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Shadow Banking: The Hidden Network Shaping Global Finance

Mr. Zeyad Shamim Shamim

Abstract

The term shadow banking was coined by economist Paul McCulley in 2007. It describes a wide range of organisations that help lend and borrow money without following the same traditional banking rules. Unlike commercial banks, which take deposits from the public, shadow banks raise money from investors and use it to extend credit, often faster and more flexibly than regulated institutions can.

Glossary

Understanding the key terminology used throughout this report is essential for accurately interpreting the discussion, analysis, and conclusions. Shadow banking has become a significant part of the global financial system, with the non-bank financial intermediation (NBFI) sector holding more than $100 trillion in financial assets globally, representing nearly half of total global financial assets, according to the Financial Stability Board. A clear understanding of these definitions will enable reviewers to evaluate the evidence better, interpret the findings, and appreciate the implications of the report's recommendations.

Executive Summary

Shadow banking is made up of companies that do things that banks do, but they do not have to follow all the usual rules. This started back in the 1980s. Now it is a big sector that handles more than $117 trillion[1], which is about half of all the money that is moved around the world. Shadow banking can be good because it gives people a way to get credit, helps new ideas appen, and is also flexible. It can be bad because it does not have the same safety measures as regular banks, like insurance to protect the money people put in.

Term	Definition
1) **Financial Intermediation**	The process through which Financial Institutions transfer funds from savers to borrowers
2) **Liquidity Mismatch**	A situation where short-term borrowing is used to finance long-term investments, creating financial risk.
3) **Securitisation**	The process of converting loans or other financial assets into securities that can be sold to investors
4) **Money Market Fund (MMF)**	An investment fund that invests in short-term, low-risk financial instruments.

[1]Bank for International Settlements. "BIS Annual Economic Report 2023," June 25, 2023. https://www.bis.org/publ/arpdf/ar2023e.htm.

1) Hedge Fund	A privately managed investment fund that uses different investment strategies to generate returns.
2) Structured Investment Vehicle	A financial entity that raises short-term funds to invest in long-term financial assets.
3) Non- Banking Financial Company (NBFC)	A financial institution that provides loans and other financial services without operating as a licensed commercial bank.
4) FinTech	The use of technology to improve and deliver financial products and services.
5) Peer-to-peer (P2P) lending	A digital platform that directly connects borrowers and lenders without a traditional bank acting as an intermediary.
6) Collateralised Debt Obligation (CDO)	A financial product created by combining different loans and selling them as investment securities.

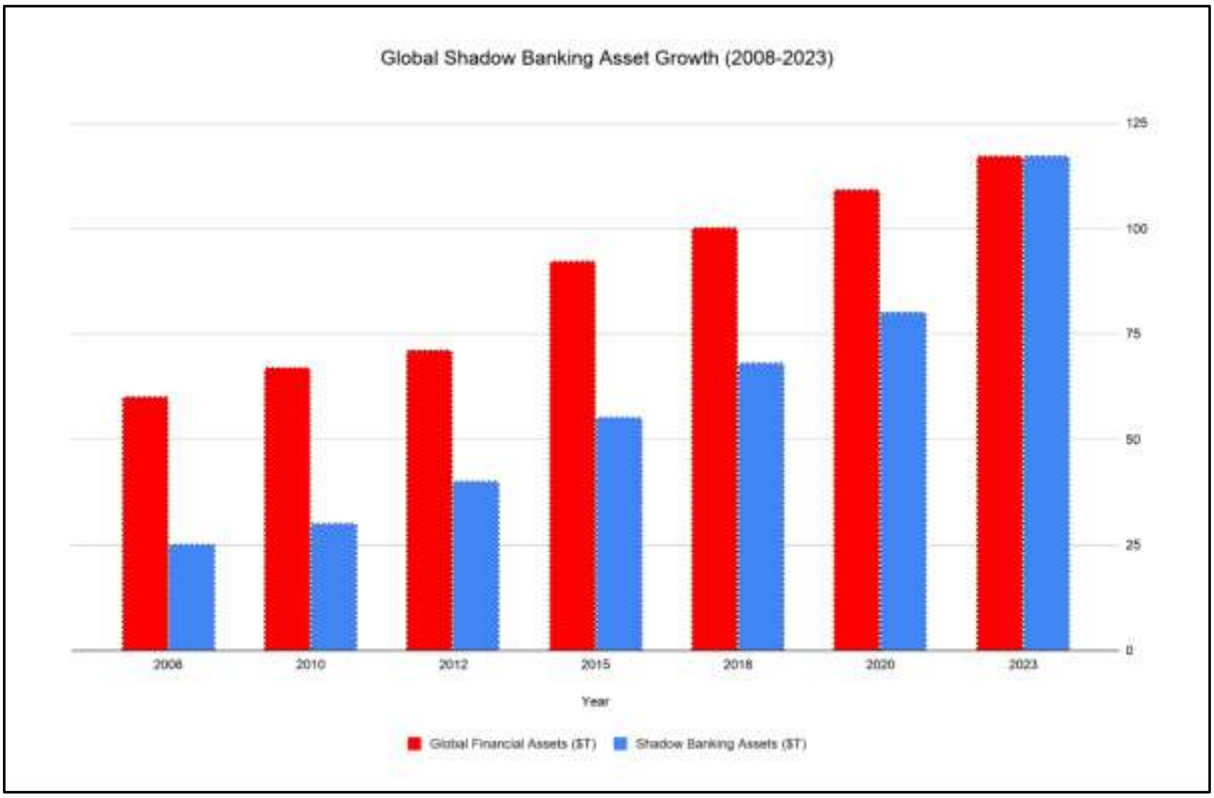


Figure 1: Global shadow banking assets have grown significantly relative to total financial assets (2008-2023).
Source: FSB estimates

The big financial crisis in 2008 showed that shadow banking has some weaknesses, so governments started trying to make it more transparent. With these new rules, shadow banking has changed with the times and gotten bigger, using digital technology to grow. This report is trying to get an understanding of shadow banking, and it says that if we make the right rules, shadow banking can help everyone have access to money and grow the economy instead of causing problems, like it did in the past.

Introduction

The term shadow banking was coined by economist Paul McCulley in 2007. It describes a wide range of organisations that help lend and borrow money without following the same traditional banking rules[2]. Unlike commercial banks, which take deposits from the public, shadow banks raise money from investors and use it to extend credit, often faster and more flexibly than regulated institutions can.

Key Shadow Banking Players include:

- Money Market Funds (MMFs) provide short-term, low-risk investment vehicles.
- Hedge funds use leverage and multifaceted strategies to generate returns.
- Structured Investment Vehicles (SIVs) invest in long-term assets using short-term funding.
- Non-Banking Financial Companies (NBFCs) lend in areas where banks are absent.

> *Key Insight*
> Shadow banking is not *illegal*. It is a legitimate, large, and growing part of global finance, but one that operates with fewer safety nets and less transparency than traditional banking.

- Fintech & peer-to-peer platforms connect borrowers and lenders digitally.

Why does it exist?

Shadow banking exists because it fills real gaps in the financial system. Traditional banks are often slow, risk-averse, and heavily regulated. Because of this, they may not lend to small businesses, startups, or individuals without a formal credit history. However, shadow banks support economic activity by providing additional sources of credit and investment.

Three forces drove the rapid growth of shadow banking in recent decades:

- Low interest rates after 2008 pushed investors to seek higher returns outside traditional savings.
- Technology, especially fintech and digital platforms, made it easier to circumvent banks entirely.
- Financial complexity, new instruments, and securitisation techniques opened the door for shadow banking entities to grow.

[2] Brookings. "Topics | Brookings," February 19, 2026. https://www.brookings.edu/topic/financial-regulation/.

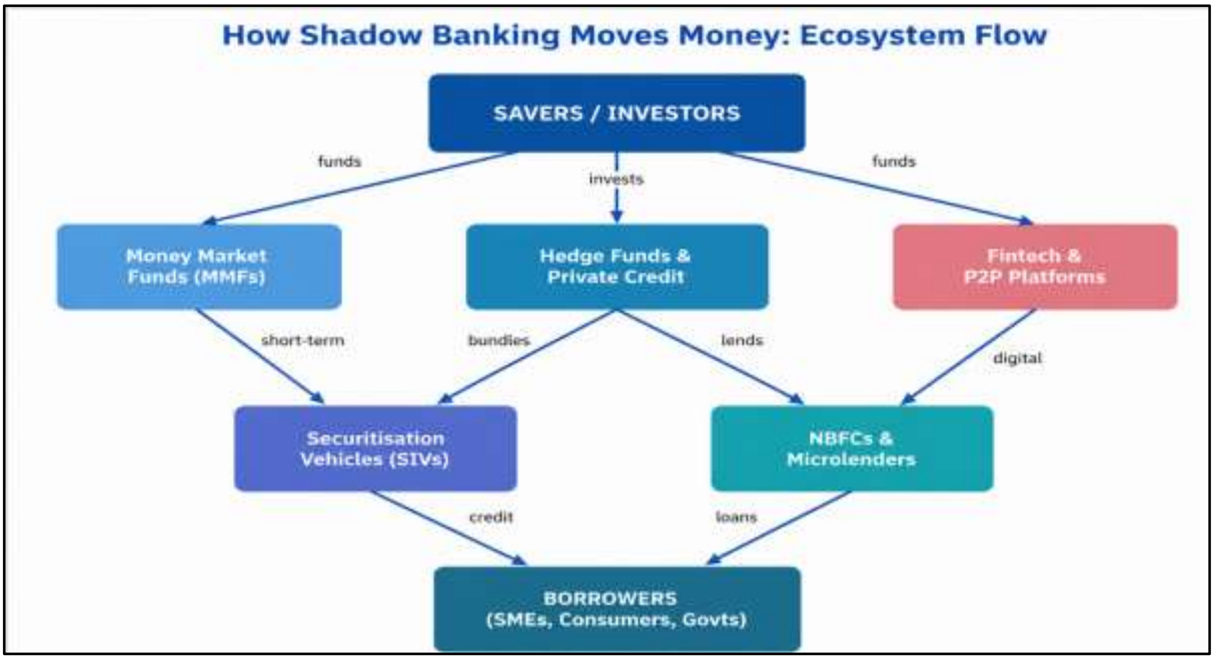


Figure 2: How money flows through the shadow banking system ecosystem from savers to borrowers via non-bank intermediaries.

Research Objectives

This research aims to:

- Understand the concept and evolution of shadow banking.
- Examine the major institutions and activities that form the shadow banking system.
- Evaluate the opportunities and risks associated with shadow banking.
- Compare the role and development of shadow banking in the United States, China, and India.
- Suggest policy recommendations that can strengthen financial stability while supporting financial innovation.

Research Question

With shadow banking managing over US$117 trillion in assets and accounting for nearly half of global financial intermediation, how can its contribution to global financial growth be sustained while minimising risks to financial stability?

Historical Evolution

Shadow banking did not appear overnight. It evolved across decades, quietly reshaping how money moves around the world. Understanding this history helps explain both its importance and its dangers.

Figure 3: Key milestones in the evolution of shadow banking from the 1970s to the present

Early Foundations (1970s-1980s): The First Wave

Shadow banking began in the 1970s, when U.S. banks were subject to strict rules, including limits on interest rates and reserve requirements. As inflation increased, financial institutions began looking for new ways to earn more money. Money Market Funds became popular because they offered higher returns than normal bank deposits and had fewer rules to follow.

In the 1980s, securitisation became very important. Banks found that they could group loans, such as mortgages, car loans, and credit card debt, and turn them into securities that could be sold to investors. This helped banks free up capital so they could extend more loans. It also led to the growth of the first shadow banking institutions.

The Expansion Era (1990s- 2007): Globalisation of Credit

The 1990s brought an explosion in financial innovation. Instruments like Collateralised Debt Obligations (CDOs) and Credit Default Swaps (CDSs) became mainstream[3]. By 2007, the U.S. shadow banking sector alone held over $20 trillion in assets, larger than the traditional banking system.

This expansion was fuelled by three forces: global capital seeking higher returns, financial products promising diversification, and regulatory gaps encouraging risk-taking. The system appeared stable until it was not.

The 2008 Crisis: A System Exposed

The Global Financial Crisis of 2008 was shadow banking's defining moment. As U.S. housing prices fell, securitised mortgage products lost value rapidly. The problem was systemic; no one knew who held the risk anymore. Institutions like Lehman Brothers, which relied on repo markets and securitisation, collapsed. Others, like AIG, nearly failed due to exposure to credit default swaps.

> ***Takeaways***
> The 2008 crisis revealed that shadow banking and traditional banking are deeply connected. When one

[3] Financial Stability Board. "Global Monitoring Report on Non-Bank Financial Intermediation 2023 - Financial Stability Board," December 15, 2024. https://www.fsb.org/2023/12/global-monitoring-report-on-non-bank-financial-intermediation-2023/.

fails, the other feels it. Trillions in shadow credit evaporated almost overnight, forcing governments worldwide to step in with massive bailouts.

The Digital Era (2000s-Present)

Today, shadow banking has entered a new phase: digital, decentralised, and faster than ever. Fintech platforms like Ant Group and LendingClub connect borrowers and lenders algorithmically. Private credit funds are growing rapidly as institutional investors bypass banks, and Decentralised Finance (DeFi) enables peer-to-peer borrowing using blockchain technology, without any central authority.

According to the FSB's 2023 report, non-bank financial intermediation now accounts for nearly half of all global financial assets; this historic milestone underlines just how central this sector has become.

The Global Landscape

How Shadow Banking Looks Around the World

Shadow banking does not look the same everywhere. Each region has developed its own version, shaped by local economic needs, regulatory culture, and financial development. What unites them all is the same underlying goal: *to provide credit and liquidity outside the traditional banking system.*

Table 2: Regional comparison of shadow banking forms, drivers, and risks

Region	Dominant Forms	Key drivers	Main Risk
United States	Securitisation, hedge funds, repos	Innovation & deregulation	Leverage & market contagion
Europe	Investment funds, insurance-linked	Cross-border integration, credit demand, and state bank limits.	Liquidity & currency mismatch
China	Trust loans, WMP's, P2P	Credit demand, state bank limits	Off-balance sheet debt
India	NBFC's, fintech credit	Financial inclusion, SME lending	Funding & liquidity shocks

United States: Innovation

The U.S. is home to the world's largest and most sophisticated shadow banking network, accounting for roughly 30% of global shadow assets. Its system has gone through decades of financial innovation, securitisation, investment funds, derivatives, and repo markets. It has driven enormous economic growth but has also produced some of the most damaging financial crises in history.

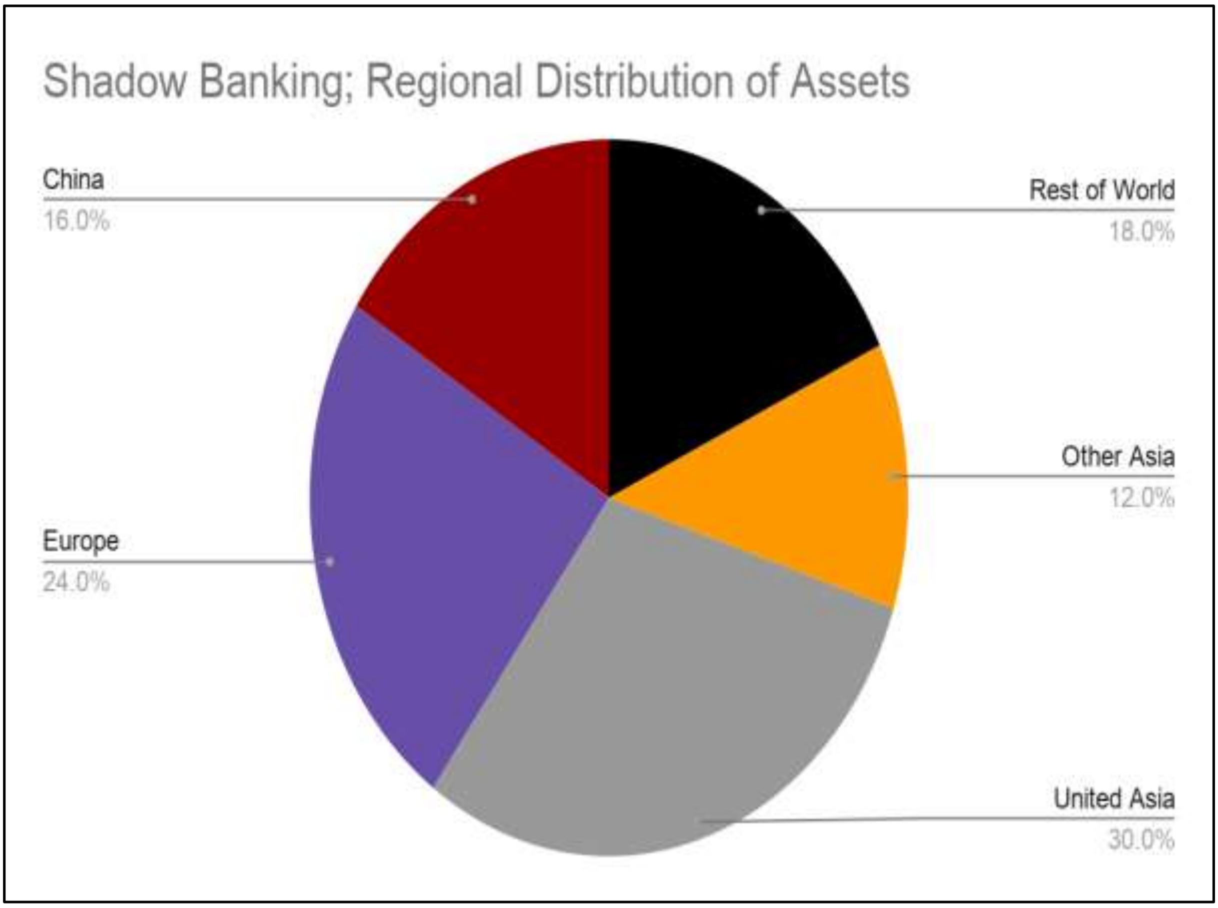
China: Growth Engine Turned Risk Source

China's shadow banking sector emerged rapidly as businesses sought to avoid state-owned banks that prioritised large corporations. Trust companies, Wealth Management Products (WMP's), and peer-to-peer lenders filled the gap. At its peak, 2016-2017, China's shadow system exceeded $10 trillion. Since 2017, regulators have launched major reforms to the Asset Management Rules (2018), which reduced shadow banking by nearly $3 trillion, but risks persist as activity shifts to new channels.

India: Inclusion Through Non-Bank Lending

In India, shadow banking operates through Non-Banking Financial Companies (NBFC's), which have been instrumental in extending credit to small businesses, rural borrowers, and first-time homebuyers. The IL&FS default in 2018 exposed the fragility of over-reliance on short-term funding. India has since introduced a four-tiered regulatory framework for NBFC's, balancing financial inclusion goals with the need for systemic stability.

Figure 4: Regional distribution of global shadow banking assets. The United States remains the dominant hub.



Evaluation

Shadow Banking's flexibility is also its greatest vulnerability. Without the same guardrails as traditional banks, problems can build quietly and spread quickly. The following are the most pressing systemic risks.

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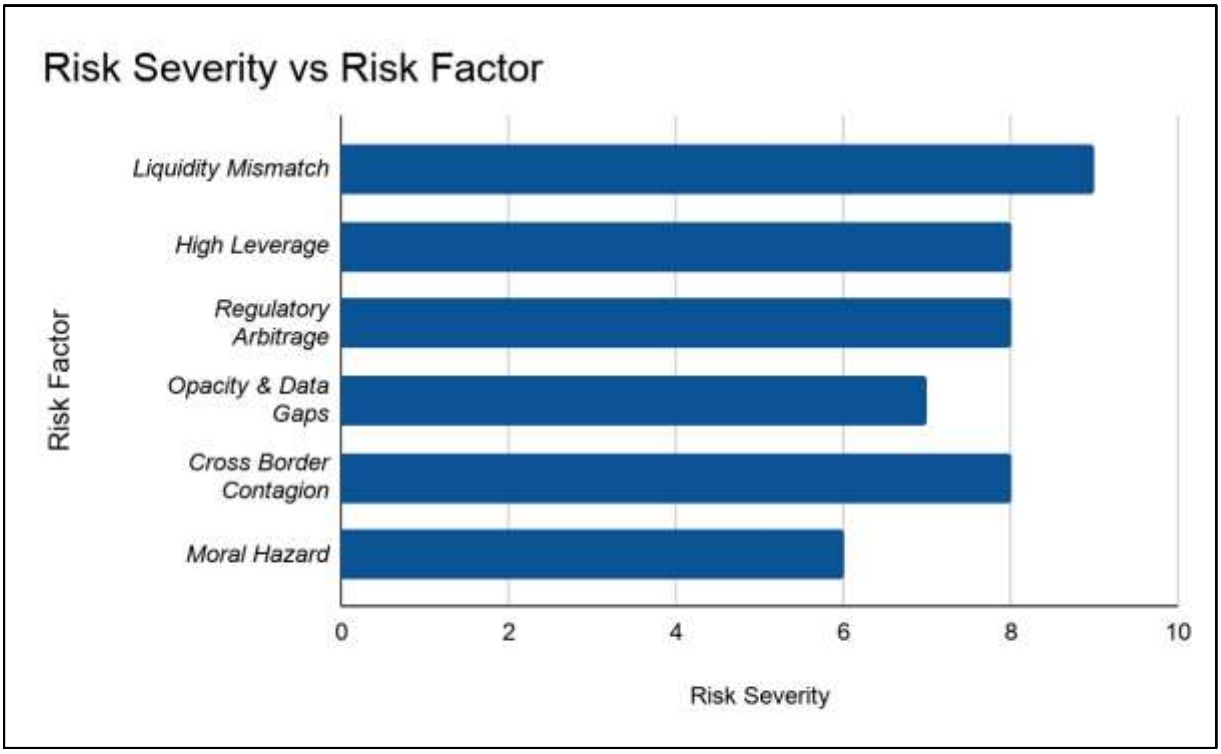
Figure 5: Key risk factors in the modern shadow banking system, rated by severity



1. Liquidity Mismatch

The most fundamental weakness of shadow banking is the mismatch between short-term borrowing and long-term lending. Shadow entities often borrow overnight or for very short periods but invest in assets that cannot be quickly sold, such as corporate loans or mortgage-backed securities. When investors panic and demand their money back, the institution is forced into "fire sales," driving prices down and spreading the damage.

2. High Leverage and Hidden Interconnectedness

Many Shadow institutions borrow multiple times their own capital to boost returns. This amplifies gains during booms and magnifies losses during downturns. The danger is compounded by interconnectedness: shadow entities often lend to and borrow from each other, creating hidden chains of exposure. When one link breaks, the effect ripples outward in ways regulators may not immediately see.

3. Regulatory Arbitrage

A key reason shadow banking grew so fast is that financial institutions deliberately moved activities to less-regulated corners to cut compliance costs. Traditional banks, facing stricter post-2008 rules, shifted credit and investment activities to affiliated non-bank entities. The risk does not disappear; it simply moves into the shadow where it is harder to track.

4. Opacity and Data Gaps

Transparency remains the Achilles heel of shadow banking. Many funds and investment vehicles do not disclose detailed financial information. Even central banks often lack real-time data on asset quality, leverage, or liquidity. The FSB has made progress in mapping global non-bank financial activities, but significant data gaps remain, especially in emerging markets. This opacity allows crises to build silently, before anyone can act.

5. Cross-Border Contagion

Because shadow banking is globally interconnected, risks can spread across borders with frightening speed. A liquidity shock in New York can ripple through Singapore into India within days. During the 2020 COVID-19 panic, investors withdrew record sums from global bond and money market funds, causing mass sell-offs that shook developing economies worldwide.

Case Studies

The **United States**, **China**, and **India** are perfect examples of how shadow banking takes on different shapes around the world, adapting closely to local needs and regulations. No matter the country, these institutions still leave their broader economies exposed to the same global financial dangers, such as sudden liquidity freezes and hidden systemic risks.

Country	Scale	Key Institutions	Major risk events	Regulatory Response
United States	*$35 trillion*	MMFs, repos, private credit	2008 crisis, 2020 liquidity freeze	Dodd-Frank, Volcker Rule
China	*$10 trillion*	WMPs, trust loans, P2P	Property bubbles, opacity	Asset Management Rules 2018
India	*$500 billion*	NBFCs, housing finance	IL&FS default 2018; Covid shock	RBI 4-Tier NBFC framework

Table 3: Comparative overview of shadow banking systems in the U.S., China, and India

United States: The Double-Edged Sword

The U.S. shadow banking system has been both the most innovative and the most dangerous in the world. Before 2008, investment banks created off-balance-sheet vehicles to securitise mortgages, generating enormous profits while hiding risks.[4] When the housing market collapsed, the entire chain unravelled. Post-crisis, Dodd-Frank and the Volcker Rule brought parts of the system under tighter scrutiny. But innovation simply shifted private credit funds, and fintech lenders now perform similar functions with fewer restrictions.

China: Ambition Without Oversight

China's shadow banking system grew at extraordinary speed, funding infrastructure and real estate projects that state banks ignored. But its opacity created serious problems; investors believed local governments would always back these products (moral hazard), leading to reckless risk-taking. Credit bubbles formed in the property sector, and complex investment chains made it nearly impossible to trace where the risk really sat. China's 2017-2018 regulatory crackdown was effective, but some activity has shifted rather than disappeared.

[4] "IOSCO," n.d. https://www.iosco.org/publications/.

India: Inclusion With Fragility

India's NBFCs played a vital role in reaching borrowers whom large banks ignored: rural consumers, small business owners, and first-time homebuyers. But the IL&FS collapse in 2018 was a wake-up call. IL&FS had borrowed heavily in the short-term markets to fund long-term infrastructure projects, the classic liquidity mismatch. When it could not roll over its debt, panic spread across India's financial markets. The RBI's four-tier supervisory framework reflects a more mature approach that supports financial inclusion while maintaining discipline.

Policy Recommendation

The challenge for policymakers is not to eliminate shadow banking, which would cut off credit to millions of people and businesses that depend on it. The challenge is to make it safer, more transparent, and more accountable. The following recommendations address the key vulnerabilities identified in this report.

1. **Strengthen Global Coordination**

Shadow banking crosses borders effortlessly, but regulation does not. The FSB, IMF, and BIS need to lead a new era of global cooperation, shared definitions and reporting standards, real-time monitoring of cross-border capital flows, and digital dashboards that give regulators visibility across jurisdictions. Financial stability is a shared responsibility.

2. **Build Transparent, Tiered Regulation**

A single rulebook cannot work for an ecosystem that includes billion-dollar hedge funds and small P2P lending apps. A tiered approach to classifying institutions by their risk level and systemic importance would allow proportionate oversight. Higher-risk, higher-leverage entities face stricter capital and liquidity requirements; smaller, innovative firms can operate under lighter but monitored frameworks. Crucially, regulators must have real-time data across the sector.

3. **Encourage Responsible Innovation**

Fintech and DeFi are reshaping shadow banking faster than regulation can keep up. Policymakers should integrate technology experts into financial authorities, create regulatory sandboxes where startups can test products under supervision, and establish clear consumer protection standards for digital lending. *Innovation is not an enemy; uncontrolled innovation is*.

4. **Promote Financial Inclusion**

Shadow banking's ability to reach underserved populations is one of its most valuable characteristics. Governments should partner with responsible non-bank lenders to fund small businesses and rural projects, provide credit guarantees for well-governed NBFCs, and invest in digital and financial literacy[5]. If designed well, shadow banking serves as a bridge to the formal financial system, not a parallel system operating in the dark.

5. **Use Technology for Risk Detection**

Modern risk management cannot rely only on quarterly reports. AI-powered surveillance tools can detect leverage build-ups, flag liquidity shortages, and track contagion pathways before they escalate. Public-private data partnerships where anonymised market data is shared securely can give regulators the real-time visibility they currently lack.

[5] Pimco. "Investment Management | PIMCO." Pacific Investment Management Company LLC, August 21, 2026. https://www.pimco.com/.

Outlook to 2030
By 2030, the line between traditional banks and shadow banking institutions will likely blur further. DeFi may gain partial regulation and wider acceptance. Central Bank Digital Currencies (CBDCs) will influence liquidity and funding channels. AI-driven credit products will become mainstream. The challenge for regulators is to stay as fast and flexible as the technology they oversee.

Conclusion

Shadow banking has become an important part of the modern financial system. Although it operates outside the traditional banking sector, increasing access to finance and supports economic growth. It has helped individuals, businesses, and investors by offering financial services that are often faster and more flexible than those provided by commercial banks..

However, this research shows that shadow banking also brings significant risks. Because many shadow banking institutions operate under fewer regulations, problems such as high leverage, liquidity shortages, and limited transparency can develop unnoticed. Similarly, the financial uncertainty during the COVID-19 pandemic showed that weaknesses in the shadow banking sector can have serious economic consequences if not properly managed.

The findings of this report suggest that shadow banking should not be viewed as either completely beneficial or completely harmful. Instead, it should be understood as a financial system that offers both opportunities and challenges. Policymakers must continue to encourage financial innovation while ensuring that appropriate safeguards are in place to protect the wider economy.

In conclusion, shadow banking will continue to play an important role in global finance. The main challenge for governments and regulators is not to stop its growth but to manage it responsibly. With balanced regulation, international cooperation, and the effective use of technology, shadow banking can continue to support economic development while reducing the risk of future financial crises.[6]

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