



# Risks and Benefits of Crowd-funding

Werner Bijkerk

Head of the IOSCO Research Department

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# Agenda

1. Introduction
2. Nature of FR crowd-funding
3. Regulatory regimes
4. Role in market based finance
5. Systemic risk issues
6. Investor protection issues
7. Conclusions and next steps

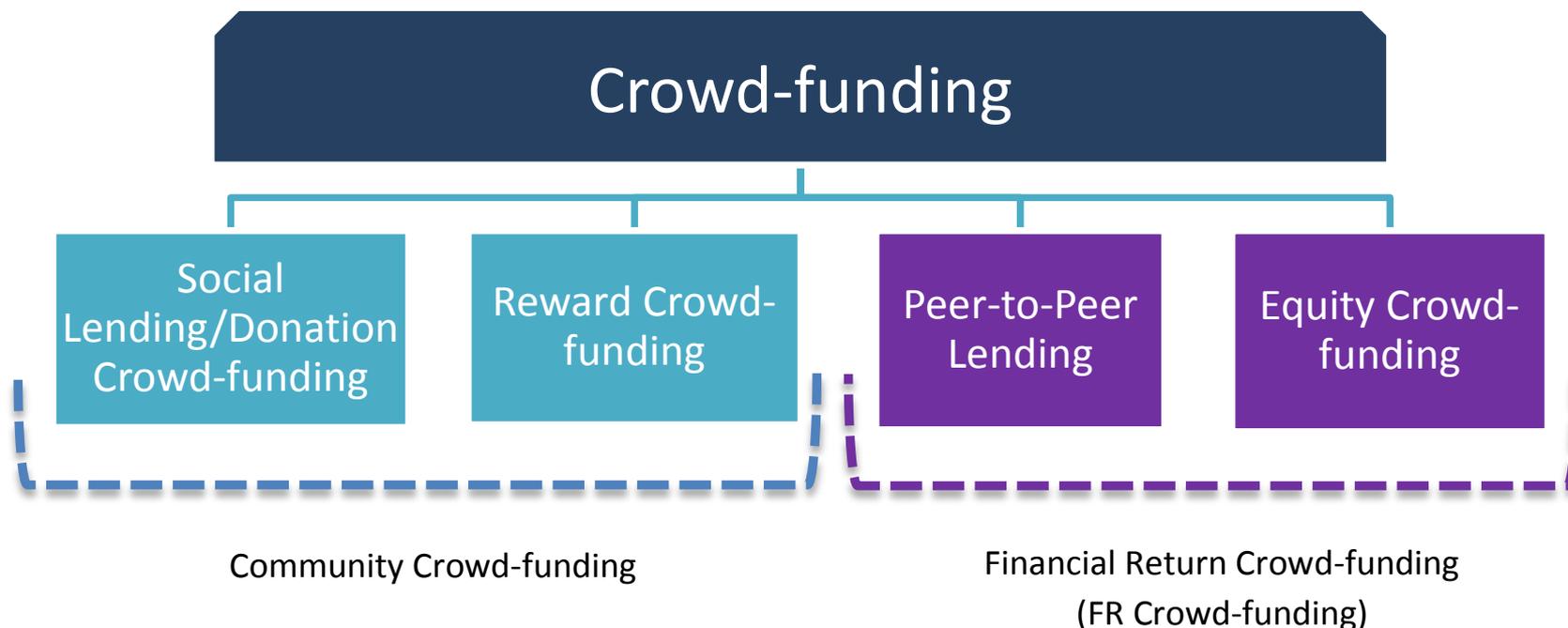
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# Introduction

- **Crowd-funding:**  
The use of small amounts of money, obtained from a large number of individuals or organisations, in order to raise funds for a project, business/personal loan or other financing needs through an online web-based platform

# Crowd-funding: four sub-categories



Source: IOSCO Research Department

# Focus on FR Crowd-funding

- Financial Return Crowd-funding (from hereon: FR Crowd-funding) is made up of two industries:
  - Peer-to-peer lending
  - Equity crowd-funding
- Peer-to-peer lending is the use of crowd-funding to originate loans which are paid back with interest
- Equity crowd-funding is the raising of funds through the issuance of stock to a large number of investors.

# Data gaps, lack of information, the research challenge

- Financial Return Crowd-funding is a relatively recent innovation
- There is ***no global database***
- There are ***no reports covering global developments*** in detail

Therefore, the research challenge was to compile manually all available data and information together:

Platform by platform, regulator by regulator.

# The Staff Working Paper

- The result is a Research Department staff working paper with a global overview, with some caveats, but a necessary first step for a better understanding of crowd-funding.
- Descriptive and exploratory report, main content:
  - The ***phenomenon and trends*** in market and regulation
  - The role in ***market based finance***
  - ***Investor protection*** issues
  - ***Potential systemic risk*** issues

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# The Nature of FR Crowd-Funding

- FR crowd-funding was made viable by the *innovation in website design* which allowed contributions from many participants at low cost
- Growth in FR crowd-funding only really begun with the onset of the financial crisis:
  - It seems that reduced capital flows to SMEs and for personal loans created a gap in the capital market
- Quantitative easing in many jurisdictions has driven interest rates close to their zero lower bound driving a “*search for yield*” pushing investors towards alternative forms of income generation (see Securities Markets Risk Outlook 2013-2014).

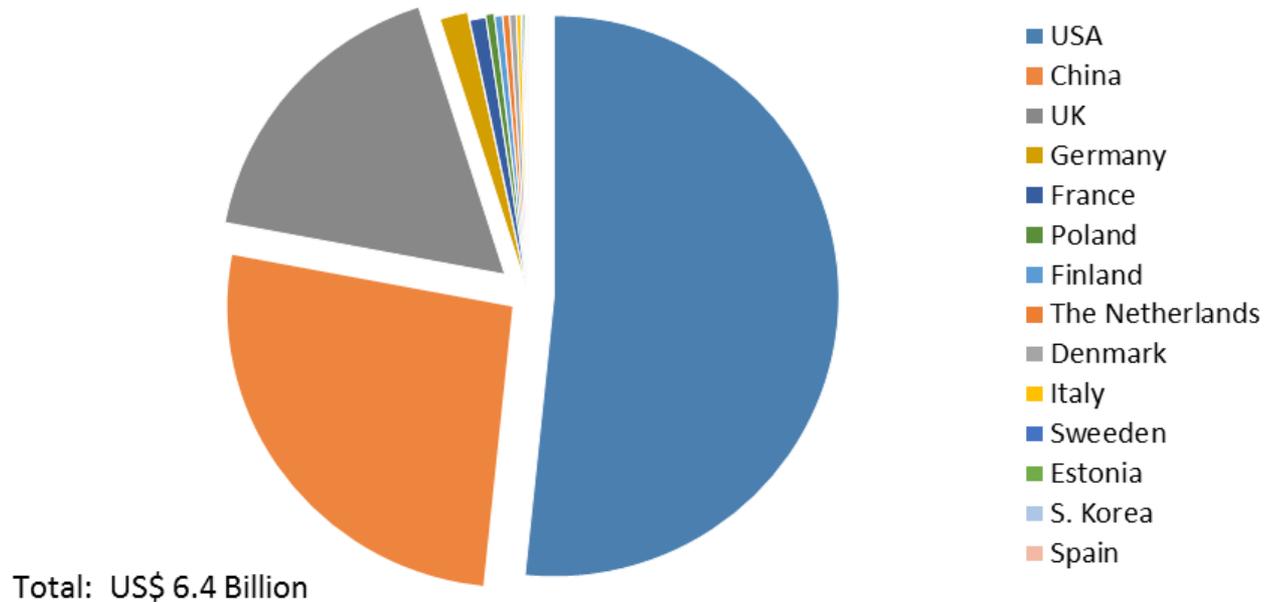
# The Nature of FR Crowd-Funding

- Peer-to-peer lending has developed as a way for ***borrowers to obtain a loan at a lower interest rate*** than they would otherwise be able to achieve through using traditional avenues of credit provision.
- ***Lenders can achieve a higher rate of return*** than on a savings account or through other traditional investments, such as government bonds.
- Consequently peer-to-peer lending has ***grown at around 100% each year*** driving growth in FR crowd-funding.

# FR crowd-funding globally

- FR crowd-funding started in the UK and US in 2007 and has spread across the globe.
- Estimated size: \$6,4 billion (end Q3, 2013)
- Concentrated in China, UK and US; Collectively they make up 96% of the overall FR crowd-funding market.
- The US is the largest market, making up 51% of the global market.
- There are many smaller markets including:
  - Argentina, Australia, Estonia, Germany, India, Italy, Netherlands, South Korea

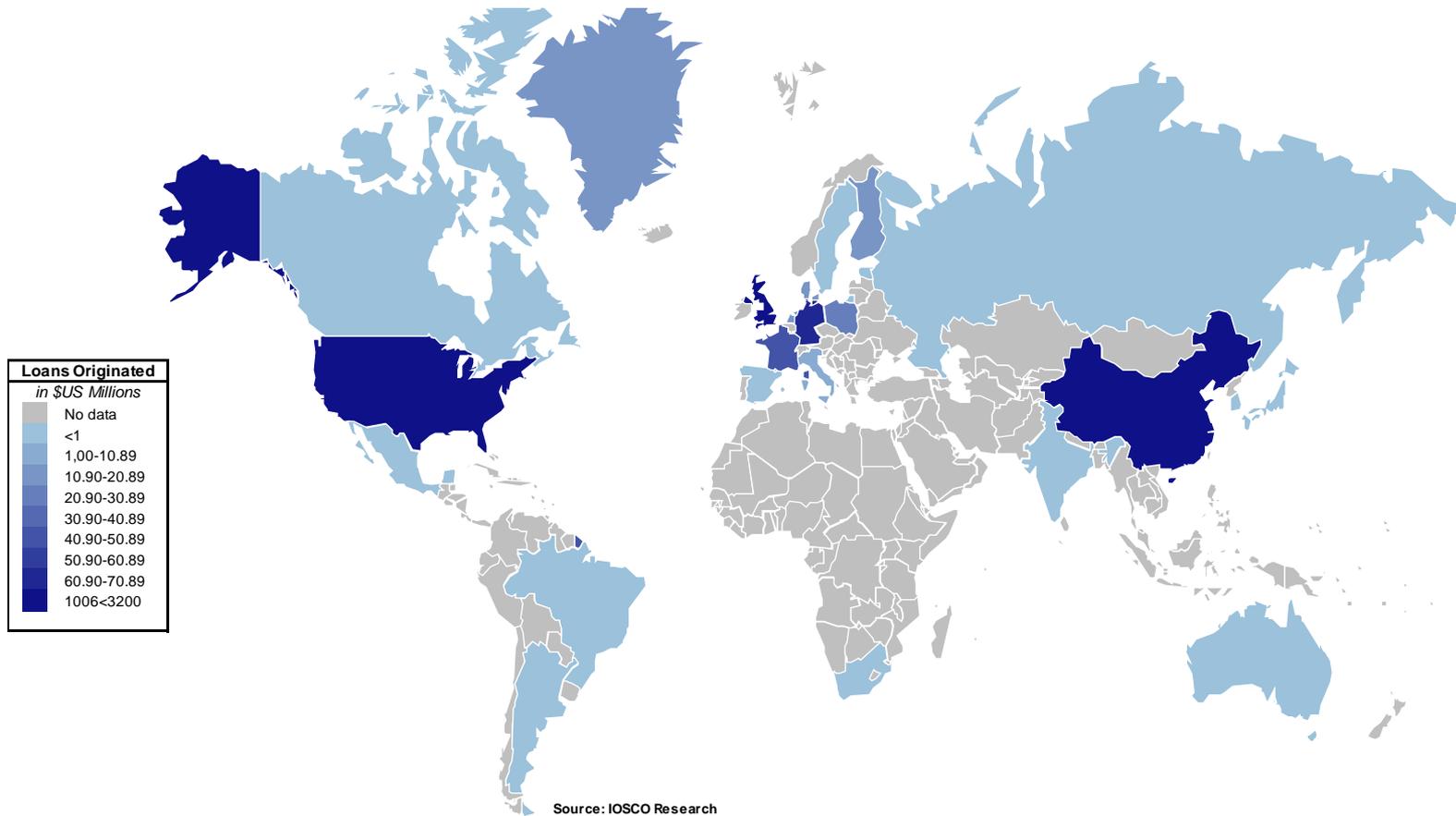
## Percentage of the peer-to-peer and equity crowd funding market by country



Source IOSCO Research Department: Based on figures from selected peer-to-peer platforms within each country

Notes: Peer-to-peer lending data is sourced directly from the websites of the largest providers. It therefore represents a lower bound estimate of the global loan pool.

# Global Distribution of FR Crowd-funding Markets



Source: IOSCO Research Department. Based on data obtained directly from platforms, therefore represents the lowest estimated size for each country

# Business Models

Three major FR crowd-funding models. The first two are peer-to-peer lending business models and the last one is an equity crowd-funding model:

- client segregated account model (platform issues loan),
- notary model (bank issues loan) and
- equity crowd-funding model

# Investor Characteristics

Very little literature available

Report by Pierrakis & Collins on 600 investors of Funding Circle (UK):

- Most of the lenders are between 40 and 60 years old.
- Almost 90% are experienced investors in securities
- Almost 40% have more than 10 years of experience working with SMEs
- 83% is male
- Median investment size was £50
- Median number of investments is 35
- Median total investment is £2,000

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# Regulatory Regimes

Equity crowd-funding. Three regimes:

1. Prohibited
2. Not prohibited but with high regulatory barriers to market entry inhibiting market growth
3. Regulation may allow the industry to exist but with strict limits on:
  - Who can invest/Investor type
  - Number of investors allowed to invest,
  - Size of the company issuing the equity
  - Other such regulatory requirements

# Regulatory Regimes

Peer-to-peer lending, five regimes:

1. Exempt market/Unregulated due to a lack of definition
2. Regulated as an intermediary
3. Regulated as a bank
4. US model (various layers –federal and state level)
5. Prohibited

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# Role in Market Based Finance

- The ***ability to raise capital***, in most cases without giving up large parcels of equity interest.
- ***Spreading of risk***
- ***Lower cost of capital/higher returns***
- Venture and seed capital requests are rarely subscribed to in the current economic environment. Crowd-funding alternatives provide an ***affordable and attainable option for raising capital***.
- ***Boost economic recovery***

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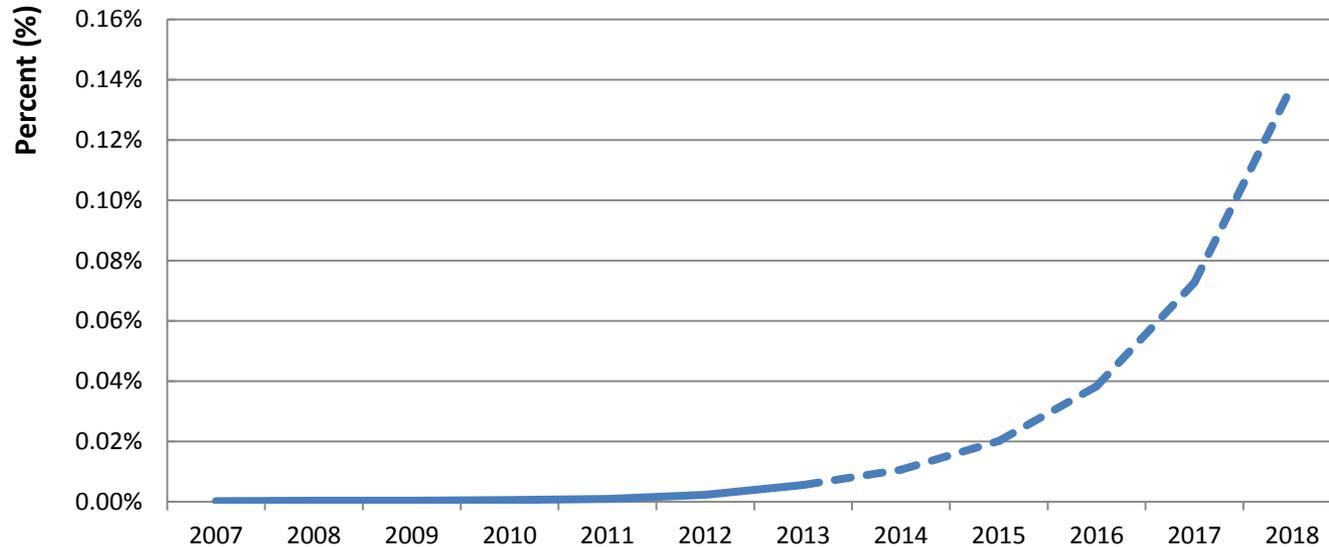
# Systemic Risk Issues

## Size and Growth:

- FR crowd-funding market is roughly **\$6.4billion**.
- The peer-to-peer lending market is small; **accounting for only a fraction of all credit** provided to the real economy.
- However, it is an industry that is almost **doubling each year** in size.
- Even though the current market size is very small in comparison to traditional credit markets, **it has the potential to grow to a sizable market in as little as five years' time**.
- Equity Crowd-funding only accounts for \$80 million of the overall FR crowd-funding market.

# Systemic Risk Issues

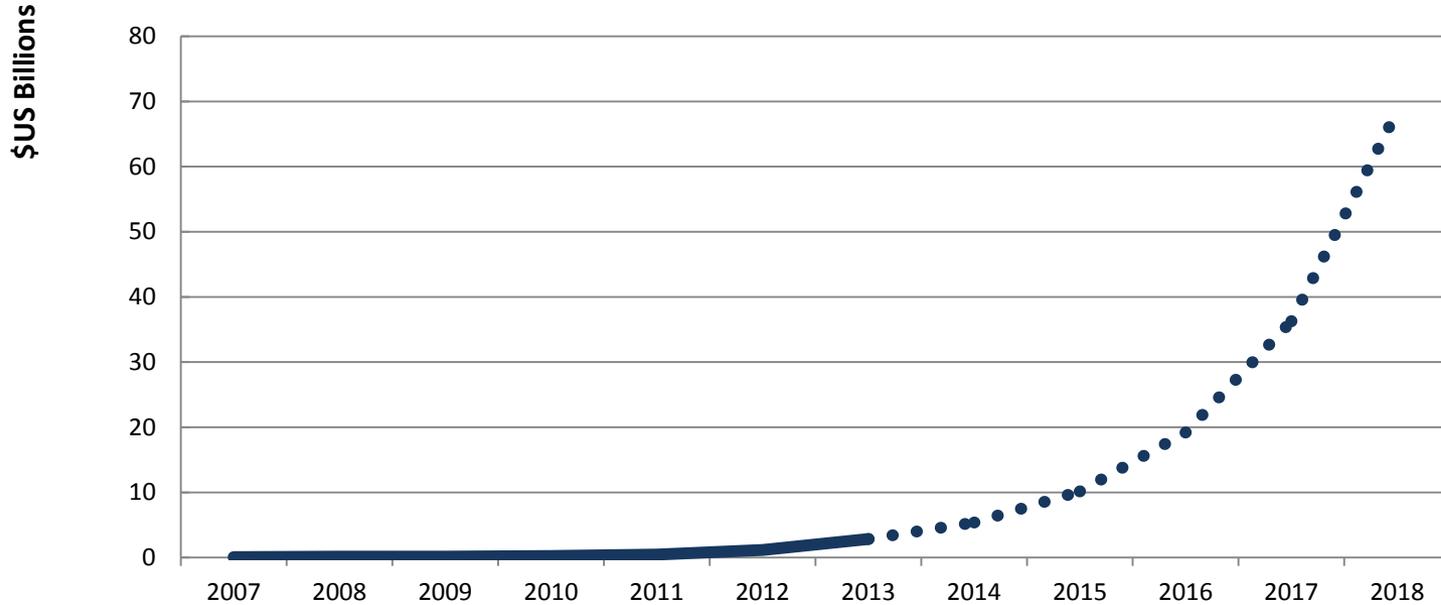
## Size and growth: Crowd-funding loans as a proportion of bank-originated credit to the non-financial sector



Source: IOSCO Research Department; compiled from Bank for International Settlements, Prosper, Lending Club, Auxmoney, Svara, Zopa, Ratesetter, Thincats, Funding Circle, isePankur, Pret d’Union.

Notes: 1) Peer-to-peer lending data is sourced directly from the websites of the largest providers; it therefore represents a lower bound estimate of the global loan pool. 2) Dotted line represents IOSCO Research Department forecast and is based on the continuation of the average yearly growth rate of 90% for the next 5 years.

## Size and Growth: Market Growth 5 Year Projection for Peer-to-Peer Lending



Source: IOSCO Research Department; Compiled from Prosper, Lending Club, Auxmoney, Svara, Zopa, Ratesetter, Thincats, Funding Circle, isePankur, Pret d'Union;

Notes: 1) Peer-to-peer lending data is sourced directly from the websites of the largest providers. It therefore represents a lower bound estimate of the global loan pool. 2) Dotted line represents IOSCO Research Department forecast and is based on the continuation of the average yearly growth rate of 90% for the next 5 years.

# Systemic Risk Issues

## Cross-Jurisdictional:

- A few platforms have chosen to open their business to other nationals, introducing ***cross border complexities***.
- Questions are yet to be answered in regards to contract law enforcement across jurisdictions and require further in-depth work to understand the ***legal implications of cross-border operations***.

# Systemic Risk Issues

## Interconnectedness :

- There have been recent examples of the ***securitisation of peer-to-peer unsecured loans***.
- This opens the market to new investment, but also opens the rest of the financial market to exposure to packaged loans which are predominately unsecured in nature.
- There have also been examples of banks lending through these sites to borrowers they would be unable to lend to otherwise

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# Investor Protection Issues

- Risk of default
  - In equity crowd-funding the risk of default/investment failure is estimated to be around 50%. In peer-to-peer lending there has been a concerted effort by the industry to reduce default rates, though the ***actual rate of default is still unknown*** for some platforms.
- Risk of fraud
  - This is compounded in both peer-to-peer lending and equity crowd-funding by the anonymity created by the online aspect of these industries.
- Institutional risk
  - There has already been a case of a peer-to-peer lending ***platform closing*** leaving no data on contracts behind and resulting in 100% investment loss.
- Lack of disclosure of risks and real return rates

# Systemic Risk Issues

## Liquidity:

- There is a ***lack of liquidity*** in peer-to-peer lending, with relatively few platforms providing a ***secondary market*** on which to sell loan portfolios.
- Equity crowd-funding has even less liquidity as there is ***no secondary market for shares*** in start-ups due to the inability to accurately judge the value of the equity shares.
- This is a ***problem for investors***, especially retail investors who may not be experienced in investing in illiquid shares or have the collateral to absorb losses in the event of default

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# Conclusions and Next Steps

## Conclusions:

- FR crowd-funding is ***small but grows fast***
- Regulatory regimes vary but ***regulators comprise of comprehensive toolset*** based on IOSCO Principles
- It is a ***growing alternative for small businesses***
- It does ***not currently constitute a systemic risk***
- There are ***investor protection issues***

# Conclusions and Next Steps

## Next steps and open issues:

- Further data gathering and monitoring is required – ***ongoing data collection and refining will be done by the Research Department***
- Report is ***shared with FSB Financial Innovation Network***
- Report could be input to ***Long-term finance project***

## Open issues for IOSCO Policy:

- ***Cross border offerings and resolution of platforms*** in case of close-down
- ***Retail investor protection and disclosure practices***
- Other investor protection issues – ***inventory of regulatory issues among IOSCO members proposed by C3***