

The Shadow Banking Dilemma: A Critical Appraisal Of Its Effects In India

Amit Kumar*, Ramanjeet Singh**,
Pratibha Wasan ***

* Associate Professor, School of Commerce and management,
Om Sterling Global University, Hisar (Haryana),
India. E-Mail: hodscm@osgu.ac.in

** Dean, Planning and Corp. Affairs, Om Sterling Global
University, Hisar (Haryana), India. E-Mail: ramanjeet@osgu.ac.in

*** Research Scholar, School of Commerce and management,
Om Sterling Global University, Hisar (Haryana),
India. E-Mail: Pratibhamgt201@osgu.ac.in

ABSTRACT

The shadow banking system is a web of specialised financial institutions that channel funding from savers to investors through a range of securitisation and secured funding techniques. Although shadow banks the institutions that constitute the shadow banking system - conduct credit and maturity transformation similar to that of traditional banks, they do so without the direct and explicit public sources of liquidity. This Paper provides the empirical, theoretical and conceptual foundation for the study. The authors argue that shadow banking activities increase the probability of a crash in the economy. In spite of its critical function, the NBFC sector in India is plagued by the following issues: Expense of borrowing money, the sluggish expansion of industry, there is intense rivalry from non-bank financial institutions (NBFCs) and the banking industry, ineffective investments and inadequate recovery methods. With this study, we hope to learn more about the pervasive challenges faced by NBFCs and assess the state of their finances as a whole.

KEY WORDS: Shadow Banking, NBFC, Basel, Financial Stability.

Introduction

As a word, "Shadow bank" was first used in 2007 by Paul Mc.Culley. It occurs everywhere. Maturity transformations by nonbank financial firms in the United States are what this word refers to (i.e. use of short-term deposits to finance long-term loans). The Financial Stability Board (FSB) defines shadow banking as credit intermediation involving companies and activities (wholly or partially) outside of the traditional banking system. Non-bank financial institutions engage in shadow banking operations such as credit intermediation, liquidity transformation, and maturity extension. Shadow banking is mainly about risk transformation through securitization in developed nations, but in economically backward economies where the financial industry is still in its developmental stage, the activities are more of a supplement to banks. Significant shifts and increased rivalry have occurred in the financial services industry during the past two to three decades. Since this has occurred, traditional banks have turned to shadow banking practises. It became clear during the recent global financial crisis that shadow banking must be closely watched and regulated. There is a chance that shadow banking operations will rise as a result of the imminent implementation of Basel III standards.

Markets and institutions within the Shadow banking sector are incredibly varied. Money market funds, hedge funds, private equity, and SPEs are all possible areas of involvement. In light of potential regulatory gaps in the shadow banking system, the G20 leaders at the Seoul summit in November 2010 requested that the Financial Stability Board, in collaboration with other international standard setting bodies, develop recommendations to strengthen the oversight and regulation of the shadow banking system. As a result, in February 2013, the Financial Stability Board Regional Consultative Group for Asia (RCGA) created a working group on shadow banking to investigate and collect data on the subject. The group conducted research and produced a report on six aspects of Asian shadow banking: the makeup of NBFIs, the nature of their oversight, the members' definition of shadow banking, the differences between shadow banking and NBFIs, the risks posed by NBFIs in Asia, and the relevance of the Financial Stability Board's recommendations on shadow banking to the region.

It was discovered that NBFCs under India's legal framework

functioned as shadow banks. However, for the past half century, they've been subject to rules set by the Reserve Bank. Thus, it can be said that the risks associated with India's shadow banks are likewise unique. There are benefits to the shadow banking system. It's a new way to get cash in hand and a source of financial stability. There are non-bank businesses with particular skills that can perform certain activities in the loan intermediation chain more cheaply and efficiently than banks. However, due to its indirect and direct links to the traditional banking system, the shadow banking sector can pose a significant threat to the stability of the financial system as a whole. Since banks are a link in the shadow banking credit intermediation chain or offer support to shadow banking organisations, the risks in the shadow banking system can have an effect on the banking system. The longer and less transparent the chain is, the greater the potential for harm.

In this paper, we attempt to summarise the literature that provides the empirical, theoretical, and conceptual foundation for shadow banking research. To put the results into proper perspective, it is important to consider them in light of previous research and theory. One may use a literature review like the one presented here to detect holes in the empirical literature.

1. REVIEW OF LITERATURE

The problems that have already been addressed in the empirical and theoretical literature pertaining to the causes, extent, nature, and determinants of the phenomenon under inquiry are expected to be the primary focus of a literature review. At the same time, it has to reflect on the viewpoints, philosophies, and points of view used in the research and analysis of the aforementioned causes and problems, as well as the methods, tools, and procedures actually applied. To avoid being merely a survey of literature published on the in subject, a good review of literature should seek to thematically classify studies focusing on diverse issues related to the phenomenon under investigation and analyse the major findings that could be taken as extending the limits of our knowledge about the phenomenon. With these considerations in mind, this chapter tries to analyse the literature on the topic of performance evaluation of NBFCs in India. However, it is important to note that a doctoral thesis such as the one

being presented here, written within the constraints of time and resources, will not be able to do enough justice to the richness of the literature; consequently, only a small number of the most important studies made in the relevant literature and published are covered in the review of literature.

Table 1: - Review of Literature

S.No	AUTHOR	YEAR	FINDINGS OF THE STUDY
1	Arora and Kashiramka	2023	This research looks at 11 of the EMEs under the FSB's watchful eye to see what factors are driving the expansion of NBFIs and financing businesses in these regions. Utilizing data from 2002–2019 and the panel corrected standard errors (PCSE) approach, the authors found that the expansion of banks, the pursuit of yield, the demand of institutional investors, and banking rules were the primary influences on the expansion of non-bank financial institutions (NBFIs). Moreover, the paper details how various banking rules have affected NBFI expansion in EMEs. While capital controls tend to impede NBFI expansion, activity regulations and constraints on financial conglomerates actually helped the sector expand. Consequently, non-banks benefit from arbitrage opportunities brought about by strict banking laws.
2	Guo et al.	2023	Focusing on the entrusted loan market in China's shadow banking sector, this research analyses the efficacy of credit regulations that support SMEs. We use the data on entrusted loans from individual transactions to calculate an index of China's pro-SME credit policies, and we found that these policies have contributed to a decrease in both the total amount of entrusted loans and their interest rate. These finding suggests that small and medium-sized enterprises (SMEs) are borrowing less from the entrusted loan market as a result of credit policies encouraging banks to increase lending to SMEs. Window advice and facilitation measures, in particular, reduce SMEs' reliance on entrusted loans more than regulatory subsidies did. According to the results of the heterogeneity study, the pro-SME credit policies were most helpful to businesses that are not linked with lending institutions, were privately owned, and operated in the real estate and manufacturing sectors. Our findings indicated that assisting SMEs in gaining access to conventional banking credit is a viable strategy for reducing their reliance on the shadow banking sector.
3	Han et al.	2023	This article employs data from non-financial listed firms and empirical analysis to provide an answer to this topic for the period between 2007 and 2017. The study concludes that the likelihood of a stock market crash is increased in businesses that engaged in high-leverage, high-risk shadow banking activities. Neither state-owned businesses nor high-trust communities saw this effect to the same degree. The correlation between non-financial firms' shadow banking activities and the probability of a stock market crash strengthens as the degree of economic policy uncertainty rises. This is how the theory goes down, anyway: As policy uncertainty grew, bank loans, investor sensitivity to external information, risk contagion, and inefficient investment mechanisms all rise, amplifying the positive association between shadow banking operations of non-financial enterprises and stock price collapses. The

			study's findings hold up across a battery of robustness tests. The theoretical and policy guidance offered in this work was extremely relevant to the ongoing examination of the complex shadow banking system and the mitigation of systemic risks.
4	Quaglia and Spendzharova	2023	This paper demonstrates the unequal influence the EU has had inside the global regime complex of shadow banking. Why? Our goal was to provide light on why the European Union's (EU) power to influence the broader regime complex has fluctuated over time with respect to its ability to affect its component regimes, such as the regimes governing hedge funds and securitization. The European Union (EU) has tried to regulate hedge funds according to stricter international standards, but to no avail. The European Union has been more effective at the global level in advocating for less stringent regulation of securitization. As such, we zero in on the degree of internal cohesion inside the EU (a quantity that can itself evolve over time) as the primary variable through which to understand its performance.
5	Abad et al.	2022	This report offers a rare and comprehensive look at the asset exposures of European Union banks to shadow banking institutions across the international monetary system. We used a large and original dataset to demonstrate that 60% of EU banks' exposures are to entities outside the EU, most notably US-based shadow banking firms. We analysed shadow banking counterparty concentration levels across many categories. While individual banks may have diversified their risks, we show that there is substantial overlap between the many shadow banking institutions. The relationship between EU bank features and exposures to shadow banking firms is also investigated. Our findings highlighted the need to continue keeping tabs on these international and industry-spanning risks and filling in any remaining data gaps.
6	Pellegrini et al.	2022	Using the CoVaR method developed by Adrian and Brunnermeier, we analysed the relationship between the traits of various financial institutions and systemic risk (2016). Using data collected from 476 European financial institutions between 2006 and 2015, we compare and contrast the services offered by traditional banks with those of "shadow" firms like Money Market Funds and Finance Services. We found that the scale of Financial Services is insensitive to systemic risk, while the size of large financial institutions, especially Money Market Funds, greatly increased the risk. We also discover that the Financial Services industry is very delicate to market risk proxies. There is a strong correlation between the amount of systemic risk posed by conventional banks and their reliance on short-term wholesale finance.
7	Rottner	2022	In order to capture the observed dynamics and quantify the increase in financial fragility, I was motivated by the accumulation of shadow bank leverage leading up to the financial crisis of 2007-2008, and I developed a nonlinear

			macroeconomic model with excessive leverage accumulation and endogenous financial crises. To show how the economy is more susceptible to future financial crises as a result of excessive leverage in the shadow banking sector, I built a model to demonstrate this phenomenon. The model is applied to data from the United States with the hope of calculating and analysing the likelihood of a run in the years leading up to the financial crisis of 2007-2008. The model predicted a high likelihood of a run even back in 2005, and it only became worse as leverage rose. The estimated increase in financial fragility is analysed, and the impact of alternative monetary and macroprudential policy methods is evaluated using counterfactual scenarios.
8	Si and Li	2022	Using annual firm-level data from China between 2003 and 2019, this research investigated how non-financial companies' involvement in the shadow banking market affects their willingness to take risks. The results demonstrate that firms are much more willing to take risks while engaging in shadow banking activities. Moreover, enterprises with larger financing limitations and lower corporate governance, as well as during periods of lax monetary conditions and severe financial stress, are particularly vulnerable to the negative effects of their shadow banking activity on their risk-taking. As an added bonus, organisations' risk-taking can be influenced by shadow banking in three distinct ways: via an increase in commercial credit, a decline in primary business performance, and a deterioration in the quality of information disclosure. Our research shows that reducing organisations' exposure to the financial risks associated with shadow banking required stronger external oversight and better internal control.
9	Yang and Shen	2022	From 2008 to 2019, data on non-financial enterprises (non-FEs) listed on China's A-share market are used to experimentally examine the effect of the SBB of non-FEs on total factor productivity (TFP). Results demonstrate that SBB has a negative effect on TFP for non-FEs, with a 4.22% drop in TFP on average for every 10% rise in non-FEs' involvement in SBB. When there is less industry rivalry and businesses are not owned by the government, the impact was greater. It may be possible to lessen the impact by easing funding constraints, lowering knowledge asymmetry, and maximising the use of financial resources. Our research elucidates the molecular mechanism by which SBB limits TFP in non-FEs. These results enhanced the theoretical investigation of the two, while also providing empirical evidence to reduce the economy's "off real to virtual" shift and boost quality, longevity, and sustainability in economic growth.
10	Allen and Gu	2021	There has been a dramatic increase in China's shadow banking sector over the past decade, primarily as a result of banking rules, the Fiscal Stimulus Plan of 2008, and lending restrictions in certain industries. Even though regulators have often tried to put new controls on banks and nonbanks, this industry has remained growing. The high need for

			funding is met by the existence of shadow banking. The conventional wisdom holds that this threatened the economy's overall stability. The situation was different in China. Second-best arrangements for funding high-risk initiatives and boosting social welfare may come in the form of entrusted loans or implicit guarantees from nonbanks, banks, or the government.
11	Bao and Huang	2021	At COVID-19, researcher examined the lending practises of both traditional and fintech lenders. We found that at the beginning of the epidemic, fintech companies were more likely to increase credit access to new and financially constrained customers when compared to bank loan records across the sample. There were concerns that the boost in credit availability following the epidemic was not sustainable, as the delinquent rate for fintech loans triples while there was no discernible change in the delinquency rate for bank loans. Bank loans were given more priority by borrowers who had both forms of loans. Our findings illuminate the advantages of shadow banking during times of crisis while also hinting to the possible vulnerability of such organisations during periods of high delinquency.
12	Deng et al.	2021	The results of this research into the impact of CEO salary deferral rules on inside debt in the shadow banking system are presented. We built a simple model to demonstrate the correlation between rising levels of bank-issued debt and the expansion of the shadow banking system. We have put our theoretical prediction about the impact of inside debt on shadow banking through proxies of non-principal-guaranteed wealth management products to the empirical test by analysing the 2010 policy of compensation deferral for Chinese banking industry CEOs. We found that banks with a CEO compensation deferral policy have more shadow banking than other banks, and this finding holds regardless of the size of the bank or the degree of government oversight. The compensation deferral policy may encourage CEOs, especially newly appointed CEOs, to engage in more shadow banking in order to avoid regulations regarding the balance-sheet risk and to boost performance, as the effect of inside debt on shadow banking is more pronounced in banks with higher loan-to-deposit and non-performing-loan ratios and in banks with CEO turnover.
13	Musthaq	2021	International financial institutions' preferred paradigm of private finance-led growth has run against a few snags. The approach has been criticised for its support of shadow banking, a system that can be negatively impacted by liquidity cycles. In this article, I argue that these critiques were insufficient because they do not question the conventional wisdom that shadow banking is only a means of facilitating credit. In this paper, I argue for a new way of thinking about the analytical framework of shadow banking, one that emphasises its role in enabling institutional investors to earn attractive returns relative to their level of risk. With this framework, I clarify two of the accommodations emerging markets make to sustain financial flows: (1) the provision of high-yielding financial assets, primarily through

			the issue of local-currency denominated sovereign bonds; and (2) the liquidity and insurance central banks provide, by drawing on expensive foreign exchange reserves, that enable investors to reap high risk-adjusted returns. The article claims that a private finance-led approach promotes the integration of developing economies into the global shadow banking system, which results in financial accumulation for global investors rather than finance (or patient capital) to accomplish development objectives.
14	Braun and Gabor	2020	The institutionalisation of central bank dominance and the growth and durability of shadow banking are the topics of this chapter's economic and political analysis. It contends that central banks' governance infrastructure had shifted to the shadow money markets. As this chapter demonstrates, central banks have been instrumental in fostering the growth of shadow money and shadow banking, two developments at the very heart of the financialization process. It sheds light on the interplay between power and infrastructure in the United States and the European Union. According to studies of monetary history, central banks and commercial banks work together to spur financial innovation. The chapter focuses on the consequences for "shadow money," which is described as "quasi-monetary obligations" formed in the shadow banking system. Since the advent of modern central banking in the late nineteenth century, monetary policy has taken on a far larger role in achieving macroeconomic stability.
15	Wullweber	2020	With the rise of the shadow banking system, a new form of state–market hybridity has emerged, challenging existing monetary approaches to financial stability. A stable financial system today has essentially come to depend on a stable shadow banking system. Central banks were in the process of adapting to this new development. To secure the logic of laissez-faire market liberalism, the sovereign must resort to unprecedented measures and radically intervene in the financial markets. This new form of state–market hybridity forces central banks to provide ample reserves, to act as a dealer of last resort, and to give shadow banking actors access to their balance sheets. Such policies, however, produced new contradictions and fragilities. Based on Foucault's concepts of sovereignty and security, this paper argues that in today's world, the rationality of the laissez-faire security dispositif has become flanked by the rationality of sovereignty to a much greater extent than previously. Without losing its dominant status, the security dispositif is currently adapting so as to operate in crisis mode based on a post-laissez-faire rationality. The repo crisis of 2019 has demonstrated that central banks were still in the process of searching for ways to handle this new constellation.

16	Kantawala	2019	According to the data and analysis presented in the research paper titled "Financial Performance of Non-Banking Financing Companies in India," the author found that there was a substantial gap between the profitability, leverage, and liquidity ratios of the different types of NBFCs. So, the ratios for various types of NBFCs were typically dissimilar. Companies could utilise variance analysis and information about typical ratios to help them decide whether or not to branch out into new areas of business while still maintaining compliance with applicable regulations. To sum up, NBFCs fall into several distinct groups, each with its own set of characteristics and behaviours, and it is up to the individual business owner to make the decision based on those characteristics and behaviours.
17	Worthington'	2018	According to a study titled "Efficiency in Pre-Merger and Post-Merger Non-Bank Financial Institutions," conducted in the field of post-mergers and consolidations, credit union M&As appeared to have increased the level of efficiency in the merged institutions, even after considering several other factors often associated with differences in efficiency. In particular, it showed how credit unions had begun to emphasise conventional banking metrics like return on investment. Similar mechanisms are at work in the financial industry, with smaller, less effective credit unions being eliminated while their assets are transferred to larger, more efficient ones. This may help bring to light for policymakers and others some more issues of interest.
18	Puliani andPuliani	2017	A book named "Manual of Non-Banking Financial Businesses" is authored by the authors. The book provided an overview of the lexicon of banking and non-banking related terminology. This book detailed the Reserve Bank of India's (RBI) periodic circulars and guidelines for managing and regulating NBFCs.
19	Khan	2016	A discussion on NBFCs in India. The Indian monetary system was the subject of this book. Commercial banks, RD banks, cooperative banks, and NBFCs (Non-Banking Financial Companies) in India were all included. This book was a great resource for learning about NBFCs in India and the various services they provided, such as their companies, classification, asset management, risk coverage, etc.
20	Taxmann	2016	Taxmann's Publications, New Delhi, had released "Statutory Handbook for Non-Banking Financial Firms." The statutes governing Non-Depository Financial Institutions were compiled in this book. There is also discussion of the regulations and laws that apply to the various NBFCs. Foreign exchange management, issuance of certificates of deposit by NBFCs, issuance of commercial papers, foreign direct investments in NBFCs, etc. were also covered in this book.
21	Ghosal	2014	Using the "Emerging Growth Model for Micro Financing Institutions: Banks or Non-Banking Finance Businesses" as an example, the author discusses the two types of financial institutions that are increasingly important in the world

			today. Microfinancing organisations have experienced a dramatic expansion in recent years. This could be largely ascribed to the growing emphasis on inclusive growth and the widespread belief that microfinance institutions are successfully reaching out to the disadvantaged with a viable economic model. So much so that microfinance institution (MFI) pioneer Mohd. Yunus issued a call to action for young people to grab the moment and construct MFIs with the aid of cutting-edge technology to reach the underprivileged at minimal cost and greatest benefit.
22	Kumar and Agarwal	2014	The article "Latest Developments in Non-banking Financial Institutions" was published in "Academicia: An International Multidisciplinary Research Magazine" by the author. Both banks and non-banking financial institutions play important roles in the Indian economy. The Non-Banking Financial Institutions (NBFIs) play a significant role in our economy by, among other things, providing a wide variety of financial services, working to offer improved equity and risk-based products, and providing both short- and long-term financing to various economic sectors. New developments in the realm of non-banking financial institutions are the focus of this article.

2. RESEARCH GAP

While Shadow Banking is a pressing problem around the world, there is a dearth of organised research on the topic, especially in India. The preceding review demonstrates that although it is important to investigate and evaluate the performance of non-bank financial companies (NBFCs), or "Shadow Banks" as they are known in India, the research in this area is not as advanced as it should be. Therefore, the proposed study would be of great use and importance.

Analyzing a company's financial performance is a rigorous way to gauge its viability, efficacy, and safety. The terms performance analysis and financial statement analysis are sometimes used interchangeably since they signify the same thing. Analysis of financial performance initiates management's decision making or planning process. In any enterprise, performance analysis is done after the financial statements have been prepared.

Shadow banking might potentially lead to systemic risk. The expansion of the shadow banking structure is an area of interest for us because of this worry. The purpose of the proposed research is to assess Shadow Banks' (also known as NBFCs) financial performance and the difficulties they confront in the Indian market.

A necessity for regulation of these unregulated sectors is highlighted by cases like the Sahara India Investors Fraud Case and the Saradha Group fraud in West Bengal.

As an alternative to traditional banking, the non-bank financial company (NBFC) sector has helped bring financial services to previously unbanked communities. Despite the fact that it deserves expansion, stricter rules are needed to deal with its growing complexity, influence, and connectivity with traditional banking. NBFCs play a crucial role in India's economy and have become a key driver of growth. The banking system relies on them to increase competition, diversify the financial sector, and disperse risks, but they also play an important complementary role. In spite of its critical function, the NBFC sector in India is plagued by the following issues:

- i. Expense of borrowing money
- ii. The sluggish expansion of industry.
- iii. There is intense rivalry from non-bank financial institutions (NBFCs) and the banking industry.
- iv. Ineffective investments and inadequate recovery methods

With this study, we hope to learn more about the pervasive challenges faced by NBFCs and assess the state of their finances as a whole.

REFERENCES

- Abad, J., D'Errico, M., Killeen, N., Luz, V., Peltonen, T., Portes, R., & Urbano, T. (2022). Mapping exposures of EU banks to the global shadow banking system. *Journal of Banking & Finance*, 134, 106168.
- Allen, F., & Gu, X. (2021). Shadow banking in China compared to other countries. *The Manchester School*, 89(5), 407-419.
- Arora, D., & Kashiramka, S. (2023). What drives the growth of shadow banks? Evidence from emerging markets. *Emerging Markets Review*, 54, 100993.
- Bao, Z., & Huang, D. (2021). Shadow banking in a crisis: Evidence from FinTech during COVID-19. *Journal of Financial and Quantitative Analysis*, 56(7), 2320-2355.
- Braun, B., & Gabor, D. (2020). Central Banking, Shadow Banking, and Infrastructural Power 1. In *The Routledge international handbook of financialization* (pp. 241-252). Routledge.
- Deng, K., Ge, W., & He, J. (2021). Inside debt and shadow banking. *Journal of Corporate Finance*, 69, 102038.
- Guo, S., Lin, G., & Ouyang, A. Y. (2023). Are pro-SME credit policies effective? Evidence from shadow banking in China. *Economic Modelling*, 119, 106115.
- Gupta, S., Kohavi, R., Tang, D., Xu, Y., Andersen, R., Bakshy, E., & Yashkov, I. (2019). Top challenges from the first practical online controlled experiments summit. *ACM SIGKDDExplorations Newsletter*, 21(1), 20-35.
- Han, X., Hsu, S., Li, J., & An, R. (2023). Economic policy uncertainty, non-financial enterprises' shadow banking activities and stock price crash risk. *Emerging Markets Review*, 101003.
- Musthaq, F. (2021). Development finance or financial accumulation for asset managers?: The perils of the global shadow banking system in developing countries. *New political economy*, 26(4), 554-573.
- Pellegrini, C. B., Cincinelli, P., Meoli, M., & Urga, G. (2022). The role of shadow banking in systemic risk in the European financial system. *Journal of Banking & Finance*, 138, 106422.
- Rottner, M. (2022). Financial crises and shadow banks: A quantitative analysis.
- Si, D. K., & Li, X. L. (2022). Shadow banking business and firm risk-taking: Evidence from China. *Research in International Business and Finance*, 62, 101729.
- Quaglia, L., & Spendzharova, A. (2023). Explaining the EU's Uneven Influence Across the International Regime Complex in Shadow Banking. *Politics and Governance*, 11(2).
- Wullweber, J. (2020). Embedded finance: the shadow banking

Special Issue on Business and Management

system, sovereign power, and a new state–market hybridity.
Journal of Cultural Economy, 13(5), 592-609.

Yang, C., & Shen, W. (2022). Non-Financial Enterprises' Shadow
Banking Business and Total Factor Productivity of Enterprises.
Sustainability, 14(13), 8150.