FSUG Position Paper on the Study of

"Crowdfunding from an Investor Perspective"

The Financial Services User Group (FSUG) is an expert group set up by the European Commission following the core objective "to secure high quality expert input to the Commission's financial services initiatives from representatives of financial services users and from individual financial services experts". The mandate of the group is to:

- advise the Commission in the context of the preparation of legislative acts or other policy initiatives affecting users of financial services, including consumers, retail investors and micro-enterprises;
- provide insight, opinion and advice concerning the practical implementation of such policies;
- proactively seek to identify key financial services issues which affect users of financial services;
- where appropriate, and in agreement with the Commission, liaise with and provide information to financial services user representatives and representative bodies at the European Union and national level, as well as to other consultative groups administered by the Commission, such as the European Consumer Consultative Group, the Payment Systems Market Expert Group, the European Securities Markets Expert Group and the Expert Group on Financial Education.

September 2015

Introduction and Background

Crowdfunding is an emerging area of financial markets intermediation that has shown impressive growth rates since the financial crisis. The main forms of crowdfunding are: a. donations, b. rewards, c. pre-sales, d. lending and e. equity, according to the taxonomy referring to the type of exchange between the project owner and the contributor/investor. Each form entails distinct specificities that has led most of the regulatory bodies to treat them differently, mainly distinguishing between crowdfunding with non-financial returns (donations, rewards and pre-sales) and crowdfunding with financial returns (lending and equity). Irrespective of the regulatory approach, the emerging industry of crowdfunding does provide an additional option for a broad spectrum of users of financial services with distinct benefits and risks. However, even though this area has been rapidly expanding, use and awareness percentages are still relatively unknown. Furthermore, the level of understanding of crowdfunding benefits and risks of the existing investors seeking financial returns is an area that has not been adequately analyzed so far and consequently there are not enough data to draw safe conclusions about future prospects.

Thus, in 2014, the FSUG drafted Terms of Reference for external research to be carried out in the area of crowdfunding with financial returns from users'/investors' perspective, focusing on: a. exploring awareness about the crowdfunding industry in general, and b. exploring benefits risk perceptions for active users of crowdfunding. The objective of this research was to shed light in these areas that have not been explored so far. The study was commissioned to the research company Oxera, which submitted the attached final report. The FSUG worked closely with Oxera, supervised and monitored the progress of the research study. It has engaged in discussions and directed the research company, and it has submitted comments and inputs on a regular basis. The study covered the following 4 (four) Member States: Germany, Poland, Spain and the UK[1].

In terms of methodology, the study is structured in three distinct parts. The first part reviews the literature on crowdfunding. The second part displays results and conclusions drawn from a market research, which measured the awareness, usage and risk of crowdfunding from the perspective of investors. This second part of the study that refers to the market research is further divided in two stages. The first stage consisted of two questions in an omnibus survey conducted via computer-assisted telephone interviews (CATI). In the second stage multiple questions were presented in an online survey or computer-assisted web interview (CAWI);

[1] Germany, Poland, the UK and Spain were the sample of countries chosen for this report. The aim was to include countries that are representative of various geographic regions and in terms of the level of development with respect to crowdfunding.

the second stage was better suited to analyze usage and perception of crowdfunding. The third part of the study consists of a detailed overview of discussions with 10 (ten) crowdfunding platforms, including a summary of the responses and a discussion of the findings.

Summary of Findings

We summarize the main findings of the study, following the structure described above.

Literature Review

- There is a growing body of literature on the rapid rise of crowdfunding in recent years.
- The growth of crowdfunding is primarily linked to two factors: a. the growth of the Internet, which facilitates new channels linking investors with fundraisers; and b. the global financial crisis that began in 2008, which reduced the availability and attractiveness of bank lending.
- The literature shows that crowdfunding is complementary to, as well as a substitute for, traditional forms of finance, as it serves new as well as existing market segments (in terms of both investors and borrowers). Specifically, detailed due diligence for smaller projects is too costly, making crowdfunding a more feasible alternative to traditional forms of finance, as platforms conduct only high-level due diligence and initial screening. Furthermore, P2P lending has also allowed capital to flow to communities that were underserved by the credit markets even prior to the retraction of those markets in 2008; individuals have been able to consolidate their loans, pay off debts, and improve their credit scores.
- The main benefit of crowdfunding is the so-called ‘wisdom of the crowd’ in projects and investments, in the form of market-testing and validation, user-based innovation and customisation, marketing, networking, follow-on funding, business development and due diligence. The ‘wisdom of the crowd’ is also considered as an additional growth factor for the crowdfunding industry.
- One of its primary risks is project risk, resulting in possible defaults or late payments. For large P2P lending platforms, default rates appear, at present, to be low, but for equity crowdfunding, failure rates are not yet known (as projects last several years and platforms have not been operating sufficiently for a long enough period to get some indication of failure rates), although they are estimated to be significant. Other risks of

crowdfunding include liquidity risks due to illiquid or non-existing secondary markets, platform failure, raising insufficient funds, fraud, future share dilution (for equity crowdfunding), and cyber attack.

- A key concern is of investor's inexperience and possibly low levels of risk awareness. This concern is increased by cases of quick funding and potential herding behaviour by investors[2]. On the other hand, both of these can be consistent with rational responses to information signals. Empirical evidence suggests that a significant proportion of investors in crowdfunding—especially equity crowdfunding—have a relatively high income as well as investment experience.
- Platforms have incentives to address these issues by adopting measures such as bringing on board sophisticated investors[3], screening projects, and being transparent about projects, past performance and the platforms' own business models. Other measures adopted by some P2P lending platforms include setting up a contingency fund to cover lost capital in the event of borrower default, and securing loans with collateral.

Market research

<u>On Awareness</u>

- Awareness levels are highest in Germany (21.5%), followed by Spain (17.4%) and then Poland (16.6%)[4]. The difference between the latter two is not statistically significant.
- Awareness rates among males are higher than among females.
- There seems to be a tendency for younger age groups to have higher awareness rates.
- Education and income are broadly positively correlated with awareness levels for all countries considered.
- Online-based articles are the most important source of awareness. Newspaper articles and books, television and friends or colleagues are also important sources of awareness.

<u>On Usage</u>

- For the largest proportion of investors, being particularly interested or excited about a specific company or project appears to be an important motivator for investing.

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[2] For example a campaign raised EUR 250,000 in only 7 hours and 18 minutes. However, it is not easy to draw safe conclusions from such behaviour schemes, as this early funding could come from friends and family or even investors that have been following the pre-launch campaign of such cases and have already collected certain levels of information.

[3] A sophisticated investor is defined as a type of investor who is deemed to have sufficient investing experience and knowledge to weigh the risks and merits of an investment opportunity.

[4] Since there is recent market research on awareness for the UK, the UK was not included in the market research exercise, but is included in other parts of the study.

- There is a positive correlation between responses indicating investing in equity crowdfunding and investing in P2P lending, meaning that investors that tend to invest in equity crowdfunding, also invest in P2P lending.
- Around 60% of the respondents have invested less than 10% of their savings in equity crowdfunding or in P2P lending.
- Concerns about the reliability of this form of investment, as well as the lack of specific regulation of platforms, were rated as the most important reasons not to invest for both forms of crowdfunding. Being concerned about poor financial returns was the least important reason not to invest for both forms. For both equity crowdfunding and P2P lending, the second most highly rated source of concern was that the platform might be fraudulent, raising concerns about platforms' reliability.
- Respondents rated more highly the risk of having poor ongoing information about the borrower in P2P lending, than they rated the risk of having poor information on the state of the investment in equity crowdfunding.

Discussions with crowdfunding platforms

- The UK has substantially larger platforms in terms of volume of funding than the other countries considered, followed by Germany, then Spain and then Poland. There is also a significant difference between P2P lending and equity crowdfunding in all the four countries, with the former having much larger platforms in terms of volume than the latter.
- Platforms tend to be growing rapidly on all size indicators considered, including volumes, and numbers of subscribers (i.e. investors and borrowers/entrepreneurs).
- Managing project risk is a key focus for all the platforms included in the discussions. Overall, as platforms become more developed, there appears to be a trend towards increased risk management, including some significant innovations. These range from better risk-spreading (e.g. and automated portfolio-building tools) to setting up insurance funds and secondary markets.
- All platforms stated that they conduct initial screening, with reported rejection rates ranging from 70% to 99% (average around 80%, one equity crowdfunding platform denoted an acceptance rate of 1.2%) of received applications
- Many platforms publish past performance data, as uncertainty about project risk has negative consequences for reputation. It should be noted however that past performance is not necessarily

a good indicator of future performance.
- A full understanding of the project risk associated with crowdfunding is limited by the short history of this form of finance. Arguably, experience of at least a full economic cycle would be required before clear conclusions can be drawn.

FSUG Position and Recommendations

The FSUG adopts a neutral position on this new type of financial innovation. We recognize the industry's huge positive potential for users of financial services and for financing the real economy and especially the micro and small enterprises. On the other hand, we are also concerned about potential risks of crowdfunding particularly for retail investors and micro enterprises (with less than 10 employees). This neutral position derives from our view that "*a full understanding of the project risk associated with crowdfunding is limited by the short history of this form of finance*" and that "*experience of at least a full economic cycle would be required before clear conclusions can be drawn*".

We believe that the main distinct characteristic of crowdfunding with financial returns is that the main motivator for investing via crowdfunding is excitement about a specific company or project. This characteristic differentiates this form of investment from users' perspective from all other alternatives of investment. This needs to be treated with caution by all crowdfunding stakeholders, as it implies that investment decision making in crowdfunding does not seem to be made primarily by rational financial principles, but rather by emotional perceptions mixed with financial returns anticipation.

Analyzing the current situation, there is some evidence to suggest that the industry (i.e. the crowdfunding platforms) has been following a rather "conservative" approach so far. High project rejection rates, low default rates of funded projects and the overall behavior of platforms regarding risk management show that platforms seem to have adopted a low-risk approach. This evidence is stronger for p2p lending than for equity crowdfunding, where a longer period of maturity is required to draw conclusions. In this context however, vital questions still remain. For example, little is known on the applied risk assessment mechanisms, especially for equity crowdfunding, where risk is by definition higher than in p2p lending. Furthermore, there is no evidence and no obvious pathway on the consequences of a major negative event in crowdfunding, regarding how stakeholders (platforms and funders) will behave.

Looking at the future, regulation is a key issue with several dimensions. In terms of investor protection, users themselves recognize the importance of regulation, as one important conclusion of the study was that "*Concerns about the reliability of this form of investment, as well as the lack of regulation of platforms, were rated as the most important reasons not to invest for both forms of crowdfunding*". Thus, investors seem to ask for higher levels of safety that can be achieved by smart regulation. In terms of industry growth, regulation seems to define how the industry will grow. Different regulatory regimes in different European Member States seem to have led the industry to follow different paths among Member States so far. Furthermore, the absence of any specific regulatory regime is practically prohibiting crowdfunding even to function in some other Member States. This brings us to another dimension of regulation at European level which refers to the need of harmonization. A single market of crowdfunding cannot be achieved unless national regulatory regimes are harmonized. Following on the single market issue, little is known on cross-border crowdfunding activity and this particular issue was highlighted in the 1st European Crowdfunding Stakeholders Forum (ECSF)[5]. However, certainly, different rules that regulate crowdfunding activity among European Member States are a significant barrier for cross border activity (other main barriers being, differences in taxation, cultural differences, project ties to local economies, language barriers).

The European relevant Authorities (SMSG-ESMA for equity crowdfunding[6] and EBA for p2p lending[7]) have already undertaken initiatives to lie the foundations by providing suggestions on how a pan-European regulatory framework could be developed respectively. Furthermore, the European Crowdfunding Network recently published a Review of Crowdfunding Regulation among European Member States (plus Canada, Israel and the United States), mentioning in the foreword that "*we are still far from a harmonised single market for crowdfunding, maybe even further than last year*"[8]. Last, we raise the issue of enhancing regulation development on crowdfunding in our recent Response to the Prospectus Directive, where we suggest that some exemptions could be granted from the obligation to prepare a prospectus for platforms, under specific circumstances.

Thus, we urge the European Commission to undertake an initiative in this area. The scale of EU harmonisation may better achieve the desired end result of a pan European crowdfunding market. Furthemore, it should be much easier to do this with emerging product markets, unlike some of the areas where national markets are deeply entrenched. At the same

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[5] Minutes of 1st ECSF: http://ec.europa.eu/finance/general-policy/docs/crowdfunding/140925-minutes_en.pdf

[6] http://www.esma.europa.eu/system/files/2014-smsg-010.pdf

[7] https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-03+(EBA+Opinion+on+lending+based+Crowdfunding).pdf

[8] http://www.eurocrowd.org/files/2014/12/ECN-Review-of-Crowdfunding-Regulation-2014.pdf

time, we acknowledge that the ideal balance of high levels of consumer protection and lowest regulatory costs, that do not severely undermine a sector in its infancy, is not easy to strike. The Commission could follow the "margin advantage" regulatory approach, identifying how much it could impose a degree of regulation without compromising the economic advantage of crowdfunding. We still worry that if there is a major failure in this emerging market, it could set things back for years, seriously hurting consumer confidence in the market. Looking at the other side of crowdfunding, namely the fundraisers, the growth of the crowdfunding industry may shed some light in the highly opaque area of SMEs and particularly micro firms financing. Currently, we have very little idea about the needs and characteristics of micro enterprises, which consist 92% of total enterprises and employ one third of the total workforce in EU-28. This is a vast area of the European economy which seems to be better suited with the crowdfunding market when compared to other financial institutions. Bearing in mind that the rejection rates of projects are considerably high (around 80%, while an equity crowdfunding platform reported a rejection rate of 99%), it is worth investigating how far P2P and crowdfunding really act as true alternatives for firms denied access to credit/capital.

Last, it is worth mentioning that we have identified a trend where regulated financial institutions are entering the p2p lending market. We remain agnostic on this trend, but we raise the issue of fair competition, in case the main incentive of the financial institutions' market entry is to stifle competition against their respective operations. In any case, we will be following this trend to shape a better picture of this interesting advancement.

Summing up, crowdfunding is a rapidly developing area that has attracted considerable interest from finance professionals, regulators, academics, businesses and, increasingly, the general population (as potential and actual investors). Understanding of the benefits and risks associated with crowdfunding (from the investor's perspective) is still developing among financial practitioners and academics. As such, a lack of clarity around what those benefits and risks might be for investors is to be expected. In this context, the regulatory authority plays an important role, in navigating the future paths of the industry. The near future will show whether crowdfunding is an alternative or a new way of financing.