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The growth of a shadow banking system in emerging markets: Evidence from India☆

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ABSTRACT

We study the determinants of the growth of those non-deposit taking non-bank financial corporations (NBFCs) which are regarded by the Reserve Bank of India as being systemically important and have grown substantially in India over the past decade. We document that bank lending to NBFCs (i) forms a significant proportion of the NBFC liabilities; (ii) fluctuates in line with bank allocation to priority lending sectors; (iii) decreases as the banks expand in the rural areas relative to urban areas; but, (iv) is virtually non-existent for the largest state-owned bank, namely State Bank of India (SBI) and its affiliates which have significant rural branch network. Starting with the financial crisis of Fall 2008, bank lending to NBFCs experienced a permanent contraction shock related to the shift of term deposits toward SBI away from other banks. These bank-NBFC linkages are present primarily for, and affect the credit growth of, those NBFCs that do loans or asset financing but not the investment companies. Overall, the findings suggest that in contrast to the prevailing views of shadow banking in the Western economies, lending to NBFCs in India is viewed by banks as a substitute for direct lending in the non-urban areas of

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the Indian economy, but this substitution is constrained by distortions in bank deposit flows due to the perceived differential government support of different banking groups.
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1. Introduction

We investigate the rapid growth of the non-bank financial corporations (NBFCs) in India as a laboratory to understand incentives underlying the growth of *shadow banking* institutions in emerging markets. Our main finding is that unlike the prevailing views on shadow banking[1] in the Western economies, which concern desire to provide "safe" collateral for financial transactions and mitigate counterparty risk[2] or simply to arbitrage bank regulations such as capital requirements,[3] the NBFCs in India appear to be substitutes for direct lending by banks in the non-urban parts of the Indian economy. Indeed, and consistent with the prevailing views of shadow banking, NBFCs in India are also linked to the banking sector, in particular, through bank lending to NBFCs which forms a significant proportion of NBFC liabilities. We study how these bank-NBFC linkages affect NBFC credit growth, how the linkages vary across types of banks in their ownership structure (state-owned versus private in case of banks), rural bank branching network relative to urban branching, and function of the NBFC (Financing versus Investment), and finally, what impact did the financial crisis in Fall 2008 have on these linkages given the relative shift of term deposits into state-owned banks due to their stronger perceived guarantees.

Exploiting a special dataset[4] of individual NBFCs over the period 2006–2011 that we collected from the Reserve Bank of India (RBI), we examine the following questions.

1) Does bank lending to the priority sectors[5] influence bank lending to the NBFCs and, in turn, how does NBFC lending itself gets affected?
2) Does bank branch expansion in rural areas relative to urban areas influence bank lending to the NBFCs and, in turn, how does NBFC lending itself gets affected?
3) Do term deposits (the more stable or less fragile form of deposits) at banks influence bank lending to the NBFCs and, in turn, how does NBFC lending itself gets affected?
4) Did the crisis have a long-term effect on the bank lending to the NBFCs and, in turn, how did NBFC lending itself get affected?
5) Do these channels influence the Investment Company and Financing Company NBFCs similarly or differentially?

Our results provide four interesting properties of bank lending to NBFCs in India over the period 2006–2011.

One, bank lending to NBFCs fluctuates in line with bank allocation to priority lending sectors; and second, this lending decreases as the banks expand in the rural areas relative to urban areas but this

[1] We discuss the prevailing views on shadow banking in Appendix I.

[2] See, in particular, Claessens et al. (2013), who survey the academic literature focused on the role of shadow banking in creating "safe" collateral to reduce counterparty risk, facilitate financial transactions, and satisfy the global demand for relatively safe assets for liquidity and hedging purposes.

[3] Acharya et al. (2013), for example, illustrate how commercial banks engaged in regulatory arbitrage of Basel capital requirements by setting up asset-backed commercial paper (ABCP) conduits, which experienced the first (shadow-banking) "run" of the financial crisis of 2007–08.

[4] Described in detail is Section 3.

[5] As per the RBI definition, *priority sector* refers to those sectors of the Indian economy, which may not get timely and adequate credit in the absence of this special dispensation. Typically, these are small value loans to farmers for agriculture and allied activities, micro and small enterprises, poor people for housing, students for education and other low-income groups and weaker sections. The RBI classifies the priority sectors into the following categories: a) Agriculture; b) Micro and Small Enterprises; c) Education; d) Housing; e) Export Credit and f) Others.

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