Survey of Financial Return Crowd-Funding for Korean SME Policy Implication

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1. Introduction

• Crowd-funding is a term describing the use of small amounts of money, obtained from a large number of individuals or organizations, to fund a project, a business or personal loan, and other needs through an online web-based platform.
• Crowd-funding has four categories: Donation crowd-funding, reward crowd-funding, peer-to-peer lending and equity crowd-funding. This paper focuses peer-to-peer lending and equity crowd-funding, being forms of market-based finance that are collectively referred to as "financial return crowd-funding" or "FR crowd-funding".
• FR crowd-funding can help economic recovery by financing small and medium enterprises (SMEs) which are a key engine of economic growth. Helping those entities more efficiently access capital for their development and expansion can contribute to job creation and economic recovery.

2. Development of FR crowd-funding

• FR crowd-funding globally has grown rapidly in the last 5 years, with data suggesting that the peer-to-peer lending market doubles each year. It accounts for approximately $6.4 billion outstanding globally.
<<Borrowing situation by the type of borrower: to be added>>

• FR crowd-funding has three main business models: the client segregated account model, the notary model and the equity crowd-funding model. The major difference between the two peer-to-peer lending models, the client segregated account model and the notary model, is that in the latter a bank originates the loan unlike the former where the platform originates the loan. The third model, equity crowd-funding, is different from peer-to-peer lending as it allocates stock equity to investors, with the financial return coming in the form of dividends and/or capital growth.
• Korean industry of crowd-funding is in very infant stage. Crowd funding firms are: Good Funding, Money Auction, Siat Funding, OMy Company, OfferTune, Open Trade, Wadeez, WeGeneration, UCan Funding, TumbleBuck, PopFunding, FundingTree, etc. Recently P2P lending firm "8 Percent" closes the platform due to the prohibition of Financial Services Commission. "Crowd-Funding Act" will be enacted during 2005. <<to be added>>
• Lending Club Case <<to be added>>

• On Deck Case <<to be added>>
• 8 Percent Case <<to be added>>

3. FR crowd-funding in the viewpoint of banking theory

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4. FR crowd-funding in the viewpoint of E-Commerce theory

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5. Benefits of FR crowd-funding

• FR crowd-funding spreads risk – the majority of investors are individuals with funding requests filled in much smaller amounts. Conventional financial institutions cannot diversify risk fully, so they have a limitation to provide money for very risky projects.
• Another benefit is the lower cost of capital and higher returns to investors – The platform of FR crowd-funding is very efficient substitute for the organization of conventional financial institution. Conventional financial industry is oligopolistic. This is another source of lower deposit-lending margin.
• Big data analysis and proximity of borrower and lender can make more precise crediting rating.

6. Risks of FR crowd-funding

• Risk of default: In equity crowd-funding the risk of default/investment failure is estimated to be around 50%. In peer-to-peer lending there has been a concerted effort by the industry to reduce default rates, which reached a high of 30% in 2009.
• Risk of platform closure/failure: Despite the short life of crowd-funding, there has already been a case of a peer-to-peer lending platform closing leaving no data on contracts behind and resulting in 100% investment loss.
• Risk of fraud: This is compounded in both peer-to-peer lending and equity crowd-funding by the anonymity created by the online aspect of these industries. This is the case for both the lender/investor and borrower/issuer parties, whereby the opportunity to defraud is an ever present reality.
• Risk of illiquidity: Investors cannot sell their participations as there doesn´t exist a secondary market.
• Risk of cyber-attack: The online nature of FR crowd-funding makes FR-crowd funding vulnerable to the risk of cyber-attacks.

• Lack of transparency and disclosure of risks: Risks tend not to be disclosed until a lender/investor becomes a member of the platform.

7. Regulatory regimes for FR crowd-funding

• The regulatory regimes are dependent on jurisdictional choices in regulation.

• Peer-to-peer lending is regulated in five different ways. These are:

- 1. Exempt/ unregulated through lack of definition
- 2. Platforms regulated as an intermediary
- 3. Platforms regulated as a bank
- 4. The US model: there are two levels of regulation, Federal regulation through the Securities and Exchange Commission (SEC) and state level, where platforms have to apply on a state-by-state basis.
- 5. Prohibited

• Equity crowd-funding is regulated under three main regimes. These are:

- 1. Regulation that prohibits equity crowd-funding completely.
- 2. Equity crowd-funding is legal but the regulation of the industry creates high barriers to entry
- 3. Regulation may allow the industry to exist, but with strict limits

<<• Korea: to be added>>

8. Systemic risks and investor protection concerns

• The industries do not pose systemic risk yet. The following impact factors are relevant in this analysis.

• Size: The peer-to-peer lending market is very small, accounting for only a fraction of all credit provided to the real economy. However, it is an industry that is almost doubling each year in size. This means that even though the current market size is too small to cause systemic risk, it has the potential to grow to a sizeable market in a short amount of time.

• Liquidity: There is a lack of liquidity in peer-to-peer lending, with relatively few platforms providing a secondary market on which to sell loan portfolios. Equity crowd-funding has even less liquidity as there is no secondary market for shares in start-ups due to the inability to accurately judge the value of the equity shares. This is a problem for investors who want to liquidate positions.

• Cross-border activities and implications: A few platforms have chosen to open their business to other nationals, introducing cross border complexities. Questions are yet to be answered in regards to contract law enforcement across jurisdictions. Further in-depth work is required to understand the legal implications of cross-border operations. Therefore, cross border complexities could become a source of systemic risk in the future.

• Interconnectedness through securitization practices and bank involvement: There have been recent examples of the securitization of peer-to-peer unsecured loans. This opens the market to new investment, but also opens the rest of the financial market to exposure to packaged loans which are predominately unsecured in nature. Since this segment of the market is extremely small, it is not currently a source of systemic risk.

9. Korean SME policy implication

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