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The Evolution of the Online Marketplace, and its Viability as an Institutional Asset Class

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Executive summary

Peer-to-peer lending has evolved rapidly in recent decades, in both form and function. The latest iteration, online crowdfunding platforms, is a novel method for funding a variety of ventures. It allows individual founders of for-profit, cultural, or social projects to request funding from many individuals. Capital is distributed with varying conditions. Some capital is philanthropic, and assigned towards specific causes. Other capital is only drawn under certain conditions, such as the development and delivery of a product. Funding can be provided in these online financial marketplaces in exchange for an equity stake in the venture or as a line of credit to be paid back with interest, reflecting traditional forms of equity and debt financing. As the online marketplace has evolved, so too have the actors operating within it. Initially a space for retail and recreational investors to provide capital, recently we have seen professional and institutional investors begin to enter the space.

This paper will first review the circumstances that have contributed to the rise of the online marketplace as the primary platform for peer-to-peer lending, and how it has expanded to encompass other areas of financing as well. It defines the diverse set of funding products that are currently offered, and provides a present-day view of the allocation of funding and volume of campaigns financed across those funding types. We will narrow our focus to debt and equity financing within the online marketplace, and review the regulatory environment of the online marketplace from a United Kingdom perspective.

The research conducted aims to answer the following question, at the request of Thomson Reuters and TAB: *Under what conditions would the online marketplace be an asset class for institutional investors to fully engage with?* We begin by reviewing the set of supply-side characteristics (low interest rate environment, strong risk models, credit assessment technologies) and demand-side factors (regulatory pressures, heavy cost structures, industry consolidation) that has made debt financing so attractive to institutional investor capital, and enabled it to grow so quickly relative to other forms of financing.

This paper then uncovers aspects of online marketplace that are areas of concern, and proposes several product-level and market-level solutions that would create a friendlier environment for institutional investors to engage with. At the product-level, it suggests the creation of certain financial instruments that will provide exposure across a number of individual campaigns, addressing concerns of ticket size and mitigating risk via asset diversification. Market-level proposals establish an institutional structure that provides reliable and objective data, information, and feedback to investors. These proposals aim to resolve concerns around information asymmetry, investment quality, and data transparency. Additionally, the paper offers suggestions for policy-makers to consider as they think about how to regulate this growing industry.

Finally, the paper concludes with a present-day analysis of the engagement of institutional investors with the online marketplace, and reviews the trends and structural factors that will influence its growth going forward.

Intro: The advent and evolution of peer-to-peer lending

Peer-to-peer lending has a deep history with roots in literature, war, and media. For centuries, the writing and publication of books have been supported by a form of crowdfunding, as authors and publishers advertised projects in subscription schemes. While the actual flow of money only began with the arrival of the product, the function remained the same – a threshold of subscribers (our investors in this case), created the necessary confidence and financing environment to risk the publication.[1]

America's flagship landmark, the Statue of Liberty is a prime example of crowdfunding. If not for the ability to raise money from a large number of New Yorkers, the statue could well be sitting in Philadelphia, Baltimore, Boston, or San Francisco. In 1885, the Statue of Liberty was in New York – but in several pieces, waiting to be assembled. Although the statue itself was a diplomatic gift to the United States from the government of France, it required $250,000 for a granite plinth – around $6.3M (£4.1m) at today's prices. New York government sources were unable to raise the necessary funds, and did not receive any assistance from Congress. At this point, Baltimore, Boston, San Francisco, and Philadelphia had offered to pay for the pedestal, as long as the statue were relocated to their respective city. Right when it seemed New York was out of options, Joseph Pulitzer decided to launch a fundraising campaign in his newspaper *The New York World.* The campaign eventually raised money from over 160,000 donors, including young children, businessmen, street cleaners and politicians, with more than three-quarters of the donations amounting to less than a dollar.[2] And just like that, the Statue of Liberty stayed in New York.

[1] "The Statue of Liberty and America's crowdfunding pioneer". BBC Online. April 24, 2013. Retrieved February 7, 2018.
[2] Ibid.

If launched today, Pulitzer's campaign would closely resemble the typical crowdfunding project you find on Crowdcube, Lending Club, or Kickstarter. Using a central collection point, the campaign raised money from a very large pool of donors each pledging what amounted to spare change. The function of using the power of the crowd to raise funds is still in use today. The difference now is that the collection point – the newspaper, in Pulitzer's case – has evolved and grown to a number of various online platforms – over one thousand at last count, according to estimates from Statista, an online statistics, market research, and business intelligence portal. Crowdfunding on the internet initially entered popular and mainstream use in the arts and music communities. For example, in 1997, fans underwrote an entire U.S. tour for the British rock band Marillion through a fan-based internet campaign.[3]

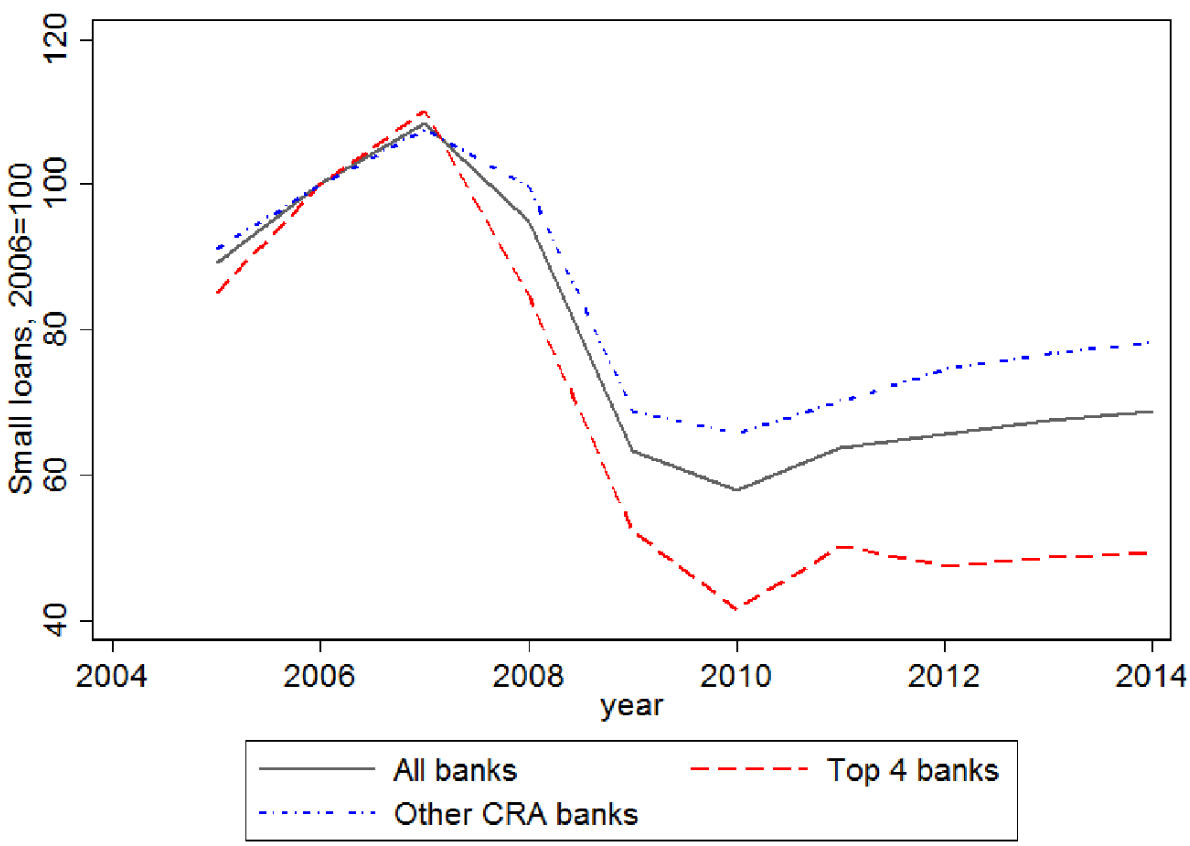
The modern online marketplace

In the aftermath of the 2008/2009 financial crisis, financial regulation was overhauled and oversight on banks increased. Financial institutions were pressured to reduce the size of their balance sheets and required to hold more defined tranches of capital. The Global Systemically Important Banks (G-SIBs) designation was created; banks included on this list published annually by the Financial Stability Board were required to maintain a higher capital level and hold less risky assets. This capital surcharge undermined their ability to underwrite small business loans, which are inherently riskier than consumer and large business lending.

[3] Agrawal, Ajay, Christian Catalini, and Avi Goldfarb. "Some Simple Economics of Crowdfunding." National Bureau of Economic Research (2014).

In addition, increased regulatory reporting requirements began squeezing the margins of regional banks, and kick started a trend of banking industry consolidation. The regional banks that traditionally served local lending needs were rolled up into larger institutions that had established, robust data aggregation and reporting arms. These factors drove a significant reduction of lending in the small and medium sized enterprise (SME) sector after the crisis. Years later, it had still not recovered. Figure 1 shows the steep drop in small business lending across all banks – but particularly the largest – with minimal recovery years after the financial crisis.

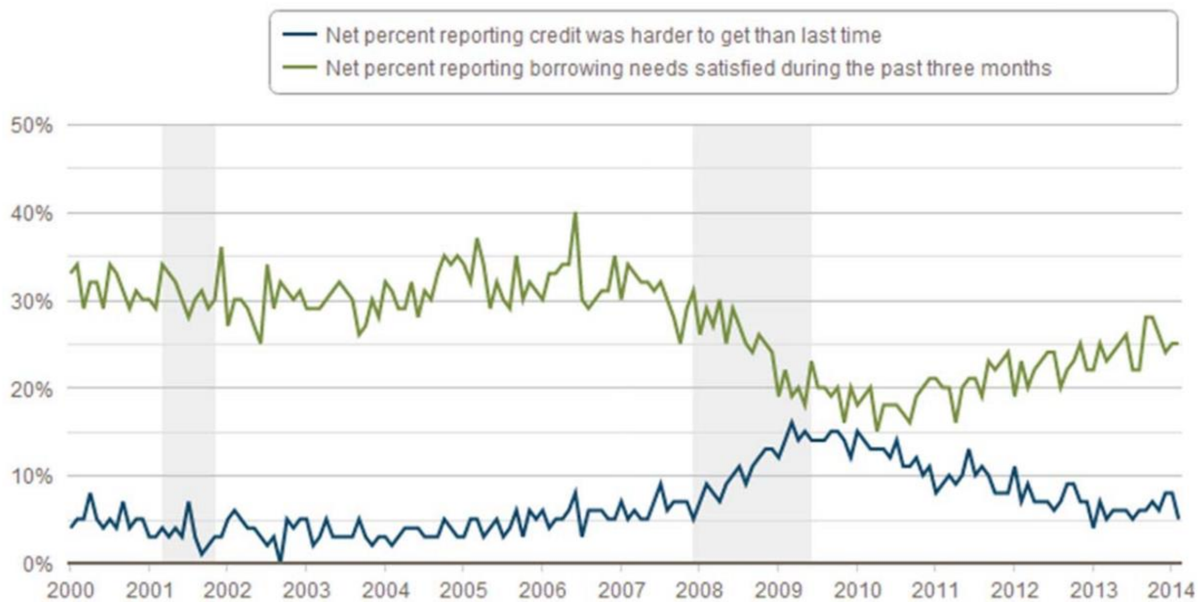
Figure 1: Annual Originations of Small Business Loans



Source: Chen, Hanson, Stein. Harvard University. November 2016.

These effects were felt in communities at the grassroots level, and are illustrated in figure 2 below. The blue line shows the steep rise in 2008 of the percentage of small business owners that felt that credit was more difficult to obtain after the crisis. The green line displays the immediate drop after the crisis in the percentage of small business owners who felt their borrowing needs were satisfied.

Figure 2: Small Business Owners' Perception of Credit Access



Source: National Federation of Independent Businesses. May 2014.

To address the credit gap, SMEs turned to the online marketplace. During the recovery, a number of new online lenders and marketplaces emerged, opening up new pools of capital for small businesses through greater innovation in how small business loans are evaluated, decisioned, and managed. The evolving online marketplace offered easy to use online applications, rapid loan decisioning, and data-driven algorithms to more accurately screen creditworthy borrowers. It is also argued that the wisdom of a crowd not only democratizes investment, but also leads to better overall lending decisions and efficient allocation of capital within the economy.

Marketplace lending began as a “peer-to-peer” model, matching consumers or small businesses looking to borrow with investors searching for yield in a near-zero interest rate environment. Like many marketplaces, the model sought to disintermediate an incumbent (in this case banks). With marketplace lenders, risk is assumed by the third-party purchaser in exchange for a larger portion of the return, as the purchaser retains the interest rate spread during the repayment period. The platforms took an origination fee (and often a servicing fee) for matching buyers and sellers, but didn’t actually hold the loans on their balance sheet. This model spawned quite a few businesses, but is difficult to scale without institutional investors on the platform. So, platforms have begun courting institutional lenders – including hedge funds and banks – to the supply side of the marketplace. This model allows the marketplace lender to originate a high volume of loans while avoiding capital constraints and leverage ratios. The universe of marketplace lenders has grown dramatically over the past few years, as niche marketplaces have proliferated in more esoteric categories and internationally.

Defining the online marketplace

Today, the online marketplace has evolved to the point of offering multiple funding products. We define those products below:

<u>Reward-based:</u> Also called non-equity financing, reward-based financing is similar to the aforementioned campaign run by Pulitzer, in which a product will be delivered if a certain funding target is met. This type of funding has been used across a range of purposes, including

motion picture promotion,[4] free software development, inventions development, scientific research, [5] and civic projects.[6]

The funding for these projects are typically distributed in an uneven manner, in which a few projects account for the majority of overall funding. Research has also found that funding increases as a project nears its goal, in what is often called "herding behavior." In addition, research also shows that friends and family account for a large portion of early fundraising, and the seed capital often encourages subsequent funders to invest in the project. In reward-based financing, funders often have varying expectations about project returns.[7]

Charity-based: Charity and donation-based financing is the collective effort of individuals to help charitable causes. In charity financing, funds are raised for pro-social or pro-environmental purposes. Examples of projects funded include teaching technology and innovation to African orphans to become self-sufficient,[8] or building an environmentally sustainable community center for a developing community in Malawi.[9]

Equity-Financing: Equity financing is the online offering of private company securities to a group of people for investment. It is a mechanism that enables broad groups of investors to fund startup companies and small businesses in return for equity. In a typical equity investment, investors give money to a business and receive ownership of a small piece of that business.

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[4] "Crowd funding: An emerging trend in Bollywood". The Times Of India. Retrieved February 7, 2018.
[5] "Crowdfunding as the future of science funding? | The Science Exchange Blog". Blog.scienceexchange.com. May 27, 2012. Retrieved February 7, 2018.
[6] "Crowdfunding and Civic Society in Europe: A Profitable Partnership?". Open Citizenship Journal. Retrieved February 7, 2018.
[7] Agrawal, Ajay, Christian Catalini, and Avi Goldfarb. "Some Simple Economics of Crowdfunding." National Bureau of Economic Research (2014).
[8] "Q&: Rizikitoto's Suraya Shivji, 17, crowd-funds for African orphans". times-standard.com.
[9] Choy, Katherine; Schlagwein, Daniel (2016), "Crowdsourcing for a better world: On the relation between IT affordances and donor motivations in charitable crowdfunding" (PDF), Information Technology & People, 29 (1)

Coverage of equity crowdfunding indicates that its potential is greatest with startup businesses that are seeking smaller investments to achieve establishment, while follow-on funding may come from other sources. Because equity crowdfunding involves investment into a commercial enterprise, it is often subject to securities and financial regulation.[10]

Debt-Financing: Debt-based financing is a process in which financing opportunities are provided to lenders, often in a bundled security. Borrowers who wish to obtain funding apply through a system which determines the borrower's credit risk and interest rate through a series of algorithms. Investors can buy securities in a fund, which then makes loans to individuals or bundles of borrowers. In this transaction, investors make money from interest on the unsecured loans; borrowers obtain capital that they typically will not have access to; and system operators make money by taking a percentage of the loan and a loan servicing fee.

Others: A *software value token* is a kind of crowdfunding for a digital or software-based value token that is offered as a reward to funders (also known as an initial coin offering).

Litigation crowdfunding allows plaintiffs or defendants to reach out to many of their peers in a semiprivate and confidential manner to obtain funding, either seeking donations or providing a reward in return for funding. It also allows investors to purchase a stake in a claim they have funded, which may allow them to get back more than their investment if the case succeeds.[11]

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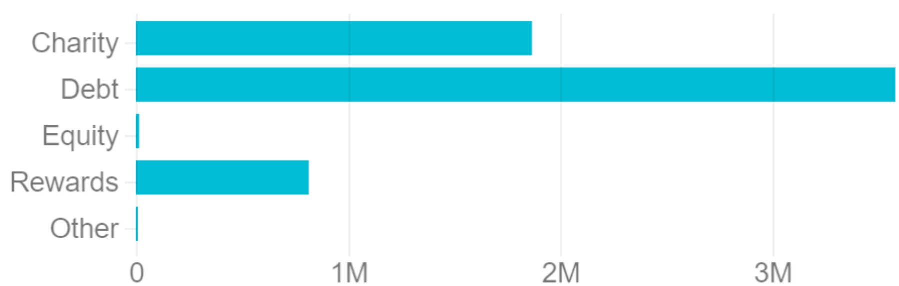
[10] Douglas, Danielle; Overly, Steven (May 20, 2012). "Washington Post: As-regulators-set-rules-for-equity-based-crowdfunding-investors-prepare-for-its-impact". The Washington Post. Retrieved February 22, 2018.

[11] Randazzo, Sara. "Litigation Funding Moves Into Mainstream". Wall Street Journal. ISSN 0099-9660. Retrieved February 6, 2018.

The current online marketplace landscape

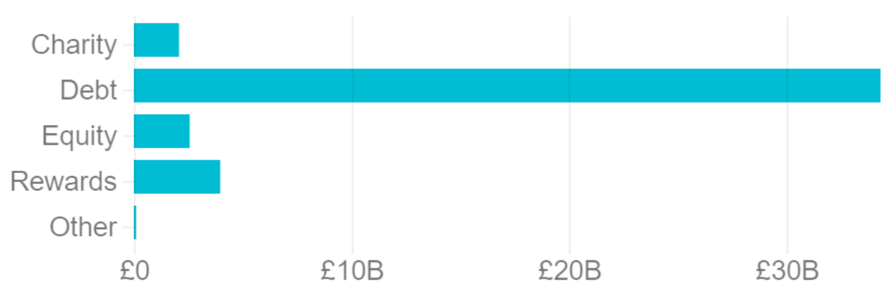
The below charts were drawn from TAB, a big data analytics and machine intelligence technology platform, which interprets billions of financial data points from thousands of crowdfunding and P2P platforms globally providing users the ability to identify fresh opportunities and make better decisions. Its platform offers a recent view (as of March 2018) of the volume and market cap of the online marketplace, in figures 3 and 4.

Figure 3: Number of campaigns funded by funding type



Source: Thomson Reuters Eikon / TAB Portal. March 2018.

Figure 4: Total amount pledged by funding type



Source: Thomson Reuters Eikon / TAB Portal. March 2018.

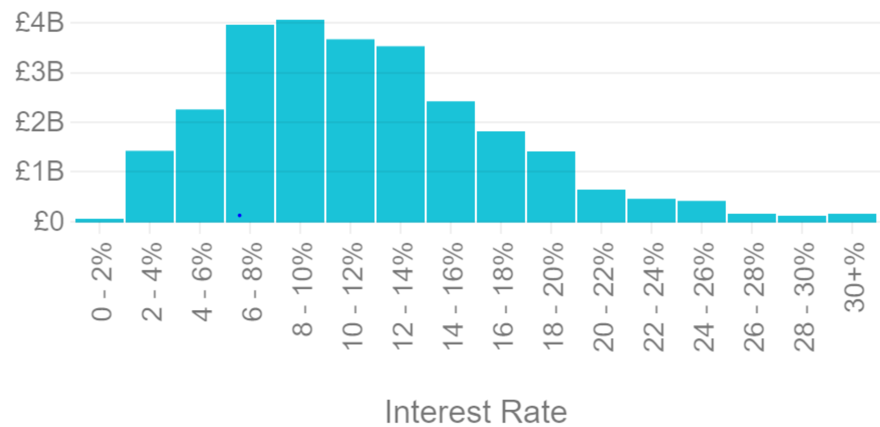
Debt financing through the online marketplace

Today, there already exists institutional investor interest and engagement with debt financing through the online marketplace. Institutional investors, including Goldman Sachs and Pollen Street Capital, have recognized a series of factors that make debt financing in the online marketplace an attractive investment. First, the regulatory backdrop is conducive to the debt markets in the online marketplace. Regulatory capital changes have created inefficiencies in certain asset classes, including SME lending. Second, banks' heavy cost structure (branch infrastructure costs, payroll, etc.) has impaired their competitiveness on small loans. Lastly, banks' focus on commoditized and large-scale markets has resulted in additional specialist lending opportunities. As this part of the economy became increasingly underserved by traditional banks, specialist funds have come in to fill the gap.

Figures 3 and 4 above show debt financing as the market share leader within the online marketplace. It also accounts for 3.57M campaigns, almost twice as much as the next closest, Charity-based projects at 1.85M campaigns.

There are a few reasons why debt financing has been more robust in the online marketplace. First, fixed income by nature is more predictable. The terms of a loan are usually fairly straightforward, with interest/coupon payments and a repayment of the principal serving as set cash flows to the lender. Second, debt financing is also more conducive to standardized terms. While there may be different tranches based on credit profile and interest rate, the debt can more easily be syndicated into a package for lenders to engage with. Lastly, the current lending landscape has made the incentives for lending favorable for both the lender and borrower. As discussed earlier, the lack of capital for SMEs and entrepreneurs since the crisis has led borrowers to turn to other alternative means of financing. The low supply and high demand has enabled lenders to charge higher interest rates, which is an attractive opportunity in the recent low interest rate environment. Figure 5 below shows the distribution of loans by interest rate. The above-market interest rates available in the online marketplace are attractive for yield-seeking lenders.

Figure 5: Distribution of online marketplace loans, by interest rate



Source: Thomson Reuters Eikon / TAB Portal. March 2018.

Equity financing through the online marketplace

Equity financing is a significantly smaller portion of the online marketplace. There are a variety of factors influencing the low engagement with equity financing in the online marketplace. Data quality and transparency is an issue, as there is no way to track the historical performance of equity financed companies. This makes it tough for investors to assess companies. There is a lack of consistent, comparable data metrics that would enable an investor to review potential equity investments on “apple-to-apple” terms. For established and publicly traded companies, GAAP accounting principles allow professional investors to build valuation models and use metrics such as EBITDA to compare the profitability of companies across industries, sectors, and geographies. The online marketplace currently does not have the robust financial data to support that sort of analysis.

There also exists questions around the quality of capital-seekers in the online marketplace. Many ventures seeking equity investment are perceived as being there as a last resort, having been rejected by traditional capital-providers. The lack of audit and verification mechanisms enables concerns of fraud to exist. The UK Financial Conduct Authority (FCA) has repeatedly warned that some companies in the online marketplace made misleading claims about their profitability. While this segment of the online marketplace holds promise, the aforementioned structural factors – along with others to be discussed below – prevent equity financing from accessing larger pools of capital.

Regulatory landscape

Currently, the UK Financial Conduct Authority (FCA) is responsible for regulating the online marketplace in the United Kingdom. Firms must seek authorization from the FCA before they can provide regulated financial services in the UK. They must apply for permissions that cover their intended activities, and must meet threshold conditions set out in the Financial Services and Markets Act 2000 (FSMA). These threshold conditions include, for example, having adequate resources and a suitable business model. These requirements apply to all firms the FCA regulates, including those that wish to operate on crowdfunding platforms.

In October 2013, the FCA published a consultation paper detailing their proposed approach to the regulation of firms operating online crowdfunding platforms or conducting other similar activities. In 2014, an updated set of rules was published, which came into force on 1 April 2014. Since then, the FCA has continued to build upon that proposed regulatory regime, actively seeking and incorporating feedback from the market.

Specifically, in regards for crowdfunding platforms, the FCA breaks their purview into two categories:

- Loan-based crowdfunding platforms (also referred as debt crowdfunding), through which people and institutions lend money to consumers or businesses in the expectation of a financial return through interest payments and repayment of capital over time.
- Investment-based crowdfunding platforms (also referred as equity crowdfunding), through which people invest in non-readily realizable shares or debt securities issued by businesses.[12]

The FCA's focus is ensuring that investor protections are appropriate for the risks in the sector while continuing to promote effective competition in the interests of consumers. They believe it is necessary to strengthen the consumer protections provided by their rules while continuing to ensure they promote competition in the sector.

The FCA stated in December of 2016 that "In our view, aspects of the loan-based crowdfunding market currently pose some risks to our objectives. We perceive risk of regulatory arbitrage in the loan-based sector, and potential for investors to misunderstand the nature of the products offered. While investment-based crowdfunding is facilitated entirely by fully-authorized firms,

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[12] Call for Input to the Post-Implementation Review of the FCA's Crowdfunding Rules. 2016, Call for Input to the Post-Implementation Review of the FCA's Crowdfunding Rules, www.fca.org.uk/publication/call-for-input/call-input-crowdfunding-rules.pdf.

most loan-based crowdfunding firms, including the largest ones, have so far operated under interim permissions. [An interim permission allows firms to trade while their application for full authorization is being approved.] Where firms operating under interim permission fail to meet the standards for full authorization, this presents risks to their existing borrowers and lenders which require careful management."[13]

For both loan-based and investment-based crowdfunding platforms, the FCA has stated the following issues: (1) it is difficult for investors to compare platforms with each other or to compare crowdfunding with other asset classes due to complex and often unclear product offerings, (2) it is difficult for investors to assess the risks and returns of investing via a platform, (3) financial promotions do not always meet their requirement to be "clear, fair and not misleading," and (4) the complex structures of some firms introduce operational risks and/or conflicts of interest that are not being sufficiently managed.[14]

Concerns of the online marketplace

The following are a list and description of concerns that financial services professionals have raised about the online marketplace. These observations were gleaned through a comprehensive literature review and a series of formal and informal interviews.

Information asymmetry

Markets at their core are intermediaries that provides information about agents and actors to allocate financial resources to their most productive ends. For a lender, access to detailed,

[13] Interim Feedback to the Call for Input to the Post-Implementation Review of the FCA's Crowdfunding Rules. 2016, https://www.fca.org.uk/publication/feedback/fs16-13.pdf.
[14] Ibid, page 9

verifiable information about a borrower is critical for lenders to be able to assess creditworthiness and decide which borrowers to lend to and at which interest rates. For an investor, access to financial statements allows the investor to make educated assumptions when valuing and benchmarking a company. Campaigns in the online marketplace are often unable to provide this information. Owners know more about their business than anyone else, but they often have difficulty conveying that information through credible channels. The FCA has raised concerns about misleading claims made by campaigns regarding their profitability, and there is limited ability to audit or verify the information provided by campaigns. This information asymmetry makes it difficult for lenders to determine a creditworthy borrower from a non-creditworthy borrower and investors to choose between projects, and results in lost capital by reducing the incentives for potential capital-providers to enter the market.

Risk of negative selection

A commonly heard criticism of the online marketplace is regarding the quality of investment opportunities available on marketplace lending platforms. The stigma attached to equity financing is that the opportunities are of low quality. The theory is that the projects listed have come to the online marketplace as a last resort, unable to secure financing via other more traditional means. This implies that more sophisticated professional investors in private equity and venture capital have chosen to pass on the investment after evaluating it. The nature of how entrepreneurs signal quality, legitimacy, and preparedness is much less defined in the virtual setting of the online marketplace than in traditional new venture settings, and that inability hinders the confidence of institutional investors to enter the equity-financing sector of the online marketplace.

Regulation

One headwind faced by digital lending platforms is the possibility of more stringent regulation. The UK Financial Conduct Authority, for example, has warned that some digital lenders were "testing the boundaries" of their interim operating permissions by introducing "provisions" funds – insurance-like pools of cash set aside to compensate lenders for losses – and balance sheet lending. It has also criticized "inadequate rules about risk and loan performance" and a nascent tendency to lend to other lenders. The strict implementation by global regulators of regulations surround these and other issues could oblige some digital lenders to revise or abandon their growth aspirations or to modify their business models accordingly. Similarly, some U.S.-based platforms, whose success to date has been built on highly selective targeting of borrowers, could invite allegations of prohibited "redlining" as they edge ever close to the regulatory territory occupied by more traditional banking rivals. In many Asia countries, meanwhile, regulations still mandate personal contact for some transactions.

That being said, market participants are comfortable with the current level of regulation. When asked what they thought of the existing regulation of peer-to-peer lending and equity-based crowdfunding, more than 90% of platforms stated that they thought current regulation was adequate and appropriate.[15]

Misalignment of incentives

Many marketplace lenders do not plan to retain risk on their balance sheets, which can create incentives to grow the volume of loans on their platform at the expense of returns for

[15] Zhang, Bryan, Peter Baeck, Tania Ziegler, Jonathan Bone, and Kieran Garvey. "Pushing Boundaries: The 2015 UK Alternative Finance Industry Report." February 2016.

investors. This misalignment of interests between online marketplace platforms and their capital providers affects the supply-side economics of the marketplace model, particularly as interest rates rise. As capital providers see their margins decrease, they may start looking elsewhere for more efficient sources of return.

Data quality and transparency

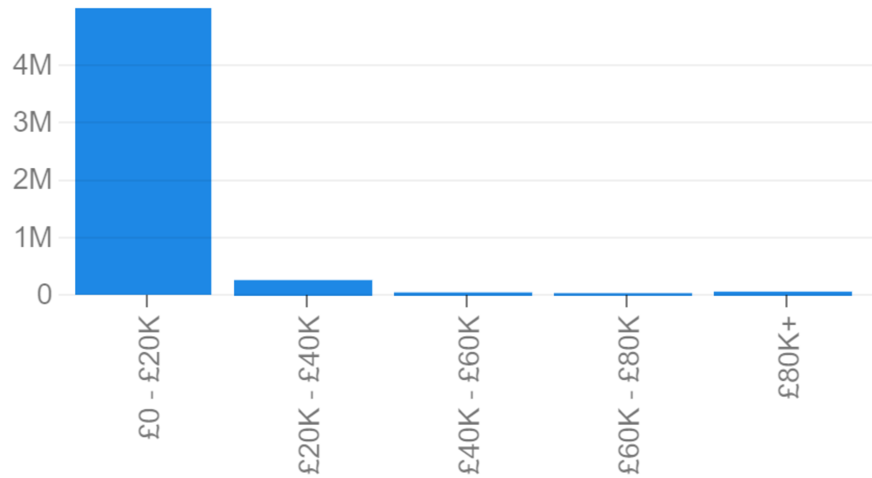
According to a study performed by Nesta in collaboration with the University of Cambridge, online marketplace platforms view the biggest risk to the future growth of the online marketplace to be platform fraud or malpractice, with 57% of surveyed platforms viewing this as a high risk to growth. This sentiment has been echoed by the FCA, which recently said that crowdfunders were giving a “misleading or unrealistically optimistic impression of the investment” while attracting retail customers with little experience of investing.

Additionally, potential investors are unable to see whom else is providing funding for campaigns in the online marketplace. Investor-side data is carefully guarded for privacy reasons. TAB as a company does not aim to collect investor-side data, and online marketplace platforms have yet to build out that functionality. This lack of transparency limits the amount of discourse around an investment, which in turn affects the broader confidence and conviction that an investor seeks to have before committing capital.

Investors have also indicated that the lack of historical data on performance is a barrier to their entry and engagement with the online marketplace. Without the ability to track past investments, investors have a tougher time ascertaining the growth potential of a company. The inability to have conviction around their forecasting results in a lack of confidence in the asset, and scares away professional investors.

Ticket size

Figure 6: Overall campaign goal, funded campaigns



Source: Thomson Reuters Eikon / TAB Portal. March 2018.

The above figure shows the overall campaign goals of funded campaigns. Almost all - 98% - of campaigns are seeking to raise less than £20K. Small ticket size continues to be a barrier for many institutional investors. Many institutional investors such as banks, pension funds and insurance companies generally consider the market too small or disintermediated to allocate expertise or resources to cover it. The small ticket size of campaigns in the online marketplace struggles to compensate investors for the time, costs, and efforts necessary to assess ventures, not to mention the additional due diligence they must perform for the larger number of campaigns.

Proposals to increase the attractiveness of the online marketplace

Market-level

The following suggestions are aimed at building an institutional structure around the online marketplace. Establishing entities that interact with and monitor the online marketplace creates a reliable feedback loop that generates confidence around the market as a whole.

Establishment of indices

The establishment of indices that serve as convenient indicators or gauges of the online marketplace serve a variety of benefits. First, they provide a historical perspective of market performance, giving investors more insight into their investment decisions. Second, they provide a yardstick with which investors can compare the performance of their portfolios. Third, indices can be used as a forecasting tool. By studying the historical performance of an index, one can forecast trends in the market. Indices can also be used to monitor and compare sectors and industries within the online marketplace.

Tracking and maintaining of historical data

Currently, there is no ability to track returns on funded equity investments in the online marketplace. However, the information exists. Companies House, the United Kingdom's registrar of companies and the executive agency and trading fund of Her Majesty's Government, requires all registered companies to file financial information, which is available to the public. Each company is assigned a unique identifier within the Companies House database. Many campaigns within the online marketplace – particularly the successful ones –

will have already received one and provide it as part of their application to raise funds on a platform. To be sure, not all campaigns tracked in TAB's online marketplace database are registered companies in the UK. But for those that are, the functionality and data exist for this information to be aggregated.

The issue lies in the process. Pulling the financial data for businesses listed in Companies House is difficult and time-intensive. Financial reports are uploaded in PDF format, which the Companies House online database will provide a link to. The data of interest will then have to be mined from the scanned document. This process of accessing, identifying, mapping, and transferring the relevant information is complex and requires human touch and judgment. In interviews with TAB engineers and data scientists, the process as it stands would require a significant amount of manual work. Until the ability to automate this process is discovered, it seems unlikely that this data can be utilized.

That being said, indications from the industry are that having the ability to track and review the returns on investments in the online marketplace would create a more favorable investing environment and increase interest among institutional investors.

Consolidation of platforms

There exists over a thousand peer-to-peer lending platforms globally, according to Statista. This is characteristic of an early stage industry with relatively low barriers to entry. Currently, a few leading platforms dominate market share. Rolling up the remaining smaller players and consolidating the market to perhaps three to five main platforms will provide a few benefits. First, it will create a more centralized location for capital to seek campaigns. Banks, lenders, institutional investors, borrowers, and capital seekers will know where to go to access the online marketplace. Second, a smaller community of platforms will increase the ease of standardization within the online marketplace. The platforms can agree to collect the same information about companies, and track metrics that will allow for benchmarking and direct comparison between projects.

However, this market structure results in a state of limited competition between lending platforms. As the industry becomes increasingly concentrated, regulators should be wary of the influence that the remaining platforms have on price and other market factors. The lack of competition may also reduce incentives for innovation.

Support for secondary markets

Secondary markets allow institutions either to sell or securitize loans, converting potentially illiquid assets into cash and shifting assets off their balance sheets. The establishment and support of a formal secondary market will allow institutional investors to fully engage with the online marketplace, introducing incentives for financial institutions to provide funding and package loans into securities that can now be sold on secondary markets. However, the heterogeneity of online marketplace campaigns, together with widely varying uses of borrowed funds, have impeded development of general standards for assessing applicants and made it difficult to securitize and sell pools of loans in the secondary market.

Product-level

The suggestions below are aimed at addressing the risks and concerns raised about the online marketplace, through the creation of new financial instruments. These instruments allow investors gain exposure to the online marketplace while reducing risk by diversifying the assets involved.

Blended financial instruments

A blended financial instrument is an investment vehicle that spans across and invests in multiple asset classes. The portfolio of assets that makes up a blended financial instrument, which usually includes large and small cap equites and bonds, can grow to include tranches of capital to investments within the online marketplace. Large fund houses often create blended financial instruments to sell as products. For example, Pollen Street Capital, a fund manager based in the UK, manages a credit fund that includes a tranche of credit allocated towards peer-to-peer lending. The presence of more traditional investment vehicles mitigates the risk associated with investing in the online marketplace and early stage companies. This investment structure also smooths volatility, allowing investors to participate in the upward potential that the online marketplace represents while providing downside protection through diversification.

Securitization

Securitization is the process of packaging individual loans and other like financial instruments, into a single instrument. It promotes liquidity in the marketplace, as this security can be sold among third-party investors. Securitization provides investors with a mechanism to reduce volatility and risk by spreading it across a number of ventures.

Establishing funds that track an industry or sector is an effective form of securitization. Similar to an exchange-traded fund or index fund, investors would be able to gain diversified exposure to a particular industry within the online marketplace, while reducing the default and credit risks associated with each campaign. Securitization has the ability to address concerns about ticket size and liquidity, provided that demand exists within the secondary market.

However, obstacles to securitization remain. Securitization has historically been weak due to the lack of uniform underwriting guidelines, the historical nature of relationship lending to small businesses, and the lack of historical data on credit performance. For these reasons, the secondary market for securitized online marketplace loans has been virtually nonexistent. Until underwriting standards and documentation for these loans become more uniform and information for estimating the risk of loss more available, markets for securitized online marketplace loans will be limited.

Regulatory and policy considerations

There has been disagreement over the appropriate level of regulation for the online marketplace. Regulation hawks have shared concern that the online marketplace could become the next subprime lending crisis. Many of the online lenders were not making loans at scale during the last financial crisis, and it is unclear how accurate their new forecasting algorithms would prove in the face of stressed economic conditions. One can envision a scenario in which retail and institutional capital is pulled out of these platforms during a recession as investors retreat to safer, lower-yielding investments.

Others view new online platforms as disruptors of an old and inefficient marketplace, and fear that regulating too early or aggressively will restrict innovation that could provide valuable products to small businesses and fill market gaps.

Issues of transparency and disclosure are the most important considerations facing regulators overseeing the growth of the online marketplace. Online lenders should be compelled to accurately and transparently disclosing terms of their loans to borrowers, such that small business borrowers can easily understand the terms of the transaction. Regulators should require that online lenders disclose information about who they are lending to and how much macroprudential risk they are assuming.[16]

Lastly, regulators should consider allocating resources to programs and partnerships that impart financial literacy and financial management to borrowers, many of whom lack this knowledge at a time when financing options are proliferating. There has been emphasis placed on educating retail consumers, and policy makers should also consider the importance of investing in financial literacy for small business owners.

The future of the online marketplace

In recent years, institutional lenders have been getting involved in the online marketplace. In 2014, New York -based KLS Diversified Asset management invested £132 million in loans to UK small businesses via the lending platform Funding Circle. Metro Bank also announced in early 2015 that it will begin lending through the lending platform Zopa. More recently big tech companies with large SME customer bases have been partnering with peer-to-peer platforms. In 2015, Chinese e-commerce platform Alibaba announced a partnership with peer-to-peer lenders Iwoca and Exbob to help small and medium-sized British companies do business in

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[16] Mills, Karen Gordon, and Brayden McCarthy. "The State of Small Business Lending: Credit Access during the Recovery and How Technology May Change the Game." Harvard Business School Working Paper. July 2014.

China.[17] Since then, many other asset managers have made significant investments in the online marketplace. Today, large fund houses such as Invesco Perpetual, Aviva, M&G Investments, Legal and General, Newton Investment Management, Woodford Investment Management, and Brooks Macdonald all hold positions in major investment trusts offering exposure to the online marketplace.[18]

Nesta's recent UK Alternative Finance Report saw increased involvement from institutional investors in the online marketplace, with 45% of platforms reporting institutional involvement in 2015, compared to 28% in 2014 and 11% in 2013. This trend was driven by debt-financing, but equity-financing has also experienced institutionalization, with Nesta estimating the level of institutional funding in equity-financing transactions to be 8% of overall funding. Data shows that the online marketplace has become an increasingly important channel of financing for entrepreneurs, start-ups and SMEs in the UK, growing at near triple-digit rates. [19]

However, the online marketplace also faces cyclical headwinds. As discussed earlier, the low interest rate environment combined with increased regulatory burden were key factors in shaping an environment that brought institutional investors to the online marketplace. However, these structural issues that made it more difficult for community banks to fill market gaps in small business lending may be fading. Repeal of financial regulation in the United States will ease capital requirements for global financial institutions, potentially re-allowing them to service the SME part of the economy. Monetary policy of leading central banks has suggested

[17] Burgess, Kate. "Alibaba Partners Alternative Lenders to Open Doors to China." Financial Times, 11 Mar. 2015, www.ft.com/content/938c07e0-c745-11e4-9e34-00144feab7de#axzz3e4JE78B7.
[18] Williams, Aime. "BlackRock Backs P2P with £12.7m Investment." Financial Times, 15 Apr. 2016, www.ft.com/content/f20dc8bc-00a1-11e6-ac98-3c15a1aa2e62.
[19] Zhang, Bryan, Peter Baeck, Tania Ziegler, Jonathan Bone, and Kieran Garvey. "Pushing Boundaries: The 2015 UK Alternative Finance Industry Report." February 2016. Page 11

that interest rates are to rise across the global economy. As interest rates rise, lenders may choose to re-allocate capital to other more productive and lower risk means of return.

The online marketplace represents a potentially disruptive change in the way that new initiatives and ventures are funded. As it grows, it will create both opportunities and risks for policy makers. New entrants are innovating and using technology in ways that improve access, time needed for delivery of capital, and the overall borrower experience. The policy challenge is to ensure that these new marketplaces have sufficient oversight to prevent abuse, but not too much oversight that the innovation is restricted or delayed. The potential of these platforms to address gaps in small business lending remains high, and if they are successful, small business will have more opportunity to grow the economy and create jobs.

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