REGULATION OF NON-DEPOSIT-TAKING CREDIT PROVIDERS

WHO SHOULD BE REGULATED AND WHY?

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Who Should Be Regulated and Why?

Introduction

This paper presents an overview of the types of non-deposit-taking credit providers (NDTCPs) that should be covered by a new non-bank financial institutions law[1]. It reflects international practice and aims to promote a common understanding among policymakers about who should be regulated and why.

The objective of this paper is to:

- Provide more detailed guidance about how the non-bank regulatory framework may apply to individual providers;
- Edify risks that are inherent to each main industry group;
- Propose some general technical parameters by which procedures should be differentiated among providers.

Background on the Role and Economic Importance of NDTCPs

NDTCP's have become important providers of SME and household finance in many countries over the last 30 years. They provide credit to enterprises and households for various purposes. They tend to operate as specialist lenders, serving specific segments of the market where banks may lack interest due to risk or low capacity. By doing this they have contributed to economic growth for small businesses and entrepreneurs.

> *"Each country should have a continuum of financial institutions that, together, offer appropriate products and services to all segments of the population."*
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> This quote borrowed from a UN publication on inclusive financial services highlights an important aspect of financial sector development.

Most research on the impact of these institutions is done in the frame of all non-bank financial institutions (NBFIs), which includes insurance-company and capital market financing. This research is informative about the role of non-bank financial intermediation, but it is often not specific enough to see the direct impact of NDTCPs

[1] NDTCP's are part of a larger sub-set of institutions commonly referred to as non-bank financial institutions (NBFI's), which includes everything from capital market institutions to insurance to other institutions involved in financial intermediation, such as savings houses and credit cooperatives. This paper only covers NDTCP's. Policymakers should be careful to distinguish between different types of NBFIs in setting regulatory policy.

which is the topic of this paper. However, there is selected data that suggest these credit providers have become a larger part of financial systems in many countries and that these market developments have a net positive impact on the flow and distribution of credit. In the U.S., for example, non-bank sourced credit now accounts over 75% of all finance. In the Euro area, the proportion is about 25% of all credit and in Asia estimates run between 10% and 15%. Compared to the impact in Serbia, which is less than 3%, and where access to finance among SME's is very weak, there is significant room to grow these sources of credit[2] without having an out-sized impact on the direction of banks. The volume of assets held by NDTCP's in OECD countries, if it is correlated with the growth of all NBFIs, can be estimated to have tripled since the 1980's.

As the same suggests NDTCP's do not take public deposits, so the likelihood of these organizations becoming a source of prudential systemic risk is very low. They secure their funding from a variety of sources, including capital markets, sophisticated private investors, wholesale borrowing from other institutions, charities, private or public donors, parent corporations, peer-to-peer lending companies, etc. The source of funding for these types of institutions are many and growing as the global capital markets develop and technology expands.

If a well-balanced regulatory framework is developed in Serbia, we can expect the entry of new NDTCPs that could be funded from external sources. However, banks and other holders of domestic savings should not be discouraged from treating these institutions as viable enterprise borrowers, subject to applicable regulations on credit risk and lending concentrations. Funding relationships between banks and NDTCP's is a foundational part of most developed financial system. Financial regulations, if enforced correctly, can prevent excessive inter-institutional lending exposures. The remote risk of contagion does not need to be a reason for excluding NDTCPs from the financial system.

NDTCP's can have significant benefits for development of the financial sector and stability. Some of these benefits include:

- **Financial sector diversification:** They help to diversify and integrate the financial sector, allowing for more lender specialization and improved access in under-served communities.

- **Financing for different stages of business growth:** Through NDTCPs SMEs are able to access different financing options as their business grows. SMEs too small for commercial banks are able to secure financing from other providers that have business models oriented to serving the regional or local community. Each of these options brings firms into contact with different financial actors and the sources of capital that are best suited to different parts of the business cycle. The ability to graduate from one form of financing to the next is critical to each SME's success.

[2] The powerful marginal impact of increasing credit to underserved parts of the economy is indicated by research a decade ago that revealed a 1% increase in credit-to-GDP can reduce poverty by 2.5% (Honohan 2004) .

- **Competition that benefits consumers and business:** In some cases, NDTCPs may increase competition among finance providers, leading to lower costs and better products and services. Examples of this competition can be seen throughout the world, for example in: South America and Africa where the development of non-banks in rural and under-served market segments have driven commercial banks to develop new products, downstream into micro and small business lending, and forge alliances with non-bank providers who demonstrated success in reaching new markets; and in developed markets like the US where non-bank sourced finance now exceeds 50% of all small business and household finance. While banks may offer a set of financial services as a packaged deal, NBFIs unbundle and tailor these services to meet the needs of specific clients. Additionally, individual NBFIs may specialize in one particular sector and develop an informational advantage. Through the process of unbundling, targeting, and specializing, NBFIs enhances competition within the financial services industry.

- **Less informal financing:** NDTCPs are formal lenders. They help to extend the net of formal finance and increase incentives for businesses to also formalize (poor access to finance is likely a contributing factor to shadow economic activity).

- **Support banking sector growth:** NDTCPs may strengthen competition with banks in some markets, but they are also financing businesses and households that over time tend to become bank customers. Successful MSMEs become long-term, profitable bank customers. In the EMN study: MFIs and Banks in Europe published in 2015, there are 13 different strategies followed by the MFIs and Banks aiming to cooperate for growth and better serve the underserved potential customers[3].

Looking around the world over the last two decades, it is clear that non-banks have been affected by financial crises (Asia 1987; Global 2008). But it is important not to generalize the experience of non-banks or what is now called "shadow banking." Many of the negative effects were created not by basic lending but by extreme forms of financial intermediation, risk segmentation and arbitrage that are not feasible in Serbia[4]. With years of experience, NDTCPs now better contained in most countries than in any time before. Indeed, available data paint a picture of a nonbank sector that has generally reduced its vulnerability to different types of shocks. The global nonbank sector is evolving in response to new regulations, changes in investor preferences, and a multitude of other factors that are always influencing the financial system. In fact, NDTCPs that are

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[3] http://www.european-microfinance.org/docs/emn_publications/emn_research_papers/research_3.pdf

[4] The historical situation in Bosnia with micro credit lending abuse was an anomaly. It was catalyzed by under-disciplined, donor-funded programs and a total absence of regulation. Today, most MFI's in Bosnia are reputable and effective lenders that serve MSMEs in under-banked markets, particularly in the agriculture sector. Conversely, there is now a challenge with over-regulation that has limited growth of these institutions even though they clearly bring positive economic benefits to the country.

actively engaged in raising funds from institutions investors tend to have higher equity ratios than banks in order to compete for funds and weather economic cycles. While there is no standard average capital level – it depends on the organization's ease of access to funding, the local market, the type of lending, and other factors – we know that for MFI's the ratio is significantly higher than banks in the early years of operation until they have a proven business model. We can anticipate that other NDTCP's will follow the same trend because these organizations will not be taking public deposits. Commercial funding for these companies will largely be based on criteria similar to corporate lending. One example of this difference is illustrated by the debt-to-equity ratio difference between a commercial bank and an investment bank. The average debt-to-equity ratio for retail and commercial U.S. banks is approximately 2.2. For investment banks, the average debt/equity is higher, about 3.1. Investment banks are not using public deposits and need to raise capital market finance from investors (who do not benefit from deposit insurance guarantees) and who want to make sure the investment bank is able to repay its debt.

There may be some cases where a NDTCP may hold less capital than a bank, but this is usually at times where bank capital requirements are temporarily high due to financial crises or where the NDTCP has access to special funding – from a parent, an affiliated organization, a charitable group, member shareholders, etc. – and the organization decides that the risk to its equity is low given the type of lending it is doing,

In the many countries where these types of credit providers exist, they have been credited in helping to buffer, rather than exacerbate, financial crises because they have less dependence on bank-sourced funding. A multi-faceted financial system that includes non-bank financial institutions can protect economies from financial shocks and enable speedy recovery when these shocks happen. This is the case because non-banks provide multiple alternatives to transform an economy's savings (and foreign sources of investment) into capital investment, which serve as backup facilities should the primary form of intermediation fail. In a financial crises bank deposits often dry up and regulators require higher reserve requirements, both of which constrains lending. NDTCP's have more flexibility to decide when to lend and when not to lend and as a result that may be more adept at allocating credit in rough market conditions because they are using their own capital to decide the risk. US Federal Reserve Member Stanley Fisher commented in a speech about the positive role nonbanks play citing: "This evolution [of non-banks] has produced material benefits: increased market liquidity, greater diversity of funding sources, and a more efficient allocation of risk among investors.

Types of NDTCPs

NDTCPs can exist in different forms and each country situation is unique. Ownership, funding, types of products and focus, risk thresholds vary considerably. Below is a categorization of NDTCPs that may be broadly applicable to Serbia. It covers:

- Micro and Small business credit providers
- Consumer finance companies

- Vendor finance companies
- Captive finance companies
- Mortgage finance
- Specialized agricultural finance
- Peer-to-peer lending intermediaries

The following pages include a narrative introduction to these organizations, some of their regulatory risks and economic benefits. A summary of this narrative is provided in the table below.

Summary of Activities and Impact of NDTCPs

NDTCP Type	Activities	Impact
Micro credit providers	Non-profit or for-profit organization that make small loans to MSMEs and households and farmers for a variety of purposes. Community-focused approach using intense monitoring or group co-guarantees. A community focused approach is where the NDTP is dedicated to a specific and usually small service area..	• Finance for excluded businesses/households • Start-ups • Tailored products/flexibility useful for SMEs • Sometimes socially stabilizing impact • Geographic reach to under-served areas
Small business lenders	For-profit companies that specialize in portfolio-based lending to small businesses.	• Fill gaps in SME finance • Sometimes advisory assistance to businesses • Finance firms that eventually become clients of banks
Consumer finance companies	For-profit companies that specialize in small loans to consumers for personal use – for home, health, life event, transportation, etc.	• Improve household access to finance • Finance for life events (weddings, funeral, health, education, etc. • Can stimulate savings through safety net effect
Vendor finance	Special purpose finance companies that finance the purchase of own products	• Stimulates commerce • Improves access to investment financing
Captive finance	Special purpose finance companies that finance the purchase of own products or affiliated companies within a closed group	• Greater financing flexibility to larger companies
Mortgage finance	Specialized lender for the purchase of real estate	• Supports home ownership • Improves access to longer-term finance • Can be a source of long-term capital into the country from external funders
Specialized agricultural finance	For-profit companies or non-profit organizations that specialize in lending to farmers and other small agricultural actors	• Improves access to finance in a critically important sector • More specialized lending tailored to farmer needs • Sometimes a source of external technical assistance to local farmers • Better financing products can encourage producers to upgrade and take risk of new opportunities
Peer-to-peer lending intermediaries	Organizations that connect small investors/funders with borrowers through an internet lending platform	• Improves access to finance for businesses and households without prudential risk to the local banking system. • Sometimes lower cost finance • More flexible financing • Funding channel for diaspora to invest in home country

Micro and Small Business Credit Providers

Profile - Micro-credit lenders

Microcredit institutions currently operate in over 100 countries, serving more than 92 million clients. They provide small business or household lending that is often targeted to under-banked segments of the market. These institutions cover poorer entrepreneurs and small business owners who have little or no collateral and wouldn't otherwise qualify for a standard bank loan. They may also help households deal with emergency situations (e.g. health), life events (e.g. marriage, new baby) or for consumption. The diversity of products and services offered reflects the fact that the financial needs of individuals, households, and enterprises can change significantly over time, especially for those who live in poverty.

Because of these varied needs, and because of the industry's focus on under-banked or un-bankable customers, microfinance institutions often use non-traditional lending methodologies. The two main mechanisms for the delivery of finance to such clients are: (1) relationship-based banking for individual entrepreneurs and small businesses; and (2) group-based models, where several entrepreneurs come together to apply for loans and other services as a group. In order to keep their services running, microfinance institutions typically charge significantly higher interest rates than those on a traditional bank loan[5]. Part of the reason for this is the high cost associated in making and monitoring the loan. Loans may be structured differently than what banks may offer. Another reason, which is often overlooked by policymakers, is the regulatory compliance costs these organizations have to bear to satisfy regulatory requirements that are may be unnecessary or disproportionate to the risks they pose in the financial system.

Since the clients of these lenders have lower incomes and often have limited access to other financial services, microfinance products tend to be for smaller monetary amounts than traditional financial services. Microcredit typically can range from a few hundred Euros to tens of thousands of Euro. The EU places a value threshold of EUR 25,000[6] on micro credit, but this is largely an arbitrary definition for the purpose of collecting data and monitoring the flow of capital to very small businesses. Unless micro credit has a special legal status to attract subsidies, fulfill social goals, or circumvent usury laws on high interest rates there is no reason to define it differently than any other form of non-bank small business lender[7]. There appears to be no reason to place a value threshold on it; if a micro credit organization wants to make loans of ranging from several hundred thousand to a few hundred Euros it should be allowed to as long as is lending prudently,

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[5] This paper does not go into the topic of interest rate regulation. In a competitive, fairly regulated market interest rate regulations may do more damage than good if they are not developed correctly, adjustable to market conditions, and based on a clear public/social policy rationale.

[6] According to the EU- EIF microcredit with social impact is defined as 150% of GDP /capita and has a different level for each country.

[7] But e.g. in Romania the Leasing and the Mortgages financial companies that are extending loans larger than EUR 100, 000 have a minimum capital requirement much larger compare to MFIs (EUR 1,2 million vs the EUR 200,000)

treating borrowers fairly and funding the loans from non-deposit sources. Placing a value threshold on micro-credit will needlessly bifurcate the market, limit competition for small business lending, and create supply gaps for many healthy, growing businesses. The objective of the non-bank regulation is not about creating classes of institutions that are limited by arbitrary definitions, but by creating a continuum of financing options – from small to large – that can allow the financial system to become an integrated and competitive system where the gaps in access to finance are eliminated. Creating a value threshold between banks and micro credit providers will not serve growing businesses who need increasingly larger loans as they grow[8]. It will sustain gaps in financing that are key to helping Serbian SMEs grow, which is where banks get new customers from. An interesting outcome of micro credit that is possible in Serbia, is that successful businesses do not stay as customers of micro credit providers beyond 3 to 6 years. Those that succeed and grow can eventually become new customers of banks. This transition will be complicated in Serbia if there is a gaps between the size of what NDTCPs can legally lend and what banks are willing to lend – and we do not see a widespread willingness of banks to downstream lending and satisfy demand for small business loans at or near the cut-off point of EUR 25,000. Some banks are willing to make smaller loans of high quality borrowers, but they most are not willing or able to address the huge demand for finance at the small business level or offer the kind of flexible terms that small businesses need.

Microcredit is available through different types of organization, which range from small non-profit organizations, charity-based organizations, to profit-making companies. The microcredit industry got its name from mission-based organizations making very small loans to very poor people. Today, many micro credit organizations are simply specialized small business lenders that make much larger loans but use some parts of micro lending technology and approaches to manage risk. This is certainly the case in Serbia and for many of its regional peers Micro credit organizations, such as Agroinvest, do small business lending that combines commercial lending (i.e. use of collateral and traditional financial analysis) with micro credit technologies (e.g. close personal monitoring, relationship-based decision-making, and in some cases personal or affiliated-person guarantees). Organizations like this operate in market segments that are upstream from what may be considered traditional micro lending segments in other parts of the world, such as Africa or Southeast Asia. The objective of having a regulatory structure for non-banks and including these types of lenders is to promote development of credit intermediation where banks are not well-serving. This includes not only certain loan sizes, but certain sectors (e,g, example agriculture) and geographic areas (e.g. the South). The financing needs of these segments is not limited to small loans, but even larger loans that some micro credit providers may be willing to provide if they are not limited by regulation, nor should they be.

[8] In the EU countries with no specific legislation, e.g. Belgium, Holland, Germany , Greece, UK, or in Romania and Bulgaria with specific legislation the MFIs are not limited to EUR 25,000, however in EU 18 the average loan amount in 2010 was EUR 6,053 and increased to EUR 7,129 in 2011

Profile – Small Business Credit Providers

There other types of companies in the world that offer small business finance that are not classified as micro credit providers. Some of these firms are new and operate from web-based platform, which is described further below, and some are straightforward business lenders that have a special mix of products useful for small businesses and/or who specialize. These organizations are usually funded by institutional or high net worth investors. As far as we know no such organizations are operating in Serbia because of the lack of a regulatory framework. With a framework in place, it is possible that innovative new lenders will seek investment at some point in time.

As suggested above, there is often no reason to make a formal distinction between micro credit and small business credit, unless the micro credit organizations deserve a special status because they are fulfilling a social role, such as helping poverty-stricken populations, providing subsidies to help unemployed youth, or any other types of mission that goes beyond the commercial activity of lending In Serbia, as with other countries in the region, there does not appear to be a need to distinguish these organizations from any other type of non-bank lender offering general loans to business and households. Legislation in France appears to have had special provisions for non-profit micro-lenders to allow them to fulfill a social role, but we do not see the need in Serbia at this time. More research would be needed to justify treating micro lenders differently than other commercial lenders.

Impact

The economic impact of non-bank micro and small business lenders is best measured in terms of their ability to access markets and sectors where banks are not actively engaged. USAID BEPs research on access to finance and its joint research with CEVES revealed major gaps and imbalance in the provision of finance around the country. The gaps could be partly addressed by these types of lenders if they were allowed to bring in new capital and compete on a level playing field. These gaps can be found among micro and small business that fall under the radar of banks; they can be found in rural and second-tier cities in towns, particularly in the south, and economically vulnerable groups, youth and women; they are also prevalent in certain sectors, such as agriculture, where most banks are not willing to lend directly to small farmers or processors, or IT, where operators have no collateral, or health services, where there is little bank specialization, etc.

In an environment where banks will remain under pressure to reduce their leverage and better manage risk, these providers can help to offset the loss of finance. There are powerful external trends forming in the growth of these types of providers, driven by innovation, better information management, new business models, new platforms for mobilizing capital, etc. Moreover, according to research by the leading accounting and consulting firm PwC there are increasing signs that European banks are willing to work with a range of alternative lenders to meet their clients' needs and relieve the strain on their own balance sheets. European Investment Bank is partnering EU Commission and co-finance the Progress, CIP and currently EaSI programs aimed to build the capacity and finance the NBFIs lending operations to underserved entrepreneurs and micro companies. Creating an environment for bank and non-bank lenders to work side-by-side or collaborate supports the "continuum" of finance that is quoted in the text box in the introduction of this paper.

Serbia can embrace these trends to address local development challenges and extend the distribution of finance in the economy without increasing risk to public deposits.

Consumer finance companies

Profile

An NDTCP that specializes in providing loans directly to consumers/households who are unable to secure bank loans for a variety of purposes. These companies can offer a wide range of products, but they often fall into one of the following categories:

- Uncollateralized personal loan for a variety of purposes. Some loans may be open-ended which allows consumers to use finance when they need finance.
- Collateralized loans, such as for a car, appliances, furniture, etc.
- Student loans, often subsidized by the government or sponsoring school, that help to pay for the cost of education
- Loan re-financing where the company provides a new loan to lower an interest rate offer better terms and conditions, etc.
- Loans collateralized by future salary payments or what is called "payday loans." This activity may not be applicable or necessary to Serbia, but it could be re-defined to include various forms of third-party informal lending that is taking place using promissory notes and

A consumer finance company generally charges a higher interest rates than a bank because it is often making unsecured loan. The cost of funding for these companies is also higher because they are not using public deposits and must demonstrate their credit worthiness to sophisticated investors.

Impact

Consumer finance is often associated with consumption financing and excess household credit. But those perceptions can be belie positive economic advantages that are not always well measured or reported. The vast majority of developed and high-growth emerging market economies have a robust industry for consumer credit that plays an important role in credit allocation, domestic development, and in some cases strengthening welfare by helping people to pay for unexpected expenses or life events.

Many of the historical challenges with consumer credit arose from bank provision of credit. This paper concerns non-bank consumer credit providers who are likely to compete in niches where loans are small and that are unlikely to have a major impact on the composition of credit allocation in the economy. The likely net benefits of allowing some non-bank consumer credit activity will be to:

- Improve access to finance among households who have legitimate needs for loans, but do not have the profile/collateral to get a loan from a bank;
- Provide greater flexibility in consumer borrowing so that households can make better timed and planned investment and consumption decisions. Example: The flexibility provided by credit also allows consumers to make timelier investments. If your house needs some roof repairs, for example, access to credit allows you to pay for them immediately. Without credit you might have to put money aside for months to complete the repairs. In the meantime, leaks might cause even more damage to your home.
- Offer modest welfare-enhancing benefits by helping households pay for urgent and relevant expenses (health, auto repair, house repair, funeral, etc.) without having to seek informal finance or make costly trade-offs in current consumption, such as putting food on the table or paying for an education
- Improve the consistency of household savings. This may seem counter-intuitive since consumer lending is usually associated with consumption and debt servicing, which tends to lower savings. But the reality in Serbian households today may be that they would save more if they had better access to finance when they needed it instead of having to keep capital in the "mattress" or stored up in liquid commodities to cover them for emergencies

The other benefit that may be realized in Serbia, if regulation is extended to it, will be reduced lending in the shadow economy, which is counter-productive for economic development, weakens competitiveness, and hinders the transmission of the central bank's monetary policy actions.

Vendor finance companies[9]

Profile

Vendor finance companies are in the business of providing loans (to businesses or consumers) to buy products or services they produce or trade. For example, car dealers may provide finance to their customers directly through a separate company that they own. The tractor company Deere will do the same in some markets. Makers of consumer appliances or providers of large-cost services may also offer their own financing through separate companies, or in cooperation with specialized finance companies. Makers of construction materials may also offer financing for the purchase of their materials; even real estate developers may offer financing for properties they construct.

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[9] Vendor and captive finance is not common in EE, the retail chains are promoting sales offering so called "Credit with the Identity Card" based on an agreement with a financial institution – usually bank, the cost of credit is included in the price, and usually is very high, in case of default the vendor recover the item purchased (car, electric appliances, computers, etc.)

Vendor financing is used to support sales of a product when banks or other forms of financing are not available. While these firms tend to take on borrowers that on average may have greater risk, as the producer of the equipment, the vendor also knows how to re-sell, service and maintain the collateral so it is usually better able to recover the loan than would a bank.

Vendor financing can be focused on consumers or businesses, therefore it is a mix of consumer finance and business finance. Manufacturing companies that offer vendor financing are usually larger well-known companies that have a strong brand. The financing is usually done through a separate subsidiary that is organized strictly for the purpose of making these loans to support the parent company.

Vendor financing companies generally have better overall financial outlook than their parent companies, because they are dealing in short term loans instead of the long-term capital expenses incurred by their parent companies. This makes them better able to deal with financing options than the parent company. This is why companies create separate captive finance companies rather than carry financing for consumers themselves.

Impact

Because vendor financing is often provided for large-scale production equipment, transportation, or real estate, it can have an impact on improving investment financing. Because these firms are often financed directly by their parent companies or a mix of financing from parent and third-party investors, the risk to the financial system is relatively low.

Vendor financing often supports credit extension in production, which historically has been low in Serbia accounting for 20 percent or less of all SME finance; the story is the same for agriculture, which historically has accounted for 5 percent of less of all SME financing. For domestic producers is supports their growth; for foreign companies selling capital goods it can make their investment more attractive and thus support greater direct investment. Since the captive finance company is usually owned by the parent company, they may be able to make "loans" that don't actually require money being paid up front. They can simply wait for the consumer to pay them in monthly payments. These finance providers are also usually able to process loans quicker than banks and third-party companies, providing more convenience to borrowers.

There is not a lot of data on the operation of these types of companies because they are often counted as part of general consumer or business finance. They are also commonplace in developed markets, thus their impact is taken for granted as being net positive. They attract minimal regulatory scrutiny (focused on lending disclosure) because of the limited scope of their lending.

Captive finance companies

Profile

A captive finance company is a legal entity created for the sole purpose of carrying out certain financial activities on behalf of its parent company. It is "captive" because it is doing financial intermediation for the benefit of the parent corporation. In some cases the activities are raising and providing credit only for the parent company and its affiliated companies – i.e. it is not providing credit to the public. In other cases, it may provide some credit to the public in the form of a vendor finance provider, which is described above.

Captive finance companies can range in size from mid-sized entities to giant firms, depending on the size of the parent company. Their range of services can also vary widely. The parent company must own more than 50 percent of that company's interests. Wholly-owned subsidiaries are not uncommon, especially in the case of finance subsidiaries. A parent company can also benefit from a finance subsidiary's separate-corporate-identity status because it can limit liability and achieve optimal returns.

For publicly-traded companies captive finance companies tend to be more of interest to the securities regulator who will want to make sure that the activities of the company and their risks are disclosed to investors. For non-publicly traded companies, captive financiers tend to be of very low risk and concern. For as long as the activities are limited to the parent corporations businesses and affiliates, there may be no need to regulate at all. If the captive finance company is involved as a vendor finance provider, then it may be regulated alongside other vendor finance companies – and even the level of regulation will depend on whether the lending is to companies or households.

Impact

Captive finance companies allow larger corporations flexibility in raising, managing and allocating finance that support their internal operations and (if they are doing vendor financing) sales of product. Because these companies separate financing activities from other corporate activities, they allow the parent company to ring fence risk and limit liability in certain areas of operation.

The captive finance company works on the strength of their parent company. The overall idea of this arrangement is for a parent company to keep many loans in house and among associated companies. When captive finance companies are doing vendor finance, the parent company benefits from the transaction by collecting revenues from the interest on loans, as well as from the profit of the sale.

Mortgage finance company
Profile

A mortgage finance companies are specialized non-bank providers of residential and commercial real estate mortgages. As banks do, they provide long-term finance for property purchases. They are financed in various ways. They can attract financing from banks who would like to have some exposure to the mortgage financing market but do not have the systems, specialization, interest in doing direct lending. Sources of finance would be long-term investors, such as insurance companies, pension funds, and other parties that want to take risk at the long end of the yield curve.

These companies grew a lot in the last 30 years, but the global financial crises slowed this growth. Long-term funding dried up in many markets forcing some of these firms to contract or leave the business.

In some developed markets like the US and UK, these firms contribute to property development and financing. During the crises they helped to offset the impact of declining bank lending, while also helping to quickly stabilize price declines. Their willingness to lend in all different kinds of economic environments has made them key parts of many developed financial systems. In the US for example, nearly a one-third of all mortgages are made by non-bank lenders mortgage lenders.

These firms may lend direct or they may serve as a loan brokerage, helping to match borrowers to bank lenders. As a brokerage they will take care of customer relations, help the borrower to complete documentation, and make key disclosures about the costs and terms of the loan. In some of the developed markets, these firms will also do mortgage loan servicing which means they collect the monthly payments from borrowers, provide recordkeeping services, and work to recover any loans gone bad. In exchange they earn a servicing fee which can be very profitable if they have sufficient operational scale.

Insurance companies and pension companies seeking to increased yields on long-term investments have been increasingly involved in financing mortgage operations that are managed and owned by third-parties.

There has been considerable development of this industry over the last few years, Today's non-bank mortgage lenders are: 1) subject to much more consumer oriented regulation and supervision; 2) more active in mortgage servicing than ever before; and 3) using technology to transform the mortgage market.

Impact

Real estate investment and property ownership has a wide-spread positive impact on economic development, so there are benefits to having any institutions like these that help to facilitate that investment. As suggested above mortgage lenders of all kinds, including banks, play a huge role in economic development around the world.

The growth of non-bank mortgage providers has proven to become a cushion for property financing when banks are scaling back to protect their capital or seek alternative business models. As a general trend the following are key impacts of these providers:

- Interest rates can be lower
- Often the service provided by non-bank lenders can be superior to a major bank especially in times when the major banks are slow in processing loan applications.
- Some non-bank lenders offer loans that wouldn't be approved through bank lenders for a variety of technical reasons. These lenders have more flexibility to finance transactions and to structure financing to suit borrower needs more easily than banks.

In Serbia, the entrance of these types of institutions (which could be support with a host of different incentives, including better valuation resources, easier construction permitting, tax relief, etc.) may also bring badly needed long-term capital into the market. Where banks are unlikely to lend local currency for long durations, these providers may be more willing to manage long-term risk because they may be able to diversify their risk over different types of borrowers or across borders.

Specialized agricultural finance

Profile

These companies are not unlike small business lenders, but they usually focus on the agriculture and food processing sectors. They may take different forms –as non-profit lenders that have a wider social and poverty reduction mission or as a for–profit lenders. An example of a non-profit company is called Root Capital, is a social investment fund that provides loans in under-develop markets. Another example is a program called FarmStart that is based in the US that provides credit to promising farmers who cannot otherwise qualify for credit from banks or the farm credit system.

For-profit operations may combine financing with technical support to farmers or processors. An example of this type of company is UK Farm Finance, Ltd., which offers a range of finance products especially designed to meet farmer needs. The specialization provided by these companies can appeal to farmers because they can obtain tailored assistance and the lender has a deep understanding of the agriculture business.

The ownership and business models of these specialized vary widely around the world. Some can be entirely private sector-funded while others may be funded in part by donors through equity. For instance there is a relatively new offshore agricultural investment company that has been organized by private investors together with Kfw to finance agricultural growth in Latin America and Africa.

Impact

These organizations tend to serve niches of the agricultural sector where there are gaps in the provision of bank finance. In Serbia, organizations like these could become a source of new finance for agribusiness and could serve the large un-formalized farmer community who have trouble raising capital because many are not registered businesses.

There is no certainty that institutions like these will develop or seek to operate in Serbia. But including them under the regulatory umbrella seems to make sense and it would open the door for new entrants in the future as non-bank institutions become more important to agricultural finance around the world.

Peer-to-peer lending intermediaries

Peer-to-peer lending, sometimes abbreviated P2P lending, is the practice of lending money to individuals or businesses through online services that match lenders directly with borrowers. There are different types, with some doing direct lending themselves and others instead focusing on connecting borrowers with a variety of lenders.

Also known as crowd-lending, many peer-to-peer loans are unsecured personal loans, though some of the largest amounts are lent to businesses. Secured loans are sometimes offered by using luxury assets such as jewelry, watches, vintage cars, buildings, and other business assets as collateral. They are made to an individual, company or charity. Other forms of peer-to-peer lending include student loans, commercial and real estate loans, as well as secured business loans. These lending intermediaries are for-profit businesses; they generate revenue by collecting a one-time fee on funded loans from borrowers and by assessing a loan servicing fee to investors or borrowers (either a fixed amount annually or a percentage of the loan amount).

While these types of intermediaries may not be working in Serbia yet, the growth of this source of financing is growing around the world. In Europe, these lenders operate in Estonia, Poland, Germany, Sweden and very possibly others. Online lenders have started emerging over the years to help fund borrowers that can’t find capital at the bank. It is very possible that they could evolve in Serbia, particularly to encourage Serbian diaspora to invest back into the country or in businesses in communities they call home.

Examples of European Countries with Peer-to-Peer Lending

Estonia: There are 7 active platforms in Estonia. Bondora, the first P2P lending platform in Estonia was established in 2009. Couple years later Omaraha followed. Widespread peer to peer lending boom has welcomed many new platforms in recent years: Estateguru (2014), Crowdestate (2014), MoneyZen (2014), Investly (2014) and Fundwise (2015). There are at least 3 new platforms emerging in year 2015, summing the whole number up to 10 platforms

Germany: In Germany, several peer-to-peer lending services have appeared, following the model of Lending Club such as auxmoney, Lendico, Smava or Zencap.

Poland: In Poland several peer-to-peer lending have been established in the 2013. One of the biggest is Give-Take.

Sweden: Peer-to-peer-lending in Sweden is regulated by Finansinspektionen. Launched in 2007, the company Trustbuddy AB was first out on the Swedish market for peer-to-peer-lending, providing a platform for high risk personal loans between 500SEK and 10,000SEK. In 2014, Lendify launched, targeting the mainstream market with personal loans between 5,000SEK and 350,000SEK. A third actor, Toborrow provides a marketplace for loans to small businesses since 2015.

These lenders don't have physical storefronts like the banks. Since the peer-to-peer lending companies offering these services operate entirely online, they can run with lower overhead and provide the service more cheaply than traditional financial institutions. In some cases, these non-bank lenders offer loans at lower rates than banks and make loan decisions more quickly and with less paperwork and red tape. They can use consumer-friendly web interfaces and improved customer service, offer new types of loan products or more easily connect potential lenders and borrowers. All of these services can better fit the needs of many small businesses.

They include well-known companies like Lending Club and OnDeck, as well as hundreds of lesser-known companies that may have foreign reach (e.g. Kiva, Fundation)[10]. These alternative lenders are offering traditional term loans, invoice financing, short term loans, and more. In the United States alone there are at least 100 non-bank small business lenders that have emerged in recent years and more are being launched every month. The UK is also seeing substantial growth.

A distinction has to be made, however between on-line lenders that are making loans in the country from those that are just offering loans. Where the on-line lenders are taking money from the public for on-lending, this becomes a tricky issue because it can become a proxy for deposit-taking, which is not the intention of the new proposed legal framework. Some policymakers argue that investors who provide funds for these lenders are taking their own risk, they know what their money is being use for because they pick who they lend to, and that regulation should be based on disclosure. Some argue its not much different than a depositor putting money into a bank in excess of the deposit guarantee limit. This is not a universally agreed position and the regulatory issues are still being worked out. For the immediate future, we recommend that the law open the door to these types of organizations to do lending in the country, but that raising domestic funds from the public be prohibited for the time being.

Impact

This industry is relatively new, so there is not a lot of analysis to measure their specific economic impact. But data is not needed to see the potential this industry has for transforming the entre business of providing finance to under-served markets. Not only are these companies meeting a need and filling a vacuum left by many banks, but they are also doing it in new and innovative ways by connecting people who want to lend money with those who want to borrow money. They are indeed forging an entirely different form of financial intermediation between savers and investors that is lowering costs, widening access to finance, and connecting markets. Some regulation appears to be necessary, which is discussed further below.

In Serbia, there are potential benefits that go beyond just improving access to finance. Because these lending platforms are in some cases helping foreign investors/lenders to

[10] Early innovators like CAN Capital have been joined by numerous others, including OnDeck, Lending Club, Funding Circle, Kabbage and Fundera.

finance foreign businesses, these platforms can become a source of inward capital and new savings to the country. Where Serbia needs a large increase in domestic savings to fund its growth strategy, sources of new capital however modest can help. The other potential benefit of these lending platforms, which was noted, is to provide a channel for diaspora funding to domestic businesses. Lastly, the creation of electronic platforms for lending can have demonstration and competition affects that can urge existing financial institutions to modernize their approach and extend their geographical reach to other Serbian communities. Our research done a few years ago on access to finance underscored the wide disparity in access to finance between Belgrade and Vojvodina and other parts of the country for example.

Institutions Not Covered in this Paper

Excluded from this list is factoring, leasing, and cooperative-based financing organizations. Factoring and leasing is already covered by separate legislation, though we would encourage the Working Group to consider integrating this independent legislation into the new non-bank framework in order to promote consistency. The regulatory requirements for factoring and leasing should not be much different than for the NDTCPs. The regulatory objectives of protecting borrowers and avoiding financial crimes are much the same. Further, the economic impact of these non-bank activities can be significant. For example over 40% of SMEs in Europe report using leasing at one time or another to finance part of their business needs. Factoring has become an established form of short-term financing for businesses that increases the flow of capital in an economy and supports commerce.

This paper does not cover cooperative financial organizations because these organizations are often taking deposits or investments from members – and as a result they need to be regulated differently. That is not to say that cooperatives are not an important form of non-bank intermediation; they should be addressed by policymakers at some point in time. Tracing the history of lending in Europe and in many other parts of the world points to the importance cooperatives and credit unions in capital allocation. Community lending in grew out of savings houses; the UK system grew from mutual associations; in the US savings and loans and credit cooperatives financed much of the countries development in the first half of the last century; in Latin America, Asia and Africa cooperatives play a strategic role in under-served communities, etc.

In our prior research on access to finance, we noted the need for the government to consider having a financial sector strategy that includes development of community-focused lenders. Cooperatives and unions are one potential source of non-bank that could address the geographical and sectoral gaps in access to finance. The Working Group may wish to consider a role for those types of institutions, or for a multi-tiered licensing of local community banks, within the broader strategy of improving non-bank development in the country. But at this stage we would not recommend including those organizations in the regulatory framework envisaged for NDTCPs; rather credit cooperatives or unions that take member funds are best included as a special category within the banking law.

Rationale for Regulation

From a general perspective there is good and strong rationale for regulating NDTCPs – on two grounds, the need for legitimacy and risks to regulatory objectives.

Need for legitimacy: The absence of a regulatory framework for these types of lenders is a limiting factor for improving access to finance in Serbia as they would be in other countries. While a handful of micro-lenders are able to operate without proper regulation, their growth is limited because they are not able to operate on proper market terms. The regulations applying to micro credit companies is largely out of line with the risks they pose and other NDTCP's have no clarity as to whether they can operate or not. Lack of regulation increases reputational risks, lowers market confidence, and increases transaction costs; it also potentially constrains the entry of reputable institutions that are willing to invest new capital and deepen the financial sector. In turn lack of regulation can have large negative reputational affects for the few institutions that are operating in the current environment.

Risk to Regulatory Objectives: Regulation should be based on how much risk each type of institution creates for the core objectives of safety and soundness, market integrity, and borrower protection. As a general rule, NDTCPs tend to affect these objectives along the following lines:

- *Risks to safety and soundness – very low:* Unlike deposit taking organizations, NDTCPs do not pose prudential risks to consumers or to the financial system in general. They have different risks than banks. Systemic risk is considerably less evident than in banking (and often does not exist at all); contagion is less likely because of the nature of the contracts involved; the potential disruption of the payments system does not arise; there are not lender of last resort dependencies so problems of moral hazard are not likely to rise, etc. Therefore the objective of safety and soundness does not provide a strong basis for regulating NDTCPs.

- *Risks to borrower protection*[11] *– low to high:* The act of getting a loan is relatively straight forward for medium and large companies, but for consumers or small business entrepreneurs it may not be that way. Consumers and small businesses are most vulnerable to deceptive or unfair lending practices. They also have limited capacity to take recourse through the legal system to protect their rights and welfare. Therefore, some oversight is warranted to safeguard against five main types of concern outlined in the side-box.

> **Key Areas of Focus for Borrower Protection**
>
> - **Predatory Lending:** Unclear or inaccurate disclosure of loan terms and conditions, intentionally withholding information, misrepresentation of costs, charging hidden or unjustified fees, imposing unfair conditions, false advertising, aggressive sales practices to get borrowers to take loans, creating loans borrowers are going to be able to pay back
> - **Misuse of information:** Misuse of borrower information or failure to protect the privacy of information. Such information should only be used for the purposes specified at the time the information is collected or as permitted by law, unless otherwise agreed with the borrower
> - **Abusive collection practices**: Borrowers are at risk if NDTCPs engage in abusive debt collection practices, make false statements, or give false information to others.
> - **Poor administration:** Ineffective operating systems can result in poor loan administration, high frequency of errors or system failures that affect borrowers.
> - **Discontinuity of operation:** Borrowers are not likely to lose money from a NDTCP going out of business, but there are various ways in which borrowers can face some detriment.

  The ultimate rationale for regulation to protect the consumer is, therefore, to correct for market imperfections or market failures which would compromise consumer welfare in a regulation-free environment. There are many market imperfections and failures in retail financial services which create a rationale for regulation, such as: problems of inadequate information on the part of the consumer; problems of asymmetric information (consumers are less well informed than are suppliers of financial services); potential principal-agent problems and issues related to conflicts of interest; problems of ascertaining quality at the point of purchase; imprecise definitions of products and contracts; inability of retail consumers to assess the safety and soundness of financial institutions except at inordinate cost; consumer under-investment in information and resultant 'free-rider' problems (whereby all consumers assume that others have investigated the safety and integrity of suppliers of financial services); because of the technicalities of some financial products, consumers are not all equally equipped to assess quality, etc.

- *Market integrity – low to moderate:* Since NDTCPs activities in the financial sector are largely limited to making and collecting loans, their scope for hurting market integrity is limited beyond what is outlined above for consumer protection. That noted, a key focus of the regulator is to make sure financial crimes are mitigated. Some NDTCPs, such as mortgage providers, deal with large sums of money and large money transactions. While the opportunity for facilitating money laundering is limited if institutions do not take deposits, some oversight is needed to ensure these

[11] EU Regulations on Borrower Protection include: Directive on Consumer Credit, 1998/7/EC, amending Directive 87/102/EEC, Directive on Consumer Credit, 2008/48/EC, Directive on Credit Agreements for Consumers, 2008/48/EC, repealing Directive 87/102/EEC, Directive on Unfair Terms in Consumer Contracts, 1993/13/EEC, Directive concerning Unfair Business-to-Consumer Commercial Practices in the Internal Market, 2005/29/EC, Directive on the Protection of Individuals with regard to the Processing of Personal Data and on the Free Movement of such data, 1995/46/EC, Directive Concerning Processing Personal Data and Protection of Privacy in the Electronic Communication Sector, 2002/58/EC, Directive on Protection of Consumers in Respect of Distance Contracts, 1997/7/EEC, Directive on the Distance Marketing of Consumer Financial Services, 2002/65/EC, Directive on Markets in Financial Instruments, 2004/39/EC (MiFID), Treaty establishing the European Community (EC Treaty), 1957 as amended.

institutions are not being complicit in illegal activities or creating structures that enable money laundering. NDTCPs need to at least identify the main sources of loan repayment, know their clients, and make sure that credit transactions are not going into default as part of a money laundering scheme.

Limited Case for Macro Risk Monitoring: There may be a third objective if the non-bank industry becomes very large and widespread, though this is not likely to happen in Serbia with the banking system being so large. This objective is related to macro monitoring of credit levels, concentrations, and wholesale funding. In some markets it may be necessary to monitor the volume of credit issued by non-banks for monetary policy reasons. In addition, in some markets, the funding sources of non-banks are relevant to the regulator if the sources represent significant counter-party risk to other financial institutions. The funding sources are also a concern if the providers are raising significant capital from investors via the capital market under circumstances where there is a risk that those investors may be easily confuse the provider with a bank, or misunderstand the nature of the risks they are taking.

But these grounds for regulation do not provide enough basis for regulating each organization the same way. Within the broader framework of regulation there is a need to differentiate how much scrutiny different organizations receive.

In the following pages we provide an overview of the main rationale for regulating the different NDTCPs and some of the benefits that will be gotten by doing this regulation.

Differentiating Regulation among NDTCPs

As outlined above NDTCP's are involved in a wide range activities. The activities differ in respect of their risk, role in financial intermediation, and impact on economic development. A decision to regulate them does not mean that all should be treated the same or face the same level of regulatory scrutiny. Rather, the regulatory approach should make a clear distinction between different objectives of regulation and the nature of activities that NDTCPs engage in.

There are two ways to think about the regulations NDTCPs. The first way is to classify them by type of institution as provided for above –e.g. micro credit, small business lenders, mortgage lender, etc. This is what we did above. The second way is according to what they are doing – their activities and what those activities mean for the objectives given above for borrower protection, financial crime, and macro credit risk monitoring. For example are they providing business loans, consumer loans, mortgage loans and are they serving businesses or consumers. Regulating institutions according to activity tends to be a better and fairer way of dispensing regulation because institutions that pose similar risks are treat the same way. If a micro credit organization is making loans to consumers just as a consumer finance company is, regulation should be the same even they may be different types of organizations. Conversely, a mortgage lender and a captive finance company do not pose the same risks for the regulator or the public. They while they may be subject to the same regulatory framework for mortgage finance company in terms of disclosure and consumer protection but some of this disclosure may not be necessary for the captive finance company – the risks are different.

Differentiating among NDTCP's by the risk they pose is a key part of the regulatory development process that the Working Group should go through[12]. Below are some thoughts about how differentiation can impact the regulatory process and the rationale for regulation by type of organization.

How to Differentiate Among NDTCPs

A good starting framework for deciding the intensity of regulation for each type of institution is to look at their activities along the following dimensions:

1. **Sophistication of the borrow and public reach of the lender:** The rationale for regulation is on organizations and activities where the most vulnerable customers, least informed borrowers are at risk. This is often determined based on the pivotal criteria of whether an organization provides services to the general public as opposed to informed business owners in specific industries or to a captive member of the same corporate group.

2. **Nature of financing being provided:** For example is it long-term finance that commits borrowers for many years or short-term finance where the borrow would not carry a long-term burden from a mistake or misunderstanding. What is the complexity of the loans being provided? Are specific characteristics of the non-bank business that create the possibility for financial crime, such as money laundering?

For example, within the above list of specialized credit providers, mortgage lenders likely present the highest risks among all of the providers. The reason for this is that mortgage lenders deal directly with the public, they are likely to have the longest running relationship with borrowers due to the long duration of loans, and they provide relatively large loans for life-time purchases, such as a house. These factors raise the risk profile of lending because the impact on consumers of something going wrong can be very significant. Similar factors may hold true for providers of small business finance, but the impact on the entrepreneur monetarily is probably lower if something goes wrong since the loans tend to be small and short-term. Therefore, while the legal framework for specialized credit may be the same, the practice of supervision may differ as the risks differ –by types of borrowers and types of products. In Serbia, for the foreseeable future, small business lenders, microfinance and, possibly, vendor finance companies (as well as

[12] E.g. in Eastern Europe/ Romania the regulation varies based on the size (capital and portfolio) of the NDTCPs. The small ones are not heavily regulated, the large ones are more regulated, supervised and controlled by the Central Bank.

leasing and factoring companies that are separately regulated) are likely to be the most active in seeking to do business.

If we apply the criteria above to the types of NDTP's described earlier in this paper, the rationale for regulating them will be based on the following characteristics of the business.

Key Attributes That Support the Rationale for Regulation*

NDTCP Type	Prudential Impact	Borrower Protection Impact	Market Integrity Impact	Type and Intensity of Supervision
Micro credit providers	Very low to no risk; only a concern if NDTCPs are financing large amounts from banking system	High to moderate for consumer lending and micro and small business lending; borrower sophistication low	Moderate due to national reach and potential for reputational effects on financial system	Moderately active on/offsite – review of lending products and disclosures and records, AML review; monitor consumer complaints and market behavior; public education.
Small business lenders		High for new small business, but moderate for more experienced SMEs	Low-moderate based on larger size of loans and need to monitor for financial crimes – i.e. AML	
Consumer finance companies		Moderate to high, but loan amounts likely to be smaller so exposure smaller	Low-moderate due to national reach and potential for reputational effects on	
Vendor finance		Moderate to low. Impact limited to specific equipment/transactions	Low due to limited interaction with general public	Light off-site monitoring - market conduct and consumer complaints; off-site review of loan programs and related documentation
Captive finance		Low-to-zero if they are not serving the public (i.e. vendor finance)	Low due to limited interaction with general public	Very light off-site monitoring Limited reporting on portfolio and activities; all supervision off-site unless pro
Mortgage finance		High based on the size, duration, and potential complexity of the loan. Moderate-to-low for business borrowers	Moderate-high due to national reach, reputational affects, potential for abuse in money laundering	Moderately active on/off-site – review of lending products and disclosures and records, AML review; monitor consumer complaints and market behavior; public education.
Specialized agricultural finance		Moderate based on the sectoral focus limiting public access. Moderate to low for more experienced SMEs.	Low-moderate based on larger size of loans and need to monitor for financial crimes – i.e. AML	Light off-site monitoring - market conduct and consumer complaints; periodic review of loan programs.
Peer-to-peer lending intermediaries		High-to-moderate based on the nature of the activity and potential; low for Serbia because there is little activity.	Low-Moderate due to national reach and limited potential for reputational effects	Moderately active offsite - consumer protection and market conduct; monitor consumer complaints and market behavior; public education.
*This are guidelines only and may differ depending on the specific activities of each organization. Organizations that have little public contact or operate in small areas or have a small volume of business are probably low risk to regulatory objectives. Likewise, those organizations that have widespread contact with the public, large volumes of business are going to be of greater regulatory interest.				

Micro and small business credit providers

These providers are likely to be the most common form of NDTCP that will operate in Serbia for the immediate future. Because they tend to lend to households and smaller businesses, their conduct and treatment of customers is a key focus of regulation.

Systematic abuse can have reputation affects that could (though unlikely) affect the integrity of the financial system.

The primary areas of focus will be on: disclosure requirements, terms of dealing and contracting, advertising, record retention and account management, conflicts of interest and related disclosure (if intermediaries or advisory services are involved), consumer complaint handling, and limitations on interest rates and fees (if usury laws are in place).

Most benefits from regulation will into the following:

- *Fair treatment of customers:* The companies deal directly with the public. While the notion of credit or taking a loan is relatively straight forward for most consumers, the terms, conditions, contractual, and collateral requirements underpinning most consumer credit often is not. The complexity of its provisions creates problems in understanding the true nature of the promise. Choosing a credit provider and evaluating financing choices can be a difficult task for a consumer, who generally does not have access to the information needed to make comparisons among providers on comparable terms or to understand whether they are getting a fair deal. Improper conduct and competence by providers can lead to unreasonable treatment of consumers and a deterioration of market confidence in the financial system overall. There is risk that the consumer will be mistreated as a result of misleading, deceptive or unfair provisions in the design of credit products. Harm to consumers can also occur through negligence in giving advice, preparing accounts, disbursing funds, calculating rates and fees, etc.

- *Accurate and appropriate disclosure:* Information provided by credit providers to consumers may mislead, falsely advertise, or contain hidden costs that make competitive analysis difficult. Negligence in the kind of information disclosed can cause consumers to make the wrong decisions.

- *Freedom from conflicts of interest:* Supervision for conflicts requires no more attention than necessary to ensure that providers having affiliations with related parties- for example a mortgage lender affiliated with a home builder- are disclosed when financing is being provided as part of a package of services.

- *Compliance with laws:* While loan sizes tend to be small, sometimes these providers can process large money transactions. This raises the specter of potential for financial crime and illicit transactions, which need to be monitored and controlled.

- *Desirable business practices:* Providers should not engage in business practices that undermine the high character of the sector. While supervision needs to tread carefully in limiting market activity, there are indirect risks to market integrity that could emerge if providers engage in practices that, although not illegal, undermine market confidence or reputation.

- *Timely and accurate transaction execution:* Providers should be held to a standard of performance that requires they are capable of processing and handling transactions efficiently. As customers rely on the timely availability of finance to close a third party transaction, significant detriment can occur if the provider is not able to affect transactions.

The depth of the regulatory process (i.e. for example via the risk based supervision process) should be decided based on the features of each organization and who they interact with.

Consumer finance companies

The regulation of consumer finance is justified on roughly same basis as overall consumer protection regulation covering goods and services. By regulating against abuse, fraud, and predatory lending, the regulator will help to protect individuals from engaging in transactions and incurring costs that are not in their best interest. In any consumer areas there potential for widespread abuse. But this is not likely in the near term based on the small volume of players that would enter the market.

These companies do not require a lot of regulatory attention unless there is reported abuse. As a result the regulator can undertake what is sometimes called "exception-based" supervision. Under this approach the regulator reacts when it notices something of concern or questionable market practices. On this basis, these organizations can be supervised using off-site monitoring until a problem is observed The NBS would use this approach along with good consumer education so that consumers can better understand what to look for. Again, going back to the objective of supervision. Financial supervision cannot eliminated all risks just as a policemen cannot eliminate all traffic violations. Consumer finance supervision needs to be based on good off-site detection mechanisms, a good consumer redress system, better informed consumers, and a strong set of disincentives for abuse. This is the most cost-effective way of consumer finance regulation.

The benefits of regulation will be much the same as what is noted for micro credit organizations. Consumer complaints have to be used as information for the regulator to detect patterns in market conduct that become a point of regulatory action. Consumer reporting, restraint and education should be the first line of defense against poor lending practices.

Vendor finance companies

The regulation of these companies will depend on who they are serving. Those serving the households will treated closer to consumer finance companies. Those serving medium and larger businesses could fall under general business regulation covering commercial contracts and fraud. In any case, the supervision of these companies is very light and based on information from consumer complaints, review of market practices, "secret shopping" and other market discipline techniques. Secret shopping, for example, is simply going to the lending office and asking questions or for information as would a customer. It may has limited application in Serbia, but it is one technique for off-site monitoring.

Business borrowers should be expected to have more knowledge than households about the financing deal they are getting; thus vendor finance providers that are serving primarily businesses, the monitoring will be the lightest for this category.

The benefits of regulation should be to make sure that lending practices are fair, equitable, well-disclosed and in compliance with other business laws.

Captive finance companies

Captive finance companies that operate as vendor finance companies should be monitored as a vendor finance providers noted above.

For captive finance companies that do not interact with the public, a case could be made for not regulating then at all since they pose no risk to the financial system or the public at large. Regulation of these non-public organizations could be as easy as registration and filing an annual statement on their activities. Indeed captive finance companies are not formally regulated for lending in many countries unless they are providing finance to some part of the public.

Mortgage finance

These companies have an elevated level of regulatory risk because they are often dealing with large amounts of money, the borrowing contract is long-term, and all of the costs, terms and conditions can be complex and confusing to consumers. Small errors or omissions can translate into considerable amounts of money for borrowers over a long period of time if lenders are careless or intentionally misrepresenting their costs. Mortgage finance also has the potential to become a source of money laundering if organizations are established for that purpose.

Lastly, because mortgage lenders require significant funding, they may be affiliated with and obtain funding from other regulated financial institutions, such as banks or insurance companies, where prudential risks are high. Without strong consolidated supervision of these banks and insurers, there would be an opportunity for parent institutions to circumvent regulatory limitations on their own balance sheet. Further, while these providers often obtain funding from sophisticated creditors and investors who understand the nature of the risks, these companies may also attempt to raise funds directly from the public outside of the realm of deposit-collection.

The funding sources of these companies are relevant to the regulator if the sources represent significant counter-party risk to other financial institutions. The funding sources are also a concern if the providers are raising significant capital from investors via the capital market under circumstances where there is a risk that those investors may be easily confuse the provider with a bank, or misunderstand the nature of the risks they are taking.

For these reasons, mortgage finance requires a higher level market conduct oversight than most of the other NDTCPs. And because banks also provide mortgages conduct is important because it can affect the reputation of the entire mortgage industry. The benefits of regulation from a borrower protection point of view are much the same as those noted above, fair treatment of customers, accurate and appropriate disclosure, freedom from conflicts of interest, etc. There is also additional benefits in the mitigation of any misuse of the organization to conduct financial crimes like money laundering.

The depth of the regulatory process (i.e. for example via the risk based supervision process) should be decided based on the features of each organization and who they interact with. More information on this goes beyond the scope of this paper, but BEP may be able to assist the NBS in setting up a proper risk-based supervisory process ("RBS supervision") if time and resources permit.

Specialized agricultural finance

These providers work with a variety of small farmers or agribusinesses that have different levels of sophistication about finance. Therefore, the rationale for regulation is the same as for small business financing.

Regulation of these providers can vary from passive, such as for vendor financing, to more active off-site oversight and market monitoring if borrowers lack understanding or if the loan programs being offered are complex. For example, some financing structures used in value-chain finance, that rely on cooperation among multiple parties and multi-party contracts can be complex and hard to understand. Regulation needs to ensure that borrowers involved in this financing arrangements get the information they need to make the right decisions.

The benefits of regulation are the same as those for small business finance.

Peer-to-peer lending intermediaries

While this is a new transformational area of lending, international experience suggests that these providers need to have some form of regulation. Not all lending practices are done in beneficial ways and not all companies are doing right by their customers. The industry is still developing, and there is very little regulation in this space. Some argue that regulating this industry too quickly could hinder the benefits that it provides to small business owners and limit future innovation. Others point to abuses in the industry, such as poor or no disclosure, no credit reporting on loans, double-dipping refinancing, prepayment penalties and loan stacking, among many other practices that are harmful to consumers and very reminiscent of practices that led market abuses in the past.

It makes sense at this stage to have some basic regulation that will help to safeguard borrowers from abuse. The primary focus needs to be on borrower protection.

The Financial Conduct Authority in the UK has begun the process of looking at this for crowdfunding and setting some regulatory standards. But it is important to bear in mind that this regulation applies to the raising of funds as well as the lending. The focus of regulatory concern, as it should be, is on the raising of public funds, which we have recommended should not be allowed Serbia at this time without further reforms and strengthening of securities regulation. Nonetheless, what they are doing in the UK may have some information benefits for the NBS.

https://www.fca.org.uk/static/documents/crowdfunding-review.pdf

The Australian Securities Commission has released some rules regarding this form of lending covering both raising funds and lending them. The focus for the NBS will be the lending regulations.

http://www.financemagnates.com/fintech/bloggers-6/peer-peer-lending-asic-provides-clarity-regulation/

The US is not a good example because its regulatory structure is over-complicated between state and federal laws. But again there may be some interesting ideas in looking at what they have done. In the US P2P lending platforms may be subject to certain consumer banking and related regulations. Consumer credit, whether bank-originated or otherwise, is subject to federal and state laws. The laws cover the credit process, including advertisements and solicitations, underwriting, agreements and disclosures, payment terms, and debt collection practices. Laws also prohibit credit discrimination and unfair or deceptive acts or practices. Other bodies of law that regulate relationships between financial institutions and consumers — e.g., privacy and data security and anti-money laundering laws — would also apply.

As a general rule, regulation of lending side of the P2P lending is largely based on the same regulatory framework that is applied to small business and consumer-focused lending. This means market conduct, disclosure, fair dealing, transparency, not giving loans to people who clearly cannot afford them, etc. Many of these issues are already covered in the consumer protection regulations applicable to banks in Serbia.

Concluding Comments

The aim of supervising NDTCPs is not to protect all borrowers from every risk. It is focus on the risks that have the greatest potential for widespread impact in the market, and to ensure that lenders provide enough information so that borrowers can act to protect themselves. The aim is also to monitor practices from a distance to ensure that there is not widespread abuse or misconduct that could threaten the integrity of the financial system.

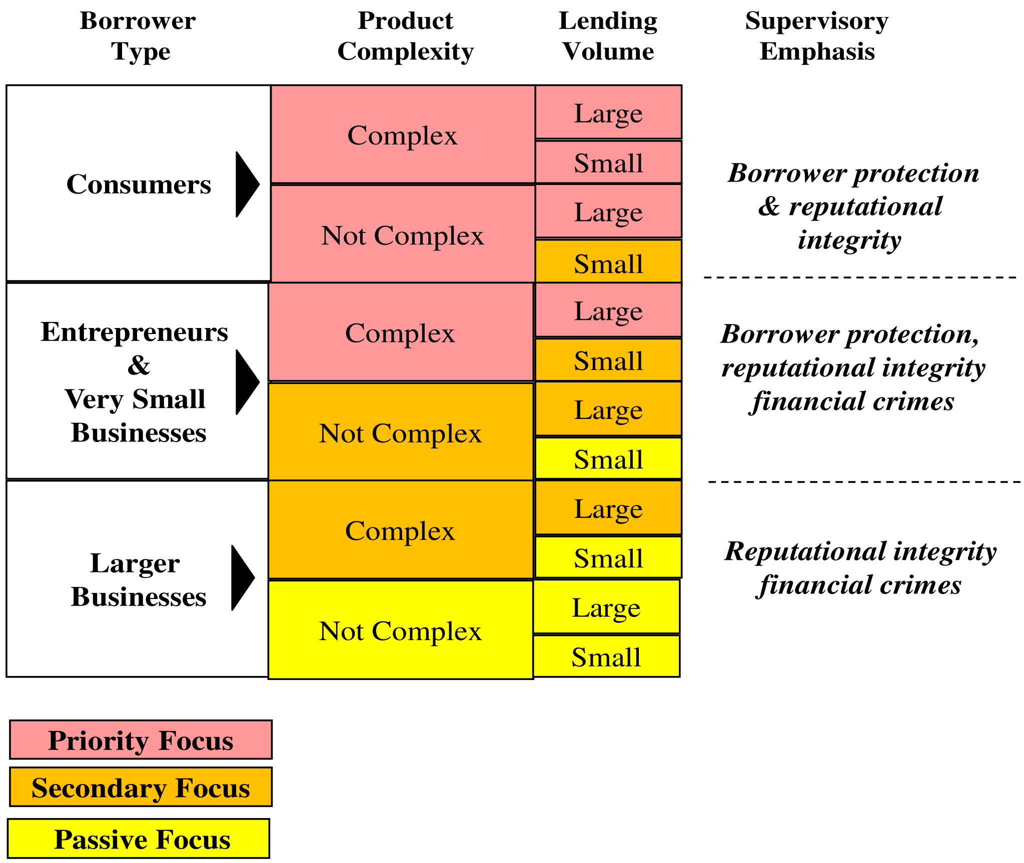
Excluding some organizations from regulation because they don't yet exist in Serbia or have little small operations is an option, but then it does not do much for supporting investment or attracting new institutions that could help deepen the market and have net benefits for society. A more robust approach is to plan for the present and the future by having a regulatory framework that is comprehensive, supports innovation, and can accommodate growth by focusing on the control of specific types of *activities* (credit making to consumers and businesses, non-deposit taking) rather than specific types of *institutions.*

The impact of differentiating between organization and activities means that instead of making regulation a binary decision – i.e. do we regulate or not – regulation becomes a fungible activity that applies to many institutions but it affects them in different ways.

All of the above organizations should have a license and be required to comply with applicable financial laws, but the regulatory framework should also make a distinction between these organizations based on what they are doing and who they impact. This will allow the regulator of NDTCPs to cover a wide range of institutions in the regulatory framework without imposing the same regulatory burden for all organizations.

The simplistic diagram presented below was designed to illustrate how regulation can differentiate according to activity,

Illustration of How Differentiation Should Inform Regulatory Focus



In this diagram the clients of NDTCPs are classified into three categories suggesting different degrees of borrower sophistication. Within these classifications products are grouped into two categories - complex and non-complex. The degree of complexity provides an indication of the types of products a lender may offer and how likely they will be misunderstood by borrower[13] For example, a simple short-term loan with an interest rate and a fixed maturity can be generally understood by most borrowers. But a longer-term loan with a lot of different contingent fees and conditions can be hard to understand and offer an abusive lender an opportunity to hide costs or to put the borrower in a poor situation. Complexity also depends on who is getting the loan. For example, consumers are usually the least educated about taking finance, whereas a small business owner who has a college degree and has already taken a loan before will have more knowledge. What may seem complex to the consumer may not be complex to the small business owner who is dealing with financial issues every day. Therefore, one product being sold to a consumer may be considered complex, but the same product being sold to

[13] In practice complexity is a call of judgement and experience and there is no dividing line. This is presented this way to convey the concept of how regulation can be differentiated. We will have to develop a wider set of criteria for deciding whether something is complex for the public or not.

more sophisticated small businesses may not be complex – thus the regulatory risks in this case depend on who is taking the product.

One further dimension, the size and scale of the lending operation "large" or "small" indicates what the market impact could be if there is a regulatory failure.

This type of classification can then be used to show where regulatory priorities should focus. This is indicated by the colors of red (priority), orange (secondary priority), and yellow (lower priority suggesting the potential for a passive approach to regulation).

Priority areas are of course those where borrowers are not very sophisticated and where there is potential for widespread abuse as a result. Size of operation and complexity of products matters, but it is less important to differentiate providers on those criteria if their clients are mostly consumers.

Areas with secondary priority are usually entrepreneurs and very small businesses because they will have a bit more sophistication and an ability to impose more market discipline on the lender to behave properly. (Still for complex products and large operations, those areas should also be included as a regulatory priority.) Moving to lower priority areas, larger businesses that have borrowing experience will be of less concern and may even be subject to very light passive oversight unless there is a reason to take action.

This is just an illustration of how the regulation of NDTCP's can be distinguished in regulations. In practice, the analysis can be more difficult when you have organizations doing different activities and serving different customer groups. Nonetheless, the approach to rationalizing regulation can be based on the same general methodology.

This paper is intended to provide information and ideas that will help guide discussion about NDTCP regulation. The USAID BEP team stands ready to provide further assistance in addressing these important issues and it looks forward to supporting the Working Group meeting when it is organized for mid to late April 2016.

[END]