

MAGAZINE

Crowdfunding and P2P lending: which opportunities for Microfinance?

Claudia Savarese

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Foreword

Every now and then we see new things around us happening and often think it will pass... but that did not happen with Microcredit and it will for sure not be the case with the Internet. Some decades ago we rediscovered and recognized that access to finance is essential for all people in society. It helps people to improve their living conditions. Along with access to finance, we also found that tailor-made products and services could indeed make a difference. Over the past years we've begun to look beyond micro credit, started to use the word finance rather than credit as we understood that excluded people are in need of a broader range of financial services. The debate about fairness and transparency made us aware that we still need to broaden our scope and find an answer to the wishes of excluded people. The logical step was thus to give meaning to the word "financial inclusion": access to a range of services at an affordable price. But there is one element that we sometimes seem to overlook: people also want to have control over their money. If people are denied services they often organize themselves. Small savings groups were the pillars of successful micro lending programmes and organizations. This was not only the case since the 80's but also from many centuries ago. Generally, people participated in these types of savings groups to retain control over their money and eventually benefit from its proceeds as well. Small savings and lending groups evolved into larger banks or insurance companies but often lost contact with their former members. Likewise, we see microfinance organizations becoming banks as well. And again with the same risks: originally well connected with their clients, the latter are denied real control or participation. Following such a path can eventually lead to takeovers by private investors, as in the case of Compartamos and SKS, or bankruptcies like that of Shore Bank or Mibanco. If we follow such a route, clients will certainly react.

There are indeed vibrations in the air that we need to recognize, to rethink our approaches. The world is becoming smaller while access and control over money becomes easier every day. And people who feel left out can and will seek new ways to regain control over their money. The rise of crowdfunding is not just an opportunity to raise funds for onward lending by microfinance institutions (MFIs). The use of the Internet can bridge gaps between people, between those with and without money. It can offer new opportunities for people to stay close to their own money while somebody else uses it. That is probably the main strength of crowdfunding: it allows for a new form of inclusion. The key message of this magazine is highlights by the first paper, "crowdfunding and Peer-to-Peer lending platforms represent an innovative way of connecting people directly, organising funding for projects and responding to financial needs."...The challenge for the micro finance sector is to look beyond crowdfunding and Peer-to-Peer (P2P) lending systems as only new sources of funding. Additionally, we need to ask ourselves how we can reorganize financial services to the new opportunities of the Internet. We should ask ourselves the question: how will microfinance look in the future? The Internet can bring lenders closer to borrowers, savers closer to enterprising people. If we succeed in internalizing the possibilities these new technologies offer, we can take the next step towards financial inclusion and true participation. It will most certainly be a system whereby the traditional forms of organizing and working will disappear. As innovators in finance we could most certainly react more swiftly than the traditional banking sector, and consequently, embed microfinance as a pillar of sustainable finance and society.

Klaas Molenaar

Former EMN President

Professor Financial Inclusion and New Entrepreneurship
The Hague University of Applied Sciences

Disruptive technical innovations: how the financial sector is changing



Innovation is the engine of development for all business sectors. Within the financial industry, innovations are needed to adapt services and credit supply to the changing needs of society or the needs specific target groups. While in some cases innovation represents a top-down process, in other cases, the people, "the crowd", foster innovation and change the way in which financial services are provided.

Since its inception, microfinance has presented itself as a revolutionary way of funding small businesses and the economic activities of excluded people, based on innovative lending methodologies that allow the provision of small loan amounts to specific target groups. In particular, it created new paths to financial services for excluded and disadvantaged groups that often experienced difficulties in accessing mainstream finance. The innovations introduced by the microfinance sector fostered its development across the world, and allowed positioned microfinance actors as an alternative to the traditional banking sector and as a way to foster financial and social inclusion.

In the last decade, new technology-driven innovations have influenced

(and disrupted) the financial sector. Some of these innovations can be seen as a natural evolution of the increased connection among individuals, via Web 2.0 technologies, creating vast social networks like Facebook and LinkedIn. In the realm of financial interactions, **crowdfunding and P2P lending platforms** represent an advanced method of linking people together for the purpose of financing various projects. Generally, they do not target any particular client group or sector, but aim to be accessible to all, facilitating and reshaping the relations that have always existed between people seeking funds and those providing them. The disruptive effect for the financial sector is that the intermediation by banks and other "brick and mortar" financial institutions are reduced by this model as funds are donated, borrowed and invested directly by individuals.

But what are the implications for microfinance providers? How can they deal with these changes and benefit from the new possibilities that these new alternative financing instruments offer?

Main factors for the recent success of alternative financing instruments for SMEs

When compared to the volume of the traditional European financial sector, the activities of crowdfunding and P2P lending platforms still represent a niche. Bank loans and traditional financial credit remain the preferred sources of external funding in the European SME sector. However, crowdfunding and P2P lending platforms have experienced exceptional growth over recent years, both in number of platforms and the amount of capital raised. Two major factors help explain this phenomenon:

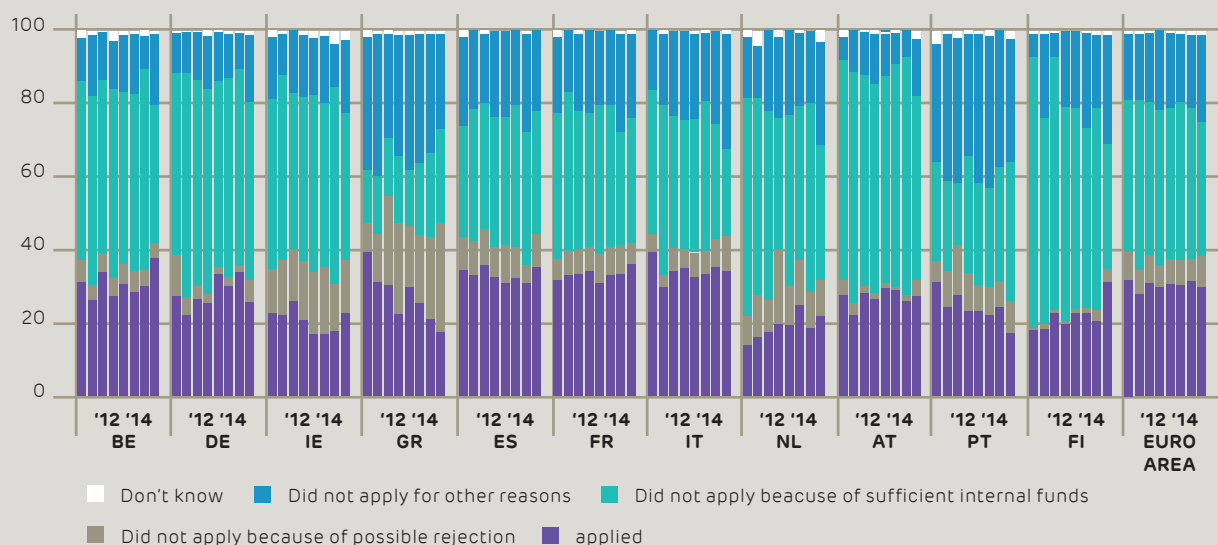
On the demand side, the ongoing credit crunch represents a major challenge for the traditional financial system. In the wake of the financial crisis, banks and other traditional financial service providers in Europe have tightened access to credit, especially for smaller loan volumes due to cost efficiency considerations and for loans to clients without sufficient collateral due to risk management considerations. Under these circumstances, it is not surprising that access to finance is still one of the most pressing concerns for companies in Europe, especially for the smallest enterprises. According to the "Survey on the access to finance of enterprises in the euro area (April 2014 – September 2014)", on average only 65% of loan applications allowed enterprises to receive the full amount they applied for. In addition, many SMEs did not apply for loans due to various reasons as shown in Figure 1. Evidently, smaller enterprises also had more difficulty in obtaining a loan. SMEs also cited the following as barriers to finance through banks: high interest rates, stringent collateral and guarantees, and excessive paperwork (Figure 2). Consequently, a number of small enterprises and start-ups are looking for alternative sources of finance.

On the supply side, changes in societal

Crowdfunding and P2P lending platforms represent an innovative way of connecting people directly, organise funding for projects and respond to financial needs

Figure 1

➔ Applications for bank loans by SMEs across euro area countries
Over the preceding six months; percentage of respondents



behaviours are also occurring. People show an increasing need to maintain control over their money when it comes to saving and investing. This has changed the way in which people allocate their financial resources: they might prefer to invest in specific and new projects instead of giving their money to banks and losing control over its use. Also, low-interest rates are diminishing the returns on traditional saving products. Over the last few decades, many individuals have accumulated investment capital.

These individuals have become the new informal investors, ready to invest their talents, experiences and money into new ventures. As a result, there

are huge amounts of investment capital that are circulating among individuals and that can be channelled by alternative models of matching private investors with investment opportunities.

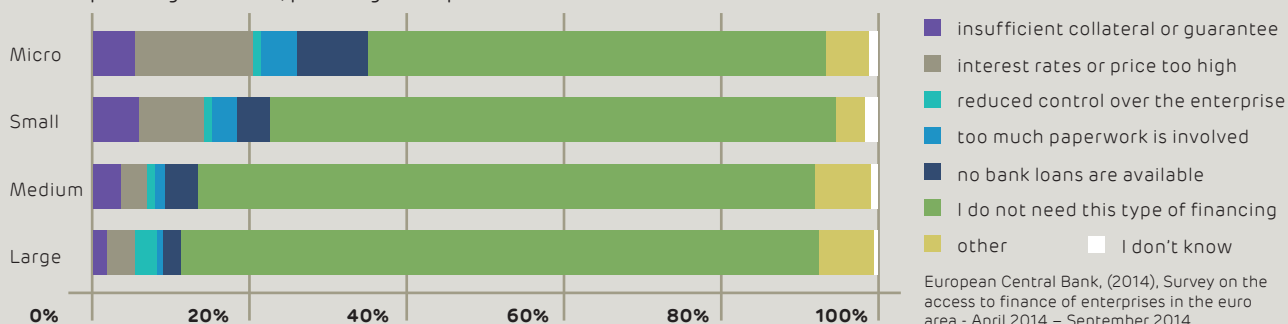
The increased connection among individuals, enhanced by the use of social media and the development of information and communication technologies, addresses both market aspects through a single approach. It connects the people seeking finance with those interested in investing their funds in new projects and businesses. Online platforms allow these individuals to "find each other" and to exchange their resources, to create networks that operate outside

the traditional financial sector.

By enabling the provider and recipient of funding, both crowdfunding and P2P lending services have the potential to strengthen the role of society in the financial system. On the other hand, traditional financial institutions tend to function independently of the communities that have created them, and have increased the distance to their clients, by introducing more and more impersonal elements in their provision of financial services. For these reasons, alternative finance models, such as crowdfunding and P2P lending, can provide a way for individuals to become active and independent actors in the financial market in different ways.

Figure 2

➔ Reasons why bank loans are not a relevant source of financing for euro area enterprises
Over the preceding six months; percentage of respondents



A general overview on Crowdfunding and its mechanisms

Crowdfunding can be considered as a collective, participatory and interactive way of funding projects. The idea is simple: a large number of people, through small individual contributions, can raise big amounts to finance other individuals and projects without the interference of financial institutions. This is usually done via the Internet, on so called "crowdfunding platforms", where projects are presented and where the "crowd" chooses which project to finance.

For different typologies of crowdfunding, the first funders are often relatives, friends and people belonging to the same group or community of the person that presents the project. This is what usually happens even without platforms: every project or start-up would look for these same funds before approaching a financial institution. What is new with crowdfunding is that, thanks to the use of online platforms and social media, these projects can reach people beyond their closest social ties, mobilize them in a short time and receive the required funds, without any intermediation of financial institutions.

A successful crowdfunding campaign needs many elements. Firstly, it is important to present projects in a clear and attractive way in order to generate interest from the public. The use of logos, video and images is very common and aims to attract potential funders. Secondly, social network ties play a huge role, since they increase project visibility and help to spread the crowdfunding campaign. This funding mechanism is essentially based on the interaction among individuals, where trust between the various actors is fundamental.

In addition to financing, crowdfunding can also serve marketing purposes: through the campaign, people raise awareness about new projects and products, and receive feedback from

potential customers. In this way, access to more traditional funding sources is accelerated (if still needed). Online platforms also facilitate contact between entrepreneurs and funders who may bring relevant knowledge and expertise to the realization of the project, and thereby improve the final product.

Classification of crowdfunding websites is usually based on the objective pursued by the "crowd":

Donation-based: These sites are usually guided by philanthropic and social intentions, as funders do not get anything in return. People contribute to the crowdfunding campaigns for personal motivations, often because they share values and interests with the promoter. They are mostly used in the non-profit sector to support various causes (social, environmental, political, etc.). The most prominent donation-based crowdfunding platform is the US platform CrowdRise.

Reward-based: Funders may, according to the amount disbursed, obtain different kinds of rewards that can range from a simple "thank you" and small gadget up to the finished product (as a form of pre-sale) in case the funding was aimed to the production of a tangible good. This model is primarily used in the artistic sector (movies, art, music, etc.), for the development of new products or as a way to test markets. The most prominent reward based crowdfunding platforms are the US-based sites Kickstarter and Indiegogo.

Lending-based: In this case, funders act as lenders. Projects take the form of personal or business lending, where the lenders receive back the principal amount plus the agreed upon interest rate. Another form that is not yet widespread is social lending, where the lenders receive the amount lent without any interest. The most prominent lending based crowdfunding platforms, also known as P2P Lending platforms, are Lending Club 5 (US) for personal lending and Funding Circle (UK) for business loans.

Equity-based: The funders invest in a company in exchange of shares or voting rights. This option usually supports start-up entrepreneurial

activities or industrial production. The most prominent equity based crowdfunding (crowdinvesting) platforms are Crowdcube (UK) and FundedbyMe (Sweden).

Nowadays, hundreds of different crowdfunding platforms exist. The increased use of online platforms shows the high level of connection among people. In fact, the decision to fund a project is not only based on financial assessment (as financial institutions would do), but is especially based on emotions, social ties and the sharing of values and interests. This kind of connection is something that people are continuously looking for and is the engine of success for these platforms.

Peer-to-Peer lending: providing loans without financial institutions

Among the crowd-based financing models, lending based crowdfunding platforms, i.e. **P2P lending platforms**, have seen the highest growth rates over the past years. Special focus is given to these P2P lending platforms, considering their innovative take on the more traditional credit services and their relevance as potential competitors or cooperation partners for microfinance providers. P2P lending platforms act as efficient online marketplaces matching borrowers and lenders. P2P lending platforms started with consumer loans around a decade ago, but over the last 4-5 years P2P business lending has expanded rapidly, especially in the UK. Compared to reward or equity based crowdfunding, borrowers on P2P lending platforms offer less and more standardized information about themselves and the nature of their project/business when registering a loan request. Based on this information, potential lenders can decide to cover a certain amount of the requested loan sum and, if the total sum is successfully backed by other lenders, get paid back over the agreed loan period including the principal lent plus the interest offered by the borrower. Traditional financial intermediation loses its role, since platforms' processes enable lenders and borrowers to enter in direct contact.

In contrast to traditional banking, P2P lending transfers the discretionary power over the lending of money to the crowd: each lender can make its own assessment on the person or project asking for funds. Although P2P lending platforms present standardised scoring data on the potential borrowers, projects are not only judged (and funded) on a purely financial assessment. People that lend money on these platforms can choose among several borrowers to find those that are in line with their interests or for which they may feel empathy.

In contrast to traditional banking, P2P lending transfers the discretionary power over the lending of money to the crowd: each lender can make its own assessment on the person or project asking for funds.

Moreover, some platforms allow them to stay informed and involved in the financed business, not only to monitor repayment, but also because investors want to actively contribute with ideas and suggestions to the project's development and realization. Consequently, it is important to stress that in P2P lending, profit maximization represents the major (but not the only) driver. Social aspects, the belief in a project, the desire to be part of a group and support innovation continue to be important factors that convince funders to contribute to the realization of a project or an idea through an online platform.

P2P lending for businesses is attractive mostly for innovative start-ups, small enterprises with growth potential, and medium sized enterprises with specific plans for diversification and focused expansion to new markets. The speed with which they could be able to obtain business loans, the flexibility and the more attractive terms of financing make P2P lending a viable business funding alternative. In fact, thanks to the lower operational and transactional costs of the platforms compared to traditional financial intermediaries, the rate for the entrepreneurs is usually lower if compared to rates charged by financial institutions. For the lender, investing into a loan via a P2P platform often represents an investment with higher returns compared to returns on saving accounts or investment funds.

Usually, fees or charges to be paid to the platform apply, but their level still makes P2P lending a financially attractive alternative to a traditional financial institution.

In P2P lending, an essential element to consider is the level of risk taken on by lenders. They may encounter the risk of default, due to inability to repay the loan. Whereas in traditional banking institutions defaults risk is spread across all clients, in the case of P2P lending, lenders are considered as investors and are exposed to the default risk of each borrower they lend to. Therefore lenders often spread their risk by lending small amounts to a large number of borrowers. Before making the investment, lenders can assess the borrower's credit risk by analysing the level of interest rate that is charged on the loan he requests. This is set by the borrower or is decided by the P2P platform after carrying out a credit risk analysis. Automatized scoring facilities are also used once online borrowers develop their own online credit history (as is already done on e-commerce platforms that offer consumer-to-consumer sales services online). However, online lending is based on the idea that the "crowd" represents a useful filter that prevents the risks of fraud, non-repayment and liquidity. In fact, the common flow of information between lenders and borrowers, based on economic and social interests, should help in reducing risk.

Online platforms: more than brokers

In this alternative financing scenario, **online platforms** play a fundamental role, since they represent the "virtual" marketplace where people's needs and interests converge. The business model that regulates their functioning can be very different, according to their nature (profit or non-profit) and to the kind of services they provide.

The first role of online platforms is to provide visibility to the projects that are seeking funding. Projects are presented in a clear way, associated to the amount that needs to be financed and the modalities to be followed by those who want to fund the project. When the "all-or-nothing" model applies, the money raised by the crowd is disbursed to the project only if it has reached the target. If not, no money is transferred.

Once a contract between the crowd and the entrepreneur is created, some platforms offer free online spaces where both parties can interact, exchange opinions and advice on the projects. This enhances and facilitates contact among entrepreneurs and their funders. In some cases, platforms also provide additional services to the fund-seekers, ranging from support in designing a successful campaign, marketing or other business development advice.

Conversely, some P2P platforms (especially for consumer loans) simply act as brokers bringing together people wanting loans and people interested in lending money. They screen the borrowers and allocate them to lenders according to required risk profile and returns. This means that transactions can be anonymous, and there are no links to individuals or specific projects. This tends to be the case with P2P consumer lending platforms, such as Zopa, the first P2P lending platform in the world and the largest in Europe. P2P business lending platforms also offer lenders the opportunity to lend on an automated basis instead rather than selecting individual businesses. P2P platforms aim to offer both

competitive rates to borrowers and high rates of return to lenders by cutting out traditional financial intermediaries. However, the platform that acts as simple "facilitator" seems to eliminate the social aspects that characterize the crowdfunding sector, and remove the contact between individuals. Another development is the entrance of institutional investors into P2P lending. Over the past year and in the face of the ongoing low interest rates of many asset classes, institutional investors are increasingly investing part of their funds to the UK-based P2P business lending platform, Funding Circle. They now finance 35% of all the loans on the platform. In this case, the P2P model is no longer about peers lending to each other because institutional investors are crowding out individual private investors. This is largely what has happened in the US. The implications of the development are not yet foreseeable.

Costs and procedures to set up an online platform can vary across

countries depending on existing regulations and on the crowdfunding model. Since interest rates on the platform tend to be kept low, income for these platforms mostly comes from commission fees and cost of additional services offered to their clients. Lending Club was the first P2P platform to do an IPO and is now listed on the stock exchange.

The landscape of existing online platforms in P2P lending and crowdfunding is very diverse. They can have more social oriented goals, aimed at improving economic conditions of people receiving funds and creating social connections among individuals, or they can act simply as facilitators to offer competitive rates to creditworthy businesses and individuals, and high returns to investors. In either case, they represent a new funding mechanism that bypasses traditional finance institutions such as banks and might offer access to credit to people and projects that find difficulties with these traditional institutions.

Some Crowdfunding Platforms in Europe

Donation



Reward



Lending



Equity



Contribution of Crowdfunding and P2P lending to financial inclusion

any specific group. What is, however, unquestionable is the fact that they offer new and additional opportunities to traditional microfinance clients.

Crowd based financing covers a diverse range of sectors; however, crowdfunding and P2P lending are not necessarily the best option for every kind of business or project. In fact, people may have drastically different needs and economic activities; similarly, financing must match the personal characteristics, aspiration and capabilities of funding recipients.

Crowdfunding was initially used to organise funds for non-profit cultural and social projects and has expanded to include other forms of capital provision, such as pre-sale and equity financing of start-ups, online lending to small businesses or invoice trading. P2P lending, on the other hand, started originally as a system to activate private funds for small loan amounts in the consumer segment and is now serving SMEs and individuals on a broader scale.

An important element to consider is the difficulty of being accepted on the platforms and having the chance to present a project. Each platform has its own criteria for initial assessment, according to the risk, activity sector and the concrete possibilities of success of the project seeking funds. These assessments do not necessarily differ significantly from those carried out by traditional financial institutions. Moreover, if a project gains access to the platform, it is not assured that the campaign will reach the requested amount.

As a result, it is not clear if the presence of so many new channels and actors will in fact lead to more and better access to financing for typical microfinance clients, such as micro enterprises and excluded groups. In fact, contrary to microfinance, which emerged as a new way of reaching out to the poor and socially excluded, these alternative financing mechanisms have not been designed to target

Crowdfunding: state of the art (and challenges) in Europe



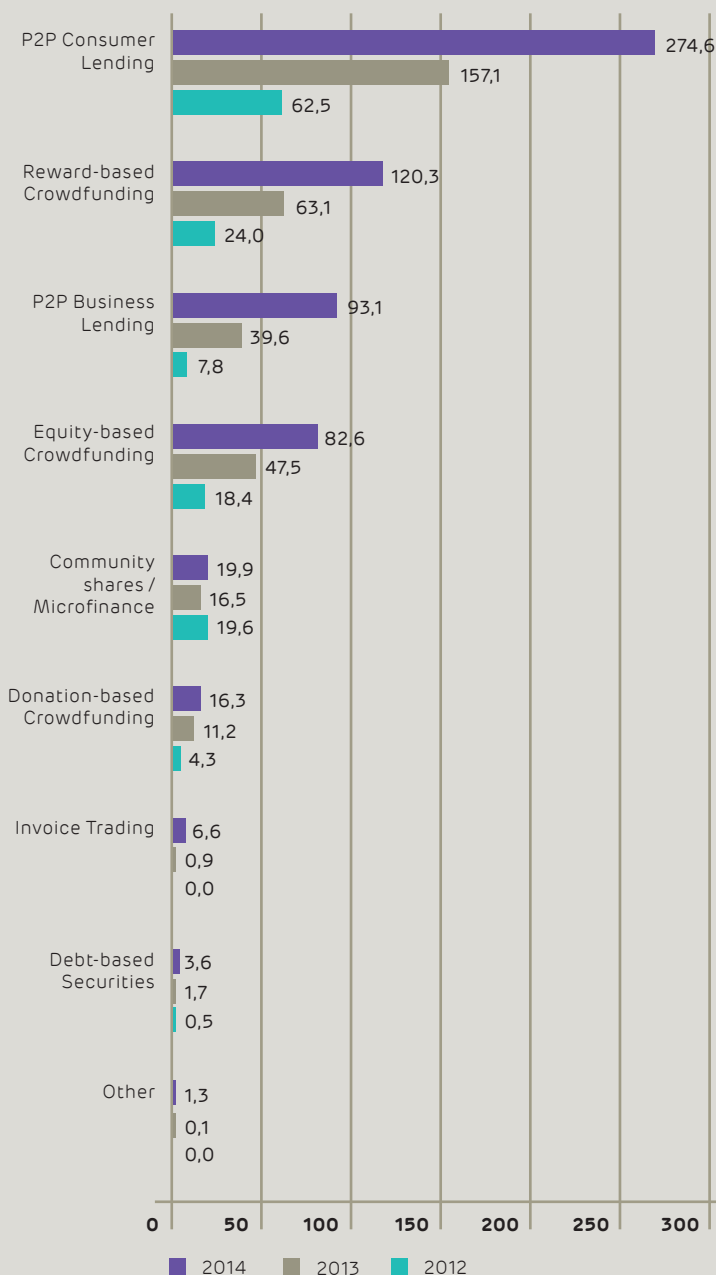
When discussing with crowdfunding and P2P lending with practitioners, you can be easily convinced that online funding mechanisms represent the future of the financial system. This is not hard to believe if considering the incredible growth that has been recorded in Europe, with an **average yearly growth rate of 146%**. In 2014, the EU online financing sector totaled nearly €3 billion, with around 250 crowdfunding platforms. The UK dominates the European market with €2,337m, while all other EU countries totaled overall €620m. The major countries after UK are France (€154 m), Germany (€140m), Sweden (€107m), Netherlands (€78m) and Spain (€62m). In 2014, over half a million projects have been financed through crowdfunding. In Europe, more than half of all crowdfunding activities can be placed in the P2P lending category, followed by reward-based and equity-based crowdfunding.

The growth of these new business models has captured not only the attention of national governments but also of the European Commission: crowdfunding is seen as an alternative, or a complement to traditional sources of finance. Due to the multiple benefits that crowdfunding offers (pre-sales, market research, word-of-mouth promotion, and visibility without additional costs), this funding mechanism is likely to compete with other forms of investment, both debt and equity. Compared to other types of finance, crowdfunding is seen as a way to reduce costs and administrative burden. Moreover, crowdfunding holds potential benefits for innovation, research and development, while contributing to growth, community development and job creation.

The European Commission seems particularly interested in the role that crowdfunding can play as a funding source for SMEs, whose demand for financing is often not met by any existing source (financing gap). According to a recent survey, excluding the UK, the European online financing sector has provided €201m of early-stage, growth and working capital financing to nearly 10,000 European start-ups and SMEs in 2014. In 2014, the European Commission set up an expert group, the **"European Crowdfunding Stakeholders Forum (ECSF)"**, with the task of assisting the

Figure 3

→ **Alternative finance models in Europe (excluding the UK)**
Volume in €M and average growth rate 2012-2014



The European Alternative Finance Benchmarking Report, Centre for Alternative Finance of University of Cambridge, February 2015

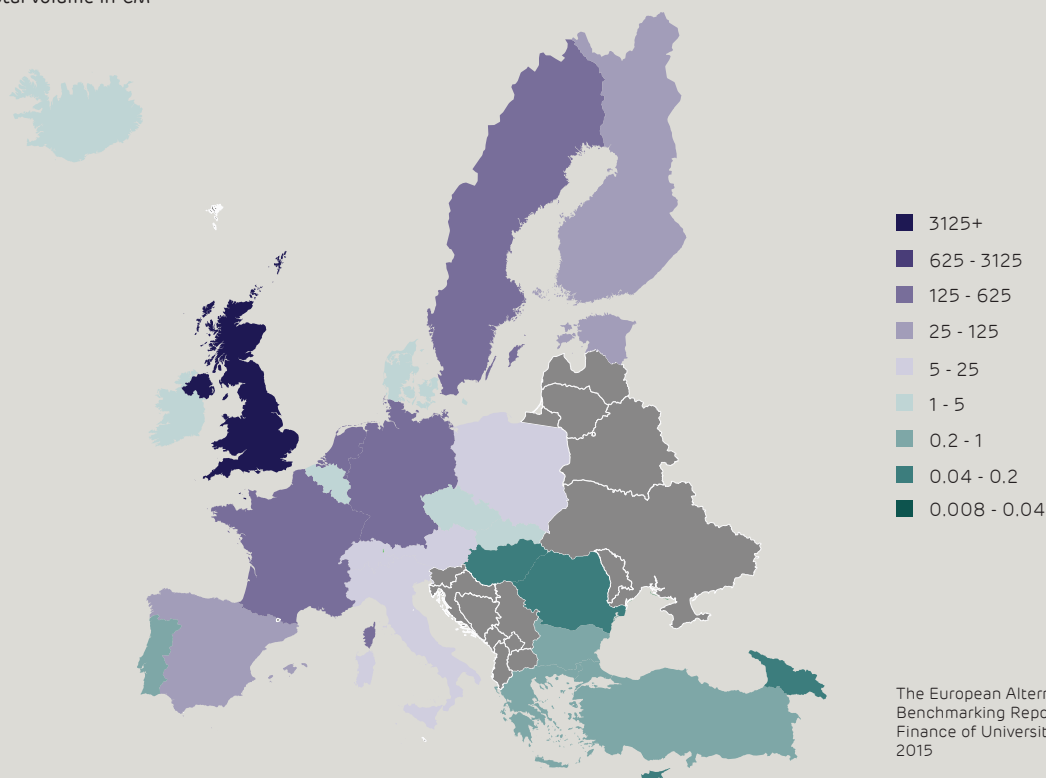
Commission in developing policies to raise awareness, share best practices and create a common framework for the sector. In particular, a pressing issue relates to the regulation of the sector, especially in terms of client protection

and cross-border investments. The development of online funding instruments varies greatly across countries, mostly due to different financial regulations that apply and which may limit growth of the sector.

Figure 4

→ Comparative volume of alternative finance transactions 2012-2014

Total volume in €M



The European Alternative Finance Benchmarking Report, Centre for Alternative Finance of University of Cambridge, February 2015

UK is leading the way in P2P lending

Karl Dayson

Executive Director

Pål Vik

Research Fellow Community Finance Solutions, University of Salford

Although still small compared with mainstream finance providers, UK crowdfunding platforms are shaping and changing the way in which funds are raised and distributed to businesses and households. The sector has grown from being largely non-existent to facilitating in excess of €2bn in crowdfunding and P2P loans in 2014, nearly 80% of the European crowdfunding market.

Yet the story of UK crowdfunding is not one about democratisation of business finance by enabling formerly disenfranchised and excluded people to gain access to and participate in the financial system, which is the story that has caught the imagination of the

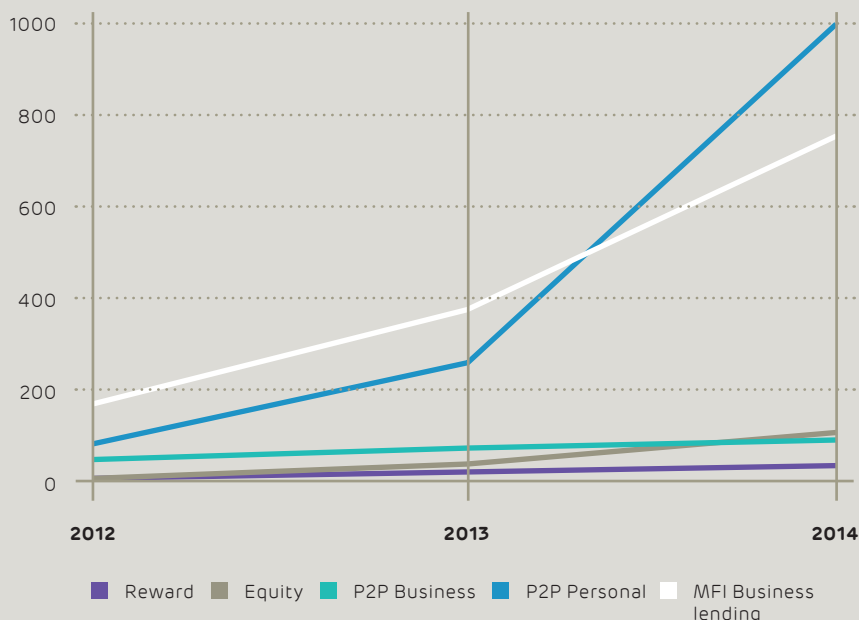
public, media and academia. Instead, its growth has largely been driven by the P2P sector seeking to capitalise on more efficient business models and sophisticated underwriting methods to compete with banks for creditworthy, established businesses and to attract investment from high net worth individuals by offering highly competitive rates of return. Figure 5 shows that P2P lending (both business and personal) provides more finance than the other types of crowdfunding and also appears to have a steeper growth trajectory.

Reward-based crowdfunding is the smallest part of the UK crowdfunding sector (in terms of business finance).

Research suggests that UK supporters tend to invest small amounts (most give less than €80) on the basis of social network links with the entrepreneur. UK businesses and organisations use reward-based crowdfunding to raise small amounts for start-up finance or to test products in the market and get feedback and input from potential consumers. The businesses that are most likely to use this form of crowdfunding are in the creative and high-tech industries (e.g. bands, computer game producers etc.) or involve projects that address specific local needs by providing a new service (e.g. broadband etc.). Equity crowdfunding in the UK is also a small but fast growing phenomenon.

Figure 5

Business finance provided by UK crowdfunding platforms
€M



Baeck, P., Collins, L. & Zhang, B. (2014), Understanding Alternative Finance
– The UK Alternative Finance Industry Report 2014, Nesta: London

The majority of the growth in the sector in the UK is driven by two platforms: Crowdcube and Seedr. Crowdcube has raised €108m for 230 businesses since its launch in February 2011 and Seedr has facilitated over 80 deals of a value in excess of €10m since it launched in July 2012. UK equity crowdfunding investors tend to be in higher income brackets and most are based in the South East part of the country. The available evidence suggests that investors are keen to be involved and help businesses as well as earn a financial return. Typically, UK equity crowdfunding platforms cater to high risk, early stage businesses and, in some cases, businesses needing capital to expand. Of the businesses funded through Crowdcube, 24% have been start-ups, 50% early-stage and 26% growth-businesses. On average, businesses typically raise between €80,000 and €350,000.

However, it is P2P lending that has had the greatest traction. UK P2P business lending has been growing considerably over the last few years and overtook P2P consumer lending in 2014 as the largest product segment

in the market. There are a handful of platforms that dominate the UK market. The most dominant platform, Funding Circle, was the first to be established, while other platforms have focused on a particular niche (i.e. ThinCats, Market Invoice). Investors tend to be high net-worth individuals that are overwhelmingly focused on financial returns, are typically in their 50s onwards and are often retired or close to retirement, are well informed about investment opportunities and have turned to P2P lending because of the low rates offered by banks. They are not particularly driven by an interest in a specific project or business, though this depends on the platform. The businesses resorting to P2P loans are well established (at least 2 years but typically 7-8 years), have a turnover in the region of €500,000-€1.4m and would under normal, pre-crisis circumstances have been able to access finance (i.e. good credit score). The average loan is typically between €90,000 and €400,000, well in excess of the €25,000 limit for microcredit in the EU.

We believe that P2P will continue to

lead the growth of sector. Debt finance caters to a larger number of SMEs than any of the other forms of finance. There is considerable scope for streamlining and automating screening to keep costs down and produce predictable returns for investors. There is also a great inherent competitive advantage in P2P platforms because of lower costs vis-à-vis banks enabling them to offer competitive rates to both borrowers and investors.

In the coming years we are likely to see institutional investors entering the P2P market in a big way, such as pension funds. It will be interesting to see the impact on a) the mix of investors and b) the balance between investors and borrowers. In the US, these investors have pushed out retail or peer investors to the extent that it is often referred to as marketplace rather than P2P lending. Will peer-investors be able to remain in the market in the UK? The potential influx of big institutional money may also pose a challenge for platforms in terms of maintaining a healthy balance between money to lend out and businesses to lend to.

But what will crowdfunding mean for MFIs? What are the opportunities and risks?

Crowdfunding, especially P2P lending, may potentially offer new exciting opportunities for MFIs. It may enable them and their customers to access a new source of capital: retail investment. Crowdfunding may also offer new and better ways of serving customers through online finance platforms.

The MFI sector may be able to tap into these benefits through partnerships with existing platforms, especially for co-financing businesses and joint use of platform technology. The challenge will be to create partnerships that are cost-effective and result in lower capital costs and greater impact for microfinance customers.

Crowdfunding may also bring new challenges to the sector. Most notably, for MFIs offering larger loans and to more established businesses, there is a risk that P2P lending platforms may move down market and pick off the least risky MFI clients. This in turn poses challenges for the sustainability of the sector.

Crowdfunding sector in Germany: growth despite the unfavorable regulation

Michael Unterberg

Policy expert on economic promotion

Benjamin Sarpog

Consultant, Evers & Jung

The first crowdfunding campaign in Germany dates back to 2004. However, 2011 is commonly considered as starting year for the sector, since a large number of actors entered the market, and the concept only then became more widely known through a very successful crowdfunding campaign for a movie adaptation of a popular TV series. According to the European Alternative Finance Benchmarking Report (2015), Germany is one of the biggest sectors in continental Europe with about 31 active crowdfunding platforms. The growth of the sector in recent years has been remarkable with annual rates beyond 100%.

However, despite the sector's growth and increasing diversification, crowdfunding in Germany is still a small niche in the broader financing landscape. Reliable figures and data about the true market size do not yet exist. Estimations of the overall allocation of capital in 2014 vary between €60m and €140m depending on the inclusion of consumer lending activities¹. So the country's sector is still in the fledgling stage, especially when compared to the UK or, more recently, France.

Compared with P2P lending and reward based crowdfunding, the German crowdfunding (equity-based crowdfunding) market received the most attention in the past years. Closely connected to the recent start-up hype in Germany, especially in Berlin, it has developed very dynamically since its beginnings in 2011. In 2014, the volume

of capital raised for start-ups and high-growth businesses was €14.7m. A total number of 57 projects were financed. While the number of successful campaigns moderately increased, the average financing volume per project increased significantly in recent years. The platform Seedmatch for example, which holds a market share of 59.4%, registered an increase from €334,000 per project in 2013 to €458,000 per project in 2014 (this included the record setting campaign of the start-up Protonet that managed to raise €3m in less than one week). The second biggest operator Companisto (25.1% market share) also stated a doubling of project size in the same period to an average of €368,000 per project. Another indication of the positive market development for start-up financing is the fact that an increasing number of businesses successfully accomplished their second and third financing rounds via these platforms. Furthermore, it can be observed that in the face of a pipeline of suitable start-ups with growth potential, the German crowdfunding market is becoming increasingly differentiated. Crowd-based investments in real estate and energy efficiency projects are especially growing niches, offering fixed returns on the amount invested. In the future, equity based crowdfunding platforms may transform into more all-purpose investment platforms, with start-up finance only one of many possible investment options. This is connected to increasing regulatory changes, which may

result in uncertainty among market participants. The German government has recently proposed a range of rules and restrictions to better protect small investors (Kleinanlegerschutzgesetz) when investing directly into companies. Although it simultaneously proposed an exemption for crowdfunding platforms regarding the limits for the obligation to produce a prospectus, 58% of the German operators surveyed in the European Alternative Finance Benchmarking Report (2015) perceive these regulations as too strict. Experts predict that the law, which will be brought into force by 1 July 2015, will slow the development of German equity crowdfunding platforms and strengthen the trend towards specialized operators focusing on niche markets like real estate or ecological project financing. P2P lending services will not be affected by this new regulation. Although in the past, the growth of the P2P lending sector in Germany was limited by German banking regulation that requires a formal banking license for the distribution of loans. Consequently, P2P platforms needed formal banks to serve the back-end from the beginning. This complicated set-up made the lending processes costlier than in less regulated countries like the UK. Nevertheless, the market has developed very dynamically over the past years. Experts estimate that the volume of capital allocated via P2P loans was approximately €115m in 2014. The largest platforms active in this segment are focused on lending to

¹ The European Alternative Finance Benchmarking Report (2015) states a volume of 140 EURm in 2014. Here figures for consumer lending are included (80 EURm). Another German benchmarking report (Crowdfinanzierung in Deutschland, 2014) estimates 60 EURm in 2014, but only relates to capital raised for business purpose.

private individuals. With an estimated market share of 80%, Auxmoney is the German market leader in P2P lending. The segment also addresses entrepreneurs seeking loans up to €25,000 to start their entrepreneurial activity. These loans are handled as consumer loans, meaning that the information provided for the lenders is limited (e.g. no business plan needed) and the scoring is based mainly on the personal credit-worthiness of the entrepreneur, not the outlook of the business. In 2014, the platform arranged credit agreements for business purposes in the amount of €28.6m. A total number of 3,021 individual projects benefited from it, amounting to an average of €9,450 per loan.

The second-largest P2P operator for businesses and start-ups is Zencap, which raised a total amount of €6.9m for 120 projects in 2014. Despite the much smaller market share, the average credit amount of €57,500 per project clearly surpasses that of Auxmoney. Zencap targets existing companies and SMEs and is affiliated with Lendico, a consumer loan oriented P2P lending platform. Both are financially backed by a well-known German start-up investor (Rocket Internet) and follow an explicit expansion strategy covering multiple European countries. In the past year they have started platforms in Spain and the Netherlands.

It can be expected that German P2P lending services will continue to steadily grow (although not as fast as the UK or US) even though the existing banking regulation is more challenging than in the UK.

Technological development of the sector can be expected to come from the burgeoning start-up sector in financial technologies (so called fintech companies). Most of these start-ups work on technical solutions to develop new interfaces between clients and banks, applying online-based algorithms to the provision of financial services. Some of these are directly relevant for lending activities by P2P platforms, e.g. Kreditech's big data approach to scoring.

The Debate

Robert Benfield

Head of Fair Business Loans, Fair Finance

Robert Benfield joined Fair Finance in 2013. He has a background in retail, commercial and corporate banking at HSBC as well as microfinance experience. He has lent money to a broad range of organisations from small start-up companies to some of the UK's largest PLCs and has international experience launching banking operations and financial products in emerging markets.

Early on in his career, Rob worked briefly as an economic analyst for the UK government at HM Treasury in their macroeconomics department. He has degrees in both Economics and International Development and in Financial Services.

Oliver Gajda

Chairman and Executive Director, European Crowdfunding Network

Oliver Gajda is the founding Chairman and Executive Director of the European Crowdfunding Network AISBL. Previously he has been involved in various sectors in Europe and the US. Since 2006, he has been self-employed, working with others across a number of fields including social entrepreneurship, microfinance, venture capital and technology. Throughout this journey he has been a journalist, lobbyist, buyout manager and a board member. He has a fairly mixed background covering a range of aspects related to the financing of innovation and small business. He is also Advisory Board Member at the leading think tank on entrepreneurship research in Germany, the Förderkreis Gründungs-Forschung e.V. (FGF) and a member of the European Crowdfunding Stakeholder Forum at the European Commission. Oliver holds two Masters degrees in Microfinance and History.

1

Why did you choose to work in microfinance?

RB. I grew up in South Wales, in a socially minded family where my mum was a social worker and my dad ran the body that represented the voluntary sector in Wales. My career at HSBC brought me into contact with numerous individuals and small businesses that were excluded from credit and financial services and my concerns for them led me to volunteer for microfinance charities delivering services in the UK. When the unique opportunity to join Fair Finance and lead their business lending operation came up, I jumped at the chance to use my skills and experience to make a real difference to financial exclusion in the UK.

2

Why did you choose to work in crowdfunding?

OG. Since you ask, I do not consider myself working in crowdfunding, so I did not yet decide I want or don't want to work in crowdfunding. I consider myself working for the crowdfunding sector. I am running the industry association of this sector in order to help it grow and professionalize, in order to create cooperation with related sectors and stakeholders. When the idea of the European Crowdfunding Network was first developed, I saw the opportunities to create a more coherent capital market for early stage and SME finance. I still believe the main disruption of crowdfunding lies in how it mobilizes capital by more or less directly connecting supply and demand through fairly simple digital means. The sector potentially offers solutions to some of the problems that other financial services, like microfinance, face. Crowdfunding in its mix of applications is complementary, competitive and disruptive to equity investing and business and consumer lending... I can think of more, but that won't add to this article. But, I do not have the answer how this will play out over time. I just know the past few years have been very exciting and the next few years will be too. In the end, I hope to have worked on building a better capital market for consumers, investors and borrowers alike, as well as small and medium sized businesses. And I am convinced that crowdfunding of all types can play an active role in this.

3

Crowdfunding and p2p lending platforms are continuously growing in Europe. In your opinion, which are the needs and the demands they answer to?

RB. 'Crowdfunding' and 'alternative finance' are currently buzzwords in the financial service sector, but neither term represents a particular financial service so it helps to identify the specific financial services being talked about. For example, all of the following can be considered crowdfunding or alternative finance: P2P consumer and business lending, reward based crowdfunding, equity based crowdfunding, donation based crowdfunding, invoice trading. Each type of funding serves specific niches of demand. If I was to generalize, then nearly all of the fastest growing platforms operate solely online, applying technological innovation and computer algorithms to meet the demand of modern businesses and consumers for speed of access to funding through remote online channels of delivery. This compares to traditional financial services that provide slower funding, require greater volumes of information from the client and face to face contact with the financial services provider.

OG. Lending based crowdfunding (we talk about consumer or small business loans from now on, delivered via so called crowd- or P2P or marketplace lending platforms, but not equity investing, not preselling, not rewards, and not donations) has seen significant growth over the past years across a number of European countries. It started out as an answer for consumer loans after the financial crisis reduced the willingness of banks to lend money. It remains strong in the consumer sector, but has also grown into business lending for smaller and medium sized companies. The reasons for its growing success are basically speed and ease of transactions, which can be done from home or the office via the Internet. Background checks on the borrowers, including credit scoring, are automated as much as possible by the platforms. Different risk categories and repayment terms are matched with adequate interest rates. Often loan requests are funded within a few days, while interest rates for borrowers are comparable to bank loans or even lower. For small loan sizes that are often used for short to mid-term capital needs, the process by far outperforms banking and microfinance loans in terms of speed, which is a key selling point.

4

Do crowdfunding and online lending simply displace bank and mainstream lending or do they (also) serve the financially excluded?

RB. The larger commercial P2P crowdlending in the UK and Europe are predominantly based on algorithms or credit scoring with similar interest rate returns to mainstream lending and so in my view it is largely overlapping with the credit scoring models risk appetite levels used by mainstream lending, rather than serving the financially excluded. It is the methods of client interaction and delivery channels, and the sources of funding used by crowdlending platforms themselves that is the difference, rather than who they lend to or how they calculate whom to lend to.

OG. Crowdlending does not displace bank or mainstream lending in any significant way yet, but it surely shows a disruptive side that is likely to change the way small loans are distributed in the future. In general, there is no focus on the financially excluded, though lessons learned from daily practice show that this particular clientele also seeks to access crowdlending. Due to the use of credit scoring and other background checks, many of these, however, may not be eligible for a crowd financed loan either. But we also see large banks collaborating with crowdlending platforms in redirecting clients their way. I would say that this is a target group somewhere in-between microfinance and traditional banking (in Europe) today. Having said that, crowdlending mechanisms will certainly also work for those that are financially excluded. Crowdfunding can also bring benefits to inclusive finance sectors, if relevant technical innovations are embraced and adequately implemented, for example in microfinance. We are already seeing other sectors, for example business angels, engaging with crowdfunding methodologies in order to manage deal flow and co-investment online.

5

What are the advantages and disadvantages of these forms of financing in terms of making a positive impact on people and entrepreneurs' life?

RB. The main advantages of this form of financing are simply providing alternative sources of finance for borrowers and providing additional competition in the funding market that benefits the terms available to borrowers.

Historically, the main disadvantage of crowdlending to provide positive impact on the lives of financially excluded people and entrepreneurs has been the difficulty of access to the Internet. However, this barrier is rapidly dissolving as the cost of Internet access decreases and the range of devices through which it can be accessed increases.

One of the advantages of these innovative new products is their variety and the niche demands they service. However, the variety of these new, innovative products is also an issue as there is a lack of regulation adapted to the sector. A large driver of the rapid growth in crowdlending has been due to these platforms being less regulated than mainstream lenders. Most regulation revolves around deposit takers such as banks and what crowdfunding platforms have done is bypassed that regulation by connecting money directly from investors to borrowers through P2P lending rather than holding deposits. They are also seen positively by governments in creating competition in the market and so there seems weak political will to regulate crowdlending as heavily as mainstream lenders. While there are competition benefits, in my view borrowers and those who lend through these platforms need to be more careful they need to be with more heavily regulated mainstream lenders.

OG. The advantages are clearly speed and ease of access. On some platforms, terms also improve for repeat borrowers as their repayment behavior from earlier loans is taken into account during the application process. The disadvantages are the lack of advice and expertise that comes with an experienced loan officer. As a result, crowdlending today works well with creditworthy clients that are financially literate enough to pursue their own credit application. These clients can access credit quickly and without complex negotiations and thus focus on their core business tasks or private matter. However, entrepreneurs and private borrowers with increased information needs, especially without relevant credit scores or where a credit line might be linked to a specific risk, such as early stage business, are unlikely to feel satisfied with crowdlending for now.

6

What are the advantages and disadvantages of these forms of financing in terms of making a positive impact on people and entrepreneurs' life?

RB. The key strengths of the microfinance approach is that credit decisions are not based on credit scoring algorithms allowing the microfinance approach to lend to individuals or businesses that would normally be excluded from crowdlending platforms due to poor or little credit history.

The key weakness of the microfinance approach is that judgmental lending is people intensive and more difficult to scale than algorithmic crowdlending.

OG. Microfinance is about allocating institutional funds, as a result the entrepreneur will receive finance once his application is cleared, in crowdlending the success of the fundraising depends on the ability to attract sufficient capital from the crowd (though a number of lending platforms work with institutions that underwrite all successful applications and keep those that fail raising sufficient support from the crowd on their books). Microfinance also offers knowledge and support to the entrepreneurs during the credit application process and beyond, something crowdlending does not offer. Especially for those clients without relevant credit scores or those excluded from the traditional finance sector, this can be a vital aspect in helping them to manage their credit obligations. As long as microfinance includes advisory and educational aspect and works actively with their clientele to improve financial literacy, it will be better placed to serve the overall aim of financial inclusion.

7

Is there anything that microfinance actors can learn particularly from the p2p online lending approach?

RB. Crowdlending has not created a new product for the end consumer; at the end of the day, it is still a simple loan product. What they have done differently is more effectively use the online delivery channel and reduce bureaucracy by being more lightly regulated. Microfinance organisations can learn how to use online delivery channels and communications better, and potentially look at models to link certain funders with certain types of borrowers directly.

OG. Crowdlending comes in different flavors. Most are commercial operations that do not have an impact strategy aiming towards those excluded from the financial sector. The majority of sites aim at credit worthy consumers or small business clients. Often, the lender does not have the choice into what proposal to invest as the platforms auto-allocate funds across a number of offers in order to diversify risk. Some also offer small business loans on a project-by-project basis; there are also socially motivated lending platforms, of course. For the microfinance sector, there are several aspects where crowdfunding might prove to be a useful test ground. These include the access to retail and institutional investors at larger scale, for example, refinancing of loan books of microfinance institutions to increase liquidity (as we already have seen with Kiva or Babyloan). Another aspect would be the digitization of certain work flows, for example, big data, credit scoring, risk profiling, asset allocation and fund distribution, all of which allow keeping the transaction cost low. The digitization of workflows should prove very useful in markets with widespread access to the Internet, as it can help reduce some of the cost related to customer interactions. Relevant technology is already offered today under SaaS models.

For the microfinance sector, there are several aspects where crowdfunding might prove to be a useful test ground. These include the access to retail and institutional investors at larger scale, for example, refinancing of loan books of microfinance institutions to increase liquidity.

8

In your opinion, are crowdlending and microfinance actors competing for the same target groups?

RB. As I mentioned earlier, the larger commercial P2P crowdlending in the UK and Europe are predominantly based on algorithms or credit scoring with similar interest rate returns to mainstream lending. Their focus is usually commercial rather than social and so they tend to focus on the more creditworthy applicants where loans can be efficiently automated based on public data. Microfinance organisations also use public data, but rather than make decisions purely based on that they delving deeper into the stories behind the data allowing them to lend to a different client group which are excluded by bank or crowdfunding platforms.

OG. In general, considering today's market development, the answer would be no. Crowdlending in Europe is mostly focused on consumer or business loans to credit worthy clients, even though they capture also clients that may find it more difficult to access bank finance. However, some crowdlending platforms are addressing the same customers as local microfinance lenders, offering small business loans of €25k, for example. In this segment, crowdlending certainly has the advantage of speed and lower cost for reaching scale, but for now it remains to be seen if this will lead to actual competition in the near future. As long as microfinance can offer value added services around advice and education, the markets may not overlap too much. But in the future, one could imagine clients graduating from microfinance institutions in order to move on to crowdlending for speed and simplicity. This is a clear market opportunity for the microfinance sector, of course, to create relevant follow up funding possibilities. We also need to wait and see how incumbent financial institutions embrace the crowdlending model and if they will be using similar models in order to serve small consumer and business loans, maybe even with a higher risk profile than they can under current banking regulation.

9

Do you expect substantial crowding out or is there room for coexistence and even cooperation?

RB. My view is that the current crowdlending platforms are mainly competing for clients with mainstream banks and not microfinance organisations, and they will not limit the growth of microfinance. As with mainstream lenders there is room for co-existence and co-operation and I see partnerships with crowd-lenders to take similar forms to those that exist with the banks with the crowdfunders realizing they cannot serve certain clients and sending these across to MFIs. Microfinance organisations can learn from the efficiency of crowdfunding platforms to help them increase speed and enhance their online delivery and communication channels. Microfinance lenders' core mission and focus is to help those excluded by financial services, whether they be excluded by banks, crowdlenders or any number of other financial services products and so the target markets and clients they serve will remain different. Microfinance organizations will adapt to work with other financial services providers as they always have done and rather than see crowdfunding as competition, they will be working out how they can work together with them to serve their different client bases.

OG. This is too early to say. It will be vital to see how both sectors come together in the next years. We need to see if cooperation can be expanded, if the microfinance sector can make use of crowdlending for its own benefit, and if microfinance institutions can become a significant source of deal flow for crowdlending platforms, amongst many other possible ways of cooperation, I would not talk of crowding out. The question of crowding out versus coexistence is also not one I would pose. Rather, I would ask to what extent the sectors will find to cooperate and assimilate. Both sectors will have to evolve and develop in order to stay relevant for the market, thus innovation will be happening in both sectors. The European Crowdfunding Network has been working on collaboration with many different sectors and we are in an ongoing discourse with many relevant stakeholders in the early stage and SME finance ecosystem, including business angels, venture capital firms, stock exchanges, banks, philanthropy and commercial investment funds and, of course, microfinance. But only over time and as the crowdlending market is maturing, we will be able to say what business models, market segments and services will truly be disruptive and which will disappear again over time. Now is the time to start innovating for the future, we will be able to measure impact in 10 or 20 years.

Field experiences



The EMN has collected field experiences from four crowdfunding platforms in Europe. This section offers a more practical analysis of the sector, highlighting various crowdfunding models and approaches.

The following experiences help to explain how online platforms work, the needs they answer to and the innovative modalities that are adapted to foster financial inclusion and access to credit in different European countries.

All credit services in one platform



CROWDABOUTNOW. , THE NETHERLANDS

The Netherlands is one of the EU countries where the crowdfunding sector is most developed. In 2014, 78 million euro was raised through around 90 online platforms.

CrowdAboutNow is one of the leading platforms in the country with a focus on entrepreneurs. Tom Vroemen founded the platform in 2010 once he realized the difficulties faced by small entrepreneurs to access capital. The idea was to fund projects through the provision of small sums by large groups of individuals. After a long and hard process to obtain the necessary licence and to create the platform (in 2010 there was no regulation), CrowdAboutNow developed a model that allows interested stakeholders to invest in companies and support projects. To date, they have financed about 150 companies, raising over €6 million. Last year the company grew by 75%, both in amount raised on the site and in number of clients. Every year

they are financing an average of 100 companies.

CrowdAboutNow is a single platform that offers all types of crowdfunding: the preferred model is business and personal lending, followed by pre-sales, equity funding and donation. The platform is used mostly by people that are seeking funds for their start-ups or expansion plans and the average amount requested is €40,000.

Reasons why entrepreneurs choose this platform for financing their activities is not limited only to the funding. In fact, they also look for direct/indirect involvement of people who believe in their project, who can give them advice and suggestions through direct contact. On the side of the investors, the return on the projects is usually not very high. This means that people who choose to fund projects are guided by additional motivations (such as sharing interests and values) that convince them to become supporters and ambassadors of the project, instead of simple financial investors. For this reason, it is considered very important that funders are aware of how the financed project proceeds.

How it works

Access to the platform, even for lending and equity models, is not based on risk assessment or credit analysis. People seeking funds are judged through a short test available on the platform that aims at determining if the entrepreneur and the project have the right profile for a successful funding campaign. Generally, in this first phase

80% of requests are rejected, mostly because it is recognized that not all projects are suitable for a crowdfunding campaign. Before accessing the platform, projects that pass the test need to collect investments from local people (family, friends...) and raise up to 30% of the total amount requested. This demonstrates that the project promoter is trustworthy. Trust is an essential element throughout the whole campaign process, considered as a better indicator of people's reliability, more important than any credit scoring system. The funding process is guided by the platform's account manager who trains and supports people to develop their campaigns.

The interest-rates charged in the lending and equity models are decided upon by the entrepreneurs, in line with the account managers' recommendations. Once the campaign has started, an all-or nothing policy applies: if the amount requested is not reached within a certain time, the investors and lenders get their money back. Crowdfunder has so far recorded a campaign success rate of 75%. For those projects that envisage a financial return, Crowdfunder uses a model in which investors are fully risk bearing.

Crowdfunder's profits come from the fees paid by project's proponents and the advisory services offered. Moreover, they also license their platform to companies that wish to create their own crowdfunding portal.

In the Netherlands, crowdfunding is seen as the way in which small companies will be financed in the future. In particular, major growth potential is seen for SMEs funding.

www.crowdfunder.nl

Microfinance through crowdfunding

BABYLOAN

BABYLOAN, FRANCE

Babyloan is a philanthropic lending platform created in 2008 by Arnaud Poissonnier, a former French banker. It is a rare example of a European platform refinancing microfinance through crowdfunding. Its activities have lent more than €10,4 million to finance nearly 23,000 borrowers in 15 countries.

Following the example of Kiva, the well-known American crowdfunding platform, Babyloan started its activities by lending to micro entrepreneurs in developing countries. Even though 90% of its activities are still in developing countries, since 2011 the platform also displays European micro entrepreneurs (initially in France and, since 2013, in Bosnia). In France, Babyloan has signed a partnership with ADIE (the biggest French Microfinance Institution), after lobbying to receive authorization from the French Central Bank and a reform of the monetary policy code. Until then, it was forbidden for individuals to lend money to borrowers or to an MFI based in France. During the past four years, 227 French projects have been funded on Babyloan through MFI partners Adie and CréaSol, for a total amount of €800,000 (the average loan amount being €3,500 in France, vs. €450 in the developing countries). Babyloan's business in France is still small compared to the activities carried out in developing countries. This is a deliberate choice, since the platform aims to preserve its original focus on developing countries.

Different from pure P2P lending platforms, Babyloan's lending process includes the intermediation of local microfinance institutions, carefully chosen according to specific criteria that include financial results and

social performance. These MFIs are in charge of choosing which clients will be displayed on the platform and of the effective disbursement of the funds. They also deal with the repayment of their customers.

The Babyloan's lender community is around 40,000 members around the world (80% are French speaking). They are quite young compared to NGO donors with an average age 40 and come from high professional categories. On the platform, users choose among the beneficiaries that are presented (using stories and pictures). Consequently, they can decide to lend €10 or more. The software developed by Babyloan and used by its 17 MFI partners automatically assigns the money lent to the entrepreneur chosen online, and the repayment is performed on the online "Piggy bank" of the Babyloan lender. As a form of social lending, lenders do not earn any interest on the money lent. Once they receive back their money, they can decide to withdraw the amount or lend it to another micro entrepreneur.

Contrary to commercial lending, 100% of lenders have been paid back to date. In fact, partner MFIs carry the risk of client default. For this reason and in order to cover their operating costs, MFIs still charge interest rates to their clients. However, if the MFI goes bankrupt or is unable to repay because it faces a major difficulty, then the lender will not receive his money back. This risk is mitigated thanks to the transparency assured by Babyloan: together with information on the borrower, the platform offers information on the financial stability of the partner MFIs connected to each borrower.

All the money raised on Babyloan is sent to the field, although a project cannot stay online for more than 3 months. If the whole amount has not been collected after this period, only the raised amount is provided by Babyloan and the MFI must find the remainder through other sponsors. However, the money raised by Babyloan (around €300,000 each month) has helped, so far, to finance in full the majority of the projects.

Babyloan can be considered as a

provider of an interesting refinancing solution to small and medium socially-oriented MFIs. This funding may allow MFIs to increase their loan portfolio, expand their outreach and ultimately lower the interest rates charged to their clients. Working with Babyloan is also a good operation for MFIs to communicate and increase their visibility in the microfinance sector. However, as loans are so far only provided in euros, Babyloan's refinancing may not be suitable for all MFIs, depending on the currency they use to disburse the loans.

Babyloan's activities in Europe satisfy the desire of Babyloan's lenders to fund projects in France and simultaneously to alleviate the funding needs displayed by the microfinance sector.

Babyloan is a social business with three sources of income: fees paid by lenders (on average, 5% of the money lent), corporate partnerships and management fees paid by MFIs. Babyloan loans are certified by FINANSOL label as social finance product, and the platform has important shareholders including several French banks and the Caisse des Depots group.

With a 100% repayment rate and more than €10 million lent, Babyloan has proven that it is possible to do microfinance through crowdfunding. However, it is probably the most difficult job in the crowdfunding sector.

Operating in 15 countries requires a high level of country risk analysis, frequent field audits, as well as managing currency issues (loans are provided in euro). Regulation problems also exist, especially when a platform wants to solicit lenders in other countries.

In fact, people from all over the world can lend money, but Babyloan cannot promote itself and its activities in all countries (it is forbidden in Belgium or Switzerland, for example). France is the first European country to adopt a clear regulation for crowdfunding platforms, but Babyloan advocates the need for European regulation. This is the only way to have powerful players in the crowdfunding sector, to raise more funds from the crowd and take part in the financing of the microfinance sector.

<http://www.babyloan.org/fr/>

The pan-European P2P consumer lending platform



BONDORA, Estonia

Bondora is a P2P consumer lending platform founded in 2009 and operates across four European markets: Estonia, Finland, Spain and Slovakia. Personal loans represent a huge market opportunity, considering that the outstanding consumer and credit card debt volume in the European Union countries amounted to over €1 trillion in 2014. Moreover, focusing on a single type of loan allows the company to build more comprehensive review, scoring and collection processes and to deliver better rates and faster service for borrowers, while at the same time ensuring attractive risk-adjusted returns for investors. To date, 10,000 investors from 37 countries have funded close to €42 million of loans through the platform.

The role of Bondora is to connect creditworthy borrowers with investors. In most of the markets in which Bondora operates, P2P lending is the only affordable alternative to a bank loan. Therefore, the platform provides financing to people that are underserved by the banking sector due to the smaller amounts required or to those who demand a faster and more convenient process than the traditional lenders can offer.

In order to qualify for a loan, a borrower needs to pass an extensive credit and fraud check. The process is heavily automated, with direct connection to the local credit bureaus, such as Equifax in Spain, which makes the application process for the borrower smooth and fast: in fact, borrowers receive loan offers immediately since the credit check and credit scoring

Key Figures

18 countries of action

22.460 projects funded

100% loans repaid

10.36.737 € collected

Figure 6

Credit Check

	October 2014	November 2014	December 2014	January 2015	February 2015	March 2015
Loan demand	38.22	39.47	33.01	39.28	44.88	49.40
Loan origination	2.17	1.87	2.00	2.22	2.88	5.87

is done while they are applying for a loan. In recent months, approximately 20% of the applications have passed the extensive credit check by Bondora analysts (Figure 6). The reasons for rejections include payment problem history, insufficient income and fraudulent activity in addition to many others.

Each borrower's loan application is scored using a proprietary scoring model and receives a Bondora Rating, from AA to HR (Figure 7), which reflects the expected risk associated with a particular loan and defines the interest rate paid by the customer. Investors can use Bondora Ratings to build a diversified portfolio in accordance with their risk and return preference, choosing to invest into loans within specific ratings (one or several) either manually or automatically using the Portfolio Managers.

During the funding process, investors can ask questions to applicants using the platform's interface, review the assigned Bondora Rating, as well as the profile of the applicant including education, employment, income level and existing liabilities; however, they are not allowed to enter into direct contact with the borrower during or after the funding process. All questions asked to the borrowers during the funding process are visible for all lenders on the platforms to make sure that all lenders make their decision based on the same information. In case of default by the borrower, Bondora handles the collection processes, channelling all collected proceeds to the investors. Investors do not have to dedicate their time and do not incur extra costs for the collection of defaulted loans.

The revenue of the company comes from the origination fee and loan

servicing fee. In addition to the ongoing revenue, Bondora has raised \$7 million in two funding rounds from private and individual investors to facilitate the growth of the platform. In February 2015, Bondora has closed a Series A funding round from early Lending Club backer, US-based Valinor Management. The new funding round will be used to further grow the origination volumes across existing markets, as well as for the expansion into new geographies.

The mid-term goal of the platform is to continue building a truly pan-European platform and start offering loans across all Eurozone countries, and thus becoming a platform that can compete with the current leaders in the P2P lending space, such as Lending Club and Prosper. However, operating across multiple European markets requires an in-depth understanding of the regulatory framework, court system processes and consumer behaviour.

Considering that the combined volume of consumer P2P online lending was estimated to be approximately €1 billion in Europe in 2014 (just 0.1% of outstanding consumer and credit card debt), there are huge opportunities for consumer and SME P2P lending platforms and the industry can be considered to be in its infancy stage, at least in Europe. On the investment, or capital supply side, the opportunity lies in the rise of institutional funds dedicated to peer lending, such as GLI Finance and Victory Park Capital, as well the interest from traditional lenders, such as Citigroup, Barclays and Santander, in placing loans through P2P lending platforms.

www.bondora.com

Figure 7

Bondora Rating

Rating	Average expected interest	Average expected default	Average expected lost	Average expected return
AA	14.79%	2.51%	1.63%	13.16%
A	16.48%	4.00%	2.60%	13.88%
B	18.24%	6.10%	4.36%	13.89%
C	22.16%	10.05%	7.31%	14.85%
D	26.63%	13.54%	10.78%	15.85%
E	32.27%	17.84%	15.23%	17.04%
F	40.68%	25.90%	21.41%	19.27%
HR	64.34%	49.12%	43.80%	20.54%

Crowd-to-Business-Lending



FINMAR, Germany

finmar is a German crowd-lending platform that connects lenders to small and medium entrepreneurs seeking funds. The idea to start the platform dates back to 2010. Clas Beese used to work in the microfinance sector and offered consulting services to entrepreneurs that wanted to access bank loans. Those people found several difficulties, mostly related to the size of the loan requested (up to €25,000), that is considered too expensive to disburse for traditional banking institutions. Microfinance could be an option, but it remains a sector that is heavily subsidized and that, in many cases, uses the same scoring systems. Clas Beese and his team decided to find more sustainable ways to help entrepreneurs to access credit.

The creation of the platform has not been easy, both in terms of time and money: they had to develop their own software and comply with the German financial regulation that required the establishment of a partnership with a bank in order to receive the operating licence. This process took two years and the platform was launched in 2013.

The entrepreneur who wants to start a crowdfunding campaign on finmar opens a user-account on the website and inputs information to explain his project. Then, he is obliged to open a (free) bank account at finmar's partner bank, since all transactions will be conducted through this financial institution, in an easy and fast way. Finally, finmar analyses the project and the credit score of the entrepreneur through the scoring agency Schufa. The results are used to establish the interest rate. Having no credit history

is generally not an issue, but having a negative credit history does not allow people to access the platform: there is always the need to balance accessibility to the platform on one side and protect lenders on the other.

Access to finmar is free: the entrepreneur has to pay fees to the platform only if his campaign is successful. Fees amount to 5.95% of the principle loan amount and are the only revenue for the platform: no consulting or additional services are offered to entrepreneurs. On the platform only campaigns up to €25,000 are accepted. This is due to two reasons. First, this provision aims to protect the borrower. In fact, in case of business failure, he is still obliged to repay the full amount to his investors. If he receives bigger amounts, he would probably be obliged to declare insolvency, and thus encounter additional problems. Secondly, when starting a new platform, it is important to "grow the crowd" and, for doing this, it is more convenient to start with lower amounts.

Investors decide which project, among those presented on the platform, to finance. Their decision is guided both by an interest in the project itself and by the desire to gain profits from the investment. The minimum investment is €250 and the maximum is €2,500. Moreover, investors and borrowers can enter into contact during the campaign and after its completion. This aspect is important both for the entrepreneur, who may receive advice for his project, and for the lenders, who can easily monitor their investment.

finmar is still in its infancy, with its first 2 financed projects of €12,000 each in the last year. The major difficulty encountered is the need for the platform to develop both sides of its clientele simultaneously: on one side, it is still difficult to place good projects on the platform; on the other, creating the crowd is still complicated, although changes in lender behaviour are occurring. However, considering the growth of the sector and the positive changes in regulation (especially at European level), this form of "crowd-to-business-lending" will attract more entrepreneurs as an alternative way to access business loans.

Major changes on the platform may include a different way to calculate the interest rate (not only based on credit history), an increase in the loan limit of €25,000 and the introduction of some forms of collaterals. Crowdfunding has a huge role to play in the future financial system and it will be important for finmar to continuously adapt its activities to the changing needs of society.

www.finmar.com

Microfinance and online platforms: opportunities from cooperation



From the viewpoint of the European microfinance sector, the recent growth of crowdfunding and P2P lending platforms can be seen as a double-edged sword. On the one side, the development has the potential to disrupt the traditional market of providing financial services and products "offline" via single financing institutions. In this regard, crowdfunding platforms will also affect microfinance providers that will have to compete with new actors in their target markets. On the other side, the new actors and approaches open up new cooperation and learning opportunities for MFIs that are interested in adopting crowd-based funding approaches to enhance and/or improve their activities and practices.

In recent years, MFIs in Europe have registered a steady increase in number of clients served and loans provided. However, they still encounter growth barriers, mostly due to high operational costs and the sectorial risks. To reduce and cover costs, as well as to mitigate risks, microfinance providers need to develop efficient and lean processes as well as stable funding patterns for their activities. As highlighted in the EMN Overview Survey 2012/2013, the general public support for microfinance provision in Europe is expected to decline in the coming years, due to budget restrictions and high public deficits at national and regional levels. Therefore, MFIs should look closely at the opportunities that the ongoing digital transformation of the economy offers to address these challenges.

For MFIs, a number of options exist to deal with the new alternative financing models that have developed as part of the ongoing crowdfunding revolution. Here are four of them in more detail:

Option 1: Crowdfunding campaigns to finance MFIs

In terms of using crowdfunding platforms for funding microfinance activities, we are used to platforms like Kiva that present individual micro-entrepreneurs to potential investors. The microfinance institution providing the loan has only a marginal role in the communication. From the perspective of the platform this is understandable because, essentially, the appeal of crowdfunding is about connecting people and individuals via financing. However, the success of online platforms for funding social projects could indicate a way for European microfinance institutions to use crowdfunding to directly fund their activities or projects. The mission of European MFIs to fight poverty and generate employment for excluded persons should appeal to individual donors and social investors that are looking for funding opportunities with social impact. Crowdfunding campaigns could cover non-financial services offered by the MFI, such as entrepreneurship training, business development services, financial education, etc. The provision of these services to target groups is well suited for promotion via social media. Moreover, pilot initiatives or the development of innovative products aimed at financial inclusion could also raise interest from the crowd and receive funds.

In order to work, such campaigns need to be well designed in order to convey the positive image and reputation of the microfinance institution (and of the microfinance sector in general). To achieve these goals, the institution will probably have to invest into developing new skills and capabilities of their communication and marketing staff. Trainings or consultancies for this, in fact, may entail additional administrative costs for the institution.

From a client perspective, the use of these funding mechanisms does not

necessarily directly reduce costs in terms of interest rate or fees charged for loan provision. However, it could allow the MFI to provide additional services to their clients free of charge, offer products that better answer clients' needs or help MFIs to increase outreach, serving more clients.

Option 2: MFIs as intermediaries

Cooperation between crowdfunding platforms and microfinance organisations with the MFIs acting as intermediaries between the platforms and the individual microfinance clients are already established, especially in developing countries, with Kiva as the most prominent example. This also could be a viable option for European microfinance organisations.

In such a model, the money raised on the platform is pooled by the microfinance institutions that disburse it to the entrepreneurs who are selected by the crowd. What makes this mechanism work is the partnership between the microfinance institution and the online platform. The latter could envisage specific pre-requisites that need to be accomplished by the MFI. They could require a certain dimension of loan portfolio, good financial and social performance, transparency and the adoption of criteria for client protection.

Once the partnership is created, the microfinance institution is in charge of collecting stories, taking pictures and video of their clients, and presenting them on the platform. This requires additional time, costs and skills by the MFI's staff. In addition, fees to pay to the platform should also be taken into consideration in the MFI's decision to engage in this kind of activity. Moreover, it is important to remember that the MFI in any case bears the risk of clients' non-repayment and have to assure the restitution of the money to the social lenders.

From a client perspective, the partnership model entails one major change, due to the fact that clients are the ones that will appear on the platform and whose stories will be shown online. Since not all crowdfunding campaigns may be successful, the MFI, in any case, integrates the funding obtained through the platform and assures the disbursement of the total amount of the loan to their clients.

Especially when partnering with social lending platforms that do not entail any interest paid to the lenders, this funding mechanism can be more convenient for the MFI if compared to other funding sources. However, the growth of the P2P sector suggests that a lot of individual investors are interested in forms of crowd based lending where a return is envisaged. This may increase financing costs for the MFI, but might guarantee a more stable and continuous flow of resources from the crowd of investors that prefer to combine philanthropic motivations with the possibility of moderate profits.

Option 3: MFIs as complementary to crowdfunding and P2P lending

The actual impact of crowdfunding on the financial inclusion of those people that are usually microfinance's clients remains unclear. Since accessing these platforms can be quite difficult and usually requires business and computer skills, the poorest might remain excluded by these new funding mechanisms although they might have informal networks in their communities that would support a crowdfunding campaign.

For these people, microfinance providers could act as access points to crowdfunding. MFIs could

support them in choosing the best crowdfunding model and in presenting themselves on the platform. This could be a service offered by the institution to those clients whose projects are most suitable for a crowdfunding campaign. In this way, MFIs could facilitate these people's access to the platform and contribute to their financial inclusion. Moreover, if the fundraising campaign launched on the website does not reach the desired amount, the MFI could fill the remaining gap, allowing the entrepreneurs to receive the total requested amount.

This may allow the MFI to finance riskier projects, while sharing the risks (as well as the profits) with the crowd. Moreover, after the initial investment in new skills and competencies of the staff, the MFI could generate success based revenues for this service covered by the client and the platform/ the crowd.

Individual clients play a central role in this scenario, because they are empowered to actively conduct their own crowdfunding campaign and are dependent on their social ties and networks.

Option 4: From MFI to P2P lending platform

Finally, microfinance providers could completely reshape their activities, introducing the technological and operational innovations of crowdfunding and P2P platforms in their day-to-day practices. According to some practitioners, setting up an online-based platform is neither complicated nor very expensive today, with replicable service models available in several European countries. However, in order to start this kind of transformation, additional skills and competences need to be learned. For this reason, MFIs would

need to rely on the support of existing platforms and their willingness to transfer their technological know-how and infrastructure in the beginning.

In this manner, an MFI could establish its own hybrid lending activity that on the one hand facilitates access to finance for excluded and disadvantaged groups, while on the other hand incorporates a community of dedicated social lenders via the platform. All lending activities could gradually be transferred to the platform, until the moment when the actual institution will ultimately be transformed into a social finance broker. This would reduce its operating and administrative costs and consequently lower the level of fees charged to clients. However, such a complete transformation would most probably change the original mission of the MFI, as access to finance would depend on the collective risk appetite of the lenders on the platform. It would also limit the influence on the level of interest to be paid by the clients.

A more balanced development option for MFIs with regard to their social mission would be to create a common national or European P2P platform through which only a part of their clients are financed. At the same time, MFIs could maintain their inclusive offline lending activities and business training services for the most excluded target groups. This operation, however, would entail major additional costs to participating MFIs that may not necessarily be compensated by cost reductions channelled through the platform.

How to position microfinance in the future alternative finance sector?

The technologically driven growth of crowdfunding and P2P lending models throughout Europe has clearly started to challenge the traditional financing sectors in several European countries. While online and crowd-based financing is not likely to become the only way of funding individuals, businesses and start-ups in the future, these platforms have the potential to create an alternative finance sector that operates without traditional banks as the main intermediaries. Since MFIs are also part of the alternative finance movement, they need to understand the innovations of these new actors in order to find the right approach to

thrive in the future financial services and products landscape.

Cooperation with and learning from crowdfunding and P2P lending models represents an opportunity for MFIs to increase their outreach, serve more clients and finance part of their operations and activities. However, it is important that MFIs preserve their original mission and goals while experimenting with the use of these new technologies.

With regard to the ongoing innovation race in the financial sector, the main question for microfinance is to examine how these innovations can be utilized to support their socially and financially excluded target groups. With this focus, it seems fruitful for MFIs to explore new possibilities that challenge the traditional lending mechanisms in an attempt to serve their clientele even better, by maximising the exciting opportunities that are emerging in the financial sector.

European Microfinance Sector Challenges

In a nutshell, the challenge for the European microfinance sector is to develop cooperation models that allow them to profit from new opportunities to stimulate peers and communities for social finance while maintaining focus on excluded individuals at the local level.

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- ➔ Funding Circle (UK) <https://www.fundingcircle.com/uk/>
- ➔ Smartika (Italy) <https://www.fundingcircle.com/uk/>



European Microfinance Network (EMN) aisbl
Rue de l'Industrie 10 - 1000 Brussels - Belgium
Tel : +32(0)2/893.24.48
emn@european-microfinance.org
www.european-microfinance.org



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