SCOTTISH EXPERT ADVISORY PANEL ON THE COLLABORATIVE ECONOMY
MEETING 31 AUGUST 2017: DISCUSSION PAPER ON COLLABORATIVE FINANCE INCLUDING FINTECH AND BALANCING COMPETITION AND REGULATION

Purpose of this paper

This paper has been drafted to ***aid discussion*** at the "Collaborative finance including Fintech and balancing competition and regulation" evidence session for the Scottish Expert Advisory Panel on the Collaborative Economy. *Recommendations cited in this paper that were made by respondents do not constitute endorsement. This paper specifically focuses on new forms of Collaborative Finance. A separate discussion paper looking at broader issues of competition and regulation accompanies this report.*

Based on information and evidence solicited through the call for evidence this paper highlights the key issues around **collaborative finance.** The job for the expert panel is to interrogate the evidence and opinions and to reflect on the key issues of debate.

The paper has been informed by a call for evidence which was open between 24 April and 29 May 2017. It asked seven questions to gather views and experiences from Scotland's citizens and businesses on the collaborative economy. 52 responses were received in total but with only two *specifically* related to collaborative finance. A full analysis of the call for evidence responses, by Craigforth, social research consultants, can be found here http://www.gov.scot/Publications/2017/08/3104**. It contains a mix of evidence and data and opinion.**

Chair's Comments

I'm delighted that we are able to invite a number of organisations to present their evidence, commentary and experiences of working close to, or in, the collaborative finance market. Not only has this market seen huge growth in recent years, it has relevance not just to businesses and start up and SME communities but also charitable institutions, foundations and the public sector.

As part of the collaborative economy, those working with new business models in the alternative finance market have been very progressive and effective in engaging with regulatory issues and institutions. There is much that we can learn from that has relevance to the broader issues of regulation within the collaborative economy.

Participants in this session are:

- Peter Baeck from Nesta, who has been researching the rise of the alternative finance market for a number of years, contributing to our wider understanding of the global market, and relevance to the UK economy. Peter will present an overview of the market at the beginning of the meeting.
- As more public sector institutions and governments look to crowdfunding to mobilise more resources and engagement in their work, Kirsty Macari will explain the purpose and impact of the crowdfunding work Angus Council are undertaking.

The Financial Conduct Authority (FCA) have been at the vanguard of practical interventions to understand the implications of collaborative finance, developing unique approaches to anticipating new business models that impact financial regulatory frameworks. The FCA were unable to attend the session but highlighted their Feedback

Statement: Interim feedback to the call for input to the post-implementation review of the FCA's crowdfunding rules[1]. An extract from this is provided in the Annex to this paper.

COLLABORATIVE FINANCE

Background

With traditional financial institutions becoming more risk averse, new ways to access capital have been emerging. Collaborative finance is a new development of financial transactions between individuals and businesses. The sector is growing and has yet to reach its potential. Collaborative finance plays an important role in helping individuals and businesses access capital contributing to inclusive growth.

PwC[2] describe collaborative finance as ***individuals and businesses who invest, lend and borrow directly between each other, such as crowd-funding and peer-to-peer lending.*** In 2015 they estimated that it generated € 250m in revenue and was valued at € 5,200m. Collaborative finance is also known as crowdfunding, two descriptions are detailed below.

- *Crowdfunding is a way of financing projects, businesses and loans through small contributions from a large number of sources, rather than large amounts from a few. Contributions are made directly or through a light–touch platform rather than through banks, charities or stock exchanges.* (Nesta)

- *Crowdfunding is a way in which people and businesses (including start-ups) can try to raise money from the public to support a business, project, campaign or individual.* Financial Conduct Authority (FCA)

Crowdfunding usually takes place on a digital platform that allows businesses or individuals to raise money, and investors to provide that money. The business or individual seeking finance often explains their project in a pitch to attract loans or investment from as many people as possible. The FCA does not regulate all models of crowdfunding[3]. The models that are regulated are:

- **loan-based**: also known as 'peer-to-peer lending', this is where consumers lend money in return for interest payments and a repayment of capital over time
- **investment-based**: consumers invest directly or indirectly in new or established businesses by buying investments such as shares or debentures

Those they don't regulate are:
- **donation-based**: people give money to enterprises or organisations they want to support
- **pre-payment or rewards-based**: people give money in return for a reward, service or product (such as concert tickets, an innovative product, or a computer game)

[1] https://www.fca.org.uk/publication/feedback/fs16-13.pdf, December 2016
[2] PwC, Assessing the size and presence of the collaborative economy in Europe, 2015
[3] https://www.fca.org.uk/consumers/crowdfunding

Nesta's study of 94 crowdfunding and P2P lending platforms examines the growth, trends and dynamics within the UK alternative finance sector in 2015. In this report, it was found that:

- In 2015, the alternative finance market grew to £3.2 billion
- The market is taking an increasing share of small business lending and start-up investment. Alternative finance business lending is 12% of the market for lending to small businesses in the UK. Equity crowdfunding is 15.6% of total UK seed and venture-stage equity investment.
- The fastest growing models in 2015 were donation-based (grew by 500% since 2014 to £12 million) and equity-based crowdfunding (grew by 295% since 2014 to £332 million).
- The market saw increased involvement from institutional investors: 45% of all platforms reported some level of institutional involvement.
- Real estate is the single most popular sector: the combined debt and equity-based funding for real estate amounted to almost £700 million in 2015.

Crowdfunding raised just over £27m in Scotland between October 2014 and September 2015. Crowdlending (P2P) to businesses was the largest sector valued at £20,529,000 with reward campaigns raising £2,586,594 and equity campaigns raising £3,948,777. The proportion of the value of UK crowdfunding raised in Scotland has risen from below 1% in 2013 to 4%[4].

Collaborative finance – call for evidence

Opportunities

Across the board, responses to the call for evidence referred to a range of potential opportunities and benefits in relation to collaborative financing:

- Several respondents – including collaborative finance businesses, business representatives and public sector respondents – referred to scope for collaborative finance to **expand the range of people engaged in the collaborative economy**. This included reference to enabling those in more rural and disconnected parts of Scotland to engage with a wider network of collaborators and customers, potential new funding opportunities for third sector and social enterprise development, and potential to enable individuals with minimal capital to develop new ideas.
- A business representative respondent also suggested that collaborative financing can help to address long-standing issues around the range of finance options available to smaller businesses.

[4] The Scottish Crowdfunding report 2016 http://www.glasgowchamberofcommerce.com/media/1764/the-scottish-crowdfunding-report-2016.pdf

- A collaborative finance business respondent suggested that Scotland has an **opportunity to create a robust and inclusive collaborative economy that can benefit all stakeholders** - enabling businesses and platforms to thrive, benefiting consumers, and addressing the needs and concerns of communities. This respondent saw an opportunity for the Scottish Government to establish the regulatory and economic frameworks to enable development of a more inclusive collaborative economy.

- A collaborative finance business respondent referred to the **strength of digital expertise and entrepreneurial networks** in Scotland as providing opportunities for development of new approaches and ideas.

- A public sector respondent referred to a local partnership which seeks to use collaborative finance to **provide funds to support community, business, sports and social enterprise**, and which was seen as having been effective in raising awareness and buy-in from consumers and businesses.[5]

- A public sector respondent **expected to see an increase in collaborative financing**, and suggested that this may be on a more commercial equity basis.

- A business representative respondent referred to **specific collaborative finance innovations** such as mutual sick pay funds, cash-pooling schemes and collective insurance schemes such as bread funds. These were seen as having a potentially significant role for providers of collaborative economy services who wish to self-organise to mitigate the risks that they face.

Challenges

The key challenges for collaborative finance raised by respondents were:

- **Connectivity** was raised as a challenge, and as potentially limiting opportunities for rural communities to participate in the collaborative economy more broadly. It was also suggested that digital skills can be a barrier to some demographic groups accessing the collaborative economy, including specific reference to deprived urban communities.

- A collaborative finance respondent raised concerns that **entrepreneurial support structures can be focused on specific demographics**, and that more diverse support is required.

- **Financial risks and failure to honour obligations** were mentioned as significant challenges by another organisation respondent. It was suggested that these concerns could act as a barrier to individuals or businesses engaging with the sector.

[5] www.crowdfunder.co.uk/angus

<u>Balancing regulation with competition and innovation</u>

Points raised by respondents in relation to balancing regulation and competition/ innovation specifically within collaborative financing included:

- A public sector respondent made reference to **potential issues for crowdfunding approaches** where consumers may not understand the implications when investing or contracting. This respondent suggested that there is a risk of large scale fraud or consumer protection offences, and that awareness raising is required to ensure that contributors understand the legal implications of their involvement.

<u>Barriers to growth</u>

Respondents identified few specific barriers to growth in relation to collaborative financing. Indeed, one respondent suggested that the issues facing the collaborative finance sector were global or European-wide, rather than being specific to Scotland. Nevertheless, it was noted that Scotland has a unique opportunity to address these barriers through an appropriate regulatory approach and a supportive environment which will enable companies to thrive.

In terms of specific barriers to growth of the collaborative finance sector, the only specific suggestion was **limited broadband and 3G/4G connectivity** across parts of Scotland.

<u>Role of government</u>

The key point raised by respondents on the role of the government specifically in relation to collaborative financing was:

- A public sector respondent suggested that **government guidance would be required** to steer any expansion of collaborative finance into the public sector.

Key considerations for discussion during evidence session

A number of stakeholders have been invited to provide additional evidence at the fourth meeting of the Expert Advisory Panel on the Collaborative Economy. Invited stakeholders have been asked to consider the following questions and will be given ten minutes to outline their responses.

1. Peer to Peer Finance in increasingly playing an important role in helping individuals and businesses access capital contributing to inclusive growth. What needs to be in place to protect participants on both sides and facilitate trust?

2. How can we ensure that participants are informed about traditional and collaborative finance models?

3. How could the innovation and learning within the collaborative finance sector, be applied to other sectors within the collaborative economy?

ANNEX

Extract from: Financial Conduct Authority- Interim feedback to the call for input to the post-implementation review of the FCA's crowdfunding rules

Feedback

Context

We published new rules to protect investors on loan-based and investment-based crowdfunding platforms in February 2014, which, subject to certain transitional provisions, generally came into force on 1 April 2014[6]. Our aim was to set a proportionate framework of rules that ensured investor protection without impeding innovation and growth in the market.

1.9 The regime we introduced reflected that the crowdfunding market was relatively new and had the potential to improve competition by helping to provide alternative sources of finance for individuals and businesses seeking to raise funds.

1.10 When we introduced the rules, we said we would conduct an interim review of the rules after one year and a full post-implementation review of the regime in 2016. We are conducting that review at the moment, using information gathered through our supervision and authorisation of crowdfunding platforms. We held a roundtable with firms, trade bodies and consumer organisations and have commissioned consumer research to ensure we hear from a broad range of stakeholders.

1.11 The call for input, published earlier this year, invited views on possible risks that may be emerging for investors and the market. It also asked whether we should consider new rules in any areas, and whether borrower protections are adequate or should be enhanced. The call for input closed on 8 September 2016. In this paper, we summarise the feedback we received and set out our plans for further work.

Chapter 5 Next Steps

5.1 The post-implementation review is continuing. This paper is an interim report to summarise what we have been told so far in response to the call for input. In this chapter, we set out our next steps in the completion of the post-implementation review including our intention to consult on new rules in some areas.

Continuing research

5.2 We are gathering further evidence to support the post-implementation review. We are investigating how the market has changed since the rules were introduced in 2014. We are also conducting research into the needs, expectations and understanding of the fundraisers and investors who use crowdfunding platforms.

5.3 To support our analysis of market developments, we have several work-streams in place:

- We are conducting a review of the business models and practices at some firms to collect evidence on potential risks and address any knowledge gaps.

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[6] 4 The FCA's regulatory approach to crowdfunding over the internet, and the promotion of non-readily realisable securities by other media: Feedback to CP13/13 and final rules (PS14/4), March 2014: www.fca.org.uk/static/documents/policy-statements/ps14-04.pdf.
Separately, we published rules to protect borrowers in Detailed rules for the FCA regime for consumer credit including feedback on FCA QCP 13/19 and 'made rules' (PS14/3), February 2014: www.fca.org.uk/publication/policy/ps14-03.pdf.

- To assist with our monitoring of the sector, we are analysing third-party market data alongside other information sources.
- We are also drawing from our work authorising and supervising firms in this sector.

Initial findings from our supervisory work

5.4 We are conducting work with firms to collect evidence on potential risks and address any knowledge gaps. This work, which is still in progress, has covered about two thirds of the loan based crowdfunding market by volume, across the personal, business and property-lending sectors.

5.5 Some of the interim results from our work on loan-based crowdfunding are as follows:

- We found inadequate disclosures about risk and loan performance.
- Firms are testing the boundaries of the regulated crowdfunding perimeter, which introduces the risk of arbitrage with investment management or banking activities.
- Firms' desire to maintain confidence in platforms has occasionally led to firms acting in a nontransparentmanner, masking true loan performance and exposing investors to risks. This has included management intervening to influence the performance of loans (e.g. by covering arrears) or otherwise acting to support the platform (e.g. lending to provision funds).
- Firms have limited scope to increase market share with their current products and are instead targeting growth through new products or in new markets. This brings the risk of operating in unfamiliar markets without appropriate expertise, exposing longer-term investors to unforeseen lending risks.
- Consumers may not realise they do not have the usual protections as borrowers, where agreements are non-commercial, and firms may not make them aware of this.
- Institutional investors could bring benefits for retail investors (e.g. due diligence) but better controls are needed to mitigate the risks – particularly around conflicts of interest.
- Some platforms allow investment in loans formed on other platforms, which can make it harder for investors to conduct due diligence or to understand the level of risk they are taking. Failure of one firm could also cause problems for other firms in the market where investors in one platform are exposed to loans on a third-party platform.

5.6 Some of the interim results from our work on investment-based crowdfunding include:

- Concerns about inadequate disclosures on investment-based crowdfunding platforms and the downplaying of risk.
- Due diligence standards vary from firm-to-firm and not all firms explain their due diligence processes on their websites.
- None of the platforms we reviewed provided an assessment of the valuation of a pitch, although they did challenge the figures proposed by fundraisers.
- Not all firms aligned their business models with the possible future success of businesses raising finance (and, ultimately, the investors).
- Not all firms had an effective internal control system in place with regards to the processes used for approving or communicating financial promotions.
- Not all firms satisfied the requirements to conduct an appropriateness test to assess whether investors have the knowledge or experience to understand the risks involved in the investment.

5.7 Our ongoing supervision of the market will help us determine whether there is a need for further rule changes.

Consumer research

5.8 The Cambridge Centre for Alternative Finance at Cambridge Judge Business School, University of Cambridge, is working with us to carry out research with the investors and fundraisers on investment-based and loan-based crowdfunding platforms.[7] This research will collect and analyse data from investor and fundraiser surveys, qualitative interviews and crowdfunding platforms' transactional databases.

5.9 This will help us understand the needs and objectives of the people and organisations served by the crowdfunding sector. We will also compare this information with our understanding of the market in 2014, when the current regime was introduced, to see if the customer base has changed.

Proposals for new rules

5.10 Through our work to date, we have identified some specific concerns for which we consider there is potential for consumer harm to warrant consulting on additional rules. We are planning to consult on the following areas.

Loan-based crowdfunding

- Under our current rules, firms should have arrangements in place such that, in the event of their failure, existing loans continue to be administered. Our experience of authorising and supervising firms suggests that wind-down plans could be improved to reduce the risks to investors of the plans not operating as expected. We propose to strengthen the rules and plan to consult on additional requirements.
- Some firms operating loan-based crowdfunding platforms allow investment in loans originated on other platforms. Where the firm acts as an aggregator and does not originate loans, this is less likely to represent a risk to our objectives. However, where other firms allow cross-investment, we are concerned that this may give rise to risks to investors as the failure of one platform may have a direct impact on the viability of others. We plan to consult on additional requirements or restrictions on cross-investment.
- In the call for input we discussed our plans to consult on extending the usual mortgage lending standards to loan-based crowdfunding platforms where the investor/lender is not acting by way of business. This was received positively by respondents and we will now proceed with the consultation.

Loan-based crowdfunding and investment-based crowdfunding

- We have concerns about the quality of communications with potential investors, particularly financial promotions. We remain concerned that standards of disclosure do not meet our expectations. As well as ongoing supervision of existing rules, we plan to consult on more prescriptive rules on the content and timing of disclosures we expect to see.

5.11 Our aim is to consult in the first quarter of 2017 and to publish the final rules in the summer of 2017.

Potential consultation on further rule changes

5.12 The consumer and market research should be completed early in 2017. At that stage, we will be able to complete the post-implementation review and determine whether further consultation on rule changes is needed. If necessary, we will be able to publish a second consultation on rule changes in mid-2017, with any such rules coming into force in 2018.

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[7] 17 Financial Conduct Authority and the University of Cambridge to review the alternative finance industry, September 2016:http://insight.jbs.cam.ac.uk/2016/joining-forces-to-review-the-alternative-finance-industry/