Mains Practice Question

Q. What do you mean by shadow banking system? What are the challenges faced by India's shadow banking system at present? (150 words)

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- Briefly explain what is shadow banking system and its role
- Enumerate the challenges faced by it in India
- Suggest ways to address these challenges
- Conclude by emphasising upon the importance as well as the need for effective regulation of such a system

Introduction

- The shadow banking system is a term for the collection of non-bank financial intermediaries that provide services similar to traditional commercial banks but have different regulatory guidelines.
- Financial Stability Board defines 'shadow banking' as the "credit intermediation involving entities and activities outside the regular banking system". It can be described as all financial activities, barring traditional banking, which requires a private or public backstop (in the form of franchise value of a bank or an insurance company, or in the form of a Government guarantee) to operate.

Body

In the context of developing economies, shadow banks play a gainful role in credit delivery and financial inclusion as:

- They can facilitate credit availability to certain sectors that might otherwise have difficulty in access to credit.
- They play both a substitute and complementary role for commercial banks as they are able to map the financing needs of the borrowers with the financing provision where the formal banking systems are confronted with regulatory constraints.
- Further, Non Banking Financial Companies (NBFCs) often take a lead role in providing innovative financial services to Micro, Small, and Medium Enterprises (MSMEs) according to their business requirements.
- NBFCs play a critical role in participating in the development of an economy by providing a fillip to transportation, employment generation, wealth creation, bank credit in rural segments and to support financially weaker sections of the society.

No twith standing the complementary role played by shadow banks to the banking system, their activities on the flip side create risks which can assume a systemic dimension. In its recently released Global Financial Stability Report, the International Monetary Fund warned of systemic risks associated with such shadow banking practices which might spill over to banks.

Such warnings are especially relevant for India as the size of its shadow banking sector appears to be on the higher side, when compared to many other large economies, as per the estimates by Basel based Financial Stability Board (FSB). In light of this, there are certain challenges faced by shadow banking system in India such as:

- **Liquidity risk:** This is one of the most common risks faced by shadow banks, as these entities undertake maturity transformation i.e., funding long term assets with short term liabilities. The risk of Asset Liability Mismatch (ALM) leading to liquidity problems is quite high.
- **Regulatory arbitrage:** Credit intermediation is, traditionally, a banking activity. Regulations applied to banks in this regard can be circumvented by transferring components of the credit intermediation function to shadow banks which are subject to less stringent regulations.
- A 2017 report by the RBI said that 99.7% of shadow banking in India involves making long-term loans against short- term funding, primarily carried out by NBFCs and housing finance companies.
- Problems also arise when such **NBFCs become too big, invest in assets of dubious quality** and are interconnected with other financial institutions, as demonstrated in the case of IL&FS.
- **Concentration risks—** too much exposure to some sectors—can also be a challenge. To illustrate, NBFCs kept on lending to real estate developers in recent years despite the sector being marred by incomplete projects, litigation, and overall slowdown. Developer loans make up around 21% of NBFCs' loan book, compared to 7% for private banks and 3% for public sector banks, as per the Credit Suisse report.

Way Forward

The challenges of shadow banking system have to be addressed at multiple levels, some of which are listed as follows:

- Strengthening the existing regulatory framework by increasing capital, liquidity, risk management, and disclosure requirements, rather than bailing out poorly managed NBFCs.
- In addition, the surveillance of the shadow banking system should be intensively carried out through off-site and on-site supervision.
- Credit Rating Agencies (CRAs) should be strengthened and must be made accountable in assessing the financial strength of firms and financial instruments.
- The steady weakening of development banks and Development Finance Institutions (DFIs) created a void that shadow bank entities attempted to fill with their inherently flawed business model. It is time to revitalise the existing development banks and set up new institutions that can finance infrastructure and other development projects that have large capital requirements and long gestation periods.

Therefore, it is important that this sector is constantly regularised and promoted to enable prudential growth of the sector keeping in view the multiple objectives of financial stability, consumer and depositor protection, and need for more players in the financial market.