Session II: Shadow Banking and the Crowdfunding Market

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Discussion of Some the Various Forms of “Shadow Banking”

Jacob Ghanty, Partner, K&L Gates London
Overview

- Discussion of some the various forms of “shadow banking”

- An overview of the crowdfunding market

- Regulatory challenges of crowdfunding
Size of the Shadow Banking Sector

Assets of non-bank financial intermediaries across 20 jurisdictions and the Euro area

Lhs: As a percentage of GDP
Rhs: In trillions of US dollars
What is a Shadow Bank?

“If it looks like a duck, quacks like a duck, and acts like a duck, then it is a duck – or so the saying goes. But what about an institution that looks like a bank and acts like a bank? Often it is not a bank – it is a shadow bank”.

Laura E. Kodres of the IMF

- Lending activities which occur outside the banking system
- It’s not new!
Drivers of Shadow Banking

- Regulatory arbitrage
- Favourable economic environment
- Technology
Types of Institution Engaged in Shadow Banking Activity

- Alternative asset managers, notably private equity firms
- Lending platforms, including P2P
- Non-bank mortgage lenders
Mortgages

- What is mortgage banking?
  - Originating a mortgage and selling it to third parties (often as mortgage-backed securities) OR holding the mortgage for investment
- Pre-financial crisis, mortgage origination heavily concentrated in a handful of bank lenders
- Since financial crisis, market has become fragmented – it’s estimated that in the US more than 40% of mortgage origination is via non-banks, e.g. Quicken Loans
- What is causing this shift?
  - Increased capital requirements on banks for mortgages
  - Cost efficiencies
  - New lenders don’t have legacy issues of the banks – it is estimated that the five largest banks in the US have incurred c.$105bn of mortgage-related litigation expense since 2011
An Overview of the Crowdfunding Marketplace

Tom Wallace, Partner, K&L Gates London
Global crowdfunding market

Global Crowdfunding Market (Raised Funds/No. of Portals)

Source: TABB Group, Massolution
UK crowdfunding market by finance type

<table>
<thead>
<tr>
<th>The crowdfunding market by platform 2014</th>
<th>Average growth rate 2012-2014</th>
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<tbody>
<tr>
<td>P2P business lending £749m</td>
<td>250%</td>
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<tr>
<td>P2P consumer lending £547m</td>
<td>108%</td>
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<tr>
<td>Invoice trading £270m</td>
<td>174%</td>
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<tr>
<td>Equity crowdfunding £84m</td>
<td>410%</td>
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<tr>
<td>Community shares 34m</td>
<td>95%</td>
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<tr>
<td>Rewards crowdfunding £26m</td>
<td>206%</td>
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<td>Pension-led funding £25m</td>
<td>5%</td>
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<tr>
<td>Debt-based securities £4.4m</td>
<td>117%</td>
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<tr>
<td>Donation crowdfunding £2.0m</td>
<td>77%</td>
</tr>
</tbody>
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Source: Understanding Alternative Finance, published by Nesta and University of Cambridge, November 2014
UK equity crowdfunding market by platform

Source: Crowdcube blog, November 2013
UK/EU P2P sector composition

Source: AltFi Data, April 2015
UK/EU P2P platform dispersion

Source: AlfFi Data, April 2015
‘Sizing the $4tn addressable opportunity’

Exhibit 2: Sizing the $4 trillion addressable opportunity

$ in billions

- **Crowdfunding**
  - $1,170 investment size
  - $1,170

- **Wealth Management**
  - $12,000 assets under management
  - $400

- **Payments**
  - $30 money transfer fees
  - $30

- **Lending**
  - $1,000
  - $258 unscored personal lending
  - $1,413
  - $166 small business loans
  - $1,224
  - $211 student loans
  - $1,052
  - Mortgage's ‘annual loan origination’

Disrupting the disrupters

‘The lenders of the revolution look familiar. [Investment banks], hedge funds and investment trusts muscle into online consumer lending.’

The lenders of the revolution look familiar, John Gapper, The FT, June 17, 2015
Regulation of Crowdfunding in the UK

Oliver Lewis, Associate, K&L Gates London
Regulatory Timeline…

March 2014: FCA publishes policy statement on crowdfunding

April 2014: consumer credit and P2P lending becomes regulated by the FCA

October 2014: End of transition period to FCA regulation: new rules for P2P lenders now in force

February 2015: FCA publishes review of regulatory regime for crowdfunding

2016: FCA to conduct post-implementation review of current regime
What is the FCA protecting against?

- Insufficient consumer understanding
- Platform failure
- Risk of cyber-attack
- Fraud
- Credit and/or investment risk is mispriced
Loan-based crowdfunding

“operating an electronic system in relation to lending”

Additional protections for individuals

Minimum prudential requirements
Investment-based crowdfunding

Regulated activity?

- Arranging or bringing about deals in investments
- Making arrangements with a view to transactions in investments
- Establishing, operating or winding up a collective investment scheme
Investment-based crowdfunding

Offers to the public

- Certified or self-certified sophisticated investors;
- Self-certified high-net-worth investors;
- Those who confirm that, in relation to the investment promoted, they will receive regulated investment advice or investment management services from an authorised person;
- Retail clients that are corporate finance contacts or venture capital contacts;
- A restricted investor – i.e. those who certify that they have not invested over a 12-month period more than 10% of their net investment portfolio in unlisted shares or unlisted debt securities (excluding their primary residence, pensions and life cover)
Investment-based crowdfunding

“Appropriateness Test”

- Where advice is not provided, the FCA expects firms to apply an “appropriateness test” to clients before issuing to them promotions for unlisted equity or debt securities. This may involve firms needing to design automated systems to assess client knowledge and experience and to check clients’ understanding of risks.

- Firms will need to ensure compliance with the FCA’s rules on appropriateness
And finally…

“Imagine a world in which there are millions of unsophisticated investors who don’t have the time or experience to evaluate businesses. Would you expect their returns to be higher or lower than the Venture Capitalists who have spent decades doing this?”

Dr Michael J Roberts, Harvard Business School