EXPLORING THE LINK BETWEEN THE EMERGENCE OF ALTERNATIVE FINANCE BUSINESS MODELS AND FINANCIAL INCLUSION

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Abstract: The paper focuses on the most recent development in the field of alternative finance business models, called crowdfunding. Based on most recent data, it will be stressed the market size of this alternative finance segment and its growth prospects across European Union member states. An indirect outcome of the paper will consist in revealing the degree of financial exclusion from traditional banking products and services and whether it is linked with a higher incidence of transactions on crowdfunding platforms. The assumption to be further investigated relies on the hypothesis that unbanked people, which are excluded by conventional financial institutions, have a sound opportunity to raise money to fund their small-size investment projects or start-ups by relying on crowdfunding.

Keywords: crowdfunding, regulation, risks, financial exclusion.

Introduction

Reshaping traditional banking business models is a topic that gained wide interest across practitioners, regulatory bodies, academia and civil society. The last decade and particularly the period after the 2008 financial crisis have witnessed the emergence, development and consolidation of particular financial institutions' business models. These noteworthy models place at the core of their activity customer centricity, transparence of financial operations and values as trust and solidarity. Their spectrum is broad, comprising ethical banks, sustainable banks, microfinance institutions or the newest crowdfunding platforms.

The paper focuses on the most recent development, called crowdfunding. It is a mean of collecting households or companies' money, via online platforms, in order to finance small or medium sized projects and start-up businesses. The specificity of this business model, that connects investors and borrowers exclusively via online platforms, depicts advantages but also peculiar risks. Both European Commission and national regulatory bodies have begun to monitor the dynamics of this financial sector niche and to find ways to issue proper legislation and harmonize it across the EU member states where crowdfunding is active.

The paper aims at providing an exploratory insight into the features, advantages, drawbacks and specific risks depicted by crowdfunding, as well as its spread and dynamics across EU countries. Based on most recent data from European Commission and audit companies, it will be stressed the market size of this alternative finance segment, its growth prospects. Although data series related to financing provided through crowd-platforms are lacking, it will be performed a selection of the most active crowdfunding platforms in Europe, to comparatively assess the peculiarities of the financing provided, in terms of maturity, borrowed amounts and interest rates charged.

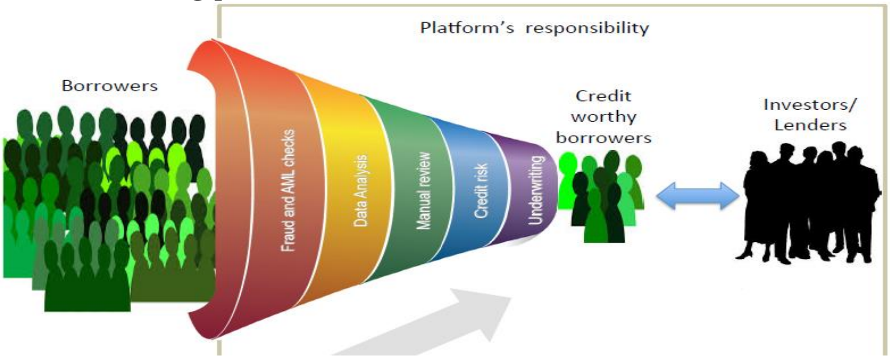
An indirect outcome of the paper will consist in revealing the degree of financial exclusion from traditional banking products and services. Financial exclusion is commonly defined as the failure of conventional financial institutions to adapt to the needs of different social groups, caused mainly by banks' selectivity and profit–orientation. The assumption to be further investigated in the paper relies on the hypothesis that unbanked people, which are excluded by conventional financial institutions, have a sound opportunity to raise money to fund their small-size investment projects or startups by relying on crowdfunding. In other words, they have to convince a crowd, by using an internet promotion and description of their business idea. Thus, the link to be examined is whether countries recording a high volume of transactions via crowdfunding platforms depict also a high level of financial exclusion from traditional banks or, on the contrary customers depict a high degree of financial sophistication and wish to diversify the ways of investing or borrowing money by means of both conventional and alternative finance.

1. Crowdfunding: meaning, peculiarities and specific risks

According to European Commission’s Guide on Crowdfunding, this specific business model is a viable alternative for raising money than traditional banking. The demand and supply of money meet on online platforms (websites), the fundamental purpose being that of chanelling financing to startups, small businesses and new projects. In its communication (2014c, p.2), the European Commission defines crowdfunding as a reliable, complementary source of finance, besides mainstream banking, and agrees that it is one of the newly emerging business models that “contribute to building a pluralistic and resilient social market economy”.

The rationale of crowdfunding is to gather easily and safely small amounts of money from large groups of individuals or crowds instead of big amounts from few people. The crowdfunding platforms advertise first the projects to be financed; if fundraising campaigns are successful, those that have applied for financing will be charged a fee by the platform. The principle most platforms operate with is all-or-nothing funding, meaning that if the crowd provides money in a total amount that exceeds the pre-defined target the "borrower" will receive the money; otherwise, every individual will get his money back and the business or project won't be financed. Crowdplatforms use to perform an a priori screening of applicants for fundraising, based on several criteria, before promoting their business or project idea on the online platform. A brief scheme is presented in the figure below.

Figure 1. The screening process



Source: Ridler, 2014

The typology of crowdfunding business models is diverse. The European Commission's Guide on Crowdfunding has identified and defined seven types, namely:

- Peer-to-peer lending. The crowd lends money to a small business or individual and expects that the money will be repaid with interest. It is very similar to traditional borrowing from a bank, except that the amount is borrowed from many investors.
- Equity crowdfunding. It allows the sale of shares in a small or medium sized business, the holders expecting a return for their investment.
- Rewards-based crowdfunding. It implies donations to a project idea or business, by obtaining in exchange some kind of non-financial reward.
- Donation-based crowdfunding. It relies on voluntary donations made by individuals for specific projects, without expecting any reward or return, neither financial nor tangible.
- Profit-sharing crowdfunding. It is a promise that small businesses make in terms of sharing future profits with the individuals that provided them funding at present.
- Debt-securities crowdfunding. People invest money in debt securities, usually bonds, issued by small businesses.

- Hybrid models, which combine the features of several crowdfunding typologies.

A public consultation launched by European Commission (2014b) at end-2013, revealed that the most well-known forms of crowdfunding are donations and rewards (74% and respectively 69% of respondents), pre-sales, profit sharing and equity (50% to 60% of respondents), lending (45%), hybrid models (32%) and debt (25%). The benefits offered by crowdfunding, as they were perceived by respondents are: less dependence on traditional forms of financing (75%), highly beneficial for innovation (74%) and for SMEs and entrepreneurs (67%).

In terms of risks involved, there are several specificities outlined by the EC's Guide on Crowdfunding:

- the intellectual property on a project idea becomes public;
- underestimating crowdfunding costs, particularly in the case of equity crowdfunding;
- reputational damage due to project owners' errors or under-preparation when launching a project to be financed through online platforms;
- law-breaching EU or national regulation;
- fraudulent platforms;
- understanding the responsibilities a project owner has towards its contributors.

Other risks revealed by a consultation launched by EC (2014) are represented by the lack of trust among citizens and the lack of knowledge on this type of online fundraising.

Another public consultation launched by EC (2014b) provided a closer insigth into crowdfunding's added value and particular risks. The risk of insufficient intellectual property rights protection is perceived as being too high by only 22% of respondents who are in position of project owners. The risks of fraud and misleading advertising are ranked as acceptable by most stakeholders (50% and 47% respectively), while about one in four respondents consider these risks to be too high. 74% of respondents believe that a scandal could undermine contributors' future confidence in crowdfunding. Other major concerns relate to risk of fraud, lack of information, maintaining contributors privacy, risks of hackers attacks on platforms, money laundering.

Table 1 depicts comparatively a selection of the most active crowdlending platforms in Europe, to gain an insight into the peculiarities of these types of loans, in terms of maturity, amounts to be borrowed and interest rates charged.

Table 1. Peer-to-peer crowdfunding models – financial information

Name of the	**Minimum**	**Maximum**	**Range of**	**Interest**

crowd lending platform	amount to borrow	amount to borrow	maturities	rates charged
Funding Circle, UK	£ 5,000	£ 1,000,000	6 - 60 months	up to 16%
Fundingknight, UK	£ 25,000	£ 150,000	1 - 5 years	8.8 - 12%
Zopa, UK	£ 1,000	£ 25,000	2 – 5 years	5.5%
Ratesetter, UK	£ 1,000	£ 25,000	6 - 60 months	8.9 – 28%
Isepankur, Estonia	€ 500	€ 10,000	3 – 60 months	26 - 38%
Kokos, Poland	zl 50	zl 25,000	2 – 36 months	up to 16%
Lainaaja, Finland	€ 200	€ 5,000	4 - 48 months	6 - 25%
Smartika, Italy	€ 1,000	€ 15,000	12 - 48 months	6.5 – 10.8%
Arboribus, Spain	€ 10,000	€ 150,000	up to 60 months	7.8%
Comunitae, Spain	€ 600	€ 6,000	6 – 24 months	6 – 12%
Smava, Germany	€ 1,000	€ 75,000	12 –120 months	2.75 – 5.95%
Auxmoney, Germany	€ 1,000	€ 25,000	12 - 60 months	2.9 - 15.25%
Bankless24, Germany	€ 1,000	€ 150,000	up to 60 months	up to 20%
Bettervest, Germany	€ 1,000	€ 200,000	up to 84 months	up to 15%
Babyloan, France	€ 200	€ 7,000	4 – 36 months	up to 27%
Prêt d’Union, France	€ 3,000	€ 40,000	24 - 60 months	7.7%
Cofunder, Ireland	£5,000	£100,000	3-5 years	Non available

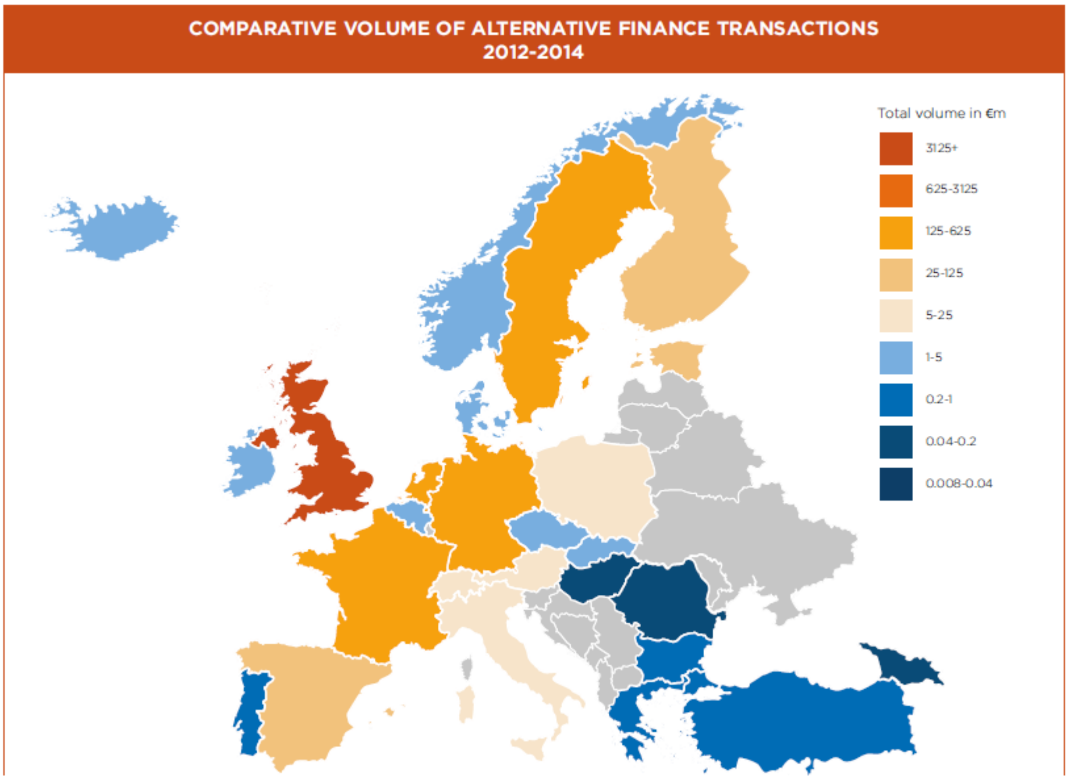
Source: data has been collected by the author from several lending platforms’ websites

The selection of peer-to-peer platforms presented in table 1 show the presence of heterogeneity across all the variables considered. In terms of the maximum amount to be borrowed, UK provides the broadest range, with up to £1,000,000. It should be mentioned that UK holds the most developed, rapid pace expanding crowdfunding market, the four platforms in the table ranging among the top 10 European lending platforms as regards the amount of funds lended. Maturities also vary greatly across online platforms, from minimum 2 months in Poland up to maximum 120 months in Germany. The most striking discrepancies are related to the range of interest rates charged among lending platforms and countries. Some of them charge high effective interest rates, a fact that raised some controversies in the media related to the social nature of this type of funding (Boitan, Barbu 2015). The explanation for which interest rates practiced for loans granted are so high is provided by Babyloan (2014), a peer-to-peer platform: a) lending to unbanked customers, who have been excluded by mainstream banking due to lack of collateral or low repayment capacity has to be compensated by a higher interest rate; b) to ensure the going concern of the business, to cover the operating costs of the platform, to prevent risks and provide a suitable financial compensation for lenders.

2. Crowdfunding market's dynamics across Europe

Wardrop et al. (2015) performed a wide-scale survey, by collecting data directly from 255 leading crowdfunding platforms in Europe, which represent around 85-90% of the European online alternative finance market. The results show that European alternative finance market, as a whole, increased by 144% in 2014. In respect of total volumes of financing raised through online platforms, UK is the leader followed by France, Germany, Sweden, Netherlands and Spain.

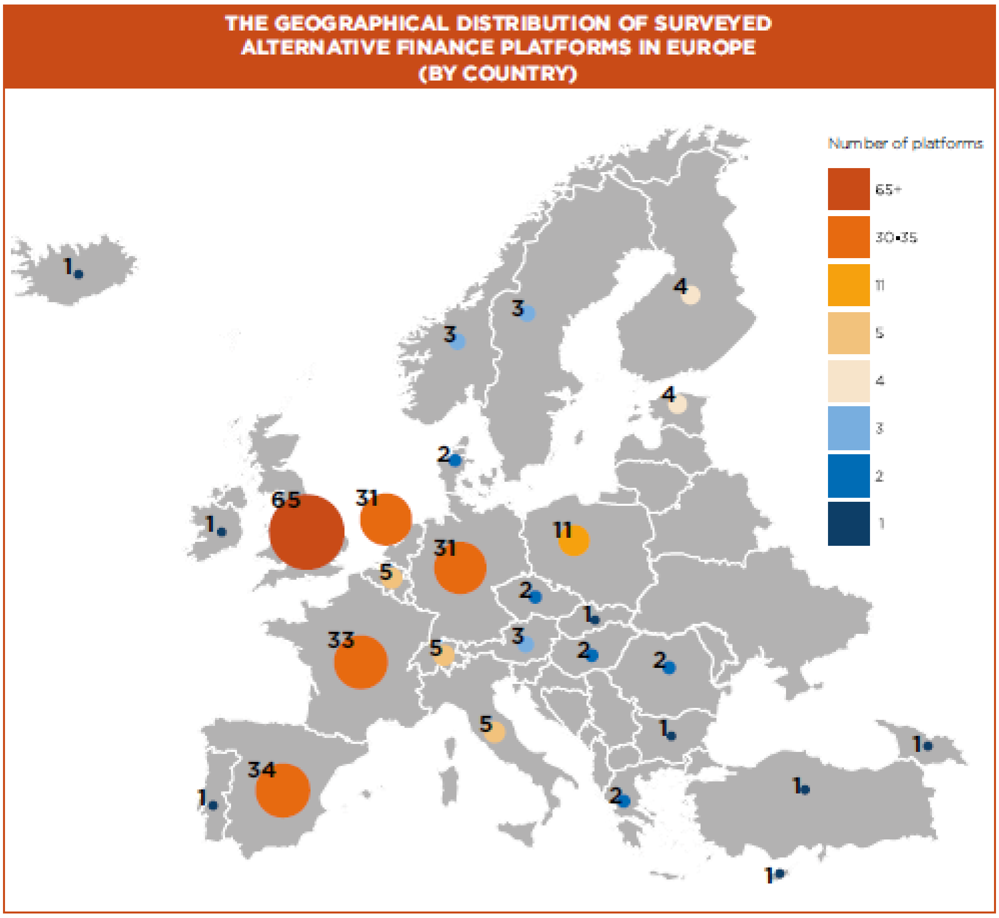
Figure 2. Volume of transactions operated through crowdfunding platforms



Source: Wardrop R., B. Zhang, R. Rau and M. Gray (2015), pag. 15

Taking a disaggregated look at the different typologies of crowdplatforms, the study revealed that "the average growth rates are high across Europe: peer-to-peer business lending grew by 272% between 2012 and 2014, reward-based crowdfunding grew by 127%, equitybased crowdfunding grew by 116% and peer-to-peer consumer lending grew by 113% in the same period" (Wardrop et al. 2015, p.9).

Figure 3. Territorial spread of European crowdfunding platforms



Source: Wardrop R., B. Zhang, R. Rau and M. Gray (2015), pag. 14

By correlating the findings in figure 2 and 3, it could be noticed that UK holds the largest number of crowdfunding platforms (65) and by far the largest aggregated amount of funds lended (over 3,000 million euros). France, Germany and Netherlands occupy the second place in this hierarchy, with around 31-33 platforms and a financing between 125 – 625 million euro. Spain holds 34 platforms but the cumulated amount of financing is lower, ranging between 25-125 million euros. At the opposite is Sweden, with only 3 platforms but a larger amount of financing mediated by them (125 – 625 million euros). Bulgaria, Slovakia, Portugal and Ireland hold only one crowdfunding platform but perform slightly better in terms of financing successfully provided than several countries with 2 platforms (it is the case of Romania and Hungary, with the smallest amount between 0, 04 and 0, 2 million euros).

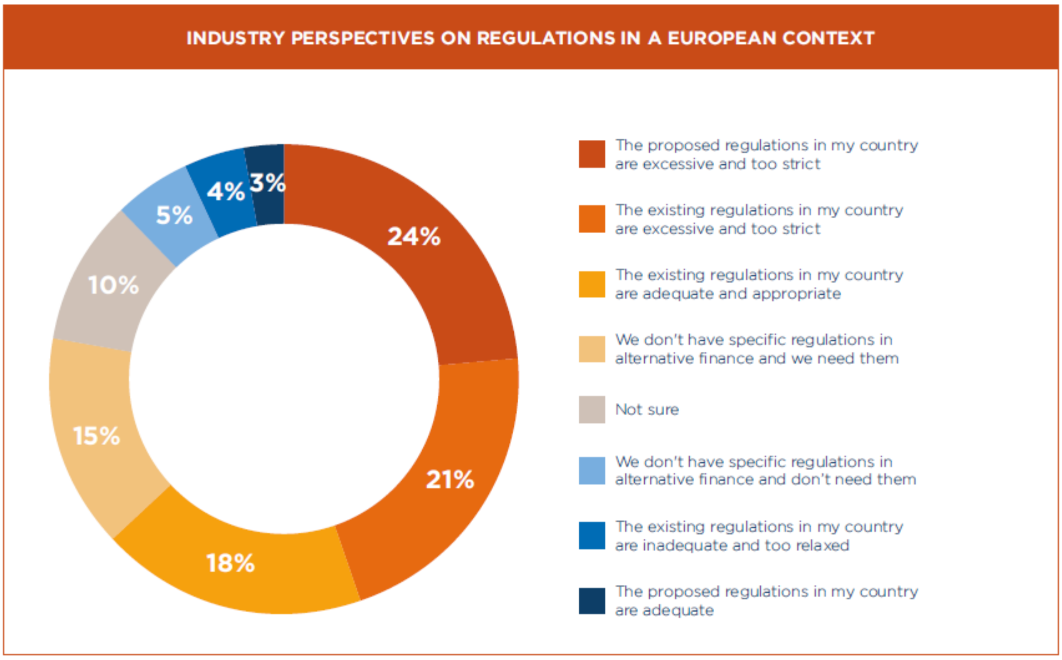
3. Regulatory challenges at European Union level

Currently, regulation of crowdfunding is characterized by heterogeneity, lack of coordinated actions at European level, fragmentation among individual jurisdictions. Although European Commission signals its intention to contribute to the harmonization, consolidation and unification of national regulations, progress is achieved in small steps and outlook suggest we are still far from a single European regulatory framework for crowdfunding.

The regulatory landscape of the European crowdfunding market is characterized by practitioners and regulators as being: i) fluid and multifaceted (Wardrop et al. 2015); ii) highly fragmented (European Crowdfunding Network 2014); iii) officially unsupportive regulatory environment (Gajda and Mason, 2013); iv) light regulation would be beneficial (Diacci and Pantani, 2014).

The figure below summarizes the perception of crowdfunding platforms on the specific regulation existing in the country of residence. It could be noticed that most respondents believe that national regulations are excessive and strict.

Figure 3. Results of the survey related to EU countries' crowdfunding regulation



Source: Wardrop R., B. Zhang, R. Rau and M. Gray (2015), pag. 24

At end-2013 the European Commission launched a consultation on issues related to assessing awareness and the existence of crowdfunding code of conduct, targeted to project owners, associations, online platforms, financial institutions, regulatory and supervisory bodies, academia and civil society. The results have indicated that awareness raising is important for all types of crowdfunding platforms, but especially for equity and lending models (49%). In terms of the code of conduct, it is not uniform across European platforms.

As mentioned in a previous paper (Boitan, Barbu 2015), traditional banks are facing a new, rapid pace evolving competitor, which operates with low administrative costs, provides simple products and has a different approach to the process of risk management. Therefore, debates are open regarding the impact and effects crowdfunding segment will exert on the whole financial industry.

In this regard, BBVA Research, in its Economic Outlook for 2013, points out the impredictibility of crowdfunding prospects for further development. The financial services consumers will continue to go to the bank to satisfy their demand of basic or more complex transactions that crowdfunding platforms do not offer. On the other hand, it is expected that crowdfunding platforms evolve toward becoming the main financial services provider for the young generation.

4. Financial inclusion: concept, indicators and pattern across EU countries

The second part of the paper addresses the issue of financial inclusion, in order to explore whether the high volume of transactions via crowdfunding platforms is partly determined by the presence of a high level of financial exclusion from traditional banking system.

Financial exclusion is a “process whereby people encounter difficulties in accessing and / or using financial services and products in the mainstream market that are appropriate to their needs and enable them to lead a normal social life in their society” (European Commission, 2008).

Financial exclusion, through its two forms, namely the difficulty of accessing financial products and services (current accounts, savings accounts, credits, insurance) and the difficulty of using them is due primarily to the failure of financial institutions to adapt to the needs of different social groups, caused by banks' selectivity, lack of explicit information and transparency practiced by traditional banks.

Financial inclusion can be proxy by several indicators developed by the Global Partnership for Financial Inclusion, with the support of the World Bank. However, this database is unbalanced and lacks the timely reporting of indicators, the most recent data being available only for 2011 year. The most representative indicators related to access and usage of financial products chosen for the purposes of this analysis have been summarized in table 2 below.

Table 2. Financial inclusion indicators

Indicator	Explanation
Account at a formal financial institution (% age 15+)	percentage of respondents aged over 15, with an account at a bank, credit union, another financial institution (e.g., cooperative, microfinance institution), including respondents who reported having a debit card.
Loan from a financial institution in the past year (% age 15+)	percentage of respondents aged over 15 who report borrowing any money from a bank, credit union, microfinance institution, or another financial institution such as a cooperative in the past 12 months.
Getting credit: Distance to frontier	the distance of each economy to the "frontier," which represents the highest performance observed on the getting credit indicator across all economies included in Doing Business. An economy's distance to frontier is indicated on a scale from 0 to 100, where 0 represents the lowest performance and 100 the best-practices frontier.
Saved at a financial institution in the past year (% age 15+)	percentage of respondents aged over 15 who report saving or setting aside any money by using an account at a formal financial institution such as a bank, credit union, microfinance institution, or cooperative in the past 12 months.

Source: World Bank database, G20 Financial Inclusion Indicators

The raw values recorded by each financial inclusion indicator as well as the main descriptive statistics have been depicted in table 3. The cells filled with red color depict a value below average recorded by a given country for a given indicator. The smaller the value of a financial inclusion indicator, the lower is the degree of financial inclusion recorded by population in a country.

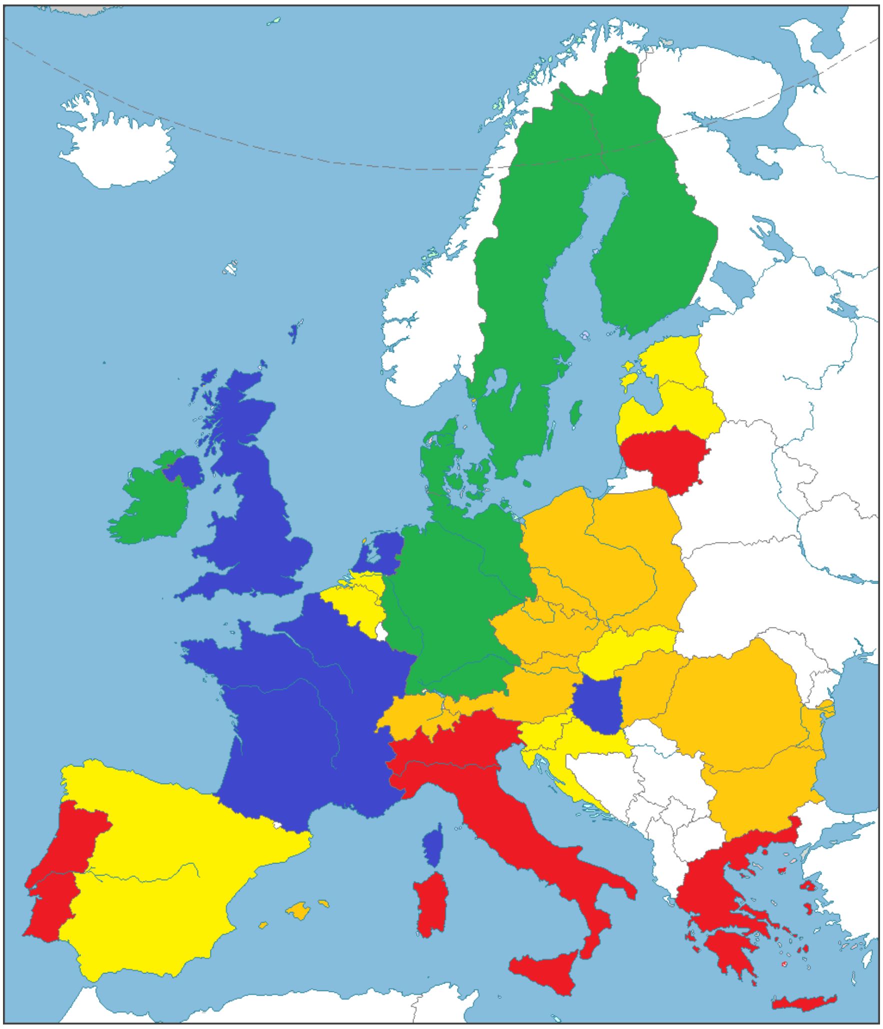
Table 3. Financial inclusion indicators (data available for 2011 year-end)

	Account at a formal financial institution (% age 15+)	Loan from a financial institution in the past year (% age 15+)	Getting credit: Distance to frontier	Saved at a financial institution in the past year (% age 15+)
Austria	97.08	8.25	81.30	51.59
Belgium	96.31	10.51	62.50	42.58
Bulgaria	52.82	7.81	87.50	4.80
Croatia	88.39	14.44	68.80	12.23
Cyprus	85.24	26.97	68.80	30.44
Czech Republic	80.65	9.47	68.80	35.48
Denmark	99.74	18.80	81.30	56.51
Estonia	96.82	7.68	75	28.87
Finland	99.65	23.88	75	56.14
France	96.98	18.65	68.80	49.52

Germany	98.13	12.55	81.30	55.90
Greece	77.94	7.93	56.30	19.87
Hungary	72.67	9.40	75	17.25
Ireland	93.89	15.72	87.50	51.26
Italy	71.01	4.59	50	15.48
Latvia	89.66	6.81	93.80	13.32
Lithuania	73.76	5.65	68.80	20.49
Luxembourg	94.59	17.44	31.30	52.01
Netherlands	98.66	12.56	68.80	57.81
Poland	70.19	9.61	93.80	17.99
Portugal	81.23	8.26	50	25.56
Romania	44.59	8.37	87.50	8.69
Slovakia	79.58	11.43	81.30	36.84
Slovenia	97.14	12.83	50	28.85
Spain	93.28	11.43	68.8	35.05
Sweden	98.99	23.40	75	63.58
United Kingdom	97.20	11.85	100	43.80
average	86.16	12.45	72.48	34.52
maximum	99.74	26.97	100.00	63.58
minimum	44.59	4.59	31.30	4.80
standard deviation	14.61	5.78	15.63	17.61

Source: author, based on data collected from World Bank database, http://datatopics.worldbank.org/g20fidata/

Figure 4. Visual representation of financial indicators' spread



Source: the author, based on data in table 3

Legend:

Color	Explanation
	4 indicators below average
	3 indicators below average
	2 indicators below average
	1 indicator below average
	4 indicators above average

The countries recording a good status of financial inclusion, with above the average values for all the four indicators are Denmark, Finland, Germany, Ireland and Sweden. At the opposite are Greece, Italy, Lithuania and Portugal with all the indicators below the average, signaling a poor status of financial inclusion. Low levels of financial inclusion indicators suggest that people don't have sound access to basic financial products. These countries are susceptible to witness a more rapid pace increase of crowdfunding presence and volume of projects financed.

However, by correlating this finding with crowdfunding platforms' data on territorial spread and amount of transactions, the conclusion is rather disappointing. Lithuania has no platform, Greece and Portugal hold one platform with transactions ranging between 0, 2 – 1 million euro while Italy is performing better, with 5 platforms and amount of transactions between 5 – 25 million euros. This pattern maintains also in the case of countries showing 3 out of 4 indicators below average (Bulgaria, Cyprus, Czech Republic, Hungary, Romania and Poland). These countries perform even worst in terms of volume of transactions operated through crowdfunding platforms, recording values ranging between 0, 04 and 1 million euro. Poland is an exception, with transactions amounting to over 5 million euros.

This might be the result of multiple factors, such as low financial literacy, lack of knowledge regarding alternative financial models, lack of trust in raising or lending money through online means and no direct, face-to-face connection.

The five countries exhibiting good levels of financial inclusion indicators also perform well in terms of amount of financing intermediated by crowdfunding platforms. Germany and Sweden have the largest market, ranging between 125 – 625 million euros, followed by Finland with 25 – 125 million euros. This finding might be explained by investors' choice to diversify their investment portfolio, without necessarily hunting a high yield or return of their investment. It is a clue that investors are well informed, holding financial literacy and a degree of sophistication and social awareness in making their investment decisions.

Conclusions

In times of financial turmoil, when monetary policy becomes restrictive and the credit crunches as banks are reluctant in providing new loans, the real sector suffers most. SMEs need funding for maintaining the going concern of their business, while investment expenses are postponed. Individuals who wish to launch a start-up in order to become self-employed and escape the unemployment trap are witnessing difficulties in obtaining financing from banking system.

On this background, crowdfunding platforms developed and expanded rapidly across Europe, by acting as a meeting point between the increasing demand of money and the money supply. A peculiarity of this alternative finance business model is that financing is chanelled voluntarily by individual investors to those projects they deem to be the most successful ones in terms of economic and social/environmental impact.

The main finding of the paper is that crowdfunding is not acting as a substitute for basic banking products, as countries most exposed to financial exclusion threat do hold neither many platforms nor large amounts of financing mediated through these platforms. People are reluctant in borrowing or lending by using this new financial business model or lacks reliable, trustful information on its functioning. On the contrary, countries depicting many platforms and larger amounts of transactions also show a good status of financial inclusion. This might be explained by customers/investors with a higher degree of financial sophistication and knowledge, wishing to diversify the ways of investing or borrowing money by means of both conventional and alternative finance.

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