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Stern Banking Regulations- A Stimulus for Shadow Banking in India

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Abstract:

Shadow banking can be termed as intermediation of the financial institutions that help in creating the credit across the global financial institutions, but the members involved are not subject to the regulatory oversight. In layman's language it means unregulated activities done by the regulatory institutions. Here the financial institutions involved do not take the deposits in the traditional manner. This paper seeks to examine the current trend in banking and financial sector; namely Shadow banking, the rationale for its emergence and its impact on the Indian Economy. The authors conclude that excessive stringent regulations on the commercial banks will result in the excessive creation of shadow banking systems which comes with its own perils.

Keywords: Shadow banking, financial intermediaries and financial systems.

1. Introduction

The Banking and Financial systems across the world are changing with a great pace. One such evolutionary change is emergence of financial intermediary systems termed as "Shadow Banking" system. The "Shadow Banking" includes all forms of financing that are not regulated by banking regulations. Shadow Banking encompasses structured finance and securitization, in which financing is indirectly raised by Special Purpose Entities ("SPEs") created by commercial banks. It also includes financing and financial services provided by other non-bank financial intermediaries—such as Finance Companies, Hedge Funds, Money-Market Mutual Funds, Real Estate Investment Trusts ("REITs"), Securities Lenders Engaging in Repo Lending, And Investment Banks.

2. Evolution of Shadow Banks

The transformation of claims over fundamentally illiquid assets into claims that are highly liquid is one of the critical functions of a commercial Bank. For e.g. the holder of a call deposit has a completely liquid claim on the bank – the full value of the deposit can be withdrawn at any time. So far deposits are primarily invested in assets, namely bank loans, which, typically, are not particularly liquid and have long maturities. And, in turn, these bank loans fund the creation of real assets in the economy, which themselves are also not particularly liquid. This function of a commercial bank is referred to as Maturity Transforming. If such transformation does not happen the economic development of the country would be stagnant. Though this is an important function, there lies a discrepancy that the depositors usually prefer their deposits to be of a shorter maturity period than borrowers, who typically require loans for long term investments.

Banks overcome this incongruity by playing on the fact that only limited number of depositors have liquidity needs at a given time. Therefore, the commercial banks can maintain a small fraction of its deposits in the form of liquid assets which are easily convertible to cash and lend the balance as long term loans. This function is also known as Qualitative Asset Transformation because, by changing the maturity of its assets, the bank also changes their liquidity. However, by performing this function, a bank is essentially exposed to a risk. The risk comes from the fact that even a healthy bank can be the victim of a liquidity crises. If all depositors demand their deposits back, the bank would have to liquidate all its assets (even those that are not liquid) to fulfill depositors' demands. Such distress sell cannot happen without suffering a loss in value, a problem of illiquidity can therefore turn into a problem of insolvency and the collapse of the bank. Even at the smallest hint of bad news depositors start withdrawing all their funds from the bank. Such liquidity crises usually multiply in geometric progression whereby the insolvency of one bank leads to prediction of failure of the entire banking system of the economy.

Given their inherent risk of instability, it is mandatory for banks are required follow the Basel norms. Basel accord mainly focus on risks to banks and the financial system. The purpose of the accord is to ensure that financial institutions have enough capital on account to meet obligations and absorb unexpected losses.

The Basel requirements further require banks to hold significantly higher capital for increased riskiness of loans (assets) on their balance sheet—known as a risk-weighted capital adequacy requirement. Raising such capital is a costly affair for most of the banks and thereby such banks find out ways to escape from maintaining such capital.

Many commercial banks therefore create special purpose entities to hold these risky assets (loans) and thereby reduce the capital adequacy norms laid by the central Bank. One such practice is the creation of off-balance-sheet entities to host some of the banks' assets and, thereby, reduce their regulatory capital requirements. Economist Paul McCulley, coined the name "shadow bank" for describing such SPE's created by the banks to sell the risky loans repackaged as Bonds. In other words, we can define Shadow Banking as "the financial intermediaries involved in facilitation of the credit across the global financial system, but the members involved are not subject to the regulatory system. It refers to the unregulated activities that are done by the regulated authorities". In general terms the shadow banking system is a financial system that does not accept the deposits from the customers in the traditional sense. These system includes certain entities that cover the entire shadow banking system. These entities include the Hedge Funds, Special purpose entities, structured Investments cycle and mutual funds. These banks do borrow funds and also accept the money from the customers in a way that they are not subject to the governmental regulations. These banks work as an intermediary between the large borrowers and large lenders. They earn the major revenue from the interest rates that is spread on the investments borrowed or lent. This type of system is very complex as it involves certain important task or activities like Derivatives, Asset Backed- Securities, Purchase Agreements, and Credit Default Swaps (CDS). This type of financial system has gained the importance and strictness since the Financial Meltdown in year 2008. As they follow different method in collection of the deposits, they are not subject to the same banking regulations prevailing to the commercial banks. It caters to more of the risk factor involvement.

In modern times this term is related to include all financial intermediaries that perform functions of a bank but are not regulated by the Banking Regulations. These include mobile wallets, crowd-funding websites, hedge funds and bond-trading platforms. The major players are the Asset management companies and Investment funds. To quote the 'The Economist' dated 1s February, 2016 "in 2013 investment funds that make such loans raised a whopping \$97 billion worldwide. Globally, between 2007 and 2012, firms thus raised \$1.7 trillion by issuing corporate bonds. Money-market funds that invest in short term securities like US treasury bills have taken off too. In China alone, they grew six times to 2.2 trillion Yuan (\$341 billion) between mid-2013 and December 2015. In December they hit a sweet spot when Federal Reserve hiked interest rates for the first time in nearly ten years. The Financial Stability Board, an international watchdog estimates that globally, the informal lending sector serviced assets worth \$80 trillion in 2014 up from \$26 trillion more than a decade earlier."

2.1. Rationale for Shadow Banking System

For example, concentration risk can be mitigated by spreading the risk across many parties. In addition, mismatches on the balance sheet – such as differing maturities and currencies – can be reduced through the improved matching of exposures and commitments. There is also more scope for specialization and benefits of scale, because different institutions focus primarily on a specific part of the intermediation process.

2.2. Perils of Shadow Banking

2.2.1. Financial Stability and Systematic Risk Concerns

Since these shadow banks do not have any specific regulations to be followed under central authority of the finance, they act as an escape to the regulatory oversights. At times, the banks take help of these shadow banks in conducting the financial activities and also they may invest in the financial products that are issued by them. Also these entities are vulnerable to the shocks, as they stand apart from the regulations of the central authority. Thus, they also pave a way for systematic risk in the economy.

2.2.2. Regulatory Arbitrage Spread across the Geographical Jurisdiction

If we see the rules that one geographical region follows, is quite different from that of the other. Example is the taxation policy that prevails in the different geographical regions. The geographically frame-worked jurisdiction pose a handicap on curbing the shadow banking activities. Due to these reasons, there can be adverse impact of the financial stability as it is wholly interconnected and integrated.

2.2.3. Challenges in Conduct of the Monetary Policy

The interconnected amongst the commercial banks and the shadow banks have paved a way to create underestimation of the monetary policy of the economy. There is lack of clarity on the activities that are done by the shadow banks and the commercial banks thereby engaged with same. Thus they lack the purview in the involvement in the financial system. Thus these act as an impediment to successful implementation of the monetary policy that immunizes the central banking authority.

2.2.4. Pro-Cyclicality and Amplification of Business Cycles

Pro-cyclicality refers to having a hand-in-hand impact on the movement in the economy. That is if there is an economic boom in the economy, the activities of the shadow banks will increase and if there is downturn, the activities will shrink. The interconnected of the commercial banks with the shadow banks have heighten the risk of assets price.

2.3. Prevalence of Shadow Banking

The term shadow banking has got its presence in all the countries may it be developed or underdeveloped. It's just the functions that differ in each of the economy. For the developed economy, the system acts as a medium to change the risk into securitization. For

those underdeveloped it acts as the supplementary to the traditional banking system. As said by the Financial Stability Board, these shadow banking systems spur the growth of the institutions that conduct these functions: -

- i. Strict banking rules with low interest rates and yield rates.
- ii. A big chunk of investors that want to earn higher returns.
- iii. Growing demand for the assets from these institutions.

2.4. Rise of Shadow Banking in India

When there was Global Financial Crisis in the world, 2008, India too had an impact of the same on the economy. The financial products of banks were at the risk. Therefore, in order to tackle this particular situation of crisis, the term shadow banking was coined. As per the definition of the shadow banking system, the intermediaries are act as credit giving entities that provide credit all across the globe. Though these entities are not registered, they do the activities that are regulatory in nature. They conduct all banking activities. It does not collect deposits like the traditional banks. Shadow banking has got an ability within itself to lower the transaction costs of the operations, make quick decision, be customer oriented and create quick provisions for the services. It acts as a medium through which one could get access to the financial services and also expand the scope of competition in the financial sector. Along with the shadow banking system, the NBFC's too have gained a major importance for the activities that are done by them. The NBFC's prevailing in the country act as the complement to the banking system in the economy. These NBFC's have tried to reach out to the niche areas of the financial constitution and have tried to provide finance to the people who are in the need. Not only these financing entities but also some other entities like mutual funds, insurance etc. have emerged as the substitution to the financial institutions. They are acting as the alternatives to the existing banking system and thus catering to the needs of the people. Following Data shows the growth in the size of Shadow banking activities in India from the year 2010 to 2014

USD billion	Shadow banking
2010	289.8
2011	327.1
2012	342.6
2013	402.9
2014	403.2

Note: Economic function-based measure. Sources: National financial accounts data; other national sources; FSB calculations.

Table 1: Quantum of Shadow Banking Activities in India

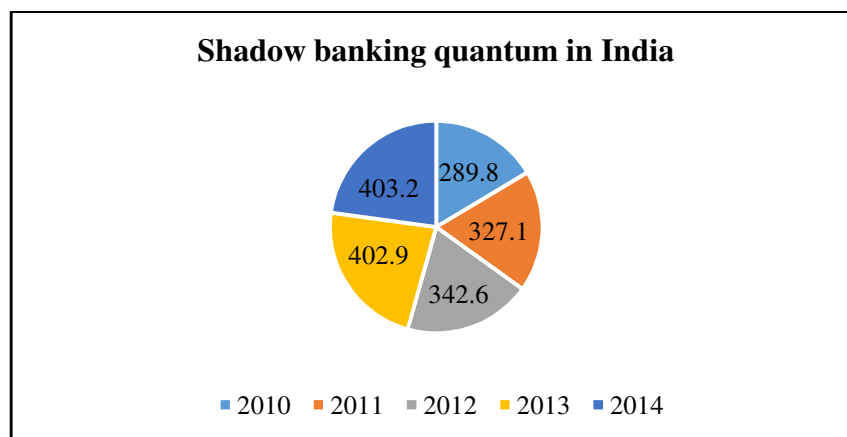


Figure 1: Quantum of Shadow Banking in India

Years	Banks	Other Financial Intermediaries (OFIs)	Shadow Banks
2010	1,501.3	276.5	289.8
2011	1,792.3	316.9	327.1
2012	1,794.5	316.4	342.6
2013	1,922.1	349.3	402.9
2014	1,981.0	357.0	403.2

Table 2: Comparison of Assets of Banks, Financial Intermediaries and Shadow banks in India (USD billion)

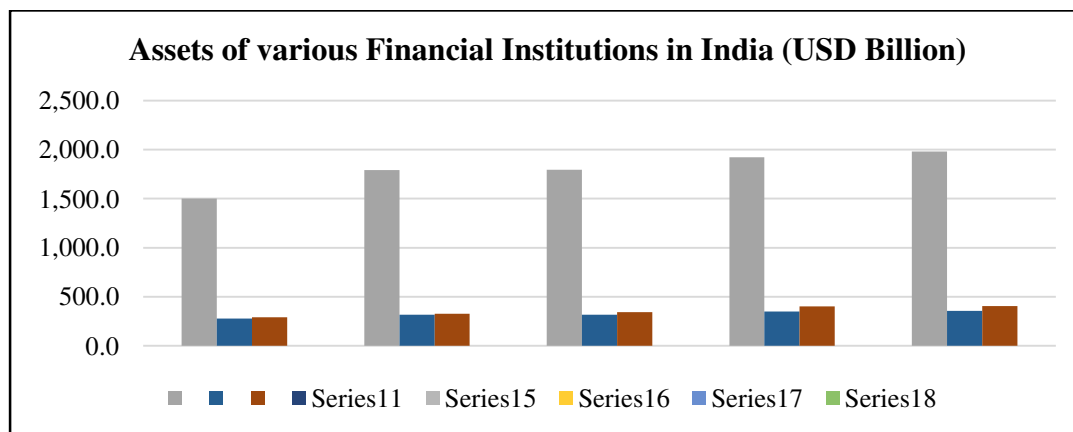


Figure 2: Comparison of Assets of Banks, Financial Intermediaries and Shadow banks in India (USD billion)

3. Challenges Offered by the Indian Shadow Banking System to the Regulators

RBI comes across various regulatory challenges while dealing with the financial intermediaries which perform the functions of finance companies, but do not come under the regulatory supervision of the RBI. The regulators are yet not well prepared to deal with such innovative measures. There is a need to bring in suitable amendments to the Banking & Financial Regulations. Shadow banking entities, especially those that are unincorporated can spring up anywhere and operate with freedom. Therefore, there is a need to put in place a structure for effective market intelligence gathering to that action may be taken as soon as possible against such entities to secure interests of consumers. There is a multiplicity of agencies involved in regulating the non-banking financial activities of entities leading to major overlap. The central government ministries like Finance and Corporate Affairs, agencies like CBI and FIU-IND (Financial Intelligence Unit – India), regulatory agencies like the Reserve Bank, SEBI, the Registrar of Companies, state government agencies like the police and others are all entitled to work on different aspects involving NBFCs and other shadow banks. These agencies have to share information and coordinate and cooperate to bring in an effective, timely and unified enforcement of the law. To overcome this hurdle, RBI is strengthening its State Level Coordination Committees (SLCC) and is considering setting up of National Level Coordination Committee is also being considered.

4. Conclusion

Shadow banks, help to bring in innovation in the economic system by eradicating the inefficiencies that exist. Due to the financial crisis of the 2008, the regulations on the activities of the banks increased and thus became more stringent. The banking regulation act of India, passed a rule that showed more strictness to be observed on the activities that were being done by shadow banks. Also the Financial Stability Board interfered and demanded for the immediate application of these rules and regulations on the shadow banks. All these regulations pondered upon increasing the capital adequacy and margin requirement norms of the commercial banks, thereby restricting their business opportunities. This was the root cause of the emergence of the Shadow Banking System. If the banking regulations continue to become more and more stringent the overall quantum of shadow banking system in the country will surely increase.

5. References

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