Shadow Banking and the Crisis in the Indian Economy

This editorial is based on the news "Crisis in NBFC Sector Could Hurt Economic Growth" which appeared in "The Hindu" on 22nd May 2019. The article talks about how the current crisis in NBFC can create problems in the Indian economy.

The current liquidity crisis in the non-banking financial companies' (NBFCs) sector may not pose a systemic risk for now but investors can impact on the overall growth of the economy in the long run.

Non-banking financial companies (NBFCs) are financial institutions that offer various banking services but do not have a banking license. Generally, these institutions are not allowed to take traditional demand deposits—readily available funds, such as those in checking or savings accounts—from the public. This limitation keeps them outside the scope of conventional oversight.

What is difference between banks & NBFCs?

NBFCs lend and make investments and hence their activities are akin to that of banks; however there are a few differences as given below:

- NBFC cannot accept demand deposits;
- NBFCs do not form part of the payment and settlement system and cannot issue cheques drawn on itself;
- deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation is not available to depositors of NBFCs, unlike in case of banks.

What is the Contribution of NBFC in the Economy?

- NBFCs play an important role in promoting inclusive growth in the country, by catering to the diverse financial needs of bank excluded customers.
- NBFCs often take a lead role in providing innovative financial services to Micro, Small, and Medium Enterprises (MSMEs) most suitable to their business requirements.
- NBFCs do play a critical role in participating in the development of an economy by providing a fillip to transportation, employment generation, wealth creation, bank credit in rural segments and to support financially weaker sections of the society.
- Emergency services like financial assistance and guidance are also provided to the customers in the matters pertaining to insurance.

How NBFC Liquidity Crisis can Impact Economic Growth?

- The mutual fund and the NBFC sector is strongly related as the mutual fund is the biggest fund provider to NBFC space by way of commercial paper and debentures.
- Experts say all the investment by mutual fund in the NBFC sector is not in high investment grade

or triple-A.
- If there is a problem with a few NBFCs, there can be a chain reaction of selling the exposure, which could create more trouble for the NBFC sector.

NBFC, Mutual Fund (Shadow Banking) and the Crisis

A mutual fund is a type of financial vehicle made up of a pool of money collected from many investors to invest in securities such as stocks, bonds, money market instruments, and other assets.

A shadow banking system is a group of financial intermediaries facilitating the creation of credit across the global financial system but whose members are not subject to regulatory oversight.

- Mutual fund companies have invested in NBFC. Banks have lent to NBFC on the basis of commercial papers (an unsecured, short-term debt instrument issued by a corporation, typically for the financing of accounts payable and inventories and meeting short-term liabilities).
    - Now such pieces of paper are nothing but junk. Since August 27, 2018, when IL&FS non-banking financial company was unable to repay the loan at the scheduled time and missed deadlines, the share market is retracting, NBFC stock prices started tumbling down.
- About 25%, of loans in India, is taken from 50-odd shadow banks(NBFC) that have expanded quickly. They are less heavily regulated and lend in particular areas such as housing.
    - They are usually prohibited from taking deposits so fund themselves with debt. They are big enough to damage India's entire financial system. Mutual funds, which are sold to the public, have $55bn of exposure to them, or 11% of total assets under management.
    - Conventional banks have loaned $70bn to shadow banks, the equivalent of two-fifths of the former's core capital
- Even if a full crisis does not erupt shadow banks may be forced to shrink. When combined with the rising NPAs of state banks, that would mean that 75% of India's financial system is on crutches.

The Risks of Shadow Banking

- Borrowing short and lending long is a high-risk game as the IL&FS collapse amply manifests.(Generally, NBFC invest in companies with long gestation period, like infrastructural projects where returns come in 12-14 years, while they take capital through short term funds such as mutual funds which entail early repayments within 3-4 years, thereby getting caught in a trap of high risks.) In the aftermath, the government has taken it over though it already indirectly owned 40% of it.
    - There is a huge mistrust in the financial market with mutual funds and banks are reluctant to lend to NBFCs. In spite of reports of solid capital ratios, there is a great deal of apprehension about the possible time-bombs buried in their balance sheets. For months now, NBFCs have been facing a liquidity crunch.
- Defaults by such NBFCs are fatal enough to damage India's entire financial system with mutual funds - which are sold to the public - having $ 55 billion of exposure to them, or 11% of total assets under management.
    - Traditional banks have loaned $ 70 billion to NBFCs which approximately equals to 40% of the banks' core capital.

International Experience

In 1997-98 the world's largest hedge fund Long-Term Capital Management (LTCM) in the US was going bankrupt. This hedge fund management firm led by Nobel prize winning economists and famous Wall Street traders enjoyed enormous clout in the US administration. The US administration forced 14 investment banks to lend money to the hedge fund to keep it alive, till elections were done and dusted. LTCM was allowed to perish quietly thereafter.

It’s some of these 14 lenders to LTCM who went bankrupt in the 2008 crisis, the seeds of which were sown in 1998 in the LTCM crisis. Perhaps, IL&FS has the potential to be India’s LTCM and not only Lehman Brothers.

A parallel can be drawn in this case and the effort of LIC to save IL&FS. By saving NBFC, govt is rewarding the failure.

SEBI Guidelines on Mutual Funds

- SEBI has decided to allow mutual funds to write call options subject to certain conditions (except Index Funds and ETFs).
- Currently, mutual fund schemes are permitted to undertake transactions in equity derivatives but cannot write options or purchase instruments with embedded written options.

Call options refer to an agreement that gives a buyer the right to purchase an asset at a specified price within a particular time period.

- Assets under management(AUM) of the industry are at a record of Rs 25 lakh crore, resulting in a revenue of about Rs 13,000 crore.
- The market regulator has decided to lower expenses paid by investors of equity mutual fund schemes.
- Total Expense ratio - TER is a percentage of a scheme's corpus that a mutual fund house charges towards expenses including administrative and management.
- TER for equity-oriented mutual fund schemes were capped at 1.25 per cent and for other schemes at one per cent.
- The cap for fund of funds will be 2.25 per cent for equity-oriented schemes and two per cent for other schemes.
- Also, the TER will go down as the AUM slab increases.
- For instance, the TER ranges between 0.8 and 1.05 per cent for the for the highest AUM slab (over Rs 500 billion), whereas it ranges between 2 and 2.25 per cent for the lowest AUM slab (0 to Rs 5 billion).
- Transparency - SEBI has mandated that commissions and expenses shall be paid from the scheme only and not by any other route.
- Further, the mutual fund industry has to adopt the full trail model of commission in all schemes without paying any upfront commission.
- Disclosure - SEBI requires category-wise disclosure of all schemes’ returns with respect to its total returns to be made available on the Association of Mutual Funds of India’s website.
- Borrowings – Companies with outstanding borrowings above Rs 1 billion shall raise 25 per cent of their incremental borrowings for the year through the bond market.

Way Forward

India also must end the regulatory arbitrage that allows shadow banks to raise most of their funds from retail investors and deposit-taking banks. Either shadow lenders should come out of the dark and be turned into banks, or a firewall will have to be erected around them to protect the rest of banking.

Drishti Input:

Shadow banking in India has its own benefits, but entails multiple risks too. Substantiate.

PDF Refernece URL: https://www.drishtiias.com/printpdf/shadow-banking-and-the-crisis-in-the-indian-economy