REGULATION OF SHADOW BANKING IN INDIA: WHAT CAN INDIA LEARN FROM OTHER NATIONS?

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ABSTRACT

The term 'shadow bank' was coined by Paul McCulley in 2007. Shadow banking involves credit intermediation involving entities (NBFCs), and activities (in whole or in part) outside of any country's regulated banking system. Although in the developed economies such as the US, shadow banks are quite complex and play a bigger role, it is increasing rapidly in the emerging economies as well.

Recent rapid rise of NBFCs in India is a cause of concern as despite heightened regulatory measures, they are still not at par with banks' supervision and regulation. Additionally, the crisis of the NBFCs triggered by the liquidity problems of IL&FS in 2018 has brought back the attention to shadow banking sector. It is important for India to regulate the functioning of its shadow banks in time if it wants to lead the race among emerging economies of the world.

The aim of this article is to delve deeper into the regulations governing Shadow Banking. Firstly, this article deals with the circumstances and mechanisms that lead to the emergence and expansion of shadow banking, and its effect on traditional banks. Secondly, it looks at the cross-country regulation of shadow banks. And finally, it explores the regulation of shadow banking in India and what India can learn from the other nations to prevent a crisis like situation in the future.

Keywords: Shadow Banking, Cross-Border Regulation, FSB, RBI, India

INTRODUCTION

Financial markets depend not only on credit expansion within formal, regulated banking networks, but also within unregulated, or shadowed, banks. Shadow banks operate outside the control of the monetary authorities, unlike regular banks.

While lending and borrowing decisions are subject to systemic and unquantifiable risks, unregulated banks ' transactions can further escalate these risks by finding new risk types inside informal credit networks. Because these networks also lead to excess risks for lenders when providing additional credit, additional charges are imposed on the borrowers. Thus, the trend of these credit networks emerges, especially in developing countries where large sections of borrowers cannot afford the high cost of such loans.

In the developing area unregulated banks have two versions. The first group offers credit to the population in the informal sector (often financially excluded) that is typically onerous terms. The second type of shadow banks, called Non-Banking Financial Companies (NBFCs), usually deal with the formal market, both in terms of their general clientele and in particular with regular banks as major providers of funds. These often rely on public deposits, bond-floating on the market and regular bank borrowing. Much of these funds go into high-risk activities. The two versions, which tend to various sectors of the economy, play tasks and entail very different risks.

Shadow banking plays a gainful role in credit distribution and financial inclusion in the developing economies such as India. They play both a replacement and a complementary role for commercial banks, as they are able to meet borrowers ' needs outside of the regulated banking system's overview. Shadow banking, however, is becoming very dangerous because it exists outside of the formal banking system and financial intermediation practices are conducted with less transparency and supervision than traditional banking. It allows the financial system to grow up to a certain level; but beyond that, it may prove risky.

DEFINITION

The term ' shadow banking ' is widely attributed to Paul McCulley, economist and investment manager, who used it to refer to 'the whole alphabet soup of levered up non-bank investment conduits, vehicles, and structures'.[i] Shadow banking has been redefined and extended by various commentators thereafter. Many have found the term synonymous with 'market-based finance' or 'market-based credit'. Supporters of the shadow banking system often prefer these terms to 'shadow banking', which they view as pejorative; to operate in the shadows clearly implies inappropriate behaviour. As will be discussed below, the FSB nevertheless uses the term 'shadow banking' and defines it as 'credit intermediation involving entities and activities outside the regular banking system'.[ii]

While there are various analogies between shadow banking and conventional banking, shadow banking lacks the regulatory backstops to help traditional banks and reduce the risk of runs: deposit insurance and access to central bank finance to ensure liquidity. While this government support will ease nervous bank investors ' fears and prevent massive withdrawals, the shadow banking system, which has no lender of last resort, currently has no such backstops. During the financial crisis of 2008, the result was uncertainty that eventually forced governments to extend central bank support to those non-bank entities, particularly MMFs.

The Financial Stability Board (FSB) has created a shadow banking concept which is widely adopted. The FSB describes shadow banking as "credit intermediation involving entities and activities outside the regular banking system".[iii] The broad definition that includes organizations that do not constitute a systemic risk and therefore the FSB has proposed to further narrow down the definition. Shadow banking does not include all forms of non-bank credit intermediation, as might appear from the above description. Only non-banks that generate bank-like risks through excessive leverage, maturity and transformation of liquidity, and (possibly flawed) transfer of credit risk, qualify as shadow banks because they present risks to financial stability. Also included in the narrower shadow banking category of the FSB are non-bank entities which undermine the stabilizing efforts of bank regulators by engaging in regulatory arbitrage[iv].

CURRENT SCENARIO

There is still no consistent and commonly agreed definition of shadow banking[v], and debates are underway on whether the term extends to certain organizations, such as credit hedge funds and exchange-traded funds[vi]. Nevertheless, the use of the term usually refers to market-funded collateral intermediation activities where deposit-like securities are provided by an individual or a chain of specialized entities to finance financial and non-financial credit extension[vii].

Defining the shadow banking phenomenon has proven difficult because the term seeks to encompass a wide array of institutions and practices that are constantly evolving in response to regulatory change and financial innovation, and that differ across jurisdictions. It is exceedingly difficult to describe a full set of characteristics that can relate to past, current and future shadow banking roles. Such practices are the focus of shadow banking public and academic discourse, and have drawn regulators and policymakers' attention.

Originally, the term was used to characterize credit intermediation[viii] dependent on securitisation, but has now come to represent various entities and activities. There is a need to employ alternative concepts like market-based financing or emerging business financing instead.[ix] The word "shadow banking" has been considered too pejorative to define such an integral part of the financial system, as this section of the financial industry may seem to be inherently opaque and dangerous.

Shadow banks are trying to make free, short-term, and liquid money-like statements that mimic bank deposits, while being largely or entirely dependent on market financing and lacking access to the public safety net.[x] Therefore, the shadow banking system is still vulnerable to modern-day variations of bank runs, like those witnessed during the financial crisis.

Thus, shadow banking activities include[xi]:-

- Credit intermediation – Any kind of lending activity including at least one intermediary between the saver and the borrower
- Liquidity transformation – Usage of short-term debts like deposits or cash-like liabilities to finance long-term investments like loans.
- Maturity transformation – Using short-term liabilities to fund investment in long-term assets.

CONDITIONS CONDUCIVE TO SHADOW BANKING

According to a report by the Financial Stability Board[xii], the prevalence of the following conditions spurs the growth of institutions engaging in shadow banking activities: -

- Stringent banking rules coupled with low real rates of interest and yield rates
- Existence of a large number of investors in search of greater returns
- Huge demand for assets from institutions

THE GROWTH OF THE SHADOW BANKING SYSTEM

Traditional banks make these short-term deposits, investing the money in long-term assets like loans, rentals, and mortgages. Pozsar defines the functioning of the shadow banking system as structured around wholesale financing by depositing like instruments and long-term asset securitisation.[xiii] Loans, rentals, and mortgages are securitized in the shadow banking system, and thus become tradable instruments. Funding also takes the form of tradable instruments, for example commercial paper and repo. Savers keep interest in the money market, rather than conventional deposits.

There are two reasons on the scale of the bid why financial institutions are involved in shadow banking. The first explanation for this is the banks side quest for yield. Over the past 30 years, the banks substituted deposits for fee-based wholesale funding as competition in the banking industry increased. Pozsar argues that this mechanism has transformed banks from low-return on-equity (RoE) utilities that originate and hold loans and finance them before deposit maturity to high ROE organizations that originate loans for the purpose of warehousing and then securitizing and distributing them or holding securitized loans through off-balance sheet vehicles.[xiv]

A second reason, however, why institutions participate in shadow banking involves attempting to escape bank regulation and capital requirements in particular. Using structured finance instruments and financial holding companies, banks were able to expand their leverage, which boosted their expected returns and also their overall risk exposure. However, this tendency was compounded by the weak monitoring incentives offered in the latest originate-to-distribute model during the origination process and the skewed incentives created by the framework for rating agencies, which had to verify the standard of the securities used as collateral.

BENEFITS OF SHADOW BANKING

There is no question that shadow banking is a pejorative term, suggesting that such agents pose significant risks to a monetary system as they function outside an appropriate oversight spotlight. The derogatory connotation, however, disregards the system's important benefits.

- **i.** Additional source of funding and liquidity
- **ii.** Risk diversification
- **iii.** Efficient resource channelling

RISKS OF SHADOW BANKING

These shadow banking advantages should not be overemphasised. Until 2008, each of the above examples was considered relatively safe but the financial crisis revealed the hidden costs associated with each of the above-mentioned benefits.[xv] As Adair Turner observed, 'the program may seem to offer combinations of lower risk, higher return, and higher liquidity that cannot be maintained objectively in the long run for a period of time.' [xvi]

- **i.** Risk of runs
- **ii.** Financial stability and systemic risk issues
- **iii.** Regulatory arbitrage spread across geographic jurisdictions
- **iv.** Monetary policy challenges
- v. Pro-cyclicity and business cycle amplification

DIFFERENCES BETWEEN SHADOW BANKS AND TRADITIONAL BANKS

- Shadow banks cannot create money unlike commercial banks, which by virtue of being depository institutions can do so
- Banks are comprehensively and tightly regulated, whereas shadow banks lacks regulatory oversight and transparency with respect to its business operations
- Commercial banks raise funds through mobilization of public deposits to a large extent. Shadow banks, on the other hand, raise funds mostly through market-based instruments such as commercial paper, debentures, or other such structured credit instruments

- While the liabilities of the shadow banks are uninsured, commercial banks' deposits enjoy Government guarantee to a limited extent generally
- During times of distress, banks have access to multiple recourses set up by the body responsible for regulatory oversight such as direct access to central bank liquidity etc. However, shadow banks do not have any such options, and therefore have to work for themselves.

CROSS COUNTRY REGULATION OF SHADOW BANKS

Shadow banking institutions exploit the inefficiencies of the prevailing economic structure through financial developments. The sub-prime crisis, however, revealed the extent of the damage that uncontrolled banking practices can cause. The crisis and the resulting recession sparked a global demand for increased market regulation.[xvii]

In 2010 the USA passed the Dodd-Frank Act to improve the Federal Reserve's weapons and control all systemically important institutions.[xviii] The EU (European Union) also has some measures in place to control securitisation and credit rating agencies. Also, the Financial Security Board (FSB), at the specific request of G-20 countries, has been working towards 'strengthening the oversight and regulation of the shadow banking system so that the risks emanating from them may be mitigated.'[xix] India is also working to improve the regulatory framework in order to curb shadow banking activities that endanger financial stability.

Thus, the cross-country perspective can be summarized as under:

- **Post-Crisis Growth Tailwinds**: Global post-crisis shadow banking growth has been driven by increased banking regulation, low interest rates, a generally beneficial economic context, growing financial technology, and increasingly supporting government policies to promote economic development and availability of credit.
- **U.S. Has Largest, but Declining Share**: According to the FSB, the US is home to the world's largest shadow banking market, totalling $14.9 trillion as of YE17. That being said, U.S. shadow banking assets have only risen at a compound annual growth rate (CAGR) of 0.8 per cent since YE10, compared to an 8.3 per cent global CAGR. This can be explained by the relative maturity of the U.S. shadow banking industry versus global peers, the decline in some pre-crisis shadow banking operations, and/or some

previous domestic activities going offshore. As a result of slowing growth in domestic shadow banking, the U.S. share of global shadow banking assets dropped from 47.6 per cent to 28.9 percent as of YE17 as of YE10.

- **Market Development and Tax Status Drive Size**: There is usually a high correlation between the size of the shadow banking assets of a given country and the overall development of the financial markets. Attributes such as deep / liquid capital markets, regularly implemented financial regulations, and well-defined creditor protections can be more supportive of non-bank financial intermediation development. More favourable tax regimes also tend to attract more shadow banking assets including the Cayman Islands (10.4% of global shadow banking assets as at YE17), Luxembourg (6.9%) and Ireland (5.4%).
- **Generally Low, But Rapidly Growing Emerging Markets**: Shadow banking growth rates in emerging market economies were higher than established peers, driven primarily by country-specific market development and the fact that those countries began from smaller absolute asset bases. China is the only country among emerging market economies that is big, both in terms of the notional size of its shadow banking assets and the pace at which those assets are rising.

CHALLENGES FACED BY REGULATING AGENCIES IN MONITORING OF SHADOW BANKS

Although its risks have been highlighted late, even in the late 1950s shadow banks were in existence. The importance and prevalence rate grew and fell as the banking system's position fell and went up in a country. The other dropped as one rose, and vice-versa. Hence, controlling a phenomenon that has existed for decades and weathered many a storm is a challenge in itself.

Regulating authorities have difficulties in reliably assessing the extent of shadow banking, as they are constantly evolving to find loopholes in the regulatory framework. On the domestic level, there is hardly any reliable statistics available regarding the nature of shadow banking institutions, their resources and their activities.[xx]

REASONS FOR REGULATING SHADOW BANKING

Before looking into the specific details of the proposed regulation, we should take a step-bank and ask if there is a need to adjust the regulatory framework of shadow banking operations. There are two explanations why they might need to control shadow banking:

- The first explanation is the prospect of using the shadow banking system as a way to avoid supervision and to do things that could be done under the conventional regulated system, thus increasing the likelihood of systemic occurrences. Before the recession, for example, several commercial banks developed special investment vehicles and conduits to buy the bank's long-term assets and fund the acquisition by issuing short-term asset-backed business paper (ABCP). Nonetheless, when required to pay off maturing ABCP, conduits sponsors (commercial banks) offer a guarantee to foreign investors in these conduits. Therefore, there was no clear shift of risk, but the assets did not appear on the balance sheet of the bank, enabling the bank to surpass leverage and to avoid capital regulations. Regulation in these cases is easy, since these activities should be integrated into the traditional banking system balance sheet.
- The second reason for regulating is that activities unique to the shadow banking system include high leverage and maturity, liquidity and credit transition, and thus make the shadow banking system vulnerable to panic and systemic incidents, just as the traditional banking system does. Of example, the "repo" acts as a deposit of institutional investors, in which there is no deposit insurance but an implied guarantee comes from the high liquidity of the collateral securities used. A panic will occur in this market if those securities ' credit rating adjustments unexpectedly occur. According to Gordon a wholesale banking panic in the shadow banking system triggered the current financial crisis in August 2007.[xxi] Problems with subprime lending became evident and investors could not determine their counterparties ' exposure to this problem and their solvency due to asymmetric information. Therefore, financial firms "runned" on other financial firms to withdraw cash from MMF and/or not to renew repo agreements or to raise the margin of repo ("haircut"). This forced major deleveraging and triggered insolvent banking system. The most complicated and fascinating is the possible control of this type of problem which is addressed below.

REGULATION OF SHADOW BANKS IN INDIA

Shadow banking in India goes by the name of non-banking financial companies (NBFC), which are a special category of companies whose activities include receiving loans, acquisition of stocks and shares, lease, hire purchase, insurance, chit funds, collective investment schemes, etc., registered under the Companies Act, 2013.

The reason NBFCs are encouraged is because they are becoming an alternative to banking and other financial institutions and their main business operation is to raise capital from public investors and depositors, and the same money can be offered to borrowers as per RBI's rules and regulations.

Given the nature of their operations, NBFCs also carry inherent risks including, excess leverage, amplification of pro-cyclicality and over-reliance on wholesale funding.[xxii] Given their exposure to niche segments, they may also suffer from concentration of risks. They are often not allowed the benefit from the central bank as lender of last resort and from deposits insurance institutions. The specific regulatory requirements for NBFCs are as follows:

- Registration: The Reserve Bank of India controls the registration of NBFCs in India. Though NBFCs do not have a banking license, they are still bound to follow the RBI rules and regulations, as RBI regulates all of India's institutions' banking and related financial activities. Section 45 IA of the Reserve Bank of India Act, 1934 (RBI Act) mandates the registration and net owned fund provisions of non-bank financial firms engaged in the acquisition of shares, commodities, bonds, debentures or securities issued by government or local authorities or other marketable securities or instruments. The Registration Certificate has to be obtained from Reserve Bank of India by the said NBFC.
- Minimum Net Owned Funds: In addition, a mandated minimum net owned fund requirement of INR 25.00 lakh not exceeding INR 200.00 lakh is enforced.
- Public Deposits: NBFCs that accept and renew public deposits up to a maximum duration of 60 months for a minimum of 12 months. Nonetheless, NBFCs cannot accept deposits due on request.

- Restrictions: NBFCs cannot give the depositors and creditors any gifts and bonuses or any other additional benefits. NBFCs may also offer interest rates which are not higher than the ceiling rate recommended by RBI.
- Credit rating: It is necessary to take up a minimum credit rating of investment grade.

CHALLENGES POSED BY SHADOW BANKS/NBFCS IN THE INDIAN CONTEXT

RBI has several responsibilities such as addressing the threats to financial stability posed by shadow banks, addressing the interests of depositors and consumers, addressing regulatory arbitration and also helping the financial sector to expand healthily and efficiently.[xxiii]

RBI faces various challenges related to the law such as dealing with different organizations that are: -

a. registered as finance companies, but do not come under the regulatory supervision of the RBI;
b. unincorporated bodies who undertake financial activities and remain unregulated;
c. incorporated companies and unincorporated entities illegally accepting deposits;
d. entities camouflaging deposits in some other names and thus illegally accepting deposits.

The truth is that the legislation is ill-equipped to deal with such revolutionary initiatives that are manipulating the existing legal framework. Suitable changes to the constitutional regulations need to be made.

Shadow banking organizations, especially unincorporated ones, can spring up anywhere and operate with impunity. Therefore, a mechanism for successful market analysis can be put in place to capture such action against such companies as soon as possible in order to secure consumer interests.

AN ANALYSIS OF THE IL&FS CRISIS

The recent Infrastructure Leasing and Financial Services (IL&FS) debt default in September 2018 was an eye opener on the financial risks relevant to the Indian NBFC market. The debt crisis has generated a credit crunch and has affected important financial sectors such as real estate and infrastructure, which rely heavily on NBFCs to fund and expand. The exposure of NBFCs to real estate developers has been measured at about INR 2.00 Lakh Crore, according to the Credit Suisse October 2018 Survey[xxiv]. The recession has also led to a decline in the index of real estate stocks and a decrease in the benchmark index during the same period as well. According to the latest financial stability reports from RBI, the share of NBFCs in total extended credit has risen from about 9.4 per cent in March 2009 to over 17 per cent by March 2018[xxv].

It may be pertinent to note that the IMF warned about the systemic risks associated with shadow banking activities in relation to NBFCs operating as lenders through the Global Financial Stability Report. These threats will easily get into banks, sooner or later causing a major havoc. A specific alert is important for India based on the large size of India's shadow banking sector as compared with many other economies, according to FSB estimates[xxvi]. As of 2018, RBI estimated that around 99.7 per cent of shadow banking in India involves creating long-term loans against short-term funding, which is mainly the NBFC and Housing Finance Companies (HFCs) strong in India. Certain prominent shadow banking institutions in India include institutional investment management firms, money market funds, fixed income funds, real estate funds and mixed funds, as well as shadow banking.

IL&FS defaulted on certain payments and failed to deliver commercial papers on September 2018's due date, which simply stated that IL&FS faced a liquidity crunch or was out of cash. The first shock came in March 2018 when the firm delayed the issuance of USD 350.00 million bonds due to demand from investors for a higher yield. Another explanation for the crisis is the recent downturn in infrastructure projects and conflicts over government-due contracts that lock around INR 9000 crore of payments.

The National Company Law Tribunal (NCLT) has recently said that a single solution to the IL&FS crisis and its INR 91,000.00 crore debt cannot be sought. The Uday Kotak-led NCLT Board announced that there is no possibility of involving significant capital injection from credible and financially sound investors. The resolution stipulates that investors will communicate with creditors together with the new board, resulting in an overall settlement across the IL&FS community[xxvii]. The only options available were hiving off and selling entire business verticals to willing buyers and failing to do so, aiming for asset level resolution through asset by asset solution pursued by various methods such as massive capital injection, asset monetization to withdraw debt and creditors resolution.

CONCLUSION AND SUGGESTIONS

Although 'shadow banking' has only recently come to the forefront of regulatory and policy discourse in its current form, bank-like entities outside the regulated banking system aren't fresh. Rather, regulations are a natural, and potentially beneficial, result. The regulatory body has, however, too readily refused to regulate prudential banks for' shadow banks.' At the same time, there is a move to restrict commercial banks ' exposure from organizations and activities that do not participate in' traditional' banking activities.

Underlying these attempts is an obsolete, dichotomous view of the financial world; organizations and actions either operate as banks and ought to be subject to banking laws (and in the United States, regulated by a banking regulator), or are non-bank institutions and should be distinguished from traditional banks. Such a perception is obsolete within an increasingly complex financial system. The planet doesn't consist solely of banks and non-banks. The shadow banking system isn't universal, but companies that have bank-like features now exist. So, we need to look beyond legal labelling and prioritize risk-generating behaviours.

By complex, pragmatic policies that try to preserve the advantages of shadow banking while targeting specific activities, however, we may alter the distribution and risk character of banks and non-banks. When done carefully, we can create a financial system that is both flexible and robust, with a thorough use of the various tools available to both government and industry.

While RBI regulates NBFCs in India, and the Securities Exchange Board of India (SEBI) regulates other special classes of shadow banking such as joint investment firms, mutual funds, and other securities-related entities, the IL&FS crisis has raised doubts about India's watertight regulatory system to prevent such future crises. With the NCLT entering into the legal framework for further damage control due to shadow banking crises, the mechanism has been given an extra backbone at any time in the near future to shield the economy from a 2008-like financial crash.

POTENTIAL REGULATORY STRATEGIES

In the case of shadow banking system-specific activities, the regulatory objective should be to try to prevent systemic crisis and financial crisis pro-cyclicality without increasing costs in normal time.

Therefore, we can use four basic types of regulation if we want to avoid systemic crisis:

a. Regulation which restricts the deposit liquidity as instruments. Policy options include refund fees or windows, suspension of convertibility, overhaul of bankruptcy laws to limit repos to “automatic stay” rules[xxviii].

b. Regulation restricting the use of deposit as tools for funding long-term investments. Potential regulations include capital requirements, limits on the use of company assets, and liquidity conditions, such as liability maturities laddering.

c. Regulation reducing asymmetric details regarding the quality of the deposit-backed properties. Here we can differentiate between two different types of regulation, which can be used in his context to minimize asymmetric information:

   i. Second, asymmetric information can be minimized by placing restrictions on the types of these financial institutions ' portfolios, such as limits on asset maturity, limits on asset allocation, limits on non-secondary market assets, and liquidity buffers, and constraints on asset types that can be used as leverage.
   ii. A second way to reduce symmetrical details is to enhance the risk assessment of the assets used through programs such as the use of coinsurance and deductibles levied on investors seeking credit default insurance and laws adjusting credit rating agency (CRA) incentives[xxix].

d. Regulation for tackling structural crisis once it happens. But good regulation will unlikely avoid all systemic crises. As part of the regulatory efforts should be directed at developing the best policies for coping with the crisis once it arises, helping to recover the system's solvency rapidly and without externalities being placed on third parties. The solution to the current crisis has essentially fallen on uninformed taxpayers with very little active involvement in the shadow banking system, and has undermined the regulator's reputation in not bailing out institutions that "mismanage."

Hence good resolution mechanisms are very important to design. Such strategies can both minimize structural crisis costs as they arise, and reduce the likelihood of their occurrence by adjusting the institutions ' incentives to over-leverage. Such resolution strategies may include the use of contingent capital, the use of convertible debt to remunerate financial institution managers and the creation for financial institutions of special bankruptcy procedures that turn debt into equity using options.

Thus, Shadow banking is an alternative to the banking system, and if appropriate regulatory measures are taken, the future of financial growth will easily depend on shadow banking at a time when there is a cash shortage in the banking sector or other financial sectors.

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[xiv] Stijn Claessens, Zoltan Pozsar, Lev Ratnovski, and Manmohan Singh, *Shadow Banking: Economics and Policy*, IMF Staff Discussion Note (December 4, 2012) SDN/12/12.

[xv] For example, the susceptibility of money market funds to runs, the complexity and uncertainty arising from securities lending in times of crisis, and the perverse incentives and regulatory arbitrage associated with securitization techniques.

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[xxix] Interestingly the FSB is silent about the regulation of CRAS because they are not considered financial institutions.