Growth Trajectory of Shadow Banking in India – Concerns and Prospects

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ABSTRACT

A sound financial system is a pre-requisite for inclusive as well as sustainable growth of the economy. The Indian financial system is dominated by the banking sector. Apart from the banking institutions, another integral part of the financial system is Non Banking Financial Companies (NBFCs). The functions of such institutions are supplementary to the banking functions except certain ways. Consequently, NBFCs are being globally recognised as shadow banks. In India, NBFCs are referred to the shadow banks as they possess a significant role and place in the Indian economy since independence like banks. However, the developments both at national and international levels have augmented the impact and growth of the shadow banking all over the world and in India, particularly during the last decade. In this perspective, the present focuses on the growth trends, issues of concerns and prospects of shadow banking in India and concludes with the implications therefrom.

Keywords: *Financial System, Sustainable growth, Shadow banking, Non Banking Financial Institutions (NBFCs).*

INTRODUCTION

A robust financial system is a prerequisite for sustainable economic growth of every nation. In all advanced economies, financial systems efficiently deliver a broad range of financial services and contribute significantly to the macroeconomic stability and sustained economic growth and prosperity (World Bank, 2003). The Indian financial system consists of varied financial institutions. Banking system is the backbone of the Indian financial economy. Since independence, the financial sector has witnessed enormous changes in respect of structure, governance, regulation, operations and focus. Banking sector transformation is an integral part of financial sector reforms ranging from nationalisation to privatisation, technological adoption, competition, financial inclusion among other significant turnarounds. Apart from banking sector, shadow banking in the form of Non-banking ?nance companies (NBFCs) possesses a significant role in the Indian financial system. Non Banking Finance Companies are part of shadow banking system in India as they function in widening access to financial services through diversification of the financial sector by supplementing the function of the organised banking sector through bridging the credit gaps. These companies have registered considerable growth in terms of their operations and scope of functioning owing to innovative products, wider scope and efficient management capabilities. NBFCs have emerged as growth engines for financial inclusion particularly for the small-scale and retail sectors. However, the implications of the regulatory framework for NBFCs also transformed from simplified to widespread policy framework. The Reserve Bank of India is continuously focusing in strengthening the risk management structure of NBFCs. NBFCs have certain advantages as compared to the banks in terms of niche segment, asset classes, and reach in the rural and unbanked areas. However, they have to depend on costly bank borrowings.

With the increasing growth as well as significant contribution of NBFCs towards economic growth by filling the financing and investing gaps particularly for small scale sector and rural areas combined with the RBI regulatory framework, it becomes imperative to examine the growth patterns along with the issues of concerns relating to NBFCs in India. In this perspective, the present paper intends to study the role, growth drivers and challenges of shadow banking in India. The paper is based on the secondary sources of data taken from RBI publications, Annual Reports of Ministry of Finance, Internet, Journals and Newspapers. The paper has been organised in the following manner. Besides introduction in Section I, the evolution and trends of Shadow banking have been discussed in Section II. The growth and prospects of NBFCs in the Indian financial system has been explained in Section III of the Paper. The key issues of concern relating to shadow banking in India have been discussed in section IV of the paper. The conclusion and suggestions have been incorporated in Section V.

SHADOW BANKING IN INDIA

The origin of shadow banking was indicated by D'Arista and Schlesinger (1993) who termed it as a parallel banking system. However, formally, the economist Paul McCulley used the term shadow banking in 2007 for the first time while addressing at Kansas City Federal Reserve Bank in Jackson Hole, Wyoming. He advocated that non – bank financial institutions that engaged in functions supplementary to the main banking operations. Shadow banking activities occupies a crucial place in the financial system. The major benefits of shadow banks comprise of

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lesser transaction cost, fast decision-making, customer focused and quick services. Shadows do not always mean dark and menacing. Shadow banking activities are integral part of the financial system. The main benefits of shadow banks lie in their ability to lower transaction costs of their operations, their quick decision-making ability, customer orientation and prompt provision of services. In India, Non Banking Finance Companies (NBFCs), are segment of shadow banking system that play a vital role in the enlargement of access to financial services, and enhancing competition and diversification of the financial sector. Non Banking Finance Companies (NBFCs) are key elements of shadow banking system in India (Sinha, 2103).

The shadow banking system is prevailing from many decades but has came into limelight after the global financial crisis of 2008. According to the Financial Stability Board (FSB), shadow banks are credit intermediation outside the regular banking system. Further, Claessens and Ratnovski (2014) defines shadow banking as all financial activities, except traditional banking, which require a private or public backstop to operate.

Non-Banking Financial Companies are registered companies in India that are engaged in the business activities akin to a bank such as granting loans and advances, purchasing marketable securities, leasing of assets, hire-purchase and insurance business. According to the Reserve Bank of India (Amendment Act) 1997, a Non-Banking Finance Company means:

(i) A Financial Institution which is a company;

(ii) A non-banking institution which is a company and which has as its principal business the receiving of deposits under any scheme or arrangement or in any other manner or lending in any manner;

(iii) Such other non-banking institution or class of such institutions as the bank may with the previous approval of the Central Government specify.

Various functions of NBFC's are parallel to those of banks. NBFCs are performing functions similar to that of banks. However there are certain differences like NBFCs cannot accept demand deposits as well as not functionary of payment and settlement system. Non-banking financial intermediaries have played a significant role in providing finance to different sectors. Although the NBFCs in various forms have existed even prior to independence, the term NBFC was first associated in the early 1950s with the establishment of Sundaram Finance, a company financing purchase and sale of cars (Acharya et al. 2013). The non-banking financial companies (NBFCs) grown in India during 1980s owing to the limitations of extremely regulated banking sector. The simplified procedures and low barriers fuelled the growth of NBFCs associated with better services and wider access with an edge over the banking sector. The vast expansion of financial liberalization in new areas such as, hire purchase, housing, equipment leasing and investment enhanced the scope of NBFCs in India (RBI, 2008). To regulate the NBFCs, the RBI introduced a 50-50 business criteria rule in 1999, according to which, a company is treated as an NBFC and registered with RBI if its financial activities constitute more than 50% of the overall assets and gross income of an entity (RBI, 2011).

In the popular discourse the role of NBFCs are seen from two distinct angles: (a) they have been very useful for sectors / activities that are generally excluded from formal banking activities; and (b) at some regularity some of the deposit raking NBFCs have been source of financial irregularity in some localized pockets and raised the issue of consumer protection. Although NBFCs have existed for a long time in India, these entities experienced sudden spurt in their activities between the late 1980s and the mid-1990s. While, on an average basis, deposits of NBFCs as a proportion of bank deposits were 0.8 percent during 1985–86 to 1989–90, they shot up to as much as 9.5 percent by 1996–97. This sharp jump in NBFC deposits was mostly owing to the high rates of interest offered on such deposits (RBI, 2003).

Further, NBFC regulations, 1998 affected the growth of the NBFCs, and the number of NBFCs declined to 7855 in 1999 from 55995 in 1995 (Nisar and Aziz, 2004). For the deposit taking NBFCs, the number of companies decreased from 1429 in 1998 to 624 in 1999. Though, deposit taking NBFCs increased from 624 in 1999 to 784 in March 2001, it started to decline thereafter and stood at 297 in March 2011. In 2006, the RBI introduced its next important set of NBFC regulations by revising the 1998 regulations to create a new NBFC category, the systemically important non-deposit taking NBFCs. The systemically important non-deposit taking NBFCs were defined as those non-deposit taking NBFCs with asset size of 1 billion rupees or more. As is well known, the concept of systemically important financial institutions became popular after the onset of ongoing global financial crisis in the summer of 2007 and a financial institution is considered systemically important if its failure poses a systemic risk to the financial system (Acharya and Öncü, 2013).

GROWTH AND PROSPECTS

In developed countries, shadow banks are comparatively versatile and play a higher role as compared to the emerging economies, where they are simpler and smaller in size. However, there are now rising concerns about the rise of shadow banking, especially in China and India (Ghosh et al. 2012; UN 2013; Li 2013).In contrast to the existing status of shadow banking in the Western economies, the NBFCs in India give a completeness of credit gamut in the economy as NBFCs acts as a substitute for direct lending to non-urban parts of the economy. In India, the size of shadow banking in the form of NBFCs is relatively small, less complex and well regulated, yet it is growing quickly and raises concerns about its sustainability and impact on the rest of the economy (Sinha 2013 and Acharya et al. 2013).

As a proportion of GDP shadow banks in India, according to FSB estimates, were 16.9% in 2012 and 17.7 % in 2013. This places India among the top 5 emerging economies experiencing high growth rates in shadow banking in 2013. Others are Argentina (50.3%), China (33.5%), Turkey (24.5%) and South Africa (19.8%). Although the growth rate is highest in Argentina, it is the third smallest among the emerging economies in terms of its share in the total.

The ASSOCHAM report (2016) found that the fruition of the regulatory structure for NBFCs in India has gone through a cyclical phase-from simplified regulations to stringent and extensive regulations and finally towards rationalisation as part of the recently revised NBFC regulatory framework. Regulation was necessary for ensuring efficacy of credit, monetary policy, safeguarding depositors' interest and ensuring healthy growth of NBFIs (Sinha 2013).

Several committees also were appointed by the government from time to time to examine the regulatory standards of NBFCs. Stringent regulation of the sector came in 1996, and subsequently in 1998 as a result of the failure of a large NBFC, they were not allowed to raise deposits from the public. Various expert committees of the Reserve Bank of India expert committees identified the need of non banking financial companies in the following areas:

- Development of sectors like transport and infrastructure
- Substantial employment generation
- Help and increase wealth creation
- Broad base economic development
- Irreplaceable supplement to bank credit in rural segments
- Major thrust on semi-urban, rural Areas and first time buyers/users
- To finance economically weaker sections.
- Huge contribution to the state exchequer.

The NBFCs is far from being a homogenous entity and include many diverse types of financial institutions from a housing finance company to an equipment leasing company. The diversity among the entities of the NBFC sector is also reflected in attributes like sizes and the extent of regulatory oversight. As of March 2016, there were 11,682 NBFCs registered with the RBI, of which 202 were deposit-accepting and 11,480 were non-deposit accepting NBFCs, of which 220 were declared as systemically important. Table 1 depicts the number of Non-Banking Financial Companies registered with the Reserve Bank from 1999 to 2016.

Table-1: Number of Non-Banking Financial Companies Registered with the Reserve Bank

Year	Number of Registered NBFCs	Annual Growth Rate	NBFCs Accepting Public Deposits	Annual Growth Rate
2009	7885	-	623	-
2000	8451	7.59	679	8.99
2001	13815	63.47	776	14.29
2002	14077	1.9	784	1.03
2003	13849	-1.62	710	-9.44
2004	13764	-0.61	604	-14.93
2005	13261	-3.65	507	-16.06
2006	13014	-1.86	428	-15.58
2007	12968	-0.35	401	-6.31
2008	12809	-1.23	364	-9.23
2009	12740	-0.54	336	-7.69
2010	12630	-0.86	308	-8.33
2011	12409	-0.02	297	-0.04
2012	12385	-0.001	271	-0.09
2013	12225	-0.01	254	-0.06
2014	12029	-0.01	241	-0.05
2015	11842	-0.03	220	-0.08
2016	11480	-0.01	202	-0.08

Source: Report on Trend and Progress of Banking in India, RBI, Various issues.

NBFCs have scripted a huge triumph story. Their contribution to the economy has grown substantially from 8.4% in 2006 to more than 14% in March 2015. In terms of financial assets, NBFCs have registered a robust growth, i.e. a compound annual growth rate (CAGR) of 19% over the past few years, consisting of 13% of the total credit and estimated to reach nearly 18% by 2018-19. The success of NBFCs can be clearly attributed to their superior product lines, lower cost, broader and effective reach, robust risk management capabilities to check and control bad debts, and proper comprehension of their customer segments. Moreover, improving macroeconomic conditions, higher credit penetration, enhanced consumption and disruptive digital trends will allow NBFCs credit to rise at a robust rate of 7-10% in the coming years.

NBFCs have steadily grown in number and market share, indicating the success of their business models and the opportunities/potential in their target markets. The share of NBFCs has steadily grown from 10.7% of banking assets in 2009 to 14.3% of banking assets in 2014 as presented in Table 2 below.

Table -2: Proportion of NBFCs Assets to Bank Assets

Year	Proportion of NBFCs Assets to Bank Assets (%)
2009	10.7
2010	11.3
2011	11.6
2012	12.7
2013	13.3
2014	14.3

Source: ASSOCHAM (2015).

There is also remarkable increase in the amount of public deposits of NBFCs deposit companies as shown in Table 3 from the period 2000-01 to 2015-16. There was decline from 2003-04 to 2008-09 but after 2009-10 it registered continuous increase in the amount of aggregate deposits.

Table -3: Aggregate Public Deposits of NBFCs- D

Year	Amount of Public Deposits (INR Billion)
2000-01	65.59
2001-02	59.33
2002-03	50.35
2003-04	43.17
2004-05	39.26
2005-06	24.48
2006-07	20.77
2007-08	20.42
2008-09	19.71
2009-10	28.31
2010-11	40.98
2011-12	57.35
2012-13	70.85
2013-14	108.08
2014-15	289.41
2015-16 (P)	379.00

Source: Report on Trends and Progress of Banking in India, 2015-16, RBI.

Non-banking financial companies improved their performance in the year 2015. According to the financial stability report (2016), NBFC loans expanded 16.6% in the year, twice as fast as the 8.8% credit growth across the banking sector. Table 4 exhibits the composition of NBFCs advances in diverse areas.

Table - 4: Composition of NBFCs Advances

Areas	Share (%)
Infrastructure	47
Commercial Vehicles	12
Corporate Loans	9
Gold Loans	7
Mortgage/Housing	7
Cars	6
Construction Equipments	4
Capital Market	3
Unsecured Retail	3
Others	2

Source: ASSOCHAM (2015).

According to a report by BCG, India's credit-GDP ratio stood at 97 percent as of FY15 versus 165 percent in China, 149 percent in Germany, 244 percent in the US and 447 percent in the UK. This means huge scope for credit market in India as a whole. Interestingly, for the same year, the NBFC-credit-to-GDP ratio in India was merely 13 percent, versus 33 percent in China, 29 percent in Germany, 130 percent in the US and 264 percent in the UK. If one observes this fact that largest segment in the banking sector is witnessing some challenges, then the opportunities to grow is expected to be higher (Sinha, 2013).

In August 2016, the union cabinet has given nod for foreign direct investment (FDI) under the automatic route in regulated NBFCs. Another report by PwC India (2016) stated that by 2020, credit lending by Indian NBFCs is estimated around 18.2% and 20.9% of the total credit off-take in the country.

ISSUES OF CONCERNS

The shadow banking lacks transparency in terms of business model, leverage position and ownership that makes it less acquiescent to regulatory framework. Since shadow bank entities have no access to central bank funding, they remain susceptible to shocks posing systemic risk. Nevertheless, the advantages of the shadow banking system of providing quick, cost effective, its ability to impulsive systemic crisis, which was recognised during the global financial crisis, cannot be wished away. The subsistence of shadow banking system was stated to have augmented the scale of the crisis owing to the following factors. Firstly, the interconnection between the regular banking and shadow banking systems had increased as the banks were lenders to these entities. Products issued by the latter enhanced the leveraged position of the banks and put them to a higher risk position. Secondly, due to the near absence of regulation, the shadow banking system was able to operate without internalising the true cost of its risk and more entities preferred to take the route of shadow banking that circumvented banking regulations. This type of regulatory arbitrage led to a system-wide build-up of huge leverage and risks. Thirdly, since shadow banks relied more on short-term deposit-like funding, which had no deposit insurance, loss of confidence resulted in runs on these unregulated institutions. In India, NBFCs, which perform bank-like credit intermediation activities, while remaining outside the banking regulatory framework, essentially exemplify the shadow banking system. India is a bank-dominated financial system wherein banks account for about 60 per cent of the financial sector's assets. Thus, as compared to other advanced economies, the size and activities of shadow banking in India are relatively smaller. Furthermore, unlike many advanced countries, in India, there is a well-defined regulatory framework for NBFCs and overtime, progressive and prudent regulatory measures have brought consolidation in the sector (Sinha, 2013). A Green Paper on Shadow Banking by European Commission (2012) outlines the following four types of risks associated with the shadow banks as follows:-

Liquidity risk – This is one of the most common risks faced by shadow banks, as these entities undertake maturity transformation i.e., funding long term assets with short term liabilities. In India, during global crisis in 2008, some NBFCs ran into severe liquidity problems as they were using short term liabilities such as commercial paper and Non-Convertible Debentures to fund their long term lending or investment.

Leverage risk – As shadow banks do not generally have prudential limits on borrowings, they can become extremely leveraged. High leverage aggravates the stress in the financial system.

Regulatory arbitrage – Regulations applied to banks in this regard can be routed by transferring components of the credit intermediation function to shadow banks which are subject to less severe regulation. Transfer of risks outside the purview of banking supervision played a significant role in the build-up to the global financial crisis.

Contagion risk – Shadow banking entities have close intertwine with the banking sector and also with other segments of the financial system, which can go ahead to contagion risk in times of loss of confidence and uncertainty.

On November 10, 2014, RBI revised regulatory framework focused on the following objectives:

- Harmonising and simplifying regulations to make compliance easier;
- Focussing on activity based regulation without impeding those segments within the sector which do not pose any significant risks to the wider financial system;
- Addressing risks and regulatory gaps wherever they exist; and
- Strengthening the governance and disclosure standards.

Under the revised regulatory framework, it is obligatory to comply with the revised prudential norms in a phased manner (ASSOCHAM, 2015).

CONCLUSION

NBFCs have been playing a very significant role as a core catalyst in the Indian ?nancial system in the form of shadow banks. The role of NBFCs as shadow banks is tremendously vital to an economy, where a large portion of the population lives in rural and semi-urban areas with modest access to financial services and benefits. The recognition of NBFCs as an integral part of the financial system is amply clear in terms of growth and policy framework. NBFCs are well positioned to construct profitable businesses in the priority sector. Considering the funding constraints, conversion to universal or small banks will provide viable option for NBFCs looking to scale up their operations and expand their reach in terms of mark access and customer base. A steady regulatory environment will provide opportunities to NBFCs to grow in the financial sector to promote inclusive growth as well. A roadmap for growth of NBFCs should be framed by the government and RBI to realign the regulatory regime realistically with long term interest of NBFCs.

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