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Whatever happened to crowdfunding?

Current reality

Since the 2008/9 financial crisis, alternative forms of finance have proliferated, both from within the existing financial sector and through newcomers. In a world where banks were, and are, required to hold more capital, it was logical for many to – instead – reduce the size of their balance sheets, deleveraging almost across the board. Hedge funds and mutual funds, as well as long-term investors like pension funds, have filled some of this credit gap, particularly for infrastructure financing and other longer-term project financing. But in many markets, both developed and emerging, banks have especially chosen to reduce lending in the SME sector. Alternatives to bank lending have, as a consequence, emerged.

Crowdfunding platforms (I include both equity investment and lending here) are blooming like wildflowers, encouraged in many jurisdictions by (relatively) low-key regulation. Crowdfunding is being talked-up a part of the fintech 'revolution', as part of the disintermediation of finance by ever-greater use of technology, and as a way to – at last – provide enough financing for SMEs and early-stage businesses in the economy. The wisdom of the crowd will, it is argued, lead to better overall lending decisions and efficient allocation of capital within the economy.

As usual, the development of the crowdfunding market has not been consistent across countries. The extent of the problem (i.e., how much of a financing gap is there?), or opportunity, varies; the business culture may favour one type of solution over another; the legal and regulatory framework may encourage or discourage crowdfunding.

The largest markets for the lending variety of crowdfunding (or peer-to-peer lending, P2P) are China, the US and the UK.[1] In all of these markets lending both to individuals and to businesses has been a feature of the market development, although the actual products vary.[2] But for the purposes of this discussion paper, it is lending to companies, and particularly to SMEs, that is of most interest.

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[1] In 2015, total P2P lending amounted to USD 117 billion in China, USD 40 billion in the USA, and USD 6 billion in the UK. Source: speech by Mark Carney, Governor of the Bank of England, Deutsche Bank conference, Wiesbaden, 25 January 2017.

[2] In the US, student loans and debt consolidation loans have been popular forms of P2P lending to individuals. In China, most lending to individuals has been to the under 25 age group, who are unable to access finance from the mainstream banking system. Again, much of the lending is linked to education costs. China has also

In emerging markets, such as in the Gulf region, the banking system was not so badly affected by the 2008/9 crisis as in the developed markets of the West. Nonetheless, with the reduction in oil prices, many banks have found themselves not as liquidity-rich as they have been in the past. In these circumstances they have preferred to lend to governments, government-related entities and large multinational and family businesses, squeezing out the SME sector. The absence of a well-developed capital market ecosystem, including early stage financing for start-ups, in these countries has made the position doubly hard for this sector of firms.

As an illustration of the importance of the SME sector, in 2014 they made up around 85% of businesses in the United Arab Emirates (UAE), contributing 50% to UAE GDP and employing 60-65% of the UAE work force. In Dubai, SMEs represent nearly 95% of all establishments in the Emirate, accounting for 42% of the workforce and contributing around 40% to the total value of Dubai's economy.[3]

Stresses and strains

Crowdfunding businesses are, themselves, almost all start-ups. Many are set up by people with backgrounds in technology and marketing, not in finance. The culture clash between established regulation and these businesses already has led, and will continue to lead, to pressures and problems.

But there are two real sets of stresses and strains: one that is most relevant to P2P lending crowdfunding and another that is most relevant to equity crowdfunding.

One way to think of P2P lending platforms is as brokers: they make introductions between parties, some of whom want to lend and some of whom want to borrow. Often, the P2P platform will perform due diligence (to varying extents) on the potential borrowers, to confirm that the business exists, that the key individuals are not criminals, and – often – to give their own view on the relative creditworthiness of the potential borrower.[4] If the borrower gets their loan, the platform takes a cut; there is usually also a charge to the lender for the ongoing administration of their account. After a period of time, the loan is repaid and rolls off.

Equity crowdfunding platforms act in a similar matchmaking capacity. But there are two substantial differences. Firstly, businesses seeking equity investors are usually earlier-stage businesses than those seeking loans through P2P platforms. So they have less of a track record of operations, if any; there is less on which a platform can do due diligence; less information for an investor, or the crowd, to analyse and debate. Secondly, the investment is, by definition, open-ended. Unlike a P2P loan,

seen, to a greater extent than other markets, loan sharks lending through P2P platforms, at extremely high interest rates. In the UK, the first platform, Zopa, has dealt predominantly with lending to individuals.

3 Ministry of the Economy April 2014.

4 There are crowdfunding proponents who argue that platforms (P2P or equity) should not carry out any due diligence at all. Instead, the entire process of information discovery, discussion and decision to lend/invest should be left to the crowd. This is, in practice, a rather purist view that is unlikely to work unless it can be somehow guaranteed that all data/information will become available.

there is no maturity date. These are the two main factors that explain the greater risk of equity crowdfunding as an asset class, in comparison to P2P lending. But the equity platform gets paid in the same way – it takes a cut of a successful investment round into a company. It may also charge the equity investors a fee for the administration of their account, in the same way that a broker might.

The key challenge for any crowdfunding business is to achieve sufficient scale to become profitable. With platforms taking a small cut of each successful transaction, and nothing for unsuccessful transactions, there is a clear incentive to get transactions completed. This creates a number of tensions and potential conflicts of interests. A P2P platform may start off with the aim of only allowing companies of a certain minimum quality (however defined) to seek funds through the platform. But what if there aren't enough of those companies? There is pressure to reduce the quality thresholds. While increasing upfront fee income for the platform, this will run the risk of a greater level of defaults for lenders, which is not in the platform's long-run interests. Internet businesses can die very quickly if user sentiment turns against them.

The same issues arise for equity crowdfunding platforms. Are there enough companies, of sufficient quality, for the platform to be able to reach its breakeven point and, eventually, make a profit?

Similarly, can crowdfunding platforms achieve enough scale while focusing on the crowd (i.e., individuals) as investors? Or will it be necessary to bring in institutional money so that, for example, larger loans can be contemplated? The introduction of institutional money in a number of markets has made it easier for P2P platforms, which initially did straight lending, to move into other credit-related areas such as factoring.

If one looks at the market in the US and in the UK, then it is noteworthy that, despite a number of players having reached significant scale (e.g., Lending Club in the US, Funding Circle in the UK), profitability is much rarer. Lending Club, set up in 2007, reached profitability for the first time in late 2015, but has subsequently experienced some significant setbacks and a reduction in business volumes. Funding Circle's UK operations, set up in 2010, reached profitability for the first time in the last quarter of 2016, on the back of record business volumes, but its operations in the US and Europe are loss-making. It is also worth noting that both these companies have moved some way away from the original idea of a P2P lender where the lenders were part of the crowd. Lending Club has moved to a model of significant institutional involvement and investment, where the loans are initially made by banks, then purchased by Lending Club, then securitised. Funding Circle has a considerable number of institutional investors lending through its platform, including the UK Government's British Business Bank.

On the equity front, profitability is a rare creature indeed; it may, in fact, be mythical. Of greater concern to the development of the market, there have been an insignificant number of companies who have received equity financing through a crowdfunding platform who have moved on to needing an exit from that, via another financing mechanism. A Dutch company went through an IPO of sorts, with the equity in the company being tradeable through another electronic platform.

Future influences

There are four main factors that will influence the future development of crowdfunding. These are:

- *Interest rates*: for almost the whole of the existence of crowdfunding, interest rates in developed markets have been at historic lows. While they remain low, crowdfunding will remain a relatively attractive investment in many countries. And the loans offered through crowdfunding sites can be at relatively low interest rates. Looking 10 to 15 years ahead, one has to assume that interest rates will have returned to more ‘normal’ levels, else the developed world economy will likely all have stagnated like Japan. With higher interest rates will come more competition from other investments, and greater loss rates (for loans);

- *Institutional participation*: as noted above, it is difficult to see many crowdfunding platforms being able to reach a viable scale based solely on the investments of individuals in the crowd. To fund enough lending (or other forms of credit) and to provide enough equity institutional participation appears to be essential. But what type of institutions? We are already seeing banks buying stakes in P2P lending platforms, or investing through platforms rather than through their own branch networks. We also see other, less traditional, credit providers investing through platforms, such as fund managers and insurers. This is, perhaps, all part of the diversification of credit supply in many countries;

- *Regulatory climate*: regulators have been keen not to stifle FinTech developments at birth, but to encourage them as, in theory, there are potential benefits for consumers and for the economy. But problems in a number of countries, including the US, China, Finland and the UK mean that it is likely regulators will tighten up on their ongoing oversight of platforms. It is also highly likely that further regulation will come into this sector once the potential impact on financial stability is fully thought through. If platforms, and other new market mechanisms, are replacing banks in some areas of credit provision, then the potential systemic consequences of that will lead to greater regulation; and

- *Deal flow*: as already discussed, the key issue for all crowdfunding platforms is the volume of deals they can source and process, without investors losing too much money. Sustainable profitability likely requires platforms to replace banks in a greater proportion of credit activities than has been the case so far.

Assumptions and Conclusions

I think it is reasonable to challenge the assumption that crowdfunding will change the way finance is conducted. For lending, crowdfunding is not the disruptor it is perceived to be and will develop into a niche proposition for investors with high-risk tolerance or risk blindness. Incumbent banks will bring institutional money to bear and will continue their dominance of lending markets. They will likely over the coming years take stakes in crowdfunding platform operators. In the same way that Multilateral Trading Facilities were expected to be the disruptors of the existing hegemony of exchanges, when in fact they merely brought fees down at the cost of fragmentation, so loan crowdfunding will become the banks' distribution channel. It won't really change the game.

Similarly, the business model for equity crowdfunding never really existed and this model will disappear in its current form. Holding periods are too long, transactional activity too low and capital amounts involved too small to make for a profitable business case.

Is this the only possible outcome? Of course not. But if we look at crowdfunding platforms as technology companies, rather than as financial brokers, then the key issue in nearly all technology markets is scale and market share, to establish a dominant position. Where is the Google, the Amazon or the Facebook of crowdfunding? It is possible that such entities will emerge at a national level, and establish a dominant position that provides enough scale to ensure ongoing profitability. Indeed, a number of crowdfunding companies, such as Funding Circle, fall into the category of 'unicorn', or a technology business that is private but valued at over USD 1 billion. But regulation will likely prevent the emergence of an international standard-bearer, such as Facebook.

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