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# Shadow Banking in India in Relation to the IL&FS Crisis

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***Abstract***

*The term "shadow banking" was used for the first time by Paul McCulley in 2007 while referring to non-banking financial institutions. Unlike in the US and Europe, where shadow banking is an option for safe transactions, in India the position of non-banking financial institutions (NBFCs) is more of an alternative available for banking transactions in semi-urban areas and in smaller areas, where the banking institutions do not have a good outreach. In addition to carrying out the basic functions of financing institutions, NBFCs also perform functions in the securities market in relation to mutual funds, unit funds, collective investment schemes, infrastructure schemes, real estate schemes, hedging, etc. The recent IL&FS crisis has raised doubts and concerns about the viability of NBFCs and their regulation under Indian financial and legal systems. In light of the crisis, risks for lending institutions and the position of shadow banking in India, this paper will examine shadow banking/NBFCs in India and outside India, financial and legal framework for regulating shadow banking in the US and Europe, financial and legal framework in India with reference to RBI and SEBI regulations, and an analysis of the IL&FS crisis in relation to shadow banking in India.*

***Keywords***: *Shadow banking, NBFCs, IL&FS, RBI, RBI Act.*

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## INTRODUCTION

The term *shadow banking* was used by PIMCO's former Managing Director Paul a McCulley in 2007, while referring to non-banking financial institutions (NBFCs) during the Annual Economic Policy Symposium of the Federal Reserve Bank of Kansas City in Jackson Hole, Wyoming. Paul A McCulley identified "shadow banks" as a variety of leveraged non-bank investment conduits, vehicles, and structures. He noticed that "unlike regulated real banks, which fund themselves with insured deposits, backstopped by access to the Fed's discount window, unregulated shadow banks fund themselves with uninsured commercial paper, which may or may not be backstopped by liquidity lines from real banks. Thus, the shadow banking system is particularly vulnerable to runs – commercial paper investors refusing to re-up when their paper matures, leaving the shadow banks with a liquidity crisis – a need to tap their back-up lines of credit with real banks and/or to liquidate assets at fire sale prices" [1]. The origin of the concept of shadow banking can be traced back to coinage of the term "parallel banking system", which led to the use of various related terms such as "securitized finance", "market-based credit system", "non-bank credit intermediation" and "network finance" while referring to the non-banking financial sector and shadow banking. It may be worth noting that contrary to the general perception, shadow banking is neither shadowy/shady, nor is it the conventional form of banking.

Following the global financial crisis of 2008, the term shadow banking found prominence. The history of the structure of shadow banking can be traced back to the late 19$^{th}$ Century, when the Bank of England started its programme to stabilize the Private Bills market by bailing out bill brokers that were not actually banks, but had been taking up the work of converting the private bills into money, something similar to what is referred to as "shadow banking" in the 21$^{st}$ Century. It may be pertinent to mention that the modern financial system is vulnerable, owing to the risks involved in the multitude of financial activities of banking and non-banking institutions.

It is not easy to define shadow banking as such, because of a variety of financial institutions, instruments and activities involved in shadow banking. Shadow banking came into the forefront owing to its contribution to systemic risk, and therefore it may be relevant to define the term based on the systemic risk implications of shadow banking. Shadow banking may be defined by using the following three approaches [2]:

1. **Based on activities**, which include maturity, liquidity and credit transformation so long as they are geared towards performing credit intermediation, such as taking savings from lenders and channelizing them towards borrowers.
2. **Based on entities**, such as Money Market Mutual Funds (MMMFs), hedge funds, peer to peer lenders, private equity funds, etc.
3. **Based on instruments**, such as repurchase agreements (repo).

According to the Financial Stability Board (FSB), shadow banking can be defined based on activity and entity as "credit intermediation involving entities and activities outside the regular banking system" [3]. However, many academic commentators have focused on the instruments and entity-based approach to define shadow banking. According to Professor Steven Schwarcz, shadow banking is the provision of any financial products and services and not just the provision by non-banks of products and services ordinarily provided by traditional banks.

An analysis of the abovementioned definitions indicates that the common perception of shadow banking lacks a precise connection with systemic risk. For instance, repos may not be useful to take care of systemic risks, especially when large liquidity reserves are held against them [4]. On the contrary, securitization by banking institutions may lead to systemic risk despite being excluded from the purview of shadow banking. According to the International Monetary Fund (IMF), shadow banking is to be identified based on non-core liabilities, which can be defined in contrast to the liabilities of banking, such as demand deposits of individuals as well as institutional creditors. This definition excludes non-traditional entities, such as non-money market mutual funds and pension funds, which do not engage in any form of maturity transformation [5].

One of the important reasons why NBFCs are preferred over banking institutions is lower number of non-performing assets (NPAs) in NBFCs compared to those of the banking institutions. However, the recent IL&FS crisis in India has exposed the financial market to the financial risks in relation to the NBFCs in India. The crisis has created a credit crunch, as reported by various newspapers and magazines, and it has had a direct effect on the real estate sector, which is largely dependent on NBFCs for growth and expansion. According to the October Report by Credit Suisse, the exposure of NBFCs to real estate developers is as high as INR 2.00 trillion. As an aftermath of the IL&FS crisis, real estate stock index has reportedly declined 26% as of October 2018 and the benchmark index has declined by 12% during the same period. Even though NBFCs are regulated by the Reserve Bank of India, the crisis has indicated the requirement of a better and stronger regulatory mechanism with respect to NBFCs in India. The scope of this paper is to understand the concept of shadow banking, the legal and financial framework of shadow banking in the global scenario, the legal and financial framework in India, a critical analysis of the recent IL&FS crisis, and a suggested regulatory and legal model in relation to shadow banking in India in the light of the IL&FS crisis.

## FINANCIAL AND LEGAL ASPECTS OF SHADOW BANKING: GLOBAL SCENARIO

During the 2010 Seoul Summit, it was pointed out by the G20 leaders that on completion of new regulatory standards for banks, potential regulatory gaps can be easily identified in shadow banking, and in this respect, the Financial Stability Board (FSB) was requested to develop recommendations for strengthening the regulatory mechanism of shadow banking. Following this request, FSB set up a Task Force in December 2010, and the first step taken by FSB was to coin a workable definition of "shadow banking," which could help in developing the regulatory mechanism easily. A two-step approach was taken up by FSB and the authorities decided to start the process from a broad definition of shadow banking as "a system of credit intermediation that involves entities and activities outside the regular banking system" and then move towards a more focused definition of shadow banking as "bank-like risks generated by the shadow banking system: maturity and liquidity transformation, excessive leverage, flawed credit risk transfer and regulatory arbitrage concerns" [6]. However, the definitions do not specify the mitigation mechanism. During the 2008 global financial crisis, very few countries had a regulated shadow banking system, and most of the countries suffered from severe crisis due to a lack of risk mitigation in place in their legal and regulatory realms.

In order to understand and create a proper risk-mitigation mechanism in shadow banking, FSB adopted a comprehensive monitoring approach, where macro (system-wide) and micro (entity/activity-based) information were used. The G20 Shadow Banking Roadmap was updated by FSB in 2015 which was followed by the 5th Integrated Annual Shadow Banking Monitoring exercise [7]. In collaboration with the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO), the FSB started the development and promotion of "five work-streams", covering indirect regulation via banking sector and direct regulation in respect of shadow banking sector, which can be summarized as follows as mentioned in the FSB October 2011 Report [8]:

1. To mitigate spillover effect between regular banking system and shadow banking system
2. To reduce susceptibility of MMFs to "runs"
3. To assess and mitigate systemic risks posed by other shadow banking entities
4. To assess and align the incentives associated with securitization to prevent a repeat of the creation of excessive leverage in the financial system
5. To dampen risks and pro-cyclical incentives associated with secured financing contracts such as repos, and securities lending that may exacerbate funding strains in times of "runs" [9].

Following the consultation period which ended in June 2012, IOSCO issued 15 policy recommendations to provide a basis for "common standards for the regulation and management of MMFs across jurisdictions in October 2012, which can be summarized as follows:

1. **General Regulatory Framework:** It was recommended that MMFs should be made a part of the Collective Investment Schemes (CIS) Regulations based on their *sui generis* features. It was further recommended that the proposed regulations should include specific limitations on the types of assets MMFs may invest in and the risks they may take. Regulators should closely monitor the development and use of other vehicles like MMFs so as to reduce regulatory arbitrage.
(Recommendations 1–3).
2. **Valuation:** Compliance with the general principle of fair value during valuation of assets has also been recommended for MMFs, and further that amortized cost method should only be used in limited circumstances. Such MMF valuation practices should be reviewed by a third party as part of their periodic reviews of the fund's accounts (Recommendations 4 and 5).
3. **Liquidity Management:** It has also been recommended that sound policy and procedures should be adopted by MMFs to know their investors. It has also been mandated that the MMFs should hold a minimum amount of liquid assets. Periodic stress testing and tools to deal with changing market conditions and redemption pressures should also be adopted (Recommendations 6–9).
4. **MMFs to Offer a Stable NAV:** A stable net asset value (NAV) should be offered by MMFs subject to measures designed to reduce the specific risks associated with their stable NAV feature and internalize the costs arising from these risks. A conversion to floating NAV should be allowed by regulators (Recommendation 10).
5. **Use of Credit Ratings:** Internal credit risk assessment should be strengthened and mechanistic dependence on external credit

ratings should be avoided. It is recommended that rating methodologies for MMFs should be made more explicit. Credit rating agencies should make their rating methodologies clear and easy to understand (Recommendations 11 and 12).

6. **Disclosure to Investors:** Absence of a capital guarantee and the possibility of principal loss should be the main feature of any MMF documentation. MMF investor disclosures should comprise all necessary information and details about their valuation practices and the procedures to be adopted during stress assessment and management (Recommendations 13 and 14).
7. **MMFs' Practices in Relation to Repos:** Guidelines regarding the practices revolving around repos issued by MMFs should be developed, strengthened and regulated (Recommendation 15).

During the Seminar on Law and Financial Stability held in Washington DC, organized by the Legal Department of International Monetary Fund (IMF) in May 2016 to commemorate the 70th Anniversary of IMF, it was pointed out that expansion of the shadow banking system is a matter of importance. It was mentioned that the expansion has been one of the key areas of attention for policy makers, since it was estimated to account for nearly 25% of the total assets of the financial sector. In order to strengthen the financial market, a connection between the banking and shadow banking institutions should be encouraged and established. Securitization is another area with respect to both banks and shadow banks which needs to be worked upon to make it safer. A strong system can only be possible if there is clarity on whether an institution-based approach or activity based approach should be adopted to define the shadow banking system [10].

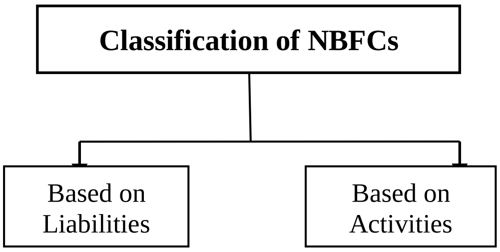
## REGULATORY AND LEGAL FRAMEWORK FOR SHADOW BANKING IN INDIA

Shadow banking in India goes by the name of non-banking financial companies (NBFC), which are a special category of companies whose activities include receiving loans, acquisition of stocks and shares, lease, hire purchase, insurance, chit funds, collective investment schemes, etc., registered under the Companies Act, 2013.

The reason why NBFCs are encouraged is that they are becoming an alternative to banking and other financial institutions and their main business activity is to raise capital from public investors and depositors and the same money can be given as loan to borrowers as per the rules and regulations of RBI.

A summary of the basic regulatory requirements of NBFCs in India is as follows:

1. **Registration:** Registration of NBFCs in India is regulated by the Reserve Bank of India. Even though NBFCs do not have banking licence, they are still bound to follow the RBI rules and regulations, since RBI governs all banking and related financial activities of institutions in India. Section 45 IA of the Reserve Bank of India Act, 1934 (RBI Act) mandates the requirement of registration and net owned fund of non-banking financial companies, which are engaged in the business of acquisition of shares, stocks, bonds, debentures or securities issued by the government or local authorities or other marketable securities and instruments. The Certificate of Registration has to be obtained by the said NBFC from the Reserve Bank of India.
2. **Minimum Net Owned Funds:** Further, there is a mandated requirement of minimum net owned fund of INR 25.00 lakh not exceeding INR 200.00 lakh.
3. **Public Deposits:** NBFCs may accept and renew public deposits for minimum 12 months up to a maximum period of 60 months. However, NBFCs cannot accept deposits payable on demand.
4. **Restrictions**: NBFCs cannot offer gifts and incentives or any other additional benefits to the depositors and investors. Further, NBFCs can offer interest rate which is not higher than the RBI prescribed ceiling rate.
5. **Credit rating**: A minimum investment grade credit rating is required to be taken up.




NBFCs can be classified as follows based on liabilities**:**

1. Deposit-accepting NBFCs (NBFC-D)
2. Non-deposit NBFCs (NBFC-ND)
3. Systematically important NBFC-ND (NBFC-ND-SI)
4. Other NBFC-ND

NBFCs can be classified as follows **based on activities:**

1. Asset finance company
2. Equipment leasing Company
3. Loan company
4. Hire purchase finance company
5. Investment company
6. Infrastructure finance company
7. Infrastructure debt fund
8. Systematically Important core Investment company
9. Collective investment management company
10. Chit funds
11. NBFC-micro finance institutions (NBFC-MFI)
12. NBFC-factors
13. Mutual benefit finance companies
14. Residuary non-banking companies

## AN ANALYSIS OF THE IL&FS CRISIS

The recent debt default by Infrastructure Leasing and Financial Services (IL&FS) in September 2018 was an eye opener about the financial risks in connection with Indian NBFC sector. The debt crisis has created a credit crunch and it has affected important financial sectors such as real estate and infrastructure, which largely depend on NBFCs for their funding and growth. According to the Credit Suisse October 2018 Report, the exposure of NBFCs to real estate developers has been estimated to be around INR 2.00 Lakh Crore. The crisis has also led to a fall in the real estate stock index and the benchmark index also declined during the said period. According to the latest RBI's financial stability reports, the share of NBFCs in total credit extended has increased from around 9.4% in March 2009 to more than 17% by March 2018 [11].

It may be pertinent to mention that IMF through the Global Financial Stability Report warned about the systemic risks associated with shadow banking practices in relation to NBFCs acting as lenders. Such risks can easily enter banks and cause a major havoc sooner or later. This particular warning is relevant for India based on the large size of the shadow banking sector in India compared to many other economies, as per the estimates of the FSB. As of 2017, it was reported by RBI that about 99.7% of shadow banking in India involves the activity of creation of long-term loans against short-term funding, which is primarily the forte of the NBFC and Housing Finance Companies (HFCs) in India [12]. Other common institutions of shadow banking in India are collective investment management companies, money market funds, fixed income funds, real estate funds and mixed funds are also comprised in shadow banking.

IL&FS defaulted on certain payments and failed to service the commercial papers on the due date in September 2018, which simply put, indicates that IL&FS ran out of cash or is in short, facing a liquidity crunch. The first shock came when the company postponed USD 350.00 million bonds issuance in March 2018 due to demand for a higher yield from investors [13]. Another reason for the crisis is the recent slump in infrastructure projects and disputes over contracts locking approximately INR 9000 crore of payments due from the government.

The National Company Law Tribunal (NCLT) has recently said that it is not possible to find a single solution for the IL&FS crisis and its INR 91,000.00 crore debt. The Uday Kotak-led NCLT Board reported that involving significant capital infusion from credible and financially strong investors is not feasible. The resolution includes a condition that investors along with the new board should engage with creditors, leading to an overall resolution across the IL&FS group [14]. The only options available were hiving off and selling entire business verticals to willing buyers and on failure of the same, go for asset level resolution including asset by asset solution explored through different methods such as significant capital infusion, asset monetization to retire debt and resolution with the creditors [15].

## CONCLUSION

Even though RBI regulates NBFCs in India, and the Securities Exchange Board of India (SEBI) regulates some special classes of shadow banking such as collective investment companies, mutual funds, and other securities related institutions, the IL&FS crisis has raised doubts about the watertight regulatory system in India to avoid such future crises. With the NCLT entering into the legal framework for further damage control due to shadow banking crises, the system has received an extra backbone to protect the economy from a 2008-like financial crash any time in the near future. Shadow banking is an alternative system to the banking system, and if proper regulatory measures are followed, the future of financial development can easily bank on shadow banking at a time when the banking sector or other financial sectors have a cash crunch.

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