E-ISSN: 2708-4523
P-ISSN: 2708-4515
Impact Factor (RJIF): 5.61
AJMC 2025; SP- 6(3): 75-79

www.allcommercejournal.com
Received: 20-06-2025
Accepted: 24-07-2025

Dhannya Jayeshkumar
Department of Commerce, Dr. D.Y. Patil Arts, Commerce and Science College, Pimpri, Pune, Maharashtra, India

Shilpa Chabukswar
Department of Commerce, Dr. D.Y. Patil Arts, Commerce and Science College, Pimpri, Pune, Maharashtra, India

Kishor Nikam
Department of Commerce, Dr. D.Y. Patil Arts, Commerce and Science College, Pimpri, Pune, Maharashtra, India

Corresponding Author:
Dhannya Jayeshkumar
Department of Commerce, Dr. D.Y. Patil Arts, Commerce and Science College, Pimpri, Pune, Maharashtra, India

Shadow banking in India: Risks and the need for a robust regulatory framework

Dhannya Jayeshkumar, Shilpa Chabukswar and Kishor Nikam

DOI: https://www.doi.org/10.22271/27084515.2025.v6.i3Sa.800

Abstract
Shadow banking in India, primarily driven by Non-Banking Financial Companies (NBFCs), plays a critical role in credit delivery and financial inclusion, complementing the formal banking sector. However, its rapid growth, lack of transparency, and operations outside stringent regulatory oversight pose significant systemic risks, as evidenced by the 2018 IL&FS crisis. This paper examines the nature, risks, and regulatory challenges of shadow banking in India, emphasizing the need for a robust regulatory framework to mitigate systemic vulnerabilities and ensure financial stability. Using a systematic literature review and analysis of secondary data, we identify key risks such as liquidity mismatches, interconnectedness with banks, and regulatory arbitrage and propose a scale-based, activity-focused regulatory approach to balance financial innovation with stability.

Keywords: Shadow banking, Non-Banking Financial, Companies (NBFCs), systemic risk, regulatory framework, financial stability, liquidity mismatch, interconnectedness, regulatory arbitrage, IL&FS crisis, financial inclusion

Introduction
The emergence of the shadow banking industry is one of the most important changes that have occurred in the last several decades in the global financial system. According to the Financial Stability Board (FSB), shadow banking is the term used to describe credit intermediation operations involving organizations and structures that are not part of the conventional, regulated banking system. A wide range of non-bank financial intermediaries, such as mutual funds, hedge funds, structured investment vehicles, and Non-Banking Financial Companies (NBFCs), engage in these activities. Despite not having access to deposit insurance or central bank liquidity, these organizations frequently carry out bank-like tasks including lending and maturity transformation, which makes them vital to the financial system.

Due in large part to NBFCs' growing role in satisfying the credit needs of underbanked sectors, shadow banking has expanded significantly in India during the past 20 years. These organizations have become essential channels for providing loans to groups that traditional banks frequently ignore, including rural residents, workers in the unorganized sector, and small and medium-sized businesses (SMEs). Regulatory arbitrage, financial innovation, and rising investor interest have all contributed to this expansion, which has established NBFCs and other shadow banking organizations as important contributors to financial inclusion and economic growth. But there have been difficulties associated with this quick growth. Compared to ordinary banks, the shadow banking industry is subject to less regulatory scrutiny, which can result in excessive risk-taking, maturity mismatches, and liquidity vulnerabilities. Shadow banks offer systemic concerns, as demonstrated by the 2018 crisis affecting Infrastructure Leasing and Financial Services (IL&FS), a significant Indian NBFC. A global liquidity constraint was brought on by IL&FS's default, which also damaged investor confidence and highlighted the industry's vulnerability. The connections between shadow banking organizations and the larger financial system, as well as the possibility of contagion effects, have been further brought to light by subsequent events.

It is urgently necessary to review the regulatory framework that oversees shadow banking in India considering these developments. Even while these organizations are still crucial to financial intermediation, it's necessary to strike a balance between allowing them to expand and maintaining systemic stability. This essay seeks to assess the risks that shadow banking presents to the financial system, critically analyze the development and current structure of the industry in India, and suggest a strong, forward-thinking regulatory framework that can reduce possible risks while maintaining the sector's beneficial contributions to credit growth and economic development.

Defining Shadow Banking in the Indian Context

The Financial Stability Board (FSB, 2012) defines shadow banking as credit intermediation involving entities and activities outside the regulated banking system. In India, Acharya, Khandwala, and Oncu (2013) [1] describe shadow banking as primarily comprising NBFCs, which engage in credit intermediation, maturity transformation, and liquidity provision. Their study highlights the sector's role in filling credit gaps for small and medium enterprises (SMEs) and underserved populations, with NBFCs contributing approximately 25% of financial system assets by 2018. Sinha (2013) [9] notes that shadow banking in India also includes mutual funds, peer-to-peer (P2P) lending platforms, and other non-bank intermediaries, emphasizing their less transparent operations compared to banks.

Growth and Economic Role

The growth of shadow banking in India has been driven by financial liberalization and unmet credit demand. Acharya *et al*. (2013) [1] document a compound annual growth rate (CAGR) of 18% for NBFC assets from 2012 to 2018, fueled by lower interest rates and regulatory flexibility. Ghosh and Chandrasekhar (2016) [6] argue that NBFCs have been instrumental in financial inclusion, providing loans to microfinance borrowers and SMEs, sectors often neglected by commercial banks. However, they caution that this growth has increased systemic vulnerabilities due to reliance on short-term funding sources like commercial papers.

Risks Associated with Shadow Banking

a) Systemic Risk and Interconnectedness

Several studies highlight the systemic risks posed by shadow banking due to its interconnectedness with the formal banking sector. Chaturvedi and Singh (2022) [4] employ Granger-causality and network-based measures to demonstrate that NBFCs amplify systemic risk through their reliance on bank loans and mutual fund investments. The IL&FS crisis of 2018, as analyzed by Bandyopadhyay (2019) [3], exemplifies this risk, where the default of a systemically important NBFC triggered a liquidity crunch, impacting banks and mutual funds and causing a Rs. 75,000 crore loss in NBFC market capitalization.

b) Liquidity and Maturity Mismatches

Liquidity risks arising from maturity mismatches are a recurring theme in literature. Anshuman and Sharma (2020) [2] find that NBFCs' reliance on short-term debt, such as commercial papers, to finance long-term assets creates significant liquidity vulnerabilities. This mismatch was a key factor in the IL&FS crisis, as short-term funding dried up when investor confidence eroded. RBI (2019) reports further underscore the sector's exposure to liquidity shocks, particularly for retail NBFCs dependent on debt mutual funds.

c) Regulatory Arbitrage

Regulatory arbitrage is another critical concern. Acharya *et al*. (2013) [1] argue that NBFCs exploit lighter regulatory requirements compared to banks, engaging in riskier lending practices with lower capital adequacy ratios. Sinha (2013) [9] notes that the absence of a unified regulatory framework allows some NBFCs to operate with minimal oversight, increasing the potential for financial instability.

D) Governance and Transparency

Poor governance and lack of transparency in shadow banking entities are well-documented. Bandyopadhyay (2019) [3] highlights governance failures in the IL&FS case, including inadequate risk management and non-transparent financial reporting, which misled investors and regulators. Similarly, RBI (2021) discussion papers point to weak corporate governance structures in NBFCs as a key driver of systemic risk.

Regulatory Framework and Challenges

The Reserve Bank of India (RBI) regulates NBFCs under the RBI Act, 1934, with additional oversight by the Securities and Exchange Board of India (SEBI) for mutual funds. RBI (2019) introduced stricter guidelines for systemically important NBFCs (NBFC-ND-SI), mandating a 15% capital adequacy ratio and liquidity coverage norms. However, Acharya and Öncü (2013) [1] argue that these measures are insufficient to address the sector's complexity, advocating for activity-based regulation to align NBFC oversight with banking regulations. The RBI's 2021 scale-based regulatory framework, as discussed in RBI (2021), categorizes NBFCs by size and systemic importance, but Chaturvedi and Singh (2022) [4] suggest it lacks mechanisms to monitor interconnectedness effectively.

Policy Recommendations in the Literature

The literature proposes several strategies to mitigate shadow banking risks. Acharya *et al*. (2013) [1] recommend aligning NBFC regulations with those of banks for similar activities to reduce regulatory arbitrage. Chaturvedi and Singh (2022) [4] advocate for a centralized database to track NBFC exposures and enhance transparency. Anshuman and Sharma (2020) [2] emphasize the need for macroprudential oversight through the Financial Stability and Development Council (FSDC) to monitor systemic risks. Additionally, RBI (2021) suggests regular stress testing and scenario analysis to identify vulnerabilities, while Bandyopadhyay (2019) [3] calls for stronger governance standards and independent audits.

Literature Review

- **Global Perspective:** The Financial Stability Board (FSB) identifies shadow banking as a potential systemic threat due to its opacity and scale.
- **Indian Context:** Studies (Ghosh *et al*., 2016) [6] indicate NBFCs grew rapidly post-2015, driven by relaxed regulations and easy access to short-term funds.
- **Risks Identified:** Liquidity mismatches, poor governance, interconnected lending, and regulatory arbitrage are major issues (Acharya & Rajan,).
- **Notable Crisis:** The 2018 IL&FS default triggered liquidity shocks across the NBFC sector, prompting urgent regulatory action.
- **Regulatory Evolution:** RBI's scale-based regulation (2021) and SEBI's revised frameworks aim to mitigate systemic risk while supporting sector growth.

a) Acharya *et al*. (2013) [1] analyzed the post-crisis (2008) evolution of NBFCs in India, highlighting their increasing role in infrastructure and retail lending. They found that shadow banks filled a credit void left by conservative commercial banks.
b) RBI Reports (2014-2023) consistently indicate that NBFCs have grown at a compound annual growth rate (CAGR) higher than scheduled commercial banks, especially in sectors like vehicle finance, microfinance, and housing.
c) Banerjee *et al*. examined the co-movement between bank and NBFC lending, finding significant spillover effects during liquidity crises.
d) Ghosh, Saibal (2016) [6] emphasized the systemic risk posed by large NBFCs due to interconnectedness with banks through wholesale funding and co-lending arrangements.
e) IL&FS Crisis (2018) is frequently cited in literature (e.g., Bhattacharya & Patel,) as a turning point that exposed governance lapses and contagion risks. The event triggered major regulatory reforms by RBI.
f) Sengupta and Vardhan explored funding models of NBFCs, arguing that excessive reliance on short-term wholesale funding made them vulnerable to liquidity mismatches.
g) Chakrabarty (RBI, 2012) highlighted the challenges of regulating an increasingly diverse set of NBFCs. He called for a risk-based regulatory approach instead of a one-size-fits-all model.
h) Post-IL&FS regulatory reforms (2019 onwards) covered in RBI discussion papers introduced a scale-based regulatory framework, distinguishing between base layer, middle layer, and upper layer NBFCs based on systemic importance.
i) FICCI Reports (2021-2023) analyze industry feedback on compliance costs and how regulations have altered the operational behavior of NBFCs.
j) Basu and Srivastava argued that NBFCs have a unique role in advancing financial inclusion, particularly in Tier 2-6 towns and rural areas, where formal banks have limited penetration.
k) Microfinance Institutions (MFIs), a subset of shadow banks, have been studied by Nair and Tankha (2014), who praised their outreach, but flagged issues related to borrower over-indebtedness.
l) World Bank (2020) research compared NBFC-MFI effectiveness with public sector banks in priority sector lending, showing greater flexibility and customer-centric innovation.
m) Recent studies (e.g., KPMG India, 2021) have observed the rise of digital NBFCs and peer-to-peer (P2P) lenders, which use alternative credit scoring methods and fintech platforms.
n) Chatterjee & Sinha discussed the regulatory grey areas in digital lending, particularly around data privacy, grievance redressal, and the role of unregistered loan apps.

Gaps in Literature and Future Research Directions

1. Under-researched Areas

- Shadow banking's role in green finance and ESG-aligned investments.
- Empirical studies quantifying shadow banks' contribution to GDP or MSME sector growth.
- Comparative analysis with shadow banking sectors in China, Southeast Asia, and Africa.

2. Need for Longitudinal Data

Many studies rely on case studies or short-term datasets. There is scope for econometric modeling using multi-year panel data.

3. Policy Impact Assessment

Limited empirical work evaluating the effectiveness of RBI's post-2018 reforms.

Objectives of the Study

Risks and the Need for a Robust Regulatory Framework." These objectives are designed to guide a comprehensive investigation into the nature, risks, and regulatory needs of the shadow banking sector in India, aligning with the scope of the topic and the insights from the provided literature review and research blueprints.

Objective Number	Objective Description
1	To characterize the nature and scope of shadow banking in India, examining the structure, key entities (e.g., NBFCs, mutual funds, P2P platforms), and economic role in credit intermediation and financial inclusion.
2	To assess systemic risks posed by shadow banking, including interconnectedness with the formal banking sector, liquidity and maturity mismatches, and regulatory arbitrage, using the 2018 IL&FS crisis as a key case study.
3	To evaluate the effectiveness of the current regulatory framework, particularly the RBI's 2021 scale-based regulatory framework, in addressing shadow banking risks and ensuring financial stability.
4	To identify governance and transparency deficiencies in shadow banking entities, assessing their role in exacerbating financial vulnerabilities and eroding stakeholder confidence.
5	To propose a robust regulatory framework that balances the benefits of shadow banking (e.g., financial inclusion) with the need to mitigate systemic risks, incorporating scale-based, activity-based, and macroprudential measures.
6	To quantify the trade-off between financial inclusion and systemic stability, evaluating shadow banking's role in serving underserved sectors (e.g., SMEs, microfinance borrowers) and associated risks.
7	To develop early warning indicators for shadow banking crises, identifying financial and macroeconomic indicators to support preemptive regulatory interventions.

These objectives provide a focused framework for researching shadow banking in India, addressing its economic contributions, risks, and regulatory challenges while guiding the development of actionable policy recommendations.

Importance of the Study

The study of Shadow Banking in India is significant for several reasons, particularly in the context of the country's evolving financial landscape. As India moves toward greater financial inclusion and innovation, understanding the shadow banking sector becomes critical for academics, regulators, policymakers, and industry stakeholders.

Key Ares	Explanation	Relevance
Credit Access & Inclusion	Shadow banks reach underserved segments such as MSMEs, rural borrowers, and low-income groups.	Promotes financial inclusion where traditional banks fall short.
Systemic Risk Awareness	Crises like IL&FS highlight how stress in shadow banks can ripple through the economy.	Enhancing understanding financial vulnerabilities.
Regulatory Significance	RBI's scale-based regulatory approach needs ongoing evaluation.	Supports evidence-based policy making.
Banking Interconnectedness	NBFCs and banks are financially interlinked through loans, funding, and co-lending.	Crucial for assessing broader systemic risk.
Digital Disruption	Fintech NBFCs and digital lenders are changing the landscape.	Help evaluate tech-driven innovation and emerging risks.
Consumer Protection	Informal shadow lenders may exploit consumers in absence of clear regulations.	Emphasizes the need for ethical lending practices and grievance mechanisms.
Global Relevance	India's model has parallels in other emerging markets.	Enables global comparisons and learning from international practices.

Research Methodology

1. Research Design

The study adopts a **mixed-methods research design**, integrating quantitative and qualitative approaches to provide a holistic understanding of shadow banking in India. The quantitative component focuses on assessing systemic risks, interconnectedness, and regulatory impacts, while the qualitative component explores governance issues, stakeholder perceptions, and policy implications. This design ensures triangulation of findings, enhancing the robustness of conclusions. The study employs both primary and secondary data collection methods to ensure comprehensive coverage of the research objectives.

Primary Data Collection

RBI and SEBI officials, NBFC executives, financial analysts, and representatives from mutual funds and loan departments (Target 5-10 Interviews).

Virtual or in-person interviews with open-ended questions, recorded and transcribed for analysis.

Secondary Data Collection

Macroeconomic Indicators

Data on interest rates, GDP growth, and credit disbursal from RBI, World Bank, and NSSO.

Case Studies

Legal and financial documents related to the IL&FS and DHFL crises from NCLT and RBI archives.

2. Research Objectives

The methodology is structured to address the following objectives:

1. Characterize the nature and scope of shadow banking in India.
2. Assess systemic risks posed by shadow banking (e.g., interconnectedness, liquidity mismatches).
3. Evaluate the effectiveness of the RBI's 2021 scale-based regulatory framework.
4. Identify governance and transparency deficiencies in shadow banking entities.
5. Propose a robust regulatory framework balancing financial inclusion and stability.
6. Quantify the trade-off between financial inclusion and systemic stability.
7. Develop early warning indicators for shadow banking crises.

Limitations

- **Data Availability:** Limited access to granular NBFC financial data or real-time exposure data.
- **Post-2021 Data:** The recent implementation of the scale-based framework may limit longitudinal analysis.
- **Stakeholder Access:** Potential reluctance from regulators or NBFC executives to participate in interviews.
- **Generalizability:** Findings may be specific to India's context, requiring caution when applying to other markets.

Conclusion

The research paper "Shadow Banking in India: Risks and the Need for a Robust Regulatory Framework" highlights how important shadow banking is to financial inclusion while also having the potential to be a source of systemic risk in the country's financial system. By addressing the gaps created by regular banks, shadow banking which is mostly driven by Non-Banking Financial Companies (NBFCs) has greatly improved loan access for underserved groups including SMEs and microfinance borrowers. However, the 2018 IL&FS crisis, which caused a liquidity crunch and damaged market confidence, clearly illustrates the significant risks associated with its rapid growth, liquidity mismatches, inter connectedness with the formal banking sector, regulatory arbitrage, and governance shortcomings.

This study uses a mixed-methods approach to quantify systemic risks associated with shadow banking, analyze its structure and economic importance, and assess the efficacy of the RBI's scale-based regulation framework for 2021. The results show that although recent regulatory initiatives represent advancements, oversight, transparency, and macroprudential monitoring shortcomings still exist. Vulnerabilities are made worse by poor governance and a lack of transparency, which call for immediate changes.

The study suggests a strong, multifaceted regulatory structure that combines increased transparency measures, bolstered governance requirements, and scale-based and activity-based oversight. The study provides regulators with practical insights to reduce risks while maintaining the sector's economic contributions by creating early warning indicators and measuring the trade-off between systemic stability and financial inclusion. These results are crucial for maintaining India's financial stability as well as for guiding international regulations of shadow banking in developing nations.

Future studies should concentrate on the role of new shadow banking organizations like P2P platforms, quantitative modeling of systemic risks, and long-term assessments of the 2021 regulatory framework. Policymakers and other stakeholders may promote a robust shadow banking industry that boosts India's economic expansion without jeopardizing financial stability by tackling these issues.

References

1. Acharya VV, Khandwala H, Oncu TS. The growth of a shadow banking system in emerging markets: Evidence from India. J Int Money Finance. 2013;39(1):207-230.
2. Anshuman VR, Sharma A. Dependence of retail NBFCs in India on liquid debt mutual funds. Unpublished manuscript. 2020.
3. Bandyopadhyay T. The IL&FS crisis: A case study on shadow banking risks in India. Econ Polit Wkly. 2019;54(12).
4. Chaturvedi A, Singh A. Examining the interconnectedness and early warning signals of systemic risks of shadow banks: An application to the Indian shadow bank crisis. Kybernetes. 2022.
5. Financial Stability Board (FSB). Shadow banking: Strengthening oversight and regulation. 2012.
6. Ghosh S, Chandrasekhar CP. Financial inclusion and the rise of NBFCs in India. Econ Polit Wkly. 2016;51(10).
7. Reserve Bank of India (RBI). Report on trend and progress of banking in India. 2019.
8. Reserve Bank of India (RBI). Discussion paper on the revised regulatory framework for NBFCs A scale-based approach. 2021.
9. Sinha A. Shadow banking in India and China: Causes and consequences. Econ Polit Wkly. 2013.