



# Crowd-funding: Business models and regulatory implications

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# Agenda

1. Introduction to crowd-funding
2. Nature of FR crowd-funding
3. Analyses of the industries
4. Investor protection concerns
5. Regulatory regimes of FR crowd-funding
6. Conclusions

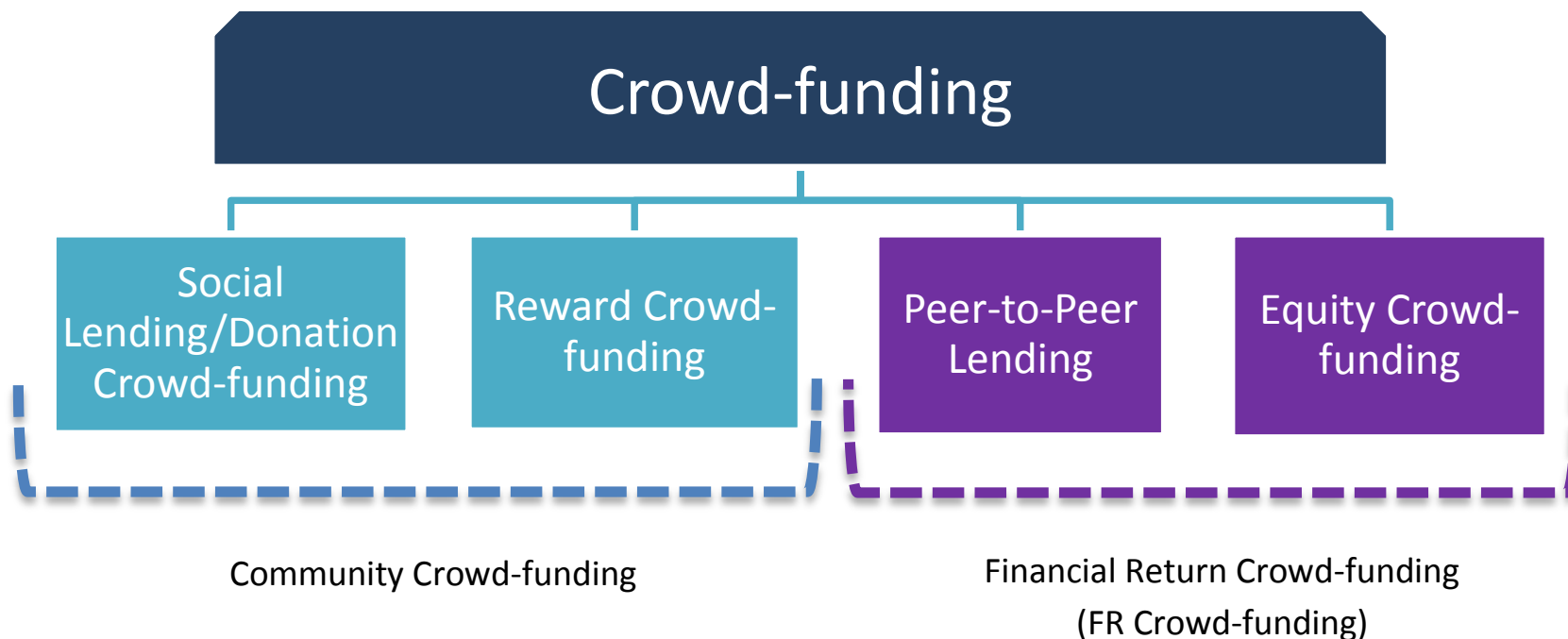
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# Introduction

- 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
- Four Distinct Industries:
  - Donation Crowd-funding
  - Reward Crowd-funding
  - Peer-to-Peer Lending
  - Equity Crowd-funding

# Crowd-funding: four sub-categories



Source: IOSCO Research Department

## **FR Crowd-funding**

- Financial Return Crowd-funding (here on 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.



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## **The Financial Crisis**

- FR crowd-funding was made viable by the innovation in website design which allowed contributions from many participants.
- Growth in FR crowd-funding only really begun with the onset of the financial crisis:
  - 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.

## The Financial Crisis

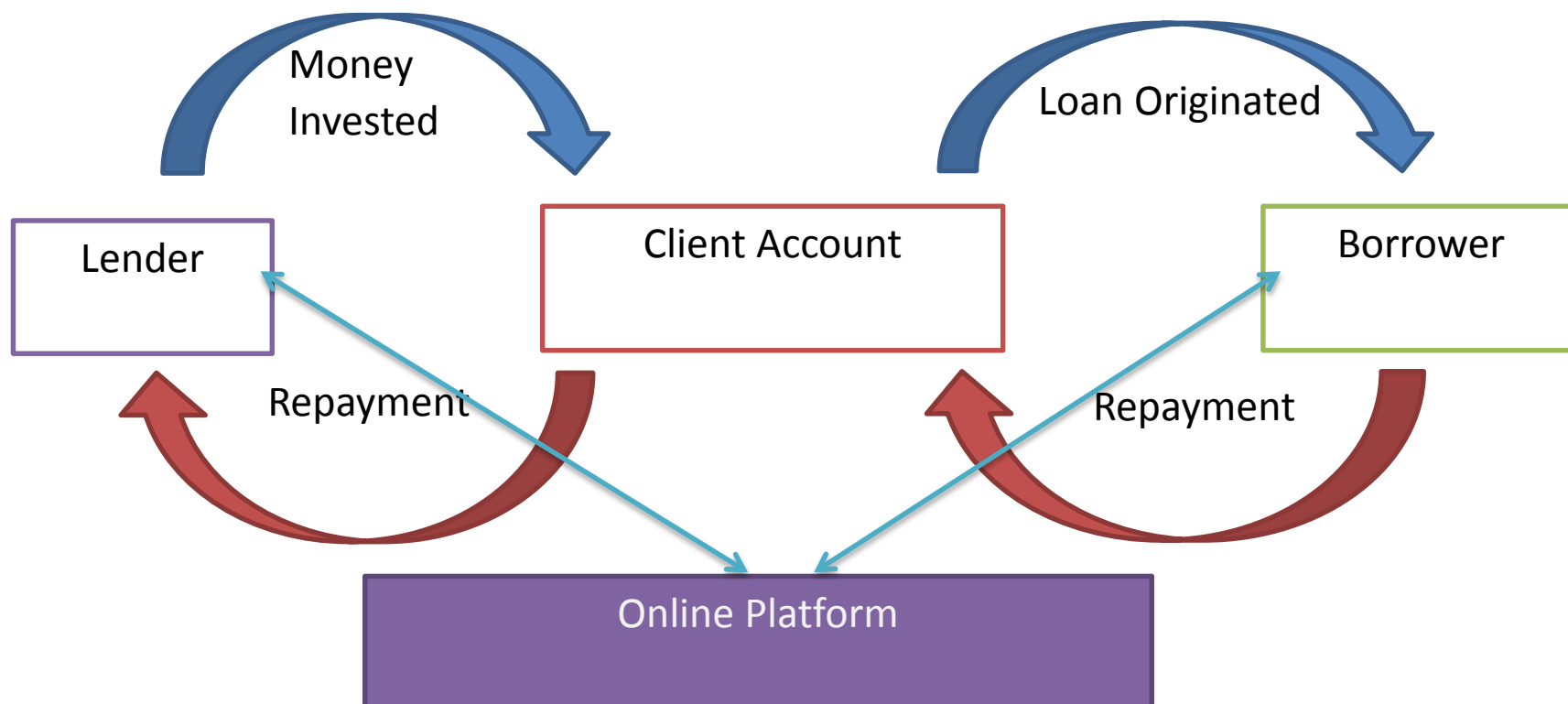
- Peer-to-Peer Lending has developed as a way for borrowers to obtain a loan at a lower interest rate than they would otherwise be able to achieve through using traditional avenues of credit provision.
- Lenders can achieve a higher rate of return than on a savings account or through other traditional 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.
- 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, South Korea.

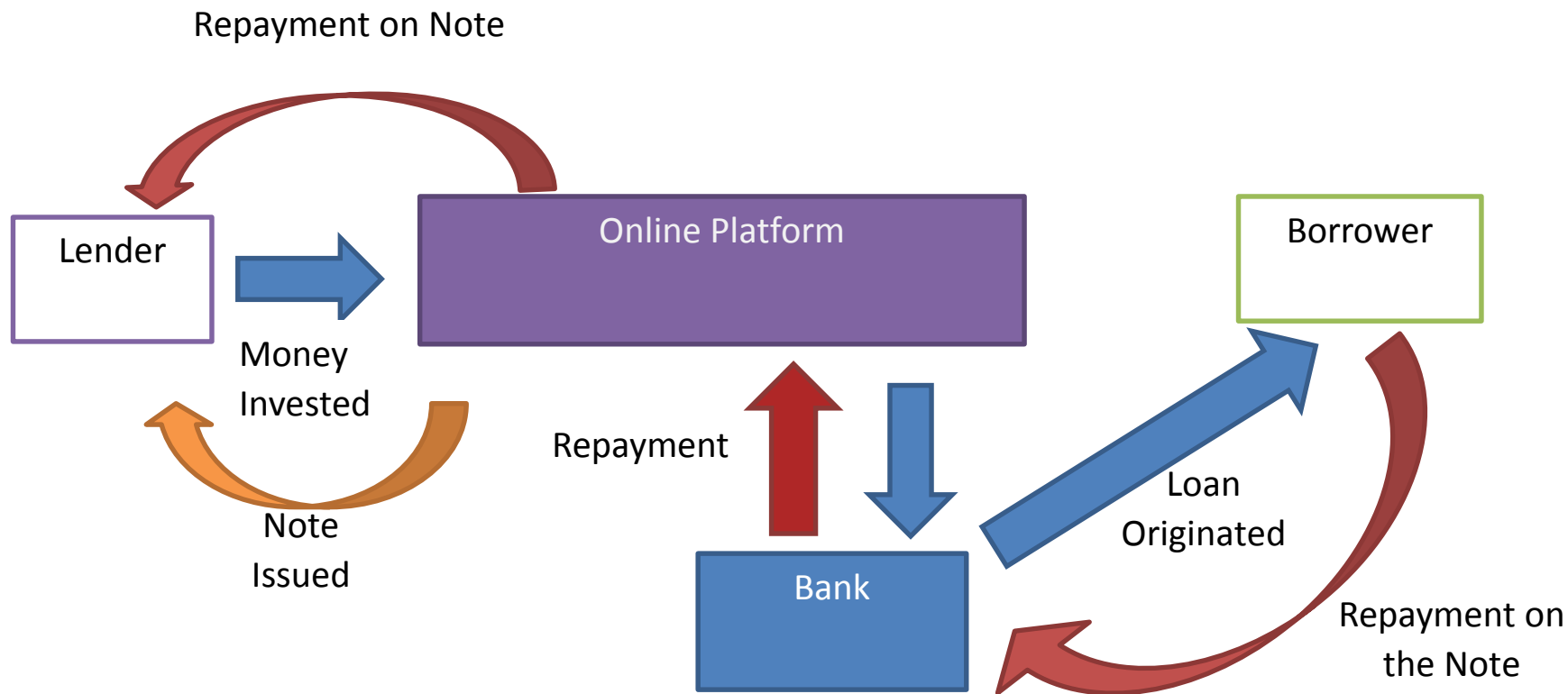
# Business Models

- Client Segregated Account Model



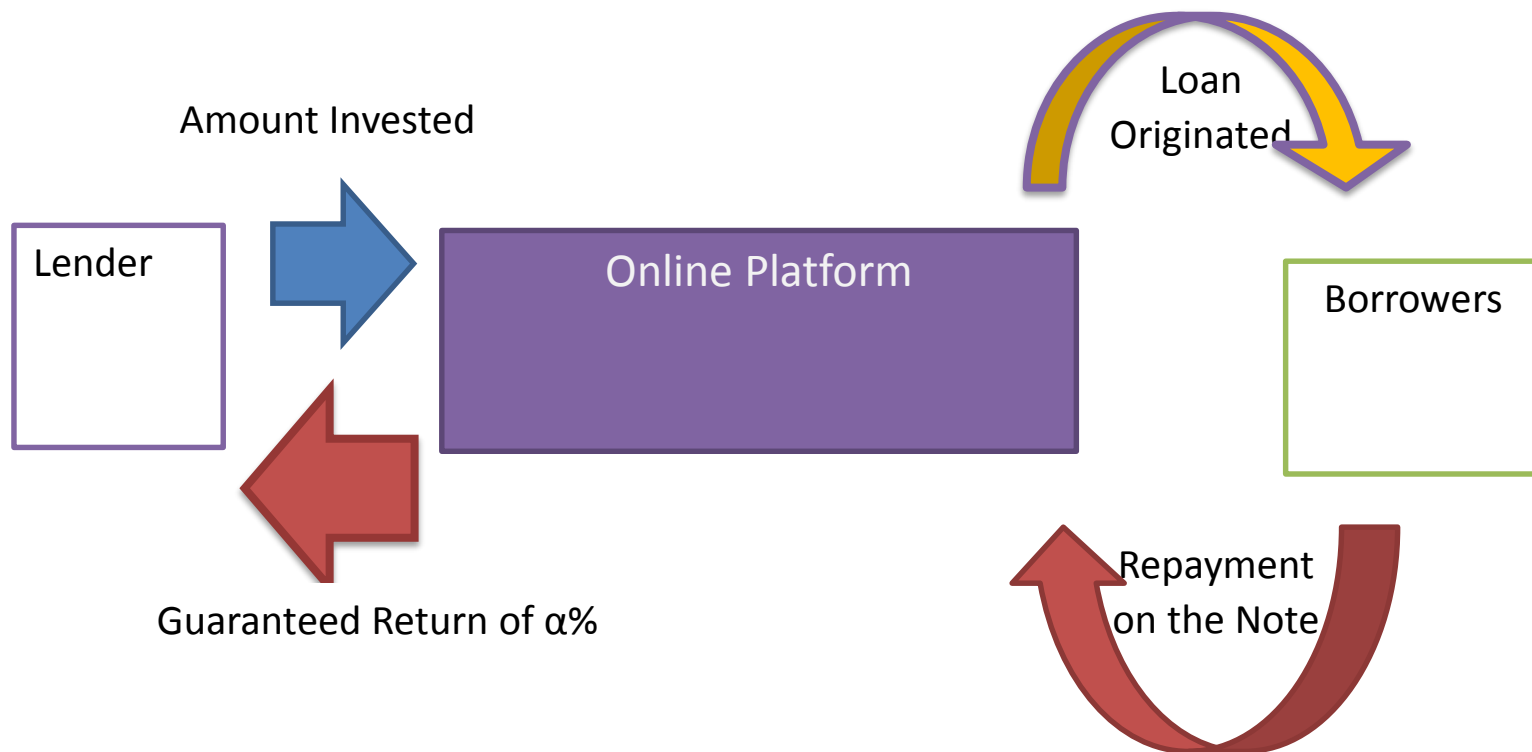
## Business Models (cont.)

- Notary Model



## Business Models (cont.)

- Guaranteed Return Model



## **Business Models (cont.)**

- Equity Crowd-funding is different as it allocates stock equity to investors, with the financial return coming in the form of dividends and/or capital growth.
- Issuer related requirements on location
- Size and offer limits
  - Canada CAD 1.5million per offer
  - Italy < EUR 5million
- Sophisticated and Professional investors restrictions
  - Special case of Israel



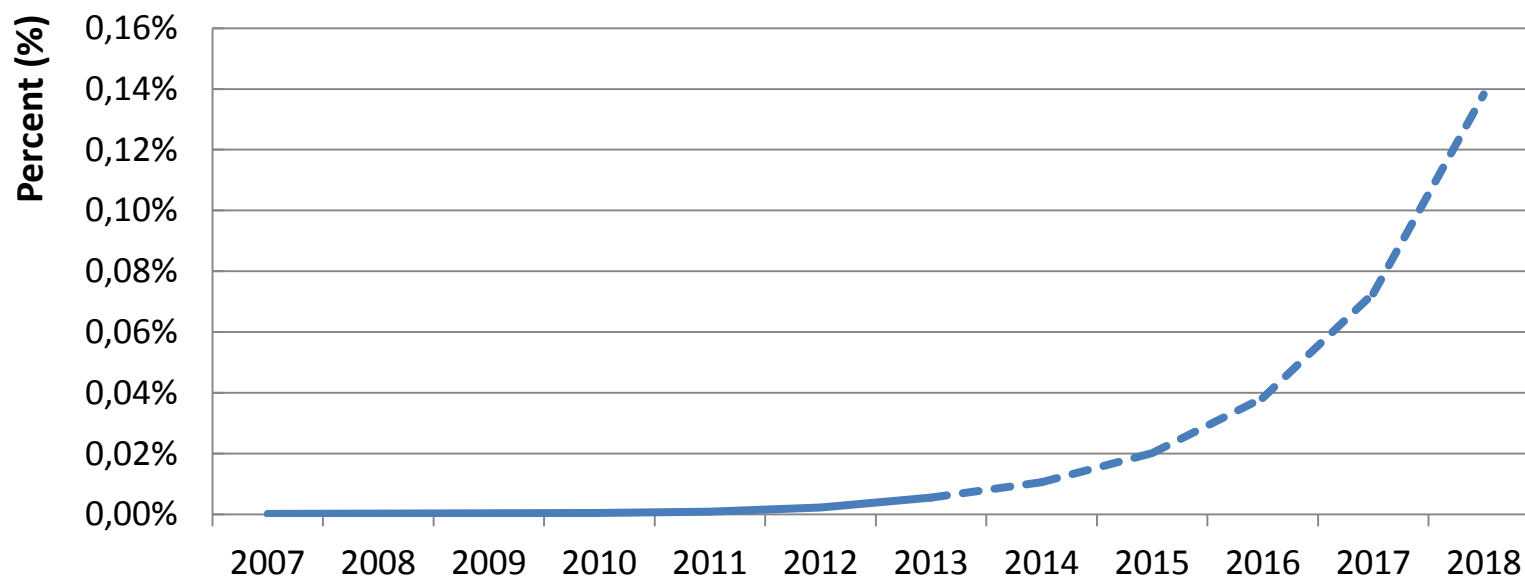
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## Size

- FR crowd-funding market is roughly \$34 billion. (Source: Massolution)
- 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 experiencing exponential growth, 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.

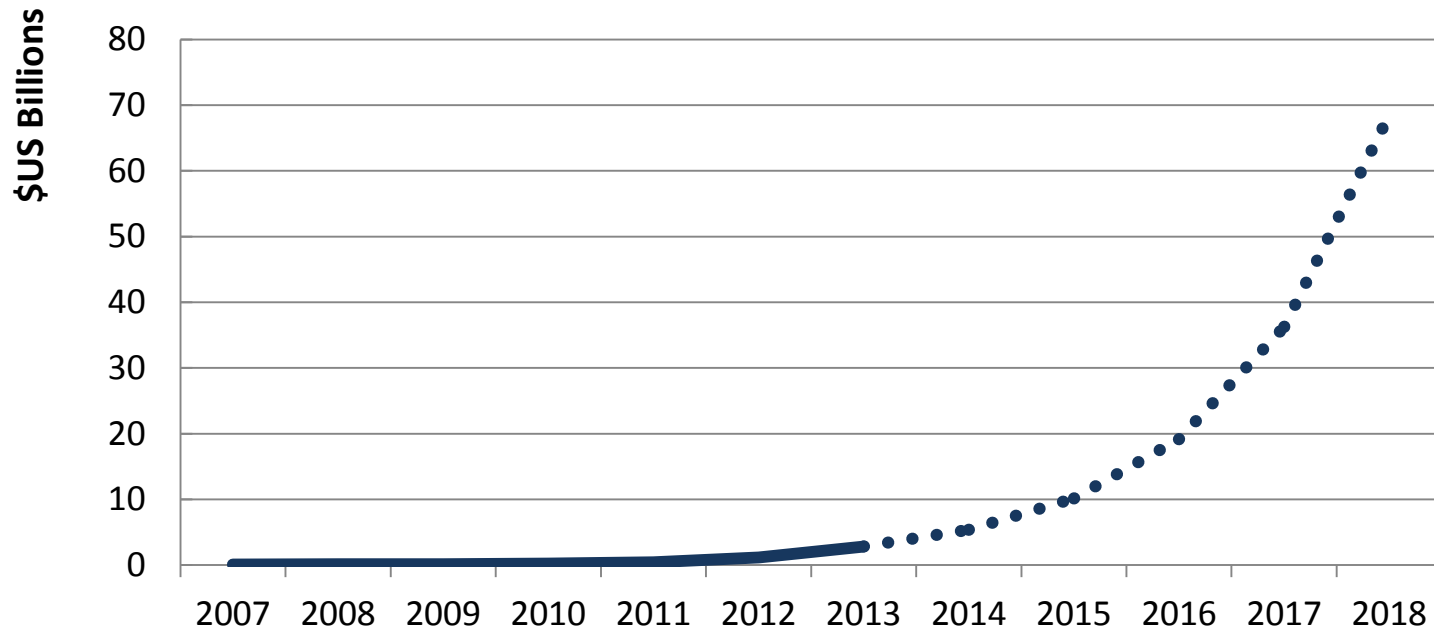
## Crowd-funding loans as a proportion of bank-originated credit to the non-financial sector



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.

## 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;

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# 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 investor protection, 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.

## **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.

# Interconnectedness through securitisation

- 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

- Liquidity
- High risk of start-ups
- Disclosures and truth in reporting
  - General risks
  - Interest rates and expected ROR
- Investment concentration issues
- Reliance of platform credit models
- Cross-jurisdictional issues

## Investor protection concerns and Regulatory investment limits

Jurisdiction	Limitation on investment
Australia (proposed)	A\$25,000 per annum with no more than A\$10,000 in a single issuer.
Canada (Québec and Ontario Regimes)	No more than CA\$2,500 per investment. In Ontario, no more than CA\$10,000 in total under the CF prospectus exemption in a calendar year (higher limits apply to accredited investors).
Canada ("Québec CF regime)	No more than CA\$1,500 per investment in total under the CF prospectus exemption
Japan	¥500,000 in a single issuer per year by an investor per year. ¥100 million per year in an issuer by all the investors in total per year.
Korea (proposed)	200% of the investor's annual income or property ownership. A cap of KRW2 million per issuer and a cap of KRW10 million for a twelve month period. However, there is no cap for sophisticated investors.
Netherlands	€40,000 for lending funding portals and €20,000 for equity/debt funding portals
Spain	€3,000 per offering or €10,000 per year per funding portal, and equity securities cannot contain a derivative component for non-accredited investors.
United States	If either annual income or net worth is less than US\$100,000, then there is a limit of the greater of US\$2,000 or 5% of the lower of annual income or net worth. If both annual income and net worth are equal to or greater than US\$100,000, then a limit of 10% of the lower of annual income or net worth, but not to exceed US\$100,000.

## **Investor protection issues (cont.)**

- Fraud
- Investor experience and Personal biases
- Conflicts of interest

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## High level policy framework

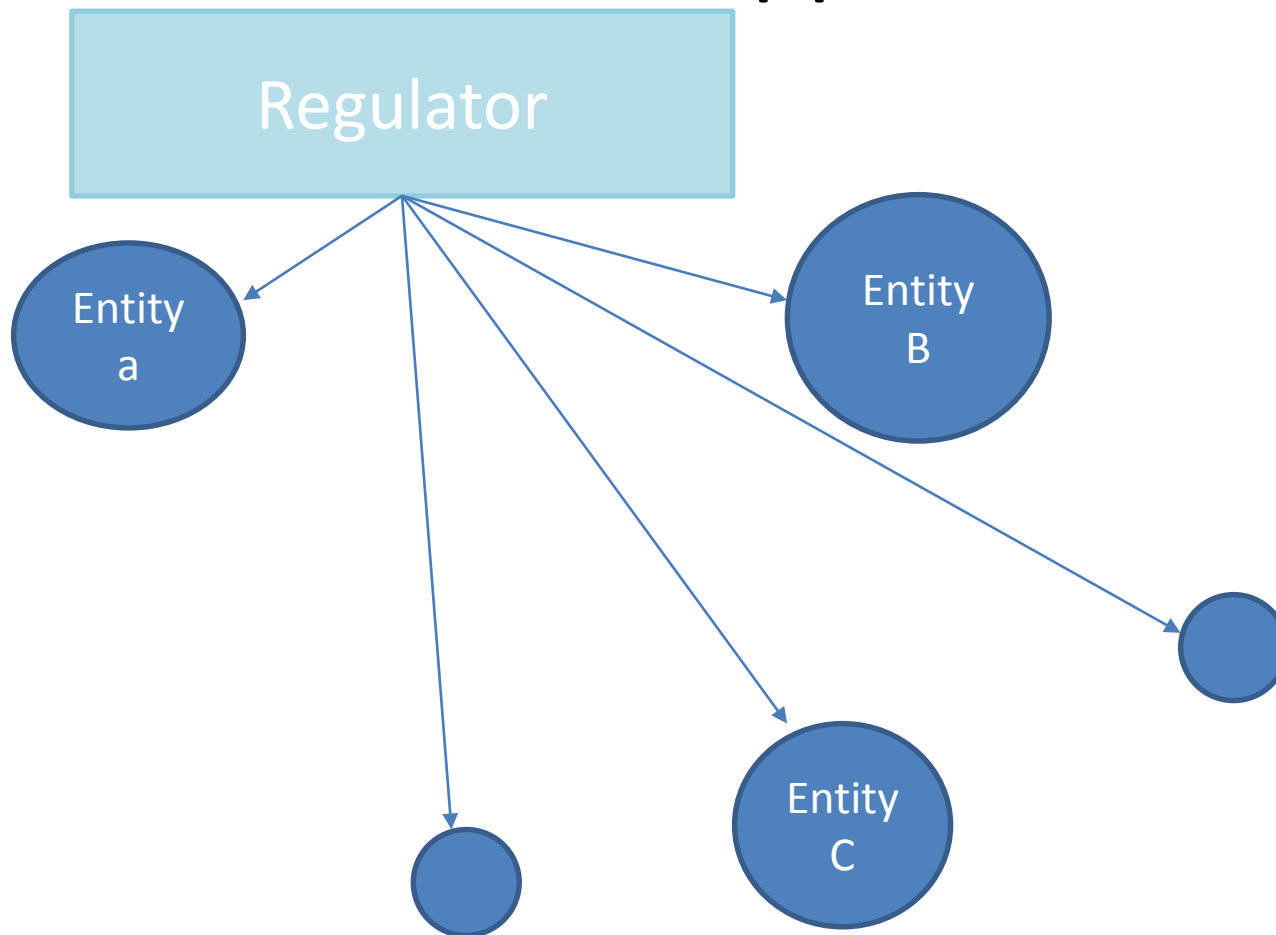
- Authorities should be able to identify the sources of shadow banking risks in non-bank financial entities in their jurisdictions. The focus is on credit intermediation activities by non-bank financial entities that are close in nature to traditional banks.
- They can do this by identifying one of two things (or both):
  - Entities engaged in shadow banking
  - Industry/market wide shadow banking activities

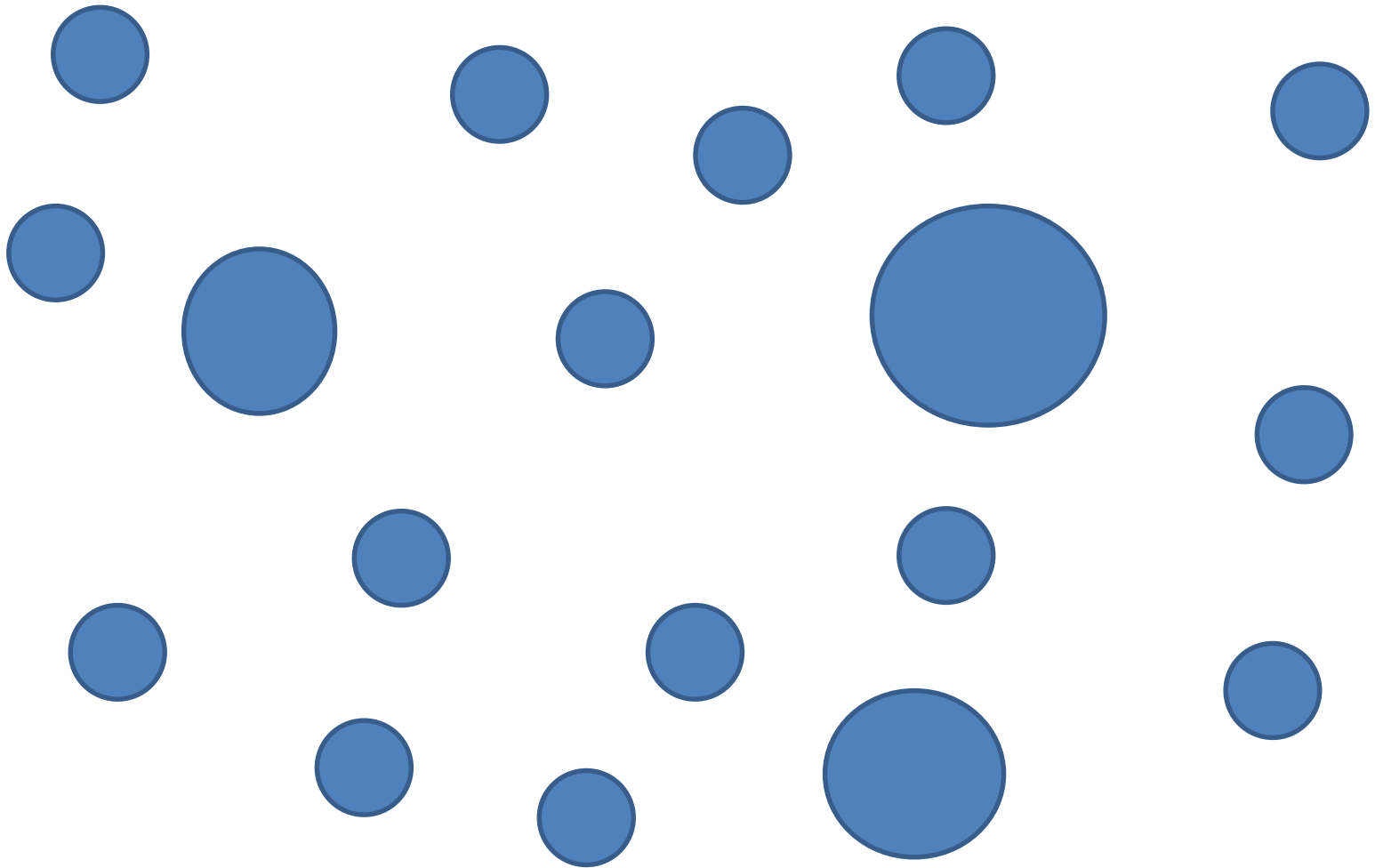
## Policy framework – Entity versus activities

- **Entity** versus **activity based** approach to policy implementation
- **Entity based approach** develops procedures/ regulations/ policy toolkits aimed at individual entities engaged in practices of concern
- Use this approach when there are entities that impose idiosyncratic risks onto the broader financial system



# Entities based approach

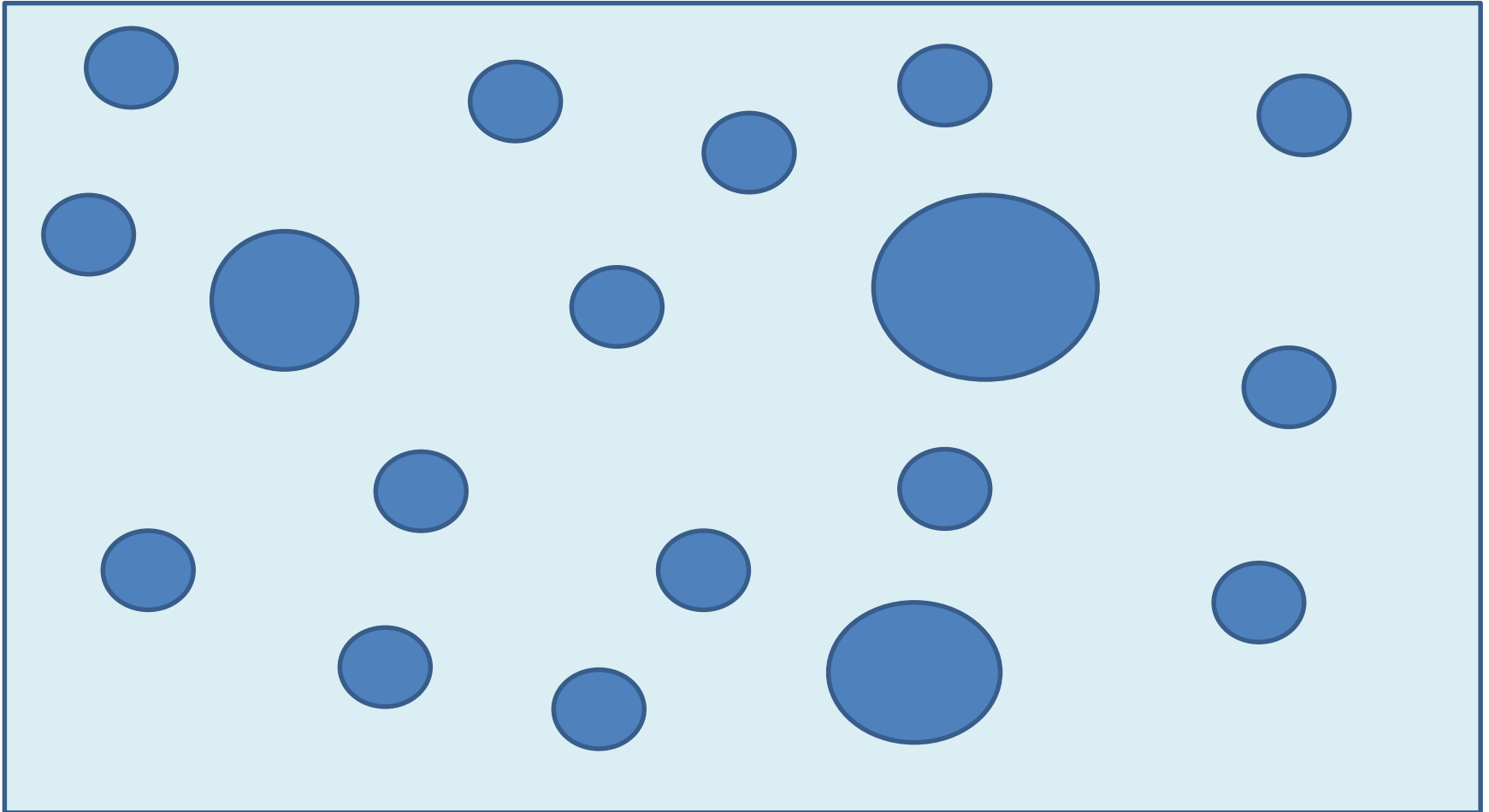




## Policy framework – Entity versus activities

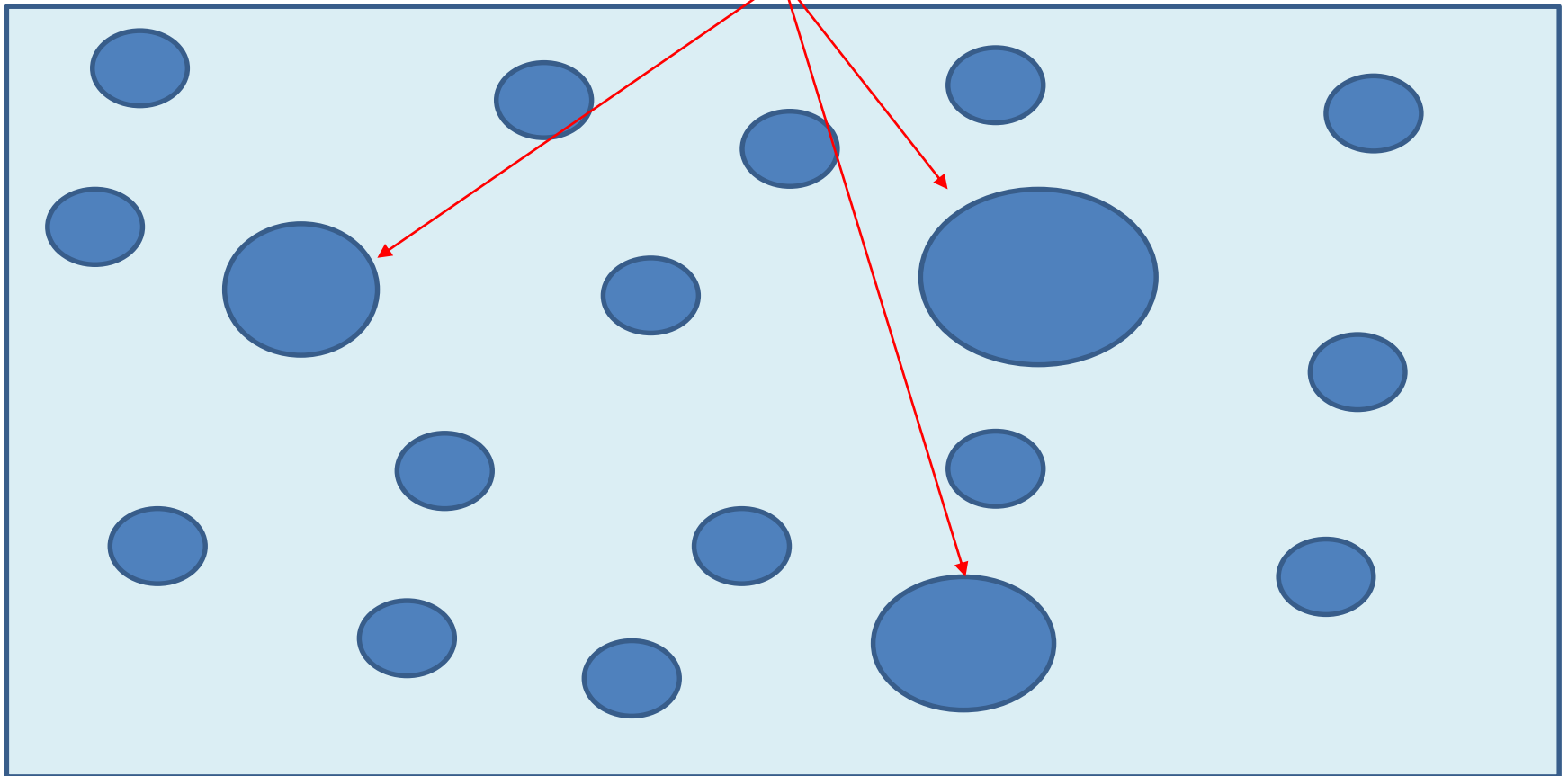
- **Activity based approach** implements procedures/ regulations/ policy toolkits aimed at tackling industry wide practices.
- Approach imposes one-size-fits-all approach on entire industry; used when the cost on implementation is not disproportionate on smaller actors

# Activities based approach



# Hybrid approach

Regulator



# Equity Crowd-funding

- Three trends in regulation:
  1. Prohibited
  2. Not prohibited but 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
    - The number of investors allowed to invest
    - The size of the company issuing the equity
    - Other such regulatory requirements

# Peer-to-Peer Lending

- There are five regulatory regime trends for the regulation of Peer-to-Peer Lending:
  1. Exempt market/Unregulated due to a lack of definition
  2. Regulated as an intermediary
  3. Regulated as a bank
  4. The US model
  5. Prohibited



## Selected FR crowdfunding regulatory regimes

Jurisdiction	Application of regulation
Australia	General securities law applies, licensed, risk management systems, clear risk warning to investors,
Canada (Québec and Ontario Regimes)	Yes, but CF exemption, no platform investment advice. Business conduct rules apply, client segregation of assets
France	Securities law, business conduct and client asset holding rules apply
Korea (proposed)	Less stringent securities laws, business conduct and client holding rules apply
Netherlands	Securities law applies (business model dependant)
Spain	Securities law applies, code of business conduct , licence custodian applied to client assets
UK	Securities law applies (business model dependant)
United States	Securities law applies, registered broker dealer, KYC provisions, segregation of client assets

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## Conclusions and looking forward

- Peer-to-Peer Lending and Equity Crowd-funding do not currently constitute a systemic risk, they clearly do not have the critical mass ...
- ... but they do pose problems for investor protection which need to be addressed.
- As these markets grow there is the potential for them to become of greater concern.
- Further monitoring and research is required. There is a need for further research in developing indicators based on hard data in regards to this topic.

## **Looking forward – developments and challenges**

- Cross border Crowd-funding
- Securitisation
- Bitcoin Crowd-funding
- Whole loan investments and bank involvement