

Credit Crunch

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Why is it news?

ILFS crisis and consequent credit crunch in the shadow banking system

What is it?

- The credit crunch refers to a sudden shortage of funds for lending, leading to a decline in loans available. It is also called a credit squeeze or credit crisis.

A credit crunch can occur for various reasons:

- A sudden increase in interest rates (e.g. in 1992, UK government increased rates to 15%)
- Direct money controls by the government (rarely used by Western Governments these days)
- A drying up of funds in the capital markets
- **Reasons for recent credit crunch** → A drying up of funds in the capital markets → this is because of the following reasons
- IL&FS crisis → consequent liquidity crisis (Liquidity crisis is a temporary issue whereas credit crunch persists relatively for a longer period)
- NBFCs are becoming risk-averse and trying to preserve cash in their books.
- Mutual funds have stayed away from lending to NBFCs as they are facing redemption pressure leading to bottlenecks in lending
- NBFCs have found it difficult to raise capital through debt markets and banks are not willing to roll on NBFCs with large wholesale exposure.
- As lending costs have gone up and lending lines have squeezed, NBFCs are resorting to lending to high margin categories

- Reluctance on the part of banks to continue with the existing lending arrangements to NBFCs.
- There have been instances of banks withdrawing unutilized lines of credit or showing apprehension towards renewal or rolling over existing credit lines
- The overall slowdown in the economy

What is Shadow banking?

- The shadow banking system is a term for the collection of non-bank financial intermediaries that provide services similar to traditional commercial banks but outside normal banking regulations.
- The shadow banking system (or shadow financial system) is a network of financial institutions comprised of non-depository banks – e.g., non-bank financial institutions, investment banks, hedge funds, and money market funds. Shadow banking in India loosely refers to NBFCs/NBFIs.