THE ESSENTIALS OF CROWDFUNDING

VOLUME 2

NEELIMA MANI

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Crowdfunding and its Significance in the Modern Financial Markets

Aki Kallio and Lasse Vuola

Introduction

Crowdfunding is a means of raising finance for projects from the crowd often through an internet-based platform where project owners pitch their idea to potential backers, who are typically not professional investors, although increasing activity by institutional investors has been recorded. Crowdfunding takes many forms and sometimes without any potential for a financial return. Crowdfunding in its current context is relatively young and business models are evolving at a fast pace. Crowdfunding platforms have emerged recently since internet technology evolved in such a way as to allow easy and simple two-way

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communication. This enables interaction between the members of the crowd of investors, as well as between the crowd and the project owners pitching their specific projects (European Securities and Markets Authority 2014).

In 2017, alternative finance volumes from across Europe grew by 36%, from 7.67 billion euros to 10.44 billion euros (Ziegler et al. 2019). Overall, the major share of European volume still originates from the UK (68%). However, excluding the UK, the European online alternative finance market grew at nearly double the UK's year-on-year growth rate—63% in comparison to 35% in 2017. While this growth was not as strong as in 2016 (101%), there was visible growth in each sub-region of continental Europe. As a whole, the market grew by just over 1.3 billion euros to 3.369 billion euros in 2017 (Ziegler et al. 2019). While there was an overall growth, the rate of growth seems to have cooled in some more mature markets even though it is continuing (Ziegler et al. 2019).

The growth of crowdfunding as a new complementary and alternative form of financing is indisputable, and its importance to businesses both domestically and internationally is already remarkable (Ziegler et al. 2019). With the ever-increasing advent of digitalization combined with tightening regulation for banks, alternative finance has become an important part of the present financial markets. The alternative of today may turn out to be the mainstream of tomorrow. It is therefore important to evaluate the role of crowdfunding as part of the history of the financial markets. This is particularly relevant in the context of what is currently happening in financial markets via the transformation brought about by digitalization and ever-increasing regulatory burden imposed especially towards banks while restricting their ability to finance small and medium-sized enterprises (SMEs). Crowdfunding, at least for the time being, can be considered one of the most viable examples of the gradual transformation of financial markets caused by emergence of financial technology (fintech). Thus, crowdfunding joins an important group of innovations, which have changed, formed, and developed the financial markets through time like credit cards, stocks, mutual funds, and online banking, all of which have been influential innovations and disruptors of their time (Atack and Neal 2009).

However, as a phenomenon, there is nothing new in crowdfunding and similar ways to access finance have been utilized in the past. Currently crowdfunding is increasingly establishing itself as an integral part of the finance industry especially for start-ups and early phase companies that have traditionally been funded by "family, friends, and fools" in order to develop and gradually attract more interest (by direct investments and/or other collaboration) from sophisticated investors and venture capital funds (Kallio and Vuola 2018; Ziegler et al. 2019). This chapter focuses on those forms of crowdfunding, which have the most relevance to the financial markets, namely debt- and investment-based crowdfunding, and aims to give an analysis why, what, and how crowdfunding has become the phenomenon we are witnessing today and at the same time contextualize it as one of the continuous innovations in the history of ever-changing modern financial markets.

Fundamentals of the Financial System

The financial system is a complex environment comprising of different markets that use various financial instruments, such as equities and bond markets, and includes a number of different institutions such as pension funds, banks, insurance companies, funds, large companies, and retail investors (Drake and Fabozzi 2010). The purpose and functioning of financial markets from an economical perspective is based on a fairly simple point of view: markets channel money from surplus sectors to deficit sectors. This mechanism leads, in theory, to the allocation of capital in a most efficient and profitable way for the economy as a whole. Well-functioning financial markets and financial system in general are a prerequisite for the economic activity and growth we are familiar with. In market driven economies, general welfare is strongly connected to efficiency of the markets (Drake and Fabozzi 2010; Kallio and Vuola 2018).

Main functions of the financial markets are (i) providing information to and between market participants, which at best makes the market work transparently and allows the information available to be immediately, equally, and correctly reflected in the prices of the financial instruments; (ii) enabling efficient allocation of funds from the surplus sector to the deficit sector often through intermediaries such as banks so that funding for necessary investments can be acquired at the lowest possible cost and without delay; (iii) risk management aimed at proportionate spread of the risk inherently built into financial markets to be divided among different investments quantitatively over time; and (iv) providing liquidity, the purpose of which is to enable an investment acquired from the financial markets to be cheaply, easily, and quickly liquidated to cash (Atack and Neal 2009; Drake and Fabozzi 2010).

The usual cause of acquiring financing is rooted in a situation where a company's (or private person's) own capital is not sufficient to carry out the necessary or targeted investments, cover running costs, or overcome unexpected costs. In these cases, equity or debt financing become the most viable option. Financing is a way to mobilize resources quicker compared to collection of such resources by cash flow, which would take a considerable amount of time. The leverage function of new capital enables faster growth, but it involves a cost. In practice, the company is always forced to pay compensation for the use of the capital it has acquired. Equity financing is in practice direct equity investments into the company in which the investor receives an ownership share equalling the value of his investment in the company. The return on equity investment consists of the profit distributed by the company as well as profits re-invested into the company. These may increase at par if the valuation of the holding in the company increases, so the return on equity investment is theoretically unlimited. Similarly, the risk is at most equal to the invested equity (not more, not less) (Ferran 2008; Drake and Fabozzi 2010).

Debt financing is both short term (i.e. for a period of less than one year), such as trade payables and overdrafts, and long term (i.e. over a period of one year or more), such as bonds and bank loans. Debt financing is always external financing, and, as such, there is always an underlined obligation to repay on fixed terms compared to equity. On the other hand, debtor also carries the credit risk and the risk of the company having sufficient cash flow, which the lender must carefully consider when making a financing decision in addition with the evaluation of potential collaterals. The risk of an unsecured debt investment is at most equal to the borrowed capital and overdue, accrued and unpaid interest related thereto (Ferran 2008). Often an investor seeks to secure his position contractually, but also by using various collateral arrangements that secure status of the creditor in the event of a serious default and ultimately in the event of insolvency of the company (Ferran 2008). Debt financing takes precedence in the ranking of the payment order in case of an insolvency of the company compared to equity financing (Ferran 2008). Since profit is a reward for risk taken in business, the lower rank of equity means more risk compared to debt. Therefore, the profit expectancy in equity is generally higher than in debt (Drake and Fabozzi 2010).

The board and the management of a company have a fiduciary duty towards the owners. Rational companies aim to optimize their financing seeking for the best available capital structure. With debt financing the company can, from the owners' perspective, often lower the total cost of capital because investors usually require higher risk premium in relation to equity investments than for debt investments (Drake and Fabozzi 2010). In general, owners of the company try to protect themselves against dilution of ownership making debt finance often a lucrative way to grow through leverage (Ferran 2008). In addition, liability to pay interest in relation to debt financing might provide opportunities to optimize corporate taxation of the company in some jurisdictions (Drake and Fabozzi 2010). With the current stagnating low interest rate era, high leverage ratio may well seem lucrative from owners' perspective.

Setting the Scene

The history of financial markets and finance are united by continuous fluctuations between economic cycles from bull markets to bear markets or bubbles to recessions as well as crises usually caused by structures that enable opportunism and moral gambling. Every crisis contains the seeds of a change, but also risks for regulative overreactions, as well as drastic market reactions. One example is the Great Depression of the US in

1929, which was caused by virtually free speculative trading of stocks and derivatives to the general public and the loss of trust through separation of ownership, as explained by Berle & Means in *The Modern Corporation and Private Property* in 1932. Another and more modern example is the subprime crisis that began in 2007, which was caused by securitization of speculative mortgages and secondary markets related thereto, which at first stage caused widespread credibility gap between banks (i.e. credit crunch), and then later spread across the financial markets as a whole. This latter crisis gradually grew into a worldwide financial crisis eventually leading to the European sovereign debt crisis when several European countries experienced the collapse of major financial institutions, bankrupts of numerous of the countries' biggest companies, high government debt, and rapidly rising bond yield spreads in government securities (Bradley 2013; Chambers and Dimson 2016).

The European sovereign debt crisis also heavily influenced later changes to functioning of and initiatives taken by the European Central Bank (ECB) such as (i) the long-term refinancing operation (LTRO), which is an enhanced credit support measure to support bank lending and liquidity in the euro area announced in 2011, (ii) the targeted longer-term refinancing operations (TLTROs), which are euro system operations that provide financing to credit institutions announced 2014, 2016, and 2019, respectively, and (iii) the asset purchase programme (APP), which is part of a package of non-standard monetary policy measures that also includes targeted longer-term refinancing operations initiated in mid-2014 including corporate sector purchase programme (CSPP), public sector purchase programme (PSPP), asset-backed securities purchase programme (ABSPP), and third covered bond purchase programme (CBPP3). The aim of the ECB with abovementioned programmes was on the one hand to offer banks long-term funding at attractive conditions in order to preserve favourable borrowing conditions for banks and stimulate bank lending to the real economy and on the other to support the monetary policy transmission mechanism and provide the amount of policy accommodation needed to ensure price stability (European Central Bank 2020). In addition, the crisis acted as a catalyst to a still persisting zero-level (or even negative) interest rate environment in Europe.

The former (i.e. Great Depression) led to the implementation of two important acts in the US. First, the Banking Act (i.e. the Glass–Steagall Act), which prohibited any one bank from both accepting deposits and underwriting securities, in order to ensure that if a bank made significant losses underwriting securities, deposits would not be adversely affected. And, second, the extremely tight Securities Act of 1933, representing the first major federal legislation to regulate the offer and sale of securities in the US in order to ensure that buyers of securities receive complete and accurate information before they invest in securities, which is still in force in the US with only some relief from the original statute (Cassis 2017; Mitchener 2005). Both Acts restricted banks' business opportunities largely for the benefit of the general public and society as a whole.

The latter caused tightening of bank regulation, such as risk-weighted capital requirements, market condition, and investor protection, in the global financial markets (especially in the US and Europe) (Chambers and Dimson 2016, pp. 193–194). The enactment of the Dodd–Frank Act in the US was a response to the subprime crisis and brought about the most significant changes to financial regulation in the US since the 1930s preventing the US government from bailing out failing banks with taxpayers' money and imposing short-selling restrictions. In Europe, similar legislative changes were implemented and, with enactments of, among others, the Capital Requirements Directive IV (CRD IV) and the Markets in Financial Instruments Directive II (MIFID II), many restrictions were imposed on banks' businesses. Actions taken both in the US and Europe have heavily impaired banks' business opportunities, by way of, among others, tying their capital to much higher ratios than before the crisis, preventing or even restricting the use and leverage of their balance sheets as well as increasing regulatory compliance and wider conduct requirements (Zestos 2016).

This restrictive trend, as described, has been particularly strong in Europe, with the result that especially the financing of small and medium-sized enterprises (SMEs) has become more challenging. This has been counterbalanced by large-scale EU-wide financing and guarantee arrangements, whose long-term effects are still unknown. In future, we shall learn whether this partial "socialization" of credit risk to the taxpayers was an effective means to counterbalance the tightening regulation. Examples of these approaches, include a corporate bond purchase programmes started by the ECB (as referred above) and the setting up the European Fund for Strategic Investments, which is an EU budget guarantee that provides a shield for the European Investment Bank covering most risky part of the projects it has funded. In authors' view, once these instruments have been introduced to the markets, it may be hard to withdraw them even in the bull market leading into a long-term partial socialization of SME credit risk to taxpayers.

Like other forms of financing, crowdfunding always works within a particular jurisdiction. The provisions laid down in the regulation, in particular the mandatory ones, must be taken into account when utilizing all forms of financing. Besides understanding the history and functioning of global financial markets, it is always necessary to place the activity within the given operating environment and regulations related thereto (Drake and Fabozzi 2010). At the same time social institutions, such as governments, central banks, market supervisors, and supranational institutions, strive to promote trading to maintain economic growth while contrary to this goal also control the markets and operations therein in order to prevent the emergence and spread of systemic risks. Financial law includes acts, which in many cases point to opposite ways aiming at enabling efficient exchange to support investment, economic growth, and employment, and, at the same time, to prevent actions threatening the basic operation of national economies through avoiding emergence of systemic crises. The goal of financial market legislation is simple: trying to optimize the functioning of the financial market. Efficiency in the financial markets does not mean extreme liberalism. On the contrary, the financial market regulation should be limited to what is necessary so that overall confidence in the financial system remains (Drake and Fabozzi 2010).

Every statute increases complexity of the legal system in a non-linear manner. New regulation may lead to artificial market practices and efficiency losses for all market players. Hence, regulation should, from a market liberal economic perspective, focus on ensuring the functioning of key market mechanisms with minimal interruption. In *Confusion de Confusiones* Joseph de la Vega well stated in 1688 that financial system is at the same time "the fairest and most deceitful business … the noblest and the most infamous in the world, the finest and most vulgar on earth".

Things have not changed so much after de la Vega. The aim for the regulator is to incentivize the fairness and nobleness and de-incentivize the deceitfulness and vulgarness.

Efforts to maximize the interests of different stakeholders in the financial markets, and competition among them, create incentives for moral gambling, which lawmakers seek to counter by creating and imposing counter-incentives as well as effective control and enforcement systems. Financial market regulation always affects competitiveness of stakeholders in the financial markets, and regulation that is too burdensome can be seen detrimental to the whole financial market system. On the other hand, legislation can also help speed up market disruption (PWC 2017). Delays are a challenge for the legislator: decision delay, legislative delay, and implementation delay cause problems for effective and well-functioning legislation. The longer the delays the legislator is facing are, the easier it is for crises to emerge and the deeper they can become.

Similarly, the faster the new forms of financing, innovations, and practices are emerging in the financial markets, the more challenging is the role of the financial market supervisor and the legislator. However, as the legislator and market supervisor seek to control systemic risk by observing and regulating existing phenomena, new forms or models and other financial innovations are evolving at an ever-increasing pace in the financial markets. Of these, crowdfunding is an illustrative example. A considerable amount of new financial regulation has come into effect during the last years affecting those operating in the financial markets by increased costs and complexity. This emphasises the ongoing struggle between the stakeholders operating in the financial markets and the broad, ever-increasing, and multi-level regulation shaping the fundaments of financial ecosystem (Kallio and Vuola 2018).

The Brief History of the Modern Financial System

The development of the international financial system is in every respect a historical, economic, and political process. Because of this, it is essential to briefly outline the past, in addition to the present, in order to be able to assess potential future developments and guidelines of the financial markets. The beginning of the international financial system as we know it today dates back to the 1970s, but, more broadly speaking, a global financial system has existed much longer. This further stresses the importance to understand events, notions and wider developments described in the written financial history, which provides the means to comprehend functioning of modern financial markets. In *On the Genealogy of Morals* Friedrich Nietzsche noted in 1887 that the whole idea of duty and personal obligation is rooted in the oldest and the most primitive relationship there is, the relationship between creditor and debtor. This statement continues to quite accurately describe fundamental relationships in the modern financial markets.

The financial markets tend to operate in cycles, which differ depending on the subject matter (volatility, share prices, etc.) under consideration. For example, it is possible to assess the business cycle or the stock market cycle, which largely differ from each other due to differences in relation to the underlying subject matter in question. Although history may not be said to repeat itself, the cyclicity of the financial markets has largely been scientifically proven (Marmer 2016; Chambers and Dimson 2016; Atack and Neal 2009) although the timing of different cycles cannot be determined with any precision.[1] Therefore, it is not surprising that the financial markets witness both highs and lows, of which the former can in the worst case create a financial bubble[2] and the latter a recession meaning a deeper and longer lasting economic downturn.[3] Previous major changes in the financial markets may be categorized in many ways (Atack and Neal 2009). They can be approached through economic bubbles in relation to their impact on the real economy.

One way to outline the most important financial market development stages is to divide them into five phases. In the first phase in the nineteenth century, the leading European industrialized countries and the colonized non-European regions they ruled moved to a gold-denominated currency system that collapsed during World War I. There were sincere efforts to return the gold-denominated currency system in the 1920s, but they failed. This can be considered the second phase of the financial markets' development. In the third phase, the Great Depression of the US, followed by significant tightening of the US financial market regulation and eventually World War II caused international financial markets to shut down almost completely. The fourth stage of the international financial system began after World War II based on gradual dismantling of the post-war regulated economy and opening of the international financial markets, which lasted up to the oil crisis of the 1970s. After the 1970s, we have more or less lived in the current historical era comprising building of the global financial system based on neoclassical theoretical approach and characterized by ever-increasing globalization. This can be called the fifth stage, which we are still in (Kari 2016). The end of the 2010s has been marked by a certain degree of inward turning tendency, during which even many influential parties have openly denied functioning of the open and global financial system. The future will show whether we are in the middle of changing paradigm and living the beginning of the new sixth stage in which the international financial system is being gradually overtaken by separate national and inward-looking systems such as we are currently, at least to some degree, witnessing in the US, Brazil, and Russia to a greater extent. Recent outbreak of COVID-19 virus might further accelerate such inward-looking tendencies on a global level.

Understanding of historical changes of both the financial market and the financial system as a whole will help to put new financial innovations, such as crowdfunding and, more broadly, fintech into perspective (Chambers and Dimson 2016). The change in the financial markets is an extremely wide and complex matter influenced by technological advances and digitalization. Also, the current political, economic, and ideological conditions affect the financial system as a whole. While international development seems to be moving towards an increasingly global financial market (despite some inward-looking tendencies), diverse corporate cultures, differences in politics, as well as legislation between countries remain prevalent.

The Modern Emergence of Crowdfunding

There is nothing new in sourcing money from the crowds. However, crowdfunding, as a concept, is a modern financial service enabled by advanced digitalization. The underlying technology of which has the potential to help investors to find ventures and projects, which need financing and, accordingly, allows the ventures or projects to find investors and backers to finance their growth and development (Dresner 2014, p. 3). Based on one definition "crowdfunding" refers to the ability of pooling small amounts of capital from a potentially large pool of interested funders and supporters (Short et al. 2017). This definition, however, is close to the definition of an initial public offering (IPO). The ability of pooling in IPO is mainly based on the marketing efforts of investment banks acting as "underwriters" whereas in crowdfunding it is based on the digital online platform and its functionalities. In recent years, we have witnessed hybrid models where IPOs have also been executed through crowdfunding platforms.

A crowdfunding platform is "an internet application bringing together project owners and their potential backers, as well as facilitating exchanges between them, according to a variety of business models" (Shneor and Flåten 2015, p. 188). The crowdfunding platforms act as intermediaries between investors and companies (or other projects) and facilitate opportunities for investors to find and support the projects they are interested in (Spacetec 2014). The platform's core value proposition is in taking down the transaction costs and lowering the bar to start a fundraising campaign effort. Just a decade ago, it was basically impossible for an early stage venture to reach out to tens of thousands of potential investors in a cost-efficient way.

Thus far, crowdfunding has been gaining ground very rapidly (European Commission 2016). Major contributing factors to this growth and spread of crowdfunding are both the international crisis in the financial markets in 2008 that has led, inter alia, tightening the capital adequacy and solvency requirements for credit institutions, and the explosion of internet usage and usability, which together have made it possible to reach large crowds of potential funders in a cost-effective manner (IOSCO 2015).

In the near future, crowdfunding may become an increasingly important source of non-bank financing. Worldwide crowdfunding market has been estimated to reach 371 billion euros in 2017 and based on market data strong growth in recent years has been continued (Ziegler et al. 2019), although the rate of growth seems to have cooled in some more mature markets (Ziegler et al. 2019). Crowdfunding is increasingly establishing itself as an integral part of the finance industry especially for start-ups and early phase companies that have traditionally been funded by "family, friends, and fools". Furthermore, crowdfunding provides a feasible alternative to unsecured bank loans that have, for the time being, been one of the most important sources of external financing for SMEs in some jurisdictions, while being almost non-existent in others (European Commission 2018b).

A Brief History of Crowdfunding

Crowdfunding as a form of financing is not a new phenomenon (Spacetec 2014). A similar approach has been used to manage investment risks before internet time (Dresner 2014). For example, in shipping, one of the oldest forms of risk management are guarantee agreements between traders and shipping companies, in which upon the event of loss of cargo all pay part of such loss, but when cargo arrives safely, all parties to the contract (i.e. the guarantors) will receive their proportional share of the profits. This approach has provided the necessary financing to carry out high-risk projects and at the same time enabled successful diversification of the risk associated with the project between the parties.

The basic principles of the crowdfunding business go back to the early eighteenth-century Ireland, where "forefather of microcredits" Jonathan Swift[4] founded the Irish Loan Fund. The Fund offered small loans to low-income rural families who did not have the collateral required by large banks or proper credit history. By the nineteenth century, more than 300 schemes were implemented in Ireland in all of which small amounts were lent by private investors to individuals who needed a loan for short periods.

One of the early contemporary crowdfunding campaigns was carried out in the US in 1885 when the project of the Statue of Liberty on Liberty Island off New York had run into severe financial difficulties. When other means had proven ineffective, Joseph Pulitzer decided to launch a fundraising campaign to fund the erection of a pedestal for the Statue of Liberty in his own newspaper, *The New York World*. In exchange for a donation, he promised to publish the names of all donors in his magazine regardless of the amount. Over 160,000 donors in about five months had donated more than US $100,000 to erect the pedestal. Most of the donations were quite small—from a few cents to one dollar (Dresner 2014). However, while possibly the most famous and most often cited, the Statue of Liberty project was not the first crowdfunding campaign.

Even earlier examples of crowdfunding are evident. One example is when poet Alexander Pope set out to translate Greek poetry into English in 1713, an effort that included the translation of Homer's epic poem, "The Iliad", and asked donors to pledge two gold guineas to support his work in exchange for having the donors' names published in the acknowledgements of an early edition of the book. Another example is that in the end of the eighteenth century, the famous composer Mozart took a similar path. He wanted to perform three piano concertos in a concert hall in Vienna and published an invitation to prospective backers offering manuscripts to those who agreed to donate funds for this purpose. This approach mirrors the way in which Kickstarter operates today, where campaigners offer backers the first chance to get access to new products offered in campaigns. However, while Mozart failed to reach his funding goal on his first attempt, he succeeded a year later in a second attempt, where 176 backers donated enough funds to bring his concerto tour alive and they were all mentioned in his concertos' manuscript.

Muhammad Yunus further developed Jonathan Swift's idea on microcredits and microfinance by founding the Grameen Bank in 1976 (being authorized in 1983 by national legislation to operate as an independent bank in Bangladesh). The goal was to grant loans for entrepreneurs too poor to qualify for traditional bank loans. The bank's funding has come from different sources, and the main contributors have shifted during times from bulk agencies to central bank of Bangladesh. Grameen Bank is founded on the principle that loans are better than charity to interrupt poverty: they offer people the opportunity to take initiatives in business or agriculture, which provide earnings and enable them to pay off the debt and start a social climb. The Bank has offered credit to classes of people formerly outscoped: the poor, women, illiterate, and unemployed people. Access to credit is based on reasonable terms, such as the group lending system and weekly instalment payments, with reasonably long terms of loans, enabling the poor to build on their existing skills to earn better income in each cycle of loans. He and Grameen Bank were jointly awarded the Nobel Peace Prize in 2006 for their efforts through micro-credit to create economic and social development from below (Grameen Bank 2006).

Between 1996 and 1997, the British rock band Marillion funded its tour in the US by collecting US $60,000 from its fans via the internet. This project and other successful fan-based funding rounds that followed gave a boost to the increasing popularity of contemporary crowdfunding from the beginning of twenty-first century. Wider utilization of the form of financing and the spread thereof was made possible by the ever-increasing accessibility to the internet and its growing use by both businesses and households, which in turn made it possible to cost-effectively reach a large crowd at the same time. ArtistShare was one of the first modern crowdfunding services when it was released in the US in 2003. Through its service the artists had, and still have, the opportunity to seek funding to cover their recording costs from a wide audience such as their own supporters and fans. Here, supporters making financial contributions receive the right to download the artist's album (or song) once it is completed. The success of ArtistShare has also attracted other players to the market, of which perhaps the best known and most successful are reward-based platforms Indiegogo since 2008 and Kickstarter from 2009.

When donation and reward-based crowdfunding started to become widespread successes, it was relatively clear that a similar approach would also be used in the capital markets to raise investment-oriented finance. During the last decade, the market started to see platforms seeking to enable capital raising from investors by utilizing opportunities offered by the internet to collect and share investment information in an easier and faster manner, while simplifying the process and using standard terms. Here, the goal was to simplify, to the extent possible, the acquisition of finance from previously heavy and burdensome processes by using modern technology. In the past, acquisition of finance from angel investors lasted at least a number of months, but by using the internet the same funding could be secured within days or at most within a few weeks. One of the most successful pioneers in the industry are the US-based peer-to-peer and business-to-business lending platform—Lending Club, founded

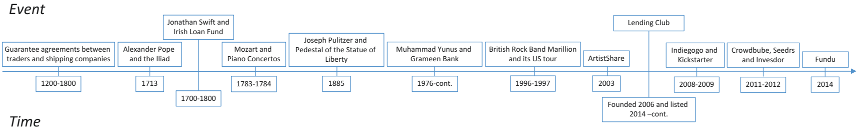

Fig. 10.1 Timeline—Brief history of crowdfunding

in 2006 in San Francisco and listed in December 2014 on the New York Stock Exchange (Freedman and Nutting 2015), and UK-based Zopa, which was launched in 2005 (Kupp and Anderson 2007) as well as Finnish-based equity platform Invesdor, which was founded in 2012, and being the first MIFID II licensed crowdfunding platform to operate cross-border in Europe (Fig. 10.1).

Crowdfunding and Its Significance in the Modern Era

Starting in 2007 from the overheated housing market in the US, and reaching full speed in 2008, the financial crisis has significantly changed the functioning of international financial markets. Increased regulation, and in particular the tightening of capital requirements for banks, has contributed to the need to find new sources of finance for businesses. Tighter regulation, especially the risk-weighted capital requirements has limited the number of companies that banks could provide debt finance for, and, in turn, led to increased borrowing costs. Therefore, it can be argued that at least to a certain extent, the changes described here have reduced the capacity of credit institutions to meet the financing needs of companies. In addition, a weak and precarious economic situation, which has only recently turned for better, has increased the risk of credit losses and thereby reduced banks' risk appetite (European Commission 2013). The situation has had a particularly strong impact on European SMEs, which have, due to historical reasons, been dependent on bank financing and, hence, resorted to alternative sources of financing (European Commission 2013, 2015). This is expected to affect the diversification of financial markets in the future. In particular, changes in the regulation of financial institutions can be seen as a limiting factor on the effective functioning of financial markets for entrepreneurial finance and growth companies.

The financial position and access to finance for growth companies and SMEs have weakened to some extent globally. As a result, companies have not always been able to meet the funding needs for their projects from existing sources of finance, which has in certain situations led to a financing gap (European Commission 2018b). Of course, not all the companies are fundable by any means of finance. However, statistics published by European Central Bank have shown evidence of a decline in access to finance for growth companies and SMEs especially in Europe in the aftermath of financial crisis even though situation has gradually improved in recent years. Based on surveys, also covenants (i.e. special conditions) as well as the security requirements of corporate loans have been tightened and interest for corporates, but especially SMEs risen (European Central Bank 2019). Although the situation in Europe is relatively good in comparison to other continents, it has developed for the worse since the financial crisis. Structural deficiencies, overcapacity, low/negative interest rates, and the absence of a pan-European banking regulatory agency have all likely contributed to European banks experiencing persistent profitability challenges (Deloitte 2019).[5] In Europe, the proportion of SMEs that mention access to finance as one of their main problems, and hence feel that they are not able to drive all potentially profitable projects, has grown (European Central Bank 2019). These findings may well be proof that the EU and national level SME guarantee facilities have not had the expected outcome. In addition, it is uncertain how socialization of credit risk affects the economy as a whole in zero (or even negative) central bank interest environment.

Low interest rates weaken banks' profitability and reduce the transparency of the actual price paid by the customer, which depends on not only each customer's financial status and profitability of the business but also the banks' current fundraising costs and the pursued level of profitability. Based on business and investor surveys (such as European Central Bank

2019) growth companies experience slower growth and higher growth thresholds. Hence, businesses, as they continue to grow, are often lacking access to finance and ability to entice new owners through listings. Low availability of alternative sources of funding, lack of expertise, and the relatively high cost of the listing process, as well as negative attitudes of owners, slow down the growth path of companies.

Therefore, from the perspective of growth-oriented companies, funding opportunities that are complementary or alternative to bank financing, such as risk and equity finance (i.e. bond markets, crowdfunding, venture capital) have increased their importance. Equity crowdfunding is especially important to finance the growth of technology-intensive businesses and innovative companies in general. This is even more relevant when a company is looking for new markets or planning to develop new products. Palmer has concluded in his study that the price of the (crowd) funding (i.e. associated costs) is not the main reason why some companies decide to use crowdfunding instead of traditional sources of finance. The main reason for companies to avoid bank-based financing is, according to Palmer, to avoid the heavy bureaucracy involved in dealing with banks in the first place (Palmer 2016).

The prevailing (zero or even negative interest) market conditions have also forced investors to look into new channels for investments providing high yields with higher risks, which have not been available from traditional sources of finance, such as banks balance sheet financing or capital markets in general. Both loan and investment-based crowdfunding include many opportunities for investors looking for investments with different return-to-risk ratios. From the investors' perspective, crowdfunding also offers a new way to diversify investments and seek higher than average profits with a higher risk profile compared to more general investment products available in the market. However, the several hundred years old banking institution is unlikely to vanish any time soon. On the contrary, there is strong indication that some leading business banks have established successful partnerships with crowdfunding platforms and other fintech companies (Nordea 2018; BBVA 2019; Deloitte 2019).

What Next?

The Fourth Industrial Revolution is underway. According to Statista—a German online portal for statistics, which makes data collected by market and opinion research institutes and data derived from the economic sector and official statistics available—there were about 26 billion devices connected to the internet around the world in 2019. The total installed base of internet connected devices is projected to amount to 75.44 billion worldwide by 2025, a fivefold increase in ten years. The internet of things, enabled by the already ubiquitous internet technology, seems to be the next major step in delivering internet's promise of making the world a connected place (Statista 2019). Currently it seems that artificial intelligence, machine learning, and the internet of things will have the most effect on the financial sector (Deloitte 2019). Digitalization is currently shaping the financial market sector with a force that has not been experienced in this scale before (Chambers and Dimson 2016). The disruption we are currently witnessing means a development during which many existing policies might be abandoned, and new ones adopted within a relatively short term. This has become even more evident after the outbreak of COVID-19 virus and how it has forced governments, institutions and companies to adopt to new and digitalized ways of working.

The financial market has, throughout its history, experienced tremendous economic and functional breakthroughs and changes, but basic operating models have remained largely unchanged, unlike, for example in industrial and service sectors (Atack and Neal 2009; Chambers and Dimson 2016). However, digitalization and technological advancement have significantly changed people's behaviour since the beginning of the twenty-first century. The virtual world has entered into all aspects of human life, and modern devices (such as tablets, mobile phones, smart watches, etc.) and applications (such as Facebook, Instagram, WhatsApp, WeChat, Skype, different e-mail applications, etc.) allow people to be continuously reached and contacted. This has given people many new opportunities to improve their living conditions and use of time, but, at the same time, mixed and overlapped time between work and leisure.

In parallel, social interaction is increasingly moving into the internet and its complex social media networks (Joinson et al. 2009; Kallio and Vuola 2018).

Not surprisingly, in the same context, people's expectations towards (financial) service providers have changed. This naturally influences financial markets, which are not a separate fort from the rest of society. People's expectations as consumers require ongoing development work from the financial markets so that financial market participants are better equipped to meet people's ever-growing expectations. Nascent technology creates numerous new business opportunities in all business sectors.[6] In the financial markets of the near future, it is likely that besides existing incumbent market operators, such as banks, also big technology companies like Amazon, Facebook (especially with its proposed cryptocurrency project Libra), Apple, Google, Tencent, or Alibaba, who are already integrating payment services on a large scale to their own services, will take a big share of the markets (Deloitte 2019).

Advances in technology seem to ensure that internet, and other sharing networks, will become more significant and take a larger part of our living environment, which will also inevitably change the financial markets as well, while enabling new service concepts and forms of financing (Morel et al. 2018). This poses challenges for current financial market participants, especially for banks (Deloitte 2019) but also creates a correspondingly high potential to newcomers (disruptors), investors, and companies seeking finance. Lawmakers and market supervisors are facing challenging times, though it is essential to keep in mind that the biggest and often most amazing things happen in a period of big breakthroughs or changes that can at this stage only be expected to accelerate through technological development. With these developments, the role of central banks may be changing rapidly. For instance, ECB is examining whether to develop a digital currency as an alternative to cash (Financial Times 2019). To further support and derive from the project, a body of six central banks (the Bank of England, Bank of Canada, BOE, the Bank of Japan, the European Central Bank, the Riksbank, and the Swiss National Bank, along with the Bank for International Settlements) have been set in order to "share experience as they assess the potential cases for central bank digital currency in their home jurisdictions" (Bloomberg 2020).

Fintech refers to those technological innovations in the field of financial services that may lead to new business models, applications, processes, or products and have a significant ancillary effect on financial markets and institutions in the way financial services are provided. The history of the financial market is full of financial innovations, but the importance of these innovations has grown and market transformation accelerated by technological advances (European Commission 2018a). Accordingly, the market is, at an accelerating pace, deploying various fintech solutions that leverage digital identification, mobile applications, cloud services, big data analysis, artificial intelligence, blockchain, and distributed ledger technologies. New technologies are changing the financial industry and the way consumers and businesses buy services. This creates opportunities for fintech-based solutions that improve access to finance and financial inclusion of digitally networked consumers (PWC 2017).

Today, crowdfunding is used to finance business growth at an accelerated pace. Until recently, it has generally been considered to be appropriate during the seed and growth stages for start-ups and especially small businesses (Spacetec 2014) involving financing from non-professional investors often reaching sums between ten thousand euros to a few million euros. In the financial markets, crowdfunding is typically seen as a high-risk mezzanine as well as debt or equity financing. However, the paradigm might be shifting. The crowdfunding market has already seen institutional interest, which may further accelerate growth of this form of financing (Ziegler et al. 2019). This trend is partly supported by regulation making crowdfunding part of regulated financial markets, as well as governments' continuous will to impose ever-stricter regulation to existing financial market players.

There may well be an underlying risk that the crowds will be pushed back in the most successful platforms, which are able to show long-term track record especially in debt crowdfunding. If this happens, the credit rating models of platforms would have been battle-tested by the non-professional crowds, but eventually the professional investors will come and harvest the fruit. In addition, deepening deflation in the financial markets seems to push more and more institutional investors to alternative finance in order to pursue profits, which are less available from traditional sources. However, recent research has shown that institutionalization across all crowdfunding model types has actually decreased between 2016 and 2017. This includes funding from pension funds, mutual funds, asset management firms, and banks (Ziegler et al. 2019).

Conclusion

The size of the crowdfunding market, and hence the importance of this form of financing, has grown rapidly (European Commission 2016) and continues to grow based on recent studies (Ziegler et al. 2019). Crowdfunding transactions taking place digitally on different technological platforms via the internet is a concrete demonstration of how digitalization and business models applying new technological solutions can influence access to finance. Subsequently, such solutions also channel and allocate the limited resources of society to benefit a larger pool of companies, investors, and consumers, and hence supporting the society as a whole.

Nevertheless, crowdfunding is not immune to risks, immorality, opportunism, and moral hazard, which have been witnessed in the financial sector from the start. Here, although the systemic risk may be quite low for the economy as a whole, it is for the benefit of all stakeholders in crowdfunding that some level of governmental control is being exercised. So far, it may be fair to argue that there are no crowdfunding platforms that are "too big to fail". The business model of crowdfunding involves the ability to seek instant profits from and at the expense of investors, for example, by loosening the service platform's customer selection. Here, it may be argued that less-informed investors may take risks which better informed investors may not. This risk is highlighted by a fact that crowdfunding platform operators are often start-ups themselves struggling with adequate cash flows and may be pressed to onboard campaigns and investors less selectively. This argument defends reasonable minimum capital requirements.

In the end, the markets naturally repair themselves when investors start to avoid those crowdfunding platforms, which price the risks of their projects and operations poorly or indifferently. For a young and developing industry, the market-based correction mechanism may not necessarily be sufficient, because the industry's overall reputation can significantly weaken already from one bigger moral gambling case. This is true especially in the current situation where advanced self-regulation of the industry has not yet formed, but competition on market shares and customers has constantly been growing and tightening. The biggest risk for crowdfunding industry and its long-term success would seem to be the industry itself if it does not take these signs of danger seriously enough.

The history of the financial markets is full of innovations, starting from the invention of money and using it as a medium of exchange, the exit from the gold-denominated currency system, and all the way to the increasing popularity of online payment systems. Crowdfunding as a form of financing is part of this series of innovations in the general history of financial markets. Crowdfunding has in quite short period acquired a small but significant position in the international financial markets making it important and accessible funding channel especially for start-ups and SMEs. It can also be stated that crowdfunding has democratized the process of commercialization and financing by making investing in start-ups more widespread and easier to access for all people, instead of being accessible to only high-net-worth individuals, business angels, or venture funds (Ziegler et al. 2019). This has also given new opportunities for companies seeking financing and diversified the functioning of existing financial markets.

The evolution of financial markets or corporate finance naturally will not end in crowdfunding. For example, blockchain technology can, if sufficiently advanced, enable completely new business models that can challenge, when scaled adequately enough, traditional corporate finance as well as crowdfunding as we know it today. Blockchain technology, like other fintech innovations, can have a significant impact on the development of financial markets in the future (Deloitte 2019). This also relates to cyber security and data privacy in general, which are issues that need to be addressed globally in order to capitalize on the benefits of digitalization not just for the good of financial markets, but for the society as a whole (European Commission 2018a). The big challenge for the regulators in this rapidly changing financial environment is to maintain an attitude of "mend it, don't end it".

In the future, it is necessary for researchers to further study the historical evolution and development of crowdfunding markets in the wider context of financial markets. The relevance of crowdfunding as a new form of financing to market participants (i.e. investors, companies, and established operators like banks) would be worthwhile researching. This is especially true in the current exceptional financial market environment, which is characterized by zero or even negative interest rates, as well as continuous liquidity injections by central banks and government-led projects or initiatives (especially in Europe), such as the European Fund for Strategic Investments and its local counterparts. An alternative historical approach may be comparisons between the development of crowdfunding and other innovations in financial markets, highlighting common and different drivers and barriers to such developments, and the actors behind them. There is also a need for more (historical) study on both the positive and negative implications of financial innovations (including crowdfunding), the determinants of risk taking by institutional and individual investors, the governance problems (including conflict of interest between different stakeholders), and the causes of volatility in financial markets in relation to emergence of fintech. All these issues have practical implications to the success and implementation speed of new financial innovations to practice and everyday service offering and use by individual banks, companies, and households.

Also increasing regulatory burden, which has mostly fallen on the shoulders of established financial institutions like banks, might distort the functioning of financial markets even further and create more concerns among investors and in the public, which can have unprecedented effects to the financial markets of today. Big shifts in current paradigm in the financial markets can make crowdfunding more attractive to institutional investors in the future. The relationship between institutional investors and crowdfunding platforms is a particularly interesting research opportunity, as it may have profound effects on industry development, and the extent to which it will remain loyal to its grass-root ideals.

Further, more research is needed on the effects on and implications of the crowdfunding industry on systemic risk especially if the growth of the industry continues as strong as it has to date. It will also be interesting to follow how quickly and agile crowdfunding platforms will adapt innovations of fintech (blockchain, AI, cloud computing, etc.) into their everyday operations compared to, for example, banks, as well as what effects will that have on the future position and service portfolios of platforms and banks respectively. In growing markets, there also seems to be an increasing pressure for consolidation of the crowdfunding platforms as well as expansion of their current product lines and ability to adapt to new and more scalable business models (e.g. setting up alternative investment funds in order to ensure steadier cash flow as well as expanding from solely lending-based crowdfunding to cover other crowdfunding forms). In addition, it is interesting to study the increasing syndication and cooperation activities between traditional banks and crowdfunding platforms.

In conclusion, we are living in interesting times of constantly evolving financial markets. In order to be able to predict future trends and directions, we must understand the past and derive from the teachings of history; and in this particular case-financial history. In order to understand history, it is essential not to highlight only similarities between historical episodes such as the Great Depression of 1929 and the subprime crisis of 2007 but also differences.[7] Such an approach shows us that history does not always have such a conclusive predictive power than we would probably like it to have (Chambers and Dimson 2016). However, history has always provided invaluable guidance to those willing to learn from events, and especially mistakes, of the past. At the finalizing phase of this chapter we are witnessing an outbreak of COVID-19 virus that hammers the global economy at forces rarely seen before. The outcomes of such crises are hard to predict. We might be entering into a beginning of a new era of disintegration in EU and rising levels of nationalisation. On the other hand, the solidarity may even strenghten among EU states, and the level of global co-operation and transparency might increase and improve.

From practical standpoint, it is useful to contextualize crowdfunding—a modern and digitalized form of financing—as part of financial markets, its rules, and mechanics. In order to achieve such a goal, it is essential to understand fluctuations between economic cycles driven by historical, economic, and political processes. Crowdfunding and fintech in general will definitely offer many interesting research topics for researchers in the financial markets for years to come.

Notes

1. Although the economic history of the past 300 years has shown many instances of financial crises and bank failures, their effects on asset values and on the real economy have been quite varied. Much depends on how the authorities react to these events. Although we understand from history the factors that lead to and exacerbate crises, the attempts to make such crises less frequent and less virulent have been largely misguided (Chambers and Dimson 2016, p. xvi).
2. "Economic bubble" means a situation in the economy where a price of a trading object (e.g. a stock or other commodity) differs from the balanced price defined by the fundamentals of the market (based on availability, valuation, supply, etc.). The bubble may form, for example, to the prices of stocks or house prices (Chambers and Dimson 2016, pp. 149–168 and 174–175). One of the traditional and frequently used examples of "economic bubble" is the so-called tulip mania, which was an investment bubble in the Netherlands between 1634 and 1637, where prices of tulip bulbs entering the markets most recently rose to record levels and eventually collapsed. The highest price of tulips was in 1637. Tulip mania is considered one of the first economic bubbles in the modern financial markets.
3. Economic cycles affect, among others, (i) the number of loan transactions, (ii) the size of the loan facilities, (iii) pricing for the loans, (iv) default rates, and (v) institutional demand for secondary trading. A buoyant economy with low default rates encourages lenders to commit to large loans and more frequently, whereas a contracting economy usually results in a more cautious approach in the number of transactions and the terms on which the loans are made. A deteriorating economy with high default rates spurs the secondary market in distressed loans (Mugasha 2007, p. 6).
4. Jonathan Swift is better known as an author of a well-known prose satire; Gulliver's Travels, or Travels into Several Remote Nations of the World. In Four Parts. By Lemuel Gulliver, First a Surgeon, and then a Captain of Several Ships.

5. US banks, compared to their European counterparts, are ahead on multiple measures. Aggressive policy interventions and forceful regulations helped propel US banks to health more quickly. And more recently, favourable GDP growth, tax cuts, and rising rates have further bolstered the state of the industry. Total assets in the US reached a peak of $17.5 trillion. Capital levels are up as well, with average tier 1 capital ratio standing at 13.14%. Return on equity (ROE) for the industry is at a post-crisis high of 11.83%. Efficiency ratios also are at their best. Similarly, on other metrics, such as non-performing loans and number of failed institutions, the US banking industry is robust (Deloitte 2019, p. 1).
6. For example: (i) video rentals (Blockbusters) have gone online (Netflix, Viaplay, HBO), (ii) instead of CDs, music is listened online via web streaming services (Spotify), (iii) instead of travel agencies, most trips and accommodations are booked directly through internet platforms (e-aggregators) (Trivago, Ebookers), and (iv) instead of visiting branches, banking is handled through online banking channels or, increasingly, via banking applications on mobile phones.
7. For example, complex and highly automatized/digitalized structured financial products—non-existent during crisis of the 1930s—were vastly used in global financial markets prior to the subprime crisis. The use of as well as lack of understanding related to these products has been identified as one of the major contributing factors to the subprime crisis (Chambers and Dimson 2016, pp. 272–276).

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11

Crowdfunding in FinTech

Paul Griffiths

Introduction

The last three decades of the twentieth century witnessed the adoption of information and communications technology (ICT) by business corporations at an increasing rate and banks were leaders and trendsetters in this process. However, this leadership role of banking in the development of corporate ICT was lost in the second half of the first decade of this millennium. This chapter intends to shed light on the process that led to this. In so doing, it addresses the questions: Why did FinTech emerge as an industrial sector, independent of banking?

The author is strongly connected to the world of ICT transformation and of banking as an information intensive industry. He entered the business world as a young graduate during the mainframe-based, bespoke systems age; he then oriented his career towards management consulting, where he carried out and led technology-enabled business transformation

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projects in the enterprise resource planning (ERP) era and the customer relationship management (CRM) and e-commerce solutions era; he replaced legacy core-banking systems by more modern client-server platform ones. On the academic side, he went back to university and enrolled on a doctoral programme that he researched into strategy-technology alignment in banks from which he graduated in 2005. He then became a full time academic and for the last three years has been researching the industrial organization of the FinTech sector. So, it is from this broad background that bridges across the practitioner and academic worlds in banking and technology that he sets out to address the above questions.

The rest of this chapter is organized in the following way. Section "Twentieth Century: ICT Emerging and Evolution" will give an overview, based on the author's professional experience, of the evolution of ICT in the last three decades of the twentieth century. From the specific perspective of banks, it will show that the financial sector in general, and banking in particular, was a driver of the ICT evolution during that period, until the mid-2000s. Section "Advent of the Tipping Point: Why Did Banks Lose Control?" will, based on current literature, identify three root-causes for banks to have lost control over the ICT agenda in the financial sector. In having lost control of the evolution of ICT, Section "A New Industrial Sector: The Emerging of FinTech" will give a framework to understand how the FinTech sector is structured based on a classification of the players according to the functional services they offer and the types of technology they apply. It will emphasize the role of crowdfunding in this landscape. Section "Discussion" will offer a discussion on the findings, and Section "Conclusions" will draw some conclusions.

Twentieth Century: ICT Emerging and Evolution

The last three decades of the twentieth century witnessed the adoption of information and communications technology (ICT) by business corporations at an increasing rate. During the 1970s and 1980s it was large systems developed and running on mainframe computers, with bespoke applications of narrow functional scope and weak integration with other functional applications. ICT was essentially about number-crunching large volumes of flat files, initially fed in by perforated cards and later in the period by magnetic tapes and discs. It was a domain restricted to the largest corporations, prominent amongst them the big banks, government institutions and universities. Systems were all corporate and managed by large IT departments with battalions of in-house programmers, analysts and systems engineers complemented by professional staff belonging to the large systems companies (that later called themselves 'integrators') such as IBM, Honeywell-Bull, ICL, Unysis. The technology platforms on which these corporate applications were developed were proprietary, with no convertibility from one vendor's platform to another vendor's: Client lock-in was the name of the game.

Democratization of ICT and its access to the smaller corporations and companies came in the mid-to-late 1980s and early 1990s with the advent of the mini-computer, the table-top personal computer, local area networks, handheld devices and, very importantly, the relational database. Democratization turned into revolution with the access to, and popularization of, the Internet.

The until then reigning mainframe computer and its centralized architecture ceded part of its domain to the distributed client-server architecture. The mainframe did not completely go away as those organizations who had them tended to keep the mainframe as database server due to its low cost per transaction for large volumes of transactions.

In parallel with client-server a significant change in the 1990s was the advent of the enterprise resource planning (ERP) systems with a new key player that with time became the dominant player in the corporate applications world, breaking the until then hegemony of the Anglo-Saxon companies: SAP from Waldorf, Germany. Being the four founders of SAP ex-IBM engineers, the first versions of their ERP ran on mainframes, but they really took off with their first client-server version that they called R/3. There were competing providers such as Oracle (with its Financials), JDEdwards, and PeopleSoft. This wave responded to a significant change in philosophy and the name of the game now had two dimensions: (a) it was all about packaged solutions, that is solutions that did not need code developed from scratch for each corporation, but that would be standard with the possibility of configuring parameters for limited adaptation to each company; and (b) integration was dominant over best-of-breed solutions, that is that now it was more important to have integration across functional applications than to have the best individual and isolated application.

Integrated packaged solutions brought with them another significant change: the concept of 'leading practices' in business processes. While the bespoke systems of the mainframe era were modelled in line with the processes of each company, in the ERP era the company would adapt its processes to the leading practices in-built in the solution. The implications of this is that the implementation of an ERP system would lead to significant changes in processes that, in turn, radically changed people's jobs. Thus, change management became an important component of implementation projects, with a focus on stakeholder management and training of people in entire processes, not just their specific task in a large process as was the case before.

Another change that came with the ERP wave is how projects were organized. The configuration of a systems project team was no longer a team of highly technical analysts and programmers, but people who were versed in business processes. The bulk of the work was not in coding but in parameter configuration and change management activities. So, the project teams were integrated mainly by non-technical systems people. ERP projects were not referred to as systems or technology projects anymore, but as business transformation projects enabled by technology.

Ripples of ERP in 1991–1993 became waves in 1994–1998 and turned into tsunamis approaching 2000 and the generalized policy of implementing 'vanilla' ERPs to sort the Y2K problem (this term was coined by Gartner Group and refers to the fact that the early mainframe systems had only two-digits for the year in dates, so it was suspected that they would all fail with the advent of the new millennium). With the advent and establishment of ERPs, came the reduction in the size of the IT departments in corporations. In effect, what adopting and implementing ERP meant was that the development of new functionalities to adapt to changes in the legal and tax environment, or to the need for new functionalities, was outsourced to the ERP vendors.

Of course, ERP were not the panacea that appears at first sight. Significant amount of coding to ensure integration with legacy systems or vertical industry-specific applications were still necessary. Although 'big bang' projects were highly promoted, common sense and risk management led to many projects being piloted and phased in, which meant that temporary interfaces had to be developed. And although the ERP vendors did produce their solutions with specific flavours for different industries, this was still not enough and corporations demanded having some of their vertical functionality developed outside of the ERP. For example, SAP achieved a highly competent footprint in the consumer packaged goods (CPG) and in the utilities industries, but never managed to produce convincing solutions for the core-banking functionalities despite having invested heavily in its solution for that sector. In other words, coding and development effort for integration did not entirely go away.

After the ERP binge running up to Y2K came the hangover in the form of a relative slowdown in the ERP market, but that did not stop the corporate-systems business as a whole. At around the time that ERP slowed down e-commerce and client relationship management (CRM) solutions emerged with force. E-commerce was the hottest product but it was severely impacted by 9/11 and the implosion of dot.com, recovering afterwards but growing at a more moderate pace.

With the slowdown of the ERP market and of the global economy after 9/11, came a consolidation within the corporate ICT solutions industry. SAP expanded its functionality into CRM, e-commerce and business intelligence through internal developments but later broke this tradition by entering the acquisitions path. Oracle, on the other hand, acquired PeopleSoft, Siebel (the leading CRM provider), JDEdwards, and many others, with significant pains in converting all these independent applications into a coherent, seamless offering to its clients. Oracle also moved into the hardware space by acquiring SUN Microsystems and SAP moved into Oracle's traditional realm, the database layer, through acquisition, too. Oracle articulated the concept of 'stack', from hardware to enterprise application, through operating systems, databases, integration layers and others. Oracle publicized itself as being able to offer the whole stack or just some of the layers.

The strong narrative of ERP vendors in terms of the importance of integration started weakening with the advent of intelligent middleware communications platforms that made unnecessary the dreaded point-to-point, or one-to-one, interface development. The nightmarish spaghetti-style interfaces that haunted CIOs and kept them awake at night, could now be substituted by simpler to understand middleware layers into which applications could easily be plugged in. Another highly significant concept that was materializing and coming of age at the turn of the century was the API (application programming interface—term that was coined decades before by Cotton and Greatorex 1968), a set of subroutine definitions, communications protocols and tools for building software. As will be seen in Section "Discussion", APIs would play an important role in the FinTech world.

The prior paragraphs give an overview of how corporate ICT in general developed from the 1970s to the early 2000s. The effect on business transformation of the adoption of ICT was highly significant, but nowhere more than in banking. Banking is an information-intensive industry, by which it is meant that differentiation comes exclusively from their intellectual capital and information or, in other words, their people, processes, relationships, and technology (Clayton and Waldron 2003; Griffiths 2003, 2005; McKeen and Smith 1996; OECD 2003, pp. 65–66).[1]

Driven by this dependence on information, banks played very much of a leading role in adoption and development of ICT, and the trajectory they followed differed from the mainstream CPG, retail, industrial products, and utilities corporations. Banks were clearly ahead of the pack in the early phase of that period, that of the bespoke systems running on mainframe computers. They were so heavily vested in those technologies and had such high numbers of transactions compared to the other industries, that they could not make the business case for moving to client-server. This, together with the fact that banking processes and applications had become highly sophisticated and business critical at an extreme, disincentivized the ERP vendors to develop vertical solutions for banking in the early days of ERP. Eventually SAP did propose a banking-solution, but its adoption was disappointingly slow and hardly ever with an end-to-end footprint but limited to fragmented pieces of the business.

Essentially, the largest banks are trapped, to this day, in their legacy systems.

Indeed, banks have adopted standard packaged solutions in many parts of their business, particularly the highly technical middle office, but the back office remains on the legacy systems. That is not to say that there have not been any client-server solutions for banks, but the more successful ones have been developed by specialized companies and not the leading ERP vendors. For example, Citi co-developed a client-server core banking system with a company called i-Flex in India, to implement in its smaller operations around the world (it later divested from i-Flex and a few years later i-Flex was absorbed by Oracle). So, essentially, banks did not participate in the ERP part of the prior narrative.

Notwithstanding their attachment to the legacy mainframe systems, banks did make some memorable breakthroughs, of which the ATM is a notable example. The generalization of ATMs in the 1980s enabled banks to give 24 × 7 service and significantly lower their banking transaction costs. This led the self-service kiosk technology that is still in the process of being adopted by other corporations in most other industries and government.

The ATM was followed by the waves of phone banking, home banking, and Internet banking. They all had in common pushing their clients out of the branch office and lowering further the costs of banking transactions and brought with them the need for omni-channel, that is the need to show the same face to the client independently of what channel the client chose to interact with her bank. So, the big banks that had departed from mainstream in the ERP age, took leadership again in the CRM phase. With this came the transformation of the banking branch office, that until the 1990s was a mini-bank in its own right with all functionalities in the branch. From the turn of the century banks took all the back-office and middle-office functionalities (e.g., bookkeeping and accounting, credit scoring, loan origination) from the branch to the head office, and most of the transactional activity out of the branch to remote channels. The branch office became far smaller and focused on value-added client services.

This narrative brings us to the mid-2000s when a tipping-point with several fronts was reached in the ICT world as will be developed in later sections. As has briefly been outlined in this section, ICT in business and government went from a rarity in the 1970s to complete infiltration and dissemination in the early 2000s. What this story is telling us is that during this period of study the world, or at least what we generally refer to as the Western world, almost unperceptively migrated from an industrial economy of predominantly tangible assets, to a knowledge one where intangible ones overwhelmingly predominate over the tangible. This is a new era where the application of ICT radically changed, and where banks lost their grip on its development.

The importance that ICT took on in the business world in general, but especially so in such an information-intensive sector as is banking, makes the research question stated in Section "Introduction" of the utmost relevance both to the practitioner and to the academic world. The process through which this happened is described in the next section.

Advent of the Tipping Point: Why Did Banks Lose Control?

Overview

A thorough review of the literature on the emerging of the FinTech sector was carried out—the emphasis was put on academic papers from 2012 onwards, as it is thought that before then would be too close to the events for clarity and that it has been found by Zavolokina et al. (2016, p. 9, fig. 1) that article publication numbers started growing that year. Based on that search this section identifies three root-causes that, although unrelated to each other, happened to coincide in time and lead banks to have lost control over the ICT agenda in the financial sector. The narrative in Section "Twentieth Century: ICT Emerging and Evolution" brings us to the mid-2000s and it announces that around that time several major events happened in the banking, the ICT world and society in general that led to the emerging of a new industrial sector that we nowadays call FinTech as a contraction of financial technology. The Basel Committee on Banking Supervision (BCBS) defines FinTech quite broadly as *[t]echnologically enabled financial innovation that could result in new business models, applications, processes or products with an associated material effect on financial markets and institutions and the provision of financial services.* (Claessens et al. 2018; Palazzeschi 2018)

So for BCBS FinTech is a form of innovation, but a very broad one at that, as it includes business models, applications, processes, or products. Dorfleitner et al. (2017) while admitting that there is no universally accepted definition of FinTech, take a more cautious approach and refrain from proposing a definition based on that while accepting that most companies in the FinTech sector share certain features, there are always enough exceptions to render them inadequate for producing a general definition. They opt to give a summary description of the different service domains of FinTechs, that they group in four: (a) financing, (b) asset management, (c) payments (in which they include cryptocurrencies), and (d) other FinTechs. The latter includes a hotchpotch of things such as insurance; search engines and comparison sites; technology, IT and infrastructure; plus 'other FinTechs'. Both approaches have limitation: BCBS stay at a conceptual level, and Dorfleitner et al. (2017) are far too broad and encompassing, which unsurprisingly gives place to so many exceptions.

In this chapter we will overcome those problems and propose and adopt a definition. We will overcome the BCBS limitation by defining FinTech as a company/organization, and we will narrow the service offering domain. We will limit the services to banking services, that is services where the core competence is managing credit risk, market risk, or banking operational risk. So, by FinTech in this chapter we understand *not the technology itself, but a digital technology-enabled entrepreneurial initiative that offers services to clients that would traditionally be considered within the domain of banks; or that are an innovative service in the natural business domain of banks; or that help banks develop their back-office processes.*

So, returning to the research question—*Why did FinTech emerge as an industrial sector, independent of banking?*—and to focus the mind we will address it by responding to four subquestions:

- What caused banks to lose leadership in the development of corporate ICT systems?
- What enabled the FinTech sector to emerge with such vitality in a business dominated by behemoths?
- What encouraged entrepreneurs to move into the service domain traditionally served by banks?
- How is the FinTech industry organized and where does crowdfunding fit in?

Arner et al. (2017) divide the co-evolution of finance and technology into three stages, namely:

(a) The *analogous age* prior to the late twentieth century,
(b) the *digitalization era* that goes from the late twentieth century until 2008, and
(c) the *diverging era* with the advent of new financial providers based on advanced technologies.

As is mostly the case, there is not a single cause for the advent of the tipping point that moved the evolution of finance and technology into the *diverging era*. This research identifies three unrelated causes that happened in the 2007–2008 point in time; it is quite probable that none of these causes alone would have caused such a disruption, but their coincidence in time enabled them to feed into each other and cause havoc in the banking industry. The first is the global financial crisis known as the Great Recession that is generally accepted as having been caused by the banking system and its greed in the mortgage segment. The second is several nearly simultaneous major breakthroughs in the technology sector that led to a drastic drop in entry barriers to the banking services sector. And finally, significant social changes with the coming of age of the millennial generation and their growing role in the business world and in relationship to banking. The rest of this section will flesh out these three causes.

The Effect of the Great Recession

The 2007–2008 recession put banks in the US, the UK, and several countries on the European continent at the brink of collapse leading to systemic failure which, in turn, led banking authorities in those markets to bail them out with public funds. Subsequent investigation into the events detected that banks accelerated their growth by taking on excessive risk that they partially transferred to other organizations through financial engineering devises concocted by their investment banking arms. In conjunction with this, the population became extremely critical of banks and there was general distrust in these institutions. These three factors led national authorities to react, and in many cases over-react, with the result of far more stringent banking regulations that caused great regulatory challenges to the banks (European Central Bank 2016; Haddad and Hornuf 2019; Kotarba 2016). These more stringent regulations worked in two directions (see Fig. 11.1).

The first was in the sense of demanding banks to significantly increase their regulatory capital so that never again would they need to be rescued with public money. Because as a result of the crisis capital was costly to acquire by banks, they reacted by reducing the denominator of the capital adequacy ratio, that is by reducing their exposure to risk. They did this by pruning those clients of higher-risk profile, and by letting go the less

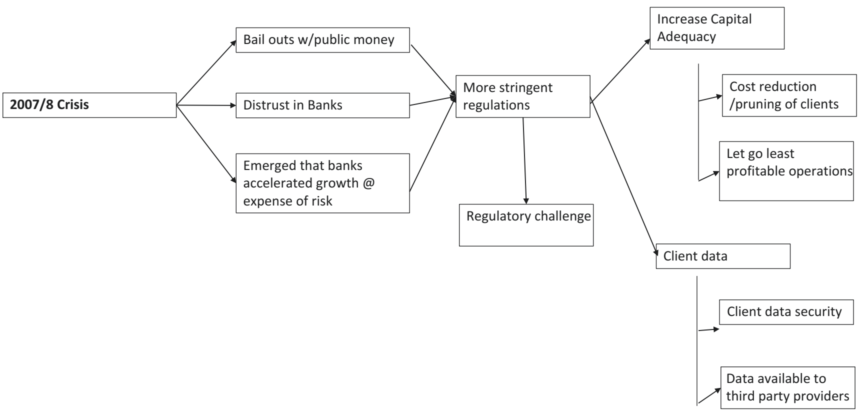

Fig. 11.1 The effect of the 2007–2008 crisis

profitable operations (e.g., certain products and geographic markets). The resulting reduction in scale in turn led them to embark on cost reduction initiatives (European Central Bank 2016; Kotarba 2016).

The other way in which more stringent regulations worked was related to client data. On the one hand the authorities put emphasis on client data security, and on the other hand bank regulators demanded that client data be made available to third-party providers in order to break the oligopoly of incumbent banks and increase competition in banking service (European Commission 2014, 2015; Tammas-Hastings 2017).

The Effect of Major Technological Breakthroughs

At the time the banks focused all their senses inside to cope with the regulatory changes that came because of the crisis, three key technology phenomena were happening. The first is incremental and refers to the continuing of Moore's law that translated into lower prices and thus giving more and more people access to devices (Lundstrom 2003; Waldrop 2016).

The second was the swift coming of age of Cloud computing with a change in mind-frame in the business community in the sense that moving from on-premise applications to cloud ones did not bring extra risks in terms of data security, and that adopting an on-demand model for technology appropriation had significant operational and balance sheet advantages (Ambrust et al. 2010; Rimal et al. 2009).

The third phenomenon was surely disruptive and is the advent of the first i-Phone and from there all the forms of smartphones that came after it. Moreover, the smartphone had the effect of enabling the development of social networks and, thus, the side effect of the advent of the data tsunami usually understated as Big Data (Barkhuus and Polichar 2011; Lee and Shin 2018; Smolan and Erwitt 2012).

These three phenomena had effect on what was to be the emerging FinTech sector, and on incumbent banks. The effects on these two groups initially developed quite independently of each other, but as will be seen opportunities for cross-fertilization emerged in later stages (EY 2018, p. 28; Gai et al. 2018; Lee and Shin 2018).

Looking at the FinTech sector first, it is found that the conjunction of the three technological phenomena had the effect of both lowering entry barriers for small new players to offer components of financial services and giving many more people access to devices and thus become potential clients for these new entrants to the financial services market offering. As opposed to entrepreneurial technology-based start-ups in other sectors, in general these new players in the FinTech sector did not have cash to burn at outrageous rates, so they developed two characteristics. On the one hand they are limited in the scope of their service, and on the other they take incremental opportunities in relatively mature markets that offer them quick cash-flow. These two characteristics translate into them focusing on niche but profitable parts of the incumbent banks' business, causing strong reaction from the banks who denounce them as avoiding regulations to take the icing of their cake (Lacasse et al. 2016).

The conjunction of taking the more profitable pieces of the banks' business and being able to serve many more people who were then possessing digital devices, converted into great opportunities for the emerging FinTechs. But their increasing visibility and the protests of the incumbent bankers led banking regulators to observe this new sector and extend at least part of the regulations to them.

From the perspective of incumbent banks, these three technological phenomena and their derivations (i.e., social networks and Big Data) had a significant impact on their own operations. Bank clients were demanding new channels such as mobile and generating massive data flows that offered significant potential if properly exploited. However, they also posed unsurmountable challenges in terms of cybersecurity, of data analytics issues and of data visualization complexities to incumbent banks that were constrained by their legacy systems as described above. This led the banks to start seeing FinTechs as potential enablers for their own processes in this new era of financial services (EY 2018; Gai et al. 2018).

Particularly on continental Europe where FinTechs were being funded more by banks than venture capital (Lee and Shin 2018), risk management challenges emerged quickly and were addressed by regulators which erected barriers for FinTechs to operate as independent client-facing service providers, but opened opportunities in the banks that were funding them. So, in general, the antagonistic atmosphere between incumbent

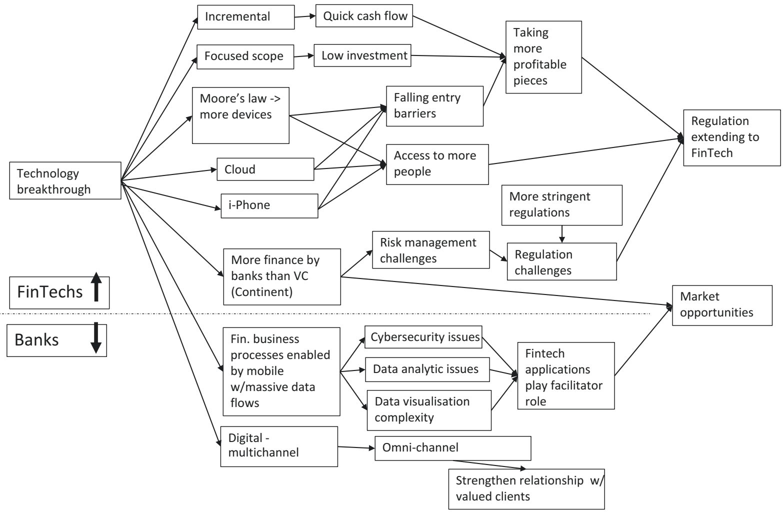

Fig. 11.2 The effect of major technological breakthroughs on FinTech and banks

banks and FinTechs that prevailed in the early post-2008 years gave way to a more collaborative spirit between both sectors. This effect of the technological breakthroughs is depicted graphically in Fig. 11.2.

The Effect of Social Changes

At the time of the financial crisis and the advent of the technological phenomena described above, the business world was going through major social transformations in terms of power as depicted by Naim (2013), of the changes in mindset that came with Generation Y taking a growing role in the workforce and of the advent of social entrepreneurs and entrepreneurship.

The Generation Y are avid adopters of mobile banking as long as it is easy to use and it poses no excessive risks in terms of data security. Both these conditions were hard to meet for incumbent bankers due to their legacy platforms, but straight forward for the FinTechs. On the other hand, due to the capital constraints mentioned above banks put effort into developing CRM processes and solutions that enabled them to strengthen their relationship with their 'valued' (i.e., the older more affluent) customers, and let go their less profitable and higher risk ones, as the Generation Y were seen to be. This opened a segment of great potential to the FinTechs (Boonsiritomachai and Pitchayadejanant 2017; Lee and Shin 2018).

In parallel with the above and especially in the Anglo-Saxon world, there emerged a new breed of what were to be called social entrepreneurs whose projects did not pursue a predominantly financial objective and thus were unfit to be assessed in terms of the banks' traditional credit scoring criteria. This new breed of entrepreneurs resort to alternative finance sources such as crowdfunding so became another market opportunity for FinTechs (Kotarba 2016).

On continental Europe it was found that while people do not trust banks much more than in the Anglo-Saxon world, they have less incentive to leave their banks and trust FinTechs even less than banks. So that becomes a barrier for FinTechs on the continent.

The effects of social changes are depicted and summarized in Fig. 11.3.

As a result of these three external forces (i.e., the Great Recession and subsequent regulatory changes, the technology breakthroughs, and the social changes) acting nearly simultaneously, banks lost control of the

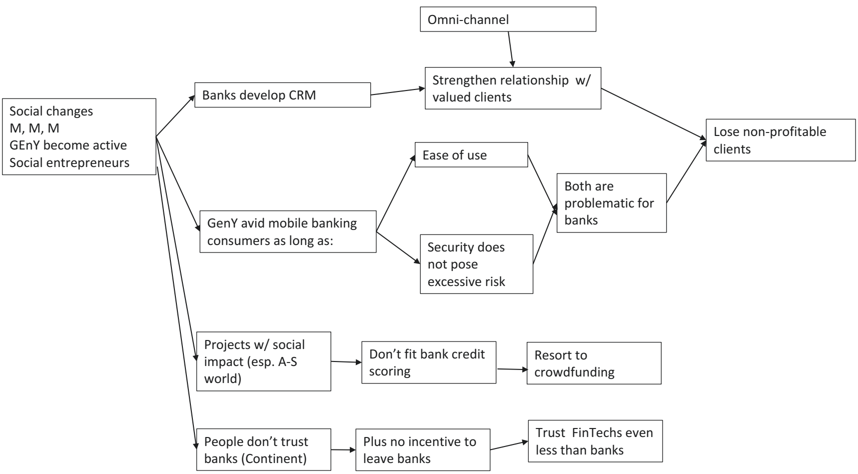

Fig. 11.3 Effects of social changes on banks and FinTech

evolution of ICT and left the door wide open for technology entrepreneurs to set up independently and eat away at the icing of their cake. The next section gives an overview of the industrial organization of this new sector.

A New Industrial Sector: The Emerging of FinTech

As mentioned above the FinTech sector is quite different from other technology-driven entrepreneurial or start-up sectors in the sense that it did not access massive funding and therefore its companies had to be focused in terms of service scope, and it did not produce great new markets but rather served extant markets that were until then poorly or underserved by banks. While, due to the latter, initially the relationship between traditional banks and FinTechs was notoriously antagonistic, with the passage of time banks realized that their constraints from legacy systems would obstruct them entering the digital era, so started to see FinTechs as possible collaborators to help overcome those barriers. This is particularly so in the data-oriented, security and privacy, and compliance spaces (Duan and Da 2012; Gai et al. 2018; Roumani et al. 2016).

Growth of the FinTech sector in terms of investment is literally exponential, going from $1.8 billion in 2010 to $19 billion in 2015 according to some sources (Citi 2016 cited by Leong et al. 2017) or from $1.5 billion in 2010 to $22 billion in 2015 according to others (Shuttlewood et al. 2016) and there are indications of steep growth in 2016 (Lee and Shin 2018). Within this context, seven banking-service areas emerge as the domains where FinTechs carry out their offering. These are: alternative finance, transactions, investment markets, banking back office, financial inclusion, cryptocurrencies, and business partner integration.

Alternative finance refers to services that supersede the traditional lending function of banks. They include personal finance, consumer finance, small and medium enterprise lending, and prominent in this category is *crowdfunding* in its four formats: reward-based, donation-based, equity-based and loan-based. Examples of reward-based crowdfunding companies include Kickstarter, Indiegogo, CrowdFunder, and RocketHub; of donation-based are GoFundMe, GiveForward, and FirstGiving; of equity-based crowdfunding companies are AngelList, Early Shares, and Crowdcube; finally, of loan-based crowdfunding companies are Funding Circle and Cumplo (Lee and Shin 2018; Shneor and Munim 2019 citing Ziegler et al. 2018).

Transactions refers to one of the most active areas of FinTech as are payments and remittances. These two areas were traditionally controlled by banks but are now giving way—in the case of payments by offering layers of service overlaying those of traditional banks and biting away at parts of the fees that banks charge in this space. In the case of remittances, it is about offering channels that circumvent bank services and fees altogether (Lee and Shin 2018).

Investment markets include services such as equity financing, retail investment, institutional investment, fund management and crowdfunding as an opportunity for investing (Lee and Shin 2018; Shneor and Munim 2019).

Banking back office is about FinTechs supplying banks agile services such as banking infrastructure, financial security services, identity verification, compliance, business tools, financial research, and energy efficiency in regard to achieving green finance. Prominent amongst these are RegTech, a flavour of FinTech aimed at helping banks comply with the demands of regulators and assist banking supervisors in keeping track of the banks under their watch (Gai et al. 2018; Puschmann 2017; Tammas-Hastings 2017).

Financial inclusion means reaching out to the unbanked and offering financial services at an extremely low cost and fill a gap that banks have never tackled, with well thought through and low-cost service offerings; micro-finance is prominent amongst this category (Lacasse et al. 2016).

Cryptocurrencies emerged as an initiative to circumvent banks altogether in the payments space but have not materialized as such; up to now they have served more as investment than payment instruments, and with doubtful outcomes at that. However, the distributed ledger technology that underlies them could be of application in many other areas such as trading and 'smart contracts' (Chen 2018; Hawlitschek et al. 2018).

Business partner integration is about FinTech offering services that bridge across the traditional offerings of banks and of other sectors with large business-to-consumer operations, such as telecommunications, retailers and airlines (Kumar et al. 2006; Rosingh et al. 2001; Schmitt and Gautam 2016).

To deliver these services FinTechs will apply one or multiple emerging technologies such as the DANCE acronym (Data, Algorithm, Networks, Cloud, Exponential) proposed by McAfee and Brynjolfsson (2017) and others including mobile, distributed ledgers, bioinformatics and behavioural biometrics, robots, all-in-one smartcards, and others.

It is helpful to understand the industry to present this in the form of a double entry table and map the FinTech companies onto the cells of this matrix (see Table 11.1).

The rest of the chapters in this book will develop the contents that will fit into the columns under alternative finance and investment markets of this framework. Those are the two service domains in the FinTech I/O framework where crowdfunding plays a key role. In the first case in its funding role, and in the second in its investment opportunities role. Just as an example of how this works, Table 11.2 reproduces the contents of one cell in this framework: The cell corresponding to Alternative Finance as a service domain, and data analytics and the exploiting of Big Data as a predominant enabling technology for those services.

It should be noted that in the Table 11.2 there are the four kinds of crowdfunding companies described above, but there are also other companies such as Touch Bank, which is a retail bank, or Retail Capital, which lends through partnership with banks, and do not conform to the crowdfunding principles but nevertheless are FinTechs in the alternative finance space.

With all this information in mind, the next section will extract some insights into how the FinTech sector emerged and evolved, and it will address the research question.

Discussion

Many interesting insights emerge from this analysis of the FinTech sector, of which four will be mentioned in this section. The first is that technological breakthroughs are all important but are only a necessary but not a sufficient condition for the advent of FinTech. Cultural-based influences

Table 11.1 The FinTech I/O framework

	Alternative Finance: Profitable Finance; Consumer banking; SME lending; Crowd-funding	*Transactions*: Payments; Remittances	*Investment Markets*: Equity financing; Retail investment Institutes. Investment; Crowd-funding	*Back Office*: Banking Infrastructure: Fin. Security; Business tools; Financial research; Regtech	*Financial Inclusion*: Reaching out: Fees and Profitability; Micro-finance	*Cryptocurrencies*: Payment or investment instrument? ICO.	*Business Partner integration*: Telcos, Retail, Airlines
Data: Exploiting ‘Big Data’							
Algorithms: AI and Cognitive Computing							
Networks: 5G, faster data accumulation							
Cloud: Lower entry barriers; local vs central computation							
Exponential improvement in digital h/w; Moore’s law effect							
Mobile							
Robotics							
Bioinformatics & behavioural biometrics							
Distributed Ledgers							
All-in-One smartcards							
VR, interactive & AR							

Table 11.2 Sample from the repository of FinTechs

Company's name	Country	Activity	Notes	Website
Lendingkart	India	Business loan for small business	Co-lending with banks	www.lendingkart.com
KredX	India	Business loan for small- and medium-sized businesses	Investors/applied for an Non-Banking Financial Company (NBFC) licence	www.kredx.com
Wefinance	USA	Lending to particular by funding from particulars		www.wefinance.com
Upstart	USA	Bring together high-potential borrowers and investors	Calculate credit score based on borrower's background	www.upstart.com
SoFi	USA	P2P lending for students		www.sofi.com
Rocket Mortgage	USA	Loans and mortgages	Focus on millennials	www.rocketmortgage.com
C2fo	UK	Short-term loans		C2fo.com
Zopa	UK	P2P lending	Founded in 2005, one of the first sites directly bringing together borrowers and savers, cutting out financial institutions from the lending process (NYT)	www.zopa.com
Touch bank	Russia	Retail banking	Online credits, loans, card, account management without paperwork, saving management	www.touchbank.com

(continued)

Table 11.2 (continued)

Company's name	Country	Activity	Notes	Website
Smart asset	USA	Advices throughout database (find best credit, loan solution among all propositions in the market	Tax, retirement, bank, account comparison tool	Smartasset.com
Simple finance	Russia	Micro lending	Asset-based loans, unsecure loans	www.ewdn.com

have also been essential and probably the most important was the Millennium generation taking their place in the labour and consumer markets. The incumbent bankers disregarded them to focus on more affluent baby-boomers, particularly in asset management services. What the banks did not anticipate is that Millennials are not individually affluent yet but that they are on the way to being the largest demographic group and as a group they hold over $1 trillion in wealth (Pitchbook).[2] This group is not interested in investing in active management funds and having costly financial advisors; they want passive management funds that can be monitored through their mobile phone. What is even of more impact is that the older generations learn to trust technologies that are embraced by the Millennials, so disregarding this generation exposes them to losing their senior relations.

A second insight is that according to some sources of the seven service categories of FinTechs, the most highly funded (Venture Scanner 2019) are lending to consumers and to businesses, (meaning small- and medium-sized enterprises, SMEs). Most of this is based on the peer-to-peer business model thus constructing links between borrowers and investors. Some of the FinTechs in this space are co-lending with banks and loan criteria vary across companies, but most want to avoid the classic credit scoring criterion in favour of seeking the highest potential borrowers and the most interesting personal projects. Based on keeping a low operating cost, these FinTechs can offer lower rates to borrowers and higher returns to lenders or investors. This insight is saying that crowdfunding is in a highly relevant position within FinTechs.

The third insight, as anticipated, is that banks have departed from their original antagonistic view of FinTechs to start finding potential in them as start-up venture opportunities and, more importantly, as resources for internal projects to make their operation more responsive, secure, compliant and efficient (EY 2018; Lee and Shin 2018). Typically, they look at FinTechs to help them reduce operational costs, provide more personalized services through data, and respond to customer behaviour changes. As a result of this, FinTechs have extended their role from retail customer facing to the back office or middle office of banks. Although it is mentioned above that alternative lending is the most funded domain, this can be contested based on the massive resources that are increasingly going into security and privacy initiatives (Gai et al. (2018), citing Gartner, says that the cybersecurity market reached $75 billion in 2015 and is projected to reach $170 billion by 2020; a significant share of this will go to financial services).

Finally, it has been said that in the UK, following the 2007–2008 financial crisis and the tarnished image with which established banks came out of it, the regulators proactively promoted FinTechs in the hope that challenger banks would emerge from them. And in effect this did happen as several challenger banks have emerged (e.g., Monzo, Metro) but their real impact on the market concentration has been marginal with the five big banks still firmly in control. What is even more disappointing is that some of these challenger banks have had to have their business models closely scrutinized by the banking supervisors under suspicion of adopting aggressive lending practices and even manipulating of balance sheets to avoid increased demand for fresh regulatory capital (FT 2019). It is hoped that the implementation of open banking supported by regulations such as Payment Services Directive 2 (PSD2) will enable FinTechs and the most agile and forward-looking mainstream banks to offer more API-enabled services and thus change the oligopolistic structure of the banking business. Traditional banks will not go away but they will most likely become a component of a more fragmented industry in the form of a network of hyperspecialists (Malone et al. 2011).

This evolution of the evolving relationship of banks and FinTechs is summarized in Fig. 11.4.

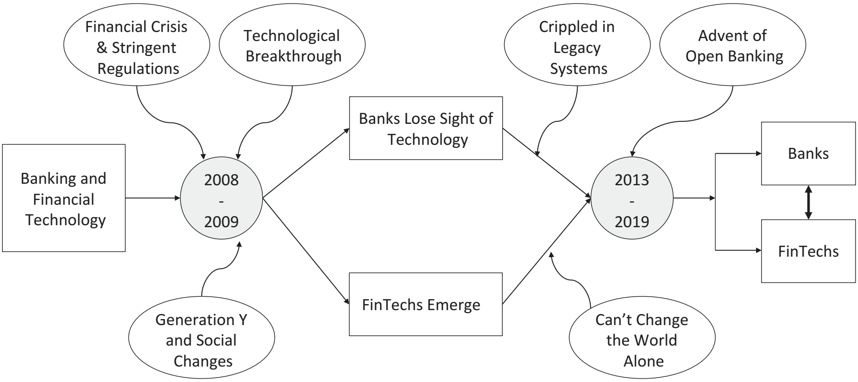

Fig. 11.4 Evolution of the relationship between banks and FinTechs

So, returning to the research question, *Why did FinTechs emerge as an industrial sector, independent of banking?* A combination of factors happening nearly simultaneously led banks to get distracted from the transformations that were happening around them. Just as the banks were looking inside their own organization to deal with the severe regulatory changes being imposed upon them as a result of the Great Recession, bankers did not perceive the importance that new technologies such as the smartphone were having, nor did they understand the cultural changes that were starting to happen with the coming of age of Gen-Y.

The effect of the smartphone and thus accessibility to devices of a mass market of relatively low income individuals, combined with the lowering of barriers to entry into the banking business of agile entrepreneurs that came with the maturing of cloud computing, enabled FinTech companies to roar into activity.

What encouraged entrepreneurs to move into the multiple banking services domains was the fact that they could detect a great number of underserved banking customers, with a young mindset, to whom they could approach with a narrow service offering driven by technology. That the offering was narrow meant that investment in developing application was relatively low; and the fact that the market was already there meant that cash flow would start coming in quickly. The combination of these two factors meant that the amount of working capital required was relatively low.

The fact that the FinTech companies developed relatively focused service offerings within a far reaching service industry as is banking, and that their services are enabled by a large spectrum of technologies that either emerged or matured in the second half of the last decade when this sector was emerging, has led the FinTech sector to encompass a large number of companies with quite different configurations. The framework presented in Table 11.1 as a double-entry table, with seven service-offering domains in one dimension, and over ten technology categories in the other, helps to understand how the sector is organized and where each company plays.

Conclusions

In summary this research has found that, distracted by the 2007–2008 crisis and its immediate regulatory changes, the banking industry lost sight of the technological breakthroughs and social changes that were happening around it. As a result, after decades of having been a driver and leader for technological change, the industry left windows wide open for nimble companies based on ground-breaking technologies to emerge and 'eat its lunch'.

It is extraordinary that in such a closely regulated industry as banking, these FinTech entrepreneurs could have found gaps in regulations to eat away at some of the most profitable icing on the banking industry's cake. It is also extraordinary that in such a short period of time FinTechs could open into so many different business domains, enabled by the emerging of such an unprecedented number of different game-changing technologies.

The FinTechs managed this feat with little capital in comparison with the deep pockets of the institutions they were outpacing. They achieved this precisely by focusing on niches where the market was already there and waiting for a solution. So, in a way, it was more a pull by social changes than a push by the FinTechs (this is quite different from other areas of technology-based entrepreneurship where the pioneers created a market). However, FinTechs should not become complacent as regulation is creeping in. Approximately one-third of the FinTech business in the Eurozone is not regulated, but going forward, FinTechs should count on the fact that banking regulations will move further into their space.

Crowdfunding and other forms of alternative finance occupy a position of relevance within the FinTech sector and together have the greatest fraction of investment as compared to the other six business domains included in the FinTech industrial organization framework. Clearly banks have great difficulty in financing the SME segment, where its traditional credit scoring techniques are not appropriate. There is, thus, a promising opportunity for crowdfunding to grow in this space.

Banks have found it hard to keep up as selecting a new technology that will drive its processes is no minor decision for a bank and in times when so many technologies are emerging, it is hard to predict which will be the winning ones. This is not a level field: Clearly banks as incumbents have far more to lose than FinTechs so the question we need to ask ourselves is this: Do extant strategy-technology alignment models apply to banks in times of so much disruption? Banks need to address this issue.

This review of the FinTech sector as a framework to give context to the theme of crowdfunding that is the focus of the rest of this book, is necessarily generic and bridges across the different markets. But clearly the process of emerging of the FinTech sector and the evolution of its relationship to banks, as synthesized in the process described in Fig. 11.4, will change from market to market. As a result of the stage of economic development, the regulatory environment, the quality of the technological infrastructure, the different attitudes towards the financial sector, and many others, the FinTech sector has evolved differently in each market. There is scope to do comparative analyses of this evolution between markets and thus arrive at a more granular knowledge on its evolution.

Finally, another question for future research is why, despite the advent of the FinTech sector with all its diverse set of players, has the market structure in terms of market control by a small number of traditional players, remained essentially unchanged. Will open banking be the answer to this problem?

Notes

1. OECD (2003, pp. 65–66) finds that financial intermediation organizations '*are intensive users of information and thus have the greatest scope to benefit from ICT*'.
2. https://pitchbook.com/news/articles/blend-becomes-latest-fintech-startup-to-bank-a-mega-round-in-2019

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Part III

Crowdfunding Around the World

12

The Concept of Crowdfunding in China

Liang Zhao and Yuanqing Li

Introduction

Crowdfunding is the practice of funding a project or venture by raising small amounts of money from the public via the Internet. Since the establishment of the first crowdfunding platform ("Demohour") in China in 2011, crowdfunding has gained substantial popularity in the country. However, the growth of crowdfunding in China is still at early stage compared to other markets and overall market potential.

The development of crowdfunding in China can be divided into three stages. First, a "Rudimentary stage" (2011–2013), when the number of platforms and the scale of fundraising was small, and the number of

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crowdfunding platforms grew slowly. Second, a "Hyper-growth stage" (2014–2015), when the number of platforms and the scale of fundraising began to increase rapidly, and when the scale of transactions expanded rapidly. And, most recently, a third "Cautious development stage" (2016–present), where due to the stricter supervision of alternative finance, the number of platforms has decreased and so did the volumes of funds raised. Most of the crowdfunding platforms were waiting for the official regulatory policy before restarting/expanding their business. Accordingly, the growth rate of the crowdfunding industry has been slowed down.

Based on past developments, the Chinese crowdfunding market has carried out some favourable explorations in crowdfunding practice. Specifically, crowdfunding project initiators have found out the power of social network interaction in boosting crowdfunding success. Some integrated crowdfunding platforms have been transferred into vertical platforms in order to strengthen competitive advantages. For example, some comprehensive crowdfunding platforms have transformed into specialized crowdfunding platforms. And, furthermore, Chinese crowdfunding practitioners have started to explore ways to educate the public and potential investors.

In term of market size and market balance, despite being the largest in the world (Ziegler et al. 2019), the Chinese crowdfunding industry exhibits its slower growth rates. The slower growth rate is mainly subject to the following problems: Firstly, the policy and legal environment of crowdfunding in China are still immature and under development, and there are still some frictions between the crowdfunding innovation and profit models and the current laws and regulations (e.g. Lin 2017; You 2017). Secondly, the Chinese-style crowdfunding credit system lacks a degree of credibility. Thirdly, intellectual property in crowdfunding projects is insufficiently protected. Lastly, Chinese society in general has limited understanding of crowdfunding and there are many misunderstandings about its use and associated risks and benefits. Accordingly, if the above problems can be solved, the Chinese crowdfunding industry is expected to achieve and regain rapid development in a standardized, regulated, and healthy way.

The purpose of the current chapter is thus to review the landscape of the crowdfunding industry in China, with a focus on providing meaningful insights from this unique and important market. We first provide extensive descriptions of different crowdfunding models in China. Based on that, we then generate context insights in different models respectively. Next, the current regulations of different crowdfunding models in China is presented and discussed. Then, through an extensive literature review, main crowdfunding research related to the Chinese market are exhibited and summarized. Finally, this chapter highlights the implications for practice and research, as well as mentioning potential future research directions.

Volumes by Models and Context Insights

As crowdfunding has different operating models, it is necessary to take all the main crowdfunding models into consideration in order to properly capture the comprehensive crowdfunding landscape in China. In this section, we report data and analysis for the four main crowdfunding models (reward-based, equity-based, loan-based, and donation-based) in China and then provide special insights of each model respectively.

Reward-Based Crowdfunding

Reward-based crowdfunding is identified as individuals contributing comparatively small amounts of money to crowdfunding projects in return for different kinds of non-monetary reward (e.g. physical products, services), while accepting a certain degree of risk of non-delivery on campaign promises (Shneor and Munim 2019). Reward-based crowdfunding is the best-known crowdfunding model in China.

According to the China Crowdfunding Industry Development Research (Yuan and Chen 2018), there were 90 operating reward-based crowdfunding platforms in mainland China. Geographically, these reward-based crowdfunding platforms are operating in 20 provincial-level administrative regions across the country. Most of the platforms are established in the coastal areas which have better financial conditions and entrepreneurial culture. Compared to the coastal areas, only a few platforms are established in the northeast, northwest, and southwest of

China. Specifically, there are 26 reward-based crowdfunding platforms in Beijing followed by Guangdong (12), Zhejiang (11), Jiangsu (7), Shandong (7), and Shanghai (6). The platforms in the coastal area capture 77% of all reward-based crowdfunding platforms in mainland China.

In 2017, 18,209 reward-based crowdfunding projects were successfully online. Among the online projects, 13,927 projects got successfully funded by the end of their fundraising periods. The success rate is 76.48%. The sum of the fundraising targets of all successful projects is RMB 2.09 billion (approx. USD 0.3 billion). Eventually, the successful projects have raised RMB 9.743 billion (approx. USD 1.38 billion) in total, which is approximately 4.5 times higher than the expected funding amount. The total backer number of successful projects is approximately 23 million (Yuan and Chen 2018).

Among the successful projects, 4144 projects got funded in the range of RMB 50,000–100,000 (approx. USD 7106–14,211) followed by RMB 10,000–50,000 (approx. USD 1421–7106) (3967 projects), RMB 1000–10,000 (approx. USD 142–1421) (2600 projects) and less than RMB 1000 (approx. USD 142) (647 projects). The projects within the top four fundraising ranges are 11,358 which account for 81.57% of all the successful projects. There were only 208 projects that were successfully funded with an amount of more than RMB 1 million (approx. USD 0.14 million).

Reward-based crowdfunding projects in mainland China can be classified into seven main categories: technology, film, and television, agriculture, tourism, music, publishing and games. Technology, agriculture, and music are the top three categories for reward-based crowdfunding in China by number of campaigns. Technology ranked first with 3558 online projects, followed by agriculture with 3351 online projects, and music ranked third with 806 online projects. Projects from the top three categories account for 42% of the total number of online projects.

Insights on Reward-Based Crowdfunding

As the best-known crowdfunding model, reward-based crowdfunding in China has some unique characteristics. First, Chinese reward-based crowdfunding supporters are more "realistic" compared with the supporter in other mature crowdfunding markets (e.g. the U.S. crowdfunding market). Most of the Chinese backers invest their money in the projects in order to buy future products. Besides that, they tend to be less interested in participating in co-creation processes (Yuan and Chen 2018). In this sense, they behave more like consumers than like supporters. Accordingly, reward-based crowdfunding can be considered as equal to pure product pre-selling in China.

In addition, reward-based crowdfunding has been used as an online marketing/market testing channel by Chinese e-commerce giants (e.g. Alibaba, JD). These corporations' participation in crowdfunding is not for fundraising but for launching their own products, increasing product awareness, and finding potential consumers.

Lastly, different from other reward-based crowdfunding markets, no commission fees are charged by most Chinese reward-based crowdfunding platforms. Instead, platforms get their income and profits from online marketing and advertising services.

Equity-Based Crowdfunding

In terms of equity-based crowdfunding, individuals invest money in purchasing offerings of private company securities with an expectation of receiving monetary rewards in the future. Equity-based crowdfunding is a game of capital markets. Therefore, it is subjected to financial regulations (Ahlers et al. 2015).

By the end of 2017, there were 89 equity-based crowdfunding platforms operating in mainland China. Geographically, among the 34 provincial-level administrative regions, equity-based crowdfunding platforms only cover 13 regions. Like the distribution of reward-based crowdfunding, most equity-based platforms are located in economically developed areas, while few platforms are established in the northeast, northwest, and southwest part of China. Specifically, 29 equity-based crowdfunding platforms are based in Beijing followed by Guangdong (24), Shanghai (15), Zhejiang (8), and Sichuan (4). The platforms in the above area capture 90% of all equity-based crowdfunding platforms in mainland China.

According to the China Crowdfunding Industry Development Research (Yuan and Chen 2018), 1053 equity-based crowdfunding projects were successfully online in 2017. Among the online projects, 745 projects got successfully funded by the end of their fundraising periods. The success rate is 70.75%. The successful projects have raised RMB 3.361 billion (approx. USD 0.48 billion) in total. In terms of categories, equity-based crowdfunding projects in mainland China can be classified into eight main categories: technology, physical stores, film and television, agriculture, tourism, music, publishing, and games. Projects from the eight main categories account for 77% of the total number of online projects. Among the eight categories, physical store, technology, and film and television are the top three categories by the number of projects. The physical store ranked top with 562 online projects, followed by technology with 137 online projects and film and television ranked third with 85 online projects.

In 2017, the total number of successful projects' backers was 41,900. Most of the successful projects are with a small number of investors. Specifically, 63% of all the successful projects had less than 60 investors. 93% of all the successful projects had less than 160 investors. Relatively few projects had many investors. Here, only 44 projects had more than 160 investors, which account for 7% of all the successful projects. In terms of total fundraising amount, 42% of all the successful projects had a total fundraising amount of less than RMB 1 million (approx. USD 0.14 million); 91% of all the successful projects had a total fundraising amount of less than RMB 10 million (approx. USD 1.4 million), while only 69 projects have successfully raised more than RMB 10 million (approx. USD 1.4 million) through equity crowdfunding, which account for 9% of all successful projects.

Insights on Equity-Based Crowdfunding

Equity-based crowdfunding has not yet been legalized in China. Equity-based crowdfunding in China refers to "Internet non-public equity financing". As public offering in China is under extremely strong supervision by the government, equity-based crowdfunding in China can only be executed in the form of private offering (Hu and Yang 2014). As a private offering, "equity-based crowdfunding" in China is strictly controlled and supervised by the China Securities Regulatory Commission (CSRC), China Banking Regulatory Commission (CBRC), China Insurance Regulatory Commission (CIRC), and the People's Bank of China (Huang et.al. 2018).

The development of equity-based crowdfunding in China suffers from perceived uncertainty, void of legalization, and strict investor threshold. Therefore, in terms of investor numbers, equity-based crowdfunding is the least popular crowdfunding model when compared to the other models (reward-based, loan-based, and donation-based).

Loan-Based Crowdfunding

Loan-based crowdfunding is also known as online Peer to Peer (P2P) lending. P2P lending is the practice of lending money to individuals or businesses through online platforms while matching lenders with borrowers, which is repaid with interest added (Mamonov and Malaga 2018). For lenders, loan-based crowdfunding platforms usually offer better interest rates than standard commercial banks.

According to an annual P2P lending report (WDZJ 2018), by the end of 2017, there were 1931 P2P lending platforms operating in mainland China. Geographically, 410 P2P lending platforms were based in Guangdong followed by Beijing (376), Shanghai (261), and Zhejiang (233). The P2P lending platforms in the top four areas capture 66% of all P2P platforms in mainland China. The total volume of transactions of P2P lending in mainland China has reached RMB 2805 billion (approx. USD 400.33 billion) in 2017 with an overall profit ratio of 9.45%. The number of investors and borrowers in the P2P industry in 2017 were approximately 17 million and 23 million respectively. The average lending period was 9.16 months in 2017.

The loan balance (e.g. remaining amount to be paid) of P2P loans is also increasing. By the end of 2017, the overall loan balance of the P2P lending industry in mainland China has reached RMB 1225 billion (approx. USD 160.56 billion). Geographically, Beijing, Shanghai, and Guangdong ranked the top three regions in terms of loan balance with the total volume of RMB 439 billion (approx. USD 62.39 billion), RMB 325 billion (approx. USD 46.19 billion), and RMB 227 billion (approx. USD 32.26 billion) respectively. The top three regions accounted for 81% of the total loan balance volume in 2017. Zhejiang, Jiangsu, and Sichuan ranked third to sixth with the loan balances of RMB 106 billion (approx. USD 15.06 billion), RMB 38 billion (approx. USD 5.4 billion), and RMB 13 billion (approx. USD 1.85 billion) respectively (WDZJ 2018).

In China, loan-based crowdfunding is the only model which has institutional participation. Institutional investors engage and collaborate with P2P lending platforms. By the end of 2017, 212 P2P lending platforms received investment from state-owned companies. 153 P2P lending platforms received investments from venture capital. 126 P2P platforms received investment from publicly listed companies and 15 P2P lending platforms received funds from banks (WDZJ 2018).

Insights on Loan-Based Crowdfunding

Loan-based crowdfunding (online P2P lending) in China has its unique characteristics. First, providing supply chain financial service through loan-based crowdfunding has been a new trend in the loan-based crowdfunding market of China. The Supply chain financial service connects various parties (buyer, seller, and financing institution) in a transaction organically to lower financing costs and improve business efficiency. There were 118 online P2P lending platforms providing supply chain financial services in 2017 (WDZJ 2018).

Second, mergers and acquisitions among platforms are popular in the loan-based crowdfunding market of China. It makes the market more and more concentrated. For large platforms, the concentration process can further consolidate the platforms' business capabilities and increase their competitiveness. For small and medium-sized platforms, the market concentration strategy gives them a way to survive under conditions of fierce competition.

Last, to expand influence, some Chinese P2P lending platforms (e.g. China Rapid Finance, Hexindai, PPdai) choose to get on overseas listings in the U.S. Some mature Chinese P2P lending platforms (e.g. Dianrong, Lufax) have opened overseas branches to offer P2P lending services in southeast Asia to increase scale and profits.

Donation-Based Crowdfunding

Donation-based crowdfunding is usually used for funding social causes, NGOs, and charity projects. Through donation-based crowdfunding, individuals donate money to support social causes, charitable projects, or persons with no expectation of receiving tangible rewards in return, while enjoying intangible benefits such as the feeling of self-fulfilment and mental satisfaction.

Specifically, there were 12 donation-based crowdfunding platforms operating in mainland China by the end of 2017 and 9513 donation-based projects were successfully launched on these platforms. Different from other crowdfunding models, donation-based crowdfunding in China follows the "keep it all" principle. This means that there will be no unsuccessful projects (unless no funds are raised at all). Here, fundraisers set funding goals and keep the entire amount raised regardless of whether they meet their goals or not (Tomczak and Brem 2013). In 2017, total fundraising target was expected to be about RMB 1.90 billion (approx. USD 0.27 billion) and the actual total fundraising amount was about RMB 401 million (approx. USD 56.99 million). Among all related projects, 6467 have raised less than RMB 10,000 (approx. USD 1421) and 1711 projects have raised amounts in the range of RMB 10,000–50,000 (approx. USD 1421–7105). In other words, 86% of all the donation-based projects (8178) have raised less than RMB 50,000 (approx. USD 7105) and only 1335 projects got funded with more than RMB 50,000 (approx. USD 7105) (Yuan and Chen 2018).

In 2017, the total backer number of all the projects was 15.98 million. Specifically, 3839 projects had between 100 and 500 supporters, 1689 projects had between 50 and 100 supporters, and 1538 projects had less than 50 supporters. Overall 74% of all the donation-based projects (7066) had less than 500 supporters (Yuan and Chen 2018).

Insights on Donation-Based Crowdfunding

Donation-based crowdfunding industry in China is still in its initial stage of development. Specifically, in terms of platform numbers, there were only 12 donation-based crowdfunding platforms in mainland China, which is substantially a lower number of platforms when compared with the total number of platforms operating in all crowdfunding models. In 2017, the total fundraising amount of donation-based crowdfunding in China was RMB 401 million (approx. USD 56.99 million). This sum was far from enough to mitigate the huge supply gap of public welfare (Yuan and Chen 2018).

In addition, donation-based crowdfunding platforms in China are not charitable organizations but private-owned companies. Therefore, they need to pay their own daily expenses by charging commission fees or advertising fees. Because of the charity nature of donation-based crowdfunding, whether charging fees can be applied as the revenue source of donation-based crowdfunding in China is questionable.

Lastly, donation-based crowdfunding in China is usually used to solve individual cases/help individuals rather than to organizational initiatives. This means that offering help to needed groups through donation-based crowdfunding is still under exploration and development in China.

Regardless of crowdfunding model operated, as elsewhere, platforms are subjected to differing regulatory requirements. In the following section we explore the current state of crowdfunding regulation in China.

Current Regulation

Because of the lack of specific regulations for supervising crowdfunding, the Chinese crowdfunding market has grown rapidly since its emergence in 2011. However, perceived substantial risks challenge all crowdfunding participants (investors, project initiators, and crowdfunding platforms) in China (Zhu and Hu 2019). To promote a more secure environment for developing the crowdfunding industry, the Chinese crowdfunding market supervision is based on two core principles: separate supervision and information disclosure.

In term of separate supervision, the equity-based crowdfunding is mainly regulated by the China Securities Regulation Commission (CSRC). The loan-based crowdfunding must be carried out under the supervision of the China Banking and Insurance Regulatory Commission (CBRC) and the People's Bank of China. In opposite, the donation-based crowdfunding and the reward-based crowdfunding are not included in the financial supervision system because they are not providing financial products and services. In addition, the Ministry of Industry and Information Technology (MIIT), the National Development and Reform Commission (NDRC), and other related ministries and commissions are required to participate in the supervision of cybersecurity and credit information system (Yuan and Chen 2018).

The crowdfunding platform is the main body for crowdfunding practices. The supervision of crowdfunding platforms is based on information disclosure. Since the crowdfunding platform is an intermediary between investors and project initiators it is required to establish a systematic and institutionalized information disclosure system in order to mitigate information asymmetry between these parties. Based on the two core principles, the central government of China has issued a series of policy announcements to regulate the operations of different crowdfunding models.

Reward-Based Crowdfunding Regulation in China

Reward-based crowdfunding is considered as product pre-selling in China. Under this viewpoint, the supporters of reward-based crowdfunding are the "consumers" and the project developers of reward-based crowdfunding are the "sellers". The reward-based crowdfunding platform acts like an online trading intermediary. The regulation of reward-based crowdfunding should be the same as the ones used to supervise online

B2C marketplaces. In general, it is subject to the supervision of the "State Administration for Industry and Commerce of the People's Republic of China". The "Law of the People's Republic of China on the Protection of Consumer Rights and Interests" and the "Administrative Measures for Online Trading" are applied to the regulating process of reward-based crowdfunding.

Specifically, as "consumers", the rights of reward-based crowdfunding supporters are under the protection of the "Law of the People's Republic of China on the Protection of Consumer Rights and Interests" and the "Administrative Measures for Online Trading". As "sellers", project developers should take related legal obligations. As "online trading intermediaries", crowdfunding platforms should take legal responsibilities related to the infringement of consumer rights caused by the products or services provided on the platforms. In addition, the "State Administration for Industry and Commerce of the People's Republic of China" may impose administrative penalties in cases of misconduct by platforms.

However, reward-based crowdfunding cannot be equally treated as general online consumption according to the concept at its core, as backers also accept a certain degree of risk of non-delivery on campaign promises (Shneor and Munim 2019). This leads some to suggest that it should be regarded as investing behaviour rather than pure consumption. Therefore, supervision may also be different. The backers of crowdfunding projects should have self-awareness of the risks and share the risks with project developers in order to achieve their mutual ambitions in a relatively high information asymmetry environment. If crowdfunding participants' rights and interests are infringed, they should be able to take legal action to defend their rights. Therefore, reward-based crowdfunding platforms should only serve as information intermediaries and not as credit intermediaries, and under such conditions they will also not assume any responsibility.

To sum up, based on different understandings of reward-based crowdfunding, there is still controversy on how to protect the rights and interests of reward-based crowdfunding participants in China.

Equity-Based Crowdfunding Regulation in China

Among the four models of crowdfunding, the regulation of equity crowdfunding is the most complicated. Due to current legislation void, genuine equity crowdfunding has not been officially accepted and carried out in China. The Chinese government has announced a series of legal provisions to manage the equity crowdfunding market in a quasi-regulated manner. The legislation remains unfinished and the ongoing legislation progress is as follows:

- On December 18, 2014, the Securities Association of China (SAC) issued the "Private Equity Crowdfunding Administrative Measures (Trial Version)". This is the first officially issued equity crowdfunding regulation. However, this trial version has no legal effect.
- On July 18, 2015, the People's Bank of China and other nine ministries issued the "Guiding Opinions on Promoting the Healthy Development of Internet Finance (Guiding Opinion)". In this "Guiding Opinion", equity crowdfunding is officially defined as the activities of public small-amount equity financing through the Internet. Publicity and small amount are two basic principles of equity crowdfunding. The equity crowdfunding platform is an information intermediary rather than a credit intermediary and equity crowdfunding is officially supervised by China Securities Regulation Commission (CSRC).
- On August 7, 2015, the CSRC issued the "Notice of the General Office of the China Securities Regulatory Commission on Conducting Special Inspections of Institutions Engaging in Equity Financing via the Internet". According to this notice, no organization or individual may carry out equity crowdfunding activities in China without the approval of the CSRC. In addition, it is stipulated that "equity crowdfunding" refers specifically to "public equity crowdfunding", while the existing "private equity crowdfunding" will be replaced by "private equity financing", and the maximum number of investors that can participate in an equity crowdfunding project is 200.

- On August 10, 2015, the SAC issued the "Measures for the Administration of Over-the-Counter Securities Business Recordation". In accordance with the measures, equity crowdfunding in China has been officially divided into two categories: "public offering (equity crowdfunding)" and "private offering (online non-public equity financing)".
- On August 17, 2016, the CSRC issued the "Interim Measures for the Administration of the Business Activities of Online Lending Information Intermediary Institutions". It is stipulated that the P2P platforms cannot be engaged in equity crowdfunding business.
- On April 14, 2016, the CSRC issued the "Implementation Plan for Special Rectification on Risks in Equity Crowdfunding" in order to get prepared to rectify the existing problems in Chinese equity crowdfunding market.
- On December 1, 2018, Li Zhibin, director of the SFC's Office for Combating Illegal Securities Futures, revealed that the CSRC is currently developing and improving the "Measures for the Pilot Administration of Equity Crowdfunding" at the third China New Financial Summit Forum.

Loan-Based Crowdfunding Regulation in China

China has the world's largest P2P lending market. However, this immature market is still suffering from some inherent risks such as the lack of credit and risk controls, the lack of industry standards, and regulation challenges.

At the national regulatory level, China Banking Regulatory Commission (CBRC), and other related departments have officially established a "1 + 3 supervision system" to monitor, manage, and mitigate inherent risks in Chinese P2P market (Huang 2018). Specifically, the "1 + 3 supervision system" refers to "one method plus three guidelines" which is mainly composed of the following regulatory documents:

- "Interim Measures for the Administration of Online Lending Intermediary Institutions' Business Activities" (Issued by the CBRC on 17 August 2016)
- "Guideline on the Administration of Recordation and Registration of Online Lending Intermediary Institutions" (Issued by the CBRC, Ministry of Industry and Information Technology and State Administration of Industry and Commerce on 28 November 2016)
- "Guideline on the Custodian Business for Online Lending Funds" (Issued by the CBRC on 22 February 2017)
- "Guideline on Information Disclosure of Online Lending Intermediary Institutions' Business Activities" (Issued by the CBRC on 24 August 2017)

Besides, the National Internet Finance Association (NIFA) has also issued several rules and standards on the information disclosures and self-regulation of Chinese P2P market in 2016.

At the local regulatory level, being supplements, some developed regions (e.g. Beijing, Shanghai) have begun to develop self-regulatory frameworks and associations by taking regional variations into consideration. Self-regulation is effective in reducing the regulatory burden and cost, eliminating the information asymmetry between the market and the regulatory authority and improving market standardization.

Donation-Based Crowdfunding Regulation in China

In China, public fundraising for charitable purposes is mainly related to the "Charity Law of the People's Republic of China". According to this law, there are clear regulations on charitable organizations using the Internet and other platforms to conduct public fundraising. Organizations or individuals that do not have the qualification for public fundraising may not use public fundraising.

Most donation-based crowdfunding projects in China are created by individuals who are facing difficulties. These troubled individuals use crowdfunding as the channel to seek help from the greater society. Fundraising activities for certain troubled individuals are guided by self-interest. Therefore, donation-based crowdfunding in China is not charitable fundraising but social assistance and may not apply to the "Charity Law of the People's Republic of China".

On July 20, 2017, the Ministry of Civil Affairs announced the "Basic Specifications for the Internet-based Public Fundraising Platform for Charity Organizations" and the "Basic Management Regulations for the Internet-based Public Fundraising Platform for Charity Organizations" to manage donation-based crowdfunding market. Donation-based crowdfunding is officially distinguished from charity fundraising.

According to the specifications and regulations, project developers should take full responsibilities of the authenticity of the provided information. Donation-based crowdfunding platform should strengthen project information review and disclosure, inform potential donors on the potential risks of the projects, and clarify the traceability of responsibility. In addition, donation-based crowdfunding platforms should disclose platform operation information to the public at least every six months.

Review of Key Research Done in China

Though the first Chinese crowdfunding platform "Demohour" went online in 2011, most Chinese crowdfunding platforms were launched after 2014 (Yuan and Chen 2018). Since then, the crowdfunding concept has been recognized in China in both research and practice with researchers starting to investigate this phenomenon within the Chinese market. In order to summarize the findings of such research, we conducted a literature review. Generally, we found out that the crowdfunding research focused on the Chinese market is still limited in scope compared to the ones based on Western market data. Specifically, our main findings are summarized as follows:

First, most of the existing Chinese crowdfunding studies are focused on investigating the success factors of crowdfunding. These mostly rely on the signalling theory and Elaboration Likelihood Model (e.g. Zheng et al. 2016; Bi et al. 2017), which were frequently adopted as the main theoretical foundations. Based on the data collected from the key players of Chinese crowdfunding market (e.g. JD Crowdfunding; Demohour;

Zhongchou), Chinese crowdfunding literature reveals that social capital (Shahab et al. 2019; Kang et al. 2017; Chen et al. 2018), trust and commitment (Zheng et al. 2016; Zhao et al. 2017; Liang et al. 2019), campaign characteristics (Du and Wang 2016; Du et al. 2019; Zhao and Vinig 2017), campaign quality (Xu et al. 2016; Yuan et al. 2016; Shahab et al. 2019; Chen et al. 2018; Zhang et al. 2017; Bi et al. 2017), as well as backer and initiator interaction (Wang et al. 2018; Xie et al. 2019) are positively associated with crowdfunding success in China.

Second, many studies explore the current status of crowdfunding in China compared to the one in other countries. In general, the degree of development of crowdfunding markets in developed countries is higher than that of developing countries (Rau 2018). However, as an emerging market, the volume of the Chinese crowdfunding market grows rapidly and has become the largest crowdfunding market in the world (Ziegler et al. 2018). Compared with the Western crowdfunding markets, the Chinese crowdfunding market has its unique characteristics. Specifically, in terms of reward-based crowdfunding, the Chinese contributors are more realistic compared to the ones in Western markets. Specifically, their motivations to contribute are mainly generated by receiving the rewards but not by helping to further develop the business ideas (Yuan and Chen 2018). In addition, the Chinese crowdfunding market is controlled by several key players (Yuan and Chen 2018). The performance of the key players (e.g. Taobao Crowdfunding, JD Crowdfunding) counts for most of the market share in China (Huang et al. 2018). As a latecomer of the crowdfunding market, the legal framework related to the regulation of the Chinese crowdfunding market is immature which hinders its further development (Yuan and Chen 2018). Specifically, this immature legal framework has brought problems such as fraud, illegal fundraising, and money laundering (Huang et al. 2018). As a result, the growth rate of the Chinese crowdfunding market has been slowed down as legal frameworks are being revisited (Chirisa and Mukarwi 2018).

Third, crowdfunding has proved to be a feasible tool in supporting creative industries and sustainable projects in China (Sun and Meng 2015). Two-thirds of the reward-based crowdfunding projects in the Chinese market are related to creative industries such as film, music, publication, animation, design, and games (Sun and Meng 2015). Besides, crowdfunding is also used to support sustainable campaigns in China (Lam and Law 2016). The success of sustainable crowdfunding projects is closely associated with public opinion and brand effect in the Chinse market (Chen et al. 2018).

Implications for Research and Practice

Theoretical Implications

Based on the review of the key Chinese crowdfunding literature, we found that existing research has provided valuable insights for understanding the Chinese crowdfunding market. However, the limitations of the current literature indicate several future research directions as well.

First, most of the existing Chinese crowdfunding literature are replicative studies. These replicate previous crowdfunding studies by using the Chinese data in order to test the validation of previous findings in non-Chinese crowdfunding market (e.g. Zheng et al. 2017). Future research could generate more special outputs by taking unique Chinese cultural factors and market characteristics into consideration. For instance, "Guanxi" is a special element of Chinese culture, which has been embedded in the daily practices of the Chinese business community (Chung and Hamilton 2001). It should be beneficial to enrich the Chinese crowdfunding literature by investigating the impact of "Guanxi" on Chinese crowdfunding practices (Zhao and Vinig 2019). Besides, the Chinese crowdfunding market has strong connections to several Chinese Internet giants (e.g. Alibaba, JD, and Tencent) (Yang and Zhang 2016). It would be interesting to explore the influences of these Internet giants on the formation and development of the Chinese crowdfunding market, and their relations with crowdfunding platforms.

Second, in terms of research perspectives, most of the existing literature aims to explore the success factors of crowdfunding in the Chinese market by analysing real market data from the platforms. The signalling theory and Elaboration Likelihood Model are mostly adopted by Chinese crowdfunding literature (e.g. Zheng et al. 2016; Bi et al. 2017). Besides, the total amount of research related to equity crowdfunding and loan-based crowdfunding is smaller compared to the research associated with reward-based and donation-based crowdfunding. To generate more meaningful insights, future research could try to analyse the Chinese crowdfunding market from other perspectives by applying alternative theoretical frames (Huang et al. 2018). In addition, more research on equity-based crowdfunding and loan-based crowdfunding should be generated.

Practical Implications

This chapter also provides several practical implications for Chinese crowdfunding practitioners, contributors, and regulators.

First, Chinese investors tend to rely on personal relationships to help make investment decisions as the Chinese business is relation-based. The personal relationship is used as substitutes for formal institutional support (Xin and Pearce 1996). In terms of the Chinese crowdfunding market, project initiators' social capital levels should be closely associated with crowdfunding success (Shahab et al. 2019). Therefore, Chinese crowdfunding practitioners should pay attention to their social capital accumulation by interacting with potential contributors to create personal trust and take full advantage of the power of social capital to promote projects within their target audiences.

Second, Chinese crowdfunding contributors are more pragmatic compared to the ones in the Western markets (Yuan and Chen 2018). Specifically, they contribute for getting the rewards, rather than being parts of the process of the project "co-creation" (Yuan and Chen 2018). Therefore, it is beneficial for Chinese crowdfunding campaign initiators to pay more attention to the design and delivery of the crowdfunding rewards. For instance, compared with the other campaigns, the campaigns with clear descriptions, well-designed reward prototypes, and determined delivery time are expected to have higher probabilities to get successful fundraising.

Third, it is of great importance for the regulators to strengthen the regulative framework to guarantee the healthy development of the equity-based and loan-based crowdfunding models in China. The regulative framework should be designed within the existing Chinese legislation system and cultural background (Hu and Yang 2014). Under the established framework, specific principles and regulations need to be promulgated to provide adequate supervision of the whole crowdfunding market and offer timely information disclosures to market participants. In addition, the development of Chinese loan-based crowdfunding market has been greatly impeded by fraud caused by the lack of nationwide credit rating systems (Wei 2015). Therefore, a comprehensive credit rating system should be established to support the development of the Chinese loan-based crowdfunding market.

Lastly, for promoting crowdfunding industry in China, it is also important to create a close integration between social media sites, digital payment systems, and crowdfunding platforms to create a seamless, convenient, and efficient process for information sharing and transactions.

Conclusion

In conclusion, given the uniqueness of culture, regulation, and social systems in China, the concept of Chinese crowdfunding could be considered as a combination of Chinese unique characteristics and general crowdfunding principles (Funk 2019). In this chapter, we introduce and discuss the crowdfunding phenomena in China concretely from the perspectives of different stakeholders (platforms, fundraisers, funders, and regulators) and crowdfunding models (reward-based, equity-based, loan-based, and donation-based). Generally, the Chinese crowdfunding market has developed rapidly and has become the world's largest crowdfunding market (Ziegler et al. 2018). However, we also find out that there are some problems in the Chinese crowdfunding market, such as underdeveloped regulatory system and personal credit system (Chirisa and Mukarwi 2018). These problems will limit the further development of the Chinese crowdfunding market. To solve these problems, specific solutions have been proposed in this chapter. Practically, this chapter can be used as prescriptive guidelines for Chinese crowdfunding stakeholders to enhance and improve market performance. In addition, we also point out some meaningful research topics for researchers to explore the Chinese crowdfunding phenomena further.

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13

An Exploratory Study on Crowdfunding in India and Bangladesh

Krishnamurthy Suresh, Stine Øyna, and Ziaul Haque Munim

Introduction

In 2013, the World Bank published a report on crowdfunding's potential in emerging markets, which estimated a market opportunity for South Asia alone of close to USD 5 billion (The World Bank 2013). The South Asia region consists of predominantly collectivist societies (Hofstede Insights 2019)—India, Bangladesh, Sri Lanka, Pakistan, Bhutan, and Nepal—where helping others through donations is an integral part of

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prevailing religious obligations and societal norms. Thus, these countries share certain cultural and religious traits that are highly consistent with the principles of crowdfunding. Yet, by 2017, the alternative finance activity in the region amounted to no more than USD 269 million, 96% of which was related to the Indian market (see Table 13.1), indicating a vast untapped potential in the Asian economies.

In the current chapter, we explore the history, ongoing activity, and future prospects of crowdfunding in new emerging markets. Specifically, we look into the cases of India and Bangladesh. Both countries represent interesting crowdfunding markets due to the cultural inclinations described above, combined with their large populations (1.3 billion people in India and 165 million in Bangladesh) and number of people living in extreme poverty (15% of the population in Bangladesh and 21% in India) (The World Bank 2019). India is, by far, the leading market of alternative finance in the South Asia region, and thus provides an interesting case to explore. The alternative finance market in Bangladesh, on the other hand, is still in its infant stage and thus far less developed. Comparing and contrasting the state and types of crowdfunding in these two markets thus allow us to reach new insights.

The remainder of this chapter consists of sections focusing on India and Bangladesh, respectively. Both sections cover the history, including cultural roots of crowdfunding in the given market, prevailing models and platforms, regulatory issues, and future prospects. Given the relatively more developed state of crowdfunding in India versus Bangladesh, the section on India is naturally more comprehensive. The chapter concludes with a few summarizing remarks on the state of crowdfunding in new emerging markets.

Table 13.1 Alternative finance volume in South Asian countries

Country	Volume (USD)[a]	Population (M)[b]	Volume per capita
Bangladesh	10,272	161	0.0001
Bhutan	10,000	0.8	0.0133
Nepal	1,014,850	28	0.0361
India	268,579,820	1352	0.1986
Pakistan	8,571,762	212	0.0404
Sri Lanka	38,926	21	0.0018

[a]Ziegler et al. (2018)
[b]The World Bank database

Crowdfunding in South Asia

Research on crowdfunding in South Asia is still somewhat limited, although a few contributions do exist. Crowdfunding studies in the Indian context examine regulatory issues (Marakkath and Attuel-mendes 2015), business model transformation (Srivastava 2016; Chirputkar et al. 2015; Gupta and Bose 2019), risk factors (Leela 2016), crowdfunding intention (Baber 2019a), and drivers of growth (Pa 2018). Similarly, studies in the Bangladeshi context examine crowdfunding business model (Adhikary and Kutsuna 2016), awareness and drivers of crowdfunding (Adhikary et al. 2018), and the drivers of crowdfunding intention (Hasan et al. 2018; Munim et al. 2020). In sum, these studies build knowledge relating to crowdfunding on the individual (backer), firm, and societal levels.

Until 2014, a few crowdfunding platforms were operational in India, and people believed that family or friends or venture capital firms would determine crowdfunding campaign success (Srivastava 2016). A majority of the early platforms were associated with creative industries like filmmaking, publishing, and design (ibid.). On the contrary, in 2019, the existing Bangladesh crowdfunding platforms are not fully functional but are more dedicated to raising funds for medical treatment or equity (Munim et al. 2020). In both the Indian and Bangladeshi context, the main drivers of crowdfunding are increased demand for alternative finance due to improved socio-economic status, significant increase of internet users, complexity of documentation, and requirement for tangible securities for credit applications in traditional financial institutions such as banks (Srivastava 2016; Adhikary et al. 2018; Marakkath and Attuel-mendes 2015).

In terms of factors influencing crowdfunding intention, findings are similar in the Indian and Bangladeshi contexts. For instance, technological awareness and experience of traditional financial market have a positive influence on a backer's crowdfunding intention (Baber 2019b; Hasan et al. 2018). Meanwhile, in societies like India and Bangladesh which can be "characterized by a low degree of thin trust between strangers, people are less willing to contribute to/invest in fundraising efforts by a stranger" (Kshetri 2015, p. 106). Therefore, the campaign owner being friends and family is positively associated with a backer's crowdfunding intention in the Indian context (Baber 2019a). However, the quality of the campaign and media coverage is more important in the Bangladesh context (Munim et al. 2020).

Crowdfunding in India

History

Crowdfunding or crowdsourcing, in various forms and under various names, has existed in India since ancient times. For instance, 'Chanda' involves people collecting small sums of money from large crowds to finance religious, cultural, and other events like festival celebrations in the local community. Another example of a historic crowdfunding campaign happened in 1962, during the war with China. The then Indian Prime Minister, Jawaharlal Nehru, appealed to the citizens of the country to contribute to the defence fund. Thousands of people, especially women, donated not only money but also their jewellery. The campaign was said to have collected over USD 220,000 in cash and much more in gold. Later, in 1976, a group of 500,000 milk farmers from the Indian state Gujarat contributed to fund the movie 'Manthan,' which was estimated around INR 1.1 million (USD 1 ≈ INR 70). After the inception of modern-day (internet-based) crowdfunding, the Indian online crowdfunding started its operations in 2012 with the launch of Wishberry, Ketto, and Milaap (Impact Guru 2017).

Prevailing Models and Platforms

The four prevailing models of crowdfunding—reward, equity, lending, and donation—are all represented in the case of India, and Fig. 13.1 presents their levels. Loan-based crowdfunding is responsible for the majority of the activity. Since 2016, equity and donation-based crowdfunding have reached similar levels. The volume of reward-based crowdfunding, however, remains low. The different types of crowdfunding in the Indian context are discussed below.

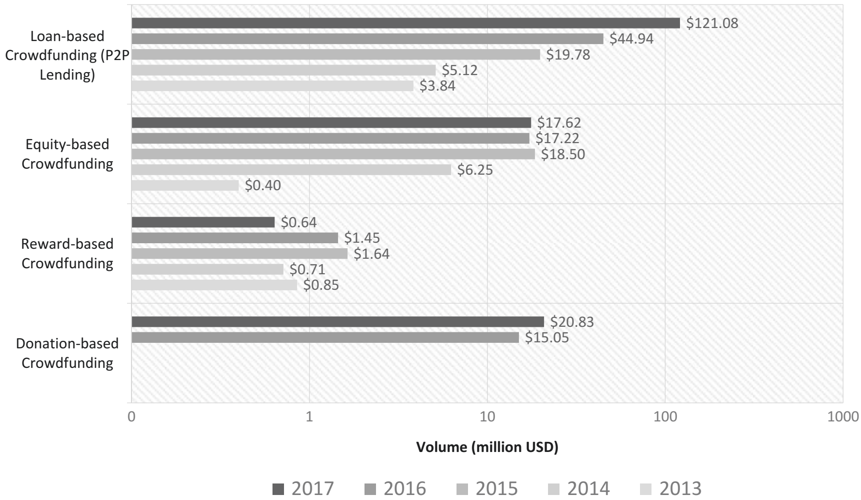

Fig. 13.1 Indian crowdfunding market volumes by model (2013–2017). (∗Based on figures from Ziegler et al. [2018])

Donation-Based Crowdfunding

Philanthropy—including charity and donations—is an integral part of the Indian culture and tradition, visible through its mention in the first Indian scripture—known as Vedas (Bhasin 2019). In India, the word 'donation' or 'giving' has different nomenclature based on religion. The Hindus term it as *daana* (giving) and *dakshina* (alms), Buddhists call it as *Bhiksha* (alms), while it is *zakat* (prescribed offerings) and *sadaqah* in Islam (Viswanath and Dadrawala 2004). As per classical Hinduism, it is considered as the *duty* of an individual to help those who are in need (Bornstein 2009). Donations are usually made for social, religious, cultural, as well as political causes. Earlier, donation was an individual activity. However, the establishment of socio-religious institutions during the nineteenth century gave birth to scientific or institutional philanthropy, which is later dominated by NGOs, trusts, and foundations.

Donation-based crowdfunding is the second-largest model by volume after P2P lending in India. Around USD 21 million were raised in 2017 (see Fig. 13.1), and, as of May 2019, there are more than 25 donation-based (Table 13.2) crowdfunding platforms operating. Campaigns on these platforms allow both individuals and NGOs to raise money in support of various causes under categories such as health, education, community development, and others.

Table 13.2 List of popular donation and reward-based crowdfunding platforms in India

Platform	Website	Model	Foundation	Commission[a]
Desired Wings	desiredwings.com	Reward	2015	10%
Dreamwallets	dreamwallets.com	Reward	2015	5% (9% under Keep What You Get (KWYG) model)
EduDharma	edudharma.com	Donation	2017	5%
Fueladream	fueladream.com	Donation + Reward	2016	Normal campaigns 6% and group campaigns 9%
GiveIndia	giveindia.org	Donation	2000	5–10%
ImpactGuru	impactguru.com	Donation	2014	*Self-driven*: 5% for individuals and social enterprises, 3% for NGOs; *Accelerate*: 12%
Ketto	ketto.org	Donation	2012	5–6%
Milaap	milaap.org	Donation	2010	5%
Wishberry	wishberry.in	Reward	2012	10%
Gocrowdera	gocrowdera.com	Donation + Reward	2014	0%

[a]Fees excluding processing charges, GST, and payment gateway charges. Data compiled from platform websites (as of May 21, 2019)

A popular form of donation-based crowdfunding in India is non-monetary donations, where backers donate products, meals, or medicine to people in need. Donatekart is one such platform that enables backers to donate various products to the NGOs which they wish to support. Another platform, Give India, enables backers to support the delivery of midday meals to poor children across the country through one of their initiatives—*Mission 10 Million Meals*. Finally, in the last two to three years, *medical crowdfunding* has taken off in India, where platforms like Milaap, Ketto, and ImpactGuru assist common people in raising money for expensive medical treatments. Given the population and poverty levels of the country, these forms of non-financial return crowdfunding have the potential to make a substantial socio-economic impact.

Reward-Based Crowdfunding

In the case of reward-based crowdfunding, backers receive a non-financial reward in return for the money contributed: as of May 2019, about nine to ten reward-based platforms were operating in India (including reward + donation, see Table 13.2), the most prominent ones being Wishberry and Fueladream. Noteworthy, some of the campaigns on Fueladream are run by students raising funds for social causes. For example, one such campaign ran by students, aimed at raising funds to help with the education of children from underprivileged homes, has been funded 534 times (Goal: INR 1,080,000). Also, platforms like Desired Wings and Rug Beneath My Feet are exclusive women-centric platforms. As per Ziegler et al. (2018), around USD 5.3 million has been raised by these platforms over the years from 2013 to 2017 (see Fig. 13.1) of which 40% of the fundraising was for business purposes.

Equity-Based Crowdfunding

India has developed into a start-up hub with the third-largest start-up ecosystem in the world, home to more than 20,000 start-ups (KPMG 2018), more than 63 million micro, small, and medium enterprises

(MSMEs) (Government of India 2017) and more than 210 active incubators/accelerators (NASSCOM 2018). Traditionally, start-ups are being funded through angel investors, private equity, or loan arrangements with banks and other financial institutions. However, since the global financial crisis of 2008, financing through traditional means became even more challenging, resulting in a credit gap where nearly 50 million MSMEs have an unmet debt demand of USD 198 billion (PWC 2018). In line with the rapid growth in the number of established start-ups, alternative means of financing these enterprises evolved.

Under equity crowdfunding, the equity shares of the company are issued to the investors in consideration for their investment. There are around 15 such platforms operating in India (as of May 2019), LetsVenture being the most prominent one (see Table 13.3). The platform has more than 4400 angel investors and has funded over 172 deals. By 2016, around 200 companies had been crowdfunded by equity-based platforms, and the total amount raised was over INR 3.5 billion. The average ticket size for small working capital was between INR 5 million and INR 60 million, while average fund-raised ticket size was between INR 30 and 40 million (Menon 2016). However, the regulatory challenges for equity crowdfunding have curbed the growth prospects of the industry. As per Ziegler et al. (2018), around USD 60 million has been raised by these platforms over the years, from 2013 to 2017 (see Fig. 13.1).

Table 13.3 List of popular equity crowdfunding platforms in India

Platform	Website	Foundation
1Crowd	1crowd.co	2015
Ah! Ventures	ahventures.in	2009
ANGLEPaisa	anglepaisa.com	2015
Coseeding	coseeding.com	2016
Enablers	enablersinvestment.com	2014
Grex	grex.in	2014
LetsVenture	letsventure.com	2013
SpicyFunds	spicyfund.com	2011
ientra	ientra.com	2016

Commission information of most of the equity crowdfunding platforms is not publicly available

Lending-Based Crowdfunding (Peer-to-Peer Lending)

Alternative lending is one of the fastest-growing segments in the Indian Fintech space, reflecting the unmet financial needs of Indian consumers and businesses. Over 40% of the population and around 90% of small businesses are not linked to formal financial institutions (EY 2017). Also, nearly 90% of the consumer market is unaddressed by the existing financiers due to insufficient credit scores (ibid.). The failure of banks and other financial institutions to meet the needs of these segments, especially after the global crisis, led to the rise of alternative lending in India. As of 2017, there were more than 225 alternative lending companies in India (ibid.).

Like other emerging economies, the country has multiple informal sources of financing for the unbanked population, like chit funds and microfinance. Chit funds are schemes that combine savings and credit (Kapoor et al. 2012). Chit funds could be registered or unregistered, organized by formal financial institutions or informal groups such as friends and relatives. In India, there are more than 10,000 registered chit funds and around 200,000 unregistered ones. The value of the unregistered chit fund industry is estimated to almost 100 times the registered value, which is about INR 300 billion (Acharya 2013).

In India, though still in a nascent stage, P2P is one of the fastest-growing markets, with current market size of around INR 2 billion, including both consumer and business loans (Saleem 2018). The market is expected to reach over USD 5 billion by 2020 (Deloitte 2017). There are currently between 40 and 50 platforms operating under the P2P model, although only 11 are registered with the Reserve Bank of India, so far. The most prominent P2P platforms are Faircent, Finzy, Lendenclub, and Monexo. The interest rates on these platforms are generally categorized based on the riskiness of loans (i.e. low risk—ultra high risk, and 'unidentified'), range between 14 and 36% (over 40% for unidentified).

In addition to providing an attractive asset class for lenders, the P2P industry acts as an avenue for financial and credit inclusion through addressing underserved people and small businesses. Mostly, the borrowers of the industry are from tier-two and tier-three locations, who would

Table 13.4 List of RBI registered peer-to-peer lending platforms in India

No	Platform	Website	Foundation	Interest rates
1	Cash Kumar	cashkumar.com	2014	18–30% (flat)
2	Monexo	monexo.co/in	2016	12–30% (for salaried loans)
3	Faircent	faircent.com	2013	12–28% (excluding unrated borrowers)
4	Peerlend.in	peerlend.in	2015	14–36%
5	AnyTimeLoan.in	anytimeloan.in	2014	Interest as low as 0.05% per day
6	i2ifunding	ki2ifunding.com	2015	12–36%
7	OMLP2P	omlp2p.com	2016	10.99–36%
8	Finzy	finzy.com/invest	2016	10.99–27.99%
9	PaisaDukan (BigWin Infotech)	bigwininfotech.com	2018	12–24%
10	Lendenclub	lendenclub.com	2015	12–35%
11	Liquiloans	liquiloans.com	2018	>10.99%

Interest rates are per annum (unless specified otherwise) and based on the riskiness of loans. Data compiled from list of NBFC-P2P companies registered with Reserve Bank of India as on March 27, 2019.

otherwise rely on money lenders for credit, paying exorbitant interest rates. Notably, participation from women (as fundraisers and investors) has been increasing in the recent past. From 2013 to 2017, P2P platforms in India included nearly USD 195 million in overall market volume, of which USD 33.19 million were for business purposes (see Fig. 13.1 and Table 13.4).

Regulations

Regulations largely depend on the type of crowdfunding. Like most of the other countries, there are no bespoke regulations for donation and reward-based crowdfunding in India. Since there is no financial return involved in these models, they fall outside the purview of regulators like the securities market and the central bank. However, they come under the ambit of other regulations related to the payment of donations (e.g. Income Tax Act 1961) and campaign content (e.g. Information Technology Act 2000). Both individuals and organizations can run campaigns on these non-financial return crowdfunding platforms. However, only Indian nationals holding an Indian bank account can raise funds. For non-profit entities to receive contributions from abroad, an FCRA (Foreign Contribution Regulation Act) approval is mandatory. Yet with equity and lending-based crowdfunding, the situation is quite different.

All types of money lending are regulated by the central bank of India—the Reserve Bank of India (RBI). Although P2P lending came to India in 2014, there was no specific regulation in place until the latter half of 2017 (Menon 2016). In 2017 RBI issued directions targeting 'Non-Banking Financial Companies' and specifically P2P lending platforms. These directions require all P2P lending platforms to obtain a certificate from RBI, while also limiting the financial services that such platforms can provide and the amount of money they can manage (e.g. maximum INR 5 million per lender and INR 50,000 to the same borrower). Additionally, the regulations do not open for the international flow of funds.

The securities market regulator, SEBI's *Consultation Paper on Crowdfunding in India* (2014), proposed a framework for raising of funds by start-ups and SMEs, through online crowdfunding platforms or websites. The proposed guidelines restrict both who are eligible to become equity crowdfunding platforms (e.g. recognized stock exchanges, SEBI-registered depositories, associations and networks of investors), who can receive funding through these platforms (i.e. early-stage start-ups/SMEs <4 years old) and how much a company can raise (i.e. <INR 100 million/12 months).

Future Prospects

Although the ideology of crowdfunding in India traces back to the Vedic period (1500–1100 BCE), online crowdfunding is still in a somewhat nascent stage. Compared to matured markets like China, USA, UK, and Europe, there is a big gap in terms of awareness, education, acceptance, and usage of crowdfunding. In the 2013–2017 period, the Indian crowdfunding volume reached USD 450 million, which is only a fraction of the potential indicated by the World Bank (The World Bank 2013). However, the industry has seen tremendous growth with a volume of USD 268 million in 2017 alone, and year-on-year growth of 116% (Ziegler et al. 2018).

The significant growth rate can be attributed to socio-economic inequality, financial exclusion, unmet financial demand (credit gap), along with various other factors. The growth of non-financial return or community-based crowdfunding is driven by an increase in charity and philanthropy among people in India, a rise in foreign donations, and support for new and innovative causes. Growth in peer-to-peer lending is related to the credit gap and unbanked population. Finally, growth in equity crowdfunding can be explained by a combination of factors, and partly by the exponential growth in start-ups and SMEs. Yet, there are also several factors hindering the further expansion of the crowdfunding market.

The lack of regulatory guidelines for crowdfunding in general and equity crowdfunding, in particular, is likely hindering the growth and prospects of the industry. The industry needs to be supported by concrete guidelines in order to secure the interests of both platforms and platform users, as well as the society in general. For this purpose, inferences could be drawn from the UK's FCA regulations for investment-based crowdfunding and JOBS Act from the USA. Considering a few companies have already been crowdfunded by equity-based platforms in India, the perspective of these key stakeholders could also be considered in framing the guidelines.

Although crowdfunding in India is already covering a wide array of sectors, there still exists a number of areas that could benefit from the concept. Examples include agriculture, legal, real estate, and politics. Even though real estate and political crowdfunding have taken off recently, lessons could be drawn from developed markets like the Middle East and the USA, for its future prospects. Having one of the largest agricultural markets in the world, India could most likely benefit from agricultural crowdfunding, which is quite popular and successful in Nigeria and other African countries.

Crowdfunding in Bangladesh

History

Bangladesh, similar to India, has a long history of crowdfunding-like approaches to donation and collection of money. Bangladesh is home to Nobel laureate Dr Muhammad Yunus, known for initiating the concept of 'microfinance' which involves lending small amounts of money to a large number of people with the purpose of alleviating poverty (Kickul et al. 2012). Another example is the so-called Somity concept, which refers to an informal co-operative where a group of people (particularly women) save together a portion of their salary or a household income that is later invested in a business (Scheyvens 2002). Somity is identical to the 'Chit Fund' concept in the Indian context. Also, during the two Eid festivals, large sums of money are donated by Muslims in the country to people in need (the concepts of *zakat* and *sadaqah* as mentioned earlier). Today, there exist crowdfunding platforms relying on the concept of Muslim donations (e.g. www.launchgood.com).

There are several examples of informal crowdfunding from Bangladesh. In 2012, when the government of Bangladesh decided to finance the Padma Bridge project (budget USD 6.7 billion, currently under construction) from domestic sources, they invited all the citizens of Bangladesh to contribute financially by donating any amount of money to designated bank accounts (Bdnews24 2012). Another example is the Rohingya refugee crisis in 2017 when a large number of people from all over the world contributed small sums of money to help people fleeing from Myanmar (UNHCR 2017). Also, collecting money from the crowd is a common way to fund medical treatment of people in need, and aid people in rural areas during the annual periods of natural calamities like floods and cyclones. Both individuals and NGOs use these types of collections.

With the help of digitalization, such activities of raising funds are now largely done via the internet, for instance through local Facebook groups such as Mastul Foundation, Donate Bangladesh, and Biddanondo. Some of these Facebook groups are aiming to move their activities to donation-based crowdfunding platforms in the near future. The JAAGO

Foundation, a civil society organization that promotes the education of the deprived children of the country, also uses a dedicated donation webpage (donate.jaago.com.bd) to raise funds. Meanwhile, the first Bangladeshi crowdfunding platform, Projekt.co, was launched in 2015.

Prevailing Models and Platforms

As can be seen in Table 13.1, the crowdfunding scenario is rather limited in Bangladesh compared to other South Asian countries. Only USD 10,272 was reported for Bangladesh in Ziegler et al. (2018), while the number is USD 268,579,820 for neighbouring country India and USD 8,571,762 for Pakistan. Indeed, India is a larger market than Bangladesh, but Pakistan has a similar market size in terms of population. These numbers, together with the history of informal crowdfunding in Bangladesh, indicate a vast untapped potential.

For a country with more than 160 million inhabitants and a long-rooted history of donation and helping others, the possibilities of crowdfunding are still largely underexplored. In an online survey conducted by the authors, among 253 Bangladeshi respondents, 33.20% had never heard about crowdfunding before participating in the survey. Similarly, Adhikary et al. (2018) conducted a physical survey in small Bangladeshi cities and found that only 5% of the 270 small business owners that were surveyed had heard of crowdfunding. Despite the low levels of crowdfunding awareness, people generally show a positive attitude towards using crowdfunding. About 78.6% of 253 respondents in the survey by the authors and 84% of 270 respondents in the survey by Adhikary et al. (2018) indicate that they would like to use a Bangladeshi platform. Consequently, the concept of crowdfunding seems to be poorly diffused in the Bangladeshi context.

The first crowdfunding platform in Bangladesh, Projekt.co, was inaugurated in 2015 as a reward-based platform focusing on the creative industries such as music, arts, and technology. The platform was, however, closed down in 2017 due to the lack of popularity of crowdfunding in Bangladesh. Another platform, donation-based GoRiseMe, was initiated in 2015. GoRiseMe is still in operation and has accommodated 33 campaigns since inception (GoRiseMe 2019), indicating that Bangladeshi people are getting familiar with the concept of crowdfunding. However, they have yet to achieve a successful campaign.

In 2018 two new platforms started their journey—oporajoy.org and fundsme.com.bd. Oporajoy is a donation-based platform and has successfully funded one campaign so far. The campaign raised about USD 150 to help a student pay for admission fees at the University of Dhaka. In total, 38 backers donated to support the campaign. Noteworthy, Oporajoy has been operating informally in Bangladesh for a few years before launching as a formal digital crowdfunding platform. Before 2018, the founder of Oporajoy was posting fund requirements for medical treatment on social media and a simple website. She has been collecting donations via cash, cheque, bank deposit, and mobile banking (e.g. Bkash), in order to support medical patients. This is an example of business model adaptability based on the context. Payment through online gateway has only recently become popular in Bangladesh. Thus, in 2018, Oporajoy transformed its operation to a modern-looking crowdfunding website with online payment gateway accommodating all possible payment mediums in the Bangladeshi context.

Today, a few crowdfunding platforms exist in Bangladesh, although with limited activity and success so far. Fundsme, which is an equity-based platform, is a sister firm of BD Venture Limited—one of two functioning venture capital firms in Bangladesh. The Fundsme project is partially funded by the Department for International Development of the UK. Despite having several published campaigns, Fundsme has not successfully funded any campaigns so far. Currently, there are no peer-to-peer lending platforms in Bangladesh, and no functioning reward-based platform, although Banglafunding.com is expected to launch as a reward-based platform in the near future. Table 13.5 summarizes key information on current and former crowdfunding platforms in Bangladesh.

Table 13.5 Crowdfunding platforms in Bangladesh

Platform	Website	Model	Foundation	Commission
Projekt	projekt.co	Reward	2015	N/A
GoRiseMe	goriseme.com	Donation	2015	3%, for Paypal 3.4% + €0.35 per donation
Fundsme	fundsme.com.bd	Equity	2018	Upfront fee on the funding goal
Oporajoy	oporajoy.org	Donation	2018	5%

While the Bangladeshi crowdfunding platforms have had limited success so far, many Bangladeshi campaigns were successfully funded on international crowdfunding platforms like Kickstarter, IndieGoGo, and GoFundMe. As of May 2019, searching for the word ‘Bangladesh’ reveals 37 campaigns on Kickstarter, 71 on IndieGoGo, and 1714 on GoFundMe. Many of these campaigns raised 100% of their pledged amount, indicating potentials of crowdfunding in the context of Bangladesh. United Nations Development Programme (UNDP) Bangladesh has also executed several successful crowdfunding campaigns to support multiple causes such as Youth Empowerment through Skills (YES) (UNDP Asia and the Pacific 2016) and farmers’ access to international markets (Dhaka Tribune 2017).

Regulation

There are ongoing discussions on the need for a legal framework on crowdfunding in Bangladesh (The Financial Express 2018). Despite the existence of several platforms, no such framework exists so far. Dr Habib, a professor and director of the Bangladesh Institute of Bank Management (BIBM), argued that lack of policy and regulatory framework is making it difficult to explore the potential of crowdfunding in Bangladesh (The Financial Express 2019). Due to extensive bureaucracy, the formation of such legal frameworks typically takes many years in the Bangladeshi context. However, in an informal telephone interview, a founder of a Bangladeshi crowdfunding platform expressed positive signals towards the development of a legal framework in the near future for crowdfunding in Bangladesh.

Meanwhile, similar to the Indian context, donation and reward-based platforms can be operated without any dedicated regulation. Reward-based platforms come under the Information and Communication Technology (ICT) Act 2006, which was enacted to facilitate e-commerce and encourage the growth of information technology. The ICT Act was later amended in 2013 and included provisions for imprisonment and/or fines for cyber-crimes (Export.gov 2018). Equity and peer-to-peer lending platforms, however, require governmental action as soon as possible.

Future Prospects

Based on the trends in the Indian and other South Asian markets, and the culture and history of monetary contributions among the population, crowdfunding appears to be a well-suited funding option for Bangladesh. Yet, among the Bangladeshi crowdfunding platforms, there was only one valid and successful crowdfunding campaign. Also, crowdfunding seems to be relatively unknown among Bangladeshi people, indicating a need for training and awareness in order for crowdfunding to become a viable funding option. In this vein, future research should investigate the barriers of crowdfunding in Bangladesh and how to overcome them.

Lack of regulatory guidance is one of several possible barriers. Assuming some similarity among the Indian and Bangladeshi market, P2P crowdfunding is a particularly relevant model for Bangladeshi alternative finance market (also in line with Adhikary et al. 2018). Given that lending and equity-based crowdfunding are dependent on regulatory interference, Bangladeshi financial authorities are required to act in order to realize the inherent potential of crowdfunding in the country. As no P2P lending platform exists in Bangladesh, establishing such platforms is likely another important enabler for crowdfunding growth in Bangladesh.

Future research should further investigate backers' investment intention in the Bangladeshi context. Hasan et al. (2018) find that technological awareness and subjective norms positively influence backers' crowdfunding intentions. Besides, Munim et al. (2020) find that liking the campaign idea and positive media coverage increases backers' likelihood of investing in a campaign. Thus, crowdfunding platforms should make sure that campaigns published in their website are innovative and appealing. Platforms and campaign owners need to promote their campaigns in media channels such as newspaper, radio, and TV to increase the success rate.

Conclusion

Both India and Bangladesh represent interesting crowdfunding markets due to the compatibility between the principles of crowdfunding and their cultures of giving, combined with their large and relatively poor populations. Although crowdfunding in India is in its infancy compared to developed markets like the USA, UK, and China, India is responsible for 96% of the alternative finance volume in the South Asia region. Indian crowdfunding platforms include all the major types of crowdfunding, with lending-based platforms being responsible for the majority of the volume. Bangladesh, together with Bhutan, is the least developed alternative finance markets in South Asia. So far, there are few platforms, and the ones that exist have limited volume and success. Yet, multiple Bangladeshi campaigns have been successful on international crowdfunding platforms, indicating a positive trend also in Bangladesh. Although at drastically different stages of development, India and Bangladesh share a vast unrealized potential with respect to the opportunities of future crowdfunding industry development.

Regardless of the significant deviation in volume, both Indian and Bangladeshi crowdfunding markets are contextually similar, at the same time, unique in comparison to other parts of the world. For instance, donation-based crowdfunding volume ranks second in India and the most popular in Bangladesh. In contrast, donation-based crowdfunding by volume and popularity ranks much lower in the North American and European contexts. Unlike many other parts of the world, contextually modified dedicated women-centric platforms, chit funds, and e-commerce-based crowdfunding models are visible in both India and Bangladesh. The relatively high share of donation-based crowdfunding activity could be attributed to the collectivist culture, the high degree of religiosity, and the socio-economic situation. These potential explanations could all motivate future research on crowdfunding in South Asia.

For both India and Bangladesh, regulatory issues and sustainability of crowdfunding platforms have been a crucial issue that needs to be studied further. For equity-based crowdfunding, Kshetri (2015) proposes that a "clear regulatory framework that balances the interests of entrepreneurs and investors reduced uncertainty" (p. 106). Local or international professional organizations such as National Crowdfunding Associations (NCFAs), the World Bank, or USAID can provide support to improve the crowdfunding ecosystem (Kshetri 2015; Adhikary et al. 2018). In sum, alternative finance, in general, and crowdfunding activity, in particular, are growing in both countries, although a vast unmet potential remains.

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14

Crowdfunding in African Market

Emmanuel James Chao, Priscilla Serwaah, Prince Baah-Peprah, and Rotem Shneor

Introduction

The crowdfunding phenomenon in Africa is somewhat lagging other regions and is still at its infancy. Despite the relatively slow adoption of crowdfunding in Africa, it is often regarded as a mechanism with great potential for increasing access to finance for entrepreneurs in developing economies in general and Africa in particular (The World Bank Group 2015). According to the Cambridge Centre for Alternative Finance (hereafter—“CCAF”), African volumes in a variety of crowdfunding models reached US $182 million in 2016, growing 118% from US $83 million in 2015 (Ziegler et al. 2018). From a regional perspective,

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whereas 41% of these volumes have been recorded in West Africa, 28% have been recorded in Southern Africa, 24% in Eastern Africa, and the remaining 7% in North and Central Africa (ibid.).

Despite representing the smallest global region in terms of volumes, Africa exhibits one of the greatest potentials for crowdfunding growth. This potential is based on Africa's global leading position in terms of adopting digital finance and mobile money, the relative low penetration of traditional financial institutions, as well as crowdfunding's cultural fit with traditional funding practices. Evidence shows that digital financial solutions have been expanding access and reach to consumers, especially for the unbanked and under-banked, while significantly lowering costs of such services and making it possible to serve the base of the pyramid in a more profitable way (Rowan et al. 2018). Furthermore, mobile money became an important component in Africa's financial services landscape, as driven by more than 140 mobile money service firms catering to one in every ten African adults (Chironga et al. 2017).

At the same time, low penetration levels of traditional financial institutions, such as banks and funds, are prevalent in many African economies (KPMG 2015). This situation leads to a systematic discrimination of micro and small enterprises in terms of access to finance, as well as often insurmountable guarantees that are required for such financing when access to finance is at least formally available. Efforts have been made to fill this gap through financial solutions provided by microcredit agencies and community institutions (George et al. 2016). However, the extent to which such interventions provide an efficient and sustainable solution remains questionable. In this context, several studies compare crowdfunding to microfinance while suggesting that the advantages of the former can compensate for the inefficiencies in the latter (Wolf 2017; Oruezabala and Peter 2016).

In terms of cultural fit, some of the limited research into crowdfunding in Africa argues that modern crowdfunding can function well in supplying funding for African entrepreneurs as it represents a technological solution for "centuries-old and culturally-rooted sub-Saharan practices of individuals helping each other through communal reciprocity" (Wolf 2017). Some also argue that it can be viewed as a conceptual broadening of the participatory financing system familiar to locals from microfinance institutions (Oruezabala and Peter 2016). Furthermore, the potential for crowdfunding is also linked to contributions through diaspora philanthropy, where social capital embedded in African diaspora connections may translate into diaspora members funding of entrepreneurs in their countries of origin (Flanigan 2017). Here, while African entrepreneurs exhibit limited knowledge of crowdfunding, they also express interest in using it once familiarized with the concept, as shown by a pioneering study made in Rwanda (Berndt and Mbassana 2016).

Overall, the conditions presented above seem to suggest great promise for crowdfunding in answering market needs that are insufficiently met by existing institutions, while simultaneously supporting development, growth, and entrepreneurship. In the current chapter we explore the current state of crowdfunding research and practice in Africa, while highlighting some of the challenges and gaps for further exploration.

The Current State of Crowdfunding in Africa

In reviewing the current state of the crowdfunding industry in Africa, we mostly report findings from the CCAF second annual Middle East and Africa bench-mark report (Ziegler et al. 2018). And, hence, unless otherwise noted, all facts and figures presented in this subsection are referring to findings from the above-named source.

Unlike other regions, where funding is locally driven by indigenous investors and platforms, crowdfunding in Africa has extensively been dominated by backers from outside of Africa. In 2016, African crowdfunding volumes reached $181.27 million, while growing 118% from 2015. However, a substantial part of this amount, capturing 88% of 2016 volumes and 89% of the 2015 volumes, was raised through foreign-based platforms headquartered in Europe and the United States. The growth curve and the dominance of foreign funds signal Africa's unexploited crowdfunding opportunities and the embryonic status of crowdfunding as a financing vehicle in Africa. These indicators may suggest several implications worth highlighting. First, there is a high possibility for the continent to continue to experience exponential growth. Second, a growing share of activities may emerge from within Africa as local platforms sprout, the populace gets better educated about and better familiarized with crowdfunding, and as regulatory institutions build legal frameworks that are more conducive and enabling of a crowdfunding ecosystem. Such developments are likely to increase indigenous backers' and investors' appetite towards crowdfunding local projects.

The African continent includes multiple regional and national markets with diverse development levels, institutional environments, and geographical conditions. Such diversity is also evident when examining the development of crowdfunding in various regions of the continent. Here, in terms of size, between 2013 and 2016, the East African region has emerged as a consistent market leader with an average annual market share of 38%. West Africa comes second with 34%, followed by the South African region with 17%. Central and North Africa are behind with 7% and 4% respectively. While some decline was registered in East and Central Africa in recent years, dramatic growth has been recorded in Southern Africa (824% in 2015 and 116% in 2016) and Western Africa (150% in 2016), which are associated with market development in South Africa and Nigeria respectively. Strong growth was also observed in North Africa growing 80% on average between 2013 and 2016, with most activities in Egypt.

At the national level, Kenya and Uganda dominate the Eastern African region. Nigeria and Cote D'Ivoire account for the major share of the Western African region. South Africa, Rwanda, and Egypt solely dominate the Southern, Central, and the Northern African regions respectively. On a continental basis, Nigeria, South Africa, and Kenya dominate Africa's crowdfunding industry overall. These three countries jointly account for 74–82% of annual African crowdfunding market volumes between 2013 and 2016.

When examining African crowdfunding by model, and like other global regions, evidence shows that a large proportion of crowdfunding volume is associated with investment models, which accounted for 79% of total volumes in 2015 and 63% in 2016. When splitting these volumes further among the various investment models, lending-based models jointly account for the largest share of investment-crowdfunding volumes, capturing 90% of such volumes in 2015 and 56% in 2016. These percentages correspond to volumes equal to $59 million in 2015 and $63 million in 2016. This development is mostly evident with respect to peer-to-peer business lending that grew 46% between 2015 and 2016, while crowd-based pro-social microlending remained stable at $34 million in both 2015 and 2016. Nevertheless, 2016 has seen the introduction of additional crowdfunding investment models in the continent. Here, equity, real estate, and profit-sharing models grew from $6.39 million in 2015 to $51.31 million in 2016, jointly representing an impressive 701% growth. Overall, the emergence of these models jointly represents 28% of total volumes raised in 2016, which explains the shrinking share of crowdlending out of investment model volumes, while the actual amount has increased.

At the same period, non-investment models of crowdfunding accounted for 21% of total volumes raised in 2015 and 37% of volumes in 2016. Here, reward-based crowdfunding experienced a modest increase from $3.17 million in 2015 to $4.17 million in 2016, while accounting for 2.3% of total volumes raised in 2016. Donation-based crowdfunding, on the other hand, exhibits more substantial volumes and growth while mostly relying on funders based outside of Africa. Under this model, $14.26 million were raised in 2015 and $63.11 million were raised in 2016, growing 342% between 2015 and 2016. This implies that donation crowdfunding is the single largest model of crowdfunding in the continent, representing 35% of total volumes raised in Africa during 2016. This stands at a stark contrast to all other regions in the world, where peer-to-peer lending models dominate.

While not yet substantiated in empirical research, one may suggest several explanations for the prominence of donation crowdfunding in the African crowdfunding context. First, one can argue that Africa is just following market development observed elsewhere, where initial crowdfunding activities were associated with non-investment types of crowdfunding that later paved the way towards the proliferation of investment-crowdfunding platforms (Bruton et al. 2015). Indeed, these dynamics have been observed in many countries in Europe, Asia, and the Americas. Second, and closely linked to the previous explanation, is the concern with risk and development of trust. In this sense, non-investment-crowdfunding engagements represent lower risk, involve modest sums, and are characterized by fewer regulatory compliance barriers than investment crowdfunding (Belleflamme and Lambert 2016; Ziegler et al. 2019). As such, non-investment crowdfunding becomes easier to implement and experiment with. Once individuals accumulate positive experiences with these models, they may develop greater willingness to gradually engage in activities that may be considered riskier, involve higher sums, and may carry greater regulatory implications (e.g. investor protection).

As the status of crowdfunding practice is now established, we now turn to examining the status of research on crowdfunding in African contexts while presenting key findings emerging from such academic work.

Emerging Insights from Crowdfunding Research in Africa

Research into crowdfunding in Africa is limited and represents early stages of market development, with most related studies being more conceptual in nature. Here, according to Wolf (2017), the crowdfunding phenomenon is congruent with traditional communal reciprocity culture of sub-Saharan African individuals. This view is also shared by Berndt (2016), who suggests that crowdfunding is a modern form of credit associations in the African context, where individuals invest in the businesses of others. Interestingly, the tradition of credit associations and other forms of microfinancing (delivered in diverse formats) have existed in many African cultures for decades. Credit associations work on the principle of communal reciprocity, where individuals usually contribute money periodically into a communal fund and the collected amount is either shared among the community members or invested on their behalf (ibid.). Notable examples of these credit associations include Susu in Ghana, Mabati in Kenya, Ekub in Ethiopia, Tontine in Mali, and Stokvels in South Africa (Coetzee 2013). Regardless of the form, these schemes thrive on small-scale financing to support group saving methods, and often involved communities are embedded with a culture of mutual supporting for business ideas.

Several studies attempt to compare crowdfunding to microfinance, with authors proposing that the advantages of the former can compensate for the inefficiencies in the latter (Wolf 2017; Oruezabala and Peter 2016). Here, based on a sample of 50 Gabonese small businesses, Oruezabala and Peter (2016) note that 78% of these SMEs derived their funding from personal funds, family, and credit associations. Thus, most of these small businesses are excluded from microfinancing, possibly due to their inability to meet certain requirements. Indeed, the researchers argue that some Microfinance Institutions are moving away from their social mission, a development that opens opportunities for crowdfunding platforms and makes crowdfunding an attractive alternative for small businesses.

Wolf (2017) suggests that the over-reliance of microfinance on subsidies makes it unsustainable thereby limiting its success and impact. Moreover, there have been calls for microfinance to focus not only on poverty reduction but also on social emancipation through creativity (de Haan and Lakwo 2010). In contrast, crowdfunding platforms are known avenues for creative and innovative ventures (Wolf 2017). Thus, although crowdfunding might draw some inspiration from microfinancing (Munyanyi and Mapfumo 2018), it can promote co-creation of innovation between entrepreneurs and funders (Wolf 2017) while strengthening the overall entrepreneurial financing dynamics which already exist in the microfinance industry (Oruezabala and Peter 2016). Accordingly, in their proposed model for crowdfunding penetration and success in Africa, Oruezabala and Peter (ibid.) present crowdfunding platforms as a source of new resources, rather as a new way to tap into old resources.

To these considerations, Flanigan (2017) introduces an additional important consideration by examining how crowdfunding could contribute towards enhancing diaspora philanthropy. For this purpose, she defined diaspora philanthropy as "money, goods, volunteer labor, knowledge and skills, and other assets donated for the social benefit of a community broader than ones' family members, in a country or region where there is a population with whom the donor(s) have ancestral ties" (ibid., p. 498). Here, Flanigan notes that an integration of the literature on the two phenomena shows that crowdfunding technologies could enhance the delivery of diaspora philanthropy—where diaspora philanthropy is seen as a subset of remittance flows into countries.

In the same spirit, online philanthropy may be viewed as the giving of financial and social capital for promoting human welfare through online platforms (Munyanyi and Mapfumo 2018). Hence, through crowdfunding, African migrants can continue supporting entrepreneurial activities by helping family members and friends in their countries of origin via the mediation of crowdfunding platforms. Again, this may be in tandem with remittances which serves as an important source of incoming capital in many African countries. Indeed, remittances sent by African migrants reached nearly $40 billion in 2010, an amount equivalent to 2.6% of Africa's gross domestic product (Mohapatra and Dilip 2011). As noted by Flanigan (2017), strategically capitalizing on the shared characteristics and complementary strengths of crowdfunding and diaspora philanthropy can help diaspora generated 'philanthropic crowdfunding' thrive.

Furthermore, diaspora members offer networks and knowledge that could help offset crowdfunding's vulnerabilities. Indeed, earlier research shows that diaspora networks have significant impact on cross-border investment (Leblang 2010). And that diaspora investments in countries of origin are affected by perceived ethnic advantage (over other investors) and altruistic tendencies, while perceptions of business impediments do not affect such investments (Gillespie et al. 1999). Bringing such insights into the context of crowdfunding, platforms may reduce informational and technical barriers for such investment opportunities and may enhance their likelihood by tapping into diaspora members' sense of ethnic advantage and altruistic orientation towards opportunities in their countries of origin. The latter reflecting beliefs that investors should invest in one's country of origin and not just send donations there (ibid.). One example for such initiative is the French-based LelapaFund platform, which is dedicated to facilitating investments in Africa by tapping onto African diasporas, which, according to one of its co-founders, perceive fewer barriers to such investments while normalizing risk associated with African venturing (Mulligan 2015).

Other authors have explored the factors influencing the plausibility of crowdfunding in Africa. More specifically, Munyanyi and Mapfumo (2018), focusing on Zimbabwe, identified four factors that influence the plausibility of crowdfunding, including strong and active social network, easy and reliable payment system, a passionate audience, and a funding gap. In this context, the identification of crowdfunding success drivers in Africa and how they can be directed towards economic development in the region are extremely important for both entrepreneurs and funders. A good example of such approach can be found in suggestions that crowdfunding may be adapted to solving regional issues such as power shortages, which are usually experienced in most parts of Africa, and by addressing a concrete need affecting people's lives, which will make crowdfunding more attractive for those who live in affected areas (Berndt 2016).

Challenges for the Development of Crowdfunding in Africa

Whereas crowdfunding is considered to present great opportunities towards enhancing access to finance, as well as supporting entrepreneurship, innovation, and development in Africa, it is also important to consider some challenges that may hinder crowdfunding adoption and growth in the continent. This is especially important when taking into considerations that the main vehicles for crowdfunding market development, namely crowdfunding platforms, are mostly entrepreneurial ventures themselves. And while entrepreneurs deal with adversity regardless of context, some challenges reign prominent in African contexts in general (e.g. Alon and Shneor 2017; Belwal and Singh 2008) and the African crowdfunding context in particular.

Regulation

In this context, researchers particularly emphasize that regulatory factors matter (Berndt 2016; Flanigan 2017). This assertion is supported by Munyanyi and Mapfumo (2018) who argue that, despite the viability of crowdfunding in Zimbabwe, there is a lot to be done to set up an enabling regulatory framework in the country. Overall, the health and strength of the SME sector in Africa is often viewed as a policy priority in most countries across the continent. Accordingly, African governments may address crowdfunding regulation as an enabler of domestic innovation and entrepreneurship. One path for such development may be facilitated by learning from the experiences of other countries elsewhere around the world. In this context, earlier research in Europe indeed showed that the more adequate national regulation is perceived to be by platforms operating in the same national market, the higher the overall crowdfunding volumes per capita in the same market (Ziegler et al. 2019).

Thus far, there remains "no bespoke, tailor-made alternative finance regulation regime that has been enacted in Africa as has been the case in other more established markets" (Ziegler et al. 2018, p. 22). And, in the absence of crowdfunding-specific regulation, generic financial services regulation applies to firms seeking to provide services falling within the scope of activities covered in existing laws. Nevertheless, several regulatory initiatives to support financial innovation more generally have been adopted by various African government agencies. These include, but are not limited to, various steps taken towards establishing regulatory sandbox processes for financial technology companies in Kenya, Mauritius, Mozambique, Rwanda, South Africa, and Uganda (Ziegler et al. 2018). In addition, the African Crowdfunding Association was established in 2015 as an industry organization dedicated to lobbying in favour of crowdfunding legislation creation and reforms, increasing public awareness of crowdfunding, and ensuring industry practices that protect investors and democratize access to capital (African Crowdfunding Association 2019).

Information Technology Infrastructure

Since online forms of crowdfunding heavily depend on access to social media and social networking sites, as well as web-based platforms, internet access is paramount to its successful dissemination and uptake. Here, an important challenge for the development of the industry in Africa relates to internet infrastructure and the relative low internet penetration in many regions across the continent. As a whole, internet penetration rate in Africa stood at just 37.3% in May 2019 in comparison to 60.8% in the rest of the world (Miniwatts Marketing Group 2019). Here, again, regional and national variations do exist, and while some countries report relatively high penetration levels such as 83% in Kenya and 80.1% in Liberia, others exhibit much lower rates such as 1.3% in Eritrea and 4.1% in Niger (ibid.). Such conditions limit the ability of African fundraisers to capitalize on the value of network externalities in crowdfunding (Wolf 2017). To overcome such challenges, crowdfunding platforms operating in Africa have leveraged mobile technology while using innovative ways to create and promote projects via SMS, popular mobile apps (e.g. WhatsApp, Messenger, Viber), and use of mobile money to fund projects (Boum 2016).

Social Trust

Furthermore, from a social-normative perspective, African countries are often found to be characterized by a relative low level of social trust (Delhey and Newton 2005). Social trust was defined as "the belief that others will not deliberately or knowingly do us harm, if they can avoid it, and will look after our interests, if this is possible" (ibid., p. 311). While this may seem at odds with traditional crowdfunding practices in Africa, it is explained by the distinction between trust towards in-group members versus strangers. Africans may exhibit trust towards familiar in-group members, while exhibiting lower levels of trust towards strangers outside their immediate circle of acquaintances (Posel and Hinks 2012) than other societies. However, both trust between strangers and trust towards online transaction are required in order to facilitate a thriving crowdfunding market (Kshetri 2015).

Research from other contexts of online transactions shows that satisfactory online customer experience enhances trust in e-retailing/online shopping (Rose et al. 2012) and in e-banking/online banking (Ghane et al. 2011). Taken together, these insights may suggest that trust can also be created with experience, and that adoption may be enhanced by creating opportunities for crowdfunding experience with low entry thresholds. Moreover, the transparency involved in crowdfunding transactions can serve as a trust facilitating mechanism (Spanos 2018). Here, information about delivery and repayment of loans, as well as non-delivery or non-payment on loans, will be publicly available and deter fundraisers from shirking such responsibilities for avoiding a damage to their reputation and self-image. Indeed, research shows that concerns about disclosure, visible failure, and projecting desperation hinder entrepreneurs from using crowdfunding (Gleasure 2015), and by extension may help curtail related moral hazards. In addition to the above, the transparent digital recording of transactions can also help in limiting opportunities for corruption in the financial sector, which represents a concern in various African countries (Hanlon 2002; Demetriades and Fielding 2012).

Finally, as platform survival and growth depend on positive user experiences and successful campaigning, most platforms engage in careful campaign filtration, validation, and selection processes. This is evident in platform onboarding rates, which reflect the percentage of campaigns published out of total campaigns requesting to be published on a given platform. Here, while onboarding rates are not yet available for African platforms, European platforms report average onboarding rates of 49% in reward crowdfunding, 74% in donation crowdfunding, 17–22% in leading crowdlending models, and 6% in equity crowdfunding (Ziegler et al. 2019). In this sense, platforms serve as risk-reducing players in comparison to independent and unverified fundraising initiatives that do not go through the scrutiny of platform validation procedures (e.g. fundraiser identity verifications, background checks).

Early Days of African Crowdfunding: Hybrid Forms of Crowdfunding

As mentioned earlier, African crowdfunding for Africans and by Africans remains at a very early stage. Accordingly, fundraisers in this sphere attempt to tap into crowdfunding's promises of improved access to finance and enhanced transparency, while manoeuvring between existing barriers to adoption at both social and institutional levels. Such efforts can be characterized as hybrid forms of crowdfunding implying combinations of multiple channels for fundraising in addition to crowdfunding platforms. In this section, we present several illustrative examples of such hybrid forms from East African crowdfunding campaigns.

First, a donation campaign created for a Tanzanian member of parliament, who got shot and was severely injured, sought to raise funds for his medical treatments. The campaign was created on the US-based global platform Gofundme by a group of Tanzanian diaspora members in the United States (Kolumbia 2017). However, in parallel, locals in Tanzania used M-Pesa mobile money to support the same campaign where the money was being paid directly to the account of the beneficiary. The local campaign was steered primarily through Word of Mouth. Here, even though most of middle-class Tanzanian citizens had the capacity to make their contribution via the Gofundme platform, they preferred sending their contribution using mobile money and direct bank account transfers. As a result, most online contributors were members of the diaspora.

Second, a different donation campaign was created to raise fund for the development of the Fishmate platform. This platform aims to serve the fishing and aqua-culture industry as a channel for information aggregation and dissemination, as well as a marketplace linking demand and suppliers among fishing communities in Kenya. The campaign was created on the global Dutch-based platform Onepercentclub by the entrepreneur—Mukeli Matai (Raymond 2015). Here, again, support from foreign and diaspora members was collected via the platform, but in addition Mutai needed to build a group of individuals who would form the base of her campaign in Kenya. This group, however, was either unable or reluctant to contribute money through the platform. In response, Mutai formed an offline fundraising campaign effort known locally in its traditional name—"Harambee". Under this effort, a "treasurer" was appointed to collect money from contributors via the M-Pesa mobile payment system or in cash. This treasurer then made a single contribution to the Onepercentclub platform, which then transferred funds to Mutai's bank account. Overall, Fishmate raised €2678 from about 20 family members in Kenya, a sum which was later matched with €6000 from the Cheetah Fund. Here, the matching fund scheme presented is an important incentive for her network to contribute online via the platform and not directly.

Third, in one of the first reward campaigns launched through a new platform being developed in Tanzania under the Dar Technology and Business Incubator, it was reported that individuals collected money from peers offline and then transferred the collected sum to the intended recipient. A major challenge from this method as highlighted by the platform owners is the difficulty in identifying those who contributed through offline groups because it is only possible to track the one who transferred the funds. As money laundering is a concern in most of the countries, it is important to establish the identity of contributors for complying with legal and ethical practices in fundraising. Here, while the platform does request detailed information from contributors of relatively large sums, it remains a challenge to establish the accuracy and trustworthiness of such information.

Overall, the above examples indicate that crowdfunding uptake in Africa requires overcoming challenges associated with trust and technical concerns at early stages of crowdfunding engagement. The cases presented above suggest that campaigners complement campaigns posted in online platforms with traditional or technical payment systems Africans are already well familiar with. Specifically, combinations of online and offline efforts seem to support fundraising activities by tapping into different groups of prospective contributors. Such approach has received support in earlier studies showing that offline activities play an important role in sustaining online communities (Lin 2007).

Indeed, initial steps towards understanding the role of offline activities in crowdfunding have shown several interesting findings in other contexts. Here, a study of civic crowdfunding (when citizens, in collaboration with government, fund projects providing a community service) concluded that integrating online and offline approaches are essential for such campaigns' success (Stiver et al. 2014). And, a different study on crowdlending in the United States showed that when borrowers are registered in same state as the borrowing group leader (used as proxy for likelihood of offline interactions) crowd loans get more bids from prospective lenders but show no effect on the total amount raised (Kuwabara et al. 2017).

Conclusion

In this chapter, the current state of crowdfunding research and practice in Africa has been outlined while highlighting some of the opportunities and challenges associated with them. Overall, we show that African crowdfunding is at its infancy. However, the extent to which crowdfunding may deliver on its promises of improved access to finance and enablement of growth remains to be substantiated empirically as the market grows and the industry matures.

Here, on the one hand, conditions of growing popularity of digital and mobile finance, low penetration of traditional financial institutions, and a long cultural heritage of communal mutual support may enhance crowdfunding uptake. On the other hand, conditions of unclear regulation, relatively low levels of internet access, and societies characterized by low social trust may all hinder crowdfunding uptake. Hence, for wider public adoption of crowdfunding, stakeholders interested in such development may need to engage in relevant policy development, implementation of technological solutions suitable for available ICT and financial infrastructure, raising public awareness through education, reducing user entry barriers, and creating low-risk or risk-free incentives for trial. Such actions can support the shift away from donation collection to investment fundraising, and from reliance on foreign investors towards enabling local micro-investors to build up their own capital base.

Implications for Future Research

Our review clearly shows that research on crowdfunding in the African context remains limited and conceptual. This implies that opportunities for future research are abundant and especially when considering empirical work that can test and challenge insights and findings from elsewhere around the world. Specifically, future research should focus on investigating crowdfunding adoption and its implication for development in Africa. Such efforts will enhance the understanding of how and to what extent does crowdfunding help in unlocking the potential of access to finance and investment opportunities for wider financial inclusiveness, business development, and job creation in Africa. Studies on crowdfunding adoption may explore the applicability of existing theoretical frameworks such as the Technology Acceptance Model (Venkatesh and Davis 2000) and the Theory of Planned Behaviour (Ajzen 1991), as well as highlight needs for their modification in the new realities of digital and mobile finance in development contexts. Studies examining the impact of crowdfunding can help us measure and capture the extent to which crowdfunding contributes to venture creation, survival, and growth, as well as the extent to which crowdfunding enables greater inclusivity and access to finance for groups that traditionally struggle with it such as women (Carter and Rosa 1998; Coleman 2000) and minorities (Ram et al. 2003).

Furthermore, the African context itself may represent a particularly conducive environment to study several important issues. First, research should identify and explore the effectivity of mechanisms and strategies for establishing trust in crowdfunding in societies characterized by low social trust. Second, research can also examine complementarities of offline and online dimensions of crowdfunding in environments characterized by limited ICT infrastructure and e-readiness. Third, research can examine the role played by diaspora in African crowdfunding campaign success in general, as well as facilitators of trust for African crowdfunding campaigns particularly vis-à-vis other international supporters.

Implications for Practice

Our review also shows that the African crowdfunding industry is at its infancy. As a new emergent sector that aims to solve market gaps by both extending and supplementing existing fundraising channels, certain critical elements need to be developed for supporting such efforts. First, regulators should engage with domestic and international industry players, as well as peers in other countries in reviewing and amending legal frameworks towards accommodating a good balance between user and investor protection while enabling the industry's responsible and sustainable growth. In addition, government bodies in collaboration with educational institutions may engage in developing training programmes and dissemination of public information about the risks and benefits of using crowdfunding for fundraising and investment purposes for both individuals and organizations.

In parallel, platforms aiming to establish themselves in African markets need to invest their resources into developing technological solutions that fit development realities and infrastructure conditions in Africa (e.g. integration of mobile payment, social media, and instant messaging functionalities), implementing relevant filtration and validation procedures for quality assurance and avoidance of fraud (e.g. creative solutions for identity verification and documentation), as well as introducing incentive mechanisms to encourage trial by prospective users while reducing entry barriers and risks associated with such trial (e.g. internal insurance funds, gradual increasing sums for fundraising based on historical performance of users).

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15

The Emergence of Crowdfunding: Study of Israel

Kalanit Efrat, Shaked Gilboa, and Daniel Berliner

An Introduction: The 'Prenumeranten' Phenomenon

The life story of Yisrael Haim of Belgrade illustrates a vivid picture of Jewish life in the eighteenth and nineteenth centuries. He fled to Vienna due to military struggles, where he was associated with the local aristocracy. During that time, he was familiarized with the *prenumeranten* (a term in Yiddish, literally meaning 'prior numbers'). The prenumeranten was a system used by Western European Jews. Back then, book production was costly, and authors were requested to pay one-third of the publishing costs

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in advance to the publishers. To collect the required amount, they used the prenumeranten scheme in which the author or other individuals on his behalf travelled to various Jewish communities, seeking to persuade people and establishments with a potential interest in the book to support it. These people and establishments were later recognized for their support by having their names printed in the volume's front matter as an acknowledgement in the book's first edition. Yisrael Haim used this system to publish a complete Ladino translation of the Bible (Bunis 1996). Thus, in the nineteenth century, the prenumeranten was a common system for publishing books, and as many as 8750 Jewish communities across Europe and North Africa participated in it (Cohen 1975).

As such, the prenumeranten system can be considered an early version of the modern crowdfunding concept. At the same time, the innovative approach for soliciting funds illustrates the cultural origins of the Jewish entrepreneurial spirit. Indeed, the crowdfunding concept found fertile ground in Israel, facilitated by a growing need for funds to support various types of ventures. These ventures were accompanied by the curiosity and inquisitiveness that is so typical of Israelis, which facilitated a generally welcoming approach to novel things and ideas. In the following section, we discuss the various aspects of the entrepreneurial ecosystem driving crowdfunding in Israel.

We begin by mapping the main components of the Israeli entrepreneurship ecosystem while discussing each in the context of crowdfunding and provide illustrative examples. We then continue by describing the crowdfunding scene in Israel, detailing its various types, and discussing the emerging trends. We conclude with implications and conclusions.

The Israeli Entrepreneurship Ecosystem

The Facets of Entrepreneurship and Innovation in Israel

The drivers of the Israeli crowdfunding are strongly associated with the country's entrepreneurship ecosystem. Israel has been an entrepreneurship leader for most of the last three decades. It is ranked fifth in the 2019

Bloomberg Innovation Index, tracking the most innovative countries (Jamrisko et al. 2019), and fifth among the developed countries in its entrepreneurial level, as reported in the Global Entrepreneurship Monitor (Menipaz and Avrahami 2019). Moreover, the country has been ranked fourth among the developed countries in the Global Entrepreneurial Spirit Index of the Global Entrepreneurship Monitor, indicating the strong entrepreneurial culture in the country (Menipaz and Avrahami 2019). The innovative culture of Israel is manifested in substantial governmental investments in research and development. Israel is the leading country among the OECD nations in gross domestic spending on R&D, with 4.5% of the country's GDP (as of 2017), and 17.4 researchers per 1000 employed (OECD 2018).

Israel is also an acknowledged leader in the tech industries (Engel and del-Palacio 2011), ending 2018 with $6B of funding raised by 645 companies, an increase of 15% from the previous year, and a 140% increase over five years. In line with these funding numbers, the number of active Israeli high-tech companies has grown by 27% since 2014 (Korbet 2019). One manifestation of Israel's entrepreneurial nature is the number of exits among Israeli high-tech firms. During the last five years, 493 companies executed an exit strategy. Whereas these numbers are declining, with more companies preferring to remain private for longer (Korbet 2019), the *exit* term had long established itself in the Israeli culture. Recent studies discussed the duality surrounding the exit strategy, concluding that whereas previous research tends to address it as a failure, about one-third of the US entrepreneurs consider it to be a signal of success (Wennberg and DeTienne 2014). For the Israeli scene, these numbers are higher. For several years already, *exit* connotes success (Noff 2017).

In line with this burgeoning entrepreneurial environment, whereas only about 8% of the population is employed in the high-tech industry, one of every three Israelis testifies that they know someone who is an entrepreneur (Korbet 2019). Sixty-five per cent of Israelis view entrepreneurship as a desirable career choice, and over 80% of them think that it represents a high success status (GEM Team 2018). Indeed, it is common knowledge that whereas in the past, Jewish mothers longed for their sons to become doctors, nowadays they wish them to be entrepreneurs.

To summarize, these numbers primarily represent a strong belief in the Israeli entrepreneurship scene—by both internal and external stakeholders—defining Israel as a cluster of entrepreneurship and innovation (Engel and del-Palacio 2011). This scene provides fertile ground and growing demand for funding to support the vast and diverse initiatives incepting in Israel on a daily base, among which is crowdfunding.

The Israel Defense Forces (IDF) as a Facilitator of an Entrepreneurial Culture

One institution with an important role in facilitating the Israeli entrepreneurial culture is mandatory army service in the IDF. The majority of the Jewish Israelis between the ages of 18 and 21 are required to enlist to the IDF and are then assigned to an army occupation unit congruent with their education, experience, and abilities and in accordance with the army needs. In the IDF, individuals are thus defined by their army occupation, and this dynamic follows them to their civilian life and future occupations. Senor and Singer (2011) cited an Israeli venture capital investor that sums up the ethos of the IDF: "Israeli **soldiers** are not defined by rank; they are defined by what they are good at" (p. 50). As such, army service plays a much more meaningful role in forming the individual's professional identity than any other factors, such as family origins.

Moreover, due to the various threats the country faces, IDF culture is grounded in innovative thinking and quickly learned lessons, joined by expressions of courage (Johnson 2011). This means, for example, that a combat unit should be able to perform multiple tasks, be flexible enough to react to changes and unexpected circumstances in the battle arena, and be empowered to improvise in the course of battle (Senor and Singer 2011). As such, the IDF culture reflects and promotes the Israeli entrepreneurial culture, characterized by delegating responsibilities to lower-ranking soldiers, operational flexibility, courage, and multi-tasking. Many Israeli entrepreneurs were imbued with these values during their army service and managed to apply them in the business world.

The army also serves as an integrative institution in Israeli society. In the army, many youngsters from varying backgrounds, such as new immigrants and people from diverse socioeconomic levels, serve together for two to three years in mandatory service and for an additional 20 years in annual reserve duty (Senor and Singer 2011). This integration, along with intense interaction, sometimes in life-threatening situations, ties army colleagues together. Consequently, high-tech firms are known to recruit soldiers from specific leading army tech units (Yablonko 2019).

In the context of crowdfunding, creators are driven by both a sense of comradeship, which provides assurance, and a feeling of 'all is possible', which allows them to defy convention and dare to pursue their goals and dreams. Many crowdfunding creators base their first wave of recruitment on their IDF buddies. For example, the donations-based campaign of *Together, we will win—Saving Ronen* was aimed towards funding a lifesaving treatment for a brain cancer patient. The campaign marketing stressed Ronen's biography as an officer and commander in an elite commando unit in the IDF, having participated in bold operations. Many of his backers were former members of the unit. The funding goal was about $285K, and it raised around $336K—a success rate of 118%.

A further example is Indorz, a startup specializing in cannabis farming technology. The firm was founded by two graduates of Israel's most renowned IDF tech unit, which serves as a facilitator of many Israeli startups. The firm launched two crowdfunding equity campaigns. In the first round, the company recruited $1.4M in a combined round, comprising 382 investors supporting the company in an open public platform, and three anonymous angels investing through a dedicated platform. This campaign's success rate was 325%. In a second round, the company recruited an additional $556.5K from 656 investors, reflecting a 390% success rate. These successful funding campaigns can be traced, among other reasons, to the IDF unit where its founders served, a fact stressed in all the media coverage, as the unit is known for its graduates' successes.

Crowdfunding as Entrepreneurial Spillover

As can be seen, entrepreneurship is well integrated in Israeli life. It receives substantial exposure in the news, and many academic institutions have incorporated it in one variety or another (technological/social) into their curriculum. This growing attention calls for an examination of the crowdfunding phenomenon as a variation of 'entrepreneurial spillover'. This means that innovation-driven entrepreneurship can spill over to other fields. While entrepreneurial spillover has previously been used to illustrate how entrepreneurship is transferred across countries (Fairlie and Lofstrom 2015), a more recent study discussed this term as describing a diffusion of entrepreneurship between organizations of the same country (García-Cabrera et al. 2017). Based on the 'entrepreneurial spillover' effect, we may presume that by being exposed to entrepreneurship through various channels, crowdfunding stakeholders are 'infected' by it and 'catch the bug'. In the context of crowdfunding, this spillover operates in two distinct ways. First, it generates an abundance of entrepreneurial initiatives that vary in scale and scope, hence allowing for different funding techniques to blossom alongside it. Second, it speeds up the market's learning process, facilitating the adoption of these tested techniques, thus, driving fundraising volume.

The Story of the Beresheet Spacecraft as a Manifestation of the Role of Crowdfunding in the Israeli Entrepreneurial Ecosystem

This innovative culture can be better explained through a recent example: on April 11, 2019, the *Beresheet* (Hebrew for Genesis, a beginning), a spacecraft designed by the SpaceIL project, made a crash landing onto the moon. A day later, Morris Kahn, the leading investor of the project and president of SpaceIL, announced project Beresheet2, the next spacecraft to be sent to the moon (Etzion 2019). The case of Beresheet is a reflection of the story of the Israeli entrepreneurship culture. The Beresheet initiative began with three young engineers who dreamed of participating in the Google Lunar X Prize challenge. Google's call was targeted at private teams, posing the challenge of building an unmanned spacecraft, land it on the moon, move it 500 metres across the lunar surface, and send high-definition pictures and video recordings back to Earth. The founders established the SpaceIL, a non-governmental agency, and launched an Indiegogo campaign in May 2014 to fund their quest. The campaign managed to raise over $250K, exceeding its goal (118%). The awareness created by their inspiring dream and nurtured by the campaign attracted a community around the project numbering 250 volunteers, as well as leading scientists, engineers, opinion leaders, and organizations. Among these stakeholders were several prominent figures and institutions: the head of the Israel Space Agency, the president of the Weizmann Institute, the president of Tel-Aviv University, Israel Aerospace Industries, and Bezeq (Israel's leading communication company). In subsequent years, the founders managed to secure additional funding of $100M from private investors (*angels*). Thus, it evolved into a joint project of SpaceIL and Israel Aerospace Industries (Goichman 2019). On February 22, 2019, the spacecraft began its journey to the moon. It received continual coverage in the Israeli media, and the Israeli public followed Beresheet journey with much pride and excitement, as Israel aspired to be the seventh nation to launch a spacecraft to the moon and the fourth nation to land on it (i24NEWS 2019).

Goichman (2019) sums up the story of the Beresheet endeavour by saying that the spacecraft is another demonstration of Israeli *chutzpah* (audacious and non-conformist behaviour). With leading nations investing billions of dollars in their space projects, Israel managed to reach a symbolic achievement by thinking 'out of the box', applying simple technologies, and flexibly exploiting opportunities. Thus, the story of Beresheet symbolizes the primary qualities that are driving Israel to become an entrepreneurship leader: daring to take risks, challenging conventions, thinking creatively, improvising, and remaining undaunted of failure along the way, along with communal support from the society in general. Beresheet's journey, therefore, is an exemplary manifestation of a crowdfunding campaign drawing on the meaningful elements of the Israeli entrepreneurial culture on its way to success. These elements will be elaborated next.

Elements of Israel's Entrepreneurial Culture and Their Manifestation in Crowdfunding Campaigns

A recent statement from an Israeli scientist sums up the Israeli entrepreneurship culture: "The courage to think, to improvise, the lack of fear to fail, the lack of fear to challenge conventions" (cited in Yair 2019, p. 25). These aspects—those that make Israel a leading entrepreneurship country—will be addressed in the following discussion. We will also demonstrate how these characteristics are manifested in Israeli crowdfunding campaigns.

Several factors contribute to the Israeli entrepreneurial culture. In an effort to provide readers with a comprehensive recipe of what makes Israel the *startup nation*, Senor and Singer (2011) identified several elements. Some of these elements can be linked to Israel's very establishment in 1948 and the immediate demand to absorb unprecedented numbers of immigrants from 100 different countries; other elements may relate to Israel's having to face ongoing military engagement and threats of terror (Rebhun and Waxman 2004). This combination of various challenges contributes to an innovative culture. In the following section, we describe the cultural elements that comprise the Israeli entrepreneurship ecosystem.

Collective Individualism

The roots of the modern State of Israel can be found in social-Zionistic movements established in the second half of the nineteenth century, which advanced values of egalitarian and collective society (Shindler 2013). The original collective nature of Israel can be found in valuing individuals who were committed to society at large and were willing to contribute to their communities unconditionally. Since then, Israel has transformed into a more individualistic culture, likely influenced by the US. However, the culture has evolved into a collective individualism (Weiss 2003). Weiss (2003) explained this amalgam of collective individualism in the country's unique geopolitical features, comprised of being small in size in comparison with neighbouring countries, joined by an ongoing sense of being bounded by hostile countries, and having to face continuous military and terror threats. This combination has led to a strong sense of community, induced by feelings of isolation. The sense of community manifests itself in open social behaviour, including interaction between individuals of different hierarchical positions. For example, many serial entrepreneurs and venture capitalists freely offer their wisdom and experience to new entrepreneurs (Yin 2017), whereas senior professors and their graduate students maintain close informal relationships (Yair 2019). The communal nature of Israeli society is also manifested in 'one degree of separation'. According to Menipaz and Avrahami (2019), about 59% of Israelis know an entrepreneur, putting Israel in second place among the developed countries regarding familiarity with active entrepreneurs. Israelis feel free to contact anyone quickly, even those they do not know (Yin 2017).

An example of the strong collectivism of Israelis can be found in the *Bringing Yehuda Back Home* campaign. Yehuda is an IDF officer who was severely injured during his army service and had become disabled due to his injury. For him to return to reside near his parents' home, he required a custom-built unit designed to accommodate his physical condition. Friends of Yehuda's family launched a campaign aimed at collecting money to fund the construction of the unit. The original funding goal was set at about $171.4K. The funding goal was reached in a matter of 18 hours. By the time the campaign ended, a sum of $447.4K was collected from 8382 backers, a success rate of 261%. Some additional examples of successful donation campaigns from recent years include campaigns raising large sums of money to support families of terror victims (ranging from $285.7K to $571.4K). These examples demonstrate how social solidarity drive Israelis to quickly converge into a community of backers that are committed to support the campaign and continue to be involved in it.

Low Power Distance and Lack of Hierarchy

The egalitarian nature of Israeli society is also manifested in its low power distance (Hofstede 2001). Israel scores 13 out of 100 on Hofstede's power distance index, indicating a very low societal power distance across life stages and organizations. This low power distance is expressed in expectations from employees to be autonomous and from managers to be accessible to their employees. Managers count on the experience of their employees, and employees expect to be consulted. Superiors often allow their subordinates to take the lead, with the latter freely challenging the thoughts and notions of the higher ranks (Yair 2019). Israelis are more likely to judge ideas by their content than by the status of their originator (Yair 2019). The workplace is characterized by an informal atmosphere and direct communication (Hofstede 1985). Israel's low power distance is congruent with Senor and Singer's (2011) assertions regarding Israeli culture as "class-less", and how this element surfaces in day-to-day business operations, with Israelis prone to challenge everything. Hofstede (1985) discussed at length how national and organizational institutions interact based on their value systems, claiming an indisputable link between the two. The low power distance indicator offers a clear example of how features of institutions at the national level merge into the business environment, thus, providing the business environment with a competitive advantage. Indeed, the inclination to continually challenge higher-ups and the lack of hierarchy lead to a sense of chaos that is facilitative of entrepreneurship (Nooteboom 1994). Examples for low power distance can be found on social media interactions between creators and backers, where backers leave questions and even phone numbers on the campaigns' social media pages (especially Facebook), requesting creators to phone them.

Israeli Chutzpah

Israel's egalitarian character, linked with an inclination to improvise and engage in courageous acts, as manifested in the Israel Defense Forces (IDF), can be related to the notion of *chutzpah*. In their book on the startup nation, Senor and Singer (2011) discussed the role of chutzpah at length as a trigger and facilitator of Israeli innovativeness. The term chutzpah is a Yiddish language expression, defined as a "laudable audacity or apparent effrontery that actually conceals a brave and often new approach to a subject or endeavour" (Schultz 2007, p. 209). A recent study by Efrat and Souchon (2016) explored the components of chutzpah, revealing it as a complex attitude encompassing creativity, spontaneity, originality, and boldness, on the one hand, and defiance, bluntness, transgression, and irreverence for conventions, on the other. Overall, these components allow for challenging existing ideas and paradigms, out-of-the-box thinking, and bold actions (Yair 2019).

While only scant academic efforts have addressed chutzpah, the concept is pervasive in popular, non-academic publications, primarily indicating its having been well integrated in businesses' day-to-day operations (Tellez 2015). In the context of entrepreneurship, chutzpah carries a distinguishing mark of guts, risk-taking, and can-do behaviours, the fuel that drives entrepreneurs forward (Morato 2012; Yin 2017). Israelis are courageous and are prepared to try things that other cultures do not (Yair 2019). They are also known for their improvisation habits, enabling them to be undeterred by low budgets and sub-optimal facilities and equipment to reach their goals (Yair 2019). Yin (2017) summarizes, claiming that "When Israelis see an opportunity, they tend to take the plunge and start something 'quick and dirty' to see if it works".

An example of chutzpah manifestation in crowdfunding is the story of *Fashanga*, an Israeli online fashion mall. The company was established by two young Israeli entrepreneurs having no previous knowledge or experience in the local fashion scene. That did not stop them from establishing an online fashion mall company while launching an equity campaign that managed to raise over $120K from eight investors. Following its initial success, the company launched a second equity-based campaign, raising over $200K from 27 investors. According to one of the co-founders, they specialize in spotting opportunities; they noticed that Israel was lacking a local online mall that would enable Israelis to shop locally while enjoying the international experience. *Fashanga*'s co-founders demonstrated boldness, daring, defiance, and creativity, all qualities associated with chutzpah.

Another example is *Just Beyond our Border—Israelis for the Syrian Children* campaign, which reflected irreverence for conventions. The campaign was initiated in 2016 by the Israeli humanitarian organization, 'Israeli Flying Aid', aiming to collect money for purchasing products and equipment for Syrian children. The campaign raised $444.3K from 8227 backers. The campaign reflected Israeli chutzpah in lifting the curtain of secrecy of the humanitarian aid provided by Israel (through a special unit of the IDF established for this purpose) to Syrians who suffered through the ongoing civil war.

High Tolerance for Failure

Chutzpah behaviour is often accompanied by a high tolerance for failure. A recent report published by the Israel Venture Capital (IVC) research centre estimates that only 4 out of 100 startups succeed, and only 4 out of every 500 will survive independently (IVC 2017). Therefore, the likelihood of failure would appear to be considered as a deterrent, inhibiting entrepreneurs from initiating new ventures. Studies on entrepreneurship have reported that tolerance of failure promotes innovation and creativity, enabling the organization to take daring moves (Kowang et al. 2015). In the Israeli context, senior managers in its high-tech industry, as well as senior scientists, treat failure as having positive features, enabling one to derive benefit from the experience, as long as he or she gets back on their feet (Yair 2019; Yin 2017).

An example of high tolerance for failure is the *TLT Board* campaign. The founder launched a campaign to raise money for an electric skateboard before he had a product in his hand. This campaign was a component of the founder's participation in a reality TV show aimed at assisting beginning entrepreneurs in their projects. The founder was very doubtful about the campaign's prospects of success and did not expect much. The campaign funding goal was approximately $2.9K, and it managed to raise around $29.8K from only 40 backers, with a success rate of 1043%. Following the success of the first campaign conducted on the Israeli platform, Headstart, the founder launched an additional campaign at Indiegogo platform a year later that did not reach its funding goal. However, the founder did succeed in launching a company selling the TLT boards.

We end this section with two illustrative cases of successful crowdfunding campaigns that encompass the various aspects of the Israeli entrepreneurial ecosystem components. The first is *InnoCan Pharma's* equity campaign, and the second is a rewards-based campaign of *Chocolate Panda*.

InnoCan Pharma: A Successful Equity Campaign

Innocan Pharma is an early-stage pharmaceutical company, established by an experienced team of serial entrepreneurs and pharmaceutical experts, led by an ex-Teva-Israel CEO. The company was founded with the goal of penetrating the worldwide pharmaceutical industry, exceeding USD 1.2 trillion revenues in 2018 (Mikulic 2019), with an innovative idea of embedding cannabis-based ingredients into dermatological products. The nature of the pharmaceutical industry has several components: it is highly regulated, long time-to-market, high cost of research and development, and is dominated by global enterprises, thus comprising a very high-risk endeavour. Nevertheless, InnoCan decided to penetrate this industry by harnessing innovative technologies into the research and development process of new pharmaceutical products and significantly shortening its Time-to-Market. The team peruse their idea and took a daring move, in establishing the entity, was enabled only by the Israeli entrepreneurial "can-do" culture and its high tolerance for failure behaviour (Kowang et al. 2015). This step was taken along with the perception that "even" failure has its positive aspects and can be seen as an opportunity for future learning (Yair 2019; Yin 2017).

On July 2018, InnoCan launched its crowdfunding campaign on the PipelBiz equity platform, with an initial funding goal of about \$285.7K. By mid-August, the company had reached an investment of approximately \$857.1K, thus achieving a success rate of 296%. The campaign was supported by 522 individuals, representing the full scope of the Israeli population. The campaign attracted investors from various geographical regions, backgrounds, and financial situations, investing sums ranging from \$143 to \$2.9K.

The company's CEO characterized the six-week campaign as a perfectly structured and timed operation with the goal of reaching the predefined amount. During these six weeks, the company utilized its Facebook company page to raise awareness and to provide updates on its progress. The presence of an ex-Teva-Israel CEO in the company's management team and the fact that the new company was developing new cannabis-based drugs generated huge interest and coverage in major Israeli online and offline media. The company leveraged its founders' and management's personal connections, experience, and reputation in order to raise awareness and attract the attention and trust of as many people as possible. Hundreds of Israelis, investors-to-be, 'picked up the gauntlet', and felt comfortable directly calling the company CEO's personal phone to learn about the investment opportunity, the company's future plans, and prospects of success. During the six-week campaign, the company's CEO stated that she had placed 25 phone calls every day with potential investors in order to explain the company's strategy and gain their trust. This open social behaviour, illustrated by strangers querying the company's CEO on her personal phone for the sake of engaging in an informal direct communication, is an accurate depiction of Israeli's lack of hierarchy and low power distance culture behaviour.

One of the company's declared goals, during and after the campaign, was to progress in the direction of an initial public offering (IPO) in the Canadian Securities Exchange (CSE). Indeed, on September 2019, the company announced a successful IPO on the CSE under the symbol "Inno", transforming its 522 crowdfunding investors into shareholders in a publicly traded company (Accesswire 2019).

The crowdfunding campaign and the company's business plan to penetrate the highly risky pharmaceutical industry—accelerating from 'zero to a hundred in six seconds'—illustrate the uniqueness of the Israeli entrepreneurship scene: risk-taking, high tolerance for failure, and can-do behaviour.

The InnoCan Pharma campaign was the first successful equity crowdfunding campaign to operate under the new Israeli regulation, enabling both early-stage entrepreneurs and crowd-investors to pursue their dreams. By utilizing this mechanism, the company raised the needed capital for its activity, with the crowd-investors given the opportunity to take part and invest in the establishment of the new entity, in the most democratic form. This campaign is still considered to be the most successful of its kind. Subsequently, many other entrepreneurial ventures have successfully raised funds through equity crowdfunding, supported by thousands of new non-accredited Israeli investors who wanted to be a part of the next big Israeli exit success story. Indeed, Wald et al. (2019) concluded that equity crowdfunding investors are driven by egotistical motivations, seeking the designation of 'entrepreneurship investor' as part of their resume.

Chocolate Panda: An Illustrative Case of a Successful Reward Campaign

Chocolate Panda is a vegan chocolate company. The company was established in 2015 by two vegan youngsters (who become a couple during the process), who decided to raise about $8.5K to launch a home business to produce vegan chocolate. The couple had not intended to launch a company, rather saw it only as a hobby. However, the collective nature of Israeli society was manifested in this campaign through the enthusiasm of Israel's very active vegan community. As a result, the campaign went viral, and within a day, the funding goal was reached. By the end of the campaign, they raised about $57.1K, achieving a remarkable success rate of 689%. The campaign was supported by 2394 backers and included 681 backers' comments.

Following the campaign's success, the creators, having considerable chutzpa, lacking the fear of failure, and having no previous experience in business administration, decided to establish a small boutique factory to produce vegan chocolate to replace their original plan of home production. They then set about producing seven different chocolate products, distributing them throughout the country (Lepler 2016).

After their initial success, the creators kept updating their backers through the Headstart platform as well as on their Facebook page. In 2017, they initiated an additional campaign, this time, for vegan chocolate snacks. The funding goal was about $34.2K, achieving about $89.2K, reflecting a 260% success rate. This second campaign was supported by 2101 backers, who wrote 538 comments. During this campaign, a boutique health food chain that was setting its sights on the vegan market decided to back the Chocolate Panda campaign, investing a considerable sum in return for the rights to launch the product's marketing.

The Chocolate Panda story demonstrates how a product that is associated with social values—in this case, the consumption of vegan food—can draw together an already-existing community of devotees that organized itself to boost its promotion and contribute to the campaign's success.

The Israeli Crowdfunding Scene

Development Over Time

Crowdfunding in Israel has become a viable option that is no longer limited to creators wanting to publish their books or music. Nowadays, many Israelis encounter the phenomenon, whether creators seek to open a new business, establish an interest-based community, or confront a personal challenge (medical or otherwise; Goldenberg 2015). Clear evidence of this can be seen in Israel's 2019 national elections when several parties chose to reach out to their backers by launching crowdfunding campaigns.

Rewards-based and donation-based crowdfunding was established in Israel in 2011 (equity-based was established in 2013), tail-winded by the success stories emanating from the predecessor US platforms—Kickstarter and Indiegogo. The Israeli crowdfunding industry is a market leader in the Middle East region and comprises a significant market in Europe. Between 2013 and 2016, the country raised \$363.25 million, with an average 11% annual growth rate. In 2015, Israel was the eighth largest market after the UK, France, Germany, The Netherlands, Finland, Spain, and Italy. During 2016, the total funds raised through crowdfunding platforms in Israel have been estimated at \$140M. A per-capita measure (2016) that enables a better understanding of the crowdfunding impact on the country, Israel was ranked 8th (\$16M), following the UK, Estonia, Monaco, Georgia, Finland, Ireland, and Denmark. Israel's leading type of crowdfunding by far is the equity, raising almost \$94M (68% of the total crowdfunding market). Second, comes Peer-to-Peer (P2P) consumer lending, estimated at \$33M (24%). The rewards and donations platforms, estimated at \$11.15M (8%), comprise the third-largest crowdfunding type (Ziegler et al. 2018b). Figures 15.1 and 15.2 present Israel's crowdfunding activity for 2015 and 2016 compared with other European countries.

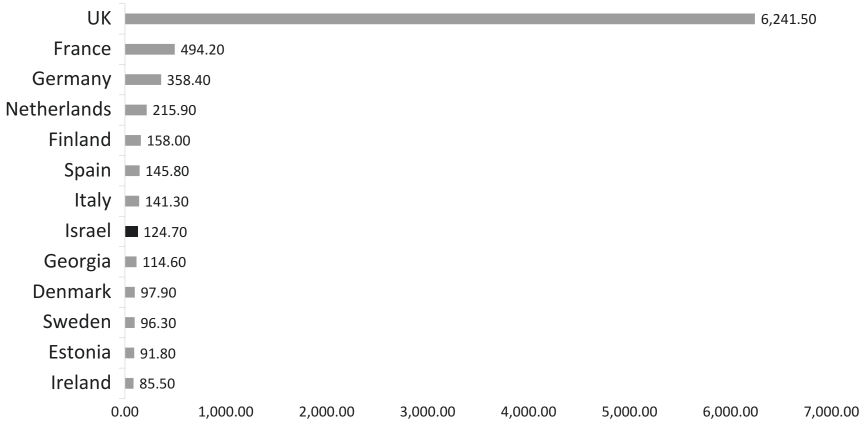

Fig. 15.1 Market volume by country for 2015 (in $ million). (Source: Based on figure from Ziegler et al. 2018a, b)

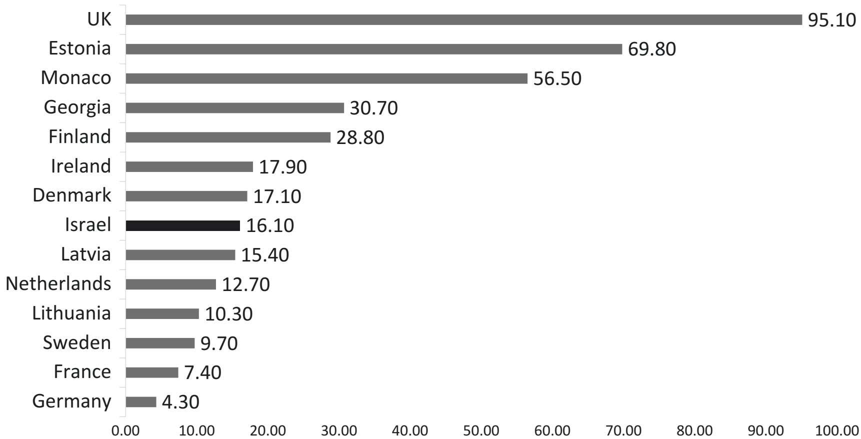

Fig. 15.2 Market volume per capita by country for 2016 (in $ million). (Source: Based on figures from Ziegler et al. 2018a, b; World Bank Data for Israel 2019)

Equity Crowdfunding

Equity Platforms

Between 2013, when Israel's first equity crowdfunding platform was launched, and mid-2017, $875M (IVC 2017) was raised through nine different equity crowdfunding platforms. Equity crowdfunding platforms were launched in Israel, as they were in most of the world, in 2013, after US President Barak Obama signed the Jumpstart Our Business Startups (JOBS) Act, allowing startups to legally raise capital from the crowd by issuing securities and remaining a private company. Since their establishment, equity crowdfunding platforms in Israel have successfully funded approximately 145 Israeli high-tech companies in the fields of internet, IT and software, communication, life science, clean-tech, and semiconductors. Within these companies, 25 have successfully executed an exit strategy, 15 were acquired, and 3 made an initial public offering (IPO). Intel is credited with the most lucrative buy-out deal by acquiring Replay Technologies, a 3-D rendering technology company, for $175M in 2016. Two life science companies have conducted successful Nasdaq IPOs: ReWalk Robotics, an exoskeleton, enabling people with paraplegia to walk, raised $36M in 2014, and UroGen Pharma, a urological cancer treatment developer, raised $58M in 2017.

The Israeli platforms are active under one or more of the three different equity crowdfunding business models, representing three different regulatory paths: (1) the accredited investors-only model, (2) the up-to-35 offerees model, and (3) the offering coordinator model. The regulatory aspects of crowdfunding, according to Israel's Securities Law, will be discussed in the following section. Table 15.1 presents the three models along with the leading platform in each.

The first equity crowdfunding platform was established in Israel in 2013 by OurCrowd and is based solely on accredited, sophisticated, and high-net-worth individual investors willing to invest large amounts of money in high-risk investments. Other than its crowdfunding platform activity, OurCrowd operates as a venture capital fund. By 2019, their joint activity reached $1.2B, with 200 companies and 30,000 registered

Table 15.1 Israel's three equity-based crowdfunding models

Business model	Leading company	Year established	Amounts raised	Number of campaigns
Qualified investors only	OurCrowd[a]	2013	$1.2B[a]	200
Up-to-35 offerees	ExitValley	2015	$27M	64
Offering Coordinator	PipelBiz	Mid-2017	$17M	42

[a]OurCrowd is active as a venture capital fund as well as an equity crowdfunding platform. Data retrieved from the platforms' websites, October 2019

investors in its portfolio, representing an average portfolio size of over $350K. Active in 150 countries worldwide, the company was acknowledged as the third-largest equity crowdfunding company in Europe (OurCrowd 2019).

The second model—the up-to-35-unaccredited investors model—was established in 2015. Under this model, the offer can be revealed to only 35 investors, and thus, it cannot be fully publicized. Several equity crowdfunding platforms are active in the Israeli market under this model. ExitValley is the model's leading platform, raising more than $28M from 15,855 investors, successfully funding 64 campaign in fields such as health, software, food, agriculture, and entertainment.

The third equity crowdfunding model is called Offering Coordinator and was introduced by the ISA to the Israeli audience during 2017. Under this model and its accompanying legislation, a company can publicly promote and advertise the selling of some parts of its equity in return for a predefined price. PipelBiz, the leading platform active under this model, has successfully raised $17M for 42 health, e-commerce, software, entertainment, leisure, and additional campaigns, allowing 7766 individual investors to participate in this most democratic form of crowdfunding.

The three equity crowdfunding models currently operating in Israel represent the development of the Israeli equity crowdfunding market. Started back in 2013 as an exclusive arena limited to high-net-worth investors, equity crowdfunding projects are now available to all Israelis wanting to participate and benefit from this opportunity to finance entrepreneurial ventures. The equity crowdfunding platforms are evolving as well, adjusting themselves and offering new creative programmes to meet the growing interest and competition. For example, ExitValley initiated an internal secondary market programme enabling investors to buy and sell shares from each other. ExitValley intends to launch an internal fund, offering investors a tool to extend and diversify their investment across several companies.

Equity and Regulations in Israel

According to Israel's Securities Law, any offer of securities to the Israeli public needs to be approved by the Israel Securities Authority (ISA). Two key terms require clarification in this regard: 'offer' and 'public'. Whereas the term 'offer' in this context is regarded as any activity, invitation, or intention meant for the convincement to purchase securities, the term 'public' is limited to the Israeli public. Thus, from an international perspective, an offer made to non-Israeli investors is not required to follow the ISA regulations; however, any foreign entity seeking to operate in Israel or approach the Israeli public must comply with the same regulations as the local institutions (ECN Report 2017).

With regard to equity crowdfunding, Israel's Securities Law has three exemptions of offering that are not required to be approved. (1) The offering of securities to no more than 35 individual investors (*up-to-35 offerees model*) on a consecutive period of 12 months. (2) The offering of securities to *sophisticated investors* such as banks, mutual funds, investment managers, investment advisers, underwriters, venture capital funds, and large corporations with equity of at least $14M. (3) The offering of securities to *high-net-worth individuals*, characterized as having $2.2M liquid assets, or having an annual income of $330K in the past two consecutive years, or holding liquid assets valued $1.4M and an annual income of $166K in the past two consecutive years. The three exemptions aforementioned have no restriction on the total investment amount asked by the issuer nor a limit on the maximum amount an individual is allowed to invest.

In 2015, an amendment to Israel's Securities Law was published, allowing companies to raise money through crowdfunding platforms. However, the Crowdfunding Regulations became effective only at the beginning of 2018. Subject to specified terms, these regulations allowed companies to openly offer shares to the Israeli public, and Israeli individuals to make investments in those companies, as long as the activity is taking place on a dedicated and authorized platform (*Offering Coordinator*).

The Crowdfunding Regulations delineate three levels of terms: platform level, issuer level, and investor level. At the platform level, the platform must be registered as an *Offering Coordinator*, pay all fees, report regularly to the ISA, and take reasonable steps to prevent fraud. Moreover, the platform must ensure compliance to the regulations regarding the offer information disclosed to the public. At the issuer level, the regulator restricts the amount that can be raised in a single offering during a period of 12 months to a range of $1.1–1.6M, subject to the involvement of a leading investor, a technology evaluation report from the Israel Innovation Authority, or both. At the investor's level, the regulator limits the maximum investment per individual to $2.8K per campaign and $5.6K per year (ECN Report 2017).

Rewards and Donations Crowdfunding

Rewards and Donations Platforms

The widespread use of crowdfunding in Israel has much to do with the operations of the first rewards-and-donation platform launched in the country—Headstart—launched online in November 2011. Initially, the platform was aimed at equity, but due to regulatory limitations, and in the face of burgeoning international platforms such as Kickstarter and Indiegogo, it began its operations in the rewards and donations domain, entering equity only recently. Headstart's growth to fame can be traced to the success of *Meir Ariel's Memorial Concert* campaign. Meir Ariel was a popular singer and songwriter, who died in 1999. Since Meir Ariel's death, his family launched an annual memorial concert, involving many artists performing his songs. In 2014, the family failed to raise the needed money for the traditional event. They decided to use Headstart, then a newly established crowdfunding platform, to raise about $114.3K, ending with approximately $133.1K, a success rate of 117%. The campaign comprised 1203 backers that supported the campaign in exchange for receiving tickets to the concert (the rewards consisted of various types of ticket deals). A year after the first concert (2015), the campaign for the annual concert raised around $167.4K, supported by 1880 backers, reaching a success rate of 130%.

The Meir Ariel's Memorial Concert Campaign received much attention in the media, contributing to the public's awareness of crowdfunding as an alternative to traditional funding channels. It was the first to demonstrate the power of crowdfunding as an additional way to raise funds among creators who are unable to afford the traditional funding channels.

Headstart had undertaken the challenging task of market education, and thus, its growth paralleled the crowdfunding market growth. The growth pace was primarily dictated by fund-seekers and crowd-funders being persuaded to use crowdfunding. Over the years, several other platforms have been established, all offering similar options for crowdfunding, and not prejudiced towards either rewards or donations campaigns. Whereas the first few years were characterized by hype in the field, recently, the number of funding volumes and platforms have stabilized, resulting in smaller platforms encountering difficulties balancing their business model. This trend signals potential changes in the crowdfunding arena for the near future. Headstart remains Israel's leading platform, capturing about 90% market share for rewards and about 80% for donations. In an October 2019 update in the platform site, Headstart reported that 5258 campaigns achieved their funding goal, raising more than $42.5M, receiving funds from more than 806,500 backers. Indeed, the brand *Headstart* has become a generic name used to refer to any crowdfunding activity. Headstart's two main competitors, Mimoona and Jumpstart, together encompass about 15% of the total Israeli market. The remaining market presence is held by numerous small platforms, mostly specializing in donation-based campaigns. The operating platforms charge fees ranging from 3% to 9%, in addition to VAT (ECN Report 2017).

Figure 15.3 presents Headstart funding volumes over the years, and Fig. 15.4 presents Headstart's success rates. As can be seen from the figures, funding volume reached a peak in 2017, stabilizing in 2018. Success rates also grew over the first few years, stabilizing at around 58% since

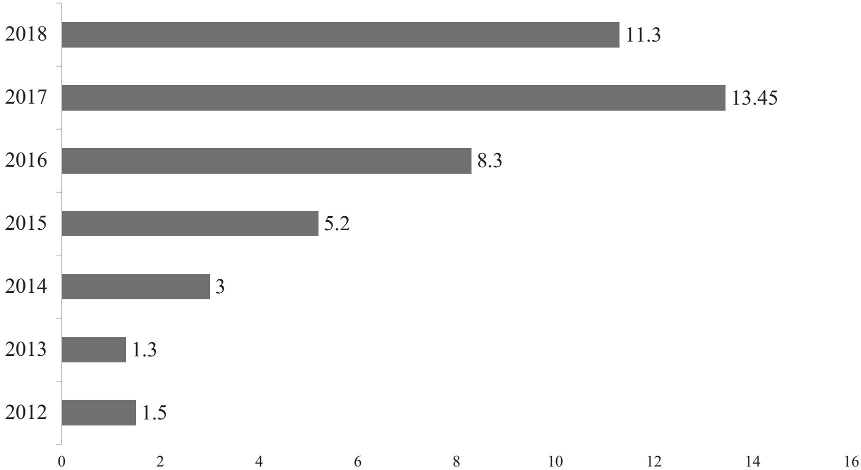

Fig. 15.3 Headstart (rewards and donations campaigns) funding volumes 2012–2018 (in $ million). (Source: Based on data received from the company)

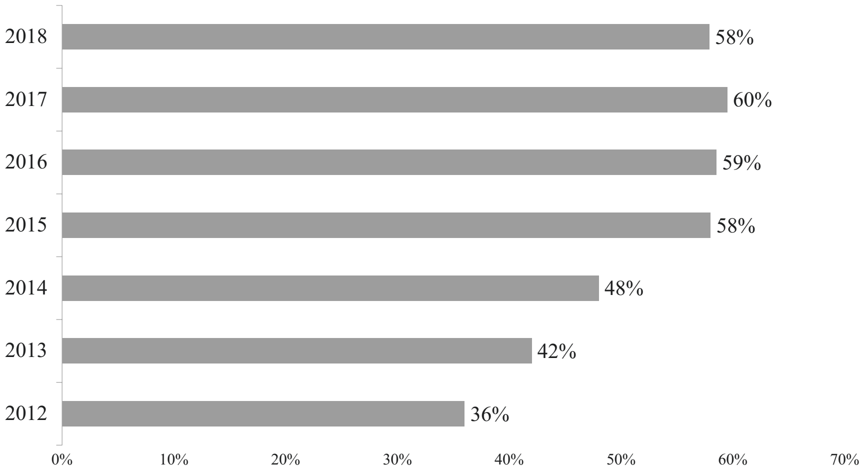

Fig. 15.4 Headstart (rewards and donations campaigns) success rates 2012–2018. (Source: Based on data received from the company)

2015. The company's success rates vary tremendously among the diverse campaign categories. Social campaigns have achieved the highest success rates, reaching 80%, followed by artistic campaigns in fields such as writing, music, comics, and film, as well as campaigns of a well-known annual festival (The Midburn, the Israeli version of Burning Man), reaching 65% success rates. Political campaigns have reached 50% success rates, whereas, surprisingly, tech campaigns have achieved only 22% and lower success rates. Moreover, in rewards campaigns, most creators produce their own products (though often behind schedule). This high rate of successful production seems to be derived from their high commitment to the backers, the majority of whom are friends and family (Samocha 2016).

These success rate statistics indicate that in the formats of rewards and donations, the successful campaigns are those characterized by their domestic nature. For example, support for an individual's medical treatment (social campaigns) or raising money to launch a local band's new album will likely be more successful than launching a campaign for a new tech gadget. For this reason, the non-equity crowdfunding platforms tend not to expand to foreign campaigns and maintain their focus on the domestic Israeli market (Or 2019). Crowdfunding studies report that domestic campaigns have an advantage in reaching their funding goals, as the majority of the backers are from the local community (Josefy et al. 2017). In this respect, Israel, due to its small size and one-degree-of-separation character, behaves like "a small community", in that individuals around the country volunteer to support campaigns, even if they do not know the creator personally (Efrat et al. 2020). This is a manifestation of Israeli society's collective individualism's (Weiss 2003) communal nature.

Regulation in Rewards-and-Donations-Based Campaigns

There are no specific laws or regulations regarding rewards- and donations-based crowdfunding. As the backers do not anticipate any financial profit, return, or non-monetary rewards that are not part of the campaign, no specific regulations, aside from the general consumer protection regulations, are applied (ECN Report 2017).

P2P (Lending) Crowdfunding

Six lending platforms are currently active in Israel; of these, three specialize in loans to small businesses. The total loaned amount was estimated at about $55M in 2018 and a total of $120M since 2013 (year of the first platform's establishment). Out of the total amount, about 25% has been P2P (person-to-person) lending. The leading platform in the field is Tarya. Currently, the estimated amounts represent only a fraction of a per cent of consumers' credit in Israel. The primary reasons for the hesitant development of P2P crowdfunding can be derived from regulation and lack of trust (ECN Report 2017).

Future Trends of Israeli Crowdfunding

Internationalization

As in other Israeli industries, as the equity crowdfunding industry evolves, it becomes international in two key aspects. The first aspect is the growing number of Israeli entrepreneurs looking to launch their campaigns on foreign platforms, mainly the two US giants—Kickstarter and Indiegogo. In facilitating their international presence, both US platforms initiated moves to support an international orientation. Indiegogo has even opened a local office in Israel. The second aspect concerns the entrance of foreign companies as investors in local platforms. These companies primarily provide financing to the local platforms, viewing their investments as strategic moves, and thus, signalling the market's growth potential.

Specialization

Alongside the internationalization of the crowdfunding industry, we note an additional trend in the form of platform specialization. Whereas at the start of Israeli crowdfunding, the local platforms were associated with either equity, P2P, or rewards-and-donation types, these features are now changing. The first and largest rewards-and-donation platform company—Headstart—transformed itself into an umbrella brand through splitting its operations into four separate sub-platforms: one sub-platform retained the original brand—*Headstart*—and serves as a rewards-based platform; the second adopted a new brand—*Giveback*—and houses donations-based campaigns; the third and most recent sub-platform—B*eactive*—focuses on legal struggle campaigns; and the fourth—*Fundit*—specializes mostly on real estate equity crowdfunding. New platforms entering the industry differentiate themselves by adopting a specific niche (e.g., political issues).

Among the equity crowdfunding markets, PipelBiz has announced the opening of the CannaVC, a venture capital fund in partnership with Everest Investment Banking, to support Israel's cannabis technology companies, thus, presenting new, mixed-model investment opportunities. Moreover, OurCrowd, Israel's largest equity crowdfunding platform has recently announced the opening of two new internal funds—one to support medical investments and the second to support environmental impact investments. All these moves represent a trend to specialization, which may be a consequence of the upsurge in the number of competitors.

Conclusions and Implications for Future Research

This chapter sought to shed light on the factors and conditions contributing to the inception and growth of crowdfunding in Israel. Our review of the field identified a set of country-level conditions encompassing the entrepreneurship ecosystem. These conditions include the entrepreneurship and innovation infrastructures, the role of the IDF in facilitating knowledge-based innovation and technologies, and the entrepreneurial spillovers driven by related and supporting organizations. These are complemented by social and cultural aspects, such as Israel's collectivistic and low-power distance society, chutzpah, and a high tolerance of failure.

The crowdfunding field is proliferating across all types, with its primary challenges currently in the form of regulatory barriers. The numbers indicate that crowdfunding is much more than a passing trend, and, with the exception of crowdlending modles, Israel exhibits patterns similar to those in other countries. These developments also apply to future trends.

Alongside the growth in campaigns' numbers and volume, we are witness to the creation of a cumulative body of knowledge, which is used by both platforms and individuals in assisting first-time entrepreneurs. This knowledge facilitates success across crowdfunding types.

Our review carries some practical implications for both platforms and entrepreneurs. Platforms, as they orientate first-time entrepreneurs, should urge them to use their close circle of friends and family as a means to recruit the additional circles based on the one-degree-of-separation phenomenon that characterizes Israeli society. As Israelis value boldness and out-of-the-box thinking, platforms can offer entrepreneurs to launch creative and innovative campaigns. In addition, due to the relatively low fear of failure, they should encourage them to launch additional campaigns, even if the initial campaign did not reach its goal. Regarding equity-based campaigns, both platforms and entrepreneurs can base their campaign advertising on the inclination of many Israelis to take part in the high-tech industry through investing in new startups. Regarding rewards- and donations-based campaign, the most successful campaigns have been those related to social values and social solidarity, a phenomenon consistent with the collectivist nature of Israeli society. Platforms can use these aspects to publicize themselves for potential entrepreneurs in order to appeal to them to use crowdfunding over alternative funding channels.

To advance our current work, we suggest three research endeavours. First, whereas most research to date has focused on the commonalities of crowdfunding across the different types (Macht and Weatherston 2015), we expect that different cultural aspects and dimensions comprise a critical factor (Shneor and Efrat 2014) and, indeed, influence the scale and rate of crowdfunding adoption. This culturally oriented direction of exploration could help advance the understanding of the differences occurring across countries regarding the adoption of crowdfunding and its manifestations (e.g., equity vs non-equity). Second, our chapter frames crowdfunding within the entrepreneurship orientation. However, empirical studies investigating this linkage have mostly focused on the equity forms of crowdfunding (e.g., Estrin et al. 2018). In light of the centrality of such elements to crowdfunding in general, a better understanding of the culturally based entrepreneurial drivers is vital. Hence future research should advance on Efrat's (2014) conclusions concerning the impact of culture on entrepreneurship, and explore the impact of additional macro level aspects (e.g., political and economic) on development and dynamics of non-equity crowdfunding. Third, whereas the crowdfunding phenomenon has attracted significant research attention due to its rapid growth, its role within existing financial frameworks is often overlooked. A valuable research direction could address the linkages, associations, and reciprocity of crowdfunding and additional finance techniques in advancing entrepreneurship.

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16

The Current State of the European Crowdfunding Market

Karsten Wenzlaff, Ana Odorović, Tania Ziegler, and Rotem Shneor

Introduction

In recent years, Europe has retained its position as the third largest global market for crowdfunding. Similar to other regional markets, it is dominated by a single country accounting for the majority of related volumes,

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namely the UK. Overall, European crowdfunding volumes were estimated at USD 18 billion in 2018, growing 51% from an estimated volume of 11.9 billion in 2017 (Ziegler et al. 2020). However, the UK accounted for 10.4 billion in 2018, while growing 30% from the USD 8 billion it recorded in 2017. Accordingly, mainland Europe (including 44 countries) has exhibited a dramatic growth of 95% from a total volume of 3.9 billion in 2017 to 7.6 billion in 2018.

Several intriguing features characterize crowdfunding in Europe, which essentially capture different facets of the market fragmentation. First, in global comparison, the UK, as the leading regional market, accounts for a smaller proportion of regional volumes (58% in 2018) than the US does in the Americas (96% in 2018) or China in the Asia Pacific region (97% in 2018). In Europe, a wider distribution of volumes across national markets is evident with the Netherlands, Germany, and France as dominant players. Other countries with large volumes, such as Italy, Spain, or Poland, Sweden, Italy, or Belgium are following closely.

Second, cross-border transactions are limited, and usually associated with non-investment models like reward and donation crowdfunding, where regulatory barriers are minimal. However, Europe has thus far failed to produce a European equivalent to global US-based platforms in these spheres (e.g. Kickstarter, Indiegogo, or GoFundMe) with relevant platforms maintaining local focus and anchoring, while competing with the US-based actors on localized features and services (e.g. language, payment systems, customer support, currency). Moreover, most platforms operating investment models, as in equity-based and debt-based crowdfunding, operate only in one country, partially due to the fragmented regulatory landscape within Europe. However, most European countries represent relatively small domestic markets, where local platforms may struggle to achieve sufficient scale towards profitability without international reach.

Against this backdrop, the European Union has created a unified crowdfunding regulation for equity- and lending-based crowdfunding (European Commission 2018c; European Parliament 2019). The ambition of the European Crowdfunding Service Provider (hereafter 'ECSP') Regime has been to improve access to finance for SMEs across Europe, while paving the way towards fewer limitations on cross-border investment activity within the continent. During the deliberation and negotiation process, the proposal morphed from a so-called opt-in regime to a binding regime for platforms in all member states, constituting a possible source of harmonization and thus reduction of fragmentation in the market starting in 2021, when the regime will come into force.

This chapter's structure is as follows. In the coming section, we first present the current state of crowdfunding markets in Europe, especially with regards to differences between national markets. Next, the principles of the ECSP Regime proposal are presented, and expectations about its impact are outlined. These discussions are supported by insights from research conducted in European countries. We conclude this chapter with a list of suggestions for further research, as well as implications for practitioners in the region.

The Current State of the European Crowdfunding Market

In the current section we present the state of European crowdfunding market. Unless otherwise stated, all data presented are adopted from the Cambridge Centre for Alternative Finance (hereafter 'CCAF') Global Alternative Finance Report (Ziegler et al. 2020) and the Fourth Annual European Alternative Finance Report (Ziegler et al. 2019).

In 2017, 597 European platforms have overseen a market turnover of USD 10.4 billion. In 2018, these figures have grown to 794 platforms overseeing a market volume of USD 18 billion. The majority of platforms are concentrated in the relatively larger Western European economies of the UK (89 platforms), Germany (63 platforms), France (51 platforms), Italy (51 platforms), the Netherlands (45 platforms) and Spain (39 platforms), with a majority of which domestically based. On the other end, Southern and Eastern European countries were served by less than 10 platforms, most of which were foreign-based. Some explanations for this may be found in a study by Dushnitsky et al. (2016), who examined the conditions associated with platform creation at the national level during the early years of the European crowdfunding industry (2008–2014). This study showed that platforms are more likely to be created in countries characterized by larger market sizes (in terms of population), higher entrepreneurship rates (in terms of share of population owning a new business), as well as where traditional financial institutions are involved (in terms of percentage of active platforms operated by established financial organizations) providing the new industry with a degree of legitimacy.

Three European countries have seen volumes surpassing the USD 1 billion mark including the UK (USD 10.4 billion), the Netherlands (USD 1.8 billion), and Germany (USD 1.2 billion), with France closely approaching this threshold with USD 933 million in 2018. Furthermore, from a regional perspective, despite relatively small domestic markets, the Nordic and Baltic States have exhibited strong growth. Here, regional volumes showed that the Nordics (Denmark, Finland, Iceland, Norway, and Sweden) accounted for USD 507 million in 2017 and USD 824 million in 2018, mostly led by Finland (USD 379 million) and Sweden (USD 298 million). The Baltics (Estonia, Latvia, and Lithuania) accounted for USD 265 million in 2017 and USD 539 million in 2018, with Latvia (USD 254 million) taking lead. Other notable regional leaders include Poland in Eastern Europe with USD 333 million and Spain in the Iberian Peninsula with USD 419 million. However, when controlling for market size, highest volumes per capita were recorded in the UK with USD 156, Latvia with USD 132, Estonia USD 121, and the Netherlands with USD 105 in 2018.

The fragmentation of crowdfunding markets in Europe can be grasped by distinguishing several categories of crowdfunding markets: (1) *Market leaders*—countries with a large crowdfunding volume, a few dozen platforms, and high volumes per capita (e.g. UK, Netherlands); (2) *Domestic-growth markets*—countries with a large crowdfunding volume, a few dozen platforms, but low volume per capita mostly driven by domestic transactions (e.g. Germany, France); (3) *International-growth markets*—countries with small crowdfunding volumes, less than 20 platforms but high volume per capita mostly driven by international transactions (e.g. Estonia, Latvia); and (4) *Slow international adapters*—countries with small crowdfunding volumes, less than 20 platforms, and small volume

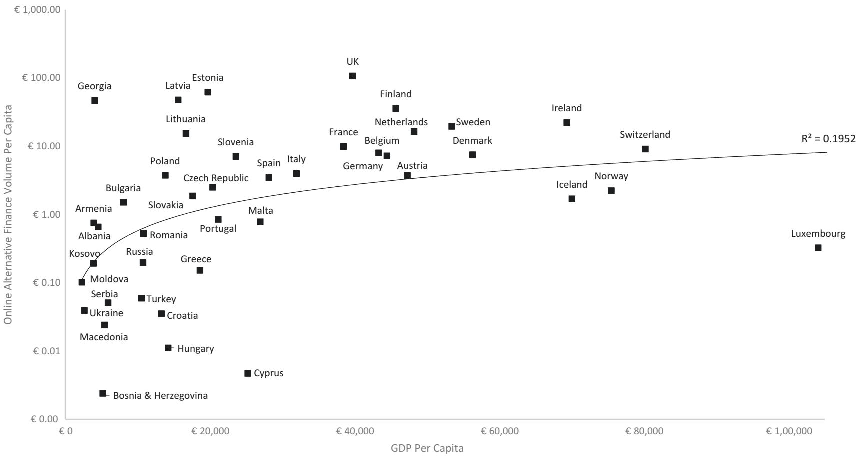

Fig. 16.1 Alternative finance volume per capita versus GDP per capita 2017. (Source: Ziegler et al. 2019)

per capita mostly driven by international transactions (e.g. countries in Central, Southern, and Eastern Europe) (Fig. 16.1).

When plotting per capita volumes against GDP per capita (Fig. 16.1), as indicator of economic development, the results suggest that volumes in countries such as the UK, Estonia, Latvia, Lithuania, and Georgia indicate an efficient utilization of the alternative finance models, whereas countries like Cyprus, Hungary, Bosnia and Herzegovina, and Luxembourg underutilized their alternative finance potential.

High volumes of P2P Consumer and Business Lending activities are associated with higher performance of a country (i.e. UK, Georgia, Latvia, and Estonia), while countries with high volumes of reward-based or donation-based crowdfunding are associated with relative underperformance of a country (i.e. Norway, Iceland, Malta, Greece, Luxembourg). This usually reflects regulatory regimes enabling investment crowdfunding versus regulatory environments in which this is constrained by existing laws, as well as where changes were made very close to data collection period. As a result, the underperformance of countries with large sectors of non-investment crowdfunding is caused by the fact that contributions per project per person are lower in the donation-based and reward-based models of crowdfunding as compared to investment models.

The fragmentation is not only evidenced by the market volumes, but also by their distribution. It is instructive to observe which European countries represent the top three performing markets by volumes according to each crowdfunding model. In 2018, the UK took the top position in 10 of the 13 business models covered by the CCAF report. Germany took the top position in real estate crowdfunding and donation-based crowdfunding, as well as second position in P2P consumer and P2P business lending. And the Netherlands had the largest market for balance sheet property lending, while taking second place in the balance sheet business lending, debt-based securities, as well as the revenue sharing models. Other market leaders include those taking second place, such as Denmark in P2P property lending, Sweden in balance sheet consumer lending, Finland in equity crowdfunding, Italy in invoice trading, and France in reward crowdfunding.

Finally, a different insight into fragmentation in Europe is evident in a recent study by Rossi and Vismara (2018), who analysed services offered by 124 investment crowdfunding platforms from the UK, France, Germany, and Italy. First, they find that platforms offer relatively few services before, during, and after the campaign, and even these vary widely by platforms. The few exceptions offered by a majority of platforms include the facilitation of interaction and period campaign updates. Second, the study also showed that the average annual number of successful campaigns were substantially higher in the UK and France versus those in Germany and Italy. Furthermore, the authors found that platforms offering a higher number of post-campaign services were associated with higher number of successful campaigns, while the number of services offered before and during campaigns were not associated with higher levels of success.

Traditional Financial Institutions in European Crowdfunding Markets

Fragmentation in the European markets is also evident with respect to relations of platforms with institutional investors (e.g. pension funds, asset management firms, banks). In continental Europe in 2017 (i.e.

excluding the UK), USD 511 million (13%) originated from institutional investors, increasing in both relative and absolute size to USD 1.1 billion (14.5%) in 2018. In 2018, these volumes reach USD 4.88 billion (47%). Some markets are heavily dependent on institutional investors, including Italy with 90%, the Benelux region with 88%, and Germany with 64% of the 2018 volumes coming from institutional investors. On the other side of the spectrum, institutional investors were associated with only 2% of volumes in the CIS (Commonwealth of Independent States) and 5% of volumes in Eastern and Baltic European countries in 2018.

Beyond the provision of funding to alternative finance offerings, institutional engagement with platforms is sometimes also evident with respect to organizational relations. Here, platform ownership by institutional partners is evident among 15–20% of platforms operating in Western Europe, but only among 4–8% of platforms operating in Baltic, Central, and South-East Europe in 2017. No platform in Eastern Europe and the CIS was owned by institutional partners in 2017.

International Scope of European Platform Operations

Data collected annually by the CCAF suggests that cross-border transactions and internationalization of platforms is on the rise in Europe. In 2017, 77% of platforms had seen cross-border inflows to local platforms, 44% of platforms saw cross-border outflows. Here, again, fragmentation is evident across Europe, where some regions are home to more internationally oriented platforms, while other regions are characterized by more domestic-facing platforms. In 2017, CIS countries, Georgia, Baltics, and Eastern European countries reported a high level of cross-border flows. Iberia, South-Eastern European countries, Ireland, Central European countries, and the Benelux countries showed a medium level of cross-border flows. Nordic countries, Germany, and France showed relatively low levels of cross-border flows. This is presented in Fig. 16.2.

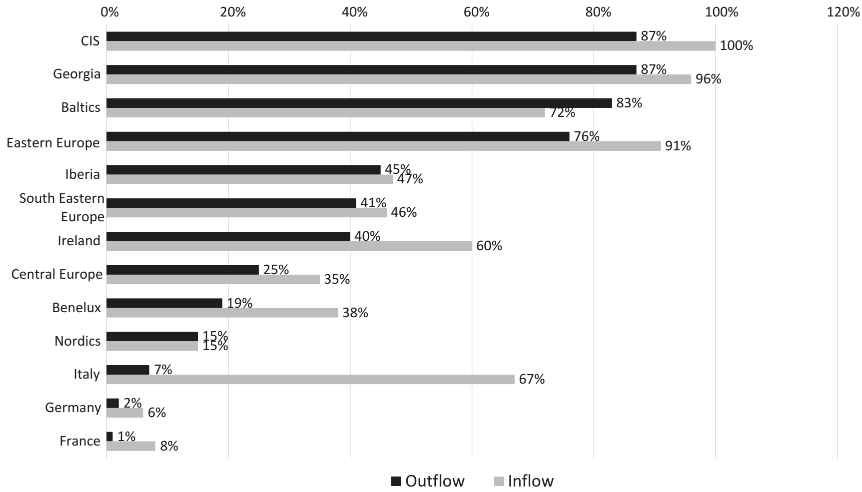

Fig. 16.2 Cross-border flows in European crowdfunding markets 2017. (Source: Ziegler et al. 2019)

These findings are especially relevant for the discussion of the ECSP Regime. According to our market classification suggested above, *Market Leaders* and *Domestic-growth Markets* incorporate a majority of domestic platforms first achieving a degree of scale operations domestically, and then engaging in cautious and limited international expansion. *International-growth Markets* include platforms that emerge from relatively small home markets, leveraging relatively permissive regulatory frameworks, while more aggressively expanding into other country markets for achieving scale, sustainability, and growth. Finally *Slow International Adapters* represent countries, where, despite scale potentialities, growth is constrained by lagging regulatory amendments as well as lower levels of social trust (Delhey and Newton 2005) and suspicion towards digital financial innovations. Here, platforms attempt tapping into international support to achieve legitimacy in the domestic markets, where international funding triggers domestic development and acceptance.

Regulation and European Crowdfunding Market Fragmentation

Thus far, a number of areas in which disparity is evident within the European crowdfunding market have been listed including volumes per country and per capita, number of platforms, model diversity, and extent of dependency on cross-border transactions and flows. In the current section we will explore aspects of fragmentation with respect to regulations and their impact on a European-level market for crowdfunding. Ever since the first report mapping the conditions and prospects of crowdfunding in Europe, regulation was identified as a key pillar that must be addressed (De Buysere et al. 2012), so that appropriate rules and measures are put in place while ensuring the necessary protection of those interested in engaging in crowdfunding (Bruntje and Gajda 2016).

While economic theory suggests that a truly integrated market would reduce disparities considerably, local and regional differences can still occur. In an integrated market, platforms could offer their services across borders, investments would flow to the platform with the best offers, while allowing successful platforms to scale and outperform competitors. However, the motivation of local investors to provide funds to local businesses on local platforms might be higher than investing in businesses residing abroad or platforms abroad, even if both domestic and foreign platforms offer the same or better investment protections and services. Such phenomenon is known from investment research as a home bias (Tesar and Werner 1995), as well as 'not invented here' attitudes towards foreign ideas and technologies (Antons and Piller 2014).

Non-investment crowdfunding models such as those employed by donation- and reward-based platforms are the least constrained in terms of regulation. Platforms like Kickstarter, Indiegogo, Global Giving or GoFundMe, based in the US, have localized the user experience by translating the website into local languages, while operating under their respective international brands (Skotte and Juvik 2019). Donation- and reward-based crowdfunding does not require platforms to be supervised by the financial authorities or comply with investor protection regulation to the extent investment platforms are required to do. Platforms in donation-based and reward-based crowdfunding have to adhere to rules in the area of digital payments, but they partner with a payment provider which ensures regulatory compliance with European laws. There are very few exceptions where donation collection requires special permits such as in Denmark and Finland, but in most other European markets requirements are more flexible. Reward-based crowdfunding platforms have to comply with other European legal frameworks, such as the e-Commerce directive, Consumer rights directive, Copyright directive, or the Platform directive, which is currently under discussion. And although these directives have not been uniformly implemented across the European Union, such regulations haven't prohibited non-investment platforms to scale across Europe.

Most concerns with regulatory fragmentation are associated with investment crowdfunding. Here, the MiFID (2004/39/EC) and MiFID II (2014/65/EU) (Markets in Financial Instruments Directive) (European Commission 2018b) should have provided a unified framework for crowdfunding intermediaries. However, platforms and their industry associations provided evidence in the Impact Assessment of the European Commission that the MiFID-framework is not suitable to their business models. Member states have in the past 'gold-plated' MiFID by adding additional provisions for consumer protection, which made operation of platforms across border an even more demanding, costly, and less efficient process.

A second symptom of a regulatory fragmentation is the different national regimes under which platforms operate. A few member states of the European Union have implemented a bespoke regime for alternative finance service providers (e.g. UK, Finland, France), however, in most European member states a bespoke regime is still lacking, which generates regulatory uncertainty of platforms operating across borders. Furthermore, differences in national regulations across Europe have been argued to not only result in distortions of the market playing fields, but also limit economic growth that can be supported by cross-border offers of crowdfunding (Gajda 2017). In this context the CCAF report showed a clear positive association between crowdfunding volumes per capita and the level to which platforms evaluated local regulations as adequate (Ziegler et al. 2019). Overall, differences in regulatory regimes stem from disparities in licensing requirements, thresholds for prospectus requirements, as well as various consumer and investor protection provisions.

Third, regulatory fragmentation can also be a result of activities of market participants. Platforms have created self-regulation frameworks, which are designed to induce trust in domestic platforms and possibly to establish a market entry barrier for foreign platforms. However, even self-regulation documents as enshrined in codes of conduct and ethics adopted by various industry organization across Europe exhibit significant differences in terms of scope, ambition, and oversight (Odorović and Wenzlaff 2020).

Against this backdrop, the European Union initiated the process towards establishing a pan-European regulatory regime in March 2018. The European Commission's FinTech Action Plan (European Commission 2018a) explicitly envisaged such goal as part of the European Capital Markets Union. More specifically, the ECSP Regime (European Commission 2018c) aimed to close the disparity in national regulations, provide robust investor protection, enable platforms to cater to clients in different countries holding a single licence, and allow small and innovative firms to raise funds across borders more effectively. Under such approach, the need to scale up regulatory compliance left limited room for opt-out provisions and partial harmonization in the case of the ECSP Regime.

The European Commission, in its proposal, suggested a passporting regime, similar to the existing MiFID regime for the offering and trading of equity and debt. The Commission proposal prohibited individual member states from adding regulatory requirements for platforms authorized as European Crowdfunding Service Providers. Such a prohibition would have created a level playing field between platforms operating in different states. It would also have curtailed regulatory arbitrage. However, in order to anticipate objection as a compromise with the Council, the Commission's proposal also allowed for the coexistence of national regulatory regimes. Accordingly, platforms wishing to stay within their respective existing regime, or operate only in one country, could stay within these national regulatory frameworks. The proposal by the Parliament sided with the Proposal by the Commission. The Council proposal went a different way. The Council instead proposed a harmonized regime with minimum standards, with member states having the option to increase the requirements on platforms operating in their countries.

The proposed regulation by the Commission foresaw several unique solutions to the regulatory dilemma of harmonizing without stifling innovation. At the same time, the proposal left a few pertaining issues subject to further debate. The European Commission embraced the view that the regulation should focus more on the status and behaviour of crowdfunding intermediaries rather than fundraising firms. Despite substantially differing risk profiles, the proposal incorporated both lending-based crowdfunding for businesses (known as P2P business lending) and equity-based crowdfunding. The blurry line of distinction between some debt and equity instruments justified equal regulatory treatment. However, P2P consumer lending remained outside the scope of the proposed regulation, although the business model of P2P consumer lending is more similar to P2P business lending than to equity-based crowdfunding, and despite the fact that some entrepreneurs took P2P consumer loans to fund their small business ventures.

The critical aspect of investor protection under the proposed regulation is a high level of transparency at the platform and the project levels. Transparency rules serve to attenuate information asymmetry inherent in all financial markets. Investors have imperfect information about both the quality of projects seeking funding and the quality of platforms' services. Therefore, the regulation sets out distinctive transparency rules for project owners and platforms. Here, instead of costly prospectus requirements, project owners have to provide investors with a simplified key investor information sheet to enable them to make sound and informed investment decisions. In this context, another crucial discussion revolves around what should be the investment threshold that triggers the exemption from prospectus requirements. The European Commission proposed a threshold of 1 million euro per project per year. The European Parliament proposed a threshold of 8 million euro per year. The Council allowed member states to set the threshold between 1 million euro and 8 million euro per year. The negotiation concluded by setting a limit at 5 million euro per year and project.

With respect to prospective investors, the European Commission was concerned that retail investors do not understand the nature of crowdfunding investments and the risks they entail. For this reason, the regulation foresees an 'appropriateness test' (a concept also known under MiFID (II)) to be a part of the investors' onboarding procedure. Such a solution is an attempt to circumvent a more burdensome 'suitability test', which would imply that a platform estimates the financial situation of its clients and their ability to bear losses associated with crowdfunding investments.

Several provisions of the regulation referred to business requirements for platforms to ensure, among others, the impartiality before and continuity of business after the completion of a campaign. Given that platforms do not take any risk on their balance sheet, the European Commission deemed capital requirements redundant in case of crowdfunding, thus, leading to a sizable reduction of costs of market entry. The Council Proposal foresaw minimum operating capital, primarily to provide a continuation of the platform business in case of insolvency. In the end, the negotiation concluded with a minimum capital requirement of 25,000 euro.

At the time of writing this chapter, technical details were still emerging, all supporting the underlying notion that the ECSP will lead to a reduction of fragmentation. As a regulation (not a directive), it will be valid in all European member states 12 months after it is passed by the Council, Parliament, and Commission, with the option for each member state to extend the 12 month grace period to 24 months. It provides a unified definition of investment crowdfunding and of crowdfunding service providers. The ECSP regime sets a unified threshold for prospectus requirements at 5 million euro per year and per project. It also stipulates that member states cannot set forth individual investor thresholds.

The ECSP will be especially relevant for lending platforms, because it prohibits member states from requiring a banking licence from lendees or lenders, which will enable new platforms to merge. The conduct of platforms is regulated uniformly across European Union member states, especially in areas of regulatory uncertainty concerning the management of conflict of interest and relations with investors.

Finally, while of great benefit in reducing disparities with respect to investment crowdfunding across Europe, the ECSP will have little effect on P2P consumer lending, as well as on non-investment crowdfunding models, as they are not covered in the proposed regulation (Hooghiemstra 2019). In addition, a remaining loophole may result in that even in cases of investment crowdfunding for businesses, not all platforms will be covered in situations where member states decide that certain financial instruments are not deemed as securities, which are covered by the ECSP. Moreover, other critical regulatory aspects related to crowdfunding practice are also not covered by this regulation. For example, in terms of taxation, some European countries offer tax incentive schemes to investors and companies using crowdfunding (e.g. UK, France, Italy, Belgium, and Spain), while other countries do not, and even among those offering incentives, such schemes vary widely (Cicchiello et al. 2019).

Outcomes of Crowdfunding in Europe

Due to both sensitivity of information and the relative recency of the phenomenon, only limited evidence from a few studies is available about the outcomes of crowdfunding in European countries. Here, a study examining P2P loans in Lithuania from the Finbee P2P consumer lending platform (Gaigalienė and Česnys 2018) showed a default rate (defined as loan payment more than 90 days late) of 13% in a sample of 6324 loans analysed.

A different study examining 413 equity funded firms in Germany and the UK (Hornuf et al. 2018) found that overall 77 firms (18.8%) successfully raised follow-up funding after the latest equity crowdfunding campaign, and 69 firms (16.7%) went insolvent, were liquidated, or were dissolved. Furthermore, the study showed that, in comparison to UK firms, equity crowdfunded German firms stood a higher chance of raising follow-up funding from business angels or venture capital, but also had a higher likelihood of failure.

Conclusions

This chapter has presented evidence on the fragmented nature of European crowdfunding with respect to volumes, number of platforms, model composition and leadership, involvement of traditional financial institutions, dependency levels on cross-border transactions, and state of national regulation. However, while fragmentation in the European crowdfunding market was high in previous years, such disparities are expected to decrease with harmonized regulation and a boost in cross-border developments.

The new rules laid out by the ECSP Regime hold promise to reduce fragmentation further, benefitting both large and small platforms towards healthier scale up supported by expansion to other European countries. Fragmentation in non-investment crowdfunding will likely continue, because of its exclusion from the ECSP regime, as well as the locally anchored nature of most of the small-scale fundraising initiatives characterizing non-investment models.

Implications for Future Research

While our review presents interesting insights about current realities in the European crowdfunding market, it also opens up opportunities for future research. Most importantly, there is the need for longitudinal study of market development dynamics, attempting to identify whether harmonization of regulation will indeed limit the extent to which the market is fragmented, as well as to what extent it will contribute to the international expansion of crowdfunding platforms across Europe. Other aspects in this context may relate to the study of the impact international platforms may have on local platforms, as international scope of investment may be more appealing to prospective fundraisers.

It will also be interesting to research the impact of clear and harmonized regulation on moves by traditional financial institutions, examining whether this will encourage them to enter the crowdfunding space and under which organizational and ownership formats. In this respect, it remains to be seen whether crowdfunding will deliver on its ideological promises of democratization of finance, or whether it will be overtaken by traditional actors with deeper pockets. This is especially relevant in mainland Europe, which has a long tradition of reliance on the banking system that can be used to enhance the legitimacy and credibility of crowdfunding actors among the general public.

In addition, more research is necessary on the outcomes of crowdfunding in the European context, capturing its short- and long-term effects on businesses, entrepreneurs, and investors. Such research remains rare and anecdotal, but of tremendous value for future platform development, policy making, and investor behaviour.

Implications for Practice

First, investment crowdfunding platforms should follow the entry into force of the ECSP regulation in their respective countries, as well as countries they may wish to expand to, and adjust their operations accordingly. This implies developing strategies both for facing new competitors from neighbouring countries entering the platforms' home markets, as well as market entry strategies for countries they may wish to enter into themselves. Such strategies may include strategic partnerships, joint venturing, as well as platform mergers across Europe.

Second, once the greatest regulatory barriers have been addressed, platforms should focus attention on improving public education and understanding of crowdfunding to support its uptake in the various markets. Regulatory ambiguity may have been detrimental for participation in this market, and with such clarity platforms should engage in more strategic customer relationship management in terms of both retaining existing users, as well as recruiting new ones.

Finally, with greater regulatory clarity, opportunities for collaboration between traditional and alternative finance players are likely to increase. Here, platform operators should strike a delicate balance between being overpowered by deep pocket institutions that may want a stake in this new fast developing market, while remaining loyal to the original driving forces behind the market in terms of expanding access to finance, and greater sharing of profits with the wider public.

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