DIGITAL ECONOMY AND FINANCIAL SYSTEMS

Crowdfunding in 360º: alternative financing for the digital era

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Executive summary

Crowdfunding is a collaborative activity which has taken on a new dimension thanks to the rapid recent progress in ICT. Crowdfunding enables large numbers of people to make small contributions to a cause, between them making a significant contribution. Crowdfunding platforms for financial gain, in formats similar to those used in social media, are a meeting place for those seeking funding (whether people or companies) and investors, who receive a financial recompense in proportion to the funds they have put up and to the risk of the projects, which is generally assessed by the platforms. This novel form of financial intermediation keeps transaction costs down and manages risks through diversification.

On the whole, the platforms transfer traditional financing models to an environment in which the funding comes from a large number of participants. Thus, several business models can be identified, depending on the financial instruments underpinning the platforms' operations. There are two major types, which depend on the status of the creditor/investment partner: crowdlending and equity crowdfunding. In the former, the investors receive a debit instrument (shareholder loans, bonds or other fixed income instruments) which specify the terms of the repayment, generally adding some profit element such as an enhanced interest rate to the amount lent. In the second case, the investors receive shares or stocks in a company, and the profitability of the investment is linked to the future success of the company's product or service.

Crowdfunding has developed around the world in the last few years, as a result of the coming together of three fundamental forces, namely: the mobilisations of supply and demand because of the economic crisis, progress in telecommunications and other technologies in the digital era, and the absence of a specific defined regulatory framework. Given that the phenomenon is still new and there are no information disclosure requirements, it is difficult to find statistics. According to the latest annual report from the consultants Massolution, EUR933mn of funding came from crowdfunding in 2012 (a growth rate of 111% over 2011), with EUR90mn coming from equity crowdfunding (30% higher than 2011). By regions, the report indicates that the North American platforms captured most of the funding (59% of the total), followed by the European (35%).

The financial crowdfunding business may be affected by rules regulating intermediary services and the issue of financial instruments, such as those relating to consumer credit, consumer protection for the sale or purchase of financial instruments, payment service provision, patent protection or venture capital. With the dual aim of encouraging this new source of funding and of protecting retail investors, some "early adopter" countries have begun to develop specific regulation for financial crowdfunding, with registration, disclosure and best practice requirements. In general, the regulation tends to be more restrictive for equity crowdfunding, setting limits for capital issuances and/or the participation of non-professional investors.

The emergence of crowdfunding as a mechanism for financial intermediation is a disruptive element in an environment where traditional banking has been used to operating almost alone. Crowdfunding platforms have grown exponentially in some regions of the world, mediating funding at competitive rates of interest – commensurate with the associated risk exposure — and frequently offering reasonable credit risk management, given the scarce information available. Financial crowdfunding offers fresh ideas over

traditional business, highlighting certain areas which the banking industry would do well to reflect upon. Thus, the banking industry could consider creating new products that are easier for the retail investor to understand, introduce new scoring tools or bring in new ways of reaching customers and a more flexible service offering. On the other hand - and some banks have already done this- the industry could work with crowdfunding platforms and even create its own platforms for higher-risk customers or low-value operations, thus taking a share in that part of the market that falls outside its traditional business.

Financial crowdfunding can play an important role as a complement to traditional sources of financing, targeting business segments that are not covered by conventional formats. It can also help entrepreneurial ventures to get off the ground, boosting innovation and, with it, economic growth. On the other hand, in a context of scarce credit and economic crisis, it can become a key factor in alleviating funding needs, contributing to economic recovery while also providing high returns for savers. However, investing through crowdfunding can bring potentially high risks of solvency and liquidity, in a market where greater informality exacerbates the asymmetry of information between borrowers and lenders. Furthermore, the mediation carried out by platforms falls into the category of shadow banking meaning that, inasmuch as they are outside the traditional banking system, the regulation with which they must comply is much less onerous. Thus, there is a need to establish a balanced regulatory framework in order to enable this complementary source of funding to develop whilst simultaneously protecting retail investors and avoiding systemic risks.

1. What is crowdfunding?

Crowdfunding is an example of a collaborative activity in which a group of individuals makes small contributions to a cause or a target and, although the individual contribution may be insignificant, a large number of participants, the crowd, means that the contribution as a whole is a large one.

Whereas the contribution of individuals in the case of, say, Wikipedia, is in the form of knowledge, crowdfunding means economic contributions to projects or ideas, constituting a new financing mechanism which provides an alternative to the traditional financial system.

Progress made in access to and use of digital technologies has enabled collaborative movements to acquire a new dimension, since the internet becomes a meeting place for all sorts of individuals, fostering the peer to peer (P2P) relationship, but also peer to business (P2B). Thus crowdfunding platforms have sprung up in formats similar to those of social media, serving as meeting points between those looking for funding (people or companies) and investors.

The economic reasons for their existence and popularity are obvious. Crowdfunding represents an alternative, in which agents with surplus resources and those with a deficit can meet directly – or nearly directly – on the market, helped by digital innovations which enable the different parties to get to know one another faster and in a more secure way. As such it brings down the associated costs, particularly transaction costs, enormously, allowing supply and demand to interact with less points of friction.

There are different types of crowdfunding adapted to the way in which investors are recompensed. Donation platforms are designed to provide funds altruistically, with no remuneration in exchange. In other cases, the fund contribution is rewarded in some non-monetary kind of way, such as the receipt of a book, being thanked in the acknowledgements of the work or taking part in a film, etc. Some of these reward crowdfunding platforms, rather than being of a philanthropic nature, involve paying for a product or service in advance, which allows entrepreneurs to fund themselves through their future customers, instead of only risking their own capital or having recourse to other traditional forms of borrowing, all of which cushions the financial risk borne by the project.

At the other end of the spectrum, there are crowdfunding models in which the investors receive a financial return commensurate with the amount of money put up and risk they have assumed. These models, known as crowdfunding with financial return, can be divided into two types, depending on the status of the investor's creditor/partner. In the case of crowdlending, investors receive a debit instrument which specifies the repayment terms of the loan, generally adding a margin to the sum lent. Conversely, in equity crowdfunding, investors receive shares or participations in a firm, and the profitability of the investment is connected to its future success.

These mediation activities are included in the definition of shadow banking, widely defined as "the mediating of credit or credit capacity for institutions and activities that are (whether wholly or partially) outside the traditional banking system". Thus, in general, financial products that are negotiated on these platforms fall outside the general legal framework applied by regulators of credit/deposit institutions, and as such are subject to much less stringent regulation. They are not covered by banking regulation, among other reasons, because: i) they do not take deposits, so the financial liability which investors assume is not a deposit; ii) the platform is not a deposit institution with the corresponding authorisation form and is not classified as within the scope of the corresponding deposit guarantee funds; or iii) they are not licenced as credit institutions.

This paper concentrates on crowdfunding platforms with financial return, since these are the ones which affect the financial system most and which may have a greater disruptive impact on the banking business. In order to provide a 360º assessment, we are looking at these digital funding platforms in the key markets of the US, Europe and Latin America.

2. Economic principles of crowdfunding

2.1. The ecosystem of crowdfunding with financial return

According to Agrawal et al. (2013), Agrawal et al. (2011) and Rodríguez de las Heras Ballell (2013), the crowdfunding ecosystem is made up of six key parts: borrowers or entrepreneurs, lenders or investors, the service being exchanged, the price at which the exchange is agreed, the digital platform and the existing regulatory framework.

In the first place, the borrowers or entrepreneurs represent the demand in the crowdfunding ecosystem. In some cases they are individuals with borrowing needs who are having difficulty in accessing banking loans. In other cases they are start-up entrepreneurs who need an injection of capital to develop a business idea or project (Schwienbacher & Larralde, 2010), but who lack the reputation which might allow them to access the traditional financial markets.

The second piece in this ecosystem is made up of the lenders or investors, who represent the market supply. Although they could find investment alternatives on the traditional financial market they have, on the one hand, few options to invest individually, given that their investment capacity is likely to be limited and, on the other, obstacles to finding and assessing projects, not only because of geographical restrictions, but also because they lack the knowhow necessary to assess a potential investment (Agrawal et al. 2013 and 2011).

The third part is the service being exchanged, financial capital. As mentioned, the investors have the capital to supply, while the borrowers need this capital. In order for the exchange to take place there needs to be a transaction price, which is the fourth part of this ecosystem. Given the characteristics of suppliers and demanders, in most cases this transaction would be impossible to carry out within the traditional financial market, since it would be impossible to agree on a price satisfactory to both parties.

At this point the fifth constituent part appears: the technological platform for crowdfunding. This enables the other four parts to start working: that is, that supply and demand, each with its specific characteristics, pair up in the market at a particular price. This technological platform allows the incentives which drive each agent to find one another, reducing the intrinsic risks thanks to the technological support (Agrawal, 2013; Schwienbacher & Larralde, 2010). Finally, as the sixth part, come the operating rules of this ecosystem.

2.2. Incentives, deterrents and market faults

The features that characterise financial intermediation according to the economic literature (Mishkin, 2012) generally affect crowdfunding with financial return as well. Thus, in the crowdfunding platform market, we find the particular incentives of the various economic agents and the typical faults of the financial markets (such as information asymmetries), all of which imply uncertainty and risks which need to be managed.

The economic agents in any market respond to the economic incentives that exist (Coase, 1960; Becker, 1974). The crowdfunding ecosystem is no exception and in it entrepreneurs, investors and the platform managers have incentives and deterrents which determine how they operate (Agrawal et al., 2013; Pazowski & Czudek, 2014).

Borrowers or entrepreneurs have the incentive to access the capital they need at a lower cost than the alternative, which may not even exist, of obtaining it in the traditional system. Another incentive is the fact that, in many cases, the platform enables entrepreneurs to receive opinions about their project. Nevertheless, this very process may generate certain deterrents for entrepreneurs, who have to reveal information about their business strategy. Similarly, as crowdfunding implies the participation of several investors, the entrepreneur may suffer a chaotic situation in terms of the management of the process because of the opinions received from different investors (Waldfogel & Chen, 2006).

In terms of the investor's incentives, crowdfunding enables them to access new investment opportunities, learn about products at an early stage of their development and participate in creating them. Among the deterrents against participating is the possibility that the entrepreneur might not be able to get the idea off the ground and fails, or else completes the project late. There is also the possibility of fraud, even though in theory the platform helps to mitigate this. As such, the investor has to face clear risks deriving from the market fault known as information asymmetry (Lewis, 2011), in a relation in which the entrepreneur has more information.

The crowdfunding platform managers, as well as seeking gains in the present through fees, also have the forward-looking aim of retaining their investors and attracting more of them, giving them incentives to ensure the quality of the projects they advertise and, as such, to improve the selection mechanisms and risk management on their platforms. As argued by Mishkin (2012), Agrawal (2013) and Ahlers et al. (2012), mitigating the faults in the financial markets requires coordinated action on the part of different agents. Good entrepreneurs can mitigate the information asymmetries by signalling, for example, giving more guarantees to the investor, with more disclosure about the whole process or by posting up their CV. The main aim is to improve the quality of the positive signals from demand to supply (Ahlers et al. 2012; Cabral, 2012).

Investors may also, in theory, collate better information to decide on whether to participate in a project. However, as argued by Agrawal et al. (2013), since they are investing small amounts, their degree of involvement in the project, and as such their incentive to gather more information about it, may be lower. Studies such as that carried out by Zhang & Liu (2012) also find the presence of herd behaviour, that is, that investors tend to be attracted towards a project that is already getting more funding, or towards those selected by an investor who has been identified as having more experience, which might be an indication of the project's quality. Finally, as pointed out above, the crowdfunding platform itself has manifest incentives in making its market work and in introducing self-regulating mechanisms to reduce the risks deriving from information asymmetry.

Although these self-regulating elements may be generated as a result of the agents' own incentives or deterrents, they are not enough, particularly in the financial markets, where the risks of errors and multiplying effects can be large. The existence of the regulator is always important, and, as we will see in a specific section on the subject below, their presence is increasingly proactive. The biases that any regulation has, however, will depend to a large degree on how the crowdfunding process develops in the different parts of the world.

3. Features of financial crowdfunding platforms

After reviewing and analysing a series of financial crowdfunding platforms, (see Appendix A) we have identified a series of aspects common to all, which we outline below:

Table 1
Characteristics of financial crowdfunding platforms

1	**They are a meeting place and showcase for projects**
2	**They mediate between investors and those looking for funding**
3	**They reduce transaction costs**
4	**They assess risk and/or classify projects**
5	**They manage risks through diversification**
6	**They take on very limited responsibility**
7	**They are based on traditional financing models**

Source: BBVA Research

- **They are a meeting place and showcase for projects**
  Crowdfunding platforms are websites that function as meeting places between investors and those requesting funding. The applicants have a space, very similar to the profiles on social media, where they describe and promote their idea, project or need, in order to attract the financing they need to carry it out. The investors see an extensive catalogue of projects to which they can lend funds in order to make a profit.

- **They mediate between investors and those looking for funding**
  The platforms provide several intermediation services (for example, handling contracts, payments and charges), for which they are paid with fees which are generally levied on both types of participants: investors and recipients of financing.

- **They reduce transaction costs**
  The information provided on the digital platforms makes it possible to match speedily the need for capital with lending capacity. This reduces transaction costs considerably – the search costs, essentially - compared with a scenario in which the meeting between these economic agents would have been practically impossible, thus making efficiency gains.

- **They assess risk and/or classify projects**
  In many cases the platforms catalogue projects by risk, after assessing the solvency of the borrower or the viability of the business initiative, and then publish this classification on the platform itself. However, they do not take on the responsibilities deriving from this assessment and insufficient diligence can lead to conclusions being made on the basis of false information, both in the case of individuals requesting financing (the platform's capacity to check the information given is limited) and in the case of entrepreneurs or start-ups (the financial information does not have to be audited).

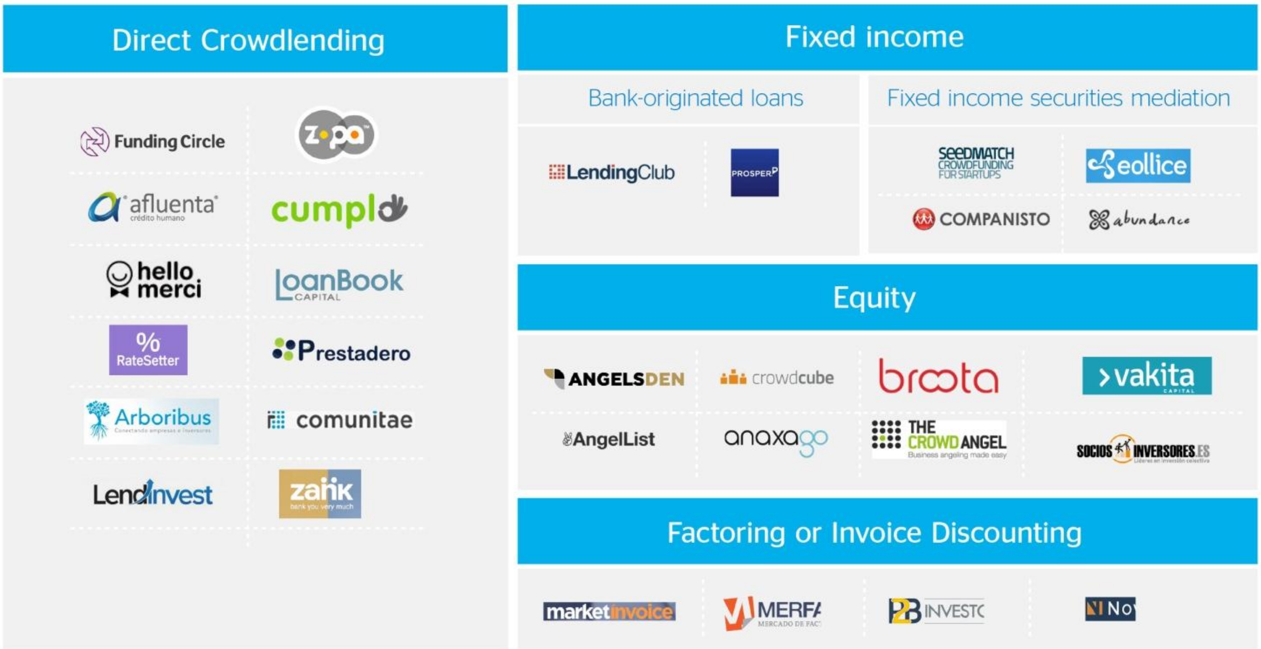
- **They manage risks through diversification**
  Whereas in traditional business the risk of bad debts is assumed by the bank granting a loan, in the case of crowdfunding this risk is shared by all the investors who have partially financed it, so the risk is diluted. (Agrawal et al, 2013).

- **They take on very limited responsibility**
  Most of the platforms are not directly involved in the financial activity of the loan or the investment that may take place, with the result that their responsibility is limited. The risks of both solvency and liquidity are assumed by the borrower or the investor.

- **They are based on traditional financing models**
  In general, the platforms transfer traditional financing models to a context in which financing comes from many participants, instead of being provided by a single institution or a small group of investors. Thus, we can classify platforms by the financial instruments underpinning the platform's operations.

4. Financial crowdfunding platforms: the different business models

Table 2
Financial crowdfunding platforms: the different business models



Source: BBVA Research

4.1. Direct crowdlending platforms

In this system the crowdfunding platforms act as administrators in establishing a loan contract between individuals, where there are several lenders and the sum with which they participate and the rates of interest received may be different from one to the other.

In most Spanish platforms and in the Argentine *Afluenta*, the investors sign a trust instrument or mandate by which the platform becomes a trustee or simply an administrator and grants the loan in its name, taking charge subsequently of the payments. On British platforms the lenders and borrowers normally sign the contracts directly. But there are cases, such as with the Spanish Lendico and the British Wellesley & Co, in which it is the platform which sets up the contract with the borrower and subsequently cedes all or part of the entire loan in stakes to the lenders. When the loans are guaranteed, as well as the loan contract between the parties, the borrower signs a guarantee agreement with a “Security Trustee”, designated by the platform, who is the guarantor on behalf of the lenders.

Platforms generally set an upper limit for each loan, as well as on all the loans that can be requested by a borrower at any one time, and a minimum investment per lender, who can diversify his or her portfolio and partially finance several loans from several borrowers. A period is set for attracting funds and a minimum proportion of the principal which must have been raised by that time (provided the borrower is prepared to accept partial funding). In order to establish the interest rate on the loan, some platforms set up a market mechanism (for example, an auction between investors) while others just set it themselves, depending on the project’s risk classification. On some platforms, it is the investors who choose the loans in which they wish to participate, whereas on others the platform automatically connects the requests and the funding offers depending on the criteria established beforehand by lenders and borrowers. Once the loan has been originated, the platform manages the payments and charges, with the amortisation generally being divided into equal monthly coupons, including principal and interest, over a defined period. Paying equal instalments (with interest rates not linked to market indexes and long amortisation periods) implies risks in the event of fluctuations in inflation or in benchmark interest rates.

In the case of non-payment, the platform collects the payments on behalf of the lenders and, in some cases, has a guarantee fund for offsetting bad debts. Nevertheless, these funds are not required to handle complaints and, in the final instance, it is the lender who bears the borrower's solvency risk. In terms of liquidity risk, some platforms have a secondary market on which lenders can make their stakes available as originated loans, although these secondary markets may have a limited liquidity. In the event of a platform collapsing, the loan contracts are still valid and the platforms generally have agreements with a third party who continues to supervise the contracts.

4.2. Platforms based on fixed income products

In this category we differentiate between platforms on which loans financed using fixed income securities (notes) are originated, and platforms which mediate products similar to those traditionally used in fixed income (promissory notes, bonds or debentures).

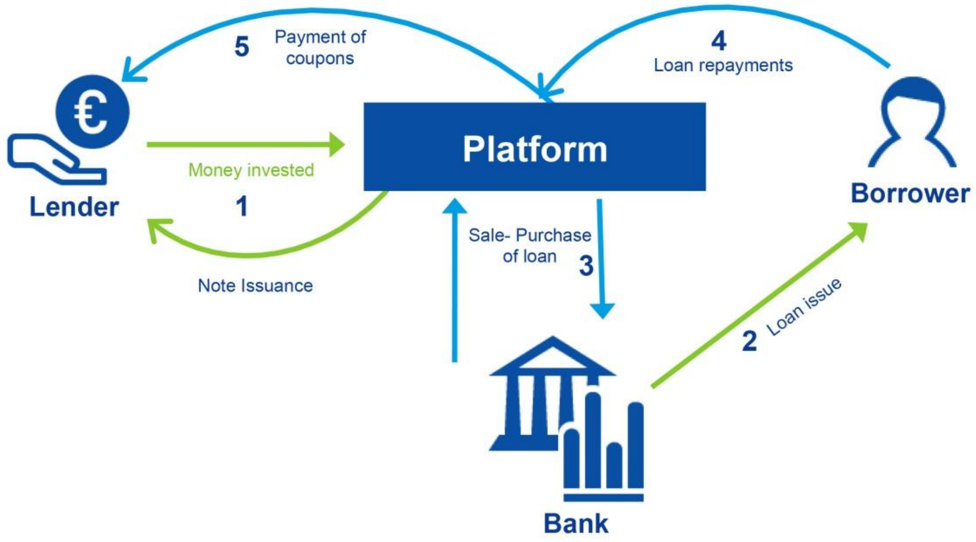
4.2.1 Bank-originated loans

Under this model the platform issues fixed income securities known as "notes" (generally at three to five years), while the bank originates the loan (which tends to be a consumer loan).

Lenders deposit the money they wish to invest in an account. The platform issues notes at par which represent the right to receive the proportion of the payments (principal and interest) to which each lender of a specific loan is due, conditional upon the platform receiving the payments from the borrower[1] (meaning that the bad debt risk is taken on by the lenders). The loan principal is advanced by a bank, to which the platform immediately returns the principal plus the corresponding fee, using the money previously deposited by the lenders to do so. In the event of a platform collapsing, an agreement will generally have been put in place with a third party whereby the latter continues to administer the loans and amortises the notes, but continuity of management is not guaranteed at any point and, hence, neither is the recouping of the investment. The notes cannot be traded on official markets but they are transferrable through another independent platform, although in no case is their sale or their value guaranteed, with the result that there is a liquidity risk.

1: The notes issued by the platform should not be confused with asset-backed securities. Unlike the latter, which are backed by a pool of financial assets, each note is backed by a single loan, so that the flow of principal and interest received by the noteholder comes from the payment by a single borrower of a specific loan.

Figure 1
Business model for mediated crowdlending platforms



Source: BBVA Research

In the United States all the crowdlending platforms we analysed follow this model, due to the regulatory restrictions on the issuance of loans by unauthorised institutions. *Lending Club* and *Prosper* are the most popular, both of them originating consumer loans.

More complex financial instruments are also being created on the back of these notes, and these are being bought by banks and investment funds to be used as an underlying asset for the issuance of asset-backed securities (ABS). As well as transforming assets that cannot be traded on official markets (the notes) into tradable ones (ABS), securitising notes may help borrowers to access funding, since the increased demand for notes by these banks (increase in the supply offering) puts downward pressure on the interest rates of loans originated through these platforms. However, given that the banks will not keep the notes — but rather turn them into securitised bonds which they will then sell on the markets — the incentives for appropriate risk assessment are likely to diminish — depending on whether the banks keep the tranche with the worst credit risk bonds or not — and they may end up granting loans to individuals with a high risk profile. The platforms have an interest in selling as many notes as possible (in order to charge their fee), which reinforces the effect mentioned. As such, securitising the notes may increase their inherent risk. As well as this, there is an additional risk of a lack of market liquidity as a result of financial crises or regulatory changes which cause demand to dry up.

4.2.2 Fixed income securities mediation

This type of platform operates solely as an intermediary between debtors (generally companies) which are offering fixed-income products similar to promissory notes, bonds or debentures (maturing at anything from a few months up to 25 years), and the investors who buy them. On the whole, all the platforms have a secondary market.

Some of the products, as well as providing fixed income, are linked to inflation, can be converted into shares or include a variable return which depends on the result of the investment (as in the case of subordinated loans with a stake in the profits, for example). The German platforms *Seedmatch* and *Companisto* frequently use this type of instrument.

4.3. Equity crowdfunding platforms

Equity crowdfunding platforms mediate shares or stakes in a company and work in a similar way to those which mediate fixed income securities, once they have been reviewed. Those looking for funding are companies, generally start-ups in their initial phases, which set an investment target and the percentage of their capital which they are offering in exchange. Once the investment target is reached, the money is transferred and the investor receives the shares or stakes in exchange. On the whole, the platform charges fees to the capital issues once the operation has been funded. Investors may buy shares in several companies, assuming all the risks inherent to this type of financial instrument. In some cases there is a secondary market for shares on the platforms themselves.

Investors tend to be given access to the information about the companies by phases, depending on the degree of commitment made, only having all the information once the funds have been received (Bestaker in Spain, for example). Certain parts of the world, such as the United States and Italy, allow the platform administrator to be a bank. Then again, some platforms (such as the British Angels Den) combine equity crowdfunding with a traditional network of business angels and organise face-to-face presentations and project discussions.

We should point out that the investment projects on equity crowdfunding platforms are generally in companies that are at the very early stages of formation, whose economic viability is particularly uncertain, for which reason there are high failure rates. There is no kind of industry guarantee covering the small investor in the event that the project financed goes bankrupt, and the only protective measures that exist are through limiting investments. In the US, for example, it is still illegal for the general public to buy equity (only registered investors can apply). However, these investments can offer very attractive yields, since there is greater exposure to risk.

4.4. Platforms based on factoring or invoice discounting

Another financing instrument which is starting to be replicated in crowdfunding is the factoring or discounting of invoices and promissory notes. On some platforms, such as the British *MarketInvoice*, the Spanish *NoviCap* or the Chilean *Merfac*, companies choose which of their invoices to make available for purchase, normally through an auction, by professional investors. Only companies with blue-chip clients may discount their invoices over these platforms. If an invoice is not paid by the customer, the seller of the invoice is required to pay the investor who has acquired it.

In other cases, a line of credit is granted against the collateral of the invoices, as in the case of the US *P2B Investor*.

5. Growth of this new form of financing

Although financial crowdfunding tends to appear on the scene after strong growth in the philanthropic platforms (donation or reward), the healthy development in this new form of financing in the last few years has been due to the collision of several forces.

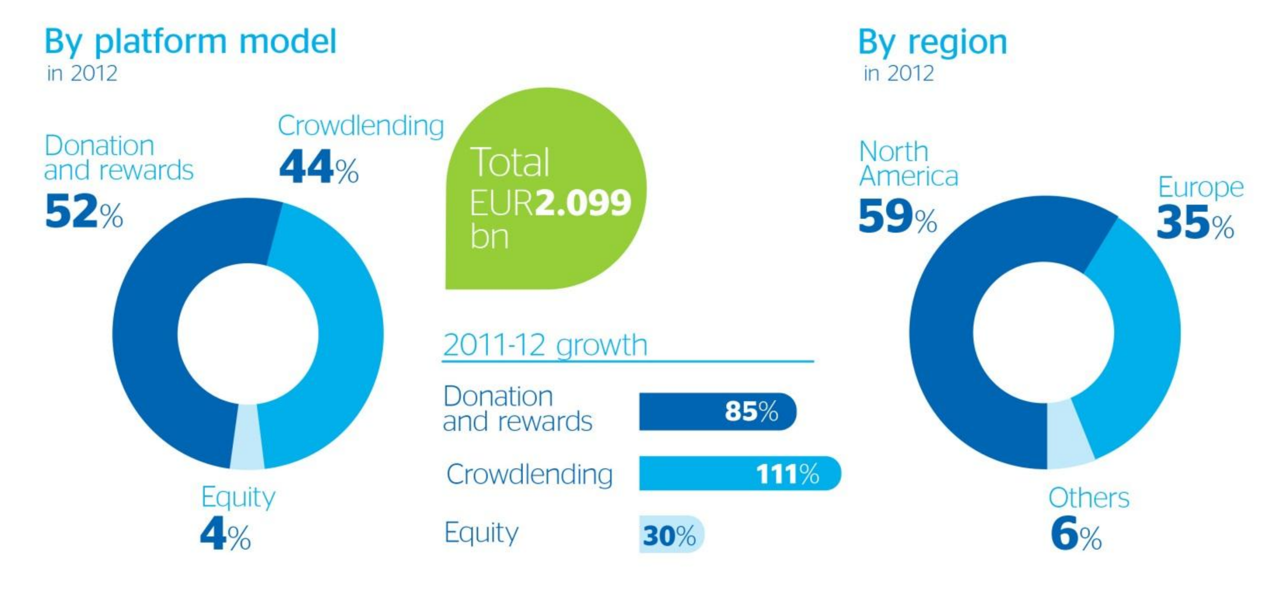
First, mobilisations of supply and demand resulting from the economic crisis have led those agents needing funding to look for alternative sources, given the scarcity of credit (particularly for projects in their initial phases and high-risk initiatives) on the one hand; on the other, savers have been on the look-out for higher yields than those on offer in the traditional financial system, in a context of low interest rates worldwide. Second, the rollout of telecoms infrastructures and major improvements in the speed of information processing in the digital era has meant that more interactive and user-friendly interfaces have been developed, at the same time as new analytical techniques from the world of Big Data have been applied to improve scoring calculations. This is all in conjunction with access to and use of the internet by a critical mass of the population — especially of financial services, such as electronic payment and online banking. Finally, the regulation limbo has allowed crowdfunding to grow gradually, although the differences between countries are large and there are cases where certain models of financial crowdfunding (particularly equity crowdfunding) are not permitted.

These three forces (funding supply and demand, digital-era technology and regulation), taken together, give us an understanding of the differences in performance of financial crowdfunding, depending on the geographical region.

Since this is a novel phenomenon which is in the midst of its growth explosion, global indicators to measure the overall impact of financial crowdfunding do not exist. Only in those regions where regulation or self-regulation requires platforms to publish their performance data can we learn about how the activity is developing and by how much.

The consultancy Massolution publishes an annual report collating data on the industry's performance. According to its 2013 report, assessing 308 platforms throughout the world, the global volume of financing through crowdfunding (both philanthropic and for financial return) reached EUR2.099bn in 2012, distributed over around one million projects (see Figure 2). If we narrow our focus to financial crowdfunding, the loans totalled EUR933mn (a growth rate of 111% from 2011) and equity crowdfunding was the channel used for EUR90mn worth of financing, 30% more than the year before. By regions, the report indicates that North America raised most financing (59% of the total), followed by the European platforms (35%).

Figure 2
Global revenues from crowdfunding



Source: Massolution

The following table shows the number of registered platforms by area.

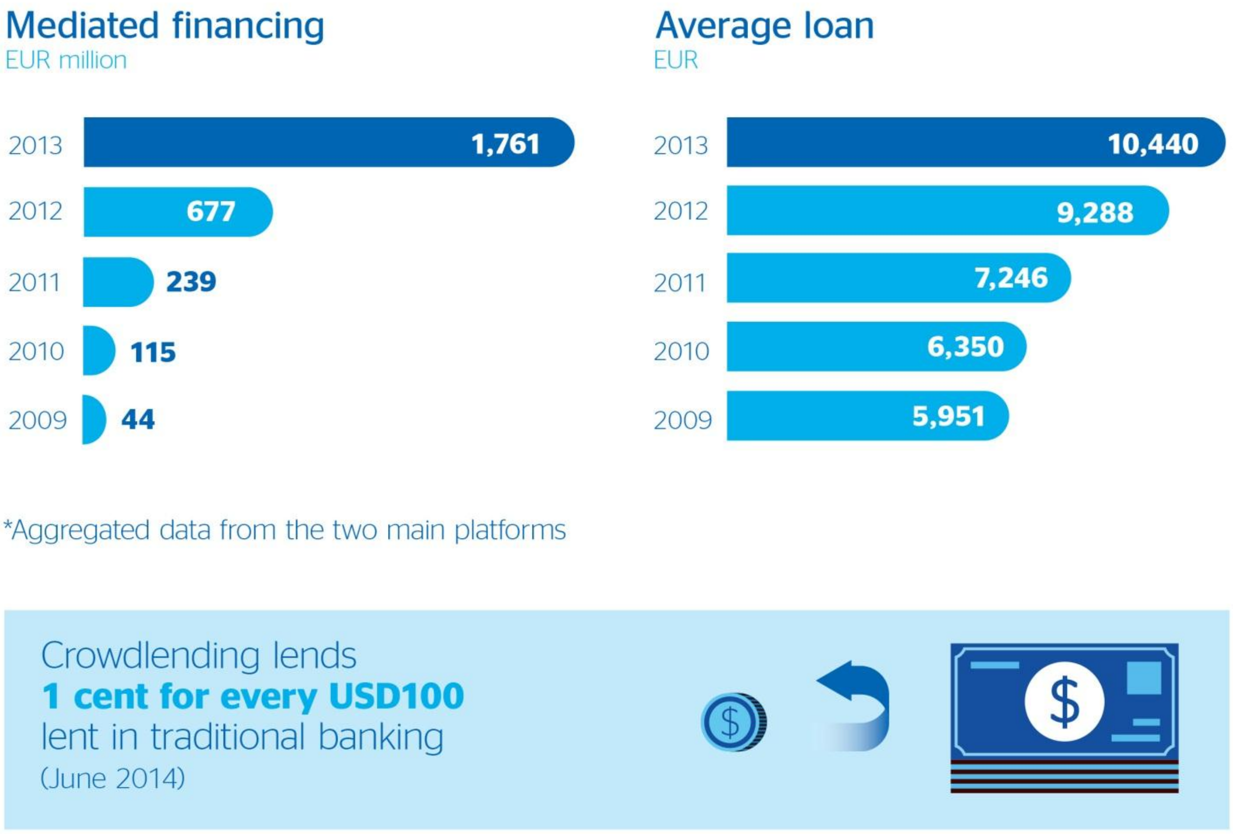
Table 3
Number of financial crowdfunding platforms (June 2013)

United States	United Kingdom	France	Spain	Germany	Italy
344	87	53	27	26	15

Source: InfoDev/World Bank

The **United States** is the most mature crowdfunding region, both in terms of the number of platforms and in the volume of funding mediated. Crowdlending is by far the most popular business model, given that equity crowdfunding remains restricted for the moment to registered investors. Two platforms which deal in mediated crowdlending, *Lending Club* and *Prosper* (specialising in consumer loans), dominate the sector between them, representing virtually the entire US market. Figure 3 illustrates how the volume of mediated financing handled by these two platforms together has changed, showing exponential growth rates.

Figure 3
United States: crowdlending, change (new operations)



Source: BBVA Research based on data from Lending Club and Prosper

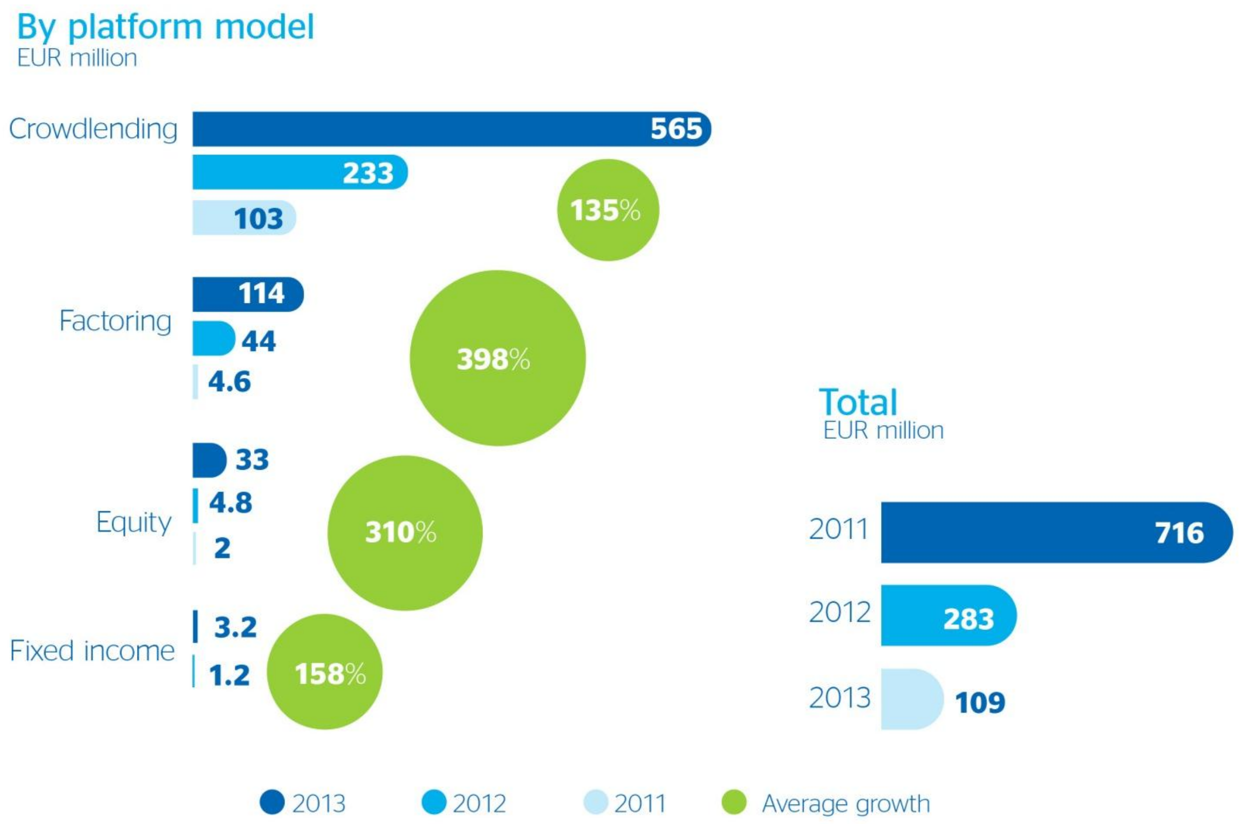
When it comes to the innovation of securitising the notes issued by crowdlending platforms, in 2013 the investment management firm Eaglewood Capital Management conducted the first securitisation of this type of asset, issuing securities for a total of US53mn, backed up by notes bought from *Lending Club*. Jefferies LLC, an investment bank, has also recently announced its forthcoming securitisation of notes bought from the *CircleBank Lending* platform.

Finally, regulatory restrictions stunted the development of equity crowdfunding until September 2013, at which point it became legal to advertise this type of issuance. However, as mentioned above, as of today access is still limited to registered investors and there are hardly any data about the volumes of financing they mediate.

In **Europe**, meanwhile, these platforms raised around EUR735mn in 2012. However, these figures are still modest if compared with loans to non-financial institutions granted by commercial banks in Europe (EUR6trn in 2012, according to the European Banking Federation), or the EUR7bn which start-ups and firms in their initial stages of development received in 2012 from venture capital investors (EVCA, 2012).

The **United Kingdom** is the most developed European country in terms of financial crowdfunding, with a volume of mediated financing of EUR716mn in 2013 (see Figure 4). The platforms which handled most financing were those using direct crowdlending (EUR565mn), followed at quite some distance by factoring operations (EUR114mn) and equity (EUR33mn). The British government has boosted this development, pioneering the use of these platforms to grant financing to small and medium enterprises (SMEs), topping up private financing with public money (offered under market conditions).

Figure 4
United Kingdom: financial crowdfunding (new operations), changes



Source: Nesta

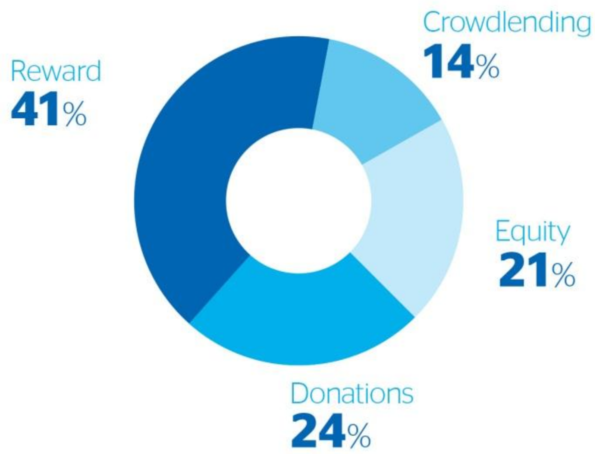
In **Spain**, according to the data from the Spanish Crowdfunding Association, the crowdfunding platforms — including donation and reward platforms — raised a total of EUR19.1mn in 2013 (see Figure 5). By platform numbers, reward and donation ones are predominant (41% and 24% respectively) compared to equity (21%) and loans (14%).

Figure 5
Spain: crowdfunding in 2013

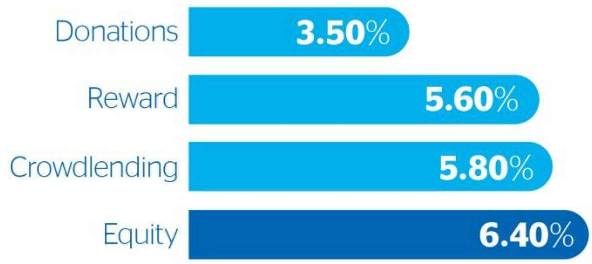
	Average sum requested per project	Average contribution per investor and project
Crowdlending	EUR30,833	EUR2,025
Equity	EUR134,856	EUR4,853

EUR
19
MILLON

Breakdown of platform, by model used



Average fees charged, by platform



Source: Spanish Crowdfunding Association

In most **Latin American** countries, crowdfunding has not yet made the leap — in any significant way — from philanthropy to financial return. In Brazil, Mexico, Chile, Argentina and Paraguay, some loan-based and investment-based platforms have sprung up, but are at a very early stage of development, whereas in Colombia, Peru and Uruguay, there are no known financial crowdfunding platforms. By countries, in Brazil at least two equity crowdfunding platforms are operating (*Eusocio*, belonging to *Crowdcube*, and *Broota*). In Mexico there are platforms for both loans (*Prestadero* and *Kubo Financiero*) and equity (*Vakita Capital*). In Argentina, the direct crowdlending platform *Afluenta* mediated loans to the value of ARS7.7mn in 2013. Chile is exceptional in the region: it has platforms using all the financial crowdfunding models: direct crowdlending (*Cumplo* and *Becual*), factoring (*Merfac*), fixed income securities (*Eollice*) and equity crowdfunding (*Broota*).

6. Regulatory progress in the last year

The financial crowdfunding business may be affected by the different norms regulating mediation services and the issuance of financial instruments. Thus, among other norms which may affect the platforms, there are:

- **Regulations on consumer credit** with which those offering mediation services for signing loan or credit contracts must comply (as is the case in many of the crowdlending platforms)
- **Consumer protection regulations**
- Depending on how the activity of equity crowdfunding is executed, it may fall within the scope of the legislation regulating the **sale or purchase of financial instruments**
- The **regulations on payment services provision** may also be applicable, in the ambit of the mediation carried out by platforms as they move sums of money between investors and those requesting funding
- Rules relating to **patent protection and capital or venture capital requirements are also applicable**

In any event, since this is a new phenomenon, there is a degree of uncertainty about the laws on crowdfunding, the first stages of which have evolved without the existence of specific regulation. Financial crowdfunding platforms operate with financing products, carrying out their activity in shadow banking. The lighter regulation in these markets and the greater informality with which many of the platforms operate increases investors' liquidity and solvency risks. Specifically, the solvency risk may be aggravated by a wider information asymmetry between debtors and creditors — or between entrepreneurs and investors — in comparison with that existing in banking loans or in regulated fixed and variable income markets.

In the countries where crowdfunding is more developed, specific regulatory bodies are starting to be formed, trying to protect the unaccredited investor but also to smooth access to financing, particularly for start-ups and small companies finding it difficult to get conventional financing. In some regions, such as the United Kingdom, the industry self-regulated from the beginning by developing disclosure standards and the adopting practice guidelines, in order to create a climate of greater trust.

This specific regulation covers issues relating to how the platforms work, differentiating with more legal clarity between the various forms of collective financing, requiring transparency and the publication of indicators, imposing investment limits and, in some cases, establishing tax breaks.

However, there is still a degree of uncertainty about how certain local regulations can be applied in the global context in which crowdfunding exists, given that operating access to the internet does not stop at national borders. The lack of coordination between regulators is an obstacle to the development of this type of financing, since it results in a fragmented market.

We review below the progress made in specific regulation by areas in the last year, giving the figures in Table 4.

Table 4
Regulatory progress over the last year in the United States and Europe

Country	Platform model	New regulation in the last year
United States (September 2013)	Equity	Capital issues can be publicly advertised on platforms. Awaiting approval: participation (with restrictions) of non-accredited investors.
United Kingdom (April 2014)	Crowdlending	Platforms will be supervised by the FCA and must have a capital floor commensurate with their lending volume.
	Equity	Restrictions imposed on the type of customers to whom direct offers can be made.
France (May 2014)	Crowdlending	Creation of a specific official register. Restrictions on issuers and investors.
	Equity	Creation of a specific official register. Restrictions on issuers.
Germany (July 2014)	Subordinated loans with profit sharing	Included under the rules of investment products, but establishing an exception (with less regulation) for issues below certain limits.
Spain (2014)	Crowdlending and equity	Registry on the stock exchange commission (CNMV), with Bank of Spain involvement in the case of crowdlending. Restrictions on issuers and investors.
Italy June 2013)	Equity	Platforms must be authorised by the stock exchange commission (CONSOB). Companies must be considered “innovative” in order to issue capital using platforms. Lighter regulation if a given placement limit per investor is not exceeded. At least 5% of participants must be professional investors.

Source: BBVA Research

6.1. United States

In September 2013 Title II of the JOBS Act (The Jumpstart Our Business Startups Act) was promulgated, allowing start-ups to advertise capital issues through online platforms. Title III, “Crowdfunding”, which will enable all kinds of investors to participate on these platforms, has not yet come into law, even though it was planned for 2014. Thus, Title III will introduce an exception to the 1933 Securities Act and for the first time will open participation in equity crowdfunding platforms (with some restrictions) to all types of investors, not only accredited ones (those with annual incomes of over USD200,000 or net worth of over USD1mn, or whose family has an annual income of over USD300,000). The issue must be executed through a broker or a platform registered with the Securities and Exchange Commission (SEC), and is subject to the following restrictions:

- For the issuer: the aggregate number of securities sold to the total number of investors in the previous twelve months should not be higher than USD1mn.
- For the investor: the aggregate number of securities bought over the previous twelve months may not be higher than:
  - Either USD2,000 or 5% of their annual income or net worth, whichever is higher, for investors whose annual income or net worth is less than USD100,000.
  - 10% of their annual income or net worth, up to a maximum of USD100,000, for investors whose annual income or net worth is equal to or higher than USD100,000.

6.2. Europe

The European Commission is working on understanding this new financing model, how it is changing and its risks. Over the last year it has conducted workshops and public consultation among its citizens, creating an expert committee on the subject on 25 June 2014, ECSF, the European Crowdfunding Stakeholder Forum, which will help the Commission to generate information and training models for entrepreneurs, as well as establishing new policies and developing best practices and/or certification processes. The Committee, made up of consumer associations, representatives from the entrepreneurial world, platform associations, researchers and financial institutions, as well as business angels, will work in conjunction with other regulatory workshops which will discuss the obstacles and inconsistencies which may exist in national regulation approaches.

The Commission does not appear at the moment to be intent on developing a new regulatory framework for crowdfunding, but rather to promote its roll-out in an environment of trust, at the same time as trying to locate how this new form of financing fits in the financial ecosystem and, in any event, prepare itself for future actions for specific rules to be applied to new business models which are beyond the scope of the current regulations.

Some member states have used the regulatory framework, or are moving on initiatives in this area, to set down the guidelines for legislating crowdfunding in their territory.

Italy: new regulation since June 2013

The Commissione Nazionale per le Societa de la Borsa (CONSOB, the stock exchange commission) was the first European body specifically to regulate equity crowdfunding. In June 2013, regulation nº 18592 was passed, one of the measures proposed by the Crescita (b) Decree, designed to promote economic growth by supporting SMEs. This rule set out the legal framework for start-ups to raise funds on online platforms. The start-ups which can take part on these platforms must have their HQ in Italy and be considered “innovative”, that is, they have to comply with a series of specific requirements, including having a strong technological bias and making investments in R+D+i.

The new law has three sections, covering general considerations, the requirement to register and the regulations applying to platforms, as well as the regulations applicable to security issuances through the platforms. Of these, we should pay particular attention to the following:

- All platforms must be registered with CONSOB.
- Regulation applicable to the platforms:
  - If the managers are banks or investment funds, they must comply with MiFID[2] regulations and will only have to report their intention to manage the platform.
  - If the managers are another type of firm, they will have to request authorisation expressly from CONSOB, but the regulation will be lighter (although in any event the issue will have to be handled by a professional broker, that is, a bank or investment fund) provided the following limits are not breached:
    - The value of securities sold to an investor is no higher than EUR500 per issue or EUR1,000 in all the issues over a year.
    - EUR5,000 and EUR10,000 if the investor is a legal person.

2: The Markets in Financial Instruments Directive (MiFID) harmonises regulation on financial instruments throughout Europe in order to improve transparency and efficiency of markets, as well as guaranteeing investor protection.

In any event, investors must complete a form indicating their level of understanding of investment risks.

- There are no limits for investors.
- For each issue, at least 5% of the participants must be professional investors as a condition for completing the operation.
- The issues which do not exceed EUR5mn do not have to present an issue prospectus.

United Kingdom: new regulation in place since April 2014

In the United Kingdom, the Financial Conduct Authority (FCA) introduced a new regulatory framework in April, *PS14/4: The FCA's regulatory approach to crowdfunding over the internet, and the promotion of non-readily realisable securities by other media*, for crowdlending platforms, which were formerly not under its supervision, and added new rules for investment-based crowdfunding platforms, a category which includes mediating both shares and debt securities. The FCA is tightening up the regulations for this second group of platforms, restricting the types of customers to whom direct offers can be made, while opting for less restrictive regulation for lending platforms, since it believes that the latter pose less risk to investors.

One of the most important changes for crowdlending platforms is the requirement to have a minimum capital float proportionate to the volume of the loans that they are mediating. Furthermore, they must apply a mechanism for protecting their customers' money when it is in their hands and have agreements in place so that, should the platform collapse, the contracts on live loans continue to be managed as agreed. The remaining new regulations are general guidelines about disclosure, how to handle complaints and the regular dispatch of data to the FCA. In general, a large part of the regulation introduced in April was already in the guidelines which the industry had adopted through its two main associations[3].

In terms of the equity crowdfunding and fixed income securities platforms, the revised rules forbid them to make direct offers to retail customers not receiving advice, unless the latter fulfil one of the following requirements: i) annual income of over GBP100,000 or net worth of GBP250,000 or more (excluding principal residence, pensions and certain insurance policies); ii) being registered as sophisticated investors; iii) having certified that they are not going to invest more than 10% of their assets (excluding principal residence, pensions and some insurance policies) in this type of asset, or iv) having a link to venture capital or corporate finance. Furthermore, when customers are not receiving professional advice, platforms must check their suitability before sending them direct offers.

France: legislation came into force in May 2014

At the end of May the French government passed regulation nº 2014-559, in force from October onwards, which exempts platforms issuing financial instruments from complying with the rules set down by the stock exchange authority *Autorité des Marchés Financiers* (AMF).

The French regulation includes measures that differ depending on whether the platforms provide crowdlending or equity operations. In the case of the first, an official register has been created for those platforms which are not managed by banks or investment firms. *Intermédiaires en financement participatif* (IFP) requires contracts to be formalised in writing and, lastly, sets limits on both the issuer (EUR1mn per project) and the investor (EUR1,000 per project, which may be extended to EUR4,000 in the case of loans not paying interest). For equity crowdfunding, an official register has been created for those platforms which are not managed by banks or investment firms, *Conseil en investissement participatif* (CIP), which sets limits on the issuer (EUR1mn for 12 months), but not on the investor.

3: See the UK Crowdfunding Association guidelines
(http://www.ukcfa.org.uk/code-of-practice-2) and of the P2P Finance Association
(http://p2pfa.info/wp-content/uploads/2014/05/P2PFA-Operating-PrinciplesV020713.pdf).

Germany: draft law in July 2014

The draft law to protect retail investors (Kleinanlegerschutzgesetz), published in July 2014, extends the regulation on investment products (VermAnIG) to subordinated loans with profit sharing, which is the predominant type of financial crowdfunding in Germany, which had up to then been beyond the scope of the law. But at the same time, the legislative draft proposes to introduce an exception so that these loans, provided they comply with certain requirements, are subject to lighter regulation; so, for example, they are not required to register a prospectus. The requirements the platforms must meet to be covered by this exemption are:

- EUR1mn maximum issue per project.
- They are negotiating subordinated loans and/or with profit sharing.
- Maximum investment of EUR10,000 per investor.

Nevertheless, these platforms will have to have their corresponding licence and, provided that an investor is going to invest more than EUR250, they will be required to issue a simplified prospectus which will have to be signed manually by the investor. Furthermore, the draft limits the advertising possibilities for investment opportunities.

Spain: regulation being developed throughout 2014

In 2014, a draft law for *Plataformas de Financiación Participativa* (PFP) or crowdfunding was developed. The initial proposal at the end of February, included in the bill to promote SME funding, was then used as a consultative document with the agents, and in October the revised text was sent to the Congress of Deputies. The proposal is very comprehensive and, as well as protecting the consumer (defined as an unqualified investor), supports the development of a new form of non-banking financing, crucial in the current environment of economic recovery.

PFPs in Spain offer online funding with a monetary return for those with activity in the country, including those who are abroad but are offering products for residents in Spain, or whose purpose is to attract customers in Spain. The projects admitted for this type of financing may only be in the areas of business, training or consumption.

The instruments which these platforms may offer are: debentures, ordinary shares, preferential shares, participations in limited companies and direct crowdlending. All the platforms wishing to operate in the country must be registered with the stock exchange commission, *Comisión Nacional del Mercado de Valores* (CNMV), with the involvement of the Bank of Spain, when the activity consists of mediating loans.

There are certain limits imposed on the investor, the projects and the platforms. Thus, the non-accredited investor (accredited investors are not set limits) must abide by the limits of:

- Investing a maximum of EUR3,000 in a single project
- Investing a maximum of EUR10,000 in crowdfunding platforms as a whole over 12 months

For their part, projects have the following limits: a developer may only have one project on a given platform and a maximum of EUR2mn of funding a year on each of the platforms (whether in one or successive rounds).

Finally, platforms may not conduct activities that are restricted to investment service firms or credit institutions; nor may automatic investment mechanisms be developed.

Crowdfunding platforms also have a series of obligations in the areas of disclosure, regulation compliance, professional behaviour on the part of their partners and capital requirements.

6.3. Latin America

The countries in the region have not established specific regulation for financial crowdfunding platforms, which are starting to show signs of life — still at the initial stage — operating within the existing body of regulations. The regulatory differences between countries are proving critical to whether equity crowdfunding platforms develop or not, which is the category generally subject to the most rigorous regulations.

In Mexico, Brazil and Chile, the legislative framework, although unclear in some cases, has enabled platforms to exist using this business model, albeit subject to certain limitations. In Mexico, equity crowdfunding is restricted to qualified investors in line with the Stock Exchange law, for they need to have held a minimum investment sum in the last year or have had income over a certain level in the two previous years. In Chile, in order to get over the regulation on public offerings, investors may only participate on platforms to which they have been invited by name by one of the entrepreneurs looking for funding. Meanwhile, Brazilian regulations set an annual limit (BRL2.4mn) on the capital which a company can raise via the issue of stakes, before it has to be registered and comply with the conventional requirements.

At the opposite end of the spectrum, Peruvian law does not permit equity crowdfunding[4]. On the whole, restrictions and regulatory uncertainty are proving an obstacle to the development of financial crowdfunding, and particularly in fixed income, in Latin America.

7. Crowdfunding and traditional banking: points to bear in mind

A background of centuries as a financing supplier has given traditional banking certain strengths. First, its accumulated experience in loan origination means that it possesses a breadth of know-how in assessing credit risk. Second, thanks to a commercial relationship with its customers that goes beyond granting loans, it has a more solid body of information about those people requesting financing who are already in its customer portfolio. It also has a long history of developing distribution channels, in the shape of traditional physical offices. Finally, parallel to its development and experience, specialist regulation has grown up which has struck a balance between the different market players.

The emergence of crowdfunding as a mechanism for financial mediation — ushered in thanks to the needs of the market, to innovation and the regulatory space — represents a disruptive element in a scenario where traditional banking was used to being practically unchallenged. Crowdfunding platforms have grown exponentially in some regions, mediating financing at competitive rates of interest — consistent with the associated level of risk — and, in many cases, offering reasonable credit risk management, in view of the paucity of information available. Financial crowdfunding offers new ideas about traditional business, revealing certain aspects which the banks would do well to reflect on and which we will touch on below.

4: See the statement, in Spanish, by the Peruvian stock exchange authority, the Superintendencia del Mercado de Valores: http://www.smv.gob.pe/Uploads/AvisoCrowfunding.pdf

- **Creating new, more understandable products for the retail investor**

  One of the successes of crowdfunding platforms has been in making financial instruments which are similar to pre-existing fixed and variable income products available to retail investors, but in stakes or amounts that are far lower than in the past, and investing in entrepreneurial projects that are closer to the investor. Traditional banking can mimic the issuance of this type of products through pre-existing digital channels such as online banking or specific new platforms. This would reduce mediation costs and, furthermore, facilitate the banking sector's entry into the crowdfunding business.

- **New scoring tools**

  Moving beyond the traditional scoring methods, which use the client's credit track record, some platforms, such as the British *Zopa*, and other platforms that issue credit online, such as *Lenddo* and *Kredit24*, seek to extract additional information from the borrower to enrich the standard risk profile. Thus, semantic analysis of replies to certain questions, the way someone interacts with the platforms, the response times, etc. become new variables which are added to traditional credit information to create a new scoring model. The aim is to learn about the customer in a digital relationship as opposed to the knowledge learned through a face-to-face relationship in a physical office.

  The digital reputation of the applicant or the project may also be included as a variable in calculating each applicant's risk profile. In order to measure it, data are used such as the number of visits to the project's web, its profile on the platform itself, the number of "likes" received, or other positive references in public profiles, the number and quality of contacts on other social media, etc. Even though the data obtained from the internet may not be of sufficient quality, it is also true that all this digital information becomes more useful when applied to subjects about whom there is hardly any information in terms of their credit history.

  Here, the banking sector can add new tools to its systems which enable it to learn about the client and their environment, for risk assessment when little financial information exists, and to extend its knowledge of those who are already customers. In any event, and particularly in the case of individuals, personal data protection measures guaranteeing customers' privacy are applicable.

- **New ways of reaching customers and giving them better service**

  Crowdfunding platforms have proved to be speedier in handling requests and originating financing than traditional methods, as well as representing a way of reaching a higher number of potential customers with profitable projects and as yet unmet needs.

  More extensive use of ICT can help the banking sector to be more agile in its products and services offering, as well as improving the user experience through new channels which can be accessed at any time and from anywhere. The presence or development of digital platforms which involve the creation of profiles or relationship networks between peers has a crowding-in effect, which may also be a new way of winning customers.

- **Banking and the crowdfunding business model**

  Some crowdlending platforms have business models in which the role of the bank is that of mediation. As outlined earlier in this report, this model is used by the US platforms *Lending Club* and *Prosper*. In these cases the bank originates a consumer loan, which is immediately sold to the platform, so the bank recovers its investment plus a fee and carries no risk. This activity can take place provided the regulation permits the sale of the loan.

Another way in which banks and crowdfunding platforms could work together would be by sharing customers and encouraging their loyalty. Thus, banks may send on to the platforms those customers to whom they cannot give financing — or not on conditions that are acceptable to the customer — because of their risk profile, while the platforms can promote the banks' accounts or cash flow management services. The bank may also opt to operate a crowdfunding platform itself (using the same brand or another, separate, one) to handle higher-risk customers or small operations, thus getting a share of the segment that falls outside its traditional business.

An offshoot from the previous idea would be to create platforms to finance local and social projects, through which the financial institution could attract deposits, committing it to invest in the projects it publishes. It might also be possible to share risks with the crowd and cover a proportion of the financing through joint investments. The brand would gain from being linked to corporate social responsibility projects, although the greater risks inherent to this type of financing would have to be borne in mind.

In any event, an attractive design is necessary, similar to that used by social media, to attract a segment of the population that is increasingly accustomed to digital media, and to improve the user experience on the journey with the financial institution, thus helping to retain the customer.

8. Conclusions

Financial crowdfunding can play a fundamental role as a complement to traditional sources of financing, above all for companies in their early development phases and for higher risk projects which experience difficulties in accessing financing from banks, given that the latter tend to have greater risk aversion. Thus, financial crowdfunding may help business initiatives and innovation to flourish, driving economic development. What is more, in a context of a credit drought and economic crisis, it could become a key element in alleviating financing needs, contributing to economic recovery, at the same time as it offers high returns on saving. Nevertheless, the risks of solvency and liquidity are potentially high for investors, in a market where greater informality exacerbates the problems of information asymmetry between those requesting funding and those supplying it.

A balanced regulatory framework is therefore necessary, one which enables this complementary source of funding to develop at the same time as it protects retail investors and avoids potentially systemic risks. Furthermore, in the case of the European Union, we need legislative harmonisation to prevent fragmented markets. Finally, over and above the role played by regulators, it is crucial to raise the level of financial literacy among the population.

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Appendix A

Table A
Platforms analysed

Country	Platform	Business model
US	Lending Club	Mediated crowdlending
	Prosper	Mediated crowdlending
	AngelList	Equity crowdfunding
	P2B Investor	Factoring
United Kingdom	Funding Circle	Direct crowdlending
	Zopa	Direct crowdlending
	RateSetter	Direct crowdlending
	LendInvest	Direct crowdlending
	MarketInvoice	Factoring
	Abundance Generation	Fixed income
	AngelsDen	Equity
	Wellesley & Co	Direct crowdlending
Several countries	Crowdcube	Equity
Chile, Brazil	Broota	Equity
Mexico	Prestadero	Direct crowdlending
	Kubo Financiero	Direct crowdlending
	Vakita Capital	Equity
Argentina	Afluenta	Direct crowdlending
Chile	Cumplo	Direct crowdlending
	Becual	Direct crowdlending
	Merfac	Factoring
	Eollice	Fixed income
Spain	Lendico	Direct crowdlending
	Comunitae	Direct crowdlending
	Arboribus	Direct crowdlending
	LoanBook	Direct crowdlending
	The Crowd Angel	Equity
	Socios Inversores	Equity
	Zank	Direct crowdlending
	NoviCap	Factoring
Germany	Seedmatch	Fixed income
	Companisto	Fixed income
France	Hellomerci	Direct crowdlending
	Anaxago	Equity

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