# 3. Turning the spotlight on shadow banking

## Pros and cons of the darkness

**Non-banking entities and activities, such as crowd-funding and peer-to-peer lending, can be a helpful complement to the banking sector to support investment and economic growth. However, they can also be a source of systemic risk if not properly supervised and regulated. Therefore, an adequate balance is needed to maximise the benefits while at the same time minimising the gloomy consequences of financial instability and regulatory arbitrage.**

### Light on the shadow

**The concept and the metrics for shadow banking are still pending**. Shadow banking is generally defined as "credit intermediation that involves entities and activities fully or partially outside the regular banking system"[17]. In 2015, the Financial Stability Board (FSB) proposed a more accurate definition considering five economic functions and their contributions to financial stability risks[18]. In addition to that, a group of economists from the International Monetary Fund (IMF) proposed an alternative definition based on the sources of funding and whether or not they are "non-core liabilities[19]. They consider that the previous definitions are short-sighted because they "miss significant non-traditional banking activities carried out by banks themselves, thus leading to an incomplete picture of [shadow banking] and of the potential vulnerabilities associated with it".

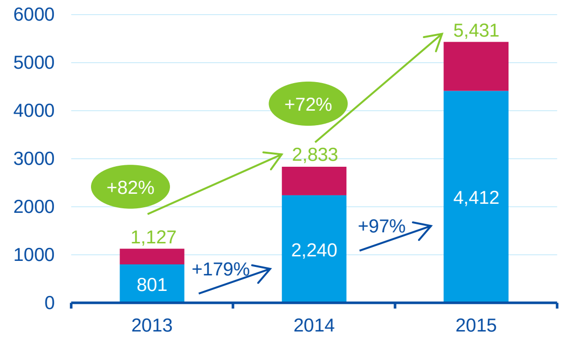
**The FSB estimated that non-bank financial intermediation totalled EUR 102.2 trillion[20] at the end of 2014** (40% of total financial system assets) and EUR 29.6 thousand billion using the narrow definition. **In the EU, at the end of 2015**, the European Systemic Risk Board (ESRB) calculated EUR 37 million trillion[21] in terms of total assets (36% of total EU financial sector assets) using the broad definition. **Focusing on the online sector, by the end of 2015**, the total for alternative finance in the Asia-Pacific region was approximately EUR 95.6 billion, EUR 33.6 billion for the Americas, and EUR 5.4 billion (+92% YoY) in Europe. The data show that the European market is still small when compared to the other two regions. In Europe, the United Kingdom is the largest market by a considerable margin[22].

---

17: Source: ESRB. EU Shadow Banking Monitor No 1 / July 2016 Page 6.
18: Source: *A measure of shadow banking based on economic functions* (sect.2.) FSB 2015 Global Shadow Banking Monitoring Report.
19: Core liabilities are issued only by banks and non-core liabilities can be issued by banks, money market funds and other financial intermediaries. Explanation can be found in *Shedding Light on Shadow Banking* Artak Harutyunyan et al. IMF WP. Jan 2016.
20: 10^12. Source: FSB's 2015 Global Shadow Banking Monitoring Report for more. Exchange rates 1.21410 USD/EUR. Source: BCBS.
21: 10^18
22: Source: Sustaining momentum: the 2ndEuropean alternative finance industry report. University of Cambridge & KPMG. 2016

Figure 1

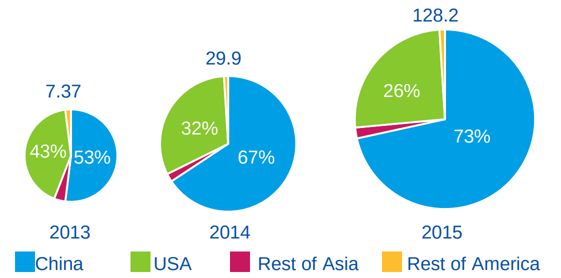
**European Online Alternative Finance Market Volumes 2013-2015 (in EUR million)**




Source: BBVA Research based on University of Cambridge & KPMG

Figure 2

**Asia-America Online Alternative Finance Market Volumes 2013-2015 (in EUR billion)**




Source: BBVA Research based on University of Cambridge & KPMG

## Digital shadow banking

With the emergence of new technologies, digital finance platforms have expanded rapidly. **They facilitate millions of transactions every day for individuals and businesses** and play a significant role in the provision of a viable 'alternative' to traditional sources of financing. A variety of online platform-based models exist, such as donation-, reward- and equity-based crowd-funding, peer-to-peer consumer and business lending, invoice trading and debt-based securities.

In Europe, funding for businesses has increased considerably since 2014, becoming an important source of finance for entrepreneurs, start-ups and small & medium-sized enterprises (SMEs). In 2015, EUR 536 million of business finance was raised through online alternative funding models, providing capital to 9,442 businesses. It is providing early stage investments to start-ups and growth capital to SMEs, stimulating regional economies and funding worthwhile causes. It should also be noted that, according to the European Commission, in recent years, access to financing has become overall the least important problem for SMEs, while in 2009 it was the second most urgent one. **The alternative business funding market has probably been a relevant variable in explaining that improvement.**

**At this point, we would like to highlight that one of the largest lending platforms is applying for a banking licence in the UK**. It will become the first *P2P banking company* under the scrutiny of the Financial Conduct and Prudential Regulation Authorities. Business diversification, synergies and consumer protection seem to be the main drivers of that strategy: deposits raised from the bank would fund P2P loans. Last, but not least, the platform will also bring protection for its consumers' deposits, given the fact that they will be included under the umbrella of the Financial Compensation Scheme, not extended to "pure" P2P depositors.

There are different possible explanations for the increase in alternative business funding platforms, one of them being the **financial crisis**: with near-zero interest rates, as investors entered these new markets, searching for the higher rates available due to P2P assets exposure. For potential borrowers, there is a wider range of credit options, as regulation has become stricter and a lack of trust in the traditional banks has expanded. Another reason that explains the expansion of alternative finance could be linked to the **nature of the traditional banking market**, where high entry barriers make it difficult for new banks to emerge. Financial intermediary costs have remained stable for years, while **the new online lender players face lower costs due to their lack of branches and lower administrative burden.**

Yet another possible explanation for this boom could be that finally **digitisation is mature enough in society** for the public to use on-line channels to perform financial transactions. But the most important driver is probably the **rise of new technologies**, which has enabled the rapid entry of new players into the financial markets.

## Digital Regulation

As a result of the expansion of the alternative finance market, governments **have started to issue local regulations with different approaches**, ranging from more restrictive ones in countries such as the US, Germany or France, versus less restraining norms in the UK and New Zealand.

In Europe, **the lack of a common legal framework may be hampering the development of online-based platforms,** as it implies major risks to both consumers and investors and does not ensure a level playing field between financial and non-financial institutions.

Recently, **fraud incidents regarding crowd-funding platforms have proved that some regulation is needed for these entities**. One of the most significant cases is related to the biggest Chinese P2P lending platform Ezu Bao, which collected 50 billion Yuan ($7.6 billion) in less than two years. Investigations revealed that top executives used investors' money to enrich themselves. After this, China issued a regulation to toughen its control of peer-to-peer lending companies.

Some of these new entrants (Lending Club, Prosper, Kabbage) favour the use of other terms, such as "market-based financing", instead of "shadow banking" to define their business. In any case, issues such as **insufficient understanding on the part of consumers, the collapse of platforms, loan defaults, cyber-attacks and credit and/or investment protection must be addressed by the authorities in regard to these players**; regulation is therefore becoming another key driver for the adoption of these alternative finance solutions.

## Conclusions

**Shadow banking can be a useful tool for helping the banking sector in the provision of credit**, especially in Europe, where approximately two-thirds of funding depends on banks[23]. Non-banking funding can also contribute to facilitating market liquidity and risk sharing and to fostering competition and innovation through the support of new ideas and projects. In particular, digital-based platforms have grown dramatically in size and scale over the past few years. On the other hand, if not adequately supervised and regulated, non-bank funding can contribute to an increase in systemic risk through interconnections with a few players from the financial system, especially the banking sector. Besides, non-bank funding might weaken the level-playing-field as a consequence of regulatory arbitrage due to undeserved advantages. The setbacks relating to fraud and cyber security attacks suffered by some P2P need to be addressed by the regulators, providing a comprehensive framework for the development of these shadow banking activities, and allowing the development of instruments that can contribute to maximizing the advantages of digital shadow banking while minimizing its inconveniences. Consumers could take advantage of gains in efficiency and have access to wider and more competitive services and, last but not least, financial entities would have the possibility of bolstering their innovation projects and learning faster.

23: Source: ECB "Shadow banking in the euro area: risks and vulnerabilities in the investment fund sector" No 174. July 16. Point 2.2

## DISCLAIMER

## This report has been produced by the Digital Regulation Unit:


### Chief Economist for Digital Regulation Unit
Álvaro Martín
alvaro.martin@bbva.com

María Álvarez
Maria.alvarez.caro@bbva.com

Vanesa Casadas
vanesa.casadas@bbva.com

Alicia Sánchez
alicia.sanchezs@bbva.com

Javier Sebastián
jsebastian@bbva.com

Ana Isabel Segovia
Ana.segovia@bbva.com

Pablo Urbiola
pablo.urbiola@bbva.com

Javier Anatole Pallás Gozálvez
javieranatole.pallas@bbva.com

### With the contribution of:
Arturo Fraile
arturo.fraile@bbva.com

Álvaro Romero
Alvaro.romero.mateu@bbva.com


## BBVA Research



CONTACT DETAILS: BBVA Research: Azul Street, 4. La Vela Building - 4 and 5 floor. 28050 Madrid (Spain). Tel.:+34 91 374 60 00 y +34 91 537 70 00 / Fax:+34 91 374 30 25 - bbvaresearch@bbva.com www.bbvaresearch.com