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### Shadow Banking-Future of Indian Banking System

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#### ABSTRACT

Shadow banking system has been operating globally since many years and it was not noticed earlier, gradually it became evident and its implications on the economy of the nation were found out to be positive. And then they were allowed to operate within nations with a given amount of freedom. The present study intended to study internationally the scope of shadow banking vis-à-vis traditional banking. The study pointed out that the functioning and performance of shadow banks was rising till the time of the crisis and it outperformed the traditional banking system. During the crisis the shadow banking started declining and at the same time the role and functioning of the traditional banking system improved.

In India the shadow banking system works as the Non-banking financial companies i.e. NBFCs, which is a very complex structure and has a high degree of interconnectedness with the traditional banks that operate in India. Another objective of this study is to find the growth of shadow banking in India over the years 1998 to 2010. The major points about the growth of NBFCs are – that the financial companies showed substantial growth rates during the years of the financial crisis. This proves that these were less affected because of the U.S. subprime mortgage crisis of 2007. Shadow banking everywhere outside India declined during the crisis period. The total assets of Non-banking financial companies have increased over the study period (1998-2010) at different rates annually. There is no uniform growth in the assets of NBFCs ever since the study period. The trend in annual growth rates with respect to previous year show that there has been negative growth in years 2000-01, 2002-03 & 2003-04. The substantial growth (annual growth with respect to previous year) was highest for 2007-08 and after this it was always a positive growth each year. The trend of the growth of the total financial assets of NBFCs from the study points out that – there has been little amount of growth each year except for a few years. The probable reasons for little growth each year are that, the shadow banks have to work under strict regulations in India & there is lack of support from the Reserve Bank of India. Internationally, shadow banking is growing substantially each year ever since the crisis and it works with all the freedom it requires

and the support it needs. In India it must be supported by the Reserve Bank of India & should be allowed to function with some freedom to operate under proper monitoring so that it grows substantially each year because there is a huge amount of scope of the shadow banks. The shadow banks would help in improving the economy of India.

**Keyword:** Shadow Banking, Financial Crisis.

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## 1. INTRODUCTION

“The shadow banking system is a term for the collection of non-bank financial intermediaries that provide services similar to traditional commercial banks. It comprises a diverse set of institutions and markets that, collectively, carry out traditional banking functions - but do so outside, or in ways only loosely linked to, the traditional system of regulated depository institutions.” -Perry Mehrling

The various important components of the shadow banking system are – money market mutual funds, asset-backed commercial paper (ABCP) conduits, repurchase agreements (repo), investment banks, mortgage companies and securitization vehicles (SIV). Shadow banking is growing at a faster rate than its rival traditional banking system. It has also grown in importance since the subprime mortgage crisis of 2007-2008 since it was a prime factor in the global recession that followed. Shadow banking system is growing everywhere including India. In India these institutions are being allowed to function under proper monitoring so that it is sound in cases of crisis.

Entities which don't come under the regulated traditional banking system but perform the core banking operations and functions are included in the shadow banking system. Mainly these entities perform credit intermediation activity i.e. deriving money from the investors or savers and lending it to the ultimate borrowers. Four key aspects of credit intermediation are –

**Maturity transformation:** deriving short term funds to be invested in long term assets.

**Liquidity transformation:** it is a concept little similar to the first one, and it is basically using cash liabilities to purchase assets like loans which are hard to sell.

**Leverage:** it is a technique to borrow money for purchasing fixed assets in order to increase the potential gains or losses on any investment.

**Credit risk transfer:** it is a technique of transferring the risk of borrower's default from the loan originator to another party who has a greater ability to absorb losses.

The main objective of this report is to find the growth (of shadow banks in India & how it has increased internationally). The study also aims to study the performance of shadow banks i.e. Non-banking financial institutions in India.

## 2. REVIEW OF LITERATURE

**Guillermo Ordonez (2013)** emphasized the importance of enhancing the gains or benefits and at the same time reduces the cost of shadow banking. **Anand Sinha (2013)** emphasized the important role played by NBFCs in the financial system and for economic growth of India. **Gary Gorton and Andrew Metrick (2010)** The study talks about shadow banking in context with the financial crisis, explains in detail how it was responsible for the crisis and gives some points which might help in fixing it. **Manmohan Singh and**

James Aitken (2010) debated on the existing size of shadow banking system and how this made impact on the funding for large banks.

### 3. METHODOLOGY

Data analysis has been done in two parts. Firstly the global data has been studied and then the Indian data has been analyzed. Internanational shadow banking data is representing data of 20 jurisdictions and the euro area as a whole. Indian shadow banking system mainly involves non-banking financial companies that are operating under the monitoring of the Reserve Bank of India. So, NBFCs data is used in the analysis of shadow banking in India. Basically secondary data is used for the present study.

### 4. RESULTS & DISCUSSION

#### 4.1. Global Scenario

The data from the European Central Bank (ECB), Figure 52.1, which represents the flow of funds for 20 jurisdictions and the euro area shows that financial assets of other financial intermediaries (OFI) representing the shadow banks reached to \$71.2 trillion, and therefore showed an increase of \$5 trillion at the end of 2012. It also shows that the total size of the financial assets of non-bank financial intermediaries was nearly half the size of assets of the banking system. The reason behind the growth of assets of the other financial intermediaries (OFI) in 2012 was the general increase in valuation of the global financial markets. The Non-bank financial intermediation reached its peak in the year 2007 with a share of total financial intermediaries of about 27%. After that it has been steady over the recent years at about 24%, which is below the level it reached at the onset of the crisis. The non-bank financial intermediation's share of total financial intermediation has reached to 24% which was at the end of 2012, but that was 0.7 percentage points up from the year 2011. It is about 46.7% if it is compared to the total financial intermediaries of the banking system.

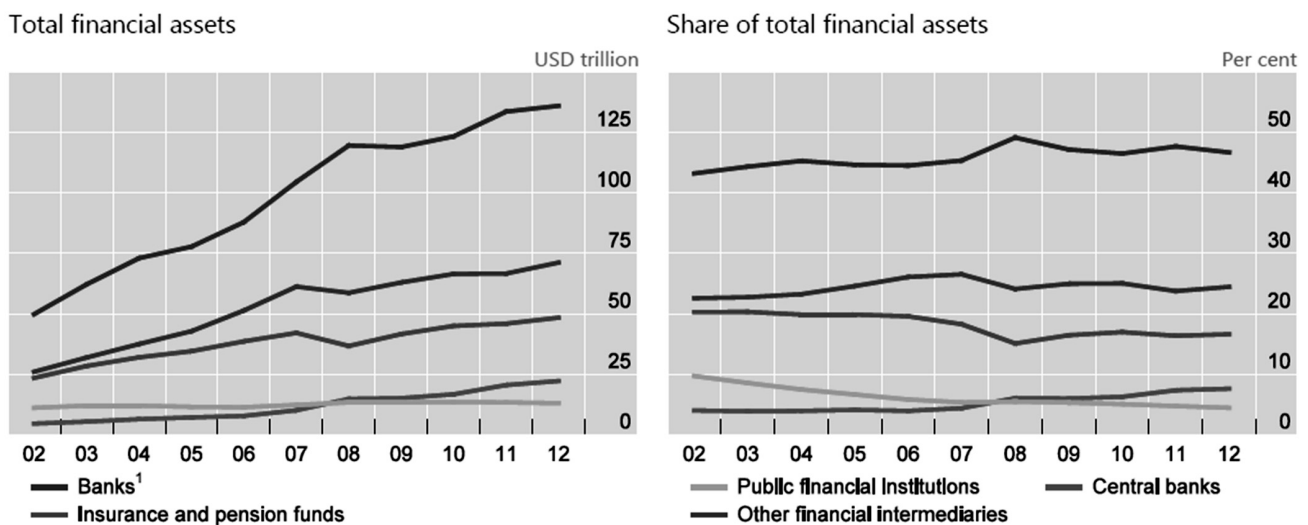


Figure 52.1: Assets of financial intermediaries (20 jurisdictions and euro area)  
 Source: Global Shadow Banking Monitoring Report 2013 by Financial Stability board

For 20 jurisdictions and the euro area as a whole, the aggregated size of the non-bank financial intermediaries was estimated as 117% of the GDP, Figure 52.2, which is again less than the peak level it

attained in 2007 of 125% of the GDP. But if we compare it with what it was at the end of 2011, the non-bank financial intermediation has gone up by 6 percentage points as a share of the GDP.

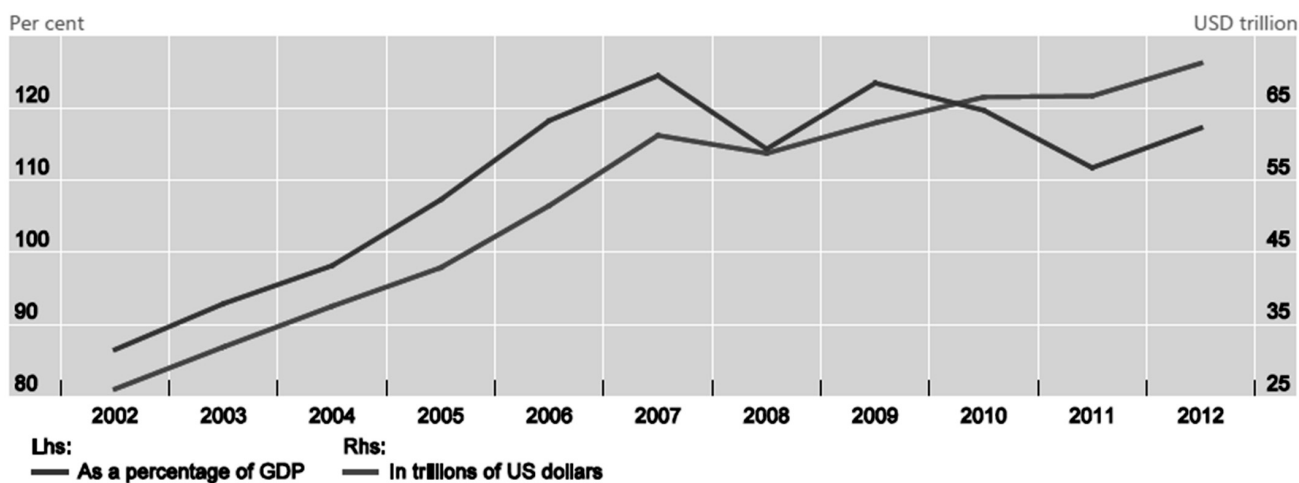


Figure 52.2: Assets of non-bank financial intermediaries (20 jurisdictions and euro area)  
Source: “Global Shadow Banking Monitoring Report 2013” - Financial Stability board

At the end of year 2012 the United States had the largest non-banking financial system with aggregated assets of \$26 trillion, and it was followed by the euro area with aggregated assets of \$22 trillion, the United Kingdom with \$9 trillion and Japan with \$4 trillion. United States share of non-banking financial system out of the 20 jurisdiction and the euro area showed an increase from 35% to 37% in 2011 and the United Kingdom share showed a decrease in its share from 14% to 12%

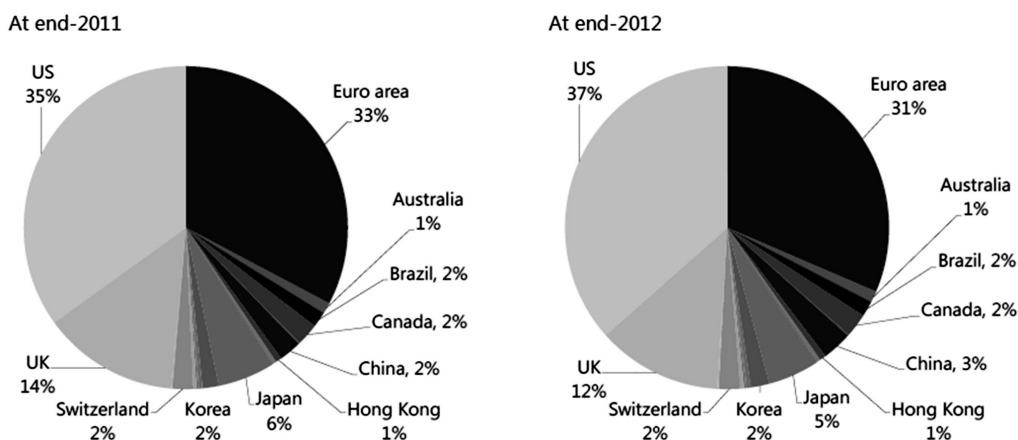


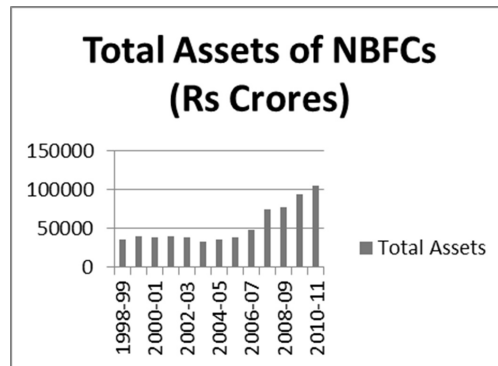
Figure 52.3: Share of assets of non-bank financial intermediaries (20 jurisdictions and euro area)  
Sources: Global Shadow Banking Monitoring Report 2013 by Financial Stability board

#### 4.2. Growth of Shadow Banking System in India

In India shadow banks operate as **Non-Banking Financial Companies (NBFCs)**. “It is a company , registered under the Companies Act, 1956 and its principal business is lending, investments in various types of shares/stocks/bonds/debentures/securities, leasing, hire-purchase, insurance business, chit business, also, its principal business is receiving deposits under any scheme or arrangement in one lump sum or in installments.

However, a Non-Banking Financial Company does not include any institution whose principal business is agricultural activity, industrial activity, trading activity or sale/purchase/construction of immovable property (Section 45 I (c) of the RBI Act, 1934). One key aspect to be kept in view is that the financial activity of loans/advances as stated in 45 I (c), should be for activity other than its own. In the absence of this provision, all companies would have been NBFCs.” The major characteristics of the shadow banks are that – their liabilities are very prone to bank runs, their assets are very risky and also they are liquid. Typically this system is highly levered.

The activities like credit transformation, liquidity transformation and conducting maturity are performed by the shadow banks and they do it outside the traditional banking system. Therefore these are very less regulated as compared to the traditional banking system or there might be chances that these are not regulated at all. In addition to this these non-banks have no direct or explicit access to central bank liquidity. These shadow banks most of the time function by involving many single financial entities which can act independently which results in multiple entities working together and that may include financial entities like banks, governments, credit rating agencies, non-bank financial companies which can be formal or informal and also the regulators. There can also be a single financial entity working alone in a shadow banking system.



Source: Data-RBI Bulletins

### 4.3. Growth of NBFCs Assets

Since 1998, the number of deposit-taking NBFCs and their shares were shrinking due to introduction of certain Norms by Reserve Bank of India. In 2006, Reserve Bank of India introduced Non-deposit taking NBFCs, which witnessed a significant growth in the new class of NBFCs. Due to the combination of both of these situations there has been a steady shrinking of the NBFC share of deposits.

Table1 reveals that the Annual Growth rates of total assets of the NBFCs in India each year was not uniform. Substantial growths were there in the years 2006, 2007 & 2009 with 28%, 53% & 22% growth respectively, whereas negative growth was there in the years 2000, 2002 & 2003 with -5%, -5% & -13% growths respectively. After 2007 in which there was maximum growth, there has been positive growth each year.

At the end of year 2012 the United States had the largest non-banking financial system, and it was followed by the euro area, then the United Kingdom and then Japan. United States share of non-banking financial system out of the 20 jurisdiction and the euro area showed an increase from 35% to 37% in 2011 and the United Kingdom share showed a decrease in its share from 14% to 12%. In India the shadow banking

system works as the Non-banking financial companies i.e. NBFCs, which is a very complex structure and has a high degree of interconnectedness with the traditional banks that operate in India.

**Table 52.1**

<i>Year</i>	<i>Percentage growth each year w.r.t previous year (%)</i>
1998-99	
1999-00	11.22943
2000-01	-5.931462
2001-02	5.843121
2002-03	-5.332262
2003-04	-13.1401
2004-05	9.919399
2005-06	5.069022026
2006-07	28.35465793
2007-08	53.5651
2008-09	3.441431
2009-10	22.15019
2010-11	11.90825

*Source:* India Stat.com

The major points about the growth of NBFCs are – that the financial companies showed substantial growth rates during the years of the financial crisis. This proved that these were less affected because of the U.S. subprime mortgage crisis of 2007. Shadow banking everywhere outside India declined during the crisis period. The total assets of Non-banking financial companies increased over the study period (1998-2010) at different rates annually. There was no uniform growth in the assets of NBFCs ever since the study period. The trend in annual growth rates with respect to previous year showed that there was negative growth in years 2000-01, 2002-03 & 2003-04. The substantial growth (annual growth with respect to previous year) was highest for 2007-08 and after this it was always a positive growth each year.

## 5. CONCLUSION

The trend of the growth of the total financial assets of NBFCs from the study points out that – there has been insignificant growth each year except for a few years. The probable reasons for insignificant is that, the shadow banks have to work under strict regulations in India & there is lack of support from the Reserve Bank of India. Internationally, shadow banking is growing substantially each year ever since the crisis and it works with all the freedom it requires and the support it needs. In India it must be supported by the Reserve Bank of India & should be allowed to function with some freedom to operate under proper monitoring so that it grows substantially each year because there is a huge amount of scope of the shadow banks. The shadow banks would help in improving the economy of India.

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