Shadow banking

What is the issue?

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Shadow banking is emerging as a major lender in emerging markets which warrants considerable management of the financial sector.

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What is a shadow bank?

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- Shadow banks are those institutions that do not collect deposits but still provide loans.
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- These include a variety of institutions, ranging from trusts, investment funds etc.,
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- It facilitates the creation of credit but they are not subject to regulatory oversight.
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- As a result, many of the institutions and instruments have been able to employ higher market, credit and liquidity risks, and do not have capital requirements commensurate with those risks.
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- Thus, there are concerns that over lending and default in such institutions can destabilise the financial system.
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What else mandates regulation of shadow banking?

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- Credit to GDP gap measures the risk associated with the credit given to household and businesses in a country.
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- A high credit to GDP gap means trouble for the banking system.

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- The high levels of credit to GDPresulted in the Sub-prime crisis of 2008.

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- <u>Deleveraging </u>of an economy refers to the simultaneous reduction of debt levels in multiple sectors, including private sectors and the government sector.

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- It is usually measured as a decline of the total debt to GDP ratio in the national account.

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- Though a phase of deleveraging was witnessed in the advanced economies and in emerging markets, credit/debt has been expanding again.

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- This is shown by the credit to GDP levels in 2017 to be 15% higher than in 2008 in the advanced economies, and more than 80% higher for emerging markets.

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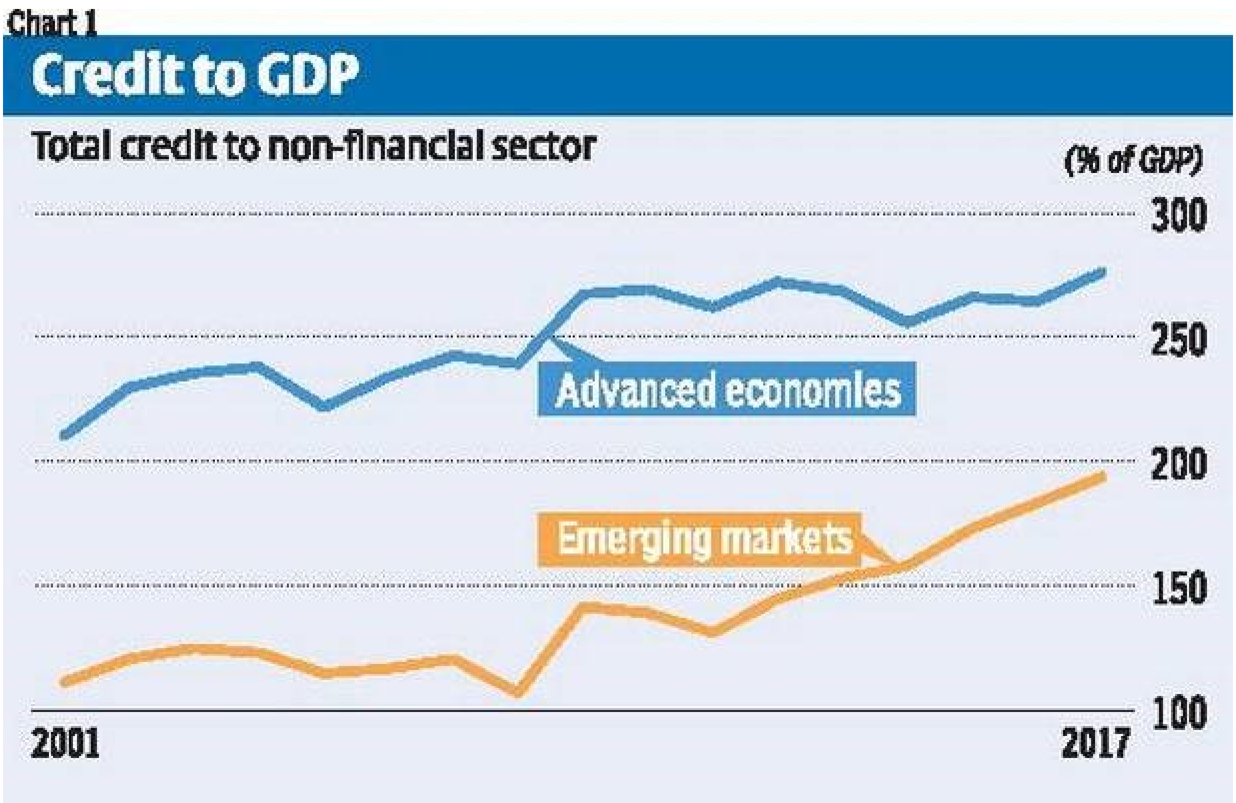

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- Hence, the attention has now shifted from bank lending to shadow banking

activities.
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Does shadow banks still play a role in debt creation?

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- Shadow lending has played a major role in the build-up to the Great Financial Crisis in 2008.
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- However, since then, shadow lending appears to have reduced, or at least been contained relative to GDP.
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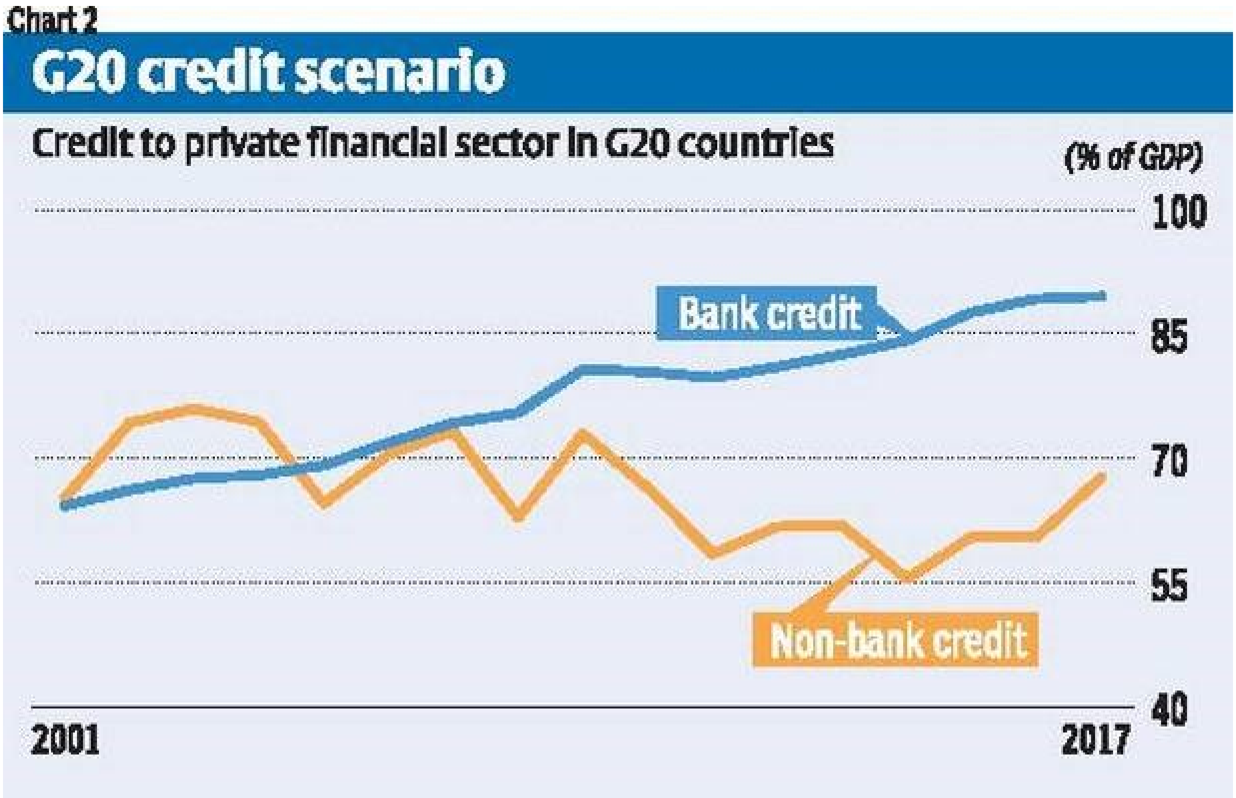

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- For the G20 countries taken as a group, credit from non-banks as a per cent of GDP was about 6% lower in 2017 than in 2007, while bank credit had actually increased by 15%.
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- Significantly, the reliance on shadow banking appears to have reduced significantly in the advanced economies by 2015-17 from what it was during 2008-10.

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- This suggests that excessive debt creation is much more a problem of the banking sector as a whole than the non-bank or shadow bank sector.
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How does China regulate the shadow banks?

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- Shadow banking has become more significant in emerging markets rather than in advanced economies in recent times.
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- Though there are concerns on shadow lending across the world, the credit extended by shadow banks in China stands at 52% of GDP.
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- However, China regulatesthe activities of shadow banks, both internally and in cross-border transactions.
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- Also, Chinese banks have become increasingly integrated to the shadow banks through their own investments, making it difficult to view these two separately.
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- So while interest rates and other variables such as maturities in shadow lending may not be subject to the same regulatory regime as for banks, there are clearly attempts to put regulatory checks on them.
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What is the case with India?

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- There is a very low spread of credit from non-banks in India, standing at 3.4% of GDP in 2015-17.
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- This is because much of the lending has turned non-performing in India and the extent of default suppresses both bank and non-bank lending.
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- Thus, there is considerable mismanagement of the financial sector and it needs to improvised to increase credit inflow in the economy.
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Source: Business Line

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