The Finance Innovation Lab response to The FCA's regulatory approach to crowdfunding (and similar activities) – FCA Consultation Paper CP13/13

1. Background

The Finance Innovation Lab is a partnership between WWF-UK and the ICAEW to incubate, accelerate and innovate new ways to change the finance system into one that better serves society, the wider economy and the environment. Over recent years we have carried out research and advocacy on policy which will facilitate a diverse finance system. In particular we have worked with the growing peer to peer finance sector as an example of a disruptive business model in the finance system designed to increase transparency and democracy.

The last few years has seen an upsurge of financial innovation focused on reducing the number of intermediaries in the retail savings and investment markets. Peer to peer lending, crowdfunding and other internet platform businesses seeking to promote direct financial transactions between individuals and businesses have attracted customers and media attention. With a business model based on transparency and simplicity, these financial innovators were the polar opposite to the sort of products based on complexity and opacity that have caused many scandals in the financial sector in recent years. There was another difference. These companies wanted to be regulated and approached the government in 2011. A statement was signed by a large number of the industry players calling for proportionate regulation of their sector. The initial response from Ministers was to reject this request using the argument that more regulation stifles innovation. By the time that The Finance Innovation Lab held its Peer to Peer Finance Policy Summit in December 2012, however, this attitude had changed and it is a great step forward to now have this consultation process on how peer to peer lending and crowdfunding can be regulated in a way that facilitates the growth of this innovative industry, but also protection for the consumer.

2. The need for a diverse finance system

The Finance Innovation Lab believes that our finance system needs to be diverse in order to be resilient to economic shocks, but also to serve the interests of society and the wider economy. Our current system, dominated by banks that are considered too big to fail and institutional investors, which allocate our savings based on their priorities for short-term profits, not ours for long-term returns, is not fit for purpose. Below are some of the areas where, as confirmed by our research, we believe diversity in the financial services sector needs to be increased:

1. **Increased transparency** - the easier it is to see how your money is being used by an intermediary, or the level of fees and charges that are applied, the better the customer experience will be.
2. **Greater accessibility for all social groups** is another feature which will improve the fairness of the financial system. Products which are open to all, and not restricted to those with higher income or more assets, should be encouraged into the system.
3. **Cutting rent seeking in finance** - if a new financial provider can demonstrate they are reducing the rent taken by them as an intermediary, this contributes too fairer and more efficient system.

4. **Investing not speculating** - financial services which make as direct a connection between investor and the real economy as possible should be favoured over those which 'make money from money'.
5. **Taking a long term view** - if equity investments in companies are being made, products which take a long term approach should be encouraged as a counterbalance to the short term bias of existing equity markets
6. **Valuing social and environmental impact** - if the product or service is improving the ability of the finance system to value environmental and social risks and benefits of any given investment, this will help improve the overall market and its sustainability
7. **Distributed profits** - products or services that encourage greater distribution of profits across the economy should be encouraged over those that concentrate profit and asset ownership in the hands of a few
8. **Simplicity** - if the product is simple and accessible to the consumer, this will improve financial literacy and act as a barrier to rent seeking behaviour in the finance system by the creation of over complex products
9. **Scalable** - finally it is important that any new alternative finance service or product is scalable, if it is to contribute to increasing the diversity of the finance system. Whilst there is space for niche products in the market, they will not transform the system on their own.

Regulation and policy need to actively promote a diverse finance system based on the features set out above. Some of the new duties of the FCA, such as enhancing competition, will support this direction. However, the approach of the FCA in implementing these duties needs to change significantly from its predecessor, the FSA. Greater account must be taken of the needs of consumers, but also in encouraging innovations, new business models and ways of operating that, if allowed to flourish, could also deliver better outcomes for society, the wider economy and environmental sustainability.

3. Principles of democratic finance

As well as removing intermediaries from the savings and investment chain, the peer to peer finance industry is also explicitly trying to increase accessibility of higher risk, higher return investments to a far wider section of the population. It does this by allowing small amounts of money to be invested, as low as £5 with some sites. By reducing the financial hurdle to, for example, buying shares in a start up or lending to a business via a retail bond or debenture, it could play a part in distributing the economic benefits of ownership across a wider band of society.

Traditionally the approach of regulation has been to professionalise any assessment of investment risk and restrict access to those who register as 'sophisticated investors' or are able to declare themselves of 'high net worth' – ie the clever and the rich. Clearly consumer protection, and the need to prevent mis-selling in an industry frequently caught doing so, is very important. On the other hand the use of exclusive language and legal requirements for taking paid advice, have put many ordinary people off engaging with how their money is invested, so losing economic opportunities as a result. Is anyone asked to state their 'net investible portfolio' when buying a house or even starting their own business? The FCA already has a general principle that "consumers should take responsibility for their own decisions" Given a proportionate regulatory framework, peer to peer finance and crowdfunding could play a role in re-educating the public about finance and taking responsibility. Consumer protection must go hand in hand with consumer opportunity and education.

4. Regulate according to risk diversity as well as diversification

Even within the peer to peer finance industry itself, there are numerous products which have very different risk profiles. This diversity of risks is another strength of the sector. Our concern with the consultation as currently drafted is that the regulatory framework seems only to recognise two categories of risk: high and low. Whilst this might make for streamlined regulation and fewer staff on the FCA payroll, it is a false economy for UK plc, as many medium risk products will end up being classified incorrectly, reducing opportunities for investors and investees alike. And, of course, only the clever and rich will be able to access to even the medium risk opportunities.

A more flexible classification should be employed by the FCA based on a wider set of factors. The person, project or business that is receiving the investment or loan will have a risk profile. A start up is clearly higher risk than established company with a customer base and revenue stream already in place, for example. The financial products have different inherent risks, equity or loan, secured or unsecured lending, length of investment period, access to secondary markets etc. Finally the platform itself will provide different levels of information and risk management options to consumers in the form of credit rating, provision funds etc. These risks should be addressed on a case by case basis as new peer to peer platforms seek regulation. This is partly because the current diversity of the sector is not reflected by the regulatory classification, but also because new business models are being invented all the time. The FCA has to be ready for this and embrace innovation, rather set up limited pigeon holes that will force new players to perform legal summersaults in order to be regulated.

5. Recommendations for the regulation of different sub-sectors of peer to peer finance

The consultation paper divides peer to peer finance into two broad categories: loans based crowdfunding and investment based crowdfunding. As we have argued above, we believe this classification is oversimplified and would certainly want to add a separate classification of debt securities. As the sector develops, however, there will almost certainly be a greater diversity of risk profiles amongst peer to peer finance websites and regulation needs to be anticipate innovations to help them to market as efficiently as possible, rather than react to them, as it has with peer to peer lending and crowdfunding equity.

5.1 Peer to peer lending

The first point to make is that the term used in the consultation for this sector, loan based crowdfunding, is not one readily used by either the firms themselves, or their customers. Peer to peer lending, the more frequently heard term, is the practice of matching capital from savers with a diversified group of individuals or companies who wish to borrow. The rates are agreed individually and the finance platform takes a fee for arranging and performing some due diligence. It is a fast growing sub-sector and accounts for the majority of capital deployed in the peer to peer finance sector. £480m was lent during 2013 an increase of 150% from 2012, according to the latest figures.[1]

The proposed regulatory framework is broadly appropriate for the type of activity. It is understood to be of higher risk than a regular savings account, so it makes sense why peer to peer lending will not come under the remit of the FSCS. In the same way there are good reasons for the prudential requirements proposed, coming as they do with a transitional period.

Proposed rules on marketing, client money and platform failure are all welcome as ways of delivering the right degree of customer protection. Many of these are indeed based on the Code of Practice already adhered to by the Peer to Peer Finance Association, who represent the main peer to peer lending sites.

The discussion in the consultation on the risks of peer to peer lending fails to mention the common practice of diversification across loans, so for most websites the capital put in by the individual is generally split across a large number loans to spread risk of default. The industry is developing a common standard of assessing risk of default, which is usually allowed for in the calculation of return advertised to customers. In addition it is not clearly explained why the proposal is to treat money being place in peer to peer lending more like an investment, than a loan. The FCA has concerns over liquidity of peer to peer loans. Some sites have developed secondary markets, albeit with limited liquidity, to facilitate withdrawal of capital before the terms of loan are up. Whilst this may not have a large bearing on the regulatory treatment of peer to peer lenders, it may do when looking at other government policies such as Individual Savers Allowances against tax. There is a strong case that peer to peer lending should be eligible as part of anyone's ISA. As it stands this is likely to be part of the investment ISA allowance, where as there is also a case that such savings could be used as part of the Cash ISA, which would significantly broaden the accessibility to the public.

5.2 Crowdfunding equity

Crowdfunding equity is the peer to peer finance sub-sector with most players, but in terms of actual capital deployed, it is still much smaller than peer to peer lending. In 2013, there was £28m invested in crowdfunding equity, and increase of 371% on 2012.[2] It is clearly a higher risk investment and is broadly equivalent to venture capital and angel investment. Many of the start ups that receive capital may well go bust, with the small minority growing fast. It is important that any investors understand this.

The regulatory framework rightly highlights the risks and seeks to ensure that investors are well aware of these risks before committing money. What is less discussed in the consultation is the fact that many of the investors will only be putting in small amounts of capital, whilst the regulatory protection that is being proposed is equivalent to that for tradition angel investors or venture capitalists. The assumption lying behind the rules is that really, only sophisticated investors or high net worth investors should be involved with this sort of thing. Two aspects of the regulations in particular appear to be overly protective of consumers and could result in the exclusion of large swathes of the population from the opportunities of crowdfunding by putting them off before they have even started. These are the nature of the 'appropriateness tests' that prospective investors

[1] Collins, Swart, Zhang (2013) The Rise of Future Finance – the UK alternative finance benchmarking report. Nesta, University of Cambridge & Berkley University of California. December 2013
[2] ibid

would have to go through and the point in the investment process at which these tests have to be applied.

The consultation states that, before accepting an investment, a platform must ensure that the person has self-certified to say they are not investing more than 10% of their 'investible portfolio', or that they are a 'sophisticated investor', of high net worth, or have taken advice from a regulated adviser. Such precautions are certainly wise for large investments, but many of those likely to engage with crowdfunding will be very small investors, who will not have access to a financial adviser and certainly not see themselves as sophisticated investors with portfolios. They are more likely to be ordinary people with a small amount of disposable income and modest savings. They might want to support an entrepreneur they believe in and understand, but will be put off by the legal hoops they will face to make this investment. The '10% rule' is supposed to be a way of encouraging such individuals to participate, but perhaps there should be a threshold of total investment, before such warnings and tests come into force. Perhaps any individual should be able to invest a nominal sum of real money (eg £200) on a platform with no appropriateness test, then if any more investments are made then the test is applied. Participation in crowdfunding is part of the education process.

This brings us to the second area of concern, which is at what point the test should be applied. Currently the consultation suggests that such tests should be applied before anyone can read financial promotions. This is equivalent to requiring proof of age from anyone who enters a shop that sells alcohol or cigarettes, as opposed to preventing them from buying it at the counter.

As the platforms will already have to comply with rules ensuring that the risks of investment are clearly stated in any financial promotion, the act of reading and thinking about these promotions will itself be helping investors consider the risks. If an appropriateness test is required it should be applied at the point of investment, not before viewing the promotions.

5.3 Debt securities

At present the consultation divides peer to peer finance into two categories: peer to peer lending (low risk), and everything else (high risk). As discussed above, this is too simplistic and there is one praticular asset class, already developing in the marketplace that should be considered differently: debt securities. These can be fixed short term retail bonds in established businesses, or longer term debentures. The nature of these products is clearly higher risk than the disaggregated lending of peer to peer sites, as your money is lent to one company. But neither is it as high a risk as start up equity. We believe that, from the outset, the regulatory framework for these products should be less stringent than for crowdfunding equity. The differentiation could be in where the appropriateness test is applied, or perhaps the threshold of investment that is allowed before any kind of appropriateness test comes into play. Another way to differentiate could be to make such investments eligible as part of an equity ISA. Many crowdfunded equity investments already qualify for SEIS or EIS tax relief, so do not need more tax incentive support, where as debt securities fall between classifications creating an un-level playing field.

6. Conclusion and recommendations

The Finance Innovation Lab warmly welcomes the FCA decision to apply a proportionate regulatory framework to peer to peer lending and crowdfunding.

Such regulation should contribute to bringing greater diversity of financial business models that maximise transparency, minimise intermediation and allow greater access to financial opportunity across income groups.

The framework must also recognise the diversity of risks being offered in peer to peer finance and apply regulation proportionate to those risks. In particular the three broad sub sectors of peer to peer finance should receive different treatment from regulation.

The proposed framework for peer to peer lending is broadly set at the right level. In addition, the Finance Innovation Lab proposes that individuals should be able to place a proportion of their cash ISA into a regulated peer to peer lending product.

The proposed framework for crowdfunding equity needs some further clarification to ensure that it does not become a regulatory barrier to investment opportunities for ordinary savers. There should be a threshold to allow very small investments on a platform to be made without any requirement for an appropriateness test to be completed by the investor. Once total investment on a platform crossed this threshold, then a plain English appropriateness test should be required to ensure understanding of risk by the investor. There should be no regulatory barrier to viewing the financial promotions, as long as the platform complies with rules for how such promotions are described.

There should be a differentiated regulatory framework for simple debt security products, such as retail bonds or debentures. These products are higher risk than conventional peer to peer lending, but not as high as start-up equity.

Peer to peer finance is a rapidly growing sector with huge innovation. The regulatory framework set out after this consultation must be adaptable to new business models and the rules establishes for existing business models may well need adjustment over the next few years. We therefore welcome the built in review of this framework in 2016.

On behalf of The Finance Innovation Lab

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