BANCA D'ITALIA EUROSISTEMA

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Non-Bank Finance and Financial Intermediation

Naples, 18-19 June 2019[1]

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On June 18-19, 2019, senior policymakers from the Euro-Mediterranean area[2] and experts from international institutions assembled to discuss key developments in the non-bank financial sector. Non-bank financial intermediation includes a wide range of instruments and intermediaries engaged in financial intermediation outside the banking system. This includes credit intermediation (via, inter alia, consumer loan providers, credit unions/cooperatives, microcredit institutions, and digital platforms), in addition to investment schemes (both collective and individual), and risk transfer services such as securitization. The conference also gave specific attention to technology enabled solutions in financial services ('fintech'), which has great potential to improve outreach and product diversification of NBFIs.

Participants acknowledged that NBFIs can become an important channel to increase financial access, particularly in bank dominated financial sectors.[3] The share of total NBFI assets in the financial sector has grown significantly since the global financial crisis and now exceeds that of the banking sector.[4] Non-bank finance can develop a more diversified credit supply, increase access to financial resources for those underserved, lower the cost of financing, and enhance competition and efficiency. Fintechs are innovating on traditional business models which can have a positive impact on financial access and the use of alternative data for credit history. While growing globally, overall NBFI composition remains heterogeneous amongst countries and specific to financial sector composition at national levels.

The seminar presented an opportunity to discuss the role of NBFIs to better support micro, small and medium-sized enterprise (MSME) financing. Bank financing for MSMEs is often constrained due to information asymmetry, risk perception, high collateral requirements, high transaction cost, and in some cases crowding out of productive finance because of sovereign financing needs.[5] In emerging markets microfinance, directed lines of credit/credit guarantee mechanisms, and early stage equity funds have all played a role in addressing the MSME financing gap. Certain jurisdictions have introduced market-based financing solutions for MSMEs through mini bonds, collective investment schemes, and dedicated listing windows on stock exchanges. Despite rapid growth in some cases, they remain small compared to bank financing. Their effective usage is dependent on SMEs having sound balance sheets, transparent management, and supported by robust credit reporting systems.

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[1] This high-level dialogue was initiated in 2013 thanks to a partnership between Banque de France, the World Bank Group and the Center for Mediterranean Integration (Marseille).

[2] The Euro-Mediterranean is an economic community of those countries bordering the Mediterranean Sea. From Europe attendees represented France, Italy, Spain, Cyprus, Greece, Portugal, Albania, and Croatia. Attendees from the Middle East and North Africa represented Morocco, Tunisia, Egypt, Jordan, Lebanon and Palestine. Participants from international institutions and regulatory bodies were on hand from the World Bank Group, the International Monetary Fund, the Financial Stability Board, the European Systemic Risk Board, the European Investment Bank and the European Central Bank.

[3] Per World Bank Group Findex data, average financial access was at 65% of adults in the ECA and 43% in the MENA as of 2017, excluding high income countries. The situation is different in Euro Area countries with more than 95% of adults having a financial account.

[4] Data from: Financial Stability Board. "Global Monitoring Report on Non-Bank Financial Intermediation 2018." https://www.fsb.org/2019/02/global-monitoring-report-on-non-bank-financial-intermediation-2018/

[5] According to data from the International Finance Corporation, the MSME financing gap reached 19% of GDP in the ECA countries and 24% of GDP in the MENA region.

Participants discussed the impact of Fintech on competition in the financial system and the unbundling of financial services, as well as recent private digital currency initiatives. They discussed the World Bank /IMF Bali Fintech agenda to harness Fintech's opportunities[6] and key dimensions to promote the sound development of Fintech. Technology enabled financial services can allow innovative solutions, new business models and successful cross-sector collaboration in financial services. However, fintech risks also rise as new technologies and business models are used by more and more institutions and new risks emerge.

Developing fintech pathways create new regulatory challenges in addition to other risks such as cybersecurity and data privacy. Authorities noted the importance of policy measures to understand and foster fintech, including as part of national financial inclusion strategies for emerging market jurisdictions.

Participants noted the risks NBFIs can pose and the importance of having access to relevant information to identify and monitor potential vulnerabilities. Risks appear particularly acute when intermediaries are involved in maturity and liquidity transformation or are significantly leveraged. Lending based on short-term funding can create liquidity risks, as well as certain collective investment schemes by failing to convert assets to cash to meet redemption requests during periods of market stress. Risks can also arise from the interconnectedness between NBFIs and banks through operational dependencies or funding relationships. Certain NBFIs also have significant cross-border linkages. Moreover, the behavior of asset managers and investment funds remains to be tested and may prove more procyclical than banks. These issues pose new challenges to regulatory and supervisory authorities.

Participants stressed the importance of appropriate oversight, regulation and supervision of activities based on risks rather than solely by institutional form to promote sound market development in the NBFI sector. Regulation should be prudential but also ensure adequate consumer protection. Clear legal and regulatory frameworks must exist for the proliferation of digital financial services, including on e-money issuance and non-bank provision of payment services. Participants acknowledged the role of proportionality in ensuring the sound development of the NBFI sector and the effectiveness in supervisory outcome. Proportionality requires that regulation and supervision be commensurate with the size, risk profile, and systemic importance of the institutions, especially in the context of the heterogeneity of NBFIs.

Macroprudential tools to assess systemic risk in the NBFI sector, for example stress testing were discussed. These instruments will take on greater importance as policymakers develop tools to understand macroprudential risks stemming from the NBFI sector. Improving the quality of data around NBFI performance, funding, and operational risks can support the development of analytical models allowing for a robust macroprudential response and overall surveillance framework to the NBFI sector.

Overall, participants agreed on the importance of NBFIs as a channel to promote continued financing growth that integrates relevant technology-related developments. Non-bank finance responds to demand from investors to diversify risk related to the banking system, offering an alternative to low-interest rate deposits and providing the real economy with financing instruments to meet specific needs, including for previously underserved households and MSMEs.

Looking forward, there is a need to redouble efforts to ensure robust regulatory framework are in place that safeguard against both micro and macro prudential risks posed by the NBFI sector. There is also a need for more robust data on NBFIs. **Participants noted the need for further cooperation at the**

[6] See: International Monetary Fund and World Bank Group. 2019. *Fintech: The Experience So Far.* http://documents.worldbank.org/curated/en/130201561082549144/pdf/Fintech-The-Experience-so-Far-Executive-Summary.pdf

international level to better assess cross-border, concentration, and interconnectedness risks. This is particularly important given cross-border nature of certain fintech-enabled financial transactions and overall institutional setup. Closely linked, fintech development must be balanced by appropriate regulatory responses to ensure consumer and investor protection and a level playing field amongst emerging private sector solutions. Policy surrounding industry structure and competition in the fintech sector will continue to emerge as priorities moving forward.