

Mapping the Shadow Payment System

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Recent years have witnessed the emergence and rapid growth of a large, diverse, and constantly evolving shadow payment system. The shadow payment platforms (SPPs) that populate this system perform many of the same core payment functions as conventional deposit-taking banks: including custody, funds transfer, and liquidity. The crucial difference is that SPPs operate outside the perimeter of bank regulation, thereby depriving customers of the deposit guarantee schemes, lender of last resort facilities, special resolution regimes, and other legal protections typically enjoyed by bank depositors.

This paper represents the first attempt to map the global shadow payment system and identify what mechanisms, if any, SPPs use to protect their customers. Examining the business models and customer contracts of over 100 SPPs, we find that it is often difficult to ascertain information essential to evaluating levels of customer protection and, where such information is available, that customers generally enjoy relatively limited structural, contractual, or other private legal protections. This puts enormous pressure on public regulatory frameworks to ensure a sufficient level of consumer protection. Regrettably, we also find that the applicable regulatory frameworks in several key jurisdictions often provide a level of protection that is far below that enjoyed by bank depositors. These findings suggest that, at least from a consumer protection perspective, SPPs are currently not an effective substitute for bank-based payment systems.

Our findings have a number of important policy implications:

- As the name implies, the shadow payment system exists largely in the shadows. The resulting information gaps are important from a consumer protection perspective. They are also important for policymakers as they seek to enhance their oversight of these increasingly important institutions.
- The majority of SPPs have not taken full advantage of private law mechanisms to protect customers from the risks of potential illiquidity and loss of value. This is not surprising given the impact of these mechanisms on the ability of SPPs to profit from the intermediation of customer funds.
- Regulation is an important part of what makes the promise of banks to perform core payment functions credible. If SPPs are to compete with banks on a level playing field, policymakers will need to ensure that the regulatory regimes that govern them provide a functionally equivalent level of consumer protection. While existing regulatory

regimes in the United States, United Kingdom and EU provide some protection, these regimes fall short of this standard.

- Effective regulatory regimes governing SPPs need not include all the features of conventional bank regulation. While we propose a bespoke regulatory regime that combines structural separation, portfolio restrictions, and trusts, there may be other potentially effective options depending on the relevant business models and underlying legal frameworks.
- SPPs and their representatives may object to the imposition of such functionally equivalent regulatory regimes on the basis that they would constrain their ability to profit from the intermediation of customer funds. Ultimately, however, absent an important and pressing policy rationale, combining payment functions with financial intermediation poses well understood risks that require strict prudential regulation.

This paper represents our first tentative steps towards a better understanding of the shadow payment system. Our exploration uncovered a world characterized by heterogeneity, complexity, uncertainty and risk. Our preliminary findings suggest that policymakers face some hard choices about how to balance technological innovation, competition, and consumer protection within this rapidly evolving system. In general, private ordering has proven insufficient to ensure that customers benefit from a level of protection equivalent to that typically enjoyed by bank depositors. Accordingly, as the system continues to grow, so too will the pressure on policymakers to ensure the effective regulation of SPPs. While this regulation need not be as sophisticated or burdensome as conventional bank regulation, it must nevertheless seek to ensure that SPPs can continue to perform their core payment functions during periods of institutional distress and insolvency. Only then will these institutions be able to compete on a level playing field with conventional deposit-taking banks.

You can download the full paper [here](#).