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Have regulations caught up with the surge in digital payment services that mirror banking functions?

Grab launches a peer-to-peer fund transfer function for GrabPay Credits. (Photo: Loke Kok Fai)

SINGAPORE: When many Singaporeans lost their deposit to oBike after news of its ghastly exit rocked the nation, consumers awoke to the risks of putting money into an e-wallets and the possibility that they might find theirs emptied all of a sudden, with little recourse for help.

That was more than six months ago yet users who have tried to get a refund on their mandatory deposits are still waiting. A shocking S$8.9 million from oBike owed to users is still outstanding.

oBike liquidators are supposed to have met creditors last month but had earlier warned that “the company’s winding up is still ongoing and no payments or distributions will be made".

READ: oBike’s closure, a cautionary tale about poorly conceived business ideas, a commentary

An abandoned oBike bicycle along a footpath in Simei on Aug 1, 2018. (Photo: Matthew Mohan)

RISE OF FINTECH

I was reminded of how much power these companies with e-wallets have at the recent Singapore Fintech Festival where banners and booths of banks such as DBS, OCBC and Bank of China outsized those of fintech companies, yet the vast number of these other fintech companies outstripped their banking counterparts.

This battle is familiar, not just to consumers and those in the financial industry but also regulators.

“There will be another financial crisis ... but it’s going to look very different from the last one,” said Monetary Authority of Singapore managing director Ravi Menon. “A good part of lending has shifted to non-banks ... this is something we need to watch very closely," he added, pointing also to how lending by banks meanwhile has become more responsible because of tighter regulations.

READ: 'Look at where debt has gone' - MAS chief warns of 3 shifts in global financial risks

Singaporean regulators seem to be gradually grasping the challenges of balancing risk controls with ensuring that regulations do not snuff out innovation.

THRIVING SHADOW BANKING SECTOR

While traditional banks worldwide have been adapting to greater scrutiny in the aftermath of the 2008 Global Financial Crisis, their rivals in the shadow banking system are also evolving.

A decade ago, as banking liquidity disappeared overnight, banks turned risk averse to lending money, and shadow micro-financing institutions sprouted overnight to offer quick, easy loans to those willing to pay high interest.

Monetary Authority of Singapore's (MAS) managing director Ravi Menon seen speaking at the inaugural Bloomberg New Economy Forum on Nov 7, 2018. (Photo: Bloomberg New Economy Forum)

There is a wide range of players in the shadow banking sector – including those that perform banking activities, peer-to-peer landing and offer less than top-grade financial products.

They are not required to have a banking licence, sometimes because the size of their holdings didn't seem to justify regulatory action, but can opportunistically profit from the interest spread between borrowers and investors through instruments including hedge funds, money market funds and repurchased agreement markets.

From 2007 to 2011, the estimated size of the broader measure of this global shadow banking system has ballooned. Today, it is valued at US$45 trillion presenting 13 per cent of the world's financial assets, according to the G20 Financial Stability Board. Half of this market resides in the US but shadow banking has mushroomed in China's burgeoning economy in recent years.

In the US and other advanced economies, economists such as Paul Krugman have warned of global amnesia to the fact that the last crisis was partially a result of the loosely regulated market for repurchase agreements (securities involving short-term loans purchase by institutional investors) in the housing sector and the liquidity run on these shadow banks.

Unlike banks, they are not required to have safeguards such as deposit insurance or exposure limits and are more susceptible to fund runs because they do not receive aid from their central banks if trouble brews.

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The run on these institutions can trigger further fire sales which will eventually contaminate and damage investments in the real economy, with the ensuing vicious spiral wrecking the whole financial system. As a result, regulations on securitisation and shadow banking has been increasingly strict in these advanced countries.

Regulators in Singapore are waking up to the potential concerns over shadow banking. While the Financial Stability Review of MAS issued from 2007 to 2010 did not really elaborate on how much of the banking sector is filled by these actors, it acknowledged the need to strengthen supervision.

A cyclist pedals along a promenade past the financial district in Singapore on Apr 14, 2015. (Photo: AFP/ROSLAN RAHM

In contrast, MAS' most recent 2018 report provides more details on non-bank activities including a breakdown of non-bank loans by sector over the years and the loans-to-deposits ratio.

THE RISE AND RISE OF BIGGER AND BIGGER PLAYERS

A new force is at play in shadow banking, coming in the form of trendy, new fintech including peer-to-peer (P2P) lending, e-wallets and mobile payments just to name a few.

Technology advantages together with a lighter regulatory burden have helped fintech companies enjoy spectacular growth in underserved sector like the US housing market – and they now account for 44 per cent of lending, with five of the largest ten lenders non-banks.

A study by Amit Seru at Stanford Graduate School of Business and his coauthors shows the share of shadow banks in the mortgage market has nearly tripled from 2007 to 2015. Big companies dominate the space as fintech firms such as Quicken Loans account for almost a third of shadow bank loan originations in the housing sector by 2015.

They also show that fintech lenders exploit different algorithms in loan pricing, and originate loans with greater convenience for their borrowers. Contrary to the common belief that technology can lower costs and prices, fintech lenders in fact command an interest rate premium for their services.

READ: Fintech, banking's great disruptor. Or is it? A commentary

Convenience, monopoly and the availability of funds to those unable to get a bank loan come with a cost.

THE SURGE OF CHINESE DIGITAL PAYMENT GIANTS

But to get a sense of how rapidly non-banks can grow, we must turn our eye to China, where the astounding rise of e-wallets and mobile payments have witnessed the fastest growth, thanks to the likes of third-party payment tools Alipay and WeChat Pay.

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Almost too-big-to-fail Ant Financial services, which owns Alipay, is now valued at US$150 billion, after enabling Alipay users to conveniently invest wallet balances in money market funds to earn capital gains. WeChat Pay too launched a similar investment vehicle Lingqian Bao in 2014.

A customer pays cash, in front of QR codes for Alipay and Wechat Pay, at a pork stall inside a market in Nantong, Jiangsu province, China August 9, 2018. (Photo: REUTERS/Stringer/File Photo)

Mobile payments in China have surged accordingly by almost 40 per cent in the first ten months of 2017 compared to the year before.

Little attention has been paid to the explosion of these shadow banking institutions and their growing linkages with the global economy.

Chinese P2P lender Paipaidai was one of the first to be listed on the New York Exchange in 2017, and just one among the almost 6,000 in China.

The Chinese P2P lending market volume reached US$445 billion in 2017, which is still very small compared to the US$448 billion that Chinese banks loaned alone in January 2018.

But Chinese regulators are catching up, with interim measures slapped on online lending in 2016, which give authorities vast enforcement powers including the imposition of criminal penalties.

More ensuing regulations coupled with a series of clampdowns have since dampened the sector, now shrunk to about 1,500 platforms as most foreclosed, became insolvent or had their founders convicted of fraud. For now, the threat of a contagion has been contained, even though small- and medium-sized enterprises borrowing from these lenders may run into financing difficulties as China's growth slows.

READ: China's economy is certainly slowing but growth is still robust, a commentary

IN SINGAPORE, CALM WATERS

In Singapore, the shadow banking sector is dominated by trust companies and money market funds. But in recent years, small P2P lending platforms that target small- and medium-sized enterprises have germinated, most founded after 2014.

According to a study by University of Cambridge and Monash University, P2P business lending has grown from US$0.12 million in 2014 to US$9.43 million in 2015 to US$88.43 million in 2016.

Since 2016, they have been regulated by MAS under the Securities and Futures Act and the Financial Advisers Act by which they are required to hold a capital market services licence. These prompt regulations have helped curb risks in this sector but may have also stiffened financial innovation, reducing the amount lent to US$83.82 million in 2017.

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In 2016, China has nearly 2,600 platforms described as P2P businesses, according to industry website www.wdzj.com, with transactions valued at around US$150 billion in 2015. (Photo: AFP/Johannes Eisele)

Overall, the boom of P2P lending in Singapore has been rather late and muted without significant risks materialising, compared to the situation in China.

On the e-wallet front, there are several players in Singapore. Key players Grab, Liquid Group, MatchMove, Razer and TransferWise all have access to Singapore's real-time payment as participants to the Direct FAST industry working group alongside MAS and some banks.

There is no Singapore equivalent of AliPay and WeChat Pay but the closest may be GrabPay which allows you to transfer funds to others, pay services and extends to Indonesia, Malaysia, Philippines, Vietnam and Thailand. Grab has also launched Grab Financial last March, and offers lending services as well as insurance to a few Southeast Asian countries.

READ: With Grab's super app ambitions, who will it eat for lunch? A commentary

PAYMENT SERVICES A TIMELY MOVE

In this context, the Payment Services Act passed in Parliament in January has been timely. The Act now requires companies that provide digital payment services to be licensed and come under MAS, and imposes limits on how much money can be held in e-wallets and transferred.

It will also require companies to ringfence funds by forbidding fintech firms from lending funds in users' e-wallet and fully securing float above S$5 million.

These are in line with Ravi Menon's previous comments that "once you take a deposit and lend it out, you become a bank. That's a clear line that a fintech cannot cross, unless it obtains a banking licence".

This move is part of MAS's efforts to create a regulatory framework conductive for innovation in fintech, after a long two years of applying a regulatory sandbox to approved fintech companies to encourage experimentation to test promising ideas in the market. The hope is that innovation and regulation in this sector can evolve together, and manage undue risks.

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Signs accepting WeChat Pay and AliPay are displayed at a shop in Singapore May 22, 2018. (Photo: REUTERS/Edgar Su/Files)

These moves will definitely help inform authorities' next steps, looking at the ride-hailing industry where another major player Go-Jek has just entered the market and we can expect competition to heat up as it goes toe-to-toe with Grab.

READ: Go-Jek's going places, but is it leaving its riders behind?

Go-Jek had earlier announced a strategic partnership with DBS in regional payment services though it is not clear if that means DBS will provide the wallet for Go-Jek or integrate Go-Jek's digital wallet Go-Pay into its ecosystem. No doubt, the competition among banks, and bank-partnered tech companies will require some monitoring.

ROAD AHEAD PAVED WITH MORE QUESTIONS

The fact is that technology has given the shadow banking sector a snazzier cover, leaving regulators with far more complex, ethical challenges. Apart from protecting consumers' hard-earned money, the rise of digital services, payments and e-wallets also raises questions of data privacy and cybersecurity – and who owns users' information and data on expenditure habits.

In the US, tech giants store the information which is not accessible to regulators without them having to jump through huge legal hoops. Yet in China, authorities have access to user data and can use that information to adjust a citizen's social credit scores, which raises difficult questions of intrusiveness and personal privacy rights. Now that's something that might get Singaporeans jumpy.

READ: Rating citizens - can China's social credit system fix its trust deficit? A commentary

Given lessons learnt from China and elsewhere, Singapore regulators are likely to take cautious moves when it comes to regulating the evolving financial services sector including new P2P lending and e-wallet players, not least to safeguard trust in the system, through protecting deposits in these tech platforms.

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A customer uses a smartphone to scan code during pay food using Go Pay at a food counter during Go-Food festival in Jakarta, Indonesia, October 27, 2018. Picture taken October 27, 2018. (Photo: REUTERS/Beawiharta)

At the same time, MAS's approach to involve non-banks actively and tap on them to shape the sector is also incentivising banks to keep up with new technologies and fostering greater innovation, an approach that is sensible given emergent sensitive issues of information protection and privacy .

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