Shadow Banking

Shadow banking is a term used to describe **bank-like activities (mainly lending)** that take place **outside the traditional banking sector**.

- It is also referred as **non-bank financial intermediation** or **market-based finance**.
- Generally, it is not regulated in the same way as traditional bank lending.
- The term 'shadow bank' was **coined by Paul McCulley in 2007**.
- **Examples** of shadow lenders include Special Purpose Entities, Non Banking Financial Companies (NBFCs), Hedge Funds etc.
- These institutions **function as intermediaries between the investors and the borrowers,** providing credit, thus, leading to financial inclusion and hence generate liquidity in the system.
    - However, **the 2008 financial crisis has shown that shadow banking can be a source of systemic risk to the banking system**. The risks can be transmitted directly and through the interconnectedness of partially-regulated entities with the banking system.
    - After the financial crisis, central banks including that of USA, Britain and the European Union (EU) have introduced many strong measures to control shadow banking.
- In India, the crisis of the NBFCs that was triggered by the **liquidity problems of IL&FS** in 2018, has brought back the attention to shadow banking sector.

Source: BS