomed, its implementation requires robust monitoring systems, supervisory capacity, and industry-wide compliance readiness.

6.6 Digital and Cybersecurity Risks

With increasing digitization in NBFC operations—particularly among fintech-NBFCs—new risks have emerged related to data privacy, cyberattacks, algorithmic lending, and digital fraud. These institutions often handle large volumes of borrower data through automated platforms and third-party service providers, raising concerns around consumer protection and regulatory oversight. The absence of a dedicated data governance framework for NBFCs may expose both firms and borrowers to significant financial and reputational harm.

7. Policy Reforms and the Way Forward

As NBFCs assume a more prominent position in India's credit ecosystem, regulatory authorities have introduced critical reforms to strengthen their resilience, address operational vulnerabilities, and enhance their role in achieving inclusive financial growth. These reforms aim to ensure that NBFCs function with sound risk management, institutional stability, and systemic alignment with India's evolving economic goals.

The most important regulatory shift came with the introduction of the **Scale-Based Regulation (SBR) Framework** by the Reserve Bank of India in 2021. Under this system, NBFCs are categorized into four layers based on their size, activity, and systemic impact—Base, Middle, Upper, and a possible Top Layer. Institutions in the Upper Layer are required to comply with enhanced prudential norms, including stricter capital adequacy ratios, improved governance structures, and mandatory disclosures. This framework replaces the earlier uniform approach with one that aligns regulatory intensity with institutional risk levels, thus fostering proportional and targeted supervision.

In addition, measures related to **liquidity management** have been significantly strengthened. The Liquidity Coverage Ratio (LCR) mandate for larger NBFCs requires maintenance of high-quality liquid assets, thereby reducing the sector's vulnerability to funding shocks. The revision of guidelines on **asset classification, income recognition**, and **provisioning norms** has further harmonized the regulatory environment between banks and NBFCs, reducing systemic loopholes and strengthening credit discipline.

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However, structural stability also depends on robust governance. Many mid-sized NBFCs continue to face challenges related to board oversight, internal controls, and ethical lending practices. Strengthening institutional governance through mandatory board independence, better audit processes, and risk accountability remains a key priority. The establishment of a uniform **fit and proper criterion** for promoters and directors across all NBFC layers would further improve transparency and managerial quality.

To ensure financial sustainability, reforms must also focus on the creation of reliable long-term funding sources. NBFCs currently depend heavily on market borrowings, which expose them to liquidity mismatches. Policy support through **development finance institutions (DFIs),** specialized refinancing agencies, or partial guarantee schemes can provide stable capital access, particularly for firms serving high-impact sectors like infrastructure, MSMEs, and affordable housing.

The rise of **digital NBFCs** and technology-integrated lending models has transformed access to finance, especially for underserved borrowers. Yet, the rapid growth of fintech-led NBFCs calls for strong oversight on data protection, algorithmic fairness, and cyber resilience. A dedicated regulatory framework that governs digital lending platforms, third-party fintech partners, and automated underwriting systems is essential to ensure responsible innovation.

Moreover, the **co-lending model** between NBFCs and banks presents a strategic path forward. By combining the institutional depth of banks with the grassroots outreach of NBFCs, this model enables wider credit penetration without overexposing either party to concentrated risk. To make co-lending more effective, policymakers should encourage standardized agreements, joint monitoring tools, and shared credit assessment protocols.

Looking ahead, a well-calibrated policy approach is needed to maintain momentum in the NBFC sector while mitigating emerging risks. Regulatory interventions must continue to evolve with market dynamics, ensuring that innovation is balanced with prudence. A focus on differentiated regulation, governance improvement, capital adequacy, and digital integrity will position NBFCs to serve as stable and responsive financial institutions that support India’s broader goals of sustainable and inclusive economic development.

8. Conclusion and Suggestions

8.1 Conclusion

Non-Banking Financial Companies (NBFCs) have emerged as a powerful force in India's financial landscape, playing a crucial role in credit distribution, financial inclusion, and sector-specific investment. Their flexible lending models, customer-centric approach, and penetration into underserved markets have significantly complemented the efforts of traditional banking institutions. NBFCs have demonstrated their utility across diverse sectors including MSMEs, housing finance, infrastructure, and rural lending. Their contribution has not only improved credit outreach but also stimulated entrepreneurship, consumption, and employment—factors critical to sustained economic growth. Despite their growing importance, NBFCs face several structural and regulatory challenges. The sector has been vulnerable to liquidity mismatches, rising NPAs, governance deficits, and digital risk exposures. These weaknesses have led to major financial disruptions in the past, prompting regulatory authorities to implement reforms such as the Scale-Based Regulation (SBR) framework, revised prudential norms, and stronger disclosure standards. While these reforms have addressed many systemic concerns, further measures are needed to enhance institutional resilience, protect customer interests, and ensure long-term sectoral sustainability.

In essence, NBFCs have the potential to evolve into stronger, more inclusive financial intermediaries, provided that innovation is guided by prudence, governance is strengthened, and regulatory oversight remains adaptive to the changing dynamics of financial markets.

8.2 Suggestions

1. **Enhance Governance Standards:** There is a pressing need to improve governance mechanisms, especially among mid- and small-sized NBFCs. Enforcing stricter board independence, transparency norms, internal audit mechanisms, and ethical lending frameworks can significantly reduce institutional risk and improve investor confidence.

2. **Strengthen Liquidity and Capital Buffers:** Policymakers should encourage NBFCs to build stronger liquidity cushions through mandatory reserve buffers and access to dedicated liquidity support systems. Exploring long-term refinancing options via Development Finance Institutions (DFIs) can also help reduce dependence on volatile short-term borrowing.
3. **Expand Digital Regulation:** As NBFCs increasingly adopt digital platforms and fintech models, it is essential to establish clear regulatory frameworks for data privacy, algorithmic fairness, cybersecurity, and digital lending partnerships. A comprehensive data governance code specific to NBFCs will safeguard borrower interests.
4. **Promote Co-Lending Models:** NBFCs should be incentivized to enter into structured co-lending partnerships with banks. Standardizing risk-sharing mechanisms, due diligence norms, and monitoring frameworks will increase credit outreach without compromising portfolio quality.
5. **Sectoral Diversification and Risk Assessment:** NBFCs should diversify their lending portfolios to avoid sectoral concentration risks. At the same time, improving credit appraisal techniques and adopting data-driven risk assessment tools will help maintain asset quality, especially in volatile market conditions.
6. **Improve Financial Literacy Among Borrowers:** To promote responsible borrowing and timely repayment, NBFCs should collaborate with government and civil society to run financial education programs in rural and semi-urban areas, particularly among first-time borrowers and informal sector workers.
7. **Create a Unified Regulatory Surveillance System:** Coordination between the RBI, SEBI, Ministry of Corporate Affairs, and state-level authorities can help ensure real-time supervision of NBFCs. A centralized digital compliance monitoring system can track regulatory breaches and financial health more effectively.
8. **Encourage Green and ESG-Based Financing:** NBFCs should be encouraged to support sustainable sectors such as clean energy, electric mobility, and climate-resilient agriculture through green lending instruments. Tax incentives or refinancing support may be considered to promote ESG-compliant practices.

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