6 October 2015

Alternative Finance – Shadow Banking and Crowdfunding

Jacob Ghanty, Partner, K&L Gates London
What are Shadow Banking and Alternative Finance?

“If it looks like a duck, quacks like a duck, and acts like a duck, then it is a duck – or so the saying goes. But what about an institution that looks like a bank and acts like a bank? Often it is not a bank – it is a shadow bank”.

- Lending activities which occur outside the banking system

Laura E. Kodres of the IMF
Types of Institution Engaged in Shadow Banking/Alternative Finance Activity

- Alternative asset managers, notably private equity firms
- Lending platforms, including P2P
- Non-bank mortgage lenders
Size of The Shadow Banking Sector

Assets of non-bank financial intermediaries across 20 jurisdictions and the Euro area
Drivers of Shadow Banking

- Regulatory arbitrage
- Favourable economic environment
- Technology
Shadows on the Horizon?

- The banks will respond
- Increasing regulatory scrutiny
- Will some of the platforms be able to cope with rapid growth?
ECB warns of risks posed by shadow banking sector
James Shotter in Frankfurt and Claire Jones in Dresden

Shadow lending crackdown looms over China’s stock market
Gabriel Wildau in Shanghai

Shadow banks grab record US loans share
Ben McLannahan in New York

GE Capital tells a cautionary tale for shadow banks
Patrick Jenkins

Shadow banking now poses top risk to US stability, warns IMF
Non-financial lending has reached $15 trillion since the crisis and is outside the control of authorities warns the Fund’s deputy chief

China in numbers: emeralds shine a warning light on shadow banking
Shadow Banking: Credit Considerations

- Which asset and which strategy?
- What else will you be doing?
- Implications for fund structure
- Assignability
- Due diligence
An Overview of the Crowdfunding Marketplace

Tom Wallace, Partner, K&L Gates London
Global Crowdfunding Market

Source: TABB Group, Massolution
UK Crowdfunding Market by Finance Type

The crowdfunding market by platform 2014

<table>
<thead>
<tr>
<th>Finance Type</th>
<th>Amount</th>
<th>Growth Rate 2012-2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>P2P business lending</td>
<td>£749m</td>
<td>250%</td>
</tr>
<tr>
<td>P2P consumer lending</td>
<td>£547m</td>
<td>108%</td>
</tr>
<tr>
<td>Invoice trading</td>
<td>£270m</td>
<td>174%</td>
</tr>
<tr>
<td>Equity crowdfunding</td>
<td>£84m</td>
<td>410%</td>
</tr>
<tr>
<td>Community shares</td>
<td>34m</td>
<td>95%</td>
</tr>
<tr>
<td>Rewards crowdfunding</td>
<td>£26m</td>
<td>206%</td>
</tr>
<tr>
<td>Pension-led funding</td>
<td>£25m</td>
<td>5%</td>
</tr>
<tr>
<td>Debt-based securities</td>
<td>£4.4m</td>
<td>117%</td>
</tr>
<tr>
<td>Donation crowdfunding</td>
<td>£2.0m</td>
<td>77%</td>
</tr>
</tbody>
</table>

Source: Understanding Alternative Finance, published by Nesta and University of Cambridge, November 2014
Snapshot of UK Equity Crowdfunding Market

crowdcube.com

Crowdfunder.co.uk

SEEDRS

InvestingZone

CrowdBnk

SYNDICATE ROOM
UK/EU P2P Sector Composition

Source: AltFi Data, April 2015
UK/EU P2P Platform Dispersion

source: AlfFi Data, April 2015
“Sizing The $4tn Addressable Opportunity”

Exhibit 2: Sizing the $4 trillion addressable opportunity

$ in billions

Crowdfunding: $1,170

Wealth Management: $12,000

Payments: $30

Lending: measured in loans outstanding

Unsecured personal lending: $1,000

Small business loans: $1,413

Student loans: $1,224

Mortgages*: $1,052

*annual loan origination

Disrupting the Disrupters

“the lenders of the revolution look familiar”
Regulation of crowdfunding in the UK

Oliver Lewis, Associate, K&L Gates London
Imagine a world in which there are millions of unsophisticated investors who don’t have the time or experience to evaluate businesses. Would you expect their returns to be higher or lower than the Venture Capitalists who have spent decades doing this?

Dr Michael J Roberts, Harvard Business School
What is the FCA protecting against?

- insufficient consumer understanding
- platform failure
- risk of cyber-attack
- fraud
- credit and/or investment risk is mispriced
Peer to Peer lending platforms

Debt based crowdfunding: “operating an electronic system in relation to lending”

Additional protections for individuals

Minimum Prudential Requirements
Investment-based crowdfunding

Regulated activity?

- Arranging or bringing about deals in investments
- Making arrangements with a view to transactions in investments
- Establishing, operating or winding up a collective investment scheme
Investment-based crowdfunding

Offers to the public

- certified or self-certified sophisticated investors
- self-certified high net worth investors
- those who confirm that, in relation to the investment promoted, they will receive regulated investment advice or investment management services from an authorised person
- retail clients that are corporate finance contacts or venture capital contacts
- restricted investors – i.e. those who certify that they have not invested over a 12-month period more than 10% of their net investment portfolio in unlisted shares or unlisted debt securities (excluding their primary residence, pensions and life cover)
Investment-based crowdfunding

Offers to the public

“Appropriateness Test”

- Where advice is not provided, the FCA expects firms to apply an “appropriateness test” to clients before issuing promotions for unlisted equity or debt securities
- This may involve firms needing to design automated systems to assess client knowledge and experience and to check clients’ understanding of risks
Alternative Finance at the CCAF

• Financial **instruments & channels** that emerge outside of the traditional finance system
• Inform policy-making and industry practice
• Core research themes:
  • Online channels
  • Risk analytics
  • Payment systems
CCAF Research

2013

THE RISE OF FUTURE FINANCE
The UK Alternative Finance Benchmarking Report

2014

UNDERSTANDING ALTERNATIVE FINANCE
The UK Alternative Finance Industry Report 2014

2015

Moving Mainstream
The European Alternative Finance Benchmarking Report
Robert Harday, Bryan Zhang, Rajkumar Pau and Ma Day
February 2015
European Benchmarking Research (Feb 2015)

- 1 Online Benchmarking Research Questionnaire
- 3 Months of Fieldwork
- 14 National/Regional Research Partners
- 27 European Countries
- 65 Platforms from the United Kingdom
- 190 Platforms from Outside of the UK
- 255 AltFin Online Platforms in Total
- Captured 85-90% of the Market
Survey launching in Q4 2015 to cover five global regions

- Americas (launching October 15)
- Asia-Pacific
- Greater China
- UK
- Europe

Network of Cambridge research partners in each region

- Americas: University of Chicago (Booth School of Business)
- China: Tsinghua University (Shenzen)
- Asia Pacific: University of Sydney
EU Market Data: Geographical Distribution European Platforms: Moving Mainstream 2015
Overall Size of the European Alternative Finance Market 2012-14

The rest of Europe 25.7%
UK 74.3%

UK's % Share of European Alternative Finance Market (3 year average)

Average Growth Rate ∆146%

2012 487m
2013 1211m
2014 2957m

Total volume in €m

Legend:
- 325+
- 625-325
- 125-625
- 25-125
- 5-25
- 1-5
- 0.25-1
- 0.04-0.2
- 0.008-0.04
Breakdown of European Market 2014 (Excluding UK)

- Non Financial 26%
  - Donation (Philanthropy)
    - 6% €36 m (+45% vs. Y-1)
  - Rewards (Non financial return)
    - 20% €120 m (+127% vs. Y-1)

- Financial 74%
  - Lending (Financial return)
    - P2P: 45% €274 m (+133% vs. Y-1)
    - Business: 15% €93 m (+270% vs. Y-1)
  - Equity (Financial return)
    - 14% €82 m (+116% vs. Y-1)

€600 m in 2014
<table>
<thead>
<tr>
<th>Country</th>
<th>Consumer Lending</th>
<th>Business Lending</th>
<th>Total Lending</th>
<th>Annual Growth Rate (2012-2014)</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>1,234</td>
<td>1,346</td>
<td>2,580</td>
<td>167%</td>
</tr>
<tr>
<td>France</td>
<td>106</td>
<td>11</td>
<td>117</td>
<td>190%</td>
</tr>
<tr>
<td>Germany</td>
<td>108</td>
<td>8</td>
<td>116</td>
<td>110%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>0</td>
<td>47</td>
<td>47</td>
<td>257%</td>
</tr>
<tr>
<td>Spain</td>
<td>0</td>
<td>19</td>
<td>19</td>
<td>374%</td>
</tr>
<tr>
<td>Nordics</td>
<td>116</td>
<td>37</td>
<td>153</td>
<td>108%</td>
</tr>
<tr>
<td><strong>Total</strong> (1)</td>
<td>~1,564</td>
<td>~1,468</td>
<td>~3,032</td>
<td>~200%</td>
</tr>
<tr>
<td><strong>Total US</strong> (2)</td>
<td>~6,200</td>
<td>~4,500</td>
<td>~10,700</td>
<td>~100%</td>
</tr>
</tbody>
</table>

(1) *Moving Mainstream: The European Alternative Finance Benchmarking Report, February 2015*
(2) *Morgan Stanley Research, May 2015*
## Comparative Data Relative to GDP (2014)

<table>
<thead>
<tr>
<th>Country</th>
<th>Total Lending ($ Billion)</th>
<th>GDP ($ Billion)</th>
<th>Lending as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>$2.580</td>
<td>$2,945</td>
<td>0.0876%</td>
</tr>
<tr>
<td>France</td>
<td>$0.117</td>
<td>$2,847</td>
<td>0.0041%</td>
</tr>
<tr>
<td>Germany</td>
<td>$0.116</td>
<td>$3,860</td>
<td>0.003%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>$0.047</td>
<td>$867</td>
<td>0.0054%</td>
</tr>
<tr>
<td>Spain</td>
<td>$0.019</td>
<td>$1,407</td>
<td>0.0013%</td>
</tr>
<tr>
<td>Nordics</td>
<td>$0.153</td>
<td>$1,278</td>
<td>0.012%</td>
</tr>
<tr>
<td>US</td>
<td>$10.700</td>
<td>$17,420</td>
<td>0.0615%</td>
</tr>
</tbody>
</table>
P2P Awareness is 80% Higher in UK than US Market

P2P Lender Awareness and Use (Among total)

- **US (1)**
  - Unaware: 64%
  - Aware but not used: 21%
  - Used: 15%

- **UK* (2)**
  - Unaware: 55%
  - Aware but not used: 38%
  - Used: 7%

(1) University of Cambridge, November 2015
(2) Morgan Stanley Research, May 2015
## Cross-Model Comparisons: Average Amount Raised + Micro-Transactions

<table>
<thead>
<tr>
<th>Model</th>
<th>Average amount raised</th>
<th>Average number of funders</th>
</tr>
</thead>
<tbody>
<tr>
<td>P2P Consumer Lending</td>
<td>£5,471</td>
<td>201</td>
</tr>
<tr>
<td>P2P Business Lending</td>
<td>£73,222</td>
<td>796</td>
</tr>
<tr>
<td>Equity Crowdfunding</td>
<td>£199,095</td>
<td>125</td>
</tr>
<tr>
<td>Rewards Crowdfunding</td>
<td>£3,766</td>
<td>77</td>
</tr>
<tr>
<td>Donation Crowdfunding</td>
<td>£6,102</td>
<td>55</td>
</tr>
<tr>
<td>Invoice Trading</td>
<td>£56,075</td>
<td>7</td>
</tr>
<tr>
<td>Pension-led Funding</td>
<td>£70,257</td>
<td>N/A</td>
</tr>
<tr>
<td>Debt-based Securities</td>
<td>£730,000</td>
<td>587</td>
</tr>
<tr>
<td>Community Shares</td>
<td>£174,286</td>
<td>474</td>
</tr>
</tbody>
</table>
Industry Perspectives: European Regulations

- 24%: The proposed regulations in my country are excessive and too strict
- 21%: The existing regulations in my country are excessive and too strict
- 18%: The existing regulations in my country are adequate and appropriate
- 15%: We don't have specific regulations in alternative finance and we need them
- 10%: Not sure
- 5%: We don't have specific regulations in alternative finance and don't need them
- 3%: The existing regulations in my country are inadequate and too relaxed
- 4%: The proposed regulations in my country are adequate
UK - Peer-to-Peer Consumer Lending: Regulations and ISAs

Lenders’ view of FCA’s regulations in p2p lending

Would a P2P Lending ISA encourage you to lend more?

- **I will lend more**: 63.87%
- **I will lend about the same**: 35.79%
- **I will lend less**: 0.34%

I didn't know peer-to-peer lending is now a regulated industry: 10.65% (393)
Unsure: 21.00% (775)
Very inadequate: 0.73% (27)
Inadequate: 7.78% (287)
Neither adequate nor inadequate: 3.69% (136)
Adequate: 43.66% (1611)
P2P Business Lending: Why SME Borrowers Chose P2P Lending

- Easier to get funded: 57% Very important, 34% Important, 6% Neither important nor unimportant, 0% Unimportant
- Speed: 53% Very important, 41% Important, 4% Neither important nor unimportant, 0% Unimportant
- Ease of use: 50% Very important, 40% Important, 8% Neither important nor unimportant, 1% Unimportant
- Transparency: 48% Very important, 38% Important, 12% Neither important nor unimportant, 2% Unimportant
- Better service: 42% Very important, 41% Important, 15% Neither important nor unimportant, 1% Unimportant
P2P Business Lending: Motivation for Lending

- To make a financial return: 82% very important, 17% important
- To diversify my portfolio: 39% very important, 49% important, 9% neither
- Support an alternative to banks: 39% very important, 37% important, 16% neither, 5% unimportant, 3% very unimportant
- Control where my money goes: 35% very important, 46% important, 14% neither, 4% unimportant, 1% very unimportant
- Ease of process: 29% very important, 58% important, 12% neither, 0% unimportant, 0% very unimportant
Lenders are Diversifying

If known, how many business loans in total have you funded through this P2P business lending platform?
Emerging Trends

- Diversification
- Affinity Investment / Social Finance
- Hybridisation (Investors & Platforms)
- Institutionalisation (Investors & Platforms)
- Brands & Crowdfunding
- Internationalisation / Regionalization / Localisation
- Regulations & Governmental Intervention; Tax Regimes
Thank You!

http://www.jbs.cam.ac.uk/ccaf

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