SHADOW BANKING AND CONVENTIONAL BANKS IN FINANCIAL SYSTEM OVERVIEW

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ABSTRACT

Objective: This study aims to analyze the relationship between shadow banking and conventional banking in the modern financial system, focusing on their roles, dependencies, and impact on financial system stability.

Research Design & Methods: This study uses a qualitative approach, including literature analysis and a theoretical review related to shadow banking and conventional banks. Data was obtained by reviewing various secondary sources, including journals, industry reports, and relevant regulations.

Findings: This study found that shadow banking and conventional banks are interdependent despite having different roles in financial intermediation. Shadow banking can increase financial inclusion by providing more flexible financing, but the lack of supervision and transparency can pose systemic risks. In contrast, conventional banks operate under strict regulation, offering stability, but are more limited in terms of flexibility and innovation.

Implications & Recommendations: This research recommends strengthening shadow banking regulations, including increased transparency, global regulatory coordination, and consumer protection. Effective regulation is important to balance financial innovation and proper supervision to maintain the global financial system's stability.

Contribution & Value Added: This study provides new insights into the dynamic relationship between shadow and conventional banking and its implications for financial stability. It contributes to the understanding of how these two sectors can work synergistically to maintain the integrity of the financial system while encouraging responsible financial innovation.

Keywords: Shadow Banking, Conventional Banking, Financial System Stability

JEL codes: G21, G28, G38
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INTRODUCTION

In the global financial system, two main sectors play a role in providing financial services, namely conventional banking and shadow banking. Conventional banks and shadow banking play an important role and are embedded in the financial system, although they have different characteristics in operation and regulation. Conventional banks operate under strict regulations and are supervised by financial authorities to ensure the stability of the banking system, these regulations aim to ensure that banks conduct their operations safely, fairly, and by sound financial principles (Soehaditama, 2023). While shadow banking includes non-bank financial institutions that offer similar financial services but with looser supervision (Chen et al., 2024). Shadow banking includes non-bank financial institutions such as finance companies, hedge funds, and asset securitization that conduct credit intermediation without the direct supervision of banking authorities. The system has grown rapidly since the 1980s, offering financing flexibility and increasing systemic risk due to lack of access to central bank emergency facilities (Pozsar et al., 2010).

In recent years, especially after the global financial crisis 2008, the financial sector has undergone significant changes with the growing issue of shadow banking (Ban & Gabor, 2016). Shadow banking consists of non-bank financial institutions that offer credit intermediation services outside conventional banking regulations, contributing to credit enhancement and financial innovation. However, it also carries potential systemic risks due to its lack of strict supervision and reliance on market liquidity. Recent research by Ge (2024) reveals that shadow banking plays a significant role in providing access to finance for entities that find it difficult to obtain credit from traditional banks, such as small and medium-sized enterprises. Shadow banking is growing rapidly in the United States, China, and Europe with diverse regulatory challenges (Chen et al., 2024; Pellegrini et al., 2021). Regions must balance financial innovation with economic stability to prevent future crises because of its growing role in the global financial system.

As non-depository institutions, shadow banks obtain funding through different mechanisms than conventional banks. Their main sources of funding include equity, bond issuance, loans from traditional banks, and long-term funding instruments such as securitization and money market funds. This model allows shadow banks to offer credit more flexibly than conventional banks, making them attractive to businesses that find it difficult to obtain loans from traditional banks (Dopico & Cobelas, 2020).

Conventional banks face significant challenges due to the rapid growth of shadow banking. Subject to strict regulations, traditional banks compete with shadow banks that offer more flexible financing and lower costs (Chen et al., 2024). Shadow banking increases competitive pressure for conventional banks, particularly regarding profitability and financial product excellence. However, research shows that the relationship between conventional banks and shadow banks is competitive and complementary. Traditional banks often utilize shadow banking to transfer risk and avoid strict regulations, while shadow banks rely on traditional banks for liquidity when facing market pressures (Boot & Thakor, 2019).

LITERATURE REVIEW

Basic Concept of Shadow Banking

Shadow banking refers to non-bank financial intermediation activities that operate outside the traditional banking system but still perform functions similar to those of banks, such as fundraising and lending (Hodula et al., 2020; Tsai, 2017). This system includes various financial entities such as investment funds, finance companies, fintech lending, and complex financial products such as securitization and repurchase agreements (repo). According to Dopico & Cobelas (2020), shadow banking has been developed as a financing solution for companies with difficulty obtaining loans from conventional banks. In addition, this institution provides a variety of attractive investment instruments for investors, with potentially higher returns than bank deposits.

Shadow banking encompasses various forms of alternative financing outside the traditional banking system, such as wealth management products, peer-to-peer lending (P2P) platforms and non-bank financial institutions. P2P lending platforms, for example, have become an innovative financial instrument that allows borrowers and lenders to connect directly through online systems without going through bank intermediaries, thereby increasing efficiency in lending (Ofir & Sadeh, 2020). In addition, investment funds and wealth management products are also part of shadow banking, providing investment opportunities with higher returns than conventional banking deposits, but with greater risks (Dopico & Cobelas, 2020).

Adrian & Shin (2009) revealed that shadow banking activities tend to have a looser regulation level than conventional banking, which can increase risks in the financial system. This lack of supervision allows shadow banking institutions to operate more flexibly, but can also lead to instability, especially in volatile market conditions. Key risks associated with shadow banking include high leverage levels, lack of transparency in financial transactions, and potential systemic impacts that could contribute to a financial crisis. Therefore, regulators must balance financial innovation and risk control to maintain overall economic stability.

Shadow banking handles traditional banking operations by shifting traditional credit relationships to securitized credit relationships, allowing financial assets to be repackaged and traded in financial markets. Securitization in shadow banking has grown rapidly, especially in the banking and fintech sectors, where non-bank institutions use securitization as a key tool to obtain liquidity and diversify their credit risk (An et al., 2021). This process enables risk shifting from the original lender to investors who purchase asset-backed securities.

In some countries such as China, the shadow banking business continues to grow as regulations change, causing imbalances in credit and liquidity risks (Feng & Qin, 2021). Research shows that securitization in China plays an important role in increasing the profitability of commercial banks, but also brings challenges in financial risk management that can affect economic stability (Liu, 2022). As shadow banking activities grow, it becomes crucial to implement stricter regulations on securitization mechanisms to prevent systemic risk. This risk may arise due to the large flow of credit into the securitization market without adequate supervision, potentially disrupting financial stability.

Basic Concept of Conventional Banks

Conventional banks are financial institutions that operate based on the interest system and provide traditional banking services such as deposits, loans, and other financial services. This bank aims to maximize profits by relying on the difference between the interest given to savers and the interest charged to borrowers (Ingratubun, 2022). Rahimah et al., (2023) argue that a conventional bank is a financial institution that operates with an interest system in fund-raising and lending activities, and acts as a financial intermediary between parties with surplus funds and parties needing funding. In the context of the modern economy, conventional banks have a vital role in maintaining financial stability, providing extensive financial services, and encouraging economic growth through sustainable lending. According to experts, conventional banks apply the principle of interest-based banking, which can affect the financial structure and banking risks (Maidah et al., 2024).

Conventional banks remain a key pillar in the global financial system due to their ability to provide broad financial access and the convenience of rapidly growing digital banking services. As financial intermediaries, conventional banks play an important role in economic growth through lending and sustainable investment (Nurpatimah & Mafruhat, 2024). Banking digitalization is also a major factor in strengthening the competitiveness of conventional banks, with innovations such as mobile banking and digital payments increasing customer efficiency and convenience (Wulandari et al., 2023).

The financial stability of conventional banks has been maintained despite the shift to digital payment systems, thanks to good risk management and effective liquidity strategies. Research shows that the adoption of digital payments does not destabilize conventional banks. Instead, it improves operational efficiency and profitability, as reflected in the increase in Return on Assets (ROA) and Return on Equity (ROE) (Taskaro & Suhari, 2024). In addition, a solid funding structure and the implementation of liquidity management strategies based on Basel III standards help conventional banks minimize liquidity risk, so they can still meet their financial obligations amid market dynamics. Digitalization of banking services, such as BI-FAST and mobile banking, also plays a role in maintaining financial stability by improving transaction efficiency and expanding access to banking services for the community (Marginingsih, 2023).

Conventional banks are often compared to value-based banking, such as ethical banking and Islamic banking, which emphasize sustainability and moral principles in their operations. Studies show that conventional banks have lower liquidity and solvency levels than banks that apply sustainability and ethical principles in their investments. This is due to the difference in business models, where value-based banks focus more on long-term investments that are more stable and do not rely on speculative financial instruments.

Conventional banks are also more vulnerable to systemic risk due to their dependence on market mechanisms and changes in interest rates that can directly impact financial stability. Interest rate fluctuations can lead to an imbalance between assets and liabilities, especially under conditions of economic crisis. Therefore, a value-based approach in banking is gaining attention as a more resilient alternative in the face of global financial instability. Stricter regulations and better risk management strategies are needed to enhance the resilience of conventional banks to external shocks and ensure the long-term sustainability of the banking sector.

METHODS

This research uses a qualitative method with a descriptive approach to understand the relationship between shadow banking and conventional banks in the modern financial system. This method was chosen as it allows in-depth analysis of complex phenomena without direct intervention in the banking process. Data was collected through a literature study from various reliable sources, including academic journals, financial regulatory reports, and annual reports of financial institutions. This literature study aims to identify the relationship pattern between the two banking systems, understand the factors that affect financial stability, and evaluate the risks arising from shadow banking activities. The analysis in this study was conducted using a comparative approach, which allows for a systematic comparison of the advantages and disadvantages of shadow banking and conventional banks.

RESULT

Link between Shadow Banking and Conventional Banks

Shadow banking is closely linked to conventional banking as both provide liquidity and financing to the economy. The system encompasses a wide range of non-bank financial entities that operate outside traditional banking regulations but still perform financial intermediation functions. This sector includes institutions such as finance companies, investment funds, and asset securitization often involved in various financial transactions with conventional banks. These two systems interact through various mechanisms, including asset securitization, asset-based financing, and inter-financial institution transactions.

The link between conventional banks and shadow banking is complex, reflecting both competition and mutual dependence. Conventional banks are often involved in shadow banking activities, either directly through securitization and interbank lending, or indirectly by providing liquidity to shadow banking institutions in times of financial stress (Zhang et al., 2023). This linkage creates interdependence, where conventional banks can benefit from the flexibility and innovation of shadow banking. In contrast, shadow banking often relies on conventional banks for funding sources and access to financial infrastructure. However, these linkages also pose systemic risks, as imbalances or disruptions in shadow banking can impact the stability of conventional banking and the overall financial system.

The efficiency of conventional commercial banks is influenced by various factors, including location of operations and capital adequacy ratio (CAR). Banks operating in big cities tend to have higher efficiency levels than banks in rural areas. This is due to wider access to financial infrastructure, a more competent workforce, and a larger number of customers in urban areas (Wulandari & Ryandono, 2020). In addition, banks with larger capital have better capacity to manage risk and improve efficiency in the production and financial intermediation process.

This efficiency imbalance allows the shadow banking sector to expand rapidly in rural areas, where conventional banks are less efficient. Interestingly, the relationship between shadow banks and conventional banks can be complementary and substitutive (Hodula et al., 2020). Conventional banks sometimes view lending to shadow banks as a substitute for direct lending in non-urban areas (Acharya et al., 2013). Shadow banking often offers more flexible financial products and easier access to finance for individuals and small businesses that may otherwise struggle to get services from commercial banks. However, as shadow banking operates outside the strict regulations of conventional banking, there are potentially higher risks related to transparency, financial stability, and consumer protection (Nainggolan, 2020).

In the long term, the link between conventional banking efficiency and shadow banking requires more intensive supervision and regulation. Efforts to improve bank efficiency in rural areas can include expanding access to digital banking, providing capital incentives, and implementing financial policy reforms. These measures can potentially reduce existing disparities while strengthening the financial system's stability as a whole.

Differences between Shadow Banking and Conventional Banks

Shadow banking and conventional banks are two entities in the financial system that have different roles but remain interconnected in the financial intermediation process. Despite their different structures, these two systems often work together in various financial transactions, such as purchasing credit-based securities or providing liquidity in the money market. This interaction creates a complex financial dynamic, where shadow banking can improve market efficiency with financial innovation, but also carries systemic risks due to lack of supervision. Therefore, the balance between the flexibility of shadow banking and the stability of conventional banks is an important aspect in maintaining the financial system's sustainability as a whole.

Table 1. Differences between Shadow Banking and Conventional Banks

Aspect	Shadow Banking	Conventional Bank
Regulation	It is not strictly regulated by financial authorities and lacks transparency.	Regulated and closely monitored by Bank Indonesia and OJK to maintain financial stability (Tirtawijaya & Wagiman, 2023).
Institutions Involved	Non-bank financial institutions such as fintechs, finance companies, hedge funds	Commercial banks, regional development banks, Islamic banks (Antari et al., 2022)
Funding Source	Capital from investors, bank loans, asset securitization	Funds from customer deposits (savings, deposits) and shareholder capital (Aprianti & Sidiq, 2021)
Main Functions	Provide alternative financing outside the traditional banking system	Collecting funds from the public and channeling them back in the form of credit
Monitoring	Lack of monitoring or not monitored by banking regulators, high risk of liquidity crisis	Closely supervised by regulators and subject to monetary policy to ensure the safety of customer funds (Taskaro & Suhari, 2024)
Risk Level	Higher due to lack of fund protection and strong risk mitigation mechanisms	Lower due to regulation, liquidity reserves, and government guarantees
Transparency	Tends to be lower due to lack of regulation and open financial reporting	High because they are required to report their financial condition regularly (Nainggolan, 2020)
Service Example	Peer-to-peer (P2P) lending, leasing, hedge funds, asset securitization	Bank loans, current accounts, savings, deposits, business loans

The distinction between shadow banking and conventional banks suggests that while shadow banking can contribute to increased financial inclusion by providing broader and more flexible access to financing, its existence also challenges financial system stability. Lack of supervision and transparency in shadow banking operations can increase credit, liquidity, and even potential financial crisis risks in the event of market shocks. In addition, the close relationship between shadow banking and conventional banks may cause a domino effect in the event of a failure in either sector. Therefore, stricter regulations and effective supervisory mechanisms are needed to mitigate systemic risks arising from the interaction between these two types of banking. Measures such as increased transparency, strengthened risk management, and coordination between regulators and industry players are key in maintaining the balance between financial innovation and overall economic stability.

Recommendations for Regulation and Financial System Stability

Regulation of shadow and conventional banking is essential to maintain financial system stability. Shadow banking, which includes financial institutions outside the strictly regulated banking system, has a role in providing alternative credit but also carries substantial risks, mainly due to the lack of supervision and high interconnectedness with conventional banks (Mugasha, 2018). Effective regulation should include the application of the same prudential principles as conventional banking, including capital requirements and financial transparency. Regulatory imbalances between shadow banking and conventional banking can potentially create distortions in financial markets, where regulatory tightening on conventional banks may drive activity to the less supervised shadow sector, increasing the phenomenon of "regulatory arbitrage" (Adrian &

Ashcraft, 2012).

The link between these two sectors means that a crisis in shadow banking can quickly spread to conventional banks, as seen in the 2007-2008 financial crisis, when the collapse of non-bank financial institutions exacerbated global instability (Ban & Gabor, 2016). Therefore, there is a need for regulation that not only focuses on conventional banking but also integrates supervision of the shadow banking sector to ensure transparency, better risk management, and policy coordination at the national and international levels to prevent systemic risks that could destabilize the wider economy (Oncu, 2016).

Table 2. Recommendations for Regulation and Financial System Stability

Regulatory Aspects	Regulatory Recommendations	References
Monitoring and Transparency	Strengthen monitoring of shadow banking by increasing transparency of financial statements and adopting digital technology for transaction monitoring.	(Li, 2021)
Systematic Risk Control	Develop a framework to reduce systemic risk from shadow banking activities, including limiting leverage and tightening capital market regulations.	(Yalçin & Okur, 2024)
Global Regulatory Coordination	Strengthen regulatory coordination between countries through the Financial Stability Board (FSB) to address shadow banking risks with global impact.	(Zarei et al., 2021)
Regulatory Integration between Conventional Banks and Shadow Banking	Develop regulations that cover conventional and shadow banking simultaneously to reduce regulatory arbitrage.	(Arora & Kashiramka, 2023)
Consumer Protection and Market Stabilization	Implement regulations that ensure consumer protection, such as transparency in loan contracts and increased supervision of securitization-based financial products.	(Dopico & Cobelas, 2020)
Digitization and Monitoring of Financial Technology (Fintech)	Integrate regulations on digital banking and fintech to prevent risks stemming from unmonitored digital platforms.	(Riazanova, 2021)

With the emergence of digital banking and fintech, the banking system is undergoing a transformation that requires risk mitigation and close supervision by regulators such as the Financial Services Authority (OJK) and Bank Indonesia (Buwono et al., 2022). These regulations are designed to strengthen financial system stability by addressing loopholes in supervision that unregulated financial entities could exploit. In this context, stricter supervision and more comprehensive policies are needed to ensure that all financial activities, including those conducted by institutions outside the traditional banking system, are under the control of financial authorities. In addition, this regulation aims to prevent systemic risks that could arise from the interconnectedness of financial institutions and imbalances in capital flows. By closing potential loopholes that can be exploited by shadow banking, this regulation seeks to avoid a repeat of the global financial crisis triggered by non-transparent and speculative financial practices. Thus, this regulation has a crucial role in maintaining the financial system's stability, as well as ensuring that the global financial system remains sustainable and able to face future economic challenges.

DISCUSSION

Although they operate differently, shadow banking and conventional banks play an important role in the financial system. Conventional banks operate under strict regulation, offering services such as savings, credit, and investment that support economic stability. In contrast, shadow banking includes non-bank financial entities that provide similar services without the same regulatory oversight, thereby increasing systemic risk. Studies show that the funding structure of conventional banks, such as the concentration of funding and the stability of the short-term funding structure, affects liquidity risk, which can impact a country's economic health. Meanwhile, conventional banks also have a role in preventing money laundering by providing intelligence to relevant authorities (Dewi & Manika, 2023).

While shadow banking is often criticized for its lack of adequate supervision, the sector can play a positive role in improving the efficiency of the global financial system. Shadow banking provides financing alternatives that can expand access to liquidity and additional credit and offer more flexible and fast solutions to meet dynamic market needs. However, without sufficient supervision, this sector also has the potential to increase systemic risks, such as market instability and financial volatility, especially if its activities are not transparent or integrated with the main financial system. On the other hand, conventional banks, while more stable and tightly regulated by supervisory authorities, are often perceived as more conservative and less innovative than shadow banking. This can make conventional banks less able to respond to rapid changes in market needs and technological innovations, limiting their ability to compete with more agile institutions in the shadow banking sector (Minaryanti & Mihajat, 2024). Therefore, while both sectors play a crucial role, it is important to balance innovation with proper supervision to maintain the stability and sustainability of the financial system.

Shadow banking and conventional banks together create a balance in a healthy financial system. With their strict regulatory structure, conventional banks provide a foundation of stability and security. At the same time, shadow banking, although less supervised, offers flexibility and innovation that can accelerate the development of financial markets. The two sectors complement each other, with conventional banks ensuring better risk management. At the same time, shadow banking can fill gaps that traditional banks may not reach, such as more specific and fast financing. However, proper regulation is essential to ensure that this collaboration provides maximum benefits without creating uncontrollable risks. Effective regulation will maintain a balance between maintaining financial system stability and encouraging innovation, allowing the two sectors to work together to optimize the allocation of financial resources, improve market efficiency, and support sustainable economic growth. With the right regulatory framework, these two sectors can function synergistically, provide greater access to finance, and contribute to more inclusive and resilient economic development.

CONCLUSION

This research addresses the relationship between shadow banking and conventional banking in the modern financial system. Shadow banking refers to nonbank financial intermediation activities outside the traditional banking system but perform similar functions such as credit intermediation. On the other hand, conventional banks operate under strict regulation and provide traditional banking services such as deposits, loans, and other financial services. The relationship between shadow banking and conventional banking involves competition and interdependence. Conventional banks are often involved in shadow banking activities, either directly through securitization and interbank lending or indirectly by providing liquidity to shadow banking institutions during financial stress. These linkages create systemic risk, as imbalances or disruptions in the shadow banking sector can affect the stability of conventional banking and the financial system.

Shadow banking and conventional banks are two entities in the financial system that have different roles but remain interconnected in the financial intermediation process, for example in regulation, institutions involved, funding sources, main functions, supervision, risk levels, transparency, and services offered. While shadow banking can improve financial inclusion by providing more flexible financing, it risks destabilizing the financial system due to lack of supervision. Therefore, this study emphasizes the importance of strengthening shadow banking regulations, including increased transparency, global regulatory coordination, and consumer protection, to balance financial innovation and proper supervision to maintain overall financial system stability.

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