SHADOW BANKING
CHRONICLES FROM THE US AND INDIA

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- *Shadow banking in the US is on the rise owing to higher regulatory pressures on banks and rapid adoption of technology leading to growth in fintechs.*
- *In India as well shadow banking is on the rise. Fintech companies are now emerging as key players, striving to fill the gaps left by banks and NBFCs.*
- *However, unlike the US, India has limited depth in its Debt Capital Markets. Fintech companies and NBFCs depend on banks for capital. This allows for greater control by the RBI in regulating this space.*

The term "Shadow Bank"[1] was coined by the economist, Paul McCulley in 2007. Shadow Banks are Non-Bank Financial Institutions involved in maturity transformations, that is, using short-term deposits to fund long-term loans. Because they are not subject to traditional bank regulations, they cannot borrow in an emergency from the Federal Reserve, and do not have traditional depositors whose funds are covered by insurance. Hence, these institutions are in the "shadows". Today, the definition covers a broad spectrum of financial institutions, including fintech, operating outside traditional bank regulations.

In India, the Reserve Bank of India (RBI) regulations extend to Non-Banking Financial Companies (NBFCs). Thus, the term Shadow Banking was not relevant until recently. With the rapid rise of fintech, which operates outside regulations, Shadow Banking is also on the rise.

SUBPRIME CRISIS - THE BIRTH OF SHADOW BANKS

The 2008 global crisis led banks to withdraw from lending, thus paving the way for an increase in Shadow Banking. A research paper titled **Fintech, Regulatory Arbitrage, and the Rise of Shadow Banks,** published in the **Journal of Financial Economics** in 2018[2], covers the key reasons for the rise in Shadow Banks in the US mortgage market.

The authors used a dataset comprising 50 lenders in the US from 2007 to 2015. The authors found two reasons for Shadow Bank growth: the increase in regulatory burden on banks (accounting for ~55%) and the use of technology (accounting for ~35%[2]).

Highlights of the study:

1. The post-subprime crisis period witnessed intensified regulatory scrutiny and burdens on banks. Consequently, despite the lower funding cost, banks experienced a decline in market share[2]. In addition, with rapid growth in technology, loan origination has begun to move online. Fintech lenders accounted for fewer than 5% of mortgages in 2007. By 2015, this share increased by 12%[2].
2. Fintechs can leverage technology for better price discrimination[3] than banks. Fintech lenders in the US employ interest rate-setting models for mortgages that have outperformed the models used by traditional players. This superior performance is attributed to a higher degree of variation in prepayment outcomes across borrowers. Using technology, fintech companies can provide customised lending solutions. Fintech companies have also been able to charge higher rates, particularly to low-risk borrowers, who may be less price-sensitive and more time-sensitive. Furthermore, fintech firms are 7% to 10% more likely to originate mortgage re-finances than traditional banks.

Today, Shadow Banks have become an integral part of the US financial system. The top US banks reported a 9.2% increase in loans to Shadow Banks in Q1 2023. Major banks are lending more money to Shadow Banks, which is becoming a significant part of their overall financial structures. The US regulators' emphasis on this issue implies that the activities of large banks in supporting Shadow Banks could have implications for financial stability[4].

[1] Kodres L.E. (2013). What is Shadow Banking? Finance and Development, Vol. 50, No. 2, International Monetary Fund
[2] Buchak G, Matvos G, Piskorski T, Seru A. 2018. Fintech, regulatory arbitrage, and the rise of shadow banks. J. Financ. Econ. 130:453–83
[3] Price Discrimination: the action of selling the same product at different prices to different buyers, in order to maximize sales and profits.
[4] Banking, Risk and Regulation (August 2023). US G-sibs' lending to shadow banks hits record high

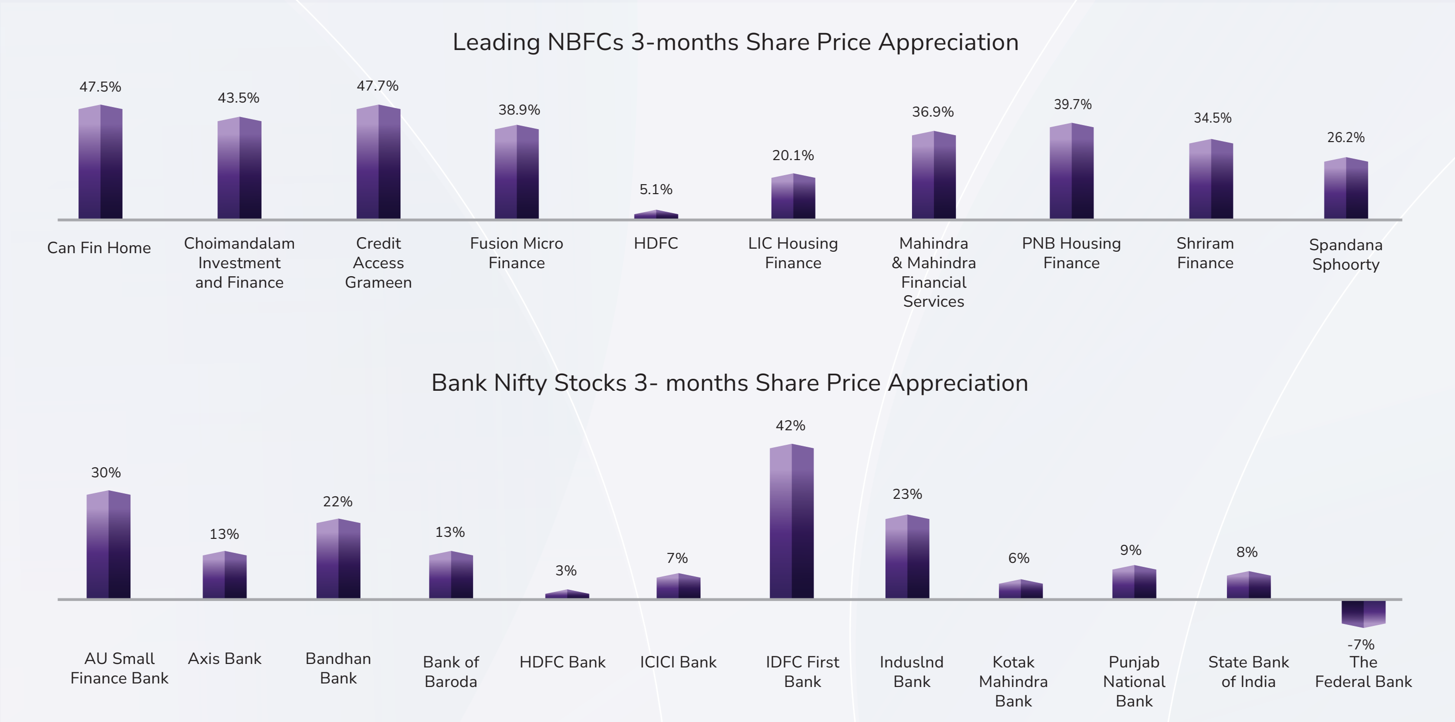
Non-Banking Financial Companies have been striving to fill the gaps left by banks since the 1960s. NBFCs were initially present in the shadows. However, their rapid growth in the 1980s and 1990s led to increased scrutiny and regulations. The RBI Act was amended in 1997 to enhance regulatory coverage of NBFCs. This finding also supports the recognition of NBFCs in being recognized as key players in the financial sector.

However, from 2018 to 2020, there were large defaults in the NBFC sector by players such as IL&FS, Diwan Housing Finance, and Reliance Home Finance. Defaults triggered a chain reaction, causing a liquidity crisis and undermining confidence in NBFCs. This resulted in RBI stepping in and tightening regulations on NBFCs in 2021.

Unlike the United States, Shadow Banking in India is significantly restricted, with the Reserve Bank of India (RBI) playing a pivotal role. However, fintech companies are now emerging as key players, striving to fill the gaps left by Banks and NBFCs. Fintech companies also cause a paradigm shift in customer engagement, given their ability to use technology to drive hyperpersonalisation. However, given their lack of access to capital, fintech companies have actively collaborated with NBFCs and Private Banks.

Over the last three years, the top NBFCs, private banks, and fintech companies have grown faster than government-owned banks. Over the last three months, nearly all prominent NBFCs produced returns exceeding 20%. This is reflected in the share prices of the NBFCs (Figure 1)[5].

Figure 1: NBFCs Outperforming Banks in Financial Year 2024



Source:The Economic Times (July 2023). NBFCs Overtake Bank Stocks in FY24. Here's Why

Technology has been pivotal in driving this growth. NBFCs and fintech companies have automated most lending processes, reduced costs, and enhanced the customer experience. These firms can leverage technology for quick loan approval, real-time credit scoring, and seamless online transactions. These firms were also able to reach customers in remote areas. Fintech players capitalise on opportunities to drive significant disruptions in the lending market.

Digital lending is the latest hotspot. Digital lending, much of which is unsecured, skyrocketed from INR 117 billion to INR 1.4 trillion between 2017 and 2020, a twelve-fold increase in five years[6]. Co-lending partnerships between banks, NBFCs, and fintech companies have played a pivotal role in this growth.

[5] The Economic Times (July 2023). NBFCs Overtake Bank Stocks in FY24. Here's Why

[6] allcloud.in. How NBFC Software Could Make Your Lending Business Easy

However, as highlighted above, the RBI plays an active role as guardrails to ensure well-managed growth. The RBI has been trained in digital lending. Recently, the RBI increased the risk weight of unsecured lending by 25%[7]. As a result, NBFCs, such as Aditya Birla Finance and Poonawalla Fincorp, have notified their fintech partners that they will no longer finance risky Buy-Now-Pay-Later (BNPL) and small-ticket consumer loans below INR 25,000. These NBFCs are now favouring collaborations with highly rated fintech companies offering loans starting at INR 50,000, signalling a shift in lending priorities[8]. Thus, the RBI is closely monitoring the rise of Shadow Banking.

Conclusion

Shadow Banking is now an integral part of the US financial system. With the rapid growth of fintech companies, Shadow Banking is also on the rise in India. However, unlike the US, India has limited depth in its Debt Capital Markets. Fintech companies and NBFCs depend on banks for capital. This allows for greater control by the RBI in regulating this space. Therefore, we do not foresee an increase in Shadow Banks in India, similar to what we have seen in the US. However, the technology continues to cause disruptions. Under the watchful eyes of the RBI, we expect growth to be well-balanced, contributing to higher financial inclusion and depth of the financial markets.

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