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BRIEF

Inclusive Finance and Shadow Banking: Worlds Apart or Worlds Converging?

"Financial stability is more likely to be jeopardized by…the rise of 'shadow banking' as a result of the withdrawal of consumers from regulated banking than from inclusion efforts."

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The term "shadow banking" came into widespread usage with the onset of the global financial crisis to refer to a broad array of entities and activities operating outside the regular banking system that were being used to perform bank-like functions.[1] The Financial Stability Board (FSB) defines the "shadow banking sector" in the broadest sense as "credit intermediation involving entities and activities outside the regular banking system" (FSB 2011).

Credit intermediation—or borrowing from one source to make loans to another—is a core element of banking. Banking regulation and supervision are designed to control credit intermediation and maximize the likelihood that banks can repay their creditors, especially retail depositors. Credit intermediation by nonbanks potentially raises two problems. First, depending on the regulatory system, such intermediation may take place without the prudential regulation and supervision required of a bank (i.e., outside the "supervisory perimeter"). If the aggregate level of such credit intermediation is significant in a given country, accumulated losses among nonbanks could affect confidence in the banking sector as well, particularly if the general public doesn't understand which institutions are supervised and which are not. Second, nonbank credit intermediation can affect the stability of the banking sector when there are significant market interconnections between banks and nonbanks, which can increase the likelihood of ripple effects across institutions.

On its face, the broad definition of shadow banking would sweep in most microfinance, as well as some of the innovation by nonbanks in digital finance heralded by the G20 as fundamental to reach excluded and underserved households and businesses and thus advance financial inclusion.[2] At the same time, since the global financial crisis of 2008–2009, the G20 has called for monitoring and reining in those shadow banking practices that helped trigger the crisis. Are these calls contradictory? Not at all—at least not yet. The destabilizing innovations of nonbanks in the period leading up to the financial crisis, such as increasingly complex derivatives, are absent from the inclusive finance landscape. While the very prevalence of nonbank actors, and the many "bank-like" activities in inclusive finance, may appear to trigger shadow banking concerns, the types of credit intermediation currently going on outside the watchful eye of banking supervisors appear to be different from the destabilizing activities that contributed to the financial crisis.

Yet with progress on financial inclusion—and ongoing innovation, sometimes reaching vast scale quickly—it is worth remembering that the very concept of shadow banking emanated from fast-changing market practices and a corresponding failure of financial regulation and supervision to keep pace. This Brief explains why approaches to inclusive finance that are currently widespread do not share the potentially destabilizing attributes of other types of shadow banking, concluding by identifying some risks worth monitoring as the picture continues to evolve.

What Are the Attendant Risks of Shadow Banking?

Recognizing that a broad definition of shadow banking dilutes the intended focus on nonbank credit intermediation *that destabilizes* the financial sector, FSB has highlighted several aspects of nonbank credit intermediation that can make it destabilizing:

- ***Maturity transformation*** is the activity of issuing short-term liabilities (such as demand deposits) and transforming them into longer-term assets (such as mortgage loans).

1 As used in this Brief, the term "shadow banking" is not intended to cast in a necessarily negative light all types of credit intermediation to which this term is sometimes applied (FSB 2013). The Financial Stability Board acknowledges that when conducted properly, intermediating credit through nonbank channels can have important advantages and contributes to the financing of the real economy (FSB 2011, 2013, 2014).

2 See, e.g., "Leaders Statement. The Pittsburg Summit." 2009.

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- ***Liquidity transformation*** is a concept similar to maturity transformation that entails using liquid liabilities (such as cash or digital value) to buy less liquid assets such as loans.
- Opportunities to create or facilitate leverage. ***Leverage*** is a general term referring to any technique to multiply gains (but also potentially losses), such as borrowing to finance lending or other investment activity.
- Opportunities for ***regulatory arbitrage***, which occur when firms tailor their behavior to qualify for lighter regulation and supervision or to evade regulation and supervision altogether.[3]

Focusing on these aspects helps to understand the real risks of shadow banking (see FSB 2011; IMF 2013) and how they might intersect with inclusive finance.

Nonbanks in Inclusive Finance—Are They Destabilizing "Shadow Banks"?

Many institutions delivering financial services to the financially excluded and underserved—such as microfinance and microcredit institutions, financial cooperatives, and issuers and distributors of e-money in digital finance models (e.g., mobile network operators)—are not licensed as banks (BCBS 2015). For many of the reasons explored below, the activities of these nonbanks do not trigger destabilizing shadow banking concerns.

Microcredit Portfolios

Microcredits—short-term loans in small amounts to unserved or underserved households and businesses—lie at the heart of many people's concept of inclusive finance. The wide array of institutions making such loans are typically funded diversely depending on the market and regulatory system, including by private or public equity, deposits or deposit-like loans from individuals, loans from banks and other institutional lenders, and retained earnings. Regardless of the composition of their funding base, however, maturity and liquidity transformations are rare because microcredit is, by definition, short term. Of course this risk can arise, however, if the microcredits are made by institutions also engaged in longer-term lending, such as housing finance, or investment.

Does this mean that nonbank institutions that issue exclusively short-term microcredit cannot adversely affect systemic stability? Not necessarily. For example, banks may have incentives to fund such institutions, or even create them, to evade regulatory restrictions on their own direct microlending activity—i.e., regulatory arbitrage, as in the case of Morocco (Lyman and Reille 2005, Chehade and Nègre 2013) and Russia, for example, where microlending institutions are not subject to the same interest rate regulation as banks themselves,[4] or because of priority-sector lending targets (as in the case of India [CGAP 2010]). While bank lending is subject to prudential regulation and supervision, risks to stability may lie in the perception of the nonbanks funded as "leveraged financial intermediaries with liabilities similar to bank-like deposits, i.e. liabilities that are perceived as redeemable at par." [5] Though many other factors were at work, market-specific "microcredit crises" in both Morocco and India suggest that the incentives for the banks can be so great—and the credit risk management of the nonbank microcredit institutions so poor—as to overwhelm the supervisor and risk triggering broader instability in the banking sector (CGAP 2010; Chen, Rasmussen, and Reille 2010).

Digital Financial Services Models

Another increasingly significant phenomenon in inclusive finance where nonbanks play key roles is digital financial services that target the mass market, including the unserved and underserved.[6] While models vary widely—and with them the roles played by nonbanks—the essential feature is a digital transactional platform that combines the functionality of a payment instrument with the value storage functionality of a transaction account (see Lauer and Lyman 2015). Once in place, additional financial services—credit, interest-bearing savings, insurance, even investment products—can be offered to these same customers via the digital transactional platform.

Currently the vast majority of digital transactional platforms do not involve credit intermediation by

3 FSB (2011) also flags what it refers to as "flawed credit risk transfer." As the credit risk transfers in question during the financial crisis are not of a type seen in inclusive finance, this Brief does not consider them.

4 In Morocco, bank refinancing of microfinance institutions not subject to interest caps (Lyman and Reille 2005) helped spur radical growth of the microlending sector in the mid-2000s and triggered a crisis that was brought under control in part through central bank intervention (Chehade and Nègre 2013). In Russia, since November 2014 the central bank has been publishing interest rates limitations on consumer loans as required by the Consumer Credit Law, but it does so for each type of financial service provider, in addition to the type of loan. This has resulted in a situation where a similar loan product could be priced widely differently depending on a provider's legal form. Several prominent commercial banks have set up microlending subsidiaries, presumably to be free to charge higher rates on consumer loans than the banks themselves could charge (http://www.kommersant.ru/doc/2206320).

5 See http://ftalphaville.ft.com/2014/11/10/2036962/the-shadow-banking-system-define-it-before-you-size-it/

6 As of 2013, mobile money accounts alone have been launched in more than 80 countries (GSMA 2014).

nonbanks: even nonbank issuers of digitally stored value are typically required to hold customer funds in prudentially regulated and supervised banks or other safe and liquid investments (see Tarazi and Breloff 2010). Moreover, for the time being at least, additional financial services beyond payments and value storage offered via digital transactional platforms involve a prudentially licensed and supervised provider.[7]

However, even if current practices do not meet any of the criteria flagged by FSB as characteristic of destabilizing shadow banking, potential for destabilization still exists. For example, in some markets unsupervised nonbanks—such as mobile network operators—often act as issuers of deposit-like stored-value products, and the growth of this phenomenon has been so fast that the effect of their possible failure on consumer behavior cannot easily be predicted.

Monitoring the Inclusive Finance Landscape through a Shadow Banking Lens

The landscape of inclusive finance is evolving rapidly—and particularly in the digital arena where the change in scale can be rapid and dramatic. While current innovations holding the promise of reaching unserved and underserved customers sustainably and affordably thus far generally do not involve the kinds of maturity and liquidity transformation that helped to trigger the financial crisis, incentives for regulatory arbitrage in inclusive finance abound, as in finance generally. FSB counsels regulators and supervisors to monitor the trends in the shadow banking sector "to address bank-like risks to financial stability emerging outside the regular banking system while not inhibiting sustainable non-bank financing models that do not pose such risks." The approach should be proportionate and focus on the activities that are material to the system: FSB suggests assessing the trends in the shadow banking sectors in terms of the size and growth rates "both in absolute terms and in relation to the total debt, GDP, and the size of the regular banking system" (FSB 2011).

To determine whether nonbanks are involved in shadow banking activities that may pose systemic risks or represent regulatory arbitrage, regulators should assess them through the lens of their underlying economic functions or activities[8] rather than legal names or forms (FSB 2013). In the inclusive finance world, the following two functions deserve attention as potential risk fronts to watch:

- **Base-of-the-pyramid (BoP) providers acting as collective investment vehicles with features that make them susceptible to runs.** These can include financial cooperatives accepting savings, microfinance and microcredit organizations allowed to accept deposits or loans and regulated differently than bank deposits, and nonbank issuers of e-money, though in most markets the current scale of any such activities is unlikely to be systemic.
- **BoP lenders dependent on short-term funding.** Systemically significant refinancing of microcredit or other BoP credit portfolios by banks (in particular, if the banks use these lenders as a way to bypass regulation and supervision) and nonbanks (especially if these nonbanks can act as collective investment vehicles) can potentially have a destabilizing effect that may be further exacerbated if microlenders are allowed to issue longer-term loan and investment products in addition to microcredit, thereby increasing maturity and liquidity transformation risks.

Innovations in inclusive finance can include models combining the above functions, such as peer-to-peer (P2P) online lending platforms, which in countries like China have reached important scale.[9]

Finally, while credit intermediation by microlending institutions may not raise *direct* financial stability concerns, rapid changes in the BoP credit—such as blurring of the lines among high interest, high write-off consumer lending, and socially oriented microlending in some countries—are bringing about consumer protection challenges that may threaten financial stability indirectly, such as where consumer discontent and distrust in microlenders spill over to the broader financial sector (BFA and RMC 2014).

These and other potential risk fronts must also be viewed in perspective—and with due attention to the consequences of ongoing financial *exclusion*

7 For example, the M-Shwari interest-bearing savings accounts and consumer loans offered to customers of the M-PESA digital transactional platform of Kenyan mobile network operator Safaricom are the products of the Commercial Bank of Africa. See http://www.cgap.org/photos-videos/m-shwari-empowering-kenyans-financial-services

8 The five economic functions suggested by FSB to assess nonbanks' involvement in shadow banking include (*i*) management of collective investment vehicles with features that make them susceptible to runs; (*ii*) loan provision that depends on short-term funding; (*iii*) intermediation of market activities that depends on short-term funding or on secured funding of client assets; (*iv*) facilitation of credit creation; and (*v*) securitization-based credit intermediation and funding of financial entities (FSB 2013).

9 See, e.g., Financial Times (2015). P2P services represent a distinct type of intermediation beyond the supervisory perimeter and raise many prudential and market conduct regulatory and supervisory issues beyond the scope of this Brief.

(including its adverse ramifications for systemic stability, as yet little studied) (GPFI 2011).[10] Here again a call by the G20 merits mention: global policy makers are encouraged "to explore the linkages among financial inclusion, financial stability, financial integrity and financial consumer protection" (G20 2012). Only with all of these interconnected policy objectives in view will a balanced approach to both inclusive finance and shadow banking be possible.

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10 See also FSB (2015) mentioning the risks of driving cross-border financial transactions into the unregulated sector due to the decline of correspondent banking services offered by international banks.

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