CROWDED HOUSE

When a storm or bad weather is approaching, you can normally tell by the approaching clouds. There could be a squall approaching in the rapidly developing world of peer to peer lenders and investment-based crowdfunding businesses. The regulator is currently concerned that practitioners have not been paying due attention to the full explanation of this new style investment and downplaying their inherent risks.

In March 2014, the FCA set out rules for how crowd-based investments could be operated and marketed to retail investors. In their first report on how the regulations are working, the regulator has indicated strongly that some providers have not articulated sufficiently their risk warnings, and the possible downside of this type of investment asset.

There are two types of crowd-based investments. Investment-based funding, which is the issue of shares or bonds in a company, and peer to peer or business lending. Crowdfunding platforms can only market directly to sophisticated or high net worth investors or those getting regulated advice, or else ensure that investors put up less than a tenth of their investible assets.

Peer to peer, or peer to business, lenders do not have that restriction, although it could well be enforced in the future if the regulator determines that for risk disclosure and suitability requirements are not sufficiently expressed by the suppliers of this asset class.

In addition, the FCA has additional concerns that a few investment-based firms also need to ensure their capital adequacy is in order. The regulator reviewed 25 investment-based crowdfunding websites and found most have been “cherry-picking” what they disclose to investors and “downplayed” important information.

For the regulator, it is a very serious concern as 62% of users are retail investors, and this has been an area of extraordinary growth in crowd funding and peer to peer lending. The rules were put in place in April, is to ensure that the anticipated growth in this area comes with appropriate investor protection in place.

Peer to peer lending websites had similar issues with regards to full disclosure. This was in addition to failing to adequately disclose an APR for the borrower, insufficient tax information and implying that capital was more secure than it actually was by comparing themselves with banks. Loan-based UK crowdfunding trebled last year, compared with a year earlier to almost £1.3bn. Business loans on the platforms rocketed up £556m to £749m, making it larger than the consumer loan segment for the first time. Consumer loans were £547m last year, up from £287m.

Meanwhile, investment-based crowdfunding is much smaller, though growing rapidly. The amount raised in startup equity or bonds was £84m last year, compared with £28m in 2013. In 2012 it was just £3.9m. There are 56 loan-based crowdfunding firms operating and 35 investment-based that are either set up or about to.

The FCA plans to carry out a full post-implementation review of the crowdfunding market and regulatory framework in 2016 to identify whether changes are required at that stage, to the existing regulatory rules.

A key priority will be to determine explanation of the full risk disclosure to the UK consumers at a time when the industry badly needs to encourage openness and engagement to get consumers saving adequately for their long-term needs.

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