The impact of crowdfunding on European microfinance

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Abstract: Crowdfunding has grown spectacularly over the past few years and is likely to revolutionise financial service provision through innovation in delivery and underwriting. This paper discusses the possible impact of crowdfunding on the microfinance sector in the European Union based on an in-depth analysis of the UK crowdfunding market. In particular, the paper asks if crowdfunding will displace or disrupt microfinance provision in the EU as we know it today. The analysis drew on interviews with experts, trade bodies and practitioners. We argue that the impact of crowdfunding on microfinance will depend on the type of crowdfunding and the country context. Equity crowdfunding is likely to have a negligible impact on microfinance, given its emphasis on providing large amounts to scalable businesses and the relatively limited role of equity in business finance. Similarly, although there are no inherent barriers to accessing reward-based crowdfunding, the evidence suggests this form caters to a limited range of businesses (especially creative industries). Peer-to-peer lending, conversely, could potentially have very significant impacts on microfinance institutions (MFIs) by taking their least risky customers, which poses a challenge to their sustainability. The effects of crowdfunding are likely to vary considerably across the EU. Countries where MFIs are largely providing very small loans to socially excluded entrepreneurs, the sector is less likely to be affected, whereas MFIs also lending to established businesses may be more vulnerable. Similarly, the impact may be cushioned where crowdfunding is limited by strict regulation of investment and lending. However, a central argument put forward in this paper is that crowdfunding is a harbinger for a transformation of financial services through technology and innovation, to which MFIs have to respond to remain relevant. There is a lack of research that considers the impact of crowdfunding on financial exclusion. This paper addresses this dearth in research through an in-depth analysis of the UK crowdfunding market.

Key words: Crowdfunding, microfinance

Introduction

Crowdfunding has the potential to completely transform financial service provision the way that Amazon has revolutionised retailing and online travel companies such as expedia.com have transformed travel industry. The industry has grown from virtually nothing before the financial crisis to a large and expanding sector in less than a decade with little to no state support.
CITE EUROPEAN/GLOBAL FIGURES

Democratises business finance and grant making by enabling the crowd to decide which organisation and business receive an investment or a loan

Another important reason for the transformative nature of crowdfunding is the inherent efficiency of scaling up using an online platform compared with branches and offices. It is estimated that US P2P lending platforms have a cost advantage of 425 basis points over banks due to the lack of a branch network, online back-office and support, outsourced collection, and automated origination and leaner operation (Moldow, 2010).

In this paper we consider, the impact of crowdfunding on the microfinance sector and the market within which EU MFIs operate

Crowdfunding can be defined as a mechanism whereby members of the public (i.e. retail savers), as opposed to accredited, professional or institutional investors and lenders, invest in or lend directly to households, organisations and businesses rather than through an institution (i.e. pension fund, ISA, managed stock portfolio etc.). These investments or loans are done in exchange for any combination of social, material and financial return or reward and are facilitated to varying degrees by crowdfunding platforms. There are three main types of crowdfunding. First, there is equity crowdfunding in which investors buy a stake in largely early-stage businesses. A not dissimilar type of crowdfunding is revenue or profit-sharing crowdfunding, by which the borrower has an obligation to repay the lender but payments are variable and a function of the profit or revenue of the firm. Second, there is reward-based crowdfunding, whereby rather than receiving a rate of return for an investment, an individual investor may receive a tangible but not financial reward in the form of a product, discounts, vouchers or an experience (e.g. invitation to launch party etc.). Finally, there is peer-to-peer (P2P) lending, which involves retail investors making loans directly to businesses.

The concept of members of the public investing directly in and lending to individuals or businesses is not new. Rotating Savings and Credit Associations have existed for a long time and the early Building Society movement was built on similar principles as crowdfunding. However, the crowdfunding movement has grown exponentially over the last decade or so for a number of reasons. First, the financial crisis has led to a contraction of business credit with the businesses traditionally benefitting from bank finance now unable to access finance at an affordable rate (British Business Bank, 2014; Collins et al, 2013; World Bank, 2013). This has created a window of opportunity for the crowdfunding industry, and especially the P2P sector, by providing a borrower/investee base of creditworthy businesses. This is probably the most important factor underpinning growth in the sector. Second, the long-term restructuring of banking and the abandonment of relationship lending through credit scoring and branch closures has also decreased access to bank finance. Finally, historically low interest rates have also underpinned growth of the P2P sector in particular, as retail savers and investors are searching for better returns.

These factors combined with widespread use of social media and web-based financial transactions (Collins et al, 2013), and the competitive advantage offered by low overhead costs due to the absence of a branch network and few products (many focusing on single product) have enabled crowdfunding platforms to increase their share of the business finance market.

Crowdfunding has grown spectacularly over the past few years and is likely to revolutionise financial service provision through innovation in delivery and underwriting. This paper discusses the possible impact of crowdfunding on the microfinance sector in the European Union based on an in-depth analysis of the UK crowdfunding market. In particular, the paper asks if crowdfunding will displace or disrupt microfinance provision in the EU as we know it today. The analysis drew on interviews with experts, trade bodies and practitioners. We argue that the impact of crowdfunding on microfinance will depend on the type of crowdfunding and the country context. Equity crowdfunding is likely to have a negligible impact on microfinance, given its emphasis on providing large amounts to scalable businesses and the relatively limited role of equity in business finance. Similarly, although there are no inherent barriers to accessing reward-based crowdfunding, the evidence suggests this form caters to a limited range of businesses (especially creative industries). Peer-to-peer lending, conversely, could potentially have very significant impacts on microfinance institutions (MFIs) by taking their least risky customers, which poses a challenge to their sustainability. The effects of crowdfunding are likely to vary considerably across the EU. Countries where MFIs are largely providing very small loans to socially excluded entrepreneurs, the sector is less likely to be affected, whereas MFIs also lending to established businesses may be more vulnerable. Similarly, the impact may be cushioned where crowdfunding is limited by strict regulation of investment and lending. However, a central argument put forward in this paper is that crowdfunding is a harbinger for a transformation of financial services through technology and innovation, to which MFIs have to respond to remain relevant.

The remainder of this paper is organised into four sections. The second section details the methodology applied, whilst the third presents the findings. The fourth section discusses the implications of the findings for European MFIs. The fifth section concludes and provides some recommendations for practitioners and academic researchers.

Methodology

Review secondary sources
The team conducted an extensive review of secondary sources, including government documents, academic papers, consultancy reports and available statistics. This generated a wealth of useful information on the investors, recipients and intermediaries of crowdfunding, which will enable the team to address Objectives 1-3. The literature overview can be found in Appendix B.

Supply mapping
A high-level mapping exercise was conducted of existing crowdfunding platforms. This review was fairly exhaustive in terms of providers but was high-level in terms of the information covered. A template was developed that focused on year established, services offered, scale, eligibility, rates and fees (see attached full overview in attached excel spreadsheet).

Case studies
Drawing on the supply mapping exercise and in liaison with BFS, the team conducted case studies of a selection of platforms. This contributed to mapping existing supply and it also enabled the team to assess potential partnership options and thus contributed to the identification of risks and opportunities. The case studies involved review of relevant documentation and interviews with managers and other relevant staff members.

Expert interviews
To supplement secondary sources, interviews with key industry experts were conducted. This was especially important to identify the potential future role of crowdfunding. The list of interviewees can be found in Appendix A.