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01

The keys to shadow banking

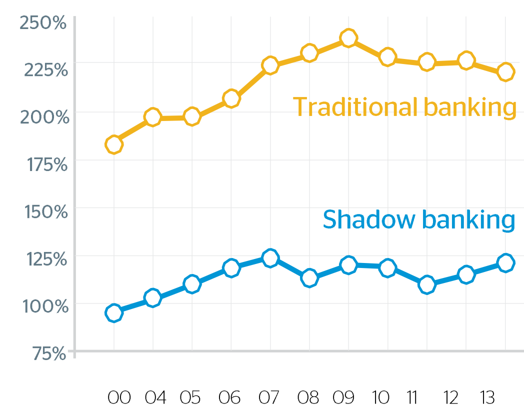
P2P financial systems are becoming more common in our economy. For this reason, we would like to provide you with the six keys to a better understanding of shadow banking, as well as its strengths and weaknesses in comparison with traditional banking.

Shadow banking is controversial even in its definition. International experts cannot agree on the characteristics of this increasingly popular financial system, which involves financial activities outside the conventional framework. For this reason, before we provide you with the keys to a better understanding of shadow banking, we would like to list three possible definitions for this system:

Financial Stability Board: Shadow banking is credit intermediation involving financial entities and activities outside the regular banking system.

Stijn Claessens and Lev Ratnovski: All financial activities, except traditional banking, which require a private or public backstop to operate. .

Zoltan Pozsar: Entities that provide credit, maturity and liquidity transformation with no government backing or access to the central bank's liquidity .



Percentage of GDP traditional banking and shadow banking.

Now that we have an idea of what this financial system refers to, we go on to list the six keys to understanding its strengths and weaknesses:

1

A complement to traditional banking

There is no doubt about this: traditional banking and shadow banking can complement each other. In fact, the shadow system is beneficial: it expands credit access and, consequently, adds liquidity to the market, and results in the distribution of financial risks.

2

Where is it most common, and why?

The biggest shadow banking systems are located in advanced economies, in other words, in countries where there has been an economic standstill in recent years, and where regulatory measures are more clearly defined.

For this reason, the IMF suggests that the shadow system will continue to grow in these advanced economies because the ongoing "tightening of banking regulation" and an increase in investor demand lead to this type of activity (strictly speaking, non-banking activities).

However, the shadow banking system is growing steadily in emerging economies, surpassing traditional banking growth. This type of development is best exemplified by China: its government has applied severe restrictions to traditional banking, leading to the height of P2P and P2B financial activities.

Potential growth of [P2P loans ( )]

In the US and the UK, this type of activity is centered around households and SMEs, even though there are some associations between these platforms and a few traditional banks. According to IMF data, by late March 2014 this markethandled more than 6.5 billion dollars..

The issue of transparency

The lack of transparency is one of the weaknesses of P2P financial activities. There are major gaps in information in this financial system; for this reason, many authorities (such as the IMF) argue that transparency should be ensured in order to improve information and encourage regulations that improve risk management.

Currently, it is still very difficult to obtain measurable data about P2P activities, ( ) both in terms of donations and shadow loans and investments.

5

The risks

In late 2013 shadow banking accounted for 30% of all systemic risk in the US banking sector. But this figure was much lower in the eurozone and the UK – 13% and 7% respectively. To stop this risk from increasing as this type of activity grows, the IMF insists that strong international political cooperation is necessary to achieve cross-border regulatory arbitration. This would make it possible to face the risks and attain global financial stability.

In fact, risks tend to increase when regulatory measures are implemented without inter-country coordination: regulatory changes in one country may result in secondary effects and increased risks in another country.

The specific risks (in) of shadow banking can be mitigated by using tools such as limiting reimbursement in collective investment or restricting investment leveraging.

Additionally, it is also necessary to expand information requirements with a view to increasing system transparency and allowing risk tracking.

6

Regulatory objectives

Authorities face the challenge of maximizing the economic benefits of shadow banking and reducing its systemic risks. It is necessary to reach a balance between the advantages of this system and traditional economic funding, whileincreasing the protection against the system's weaknesses. Diverse country regulations lead to a company being considered a bank in one country and a shadow bank in another.

For this reason, the IMF suggests that political frameworks be established that identify and respond to the threats against financial stability; this type of framework has increased since the global financial crisis.

In fact, the IMF recommends that banking entities and shadow entities be distinguished by activities, function and level of risk.

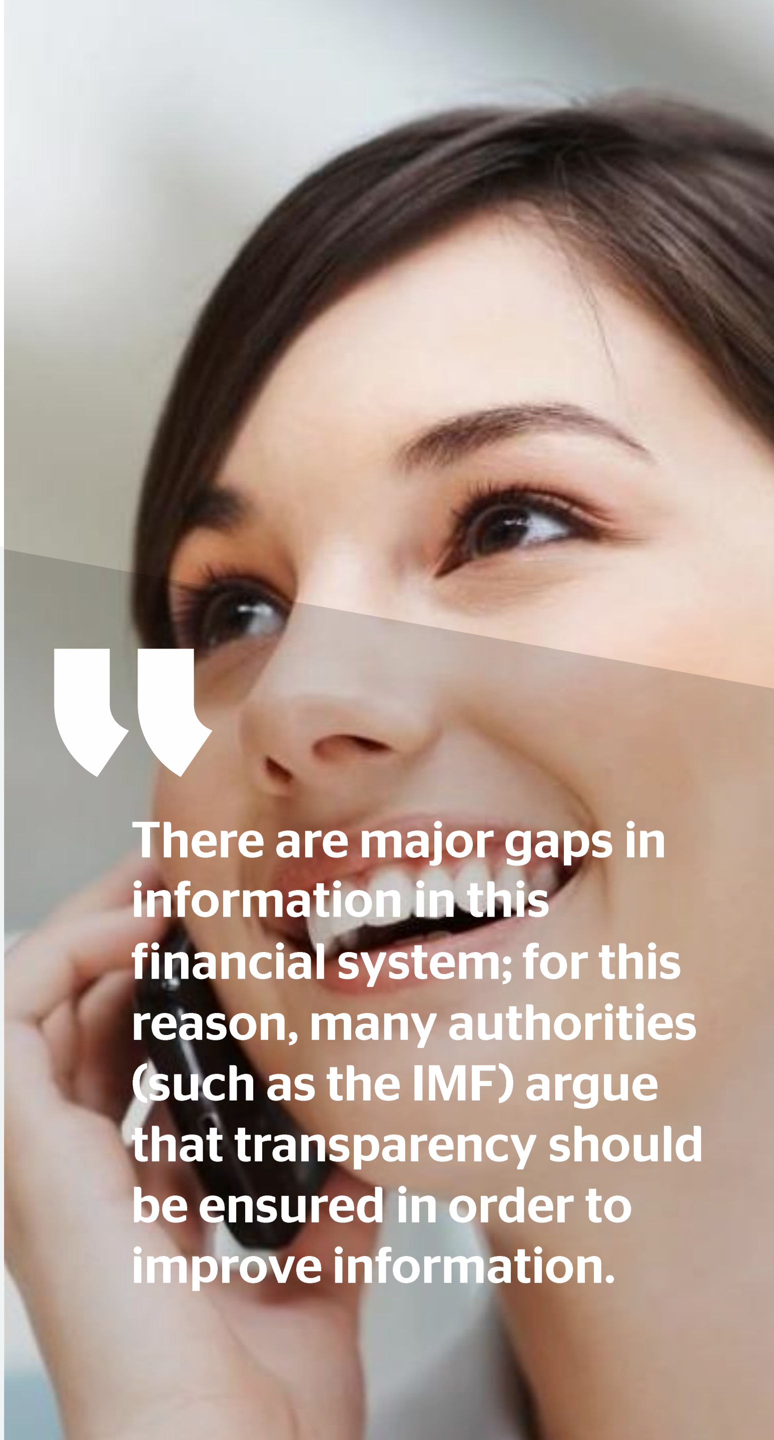
Lastly, the IMF suggests four stages for a regulatory response to shadow banking:

1. Systemically identify risks based on broad supervision of the financial sector by a macroprudential authority.

2. Consider and potentially adopt political measures, which include macroprudential measures, changes in business behavior and non-regulatory measures.

3. Supervise and implement these measures, based on the experience of microprudential authorities.

4. Evaluate the effectiveness of the above-mentioned political and economic measures at least once a year, and report the results internationally.



02

What is the P2P financial ecosystem like?

The P2P financial market is booming around the world. With growth of 111%, it has become something more than an alternative: in 2012 it handled more than 2,099 million euros in over one million projects, according to the latest report by the consultancy firm Massolution. This is why we wanted to analyze all the agents that are part of this alternative funding ecosystem.

1. The entrepreneurs or borrowers

The boom experienced by the P2P financial ecosystem (f) in recent years is largely due to the growing demand by entrepreneurs who need investments for their projects, but faced with the global economic difficulties and the credit squeeze during the crisis, encounter many barriers when trying to access the more traditional financial system.

In many cases these are small entrepreneurs who are looking for their first funding for their project or need an injection of capital to make their business idea a reality. However, they have no financial "reputation" to be able to access the traditional market with guarantees.

2. The investors or lenders

And the investors come into play to meet this growing demand by the entrepreneurs. They are an alternative in the traditional financial market, although they also have to overcome a series of barriers to be able to assess the projects that offer the greatest potential.

In fact, in the early stages of the projects, the investors are usually friends and relatives, but their involvement in the fundraising process disappears as the project progresses, according to an analysis by Agrawal, Catalini and Goldfarb.

Beyond these close investors, other lenders are appearing with the P2P financial market:

Business Angel

Through the so-called equity crowdfunding platforms, the microinvestors obtain shares or stakes in the company they invest in. They become the company's owners and the return on their investment is linked to the company's success and the distribution of profits.

Lenders

Through crowdlending platforms like LendingClub or Prosper, the investors lend money to the companies without becoming owners, as in the case of crowdfunding. Those who invest in this way receive a debit instrument that specifies the terms and conditions for repaying the loan.

Thus, at the end of the stipulated period, they receive all the money lent plus a return that will depend on the risk assumed. The greater the number of investors, the more diversified becomes the risk among them. The minimum amount for investing is usually around €25.

Donors

The investor seeks nothing in exchange for the donation, so this is usually the case with charitable or humanitarian projects. It is collective funding, with no kind of remuneration in exchange.

Investors and future customers

Entrepreneurs can fund themselves through their future customers, instead of risking their own capital only.

It goes one step further in the philanthropic nature of donations, as the investor is paying in advance for the service or product.

3. The financial capital and the price of this capital

In this traditional interplay of funding supply and demand, the entrepreneurs require capital which is offered by the investors, but they have to do so through what is known as a non-regulated market, the so-called shadow banking.

As we have seen, there are different "patronage" models: they can be donations for promoting the project or small investments in exchange for rewards such as having access to the product or service in which they invest, or investments in exchange for shares in the entrepreneur's startup.

4. The digital platform

In this context, the fourth piece in this ecosystem becomes increasingly essential: the technology platform that makes it possible for the other pieces in the mechanism to work, i.e. matching supply and demand, with their specific features, in a market that is becoming less and less "shadowy". This technology platform matches the incentives of the entrepreneurs and investors, while reducing the risks thanks to the support of technology.

This platform is the basis of the boom of this alternative ecosystem: the entrepreneurs can access funding that would be very difficult to obtain on the traditional market and, through the platform, can receive input from third parties about their project. Meanwhile, the investors can look for new investment opportunities and take part in the creation of a new project.

One of the disadvantages that must be mentioned is the risk taken by the entrepreneurs by having to publicly set out their projects and their business strategy without having finished it; while the investors run the risk of seeing how their business bet fails.

In turn, the platforms, as new market referees, have to ensure the quality of the projects they announce and, therefore, enhance their risk selection and management mechanisms. The goal of building loyalty and attracting more investors and their benefits are the fees and commissions.

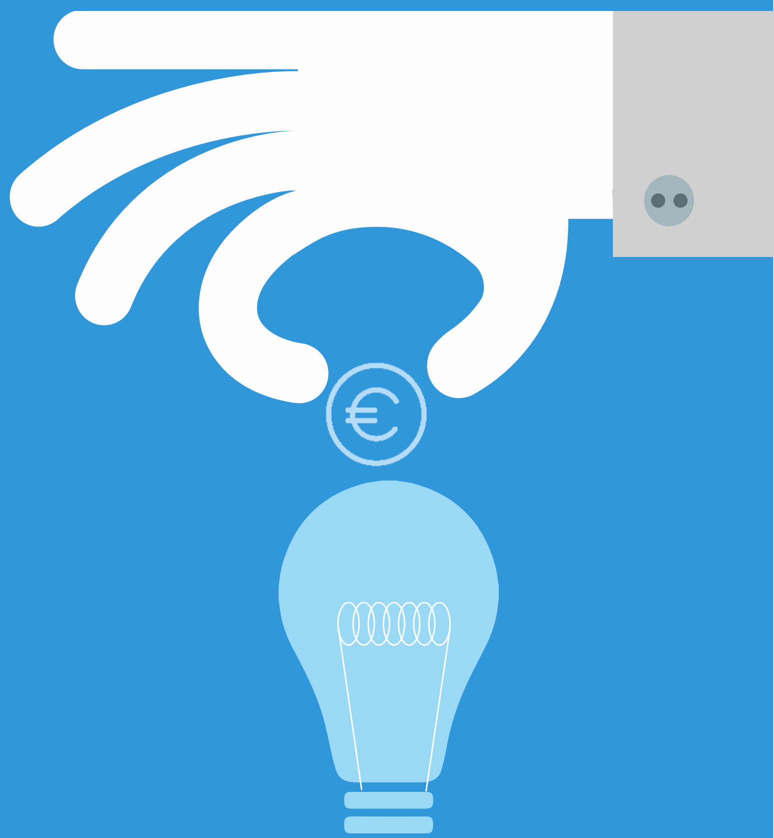
5. Regulation

The operating rules for this ecosystem have not yet been established and are not as transparent as they should be for mitigating the risks of the investments. There is some uncertainty regarding the legislation to be applied to this alternative funding market, which in its early stages has developed with no specific regulation, hence the nickname "shadow banking".

The less stringent regulation of these markets and the higher degree of informality with which many of the platforms operate increase the liquidity and solvency risks faced by the investors. The lack of transparency and the information asymmetry between entrepreneurs and investors is much larger than on the strictly regulated traditional financial market.

In fact, specific regulations (in) are beginning to emerge in the countries where this alternative funding system has developed more strongly, that regulate this activity by attempting, on the one hand, to protect unqualified investors and, on the other, to make it easier to access funding, especially for startups or small businesses, which find it difficult to fund themselves through more traditional channels.

INFOGRAPHIC 03



Business Models

P2P lending platforms are an alternative to traditional funding methods, offering more favorable and flexible conditions.

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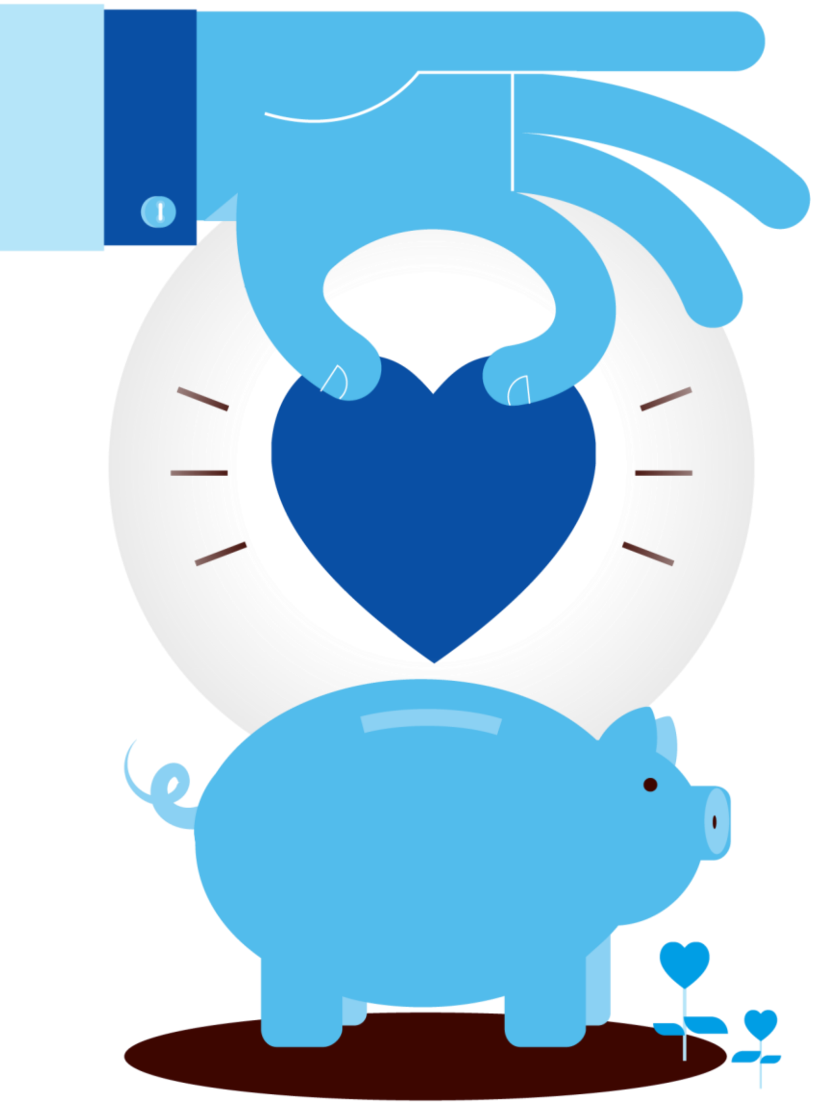
Donation platforms



They provide funding altruistically, without any compensation in return.

It's a kind of collective financing, typically used to fund solidarity and humanitarian projects.

They are the same old donations, but done with the help of the Internet and social networks, which are their base and dissemination tools.

Donations are not defined, and they can range from one euro to thousands of euros.

The Key
The satisfaction of the donor

Funder
Donor

Platforms
Kickstarter, Indiegogo

Reward platforms

It goes a step beyond philanthropy: the sponsor provides funding in exchange for a non-monetary reward (such as appearing in the credits of a work), or paying in advance a service or a product.

The entrepreneur can get funding through future clients, rather than only risking his own capital.

The key
Getting the product or service you support.

Funder
Sponsors

Platforms
Quirky. Tilt

Platforms with **financial return**

Crowdlending

Investors receive a debt instrument specifying the terms of the loan's repayment, including a return on the invested capital.

The goal is to get many investors to diversify. The minimum amount to invest is usually around 25 euros.

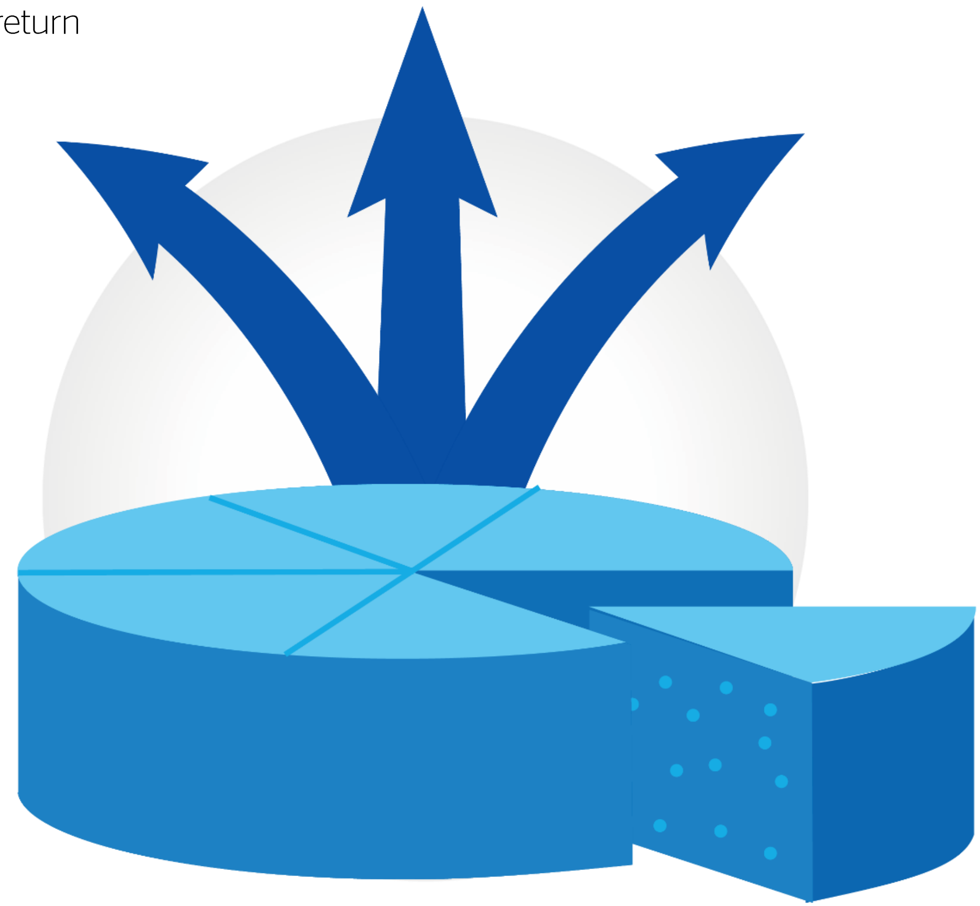
The key
Loans outside the traditional financial system

Funder
Lender

Platforms
LendingClub, Prosper

Equity crowdfunding

Micro-investors get shares in a company, and the return on investment is linked to its future success.



The key
Obtain shares of a company

Funder
Investor

Platforms
Crowdcube, CircleUp, AngelList

04/INTERVIEW

"Entrepreneurs have to attract investment and generate a striking effect that makes a difference"

Money with entrepreneurial spirit is one of the mottoes of Zencap, the European crowdlending platform. We spoke with Pablo Díaz, head of Business Development at Zencap in Spain, to find out in greater depth how a P2P financial platform works. (f).

Is the financial system adapting to the new pronounced economic needs especially during the global economic turmoil?

The new models of participatory funding certainly respond in all their forms (loan, stocks or donation) to a market need. Their versatility, transparency and efficiency democratize funding alternatives that were previously reserved for a small number of people. Platforms like Zencap provide employers/entrepreneurs and investors a unique opportunity to access the end product without intermediaries, with the transparency necessary to form an opinion and make a decision, and with sufficient diversification

to enable the risks inherent in these types of investments to be mitigated. Risks whose lack of transparency in the past has been exceptionally exposed as a result of the economic turmoil.

What are the advantages and risks of this booming alternative funding market?

As noted, all participatory funding platforms provide both parties with the chance to get in contact with each other without intermediaries, in a transparent and efficient manner. All parties gain by easily accessing what they need. Nevertheless, participatory funding platforms are not without risks.

The actual financial risks that are characteristic of these types of transactions also affect crowdlending platforms: market, liquidity, credit, operational and legal risk; however, default rates of crowdlending platforms worldwide range between 0.2% and 7%, which is well below traditional credit systems.

The main benefit of a platform like Zencap is its exceptionally prudent selection of loans whose rates increase based on calculating the probability of default, as well as the ability to diversify that it provides investors .

Can this alternative system be compatible with the traditional one?

All participatory funding platforms complement their big brothers. Those aimed at donations complement foundations and NGOs, those that do so through stocks complement Business angels networks and even, if necessary, venture capital funds, and crowdlending platforms complement commercial banks by their very nature.

For example, in the case of Zencap, the profile of the companies that come to ask for funding are those that are particularly attracted to online processes, that have had bad experiences with traditional banking or are simply attracted by the flexibility to complement their existing bank lending facilities.

In short, completely complementary.

What kind of financial risk exists in these alternative platforms?

As explained above the main risks are those that are inherent in these types of financial products. They have certainly been mitigated by the caution with which these platforms are settling in the financial landscape, especially after the debacle in America of Prosper in 2006.

In addition there is the possibility that some platforms do not act with the necessary rigor when selecting projects, the information available or even the management of receipts and payments. In any case the best defense against the latter risk is to ensure that the platform on which we invest provides sufficient transparency in both the selection of projects or loans, as well as commissions, risk management, etc.

Should a regulation be established to manage this risk as it exists in the traditional market?

I think that we will soon see new legislation passed in the Spanish Parliament. Even the EU is beginning to draft guidelines as a basis for those countries that have not yet done so. I think the government is to legislate and that any legislation that maintains a balance between protecting the interests of investors and/or companies who come to these markets and the platforms themselves are always positive because they benefit everyone.

What do you think about the laws that are being passed in different countries?

English-speaking countries are more mature in these markets because they have been the first to implement it. Spain has presented a draft law that reasonably covers all aspects of these new funding routes. The distinction between different types of funding still needs to be honed in, particularly between credit and stocks, but this does not alter the fact that it will surely result in greater control for the benefit of all parts of a reality that is here to stay.

From the point of view of the SME or entrepreneur seeking investment, how would you recommend "selling" your project to attract these investments?

I think there is a balance between understanding the product, the market and the investors who you are going to get. It is also capital.

Note that not all investors devote equal time to each project and there are striking effects that generate confidence among investors: convincing a good number of friends to invest initially or attracting an investor known in the industry can generate a striking effect that makes a difference.

In a world of information overload, it's not enough to do things well, you have to know how to show it.

05

The dictionary of P2P finance

Beyond the traditional financial market, the number of P2P financial transactions is growing, which is a booming alternative market. If you want to keep abreast of all these concepts, we are providing you with some vocabulary to help you understand the key terms.

Crowdfunding ( )

Crowdfunding platforms go a step beyond the philanthropic nature: the patron provides funding in exchange for a non-cash consideration (such as appearing in the credits of a work), or prepaying a service or a product. Entrepreneurs can fund themselves through their future customers, instead of risking their own capital only. This type of platform includes Quirky, among others.

This phenomenon is part of the collaborative movement, that has acquired a new dimension through advances in new technology.

Crowdlending ( )

Investors receive a debit instrument that specifies the terms and conditions for repaying the loan, adding a return on the amount borrowed.

The goal is to get many investors to diversify. The minimum amount for investing is usually around €25. This type of platform includes LendingClub and Prosper.

Equity crowdunfing ( )
Investors receive monetary compensation commensurate with their contributions of funds and the risk taken. In this case, microinvestors obtain shares or stakes in a company, and the return on investment is linked to its future success. This type of platform includes Crowdcube, CircleUP and AngelList.

Microcredits
These loans do not require personal guarantees because they are small amounts requested by entrepreneurs without many resources, so they do not have to provide collateral. These are the most commonly-used loans to finance projects that could not otherwise obtain funds.

Risk profile
This is all financial activity associated with an investor indicating their ability to assume losses; although it should be noted that the greater the risk assumed, the greater the returns that can be obtained.

Donation crowdfunding platform ( )
These platforms provide funding altruistically, without any compensation in return. It is a kind of collective financing used normally to finance solidarity or humanitarian projects.

These are the donations that have always been given, but the internet and social networks help to act as a base and aid dissemination. The donations are not for a certain amount; they can range from one euro to thousands of euros. This type of platform includes Kickstarter and Indiegogo.

P2P Loans

These are loans between individuals (peer to peer), which are often operated through P2P platforms. These have become an alternative to traditional financing models for borrowing money.

Liquidity risk

This is when one party in the financial operation might not obtain the necessary liquidity to assume its obligations.

Credit risk

This may be associated to liquidity risk and is the possibility that one of the parties of the financial transaction does not assume an obligation and causes a financial loss for the other party.

Operational risk

This refers to the possibility of experiencing losses resulting from failures in processes, information, and internal systems of the platform as well as due to human error or the consequences that events external to the operation may have in the process, such as reputation risks for instance.

Market risk

This is the risk that the fair value or future cash flows of a financial instrument may fluctuate as a result of price variations in the market.

Shadow banking

According to the Financial Stability Board: it is the system of credit intermediation that involves entities and activities outside regular banking.

Zoltan Pozsar, also clarifies that they are financial intermediaries that conduct maturity, credit, and liquidity transformation without access to central bank liquidity or public sector credit guarantees.

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