

Shadow Banking as Transmitter of Systemic Risk : An India Centric Review of Literature

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Abstract

Traditional banks and the evolution of securitization have led to the parallel development of Shadow Banks (SB) which changed the financial landscape of many economies around the world. Many of their activities levelled as off-balance sheet financing outside the regulatory purview have the potential to build up Systemic Risk (SR) capable of disrupting the entire financial economy. The growing size, extending leverage and investments into risky assets increase the various risks due to interconnectedness, and regulatory arbitrage raises serious concerns among the regulators. In India, their growth has been phenomenal over the last decade that has enormous potential for contributing to SR. The paper presents the various dimensions of their activities as the global transmitter of SR, with particular emphasis on India.

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I. Introduction

There was a general notion that banking activity only creates systemic risk, as their failures poses adverse effect on the entire financial system than any other business organization. But, the parallel development of Shadow Banks (SBs), started occupying the prominent position in the financial system. Their activities are considered to safe pre-Global Financial Crisis (GFC) era and hence the attention of regulators and policy makers were only on conventional banking. However, the crisis revealed SBs as major contributors to systemic risk (SR), accelerating financial vulnerability (Fan and Pan, 2020). Though they play a beneficial role, SBs contribute to opacity and fragility by transforming simple financial intermediation into complex structure.

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China, SBs are growing at an increasing pace creating a major concern. In India, though they complement traditional banking, they enhance the credit but pose a severe risk to the entire economy due to their growing interconnections with other components of the financial system. Most studies relating to SB are based on advanced countries, i.e., American and European countries and in the context of emerging nations, China is variedly studied. While in the Indian context, the study based on SB is few and only emphasizes their growth. Though many reports stress that their activities pose a serious threat to the economy and can result in financial instability, an exhaustive study concerning SB and SR is not evident.

While presenting the overview of SB, we have seen that it is one of the crucial components of the financial system and recently carried the attention of various researchers and policymakers. Various academic literature reveals that SB is one of the essential elements of the financial system and runs parallel to traditional banking activity. The various activities which positively complement the economy, its dark side cannot be ignored, as it has the potential to contribute towards systemic risk as it can contract the financial economy.

Notes

1. Established over 30 years ago, the IL&FS is a NBFC or "shadow bank" has been listed as systemically important institution by Reserve Bank of India (RBI) with over ₹1,15,000 crore of assets and ₹91,000 crore of debt. IL&FS had a high degree of interlinkages with banks, mutual funds and infrastructure players. In the year 2018, it fell short of cash and defaulted on several of its obligations like bank loans, long term and short term deposits and also failed to meet the commercial paper redemption obligations which jeopardised hundreds of investors, banks and mutual fund associated with. Since then the outlook of NBFC has been gloomy as the top 15 NBFC estimated to have loss over ₹75,000 crore in the third week of September 2018.

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