 ***DOI:** https://doij.org/10.10000/IJLMH.118027*

INTERNATIONAL JOURNAL OF LAW MANAGEMENT & HUMANITIES

[ISSN 2581-5369]

Volume 7 | Issue 4

2024

Beyond the Banks: A Look at the US and Indian Shadow Banking Industry

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ABSTRACT

Shadow banking, as defined by the Financial Stability Board, refers to credit intermediation activities conducted by entities that fall outside the traditional banking system. Although this sector has long been a part of the financial ecosystem, it came under intense scrutiny following the 2008 global financial crisis. In India, the shadow banking industry predominantly consists of non-banking financial companies ("NBFCs") and various money market funds. It is essential, however, to distinguish between the characteristics of Indian NBFCs and those of shadow banking entities in the United States. The 2018 IL&FS infrastructure collapse in India uncovered significant weaknesses within the NBFC sector, underscoring the urgent need for robust regulations to manage interconnectedness and mitigate risks. Additionally, the rapid expansion of certain NBFCs necessitates close surveillance to ensure their financial health and stability. This article explores the complex landscape of shadow banking in both the US and India, focusing on the unique challenges each faces and the regulatory frameworks required to sustain systemic stability and resilience in this crucial sector.

***Keywords**: Shadow Banking, NBFC, Banks.*

I. INTRODUCTION

According to the Financial Stability Board, shadow banking refers to the practice of credit intermediation by firms that operate outside of the traditional banking system. It has existed for a considerable period of time, but gained significant attention following the global financial crisis of 2008.[2] In India, the shadow banking industry mostly consists of non-banking financial firms and various money market funds. However, it is important to note that NBFCs in India are fundamentally different from shadow banking institutions in the United States. The 2018 IL&FS infrastructure collapse in India revealed weaknesses in the Non-Banking Financial Company (**'NBFC'**) industry, emphasizing the necessity for more stringent regulations regarding interconnections and risk mitigation. Furthermore, it is crucial to closely monitor the

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[2] Shadow Banking: Scoping the Issues, (2011), https://www.fsb.org/2011/04/shadow-banking-scoping-the-issues/ (last visited June 24, 2024).

 [ISSN 2581-5369]

swift expansion of certain NBFCs in order to guarantee their continued financial stability.[3]

II. The context of the United States

The shadow banking system in the US is an intricate network that exists outside of the conventional banking system. In this context, non-bank entities such as investment banks, hedge funds, and money market funds facilitate credit intermediation by linking investors and debtors. Shadow banks, in contrast to conventional banks, enjoy greater operational flexibility as a result of less stringent regulatory oversight.

This system operates through a multitude of processes. Securitization is one of the process of combining loans and selling them as securities, which enables banks to release funds for additional lending. Nevertheless, the lack of transparency of these intricate formations contributed to the occurrence of the 2008 financial crisis. In addition, the repo market enables institutions to obtain short-term finance by borrowing cash and using securities as collateral. Investment banks provide the connection between borrowers and investors for a range of financial instruments, such as derivatives and intricate contracts linked to the performance of underlying assets.[4]

Shadow banking has specific benefits. It enhances financial accessibility for borrowers who may not meet the requirements for conventional bank loans, hence promoting economic activity. In addition, by offering alternative funding channels and innovative financial products, it helps to improve the allocation of money in the market. Moreover, the repo market and other financial instruments play a crucial role in preserving liquidity by permitting short-term funding.

Nevertheless, the absence of regulation in this system presents substantial hazards. The interdependence of shadow banks gives rise to a cascading effect - the failure of one can disrupt credit markets and destabilize the entire economy. In addition, intricate financial products and activities sometimes take place "off-balance sheet," indicating that they are not included in conventional financial statements. This poses a challenge for regulators in evaluating systemic risk and averting crises. The lack of transparency in securitization systems during the 2008 crisis serves as a prime example of this difficulty. Ultimately, the need on immediate financing in shadow banking exposes it to abrupt changes in the market that might initiate liquidity

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[3] www.ETBFSI.com, *How the IL&FS Crisis Ravaged India's NBFC Sector - A Timeline - ET BFSI*, ETBFSI.COM, https://bfsi.economictimes.indiatimes.com/news/nbfc/how-the-ilfs-crisis-ravaged-indias-nbfc-sector-a-timeline/90541212 (last visited June 24, 2024).

[4] Laura E. Kodres, What is Shadow Banking?, Finance & Development, June 2013, available at https://www.imf.org/external/pubs/ft/fandd/2013/06/basics.htm.

problems.[5]

The 2008 financial crisis acted as a catalyst, leading to the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[6] The purpose of this legislation was to enhance the oversight of specific financial instruments known as derivatives and money market funds. Nevertheless, the efficacy of these reforms is still a matter of contention, indicating the necessity for more measures to guarantee a more secure financial system.[7]

Shadow banks play a prominent role in the financial sector of the United States, presenting advantages as well as potential hazards. In order to limit systemic risks and prevent future crises, it is essential to make steps to enhance transparency and enact effective laws. By comprehending the complexities of this system, we may strive towards a more resilient financial ecosystem that fosters economic expansion and stability.

III. The context of India

India's shadow banking system has a relatively limited presence. Consisting mainly of NBFCs and money market funds, this sector makes for approximately 20% of the country's GDP, which is considerably less than that of countries such as the US. Indian non-banking financial companies (NBFCs) are significantly regulated by the Reserve Bank of India (**'RBI'**). These encompass regulations regarding the sufficiency of capital, the availability of liquid assets, and the standards for governance. This layer of supervision helps to reduce some of the inherent hazards linked to conventional shadow banking.[8]

Indian non-banking financial companies (NBFCs) often concentrate on certain sectors such as microfinance, housing financing, or auto loans. This specialization mitigates the interdependence and intricacy observed in certain global shadow banking systems. India's compartmentalized approach to its financial system effectively isolates potential breakdowns within specific parts, therefore preventing a domino effect that may impact the entire system, unlike the opaque systems that contributed to the 2008 crisis.

However, India's shadow banking sector does have certain difficulties. The 2018 downfall of IL&FS, a major infrastructure company, revealed weaknesses in the NBFC industry,

[5] Explainer - What is shadow banking?, Central Bank of Ireland, https://centralbank.ie/consumer-hub/explainers/what-is-shadow-banking (last visited Jun 25, 2024).
[6] Text - H.R.4173 - 111th Congress (2009-2010): Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R.4173, 111th Cong. (2010), https://www.congress.gov/bill/111th-congress/house-bill/4173/text.
[7] Wall Street Reform: The Dodd-Frank Act, The White House, https://obamawhitehouse.archives.gov/node/73351 (last visited Jun 27, 2024).
[8] Reserve Bank of India - RBI Bulletin, https://www.rbi.org.in/Scripts/BS_ViewBulletin.aspx?Id=17147 (last visited Jun 26, 2024).

specifically in terms of interconnections and risk management strategies. This episode emphasized the necessity for more stringent restrictions regarding the management of inter-NBFC exposure and the overall risk profile of NBFCs. In addition, it is crucial to closely monitor the rapid expansion of certain NBFC to ensure their financial stability and prevent undue reliance on borrowed funds.

The Indian government and the RBI are confronted with the task of nurturing the expansion of the NBFC industry in order to advance financial inclusivity, while also ensuring the protection of the financial system. This can be accomplished by employing a multifaceted strategy. First and foremost, it is essential to enhance rules pertaining to the interconnections and risk management within the Non-Banking Financial Company (NBFC) sector.[9] Furthermore, enhancing openness and improving data collection about non-banking financial company (NBFC) operations will offer authorities a more comprehensive understanding of the overall stability of the system. Ultimately, promoting innovation in financial technology (**'FinTech'**) can effectively enhance the availability of financial services while ensuring regulatory supervision.

Although smaller and subject to more regulations than its global competitors, it nonetheless necessitates ongoing supervision. India can optimize the advantages of Non-Banking Financial Companies (NBFCs) for promoting financial inclusion and maintaining a secure financial system by drawing lessons from previous experiences, enacting efficient rules, and embracing innovation.[10]

IV. COMPARATIVE STUDY

Although the term "shadow banking" may evoke the idea of a secretive financial network, a deeper analysis reveals two distinct systems - one being a vast and unregulated entity in the US, and the other being a more tightly controlled system in India. The US system, which is considerably larger and consists of many institutions such as investment banks and hedge funds, previously functioned with a less stringent regulatory approach. However, the freedom that existed before 2008 contained the beginnings of the 2008 financial crisis. During this time, intricate financial tools such as securitization, which involves combining loans and selling them as investments, concealed hidden dangers and established a network of interdependencies. A

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[9] Empowering India's financial landscape: Decoding the role of NBFCs, THE ECONOMIC TIMES, Sep. 1, 2023, https://economictimes.indiatimes.com/markets/stocks/news/empowering-indias-financial-landscape-decoding-the-role-of-nbfcs/articleshow/103268483.cms?from=mdr (last visited June 27, 2024).

[10] Fintech and the Digital Transformation of Financial Services: Implications for Market Structure and Public Policy. (2021)The Bank for International Settlements and the World Bank Group Available at: https://www.bis.org/publ/bppdf/bispap117.pdf.

solitary failure has the potential to initiate a chain reaction, causing instability across the entirety of the financial system.

India's shadow banking system, in sharp contrast, portrays a more prudent depiction. Consisting mainly of NBFCs and money market funds, this sector represents a lesser proportion of the total economy in comparison to the United States. The Reserve Bank of India (RBI) enforces laws that serve as safeguards, imposing capital adequacy limits, liquidity restrictions, and governance standards. This regulatory supervision helps to reduce some of the systemic hazards linked to conventional shadow banking. In addition, Indian NBFCs often focus on certain sectors such as microfinance, housing finance, or auto loans. This emphasis decreases the level of interdependence within the system. India's segmented approach to its financial system helps contain possible problems within certain segments, so preventing a cascading financial catastrophe. In contrast to the intricate network of the US, where a single failure can have far-reaching consequences, India's system is designed to isolate and mitigate risks.

Nevertheless, both the United States and India have difficulties in maneuvering through their individual shadow banking sectors. The 2008 crisis revealed the weaknesses of the US system, leading to the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The purpose of this act was to enhance the regulation of specific derivatives and money market funds. Nevertheless, there is an ongoing discussion regarding the efficacy of the subject, emphasizing the persistent requirement for a strong regulatory framework to guarantee the stability of the financial system.

India has also faced its fair share of challenges. The 2018 downfall of IL&FS, a major infrastructure company, revealed weaknesses in the Non-Banking Financial Company (NBFC) industry, specifically in terms of interconnections and risk management strategies. This occurrence highlights the necessity for more stringent rules regarding these factors, as well as the promotion of transparency and improved data gathering on NBFC activities.[11]

V. Conclusion

Both countries face a common issue in the future - they need to develop their shadow banking systems to encourage financial inclusion and meet credit demands, while also ensuring financial stability. The US can gain insights from India's expertise in laws and sector specialization, while India can reap advantages from US initiatives to enhance transparency and implement efficient risk management techniques. The technological breakthroughs in financial technology

[11] The Past & Future of Indian Finance, (2024), https://www.hks.harvard.edu/centers/mrcbg/programs/growthpolicy/past-future-indian-finance (last visited June 28, 2024).

(FinTech) provide a potential opportunity for both countries. By adopting FinTech, they can enhance the availability of financial services while upholding regulatory supervision.

Essentially, the shadow banking systems of the US and India, albeit serving comparable functions, function in significantly contrasting environments. By comprehending these differences, promoting a culture of information sharing, and consistently enhancing their individual systems, both countries may utilize the potential of shadow banking to create a stronger, more inclusive, and more resilient financial environment.

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