Risks and Benefits of Crowd-funding

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2. Nature of FR crowd-funding
3. Regulatory regimes
4. Role in market based finance
5. Systemic risk issues
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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

- Social Lending/Donation Crowd-funding
- Reward Crowd-funding
- Peer-to-Peer Lending
- Equity Crowd-funding

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

Total: US$ 6.4 Billion

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 $6.4\text{billion}$. 
• The peer-to-peer lending the 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; Complied 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 \textit{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:

• 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