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The future of crowd-sourced funding in the UK

Policy briefing

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The Big Innovation Centre is an initiative of The Work Foundation and Lancaster University. Launched in September 2011, it brings together a range of companies, trusts, universities and public bodies to research and propose practical reforms with the ambition of making the UK a global open innovation hub as part of the urgent task of rebalancing and growing the UK economy, and with the vision of building a world-class innovation and investment ecosystem by 2025. For further details, please visit www.biginnovationcentre.com.

A new way to finance business

Peer-to-peer lending and equity crowdfunding platforms provide online marketplaces which link individuals and businesses to small-scale investors. These fast-growing online marketplaces for equity and for loanable funds offer the prospect of an alternative source of funding for small businesses as well as new business opportunities for the digital firms that create and run them. But there is concern that users of the sites are not adequately protected. As well as leaving users open to fraud and mismanagement of their money, the growth potential of responsible and useful platform operators could be stifled if potential users are put off. In this context, the Department for Business, Innovation and Skills (BIS) has recently announced its intention to look at the possibility of regulatory reform applying to the area as part of its wider efforts to support the development of innovative markets and business models in the UK[1].

The prospect of alternative sources of credit or funding looks particularly tantalising in the context of current belt-tightening on the part of traditional suppliers such as banks and venture capital funds. But the benefits of a thriving sector go beyond the current economic situation; these mechanisms may one day exist as a key part of a well-functioning financial services ecosystem alongside more traditional institutions. The expansion of affordable borrowing or funding opportunities could extend critical investment money to firms in other sectors. Of particular interest is the effect of the platforms on the funding landscape for SMEs and start-ups. And the platforms are employers and value-creators in their own right; early leadership in the field might help to give the UK a competitive advantage that allows them to sustain their growth into the future.

The aim of this note is threefold: first, it is intended to inform readers about innovative new financial services, second to explain the effects of the current regulatory system on the operation of such platforms, and third to make the case for greater formal oversight of the sector in order to safeguard its future growth. As such it focuses on peer-to-peer lending and equity crowdfunding as two areas which have proven growth potential and generated policy debate both in the UK and overseas.

Peer-to-peer lending platforms facilitate the arrangement of micro loans between individuals. Borrowers can access their desired amount of credit by tapping into the loanable funds of a large number of lenders with distinct repayment terms being agreed with each. In effect the platforms offer a marketplace for loans which allows borrowers to crowd-source credit in small chunks and lender to pool risk. The challenge, however, will be growing the supply of lenders.

Crowdfunding platforms are similar in that they allow users to raise a given amount for an advertised product or project through payment from multiple sources. However, funding

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1 September 2012 BIS Report, Removing Red Tape for Challenger Businesses
http://www.bis.gov.uk/assets/biscore/enterprise/docs/r/12-984-removing-red-tape-for-challenger-businesses

arranged through the best established platforms is in the form of donations; if there are tangible rewards for funders these will be in the form of access to the finished product or associated merchandise as opposed to financial in nature. The model tends to favour creative projects and consumer products due to their capacity to capture the imaginations of funders and/or to operate as a sort of early-stage pre-order system. Similar platforms for the sale of equity in projects are intended to combine this mechanism for mass appraisal of ventures with the further incentive for backers of a financial stake in outcomes.

The first part of this note summarises the current situation for firms seeking credit and explains in greater detail the workings of peer-to-peer lending platforms from the perspective of both lenders and borrowers. It then discusses the possible systemic impact of the new marketplaces and the case for regulatory reform aimed at building confidence amongst its potential users. The second section covers the current opportunities for SMEs to gain funding in return for equity and provides further detail on the recent expansion of crowdfunding on a donations model. Using recent legislative developments in the US as an example, we explore the potential for new investment models straddling the middle ground between these funding mechanisms and stress the need for regulatory clarity if such platforms are to have the best possible chance of success in the UK. The final section discusses the steps that are already being taken by the government and the case for regulatory reform.

Peer-to-peer Lending

The Bank of England's July Lending Report[2] shows that the amount of lending available to small and medium-sized firms continued to decline in the quarter up to May 2012. The extent to which this can be explained by banks being unwilling to lend is unclear; we would expect firms to defer investment spending during a downturn. But the decline in total lending, as well as the increased gap between interest rates on loans offered to small and large firms[3], does suggest that the barriers to credit faced by SMEs in part results from market failures that have been exacerbated by the on-going banking crisis.

The Big Innovation Centre has previously argued that the ability of banks to move risks off balance sheets through securitisation creates a bias against activities that, like lending to SMEs, cannot be re-categorised, and this bias is further exacerbated in the case of firms whose assets are intangible and thus harder to assess using credit scoring models.

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2 Trends in Lending, July 2012
http://www.bankofengland.co.uk/publications/Documents/other/monetary/trendsJuly12.pdf
3 Trends in Lending, April 2012
http://www.bankofengland.co.uk/publications/Documents/other/monetary/trendsApril12.pdf

Innovative sources of credit could, by changing the cost structure attached to providing loans, create sustainable new markets in which such firms are able to source funding at competitive interest rates.

How does P2P lending work?

The P2P Finance Association[1] defines peer-to-peer finance providers as 'platforms that facilitate funding via direct, one-to-one contracts between a single recipient and multiple providers of funds, where the majority of providers and borrowers are consumers or small businesses.' Although the bulk of the lending has been to consumers, platforms specialising in connecting companies to lenders have grown rapidly. Funding Circle[1] is one such platform. It has arranged loans to businesses of a total value exceeding £50 million.

Funding Circle's variant of the P2P model screens businesses for credit information and uses this to give them a grade from A+ to C or reject them. For loans of over £100,000company assets may be taken as security. This rating is provided to potential investors on the website alongside information regarding the rates of bad debt for each band, as well as a target interest rate set by the borrowing company and minimum rate set by Funding Circle based on the assigned band. Details of any previous loans taken by the company using the platform are available.

Users 'bid' to lend by specifying the amount of money and interest rates they are willing to offer. Once the company reaches 100% of its target those lenders with the highest proposed interest rate are eliminated with each successive lower bid. Once bidding is closes the rate repayable by the borrower, via the platform, is determined by taking an average of the rates offered by lenders weighted by the size of the attached funds.

1 http://www.p2pfinanceassociation.org.uk/

The peer-to-peer lending model has potential for substantial savings in loan co-ordination. By effectively bypassing many of the fixed costs attached to the traditional banking model platforms are able to offer higher interest rates to lenders at a profit. For many of them the service acts as a substitute for traditional savings accounts held with banks, which offer lower interest rates. In turn, lenders have a larger surplus which they are able to cut into in order to offer more attractive rates to borrowers. Requiring lenders to bid for the opportunity to lend provides a neat incentive for them to do so.

Interestingly, the rates offered by Funding Circle appear to be higher than the indicative median interest rates offered to SMEs. The Bank of England's lending report has these at between 4-5% for 'smaller SMEs'. The average interest rate agreed for loans arranged with Funding Circle is 9.1%, with even higher rates for those borrowers in higher risk bands.. Effectively it is opening up an entirely new market for loans. The small size and relative youth of the sector mean that as yet we do not have reliable information on the types of firms who are seeking and obtaining the loans. It is therefore unclear whether borrowers are

typically businesses who have found themselves turned away by banks or which have chosen to borrow peer-to-peer for other reasons – sites advertise the speed with which loans can be arranged, for example. We also do not have the data to compare the term structure and repayment schedule of loans offered by the platform and by banks. Therefore we do not know at this time whether lending arranged using peer-to-peer platforms is replacing traditional credit arrangements or acting as a complement to them.

That said, whoever the loans are going to, the growth of alternative sources of lending could lead to a more resilient financial system if it means that a crash in banking activity is not in effect a crash in the availability of all credit opportunities. Beyond the crisis, innovations that cut costs and consequently offer competitively priced options to businesses might provide the impetus for traditional lenders to improve the terms of their loans.

However there is a major limiting factor to any potential explosion in peer-to-peer activity; credibility. Currently regulators do not have a remit to investigate and audit the internal processes of platforms. Combined with the fact that lenders are not covered by the Financial Services Compensation Scheme (FSCS) should debt go bad this means that for potential lenders the use of such platforms is perceived to carry a greater risk than traditional alternatives. Platforms are regulated by the Office of Fair Trading (OFT) but not the Financial Services Authority (FSA). UK banks offering savings accounts to consumers are scrutinised and the FSA is able to initiate interventions at an earlier stage should savings be threatened by risky behaviour or otherwise. This adds an extra safeguard for savers. In contrast, integral elements of the business models of peer-to-peer platforms are not assessed by regulators and hence if there were weaknesses here there would be no mechanism in place to ensure outside intervention.

The splitting of loans between many parties who each have only a small stake in the outcome presents a challenge for regulators that is distinct from traditional means of private placement of debt. When lenders have a large stake in the outcome of a deal, it can be reasonably assumed that they will perform some kind of due diligence of the borrower. There is a direct link between this process and returns on investment. With very large numbers of lenders it becomes prohibitively expensive for each lender to perform thorough checks. Users of peer-to-peer lending platforms must therefore judge that operators have an incentive to assess borrowers in a way that holds their interests to be central.

While platform operators have the incentive to ensure that interest rates are well matched to risk in order to enhance the reputation of the process and thus win more commission in the long term, it is not inconceivable that others might set up platforms that do not aim to be sustainable. If enough money can be made by taking commission for the arrangement of loans to cover the platform's operating costs, it could be profitable to arrange them indiscriminately, if only for the short period before lenders realised the unreliability of the risk-assessing mechanism. Businesses who take sensible steps to match the risk that is presented to lenders to the actual risk will not reap the full benefit of these efforts if there is no credible way to distinguish them in the eyes of lenders from those who are not providing due diligence.

Providers differ in their approach to the problem. Some emphasise that risk is held by the lender. Ratesetter, another specialist in loans to individuals, have a 'provision fund' which will pay lenders in the event of default or late payments. This currently stands at double the estimated value of bad debt. Zopa[4], a provider of loans to individuals, has called for tighter regulation, including minimum capital standards, FSA approval of directors and checks on risk controls.

This lack of clarity is a problem. In new areas of economic activity the development of the market is conditioned by a number of social and economic factors. Our forthcoming work on making markets highlights the important role of government in the form of regulations and standards. These promote the confidence and competition that are necessary for a market to thrive. Clarity on the legal requirements and associated sanctions placed on such platforms could reassure investors as to the standard at which platforms are operated, while closer scrutiny of their business models could help prevent damaging failures. The government's creation of a new Working Group to monitor the sector and examine the potential for regulation is an important first step. More details and discussion of its announcement can be found on page 11.

Selling equity to the crowd

As the Big Innovation Centre has discussed previously[5] many potentially high-growth firms, particularly start-ups, can find obtaining access to bank lending difficult. For some, barriers will extend to lending with peer-to-peer channels. For example, young start-ups do not have the borrowing record to satisfy credit checks, and the nature of some projects is that they will only produce profit after a protracted period of investment that is longer than the loan period offered. Given these problems, securing investment in return for equity might present a better opportunity for many. However, there also exist a number of hurdles for those who seek funding via this route; research by Nesta found that investment activity on the part of venture capital funds was lower in 2010 than after the dotcom crash[6], while the high costs associated with public offerings make them an infeasible option for many.

In the run up to the financial crisis venture capital funds had offered funding to firms deemed to hold the potential for rapid growth, particularly those in sectors such as technology or healthcare. Operators of such funds may be better able than banks to value intangible assets because of their specialisation in particular sectors. Equally, specialisation may actively add value to a project by offering the expertise, mentoring, and contacts associated with the investor. In the period before the downturn US venture capital funds had an impressive track record of backing firms that would go on to achieve high growth in value and in the numbers they employed, particularly in the case of technology firms. However,

4 http://uk.zopa.com/
5 Hutton and Nightingale, The Discouraged Economy
http://biginnovationcentre.com/Assets/Docs/Reports/The%20Discouraged%20Economy.pdf
6 Yannis Pierrakis, Venture Capital: Now and After the Dotcom Crash
http://www.nesta.org.uk/library/documents/Venture_Capital.pdf

fundraising for venture capital schemes has been hit hard by the current crisis, as has the speed at which funds are able to make a return on their investments.[4] In combination, these factors have produced a fall in the total available funding for smaller firms.

This scarcity of private backers has not prompted an increase in public offerings as a response. There are a number of factors that might deter SMEs from going public. The fixed costs of an IPO are high and the smaller the firm the bigger these costs are in proportion to funds raised. The secondary market for securities is less well developed, meaning that the share price may be unreflective of the value of the firm if institutional investors place a high value on liquidity. Additionally, a move towards public ownership may reduce the steering power of the company's founders without the compensating factor of the sorts of expertise that may be on offer from angel or venture capital investors.

Bucking this trend, some businesses have received funding crowd-sourced using platforms such as the US-based Kickstarter[7]. Many project operators advertise donations as being purely charitable, but where feasible donors might get some tangible return in the form of products or exclusive content. Others might be offered input into the project, one example of such a scheme being 'Interstellar Marines'[8], a videogame currently under development in Denmark. The game can be pre-ordered and users can donate further at their discretion in order to gain badges and access certain privileges related to the online community. Supporters have differential access to mini-games and other content, such as demonstrations of newly designed guns that will be available in-game. These features, as well as funding, are provided and arranged over the developer's own website rather than using a Kickstarter-style platform. Kickstarter has announced that it will be open to UK-based projects from the end of October.

The emergence of such initiatives offers a promising opportunity for some SMEs to tap into new sources of finance, and is to be considered a positive development as a result. However, empirical data on the relationship between successful fundraising via such platforms and the demand for eventual products is unavailable. UK Interactive Entertainment has argued that the model may favour franchises and developers with an established fan-base[9]. Plus, the products-as-rewards approach to seeking donations does not act as a direct link between its productive potential and the amount of funding offered, especially where users see the potential for commercial success without wishing to own the product themselves. Investors who are knowledgeable about a given industry might spot a gap in the market for a product or service even if they do not themselves fall into the targeted demographic.

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7 http://www.kickstarter.com/
8 http://www.interstellarmarines.com/
9 UKIE Crowd Funding Report - A Proposal to Facilitate Crowd Funding in the UK - February 2012
http://ukie.org.uk/content/ukie-crowd-funding-report-proposal-facilitate-crowd-funding-uk-february-2012

Equity-based funding offers to address these gaps in provision and produce a direct link between funding for a project and the perception of its likely profitability on the part of funders. However, in the UK as with the US there are regulatory barriers to the creation of a large-scale equity funding platform in the Kickstarter model. The recently passed Jumpstart Our Business Startups (JOBS) Act contains a number of provisions aimed at easing the regulatory restrictions on such securities.

Taking inspiration from the JOBS Act

Currently a company must register any securities it issues to US investors with the Securities Exchange Commission (SEC) unless it sells them exclusively to accredited investors. An individual must satisfy a number of conditions to qualify as an accredited investor; typically s/he must have a net worth of $1million or above or have earned at least $200,000 per annum for the previous two years.

This leaves would-be crowdfunding platforms two options. On the one hand they could go through the administrative process of registering shares for each company funded, a strategy that is likely to necessitate self-defeating charges on participating firms in order to cover costs. Alternatively they could limit the pool of investors to a minority of the population, contrary to the concept of crowdfunding.

The JOBS Act aims to rectify this by granting a number of exemptions from SEC oversight. Crucially, securities may be sold to ordinary members of the public with limited SEC scrutiny provided that the total raised by each offering does not exceed $1million and the total invested by each individual does not exceed the lesser of $10,000 or 10% of his/her annual income. The issuer, be it an intermediary body such as a crowdfunding platform provider or the company itself, must provide appropriate warnings to investors as to the nature of the risks they are taking on and must outsource the management of cash to a registered dealer or broker. The issuer must state a target amount and deadline for fundraising and ensure that the third-party custodian does not pay out to the company until at least 60% of the target has been reached. Finally, securities of this nature cannot be transferred during the year after the purchase date unless it is to either the issuer or to an accredited investor.

The situation in the UK

With respect to equity crowdfunding the regulatory system in the UK shares some similarities to that of the US. The Financial Services and Markets Act prohibits the promotion, rather than the sale, of financial products such as shares to those who are not self-certified as having specialist investment knowledge or high worth (holding at least £500,000 of assets). This means that a company can advertise an equity sale as long as the details of the equity offer are available only to those eligible under these criteria. Separately, the EU's Prospectus Directive requires that any issuance of shares to non-sophisticated investors must be accompanied by a prospectus unless it meets a number of conditions, the most

relevant in the case of crowdfunding being a requirement that the number of investors from each member state is fewer than 150.[10]

In the UK there are already two equity-based platforms, Seedrs[11] and Crowdcube[12], suggesting there may be some wriggle room for equity crowdfunding already. Investment in private companies is regulated lightly, but there are stricter rules for public advertisement of investment opportunities, and this is the category into which the equity crowdfunding model would fall if it was to make investment available to the widest possible audience. Ross Dawson and Steve Bynghall split the crowdfunding models available under current regulation into three typologies; selling to a private network, selling to highly qualified investors, and indirect investment in the business through a separate vehicle. [13]

Seedrs has obtained FSA authorisation to arrange crowdfunding for collective investment schemes, and is 'approved subject to capitalisation'. There is an exemption allowing it to promote unregulated schemes so long as its services are available only to those knowledgeable in the area. This will rely on discretionary vetting on the part of Seedrs, which limits the pool of investors and imposes additional costs to transactions. The vetting process appears to take the form of an online questionnaire to be filled in by potential investors. So far the platform has facilitated the funding of four pitches in return for equity. Taking another approach, Crowdcube have found a way to operate a platform that handles equity crowdfunding without a need to vet investors, something which has required a lengthy development process and access to legal expertise. Dawson and Bynghall categorise it as a platform that sells debt or equity to a private network. As of July the platform had raised over £3.9million for 24 projects.

While these developments demonstrate the viability of online platforms as a way to arrange equity transactions, the situation is far from ideal. Unlike the system that is aimed for in the JOBS Act, platforms must either narrow their investor base or be subject to complex and opaque legal requirements that may act as an effective barrier to entry for new operators.

The case for change

The UK appears to have an early mover advantage in this area and as we have argued elsewhere, has a banking system which poorly caters to some of our most innovative firms. We should wholeheartedly embrace any actions with the potential to support these operations, and to build confidence in them. Yet, the analysis above points to significant challenges for the sector. In both the case of peer-to-peer and equity crowd-funding it seems clear that greater clarity as to the legal requirements of firms who are seeking to operate such models is needed.

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10 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX%3A32003L0071%3AEN%3AHTML
11 http://www.seedrs.com/
12 http://www.crowdcube.com/
13 Getting Results From Crowds, Ross Dawson and Steve Bynghall. 2011

The government has acknowledged this agenda in the recent *Removing Red Tape for Challenger Businesses* report, which details a number of measures designed to tackle the problem. Most significant amongst these is the creation of a working group comprising members from the Treasury, BIS, the FSA, the OFT and the Cabinet Office which is tasked with monitoring the sector's development and examining the case for regulation.

Separately, the announcement confirms the details of a scheme, first announced as part of the March budget, to make a Business Finance Partnership fund worth £100m available to bids from peer-to-peer lenders. This followed the recommendations of Tim Breedon in March 2012[14]. Both moves show that the sector's growth is on the government's agenda, a development which is to be welcomed.

However, the view on regulation is that at this stage it should be light-touch in order to allow the as-yet immature market the freedom to grow. The argument is that further administrative and capital requirements for operators in the peer-to-peer space could prove too burdensome for potential new entrants, and inadvertently preclude business-models that might otherwise flourish. The announcement also makes the case that while credibility is a challenge for the growth of the sector, the cost of rectifying this situation should fall on companies themselves.

The challenge is that regulation in this field is inherently difficult to develop. The lending organisations can not be regulated as banks, capital requirements would for example be meaningless here. Similarly the peer-to-peer funding models do not operate like traditional stock markets. Furthermore, regulation tailored specifically towards the business models currently used by platforms could risk preventing alternative and as-yet unknown approaches from flourishing. Clearly, if there is to be greater oversight of the sector it should not be on the same scale nor as prescriptive as in the case of other financial services. Relative to these sources of funding the amount being dealt with is small, and so the systemic impact of poor regulation would be negligible.

Unfortunately there are significant risks associated with the limited approach. The unprofessional or fraudulent operations of one single organisation in this area could damage the reputation of the sector, and slow its development. Alongside the Task Force there is a need to set up a more practical flexible monitoring group with the expertise to supervise this companies acting in the sector. This would allow for early warnings of, and possibly interventions into dubious practices while being nimble enough to always keep one step ahead of the game.

The impact of regulatory reform in this area will be hard to judge. But financial innovations will proceed with or without targeted regulation, and if policymakers are to ensure that innovators are best able to provide vital funding to high-growth firms while lenders, investors

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14 Bosting Finance Options for Business, March 2012
http://www.bis.gov.uk/assets/biscore/enterprise/docs/b/12-668-boosting-finance-options-for-business.pdf

and recipient businesses are adequately protected, it will be crucial for them to keep a close watch on developments and the potential opportunities for regulatory improvements.

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