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ROLE OF SHADOW BANKING– IN INDIAN ECONOMY

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INTRODUCTION

The financial system in a large, diverse economy like India's uses a multiagency approach to meet the savings and credit needs of different demographics. This means that non-bank financial companies (NBFCs) and commercial banks have both had an impact on the country's economy. In India's private nonbanking financial services sector, you'll find a mixed bag of large, national players and many smaller, regional players. These NBFCs provide a wide range of financial services, including fee-based and fund-based choices, to both retail and non-retail clients.

Based on the information cited above, this section of the article highlights how NBFCs have helped the Indian economy thrive[2].

After the "2009-Sub Prime Crisis," world leaders started paying attention to the shadow banking sector. The term "shadow banking" describes a system of non-banking financial intermediaries that, although not formally regulated, provide services similar to those of traditional banks in a given jurisdiction. The banking industry is closely related to this one. Some examples of shadow banking include mortgage companies, investment banks, money market funds, securitization vehicles, repurchase agreements, and asset backed commercial papers. The number of underground banks around the world has increased dramatically after the 2008 financial meltdown. This sector played a vital role in the growth of India's financial economy, which now boasts more than 11,000 shadow banks.

Following the horrific "Global Financial Crisis (GFC 2007–2008)," the globe has taken the non-banking financial sector's existence very seriously. The subprime crisis taught the Indian banking sector a valuable lesson: it had to pay more attention and be more regulated after it almost went extinct.

These "shadow banks" are vital to expanding access to banking services in emerging nations

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[2] "Policing NBFCs." *Economic and Political Weekly*, vol. 32, no. 33/34, 1997, pp. 2079–80. *JSTOR*, http://www.jstor.org/stable/4405742. Accessed 9 Jan. 2024.

like India. As an alternative to and supplement to the more established banking system, these shadow banks sprung up. Between the needs of large manufacturing industries and those of individuals living in small, rural towns, they performed an essential role. In India, this industry encompasses a wide range of businesses, including those dealing in insurance, nidhi, stock broking, chit funds, investments, merchant banking, and more.[3]

Shadow banking in India expanded significantly following the financial crisis. A lot of NBFCs had trouble meeting their financial obligations in 2008 due to a lack of liquidity. Due to the sale of short-term papers by investee banks and mutual funds in these NBFCs, the sector's liquidity became precarious. Because bank credit was already at a premium, the Reserve Bank of India (RBI) opened the liquidity window to help these non-financial businesses. The structure of the Indian financial industry is quite intricate. Cooperative banks, RRBs, NABARD, SIDBI, NHB, and NBFCs are all part of the formal network that makes up India's financial market. There is also a regulated official sector, but there is also a large informal network of moneylenders including pawn shops, gold saving and lending businesses, nidhis, chit funds, and Badla. A specific study of these institutions cannot be conducted due to a lack of data, as they are not regulated. Since NBFCs account for a disproportionate share of the Indian Shadow Banking System, this research focuses solely on them.

No matter the situation, NBFCs play an important role, and India is no exception with its prominent banking industry. These non-bank financial companies voluntarily provide the same services to consumers who are denied by traditional banks for loans or other services. Therefore, non-bank financial companies (NBFCs) have seen phenomenal growth in recent years, and their total assets are now equal to over 14% of those of commercial banks (not including RRBs). In order to qualify as an NBFC, a company must not be involved in the following activities: farming, manufacturing, trading goods (other than securities), or building real estate.

FUNCTIONS OF FINANCIAL SYSTEM IN INDIA

Among the world's most ancient and rapidly expanding financial markets, the one in India is among the most dynamic and exciting. Stocks, bonds, precious metals, and other financial assets and derivatives are traded on the financial market. Actually, the financial market mediates between those in need and those with surplus funds, between savers and those

[3] Basu, Priya, and Pradeep Srivastava. “Exploring Possibilities: Microfinance and Rural Credit Access for the Poor in India.” *Economic and Political Weekly*, vol. 40, no. 17, 2005, pp. 1747–56. *JSTOR*, http://www.jstor.org/stable/4416534. Accessed 9 Jan. 2024.

looking to make a profit from their savings. Therefore, the financial market acts as a conduit for the movement of capital from providers to consumers.[4]

In the nineteenth century, security exchanges were established in Mumbai, Ahmedabad, and Kolkata, which led to the organization of India's financial market. By the 1960s, there were eight such marketplaces. After liberalization in 1991, numerous new enterprises from different industrial segments began to thrive in the Indian market, which had previously been sluggish due to regulatory restraints. There are two main types of financial markets in India: official and informal.

A financial market's role is to facilitate transactions between lenders and borrowers. It serves multiple purposes, such as determining prices, creating and discovering new financial instruments, raising capital, allowing investors to trade their instruments at fair prices, dividing up risk, and providing useful information for investment decisions. The financial market is crucial for the distribution of a country's limited resources, as it facilitates the raising of capital and the valuation of assets for investors.

The main functions of financial market are as below:

- Price determination of financial instruments
- Mobilization of funds and savings of investors with appropriate return
- liquidity to investors to sell securities readily into cash
- Risk sharing between investors and borrowers
- Easy access to potential buyers and sellers saving time and money
- Reduced transaction cost and provide source of information of better investment decisions
- Capital formation by channelizing the money of investors into economy.

Banking institutions and non-banking institutions are two broad categories of financial organizations. In contrast to banks, which create credit, non-banking institutions only sell it. There are a great number of tiny, privately held businesses in India's economy that fall outside of the banking sector and into the non-banking category. When it comes to the aforementioned financial market operations, the non-banking segment plays a significant role by helping small and unorganized borrowers mobilize their funds. When it comes to allocating India's meager financial resources, they're indispensable. Nonbank financial companies serve the varied requirements of clients who are not affiliated with banks[5].

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[4] Patnaik, Ila, and Ajay Shah. *REFORMING INDIA'S FINANCIAL SYSTEM*. Carnegie Endowment for International Peace, 2014. *JSTOR*, http://www.jstor.org/stable/resrep12862. Accessed 9 Jan. 2024.

[5] S. Kumarasundaram. "The Indian Financial System: Its Deficiencies and Some Remedies." *Economic and Political Weekly*, vol. 17, no. 19, 1982, pp. 793–98. *JSTOR*, http://www.jstor.org/stable/4370896. Accessed 9

GROWTH OF NON-BANKING FINANCIAL INSTITUTIONS/ SHADOW BANKS IN INDIA

EMERGENCE OF INDIAN NBFCS FROM SHADOW

When it comes to global financial markets, the Indian NBFC sector is among the fastest-growing. There has been a dramatic change in the expansion of these NBFCs within the past several years. No one could have predicted this when they emerged from the shadows of the mainstream banking system to carve out their own unique market niche. Even before independence, non-banking final institutions were there. One of the earliest NBFCs, Sundaram Finance, was established in 1954, and its origins may be traced back to the 1950s. Funding the purchase of passenger cars and commercial vehicles was the primary purpose of this company. There have been hundreds of such businesses that provide for the basic necessities of life ever since. In 1963, the Reserve Bank of India (RBI) added a new chapter IIIB to the RBI Act, 1934 in order to better manage these institutions in light of the sensational rise of these "fly-by-night" businesses.

According to Section 45-I (f) of the RBI Act, a nonbank financial institution (NBFI) is defined as follows: "Non-banking financial institution" can refer to: (i) A company that offers financial services; (ii) A company that does not provide banking services but whose main activity is to accept deposits or lend money in any way; (iii) Any other type of non-banking institution that the bank (with the prior approval of the Central Government and through a notification in the Official Gazette) specifies.

Afterwards, the Act was amended to include other provisions aimed at safeguarding investor interests. Many groups were organized into committees to examine the current structure. A handful of suggestions made by various committees at various points in time have been implemented here, paving the way for more effective regulation of this non-banking sector:

Further categorization of NBFCs into three groups according to finance needs and company type was introduced in a new rule in 1998.

1. . Non-bank financial companies (NBFCs) that accept deposits
2. NBFCs that do not accept deposits
3. Principal Investment Firms

The number of NBFC registrations fell dramatically from 55,995 in March 1995 to 7855 in March 1999, because to this new rule, which had an effect on their growth. The number of deposit-taking companies also fell, with 624 registrations in March 1999 compared to 1429 in

Jan. 2024.

March 1998. Despite this, there was a rise of 784 registrations for deposit-taking organizations in 2001. From 237.7 billion rupees in March 2009—52.3% of total assets—to 172.7 billion rupees in March 2010—15.7% of total assets—there was a precipitous fall in deposits. You can see the dramatic fall in NBFC deposits in the table below, which compares the two types of deposits for the fiscal years 2006 and 2011, as well as for 2010 and 2011.

The recently implemented regulations by RBI unquestionably hampered the expansion of this unregulated industry through increased oversight. In 2006, the Reserve Bank of India (RBI) released new regulations that updated those from 1998 and expanded the definition of non-bank financial company (NBFC) to include "Systematically Important Non Deposit taking NBFC" with assets of 100 crore or more. Regulations enacted in 2006 included the "Capital Adequacy Requirement" as one of the most significant regulatory frameworks. This system stipulated that NBFCs must keep a certain "Capital to risk-weighted asset ratio" (CRAR). The ratio for systematically important non-deposit-taking enterprises was set at 10%, while for deposit-taking companies it was chosen to be 12-15%. In subsequent years, there were a number of adjustments made to the CRAR %. In order to ensure the safety of investors' capital, NBFCs were subject to stringent regulations[6].

There are several different types of non-banking financial institutions in India. Primary Dealers (PD), Non-Banking Financial Companies (NBFC), and All India Financial Institutions (AIFI) are the three categories identified above. Sectors such as agriculture, rural development, housing, etc., can access long-term funding through AIFIs. PDs are crucial for government securities, and NBFCs carved out a special place for themselves in the service industry.

By issuing directives under the Reserve Bank of India Act, 1934 (chapter III B), the Reserve Bank of India (RBI) regulates the operations and functioning of non-bank financial companies (NBFCs). An NBFC must register as a deposit-taking firm with the RBI in accordance with the Act. With this registration, it can legally operate as an NBFC. The RBI requires a minimum net owned fund (NOF) of ì. 25 lakh (increased to ì. 200 lakh i.e. April 21, 1999) from companies registered under the Companies Act, 1956 that want to start non-banking financial institution activity in order for them to do registration. Deposits from the public can only be held by NBFCs that have a current Certificate of Registration. Non-Banking Financial Companies (NBFCs) that take public deposits are required to follow the

[6] K. B. L. Mathur. “Regulation of India’s Financial Sector: The State’s Role.” *Economic and Political Weekly*, vol. 39, no. 12, 2004, pp. 1253–58. *JSTOR*, http://www.jstor.org/stable/4414803. Accessed 9 Jan. 2024.

rules laid out by the Reserve Bank of India (RBI) in 1998[7]. The following are the rules and regulations that govern the time that NBFCs can take deposits:

1. They can take deposits from the public for at least 12 months and up to 60 months.
2. They are unable to take deposits that can be repaid at a later date.
3. They are not allowed to provide interest rates that exceed the ceiling rate set by RBI periodically.
4. They are prohibited from providing the depositor with any kind of additional benefit, including gifts or incentives.
5. A credit rating of at least investment grade is required.
6. There is no insurance for their deposits.
7. Banks are not obligated to return deposits made by NBFCs, according to RBI.

The Reserve Bank of India (RBI) maintains a registry of non-bank financial companies (NBFCs), including those that deal in equipment leasing, hire purchase, loans, and investments. Any bank or other lending institution whose main line of business is equipment leasing or financing is considered an Equipment Leasing Company. Any financial intermediary whose main business is to finance hire purchase transactions is considered a hire-purchase company. By "Loan Company," we mean any bank or other financial organization whose main function is to lend money, whether for operating expenses, capital expenditures, or any other purpose (but not equipment leasing or hire-purchase financing). Investment companies are defined as any type of financial intermediary whose main activity is the purchase and sale of securities.

Due to changes in regulatory policy, the Reserve Bank of India (RBI) has classed non-bank financial companies (NBFCs), giving particular attention to those that create assets. Consequently, NBFCs were reclassified in December 2006. Asset Finance firms (AFCs), Loan Companies (LCs), and Investment Companies (ICs) now make up NBFCs, as opposed to the previous three categories, which included equipment leasing, hire purchase, and investment firms. According to this definition, an AFC is a bank whose main activity is to lend money for the physical assets that underpin the country's many economic and productive endeavors. There is a wide variety of intermediaries in India's non-banking financial industry. Based on what they do primarily, they fall into one of these broad categories.

- Equipment leasing company (ELC)

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[7] Bhatt, V. V. “On Improving Effectiveness and Efficiency of Financial System in India.” *Economic and Political Weekly*, vol. 26, no. 41, 1991, pp. 2367–72. *JSTOR*, http://www.jstor.org/stable/4398155. Accessed 9 Jan. 2024.

- Hire Purchase finance company (HPFC)
- Housing finance company(HFC)
- Investment company (IC)
- Loan company (LC)
- Mutual Benefit companies (MBFC) i.e., Nidhis
- Residual non-banking company (RNBC)
- Miscellaneous non-banking companies (MNBC) i.e., Chit fund company.
- Micro Finance Companies
- Insurance Companies
- Stock Broking Companies
- Merchant Banking Companies.

Reserve Bank of India regulates the following types of financial institutions: Equipment Leasing Companies (ELCs), Hire Purchase Finance Companies (HPFCs), Investment Companies (ICs), Loan Companies (LCs), and Residual Non-Banking Financial Companies (RNBCs). The Department of Company Affairs of the Government of India is responsible for regulating Mutual Benefit Companies (MBFC), often known as Nidhi. The National Housing Bank is in charge of housing finance corporations (HFCs). The Reserve Bank of India and the Registrar of Chits of the relevant states are in charge of overseeing Miscellaneous Non-Banking businesses (MNBC), sometimes known as chit fund businesses. The Indian government's Department of Company Affairs oversees microfinance institutions, the Insurance Regulatory and Development Authority oversees insurance companies, the Securities and Exchange Board of India oversees stock brokerage companies, and the Securities and Exchange Board of India oversees merchant banking companies[8].

Looking at the NBFC sector's expansion since 1992, when RBI put several statutory controls on them, we can see that they were finally subject to the right regulatory framework. Following the subprime crisis, RBI took the lead in implementing several reforms in this industry.

The Reserve Bank of India (RBI) is persistent in its attempts to regulate this sector outside of banking. Based on data from the FSB in Switzerland, Investec's analysis indicates that in 2016, Indian NBFCs had assets of $310 billion. This accounted for 17% of the country's total banking assets and 9% of the country's total financial assets, which were $3,340 billion. Since

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[8] BHATTACHARYYA, Sidhakam, and Gautam BANDYOPADHYAY. "URBAN LOCAL BODIES IN INDIA: FINANCIAL CONTROL FOR BETTER FINANCIAL PERFORMANCE." *Theoretical and Empirical Researches in Urban Management*, vol. 7, no. 3, 2012, pp. 24–37. *JSTOR*, http://www.jstor.org/stable/24873324. Accessed 9 Jan. 2024.

NBFC assets only made up 4% of total assets in the US and 1% of total assets in China, according to their data, this ratio was significantly higher than in other industrialized nations. The report also revealed that in 2017, NBFC accounted for 46.5% of mortgage assets. According to Investec's research, NBFC stability was severely affected when investor confidence was shaken due to the IL&FS default in September, which led to a precipitous decline in market liquidity.

The growth of NBFCs was robust prior to the challenging year of defaults in 2018. In FY14–15, the proportion of total credit extended by NBFCs and HFCs was 15.2%; by FY18, that proportion had increased to 19.2%. The industry's rise can be attributed mostly to the ease and informality of its lending practices[9].

Since the country's public sector banks could only meet a portion of the lending demand, NBFCs and HFCs stepped in to fill the void. From 2014 to 2017, market interest rates were falling. As a result, mutual funds became new investment options for the public. As a result, mutual funds showed rapid growth during this span, with assets under management rising by 75%, reaching approximately 9 lakh crore, between March 2016 and March 2018. Concurrently, between March 2016 and September 2018, NBFCs issued 1.2 lakh crore worth of commercial papers to mutual funds, significantly increasing their short-term borrowings.

Numerous occurrences of this kind began in 2018, merely interfering with the success narrative of this non-banking sector. Starting on March 1, SBI raised its 1-year marginal cost of fund-based lending rates; on June 1, these rates were raised again, marking the beginning of restrictive interest rates in 2018. In keeping with this trend, the Reserve Bank of India (RBI) raised the repo rate for the first time in four and a half years, and it did so again in August. When September rolled around, IL&FS failed to pay its duty. It is difficult to predict when this sector will once again experience growth on par with its previous levels, and worries about the overall economy's liquidity shortage have only grown since then.

SIGNIFICANCE IN INDIAN ECONOMY

As per the RBI and other expert committees NBFCs were recognized as a special agent for below mentioned activities:

- To provide funding for development of transport and infrastructure activities
- For substantial generation of employment
- To help in wealth creation
- To help in economic development

[9] EPW Research Foundation. "Financial System in Crisis." *Economic and Political Weekly*, vol. 36, no. 33, 2001, pp. 3104–10. *JSTOR*, http://www.jstor.org/stable/4410985. Accessed 9 Jan. 2024.

- To supplement in bank credits in rural and semi-urban segments
- To finance in weaker section of society
- To provide contribution to State Exchequer

An essential aspect of India's monetary system is the non-banking financial corporations (NBFCs). Micro, small, and medium companies (MSMEs) constitute the backbone of innovation and entrepreneurship, and they play an essential role in providing finance to underbanked communities. To implement their innovative ideas, this segment pitches to low-level customers and meets their credit needs. But unlike banks, NBFCs are nonetheless subject to a number of regulations that make their operations more difficult.

In terms of assets, both banks and NBFCs are heading in the same way; but, when it comes to liabilities, NBFCs are still subject to additional regulations. The Reserve Bank of India (RBI) has to pass more liberalised legislation to allow non-bank financial companies (NBFCs) to thrive. The government's present focus on encouraging innovation and entrepreneurship highlights the critical importance of supporting the growth of NBFCs to supply companies with capital. By channelling the economy towards the present-day production frontiers, the financial system helps increase output by transforming the total wealth into productive forms. A faster rate of economic growth is the ultimate goal of the financial system. Transferring money from countries with surpluses to those with deficits is what the financial system is all about. Investment, consumer durables, housing, and other needs for capital determine the amount of capital that can be provided by the banking system and saved by the general public. To facilitate savings and investment, the financial system primarily acts as a conduit between savers and investors[10].

Therefore, a financial system facilitates more investment. When deficit spending units are able to command more capital, they are able to undertake additional investments. Services, products, markets, and institutions all make up India's financial system. As well as providing customers with credit and other forms of financing, financial institutions also serve as safe havens for customers' investments. Additionally, they offer a range of financial services to the local population. Banking institutions and non-banking ones are the two main categories of financial organizations. All non-bank financial institutions do is extend credit. Banking institutions rely on non-banking financial intermediaries to augment their services[11].

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[10]Guoping Li, and Hong Zhou. “Globalization of Financial Capitalism and Its Impact on Financial Sovereignty.” *World Review of Political Economy*, vol. 6, no. 2, 2015, pp. 176–91. *JSTOR*, https://doi.org/10.13169/worlrevipoliecon.6.2.0176. Accessed 9 Jan. 2024.

[11] REDDY, Y. V. “India’s Financial Sector in Current Times.” *Economic and Political Weekly*, vol. 44, no. 45, 2009, pp. 13–15. *JSTOR*, http://www.jstor.org/stable/25663757. Accessed 9 Jan. 2024.

IMPACT ON INDIAN FINANCIAL MARKET

The NBFC sector outperforms the banking sector in terms of profitability, thanks to its reduced operating costs, which in turn allow it to offer customers cheaper loans. There has been a lot of focus on NBFC defaults in recent years. The liquidity issue has been a major obstacle for Indian NBFCs. It was possible that the general expansion of the economy was affected when IL&FS went into default in September 2018. There is a serious shortage of capital for non-bank financial companies (NBFCs) because many financial institutions withdrew their support shortly after the crisis. There is no longer any way for NBFC to pay its investors. Construction, infrastructure, automotive, fast-moving consumer goods, jewelry, jewels, and many more industries will feel the effects of the NBFC sector's decline. Gross domestic product growth has slowed due to falling consumer spending.

The global economy has also benefited from the shadow banking sector in India. According to the 2017 RBI bulletin, the number of shadow banks jumped from US$ 31 trillion in 2010 to US$ 34 trillion in 2015, marking a dramatic increase in their impact on the global scene since 2009. per the FSB report in 2017. With an asset size of $426 billion in 2015, the Indian shadow banking sector was 1.3% of all shadow banks. In2015, the size of shadow banking assets accounted for around 14% of all domestic financial assets. Moreover, NBFC sizes declined significantly due to stricter prudential regulations and the 2006 launch of systematically important non-deposit taking NBFCs. The asset size of NBFCs decreased after 2014 due to the strict registration regulations, which led to an increase in the number of NBFCs. The revolutionary diversification of this market was brought about by the 2006 categorization of NBFCs into 12 groups depending on their activity.

The Reserve Bank of India has long prioritized bolstering the lending and recovery operations within this industry. In 2010, RBI opened the sector's gates for infrastructure projects through the National Bank for Financial and Insurance Companies (NBFC-IFC), expanding it beyond its two primary sectors of loan and investment. In 2011, NBFC-IDFs were established to provide better debt financing for infrastructure projects with long-term loans. To further address the needs of the microfinance sector, NBFC-MFI was also established in 2011. Concerns regarding the cost of credit and lending activities were also on the RBI's mind. In addition, the Factoring Act of 2011 required the notification of NBFC-factors the same year.

Despite NBFCs' expansion into nearly every sector of the financial industry, lending firms remained their most important arm, accounting for 36.2% of NBFCs' total assets as of March 2017. The next largest group was NBFC-IFC, then AFC, and finally MFIs, after Loan

Company.

NBFCs' strong development is a reflection of their adaptability. They also outperformed the major banks in terms of their balance sheet. While public sector banks accounted for 13% of the overall credit facility in 2016–17, the largest growth was in the credit facility extended by NBFCs, NDs, and SIs, which is challenging the credit component extended by the banking sector. Consequently, in 2017, the loan percentage to total GDP increased by 8 percentage points. Bandhan Financial Services and Infrastructure Development Finance Corporation, two big players in the non-bank financial company (NBFC) sector, converted to banks in 2015 and 2016, which led to a decline in the NBFC industry's stake. The proportion rose once further in 2017 as a result of growing credit intermediation between the banking and non-banking sectors.

Profits attributable to non-bank financial companies as a percentage of GDP were about 0.4% in 2018, up slightly from 0.3% in 2015. Viewed as a whole, India's GDP fell from 7.8 percent in 2008 to 3% in 2018. In recent years, asset quality has declined as a result of NBFCs' inability to sustain their high growth and market dominance. Between March 2012 and the end of March 2017, the ratio of gross nonperforming assets (GNPA) rose from 2.9% to 5%. The prior year's 5.3% GNPA rose to 6.1% in the 2018–19 fiscal year. Return on assets (ROA) followed asset quality and showed a declining curve beginning in 2013. The ratio of capital to asset value has been falling for some time now as well.

FUTURE PROSPECTS OF SHADOW BANKS AND NBFCs

CHALLENGES POSED BY SHADOW BANKS/NBFCS IN THE INDIAN CONTEXT

India is also attempting to strengthen its regulatory framework to halt shadow banking operations because of the danger they pose to the country's financial stability. One of the several legal concerns faced by the RBI is dealing with various companies that are incorporated as finance corporations but do not fall under its regulatory supervision. The truth is that novel approaches that take advantage of the existing legal framework are beyond the capabilities of the law to handle.

It is necessary for different market participants, such as banks and NBFCs, to establish a solid cooperation in this period of interdependence, when all nations are influencing one another. Achieving parity between NBFCs and banks is a top priority. For instance, this is addressed by the provisions of the new Companies Act 2013 that deal with non-performing assets. It is also recommended that NBFCs be included in the SARFAESI Act so that they can access

improved recovery mechanisms similar to banks[12].

While we have looked at the dangers and drawbacks of shadow banks, it is also clear that NBFCs and other shadow banks fill a demand that traditional banks ignore. When NBFCs are properly regulated, they have the potential to become "Skill and Capacity Builders" that bolster economies. Financial inclusion is a major concern in India, and shadow banks are helping to address this by supplementing and assisting traditional banks. Unregulated financial services prey on the many unbanked areas, which in turn attract a wide range of fraudulent consumers and investors. The government should not seek to eradicate shadow banking altogether, but rather to enhance regulatory monitoring and ensure that laws and regulations are kept up-to-date to address the evolving economic landscape.

NBFCS: LEADING THE CHARGE OR A FRAGMENTED MARKET

The credit expansion in the Indian market was spectacular. According to the 2008 IBEF Banking Report, public and private sector banks have increased their lending by 11% over the past decade. The non-banking sector, on the other hand, had a chance to develop novel lending policies and models because the retail and MSME sectors remained underpenetrated. When compared to traditional banks, the non-banking sector has been more successful in deploying credit in recent years. From 15% in 2015 to 16% in 2017, the proportion of new disbursals made by NBFCs rose significantly (CRISIL, September 2018).

Since the nonbanking sector has introduced numerous novel products for all types of customers, NBFCs' strength has always been in the retail and MSME segments; as of FY18, the total outstanding credit was INR 7.5 trillion (ICRA, 2018). In an environment where the Reserve Bank of India is tightening regulations on banks, non-bank financial companies are capitalizing on the chance for less formal financing. Exploring the reasons behind NBFCs' rapid market penetration and subsequent failure to maintain it is sure to yield a plethora of viewpoints.

The sector's success story couldn't continue, even with the overnight surge. There was a slowdown in the rise of NBFCs beginning in 2017, and significant participants in this sector went bankrupt shortly after. In FY 2017, there were 115,22 registered NBFCs, according to the RBI report on the development and evolution of banking in India, 2017. There has been an increase in the market penetration of this industry, according to data given by RBI on new registration of NBFCs. Still, NBFCs had a tough time in subsequent years, despite the fast expansion. By the middle of 2018, the Reserve Bank of India had revoked the licenses of 368

[12] NAIR, TARA S. "Microfinance: Lessons from a Crisis." *Economic and Political Weekly*, vol. 46, no. 6, 2011, pp. 23–26. *JSTOR*, http://www.jstor.org/stable/27918113. Accessed 9 Jan. 2024.

moneylenders—double the number from 2017—due to the incapacity and asset liability mismatch that several NBFCs had disclosed. In addition, IL&FS went into default on its credit commitments in September 2018. If recent reports and data are to be believed, the Reserve Bank of India (RBI) may take further action to clean up this area, perhaps leading to the loss of licenses for numerous tiny non-banking industries.

Additionally, NBFCs faced intense competition due to the arrival of new digital lenders. These online loan providers, also referred to as fintech's, are vying for a piece of the Indian lending pie by using their superior data and technological capabilities. These businesses offer loans that are both on and off-balance sheet. These businesses provide a good customer experience, have lower fees, and shorter return times. As of July 2018, these digital enterprises have $1 trillion in prospects over the next five years, according to a report by moneycontrol.com.

When we examine the chart of non-banking enterprises, we can see that they saw tremendous growth up until 2015–2016. But both the number of enterprises and their market share started to fall after 2016[13].

CONSIDERATION FOR BUILDING THE NBFCS OF FUTURE

Against all difficulties, NBFCs established their own niche. National bank financial companies (NBFCs) need to reevaluate their strategies and business models in light of the shifting dynamics of the market, rising consumer expectations, and the widespread adoption of digital business models. Increased laws made it vital for these organizations to establish a comprehensive risk model, as they faced repeated failures and a liquidity shortage. Since there are still large corporations that are generating a lot of money from this industry group alone, the recent defaults do not prove that non-banking enterprises in general are failing. The problem is that non-banking businesses should reorganize their model to be more like successful ones.

Keeping the aforementioned things in mind will help construct the NBFCs of the future. In order for NBFCs to achieve better outcomes, they need think about the aforementioned criteria when they decide on their long-term vision. Current participants are compelled to revamp their business models in response to the evolving regulation landscape, the increasing number of digital models, and the growing demands of customers. On the other hand, new competitors are compelled to reevaluate their strategies. This is an ongoing process of

[13] Basu, Priya, and Pradeep Srivastava. "Exploring Possibilities: Microfinance and Rural Credit Access for the Poor in India." *Economic and Political Weekly*, vol. 40, no. 17, 2005, pp. 1747–56. *JSTOR*, http://www.jstor.org/stable/4416534. Accessed 9 Jan. 2024.

transition that will yield numerous advantages, both monetary and otherwise.

To accommodate the various savings and credit requirements of India's diversified population, the country's financial system employs a multiagency strategy. This indicates that the country's economy has been affected by both commercial banks and non-bank financial companies (NBFCs). Many minor regional firms coexist with a few larger national ones in India's private nonbanking financial services market. These NBFCs provide a wide range of financial services, including fee-based and fund-based choices, to both retail and non-retail clients.

This section of the article highlights the role of NBFCs in the expansion of the Indian economy, in light of the previous study.

After the "2009-Sub Prime Crisis," world leaders started paying attention to the shadow banking sector. The term "shadow banking" describes a system of non-banking financial intermediaries that, although not formally regulated, provide services similar to those of traditional banks in a given jurisdiction. The banking industry is closely related to this one. Some examples of shadow banking include mortgage companies, investment banks, money market funds, securitization vehicles, repurchase agreements, and asset backed commercial papers. The number of underground banks around the world has increased dramatically after the 2008 financial meltdown. With over 11,000 shadow banks operating in the country today, this industry was crucial to the development of India's financial market[14].

Following the horrific "Global Financial Crisis (GFC 2007–2008)," the globe has taken the non-banking financial sector's existence very seriously. The subprime crisis taught the Indian banking sector a valuable lesson: it had to pay more attention and be more regulated after it almost went extinct.

These "shadow banks" are vital to expanding access to banking services in emerging nations like India. As an alternative to and supplement to the more established banking system, these shadow banks sprung up. Between the needs of large manufacturing industries and those of individuals living in small, rural towns, they performed an essential role. In India, this industry encompasses a wide range of businesses, including those dealing in insurance, nidhi, stock broking, chit funds, investments, merchant banking, and more. Shadow banking in India expanded significantly following the financial crisis. A lot of NBFCs had trouble meeting their financial obligations in 2008 due to a lack of liquidity. Due to the sale of short-term papers by investee banks and mutual funds in these NBFCs, the sector's liquidity

[14] "Policing NBFCs." *Economic and Political Weekly*, vol. 32, no. 33/34, 1997, pp. 2079–80. *JSTOR*, http://www.jstor.org/stable/4405742. Accessed 9 Jan. 2024.

became precarious. Because bank credit was already at a premium, the Reserve Bank of India (RBI) opened the liquidity window to help these non-financial businesses. The structure of the Indian financial industry is quite intricate. Cooperative banks, RRBs, NABARD, SIDBI, NHB, and NBFCs are all part of the formal network that makes up India's financial market. There is also a regulated official sector, but there is also a large informal network of moneylenders including pawn shops, gold saving and lending businesses, nidhis, chit funds, and Badla. A specific study of these institutions cannot be conducted due to a lack of data, as they are not regulated. Since NBFCs account for a disproportionate share of the Indian Shadow Banking System, this research focuses solely on them.[15]

No matter the situation, NBFCs play an important role, and India is no exception with its prominent banking industry. These non-bank financial companies voluntarily provide the same services to consumers who are denied by traditional banks for loans or other services. Therefore, non-bank financial companies (NBFCs) have seen phenomenal growth in recent years, and their total assets are now equal to over 14% of those of commercial banks (not including RRBs). In order to qualify as an NBFC, a company must not be involved in the following activities: farming, manufacturing, trading goods (other than securities), or building real estate.

SHADOW BANKING: MONEY MARKET’S ODD RELATIONSHIP WITH THE LAW

For the purpose of providing credit and financial services without being subject to the same level of regulation as traditional banking institutions, shadow banking refers to financial intermediaries that operate outside of the traditional banking system. Entities such as money market funds, hedge funds, and other non-bank financial firms are included in this sector of the financial industry. The activities of shadow banks are comparable to those of ordinary banks in terms of lending and borrowing. Shadow banks raise funds for short-term use through the money markets and invest in assets with longer-term maturity. Because of this, they are able to contribute to the expansion of the economy by supplying liquidity and credit in areas where it might otherwise be lacking. Nevertheless, the absence of regulatory control might result in potential hazards such as financial instability. This is due to the fact that these organisations might not be as accountable or as transparent as traditional banks.

Regulatory oversight of financial services is a challenging and contentious endeavour. When

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[15] REDDY, Y. V. “Financial Sector Regulation in India.” *Economic and Political Weekly*, vol. 45, no. 14, 2010, pp. 40–50. *JSTOR*, http://www.jstor.org/stable/25664304. Accessed 9 Jan. 2024.

it comes to striking the correct balance between a market-reliance strategy that encourages innovation and a market-design approach that places an emphasis on soundness and stability, there is no consensus. On the other hand, this occurs in the best of circumstances, that is, when there is consensus of opinion regarding what should or should not be regulated. This is not one of those moments, which is a great disappointment.

The term "shadow banking" refers to a notion that is utilised by the Financial Stability Board (FSB) and is also utilised by the European Commission in order to pursue a regulatory agenda that aims to address (some of) the risks that are present at the fringes of the financial system. "Shadow banking" is defined as "a system of credit intermediation that involves entities and activities outside the regular banking system, and raises i) systemic risk concerns, in particular by maturity/liquidity transformation, leverage, and flawed credit risk transfer, and/or ii) regulatory arbitrage concerns," according to the framework of the Financial Stability Board (FSB), which serves as the foundation for the majority of policy work. Any individual who, after reading this definition, is left feeling perplexed is likely to be pardoned (it is possible that someone else works at the FSB). After looking at the data that was provided by the FSB, the image that emerges is not always more clear with each passing moment.

There are significant differences between size and growth, and these differences are not only significant in and of themselves, but also in the sense that they indicate deeper tensions surrounding the idea and the implications it carries. Do well-established actors make up a part of shadow banking, or does it consist of the rapidly expanding body of exotic financial entities? Is it limited to these types of financial "entities," or does it also include transactional phenomena, such as "shadow" transactions carried out by actors who are subject to regulation? It could be the result of market participants trying to take advantage of loopholes in the laws, but it could also be the consequence of other forces at work. In order to establish the actual dangers posed by shadow banking, it is necessary to answer these questions.

Shadow Banking. What has been done, and what remains to be done

The term "shadow banking" is not intended to be merely a descriptive idea; rather, it is intended to be a tool for policymaking. This section examines the initiatives that are currently being undertaken (what is being done) and evaluates the magnitude of the task (what is still that needs to be done). We differentiate between the views of "intermediation" (1) and "monetization" (2) in order to maintain coherence with the section that appeared before this one.

(a) Shadow banking's 'intermediation' perspective. When priorities collide

Rules and initiatives: indirect and direct regulation

(a) The first significant obstacle is the regulation of the financing vehicles that are "dependent" on the banks that are backing them financially. During the crisis, these vehicles caused three problems. Firstly, some of them were used to hide assets off-balance sheet, so they weren't included in capital requirements calculations and the risk wasn't reported. Secondly, when the risks were really transferred to the vehicles, the resulting originate-to-distribute model confused the incentives of the banks that originated the loans with those of the investors, leading to lax origination standards (i.e., banks gave credit to weaker borrowers knowing they wouldn't have to bear the risk). Lastly, securitization became too complex, and the original loans were packaged and repackaged in such a way that the buyers of the final assets had no idea what was at the end of the "securitization chain."

For the misreporting problem, the adopted measures include risk-weights that penalise re-securitizations; for the misalignment problem, the stringent rules on risk transfer and riskweights on securitization exposures are used; and for the misreporting problem, the so-called "skin-in-the-game" rule requires sponsors to retain 5% of securitization exposures.

(b) In the realm of direct regulation, new regulations have been enacted for Alternative Investment Fund Managers (AIFMs), which include hedge funds, and there is a proposal for a regulation on mutual funds (MFFs). The problem with both is that it is difficult to reconcile their purportedly prudential focus (which is in line with leverage limits) with the rest of the constraints that are included in the rules. These constraints include things like transparency, asset portfolios, client protection, and so on. Additionally, the fact that their supervision corresponds to securities commissions rather than the prudential supervisors is another issue.

The path before us. Am I able to have everything?

One of the challenges that arises when attempting to implement the necessary reforms to address the 'intermediation' perspective of shadow banking is the fact that the law is a delicate instrument that has its own limitations. Due to the fact that there is no such thing as a complete law, it is necessary to interpret the rules that are already in place in order to address new circumstances that are not expressly covered by the rules. These scenarios include regulatory arbitrage scenarios. Specifically, this is accomplished by making an appeal to the "legislative intent" that underpins the rules. The problem emerges when such aim is not explicitly stated, which is the situation in

this instance.

(c) In the Basel Framework, the 'indirect' rules should be taken into consideration. When it comes to financing vehicles that are largely dependent on their sponsor, the question that needs to be answered is how the legislation should operate. There is a great deal of complexity involved in determining when the risk associated with an asset has been "retained" by the sponsor. Taking a substance-over-form approach, in which particular rules require sponsors to consolidate the vehicles in each instance of support or dependence, will result in the development of techniques to avoid each new restriction. At some point in the future, it is quite probable that the rules will be simplified, and the strategy that prioritises substance over form will be abandoned.

Alternatively, there is the option of having regulations that are founded on principles and leaving interpretation up to the discretion of supervisors. However, in order for supervisors to appropriately exercise discretion, it is necessary for the intention that behind the regulations to be made apparent. The catch-22 is that securitization vehicle regulations stipulate, on the one hand, that sponsors can't be exempt from capital requirements calculations unless they have some sort of exposure to the vehicle or its assets; and, on the other, that sponsors can't be exempt from maintaining exposures of at least 5% (refer to the "skinin-the-game" requirements up top). Consequently, this gives rise to a dilemma regarding the behaviour that is anticipated from sponsors: should they maintain a significant exposure in order to demonstrate that their interests are congruent with those of investors, or should they maintain the minimum in order to guarantee that the sponsor and the vehicle are distinct from one another?

Given the contradictory attitudes that politicians have regarding securitization, the confusion is even more widespread. After spending years putting an emphasis on safety and soundness, as well as the dangers of excessive securitization, officials in the European Union have recently come to the realisation that securitization is a powerful tool for mobilising resources, and they have also discreetly altered their approach. The European Commission outlines its objective to create a "sustainable high-quality securitization market relying on simple, transparent, and standardised securitization instruments" in its document titled "Building a Capital Markets Union." This objective would necessitate the establishment of a particular prudential regime for this particular type of securitization.

When it comes to interpreting the new rules, are supervisors required to take a cautious or facilitating attitude, in the event that such revisions are implemented? Because legal writings are to be applied presumptually with the understanding that there is a singular legislative

purpose, they have an intrinsic "stickiness." How long until we see a shift in the way laws are interpreted, if new policies and attitudes emerge from the prevailing winds? It is the responsibility of policymakers to ensure that the law, in its entirety, reflects a coherent legislative objective while still allowing for some leeway in terms of how it is interpreted. The very least that they should do is make an effort to avoid sending contradictory information, which would render a definitive interpretation impossible.

(d) The message is the same with regard to the direct regulation of obscure financial institutions. Depending on how broadly one interprets the references to "deposits or repayable funds," "public," and "grant credits," the definition of "credit institution" in EU banking rules is broad enough to include various shadow banks. The definition states that "credit institution" refers to an organisation whose primary business is to accept deposits or other repayable funds from the general public and to grant credits for its own account. It is not the question of whether or not banking regulations may be applied to shadow banks; rather, the issue is that shadow banks are currently subject to other regulations that are looser in nature (such as those governing investment businesses, UCITS, or hedge funds).

Therefore, the question that has to be answered is why entities that are exposed to comparable dangers are not subject to regulations that are equivalent. The correct response is that path-dependent inertia and express policy choices are the answer. A division between "banking," "insurance-pensions," and "capital markets" is the foundation upon which the laws that are currently in place are based. This distinction is not only illogical from a prudential standpoint, but it is also difficult to alter. There would be some protest from arbitrageurs, but there would also be other opposition that would be warranted for two reasons. One of the reasons is that prudential standards for banks require an insurmountable amount of work, which would cause non-bank financial intermediaries to become suffocated. If this were to occur, it would be significantly more challenging to reduce the burden of implementing socially acceptable financial innovations. GSEs were an example of a situation in which regulatory subsidies appear to be erroneous when viewed through the lens of hindsight; yet, other instances demonstrate that policymakers are prepared to choose forbearance even more frequently. Consider companies that deal in electronic money. They are subject to a regulatory environment that is less stringent, and they have made significant headway in African countries in terms of financial inclusion (via the use of mobile money). But mobile network providers that offer financial services through mobile phones are considered "shadow banks," and according to the reasoning presented above, they ought to be subject to the same

prudential regulations as traditional banks.

Second, the existence of prudential norms is partially supported by the moral hazard problem that arises as a consequence of the access that banks have to public backstops (deposit insurance or discount window). If this is the case, then companies that are subject to prudential standards ought to have access to deposit insurance and liquidity support. Alternatively, only companies that have access to those backstops ought to be subject to the same requirements. However, legislators are still not prepared to explicitly link prudential regulations with backstops, therefore one of the finalistic conditions for prudential rules cannot be applied to their interpretation.

Policymakers are confused about what to do and aware of the political difficulties of passing meaningful reform, so they use a concept that is so indeterminate that successes can be more easily sold and failures can be more easily disguised. This is one of the two possible readings of the broadness of the concept of shadow banking. The first reading is that policymakers are setting an ambitious agenda of reforms, which can only be encompassed using a wide concept.

In spite of the fact that it is too soon to determine which of the two interpretations is more accurate, this article presents a sceptical viewpoint. It is important to note that although the measures taken by the European Union Commission and the Financial Stability Board (FSB) are more stringent in identifying the issue, they are still limited to the "intermediation" perspective of shadow banking. Within the framework of the "intermediation" perspective, they exhibit an excessive amount of concentration on the issues that are brought up by the "new" entities (such as mutual funds, hedge funds, or securitization entities), rather than the function that core actors play within the system. Additionally, there is an excessive amount of focus placed on a narrative of regulatory arbitrage, while there is an insufficient amount of emphasis placed on the 'institutional design' perspective. This perspective demonstrates that many instances of shadow banking are a direct consequence of policy choices. When the function of GSEs, dealer banks, and repos has been propped up by public policies, it is impossible to pretend astonished by their importance during the crisis. This is because the role of these institutions has been enhanced.

Despite the fact that there are instances of the problem that respond to a "intermediation" perspective and a regulatory arbitrage narrative (for example, securitization entities), it is difficult to anticipate the success of reforms. This is because attention shifts as policymakers shift their priorities from the reduction of risk to the mobilisation of financial resources. As a result, it is significantly more challenging to maintain a positive attitude regarding the

"monetization" perspective, in which not only the options may be unappealing, but also the outcomes of reforms may be unpredictable.

In light of all of this, prudence is required. A young mouse in the story made the following observation: "It is simple to sit down and think of big ideas, but who will ring the bell for the cat?" The term "shadow banking" refers to a concept that is unquestionably significant and has a great deal more to offer than what is initially apparent. On the other hand, the manner in which the problem is characterised and the varying degrees of clarity with which policies are outlined give rise to the suspicion that, rather than shedding light on the shadows, we might continue to struggle with it for some time for the foreseeable future.