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# Concept of Shadow Banking in India

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**ABSTRACT**

*The term shadow bank was coined by Paul McCulley in 2007. It is a universal phenomenon. In the US it implies, non-bank financial institutions engaging in maturity transformations (i.e. use of short-term deposits to finance long-term loans). The Financial Stability Board defines shadow banking as the credit intermediation involving entities and activities (fully or partially) outside the regular banking system. Shadow banking activities include credit intermediation and liquidity and maturity transformation that take place outside the regulated banking system.*

*In advanced economies, shadow banking is more of risk transformation through securitization, while in the economically backward economies where financial market is still in developing stage, the activities are more of supplementary to banking activities. The last two to three decades, the financial sector has witnessed a lot of changes and growing competition. This has caused banks to indulge in shadow banking.*

*The recent global financial crisis brought to fore the need for monitoring and regulating the activities of shadow banking. With the forthcoming implementation of Basel III norms, there is a possibility of increase in shadow banking activities.*

*The present paper intends to study the concept of shadow banking, the extent of shadow banking in India, and its pros and cons.*

**KEYWORDS : Shadow Banking, Financial Sector, Banking, Global**

## INTRODUCTION

The Great Recession in the US was associated with a severe financial crisis, but people did not rush to their banks to withdraw deposits. However a closer look suggests that the crisis was not very different from a typical banking crisis except it was triggered outside the traditional banking sector. This financial crisis can be viewed as a banking crisis that originated in the shadow banking system.

Shadow banking system has grown significantly in the last thirty years. This system has grown outside the over site of regulators because banking and finance in general have expanded in recent decades and has resulted in growth of shadow system largely to avoid the costs with regulations.

## REVIEW OF LITERATURE

Shrestha (2007) found that growing level of intermediation activities of the non-bank financial intermediaries (NBFIs) causes a shift in deposits from banks to non-banks in South-East Asian Countries. He observed that since the deposits of the NBFIs are not included in the monetary aggregates, the conduct of monetary policy gets undermined for regimes, which follow monetary targeting framework.

A Deutsche Bundesbank study (2014) contended that the growing activities of shadow banks might weaken the transmission of monetary policy measures via commercial banks (through interest rate and bank credit channel), but, on the contrary, the asset prices channel may become effective in the monetary policy transmission process. An expansionary monetary policy might fuel asset prices, which, in turn, might increase the leverage of the shadow banks, expand their balance sheets, reduce their risk premium and thereby increase lending to non-financial sector and finally the level of real activity

Hannan and Hanweck felt that the insolvency for Banks, become true when current losses exhaust capital completely. It also occurs when the return on assets (ROA) is less than the negative capital-asset ratio. The probability of insolvency is explained in terms of an equation p, 1/(2(Z2 ). The help of Z-statistics is commonly employed by Academicians in computing probabilitie

## Meaning of Shadow Banking

Shadow banking is a universal phenomenon, although it takes on different forms. In advanced economies where the financial system is more matured, the form of shadow banking is more of risk transformation through securitization; while in the economically backward economies where financial market is still in a developing stage, the activities are more of supplementary to banking activities. However, in both the structures, shadow banking operates outside the regular banking system and financial intermediation activities are undertaken with less transparency and regulation than the conventional banking.

The term 'shadow bank' was coined by Paul McCulley in 2007, by and large, in the context of US non-bank financial institutions engaging in maturity transformations (use of short-term deposits to finance long-term loans). However, a formal touch to the institutions of shadow banking was given by the Financial Stability Board, which defined 'shadow banking' as the "credit intermediation involving entities and activities (fully or partially) outside the regular banking system". Shadow banking activities, thus, include credit intermediation (any kind of lending activity where the saver does not lend directly to the borrower, and at least one intermediary is involved), and liquidity transformation (investing in illiquid assets while acquiring funding through more liquid liabilities) & maturity transformation (use of short-term liabilities to fund investment in long-term assets) that take place outside the regulated banking system. Focusing on the pre-requisites for sustenance of shadow banking, Claessens and Ratnovski (2014) have described shadow banking as all financial activities, barring traditional banking, which require a private or public backstop (in the form of franchise value of a bank or insurance company, or in the form of a Government guarantee) to operate.

How shadow banking system works

Depositors(Institutional investors and large corporations) need a place to park liquid funds that provides them with ready access to their money, pays interest rate higher than that offered by traditional banks and spares them the expenses and hassles of managing their own cash. Banks, investment banks and broker-deal firms are willing to provide such a product say in the form of repo transaction.

## Challenges posed by the shadow banks to the global economy and economies

**a. Financial Stability and Systemic Risk Concerns**

Across various economies, regulatory arbitrage was used to create shadow banking entities. In many instances, banks themselves composed part of the shadow banking chain by floating a specialized subsidiary to carry out shadow banking activities. Banks also invested in financial products issued by other shadow banking entities. Since shadow bank entities have no access to central bank funding or safety nets like deposit insurance, they remain vulnerable to shocks. Given the huge size of shadow bank activities and their inter-linkages with other entities of the financial sector, any shock in the shadow banking segment can get amplified, giving rise to systemic risk concern. The capacity of shadow banks to precipitate systemic crisis was manifested in the recent global financial crisis.

**b. Regulatory arbitrage spread across geographical jurisdictions**

Different legal and regulatory frameworks across geographical jurisdictions also pose a significant handicap in curbing the shadow banking activities, which are spread across borders. For instance, high taxation in some jurisdictions sometimes generates tax avoidance strategies by financial firms. Tax haven countries with their eye on attracting foreign capital and creation of jobs in their economies keep their tax rates low. Firms in high taxation countries restructure their financial activity by shifting some high tax activities to low tax countries. This, at times, generates large and significant hot money flows, which itself, is a source of instability for both set of countries from where it outflows to where it flows in. This, at times, has an adverse effect on financial stability, especially at a time when the whole global economy is far more integrated than ever.

**c. Challenges in the conduct of Monetary Policy**

Opaqueness of its structure, size, operations and inter-linkages of shadow banks with commercial banks and other arms of the financial sector might distort the information content of monetary policy indicators and thereby undermine the conduct of monetary policy. For instance, a Central Bank might lose control over the credit aggregate (as these entities broadly remain outside the regulatory purview), which might weaken the monetary policy transmission through credit channel. This concern was highlighted even in the 1950s. Thorn (1957) advocated some form of control over credit abilities of the non-bank financial intermediaries for the successful implementation of monetary policy as these entities remain immune to direct central bank control

Shadow banking activities, which broadly remain less regulated, have been reported to act pro-cyclically, which might amplify financial and economic cycles. Their leverage would rise during booms (as they face little problem in arranging funds) as assets price rise and margin/ haircuts on secured lending remain low. On the contrary, during the downturn phase (as the funding becomes difficult) as asset prices fall and margins/ haircuts on secured loan become tighter, shadow bank get compelled to undertake deleveraging.

Pro-cyclicality of shadow banks may also get exacerbated owing to their inter-connectedness with the banks. FSB (2012) observed that inter-connectedness of the shadow banks with the banks might aggravate the pro-cyclical build-up of leverage and thereby heighten the risks of asset price bubbles, especially when the investment assets of the two systems are correlated.

This pro-cyclicality in the financial system might amplify financial and business cycles. High pro-cyclicality of the shadow banking sector has implications for the real sector, which might also get affected adversely as funding by the shadow banks to the real.

**Shadow banking and India**

Compared to its foreign counterparts, the size of shadow banking system is relatively smaller in India. Due to the conservative banking practices, shadow banks have been under constant regulatory surveillance. Moreover, many activities that contributed to the global financial crisis are either not allowed, or if allowed, have to follow regulatory limits. For instance, complex and synthetic derivative products that were responsible for the global crisis are presently not permitted in India.

Notwithstanding the regulatory forbearance, Indian banking system too remains vulnerable to shadow banking practices. In India, Non-Banking Financial Companies epitomize the shadow banking system as they perform bank-like credit intermediation outside the purview of banking regulation. Today, NBFC is the fastest growing segment in the Indian financial sector with annual growth higher than the banking sector.

**Evolution of Regulation of NBFCs in India**

In the wake of failure of several banks in the late 1950s and early 1960s in India, large number of ordinary depositors lost their money. This led to the formation of the Deposit Insurance Corporation by the Reserve Bank, to provide the necessary safety net for the bank depositors. The Reserve Bank then noted that the deposit taking activities were undertaken by non-banking companies also. Though they were not systemically as important as the banks, the Reserve Bank initiated regulating them, as they had the potential to cause pain to their depositors.

Later in 1996, in the wake of the failure of a big NBFC, the Reserve Bank tightened the regulatory structure over the NBFCs, with rigorous registration requirements, enhanced reporting and supervision. Reserve Bank also decided that no more NBFC will be permitted to raise deposits from the public. Later when the NBFCs sourced their funding heavily from the banking system, thereby raising systemic risk issues, sensing that it can cause financial instability, the Reserve Bank brought asset side prudential regulations onto the NBFCs.

**NBFCs of India**

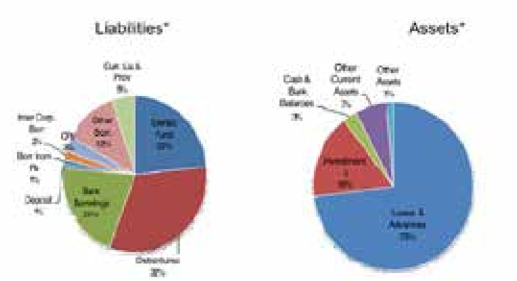
The 'NBFCs' of India include not just the finance companies, but also a wider group of companies that are engaged in investment, insurance, chit fund, nidhi, merchant banking, stock broking, alternative investments etc. as their principal business. NBFCs being financial intermediaries are playing a supplementary role to banks. NBFCs especially those catering to the urban and rural poor, namely NBFC-MFIs and Asset Finance Companies have a complimentary role in the financial inclusion agenda of the country. Further, some of the big NBFCs viz; infrastructure finance companies are engaged in lending exclusively to the infrastructure sector, and some are into factoring business, thereby giving fillip to the growth and development of the respective sector of their operations. In short, NBFCs bring the much needed diversity to the financial sector.

**Profile of NBFCs**

The total number of NBFCs as on March 31, 2014 are 12,029 of which deposit taking NBFCs are 241 and non-deposit taking NBFCs with asset size of ` 100 crore and above are 465, non-deposit taking NBFCs with asset size between ` 50 crore and ` 100 crore are 314 and those with asset size less than ` 50 crore are 11009. As on March 31, 2014, the average leverage ratio (outside liabilities to owned fund) of the NBFCs-ND-SI stood at 2.94, return on assets (net profit as a percentage of total assets) stood at 2.3%, Return on equity (net profit as a percentage of equity) stood at 9.22% and the gross NPA as a percentage of total credit exposure (aggregate level) stood at 2.8%.

**Asset Liability composition:**

Liabilities* of the NBFC sector: Owned funds (23% of total liabilities), debentures (32%), bank borrowings (21%), deposit (1%), borrowings from Financial Institutions (1%), Inter-corporate borrowings (2%), Commercial Paper (3%), other borrowings (12%), and current liabilities & provisions (5%). Assets*: Loans & advances (73% of total assets), investments (16%), cash and bank balances (3%), other current assets (7%) and other assets (1%).




*The data pertains to only reported deposit taking NBFCs and those non-deposit taking NBFCs with asset size of ` 100 crore and above. All figures are as on end March, 2014

Source: Danger posed by shadow banking systems to the Global financial System-The Indian Case by R. Gandhi, RBI Monthly Bulletin September 2014

## CONCLUSION

The shadow banking sector is an extremely diverse group of markets and institutions. They can be involved in money market and hedge funds, or private equity and special purpose entities. At the November 2010 Seoul summit, considering the potential o regulatory gaps emerging in the shadow banking system, the G20 leaders requested the Financial Stability Board in collaboration with other international standard setting bodies, develop recommendations to strengthen the oversight and regulation of the shadow banking system.

Based on this the working group on shadow banking was established in February 2013 by the Financial Stability Board Regional Consultative Group for Asia(RCGA) to conduct and study on shadow banking in Asia. The group surveyed and reported on six areas o shadow banking in Asia namely, the profile of non-bank financial intermediaries in Asia, how these entities are regulated, the definition of shadow banking applied by members, the distinction between shadow banking and NBFI's in Asia, the potential risks emanating from NBFI's in Asia and the applicability of Financial Stability Board's recommendations on shadow banking to Asia.

In India it was identified that constitution of NBFC's acted as shadow banks. However they have been under the regulation of Reserve Bank for the past 50 years. Thus it can be considered that the shadow banks in India are of a different genre and the dangers posed by them are also of different genre.

There are advantages arising out of shadow banking system. It provides an alternative source of funding and liquidity. Non-bank entities with specialized expertise are in a position to provide efficient credit and certain functions in the credit intermediation chain more cost-efficiently. However, shadow banking system can become a source of systemic risk both directly and through its interconnectedness with the regular banking system. The risks in the shadow banking system can affect the banking system as banks form a part of shadow banking credit intermediation chain or provide support to shadow banking entities. These risks are amplified as the chain becomes longer and less transparent.

Thus the growing size and interconnectedness of NBFC's in India is something to be concerned about. The Reserve Bank has been working on streamlining the regulation of NBFC's and the major concern has been to protect the customer's interest. In India there are many companies that are registered as finance companies, whether incorporated or unincorporated but are not regulated by the reserve bank. A lot needs to be done to change the law and enforcement of the law, which is a big challenge in India. However the presence of NBFC's is important as they play a complimentary and supplementary role in the financial banking system. They further financial inclusion and also provide depth to the financial market. Thus the aim must be to bring about prudential growth of the sector.

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