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**"THE RISE OF ALTERNATIVE FINANCE: HOW FINTECH**  
**COMPANIES ARE REVOLUTIONIZING THE FINANCIAL SERVICES**  
**AND THE TRADITIONAL BANK FINANCING"**

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## **Introduction**

In the last two decades, we have experienced the entrance of Internet, social media and mobile devices that have changed the way we interact with people and things.

This revolution has taken longer to penetrate, however, after the global Financial Crisis of 2008 that deeply affected the banking sector, forcing financial Authorities to impose high restrictions for bank lending, this revolution has involved many areas of business with particular focus on financial services and payments.

The unavailability of bank financing pushed individuals and SMEs to find alternative solutions to finance and in this context, Fintech industry developed.

Fintech is a term coming from the contraction of two words: “Finance” and “Technology” and refers to all companies that apply technological innovations to financial services sectors. This industry is fragmented into many sectors offering products and services to a broad range of customers and in the case of financial services, Alternative Finance is the Fintech area that is bringing the most important innovations in terms of finance, by using online marketplaces that work by matching the demand of borrowers with the offers of investors and lenders. Alternative Finance is characterized by many sub-sectors: Crowdfunding, Online Invoice Trading, Merchant finance, Payments and Trade Finance which differ on their business models but mutually shares some features, such as the fact of being totally web-based and non-bank players. Basically, they offer products and services as banks but leverage customer experience. Indeed, with the advent of Digital Revolution customers have changed their minds, so that their new expectations rely on joining digital experiences in almost everything they do and, while banks are still retarded, Fintech companies are able to offer customers what they want.

Today the market is characterized by the presence of more than 1,250 non-bank players across the world and the expansion of Alternative Finance has moved also towards emerging countries. According to that, the situation for retail banking is not so wealthy. Banks are facing the competition of new challengers and have to choose how to deal with it, whether to fight or collaborate with them.

In next chapters we will go deeply with the analysis of Alternative Finance, focusing on how such phenomenon is revolutionizing the banking sector. In particular, the first chapter will give an overview of the economic and financial environment where SMEs and banks have to survive. The second chapter will focus on having a more understanding about Fintech industry and factors that make Fintech a revolution.

Following chapter will focus on the analysis of Alternative Finance, in terms of market shares and understanding of its main sub-sectors. To better understand how they work, chapter four will provide a description per each business model of Alternative Finance and an additional case study. Among the different business models characterizing Alternative Finance, particular attention will be given to Peer-to-Peer lending and Invoice Trading, which represent the main sources of alternative finance for SMEs and, for these will be provided specific show cases.

For what it concerns the Peer-to-Peer lending option, I experienced a real online loan application on the web site of an Italian leading platform and I also interviewed one of the key staff of the same platform to gather more information about the operating process.

For what it concerns the Invoice trading, instead, I interviewed the key staff of another Italian start-up that recently entered the market and got some information about their business.

Chapter five will give an overview of the state of art of the regulatory framework, both European and per-country, to understand how regulation is approaching the phenomenon of Alternative Finance and what are the main differences across countries.

The end chapter will finally provide a SWOT Analysis of Fintech and Alternative Finance industries and the analysis of potential banking solutions to approach them.

## **Chapter I – OVERVIEW OF THE ECONOMIC AND FINANCIAL ENVIRONMENT AFTER THE GLOBAL FINANCIAL CRISIS**

The economic and financial environment where we live is characterized by, on one side, the presence of large and small businesses driving the economy of each country but that cannot find financing and, on the other side, the presence of banking industry that is now in troubles, suffering from the advent of digitalization and technological changes.

This chapter provides an overview of the economic and financial environment in the aftermath of the Global Financial Crisis of 2008.

### **I.1|Overview on Small and medium enterprises**

Small and medium enterprises (SMEs) represent the major drivers of the economic activity and employment in most developing economies, as well as a way to improve innovation and technology.

A report of the World Economic Forum<sup>1</sup> shows that the amount of micro, small and medium enterprises in emerging markets varies between 365 and 445 million, out of which 25 million to 30 million are formal SMEs and 55 million to 70 million are formal micro-enterprises. In developed markets it is possible to estimate approximately 100 million formal SMEs.

### **I.2|Overview on the banking industry**

Generally, when we talk about banking we think about international institutions that operate across the world offering services that range from checking account, lending financing, payments processing and wealth management. When we talk about banks, we think about complex products, like derivatives, CDOs, CDS and the presence of a large physical branch network.

Besides family and friends, bank financing has always been the most important source of external finance for individuals and businesses. Normally, large companies with profitable investments and collaterals have easier access to bank financing, while small and medium enterprises (SMEs) often do not because they are always considered high-risk firms. This is because, as the “World Economic Forum” highlights in its report, finances of SMEs are characterized by high complexity and low scale, which lead banks to limit their lending services.

Generally, SMEs have to deal with many issues, such as: securing loan-term funding, handling

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<sup>1</sup> WORLD ECONOMIC FORUM, (October 2015), *The Future of FinTech - A Paradigm Shift in Small Business Finance*, available online at <http://www3.weforum.org> .

late payments, managing working capital and taking care of collections and; because of that they need money, but specific challenges limit traditional bank lending to SMEs. Reasons behind this are related to the fact that SMEs usually lack internal skills and resources to manage finance and to conduct systematic fundraising.

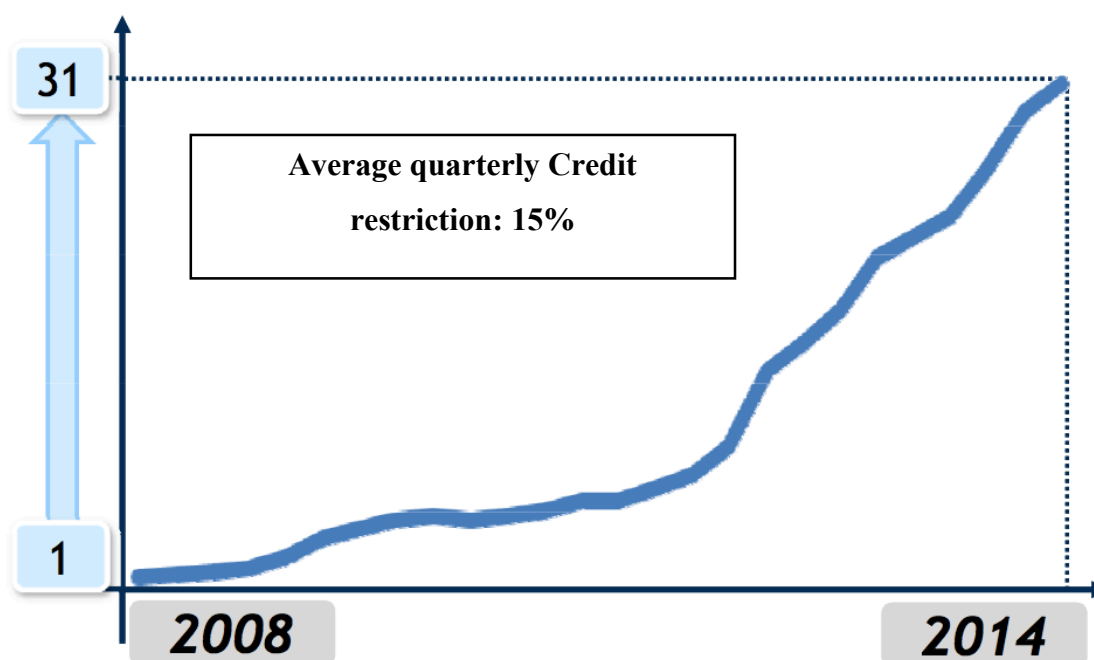
Literature highlights two main problems. The first is characterized by information asymmetry, as a result of a lack of supporting a solid financial information infrastructure. Often, SMEs do not produce audited financial statements that yield credible financial information for a bank to assess the financial situation. Furthermore, for smaller enterprises, the line of separation between the finances of the owner and those of the business is usually indistinct. A second challenge can be considered the principal/agent problem, particularly acute in the case of SMEs. Once financing is received, the entrepreneur may use funds in ways different than those for which it was intended. In other words, the high intrinsic risk of the entrepreneur may exceed the risk appetite of the banks, which, consequently reject the financing requests.

### **I.3|The negative effects of the Global Financial Crisis on lending activity**

In the aftermath of the Global Financial Crisis of 2008, the above situation exacerbated. The Great Recession had severe effects. First, governments dropped their interest rates to nearly 0%. Second, banks reduced credit concession and cut back significantly on the risk they were willing to take with loans, due to a strengthening in bank regulation imposed by Basel III, which aims at avoid further collapses (more details on Basel III are provided in Appendix A). Third, a worsening of credit ratings for businesses.

This context just made it even more difficult than typical for small and medium size businesses getting capital.

**Figure 1** – Credit restriction between 2008 and 2014 and analysis of qualitative index on European credit restriction



(\*) -1 significant loosening; +1 significant restriction

**Source** – Ronchi S. (June 16, 2014), *Supply Chain Finance: Nuove opportunità di collaborazione nella filiera*

According to the World Economic Forum, in the United States, SMEs loans, as a percentage of all bank business loans, fell from 35% to 24% while in Europe the borrowing costs for SMEs increased by 150%. A proportion of 45% to 55% of worldwide SMEs do not have a loan overdraft but would need one, while 21% to 24% have a loan but suffers significantly financial contractions.

The above situation is similar for Italy. An article<sup>2</sup> by “Il Sole 24 Ore” states that in 2009, the number of SMEs that obtained financing from banks moved from 64,2% to 29% and 23,8% in 2013. In addition, the situation is worsened by the interest rates charged by banks, higher than those paid by larger enterprises. Furthermore, between 2008 and 2013, banks and other financial institutions started to select customers basing on severe creditworthiness criteria, limiting the access to credit for those SMEs that did not satisfy certain requirements.

<sup>2</sup> Bartoloni M. (January 20, 2015), *La morsa del credit crunch: in quattro anni 100 miliardi di mancato credito per le PMI*, available online at <http://www.ilsole24ore.com/art/notizie/2015-01-20/la-morsa-credit-crunch-quattro-anni-100-miliardi-mancato-credito-le-pmi-170054.shtml?uuid=ABTM9ugC> .

## I.4| The old banking is broken

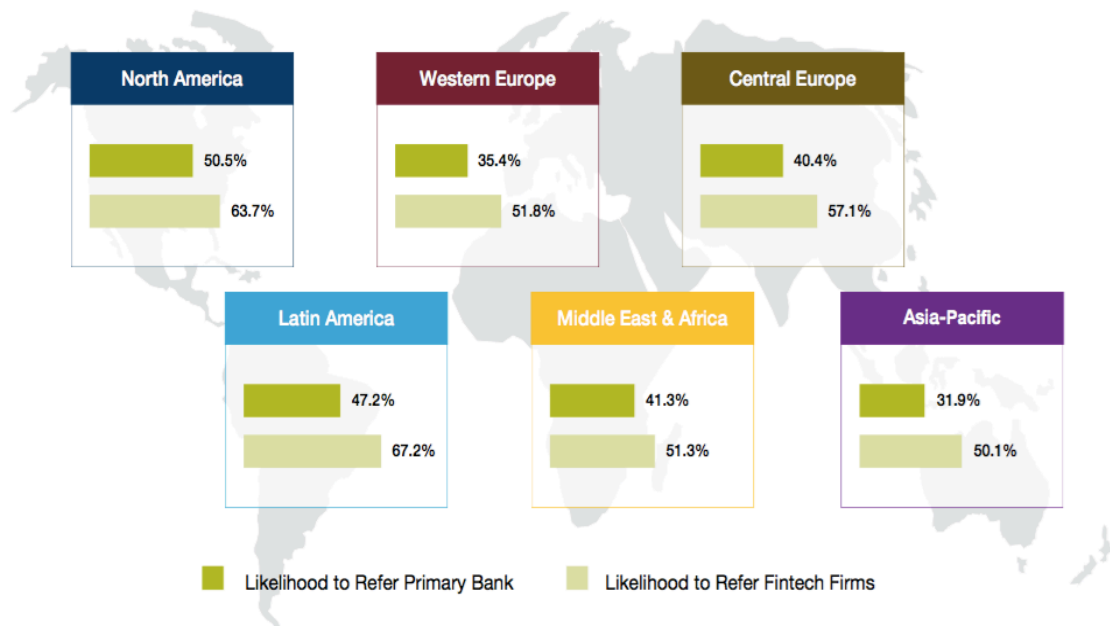
In addition to the negative effects of the Financial Crisis that destroyed asset values equal to 50% of the world GDP for a huge amount of money (almost \$30 trillion), the high complexity behind the banking industry led the sector to go astray.

Today, it is possible to state that the old banking is broken and that a new world is coming. The reasons why this is happening rely on a series of factors that do not fit well with the era of digitalization and technology revolution, based on an easier and faster way to approach every market.

The above factors do not prepare banks to survive the revolution that is coming out, since they relate to a number of weaknesses of financial institutions, such as:

1. **Business models outdated:** banks rely on systems that are not tech and are not in the Internet space;
2. **Fraudulent behaviours:** surveys show that twenty of the world's biggest banks have paid more than \$200bn in fines for misdeeds, ranging from manipulation of currency and interest rate markets and compensating customers, who were wrongly sold mortgages in the US or insurance products in Britain;
3. **No money for shareholders any more:** while in the past, the banks gave money to their shareholders from 7 to 5%, today they do not. They try to cut costs, however, they are still inefficient;
4. **Absence of innovations:** the level of innovation coming from the banking sector is paralysed. From mid 1960, when they developed the Automated Teller Machine (ATM) that represented a big surprise for those years, the last worthy innovation is represented by the Online banking in 1990;
5. **Lost of customer trust:** since the Financial Crisis, the level of customer's trust within the banking sector has severely decreased and banks find difficult to reclaim clients who left and retain the ones who remained. Today, the number of people who would recommend their banks to family and friends is decreasing globally. The World Retail Banking Report of 2016, points out the likelihood associated with people that would refer primary banks or Fintech firms.

**Figure 2 - The likelihood to refer Primary banks or Fintech firms?**



Source – The World Retail Banking Report 2016

As figure 2 shows, in every region of the globe, customers are more likely (54.9%) to refer their Fintech providers to someone they know, rather than their banks (38.4%).

## **Chapter II - THE FINTECH REVOLUTION: how Fintech will reshape small business finance**

In a context characterised by economic and financial difficulties for small and medium- size businesses and the old banking system ending, markets are looking for a big change. At the same time, customers changed their minds and the way to approach products and services, becoming more digitalized and enlarging their expectations.

In this situation, Fintech companies are emerging and driving a big revolution, becoming one of the most powerful tools supporting the growth of businesses and bringing the innovation across all industries.

The current chapter gives a 360-degree view on Fintech industry, by providing an explanation of drivers, value propositions, market segmentation and outlooks.

### **II.1|What is Fintech?**

The term “**FinTech**” refers to a dynamic ecosystem, whose name derives from a contraction of two words: Finance and Technology and defines “**companies that provide or facilitate financial services by using technology**<sup>3</sup>”.

A report<sup>4</sup> by KPMG and H2 Ventures defines Fintech companies as “*those companies using technology to the best advantage and driving disruption within the financial services industry. These companies have a commitment to excellence, superior customer experience and a demonstrated ability to do one thing in a market better than everyone else*”.

The financial services sector had always been characterized by the use of technology, however, with the last innovations, this sector witnessed the creation of new and fast growing alternative finance markets that see the use of internet and technological devices for doing business, giving space to a proper “Digital Revolution”.

Basically, Fintech has affected most segments of the whole global market, with particular focus on Financial Services, the epicentre of Fintech disruption (see Figure 3).

Fintech companies aim at reach efficient and effective financial solutions at a lower scale, by disintermediating the role of incumbents, such as banks and, servicing customers directly through the use of online and mobile channels that are reshaping the way customers access financial products and services by providing solutions that can better address customer needs

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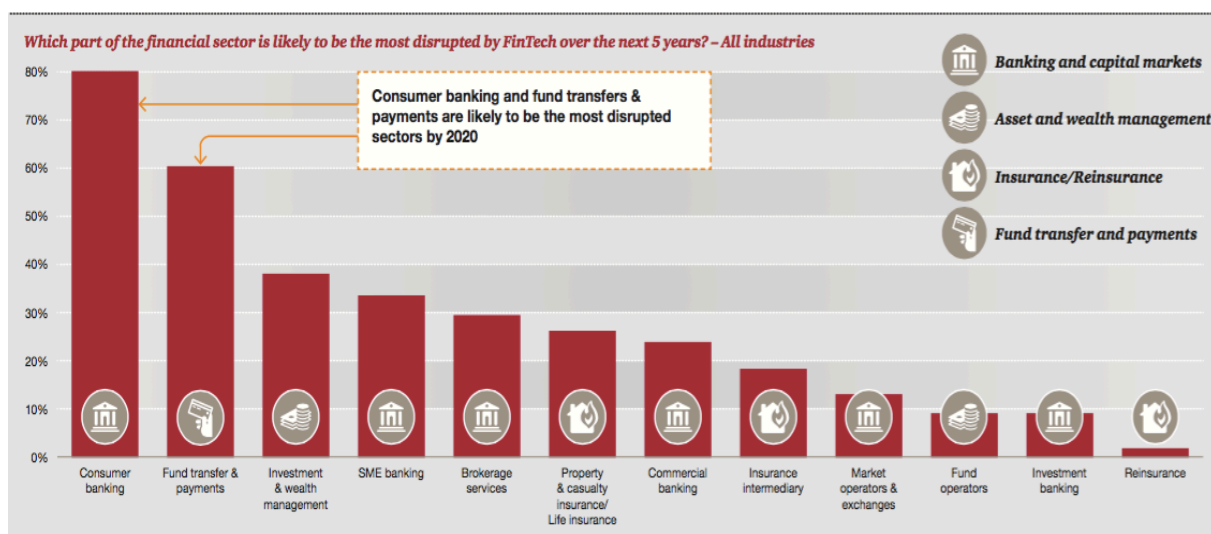
<sup>3</sup> WORLD ECONOMIC FORUM, (October 2015), *The Future of FinTech - A Paradigm Shift in Small Business Finance*, available online at <http://www3.weforum.org> .

<sup>4</sup> KPMG - H2 Ventures (2015), *Fintech 100 – Lending global Fintech innovators Report 2015*, available online at <http://fintechinnovators.com/uploads/H2-Fintech-Innovators-2015.pdf>



by offering enhanced accessibility, convenience and tailored products.

**Figure 3 – Fintech disruption in Financial sector**



Source – Pwc, Global Fintech Report, March 2016

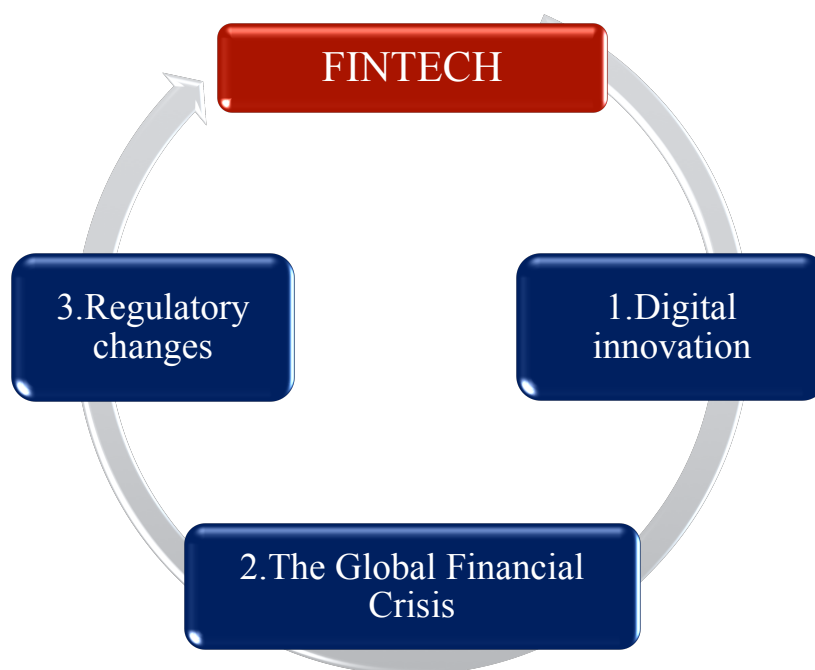
## II.2|Drivers of Fintech Disruption

Fintech revolution depends on many factors. First, **technological advances** that provide new advanced solutions and capabilities that influence consumer behaviour and expectations, as well as driving a change within the industry. The penetration of smartphones and internet has been revolutionising the virtual connectivity allowing individuals and businesses to connect and doing things in ways previously unknown. Second, the **Global Financial Crisis** that led the public opinion to lose faith in traditional financial institutions. This has created an environment whereby the consumer is open to adopting new business models and products from new providers, meanwhile the crisis has led traditional financial institutions to fail investments in technology and innovation. Third, the set of **regulatory restrictions** imposed on banking sector has been contributing to the worsening of the sector, by increasing operating costs of compliance and reducing R&D budgeting.

As a result, banks lost competitiveness and have to assist to the entrance onto the markets of non-banking players, which are able to offer alternative financial products and services that can substitute the ones provided by banks and can fill the financing gap widen in the post-crisis environment for start-ups and SMEs.

These new players are focused on the digital distribution of data through a globalized network that use software and servers.

*Figure 4 - Drivers of change*



### **II.3| What is Fintech Revolution?**

When we talk about Fintech Revolution we refer to the great number of success factors that characterize companies, which operate within such industry and that outline the borders between traditional banking and the new challengers.

If on one side there is the banking industry with numerous gaps that lead the consumer to look for other financial providers, on the other side, there are non-bank players that offer consumers products and services that are similar to those provided by banks, but in a different way that exerts a great influence over customers' decisions about their financial services providers.

The value proposition of Fintech is based on the following key factors:

- 1. Good customer experience:** with the advent of Internet and mobile devices, customers has become “digital friendly”, so that, they enlarged their expectations on products and services delivery, totally based on technology and digital improvements. Fintech offer customers the experience to get what they are looking for in a few minutes, wherever they are and in an easy way.
- 2. Faster service:** Fintech offers products and services in less than a half of the time took by banks;
- 3. Simplification of products, processes and communication:** Fintech firms offer simplified products than banks, reduce the complexity behind banking industry, including less bureaucracy issues and, allow consumers to have a direct customer

service with immediate effect;

4. **Specialization and Personalization:** Fintech companies limit their offerings on a few core products to a targeted customer audience;
5. **IT infrastructure:** Fintech totally operate online, by using advanced IT infrastructures, including marketplaces that connects one arm of the market (for instance: borrowers) with the other arm of the market (for instance: Investors);
6. **Low costs:** Fintech companies do not have physical infrastructures and, consequently, no employees and no taxes. This severely reduces operating costs and allows new challengers to invest in high level of innovation.

## II.4|Segmentation of Fintech market

Fintech ecosystem involves many areas of business. A report by McKinsey Panorama<sup>5</sup> proposes a “Customer-Product” segmentation of this sector.

As the figure shows, the targets of customers range from “Retail”, to “Commercial”, such as small and medium-size businesses to “Large Corporations” that include public and non-banking institutions.

Products, whereas, range from “Revenue share”, “Lending and Financing” to “Sales and Trading”. The highest concentration of capital invested is in “**Payments**” (retail payments), which represent the most important segment characterising Fintech space, together with the use of innovative data.

The advent of Internet and mobile technology has significantly changed the way to pay, with the surge of new technology-driven payment processes, new digital applications that make payments easier, alternative processing networks and the increased use of electronic devices to transfer money among accounts.

Another very important segment of Fintech landscape involves the use of “**Big Data and Advances analytics**” that permit to gather a large flow of information to predict “next best actions”. Building a comprehensive data ecosystem means to access customer data and have a 360- degree view on customer activities and behaviour. This allows firms to leverage this information to drive decisions across a broad range of actions, from customer acquisition to understanding credit scoring.

A high concentration of Fintech activity is also in Lending segment, characterized by the emergence of “**Online Platforms**” that allow individuals and businesses to lend and borrow

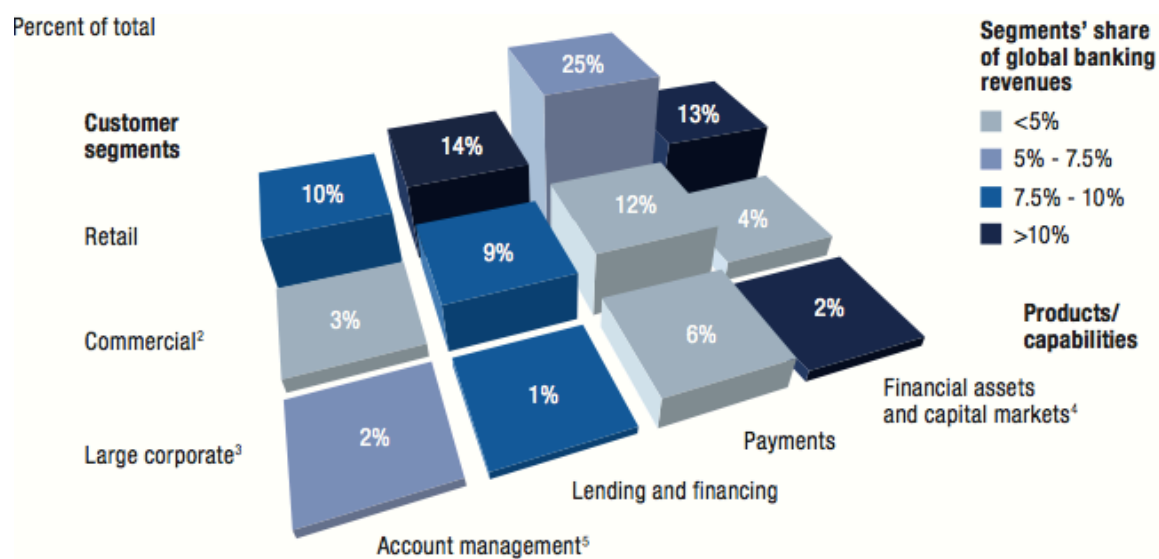
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<sup>5</sup> McKinsey & Company, *Cutting Through the FinTech Noise: Markers of Success, Imperatives For Banks*, available online at <http://www.mckinsey.com/industries/financial-services/our-insights/cutting-through-the-noise-around-financial-technology>, December 2015

money among each other. Fintech innovation also manifests itself in the development of alternative credit models, use of non-traditional data sources and powerful data analytics to price risks and lower operating costs than traditional bank financing.

A report by Accenture<sup>6</sup> defines platforms in this way “A digital platform brings together process, people, technology and information into a value network that provides consumers and businesses access to an extensive selection of products and services within and across multiple markets. By enabling multiple parties to engage in networked commerce, digital platforms create a multiplier effect, quickly increasing demand for products and services and generating additional value for various users along with the platform’s owner”. Online platforms are a key point in Fintech sector, because they serve to bring products and services together into a richer and a personalised customer experience. They build connections across the value chain among consumers, suppliers, retailers and the different players operating within the market.

**Figure 5 –Global Fintech Activity by Customer-Product segments**



Source – McKinsey Panorama

<sup>6</sup> Accenture Strategy (2016), *Value unchained-Linking into the network effect of digital platforms*, available online at [https://www.accenture.com/\\_acnmedia/Accenture/Conversion-Assets/DotCom/Documents/Global/PDF/Strategy\\_5/Accenture-Strategy-TS-Digital-Platforms.pdf](https://www.accenture.com/_acnmedia/Accenture/Conversion-Assets/DotCom/Documents/Global/PDF/Strategy_5/Accenture-Strategy-TS-Digital-Platforms.pdf).

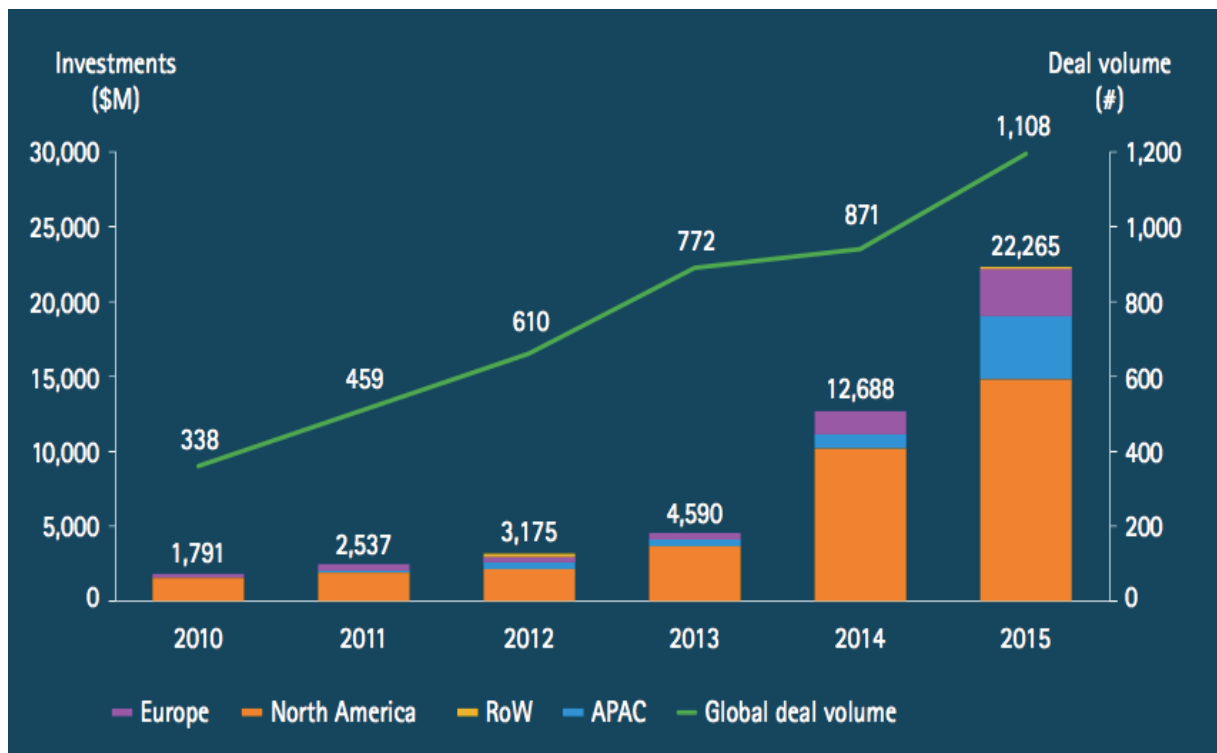
## II.5| The growth of Fintech

In its report<sup>7</sup>, Accenture pointed out that the global investments in Fintech ventures that in 2014 were tripled to \$12.21 billion, grew by 75% by 2015, reaching almost \$22.3 billion from deal-flow across Europe, North America and Asia-Pacific (APAC). This trend confirms that Fintech industry has reached a new level of maturity and it is now moving into mainstream.

Fintech Investment in Asia-Pacific more than quadrupled in 2015 to \$4.3 billion, becoming the second biggest region for Fintech investment after North America, accounting for 19% of global financing activity. In particular, China has the lion’s share of investment, accounting for 45% in 2015, while India makes up 38% and is growing fast with Mumbai, Bangalore and Beijing as the major Fintech hubs in the region by the number of deals.

For what it concerns deal volumes, 78% went to Fintech companies targeting the banking industry, 9% to wealth management and asset management companies and 1% to the insurance sector. Payments is the most popular segment for Fintech deals in Asia-Pacific, accounting for 38% of the total.

**Figure 6 - Global Fintech financing activity (2010-2015)**



**Source** – Accenture Report: Fintech and the evolving landscape: landing points for the industry

<sup>7</sup> Accenture (2016), *Fintech and the evolving landscape: landing points for the industry*, available online at [http://www.fintechinnovationlablondon.co.uk/pdf/Fintech\\_Evolving\\_Landscape\\_2016.pdf](http://www.fintechinnovationlablondon.co.uk/pdf/Fintech_Evolving_Landscape_2016.pdf)

## **Chapter III – INTRODUCTION TO ALTERNATIVE FINANCE**

The previous chapter focused on the whole Fintech industry and its segmentation within the major areas of business. Among the large product offerings, from now on, we will focus on “lending and financing” target, which includes the Financial Services sector.

A common way to address the disruption of Fintech in the Financial Services sector is known as Alternative Finance that embraces different areas of finance, subject to Fintech Revolution. This chapter will give a global view on the evolutionary steps and the market composition across major countries of the Alternative Finance.

### **III.1| Defining Alternative Finance**

Alternative Finance can be considered an “umbrella term”, covering a different range of financial solutions. It does not exist a proper definition for Alternative Finance, when we talk about it, we just refer to a constantly evolving and rapidly expanding sector, composed by different segments of business.

In order to have a clear vision, at a very basic level, it may be possible to define Alternative Finance as all “*about the provision of finance to individual borrowers and SMEs, funded by means other than the banking sector*”<sup>8</sup>. However, Alternative Finance involves high levels of technology, so, it may be possible to change the former definition with: “*about providing a technology-based solution to financing businesses and consumers*”.

In short, it is a sector that offers finance in a more technological way, by disintermediating the traditional role of incumbents.

### **III.2| Forms of Alternative Finance Solutions**

Today, there are over a dozen different forms in which Alternative Finance can be divided up into and these may vary depending on the size and target of the market.

The most important and commonly used can be summarized as follow:

- **Crowdfunding;**
- **Online Invoice financing;**
- **Merchant Finance;**
- **Payments;**
- **Supply Chain Finance;**
- **Trade Finance.**

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<sup>8</sup> [www.glifinance.com](http://www.glifinance.com)

Each above sub-sector contains multiple business models that will be deeply analysed in the next chapter.

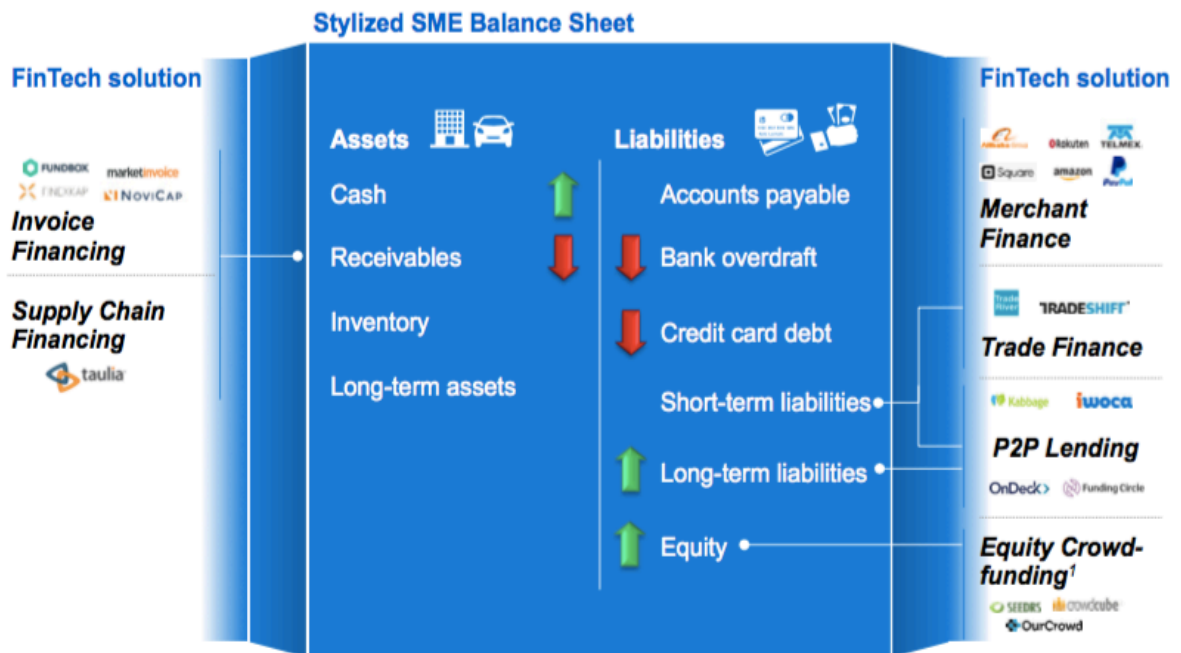
Despite many differences, all of such forms of financing share the following characteristics:

1. They are “digital businesses” operating through online platforms;
2. They provide financial services but they are not banks;
3. They leverage the scale of online platforms to secure numerous lenders and investors.

Right at the top, the most relevant models are Crowdfunding, which includes: Equity Crowdfunding and Peer-to-Peer Lending and, Invoice Financing. These represent the most viable and effective source of fund rising for start-ups and SMEs across the world.

According to the World Economic Forum, turning to these solutions can have positive effects on SME’s balance sheet situation. Indeed, many issues faced by entrepreneurs would be overcome with more availability of cash, working capital improvements and more stable and secure funding, all easily available from Alternative Finance platforms.

**Figure 7 - Stylized SME Balance Sheet and the impact of Alternative Finance solutions**



Source – World Economic Forum

### **III.3| Alternative Finance history**

Even though the Alternative Finance universe is apparently new, the concept behind it is not new. Facilitating the allocation of capital is an old concept as capitalism and getting money from the “crowd” (basic concept of Crowdfunding) is traced back to 18<sup>th</sup> century. Indeed, school of thoughts attribute the creation of Crowdfunding to Jonathan Swift, an Irish writer who inspired the “Irish Loan Fund” to fight the poverty of that time; others attribute the merit of creation to the fundraising campaign that Joseph Pulitzer launched through the newspaper “*The World*” to fund 150,000 dollars for a pedestal for the Statue of Liberty.

The history of Alternative Finance can be summarized in four main periods:

#### **1. 1990s – 2000s: Internet enables the first online Crowdfunding campaigns**

With the advent of Internet, people started to exchange contents via email, instant messages and fan pages. In this way, they contributed to create communities which aim to share common interests and work together for common purposes. In this atmosphere, a British rock group “*Marillion*” was the first to use the power of the crowd as a source of finance. In 1997 they ask fans to fund 60,000 dollars for US tours and subsequent albums, directly on their website.

#### **2. 2000 - 2005: The era of Microlending and P2P**

This period witnessed the emergence of sites, like *Kiva*, based on online microlending, which enabled individuals to support projects and ideas by lending small amount of money.

The real innovation came with the arrival of platforms, like *Zopa* and *Prosper*, which provide lending between individuals (peer- to- peer).

#### **3. 2005 - 2014: The Excitement Phase**

The two biggest drivers of growth of Alternative Finance market were probably the advent of “Web 2.0” and the Financial Crisis of 2008.

The former got people used to the idea of being part of online communities, whose aim is to share common interests and pursuing mutual goals. In this period, platforms like *Indiegogo* and *Kickstarter* came to light, becoming popular all around the world. The latter, led SMEs finding new sources of financing and investors new asset classes.

#### **4. Today: The Execution Phase**

Today the Alternative Finance industry is mature and starts to enter the mainstream. The number of platforms operating within this sector has been constantly increasing all over the world.



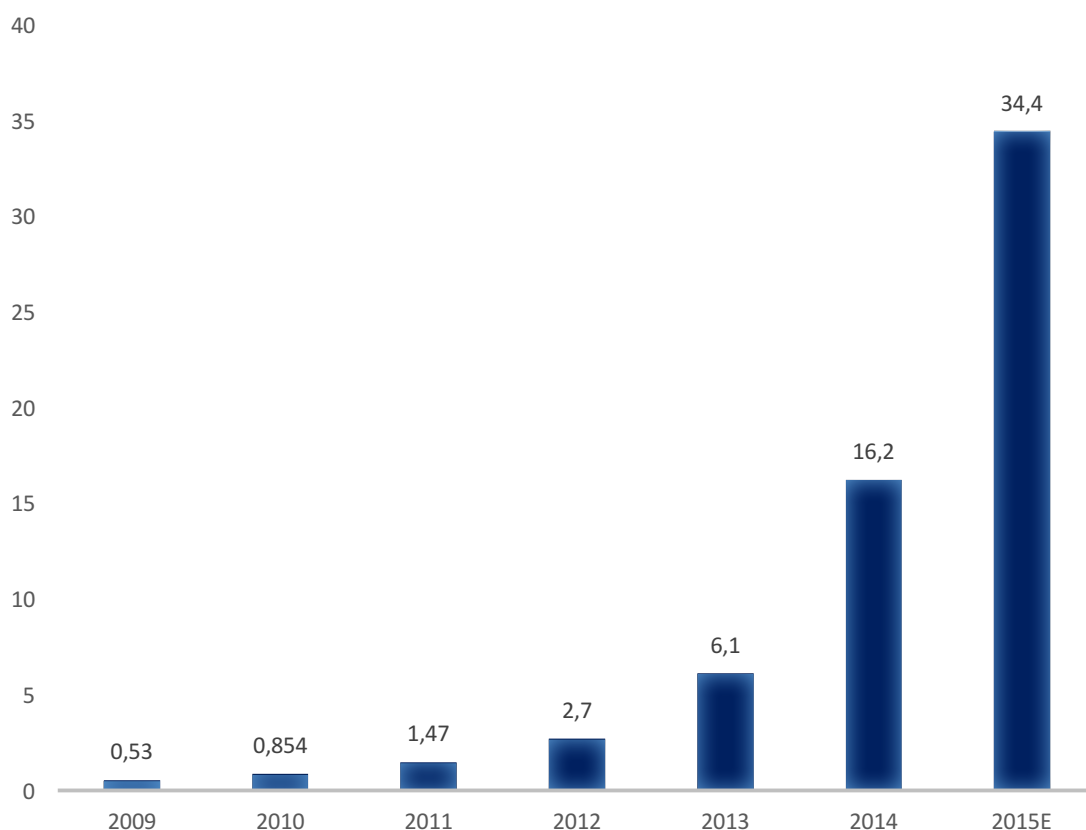
### III.4|A global overview of the Alternative Finance market

With the entrance of Fintech into the mainstream, Alternative Finance is growing so fast alongside the three primary markets, such as: Continental Europe, US and Asia-Pacific Region.

#### III.4.1|Worldwide Crowdfunding Market

According to Massolution, at the end of December 2014, Crowdfunding platforms operating worldwide has reached an amount of **1250**, of which 600 in Europe and 375 in the North America, recording an increase of almost **167%** of the total volume, moving from \$6,1 billion by 2013 to **\$16,2** billion dollars by 2014.

*Figure 8 – Worldwide growth of Crowdfunding’s volume (\$Million) between 2009 and 2015*



**Source** – <http://italiancrowdfunding.it/crowdfunding-anno-del-boom-2015>, last update 22/08/2015

Among all Crowdfunding models, in 2014, **lending platforms** confirmed their primary position with \$11,08 billion in funding volumes, followed by **donation-based models** that reached \$1,94 billion; **reward-based models** with \$1,33 billion, of which 92% in the US that host the most important operating platforms, such as Kickstarter, Indiegogo and GoFundMe and finally; **equity-based models** with respectively \$1,11 billion in funding volumes.

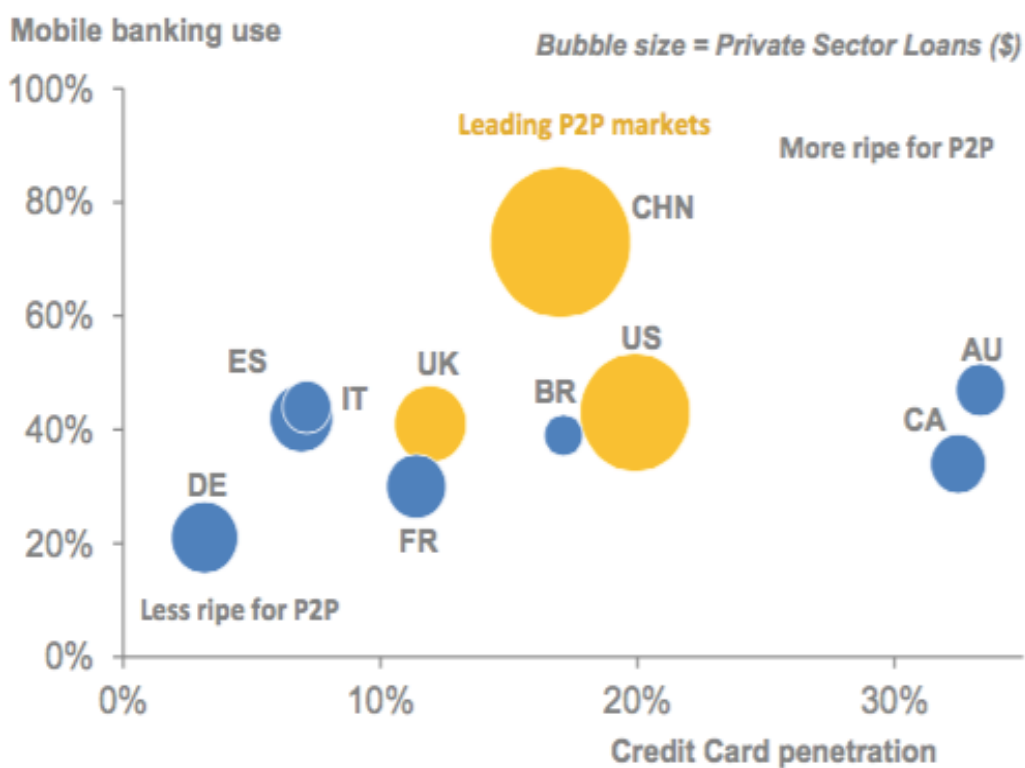
### III.4.2| Global Peer-to-Peer Lending market

According to a Morgan Stanley Research<sup>9</sup>, in the US, marketplace lending is in lift-off and expected to reach 10% of unsecured consumer and SMEs lending by 2020.

Outside the US, China and the UK are the most compelling markets for marketplace lending, while Australia is still a nascent market, showing good promises given its shared characteristics with the UK (see Figure 9).

Furthermore, the global marketplace lending is estimated to reach \$290 billion by 2020 (see Figure 10).

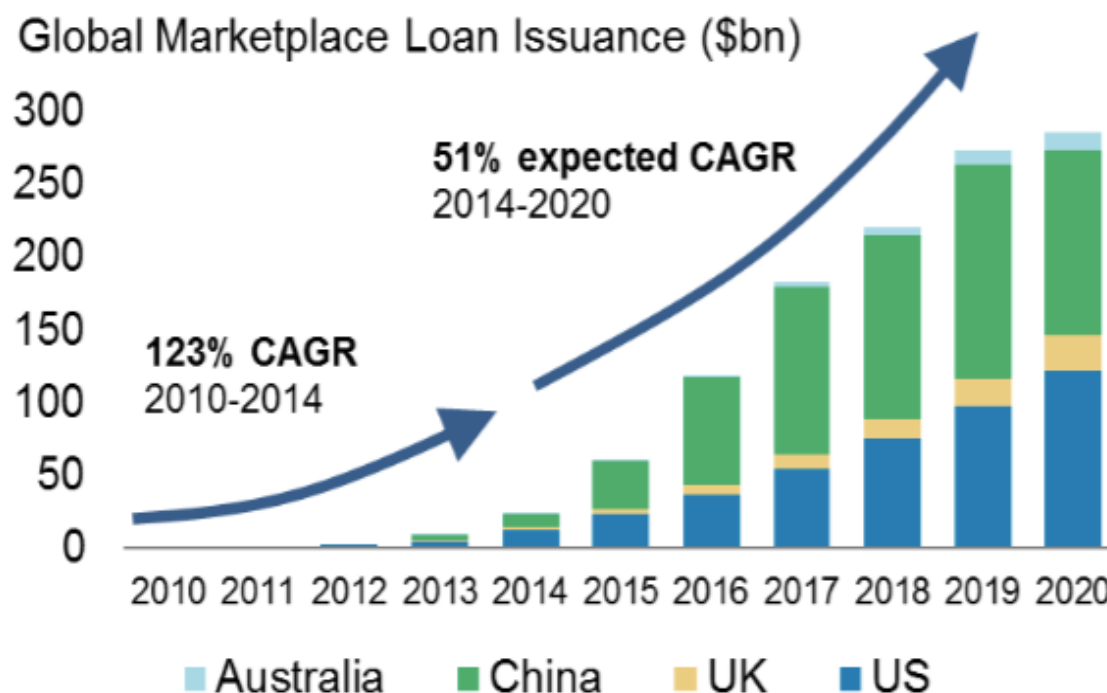
**Figure 9** – Key markets for Marketplace lending



Source – Morgan Stanley Report

<sup>9</sup> Morgan Stanley Blue Paper – *Global Marketplace Lending Disruptive Innovation in Financials*, available at <http://bebeez.it/wp-content/blogs.dir/5825/files/2015/06/GlobalMarketplaceLending.pdf>, May 19, 2015.

*Figure 10 –Global marketplace lending estimates*



Source – Morgan Stanley Report

### III.4.3| Size and growth of Alternative Finance market in the US

Since 2010, the US marketplace loan origination has doubled every year and reached \$12 billion by 2014.

Morgan Stanley Report points out that US **Unsecured Consumer** is the main target for Peer-to-Peer platforms, which issue loans to refinance existing debts. Unsecured Consumer Lending is dominated by early entrants, such as **Lending Club** and **Prosper** that are respectively the first and the second consumer online lending platforms taking 60% and 20% share in loan issuance in 2014.

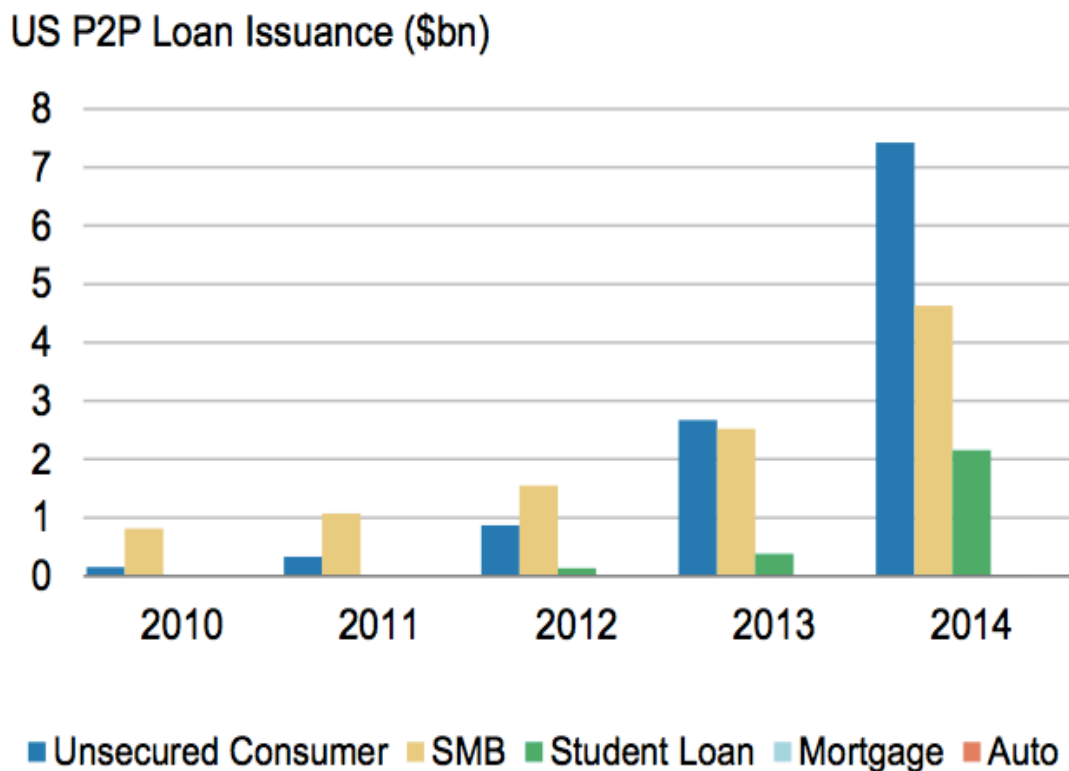
For what it concerns **SME lending** market, it is more fragmented than the consumer unsecured segment, however platforms like **On Deck** and **Kabbage** dominate the small business market. Estimates show that SME marketplace lenders represented \$4.6 billion in 2014 issuance (2.1% of the total market).

Furthermore, issuance is expected to expand at a 47% CAGR through 2020, primarily through the creation of new credit rather than taking share from incumbents. In 2020, an annual SME loan volume of \$47 billion (account for 16% of total US SME issuance) is forecasted – see Figure 12.

Beyond consumer and business lending sectors, US marketplace lenders have started to enter the **student loan, mortgage and auto loan markets**. To date, only student loan has seen

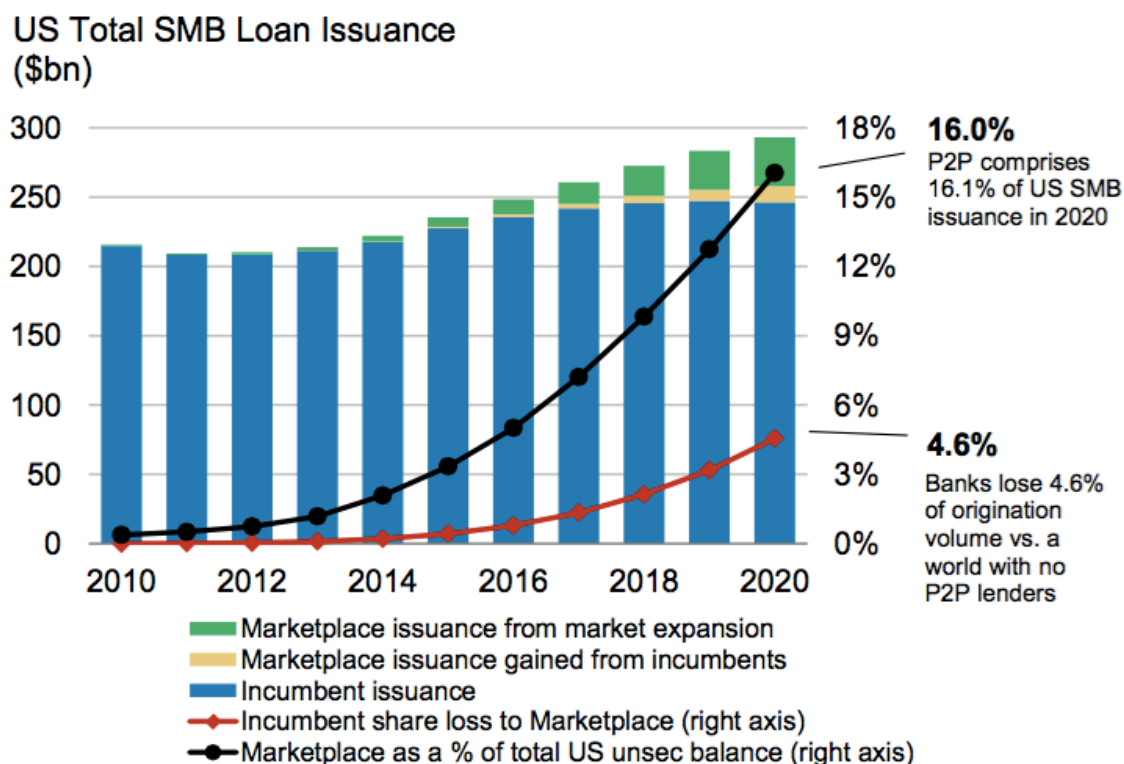
significant traction, issuing over \$3 billion through the leading platforms, such as **SoFi** and **CommonBond**. The increase in the application of student loans is particularly due to “Millennials”, people between 18-34 years old, which are becoming a larger portion of the consumer loan market as they look for credit to finance major purchases or refinance their student debt. According to that, they can be considered as the prime targets for P2P lending as they value the convenience of transacting online and are less loyal to banks than other part of the population.

*Figure 11 – US marketplace lending by addressable markets*



Source – Morgan Stanley Report

Figure 12 – Penetration of SME marketplace lending



Source – Morgan Stanley Report

### III.4.4| Size and growth of Alternative Finance market in Europe

Between 2012 and 2014, European online Alternative Finance market is composed by **255** platforms, displaced among 27 countries. Among European countries, **UK** represents the **leader in Alternative Finance** market, contributing more than 80% of the entire European market origination in 2014 with more than 65 different operating platforms.

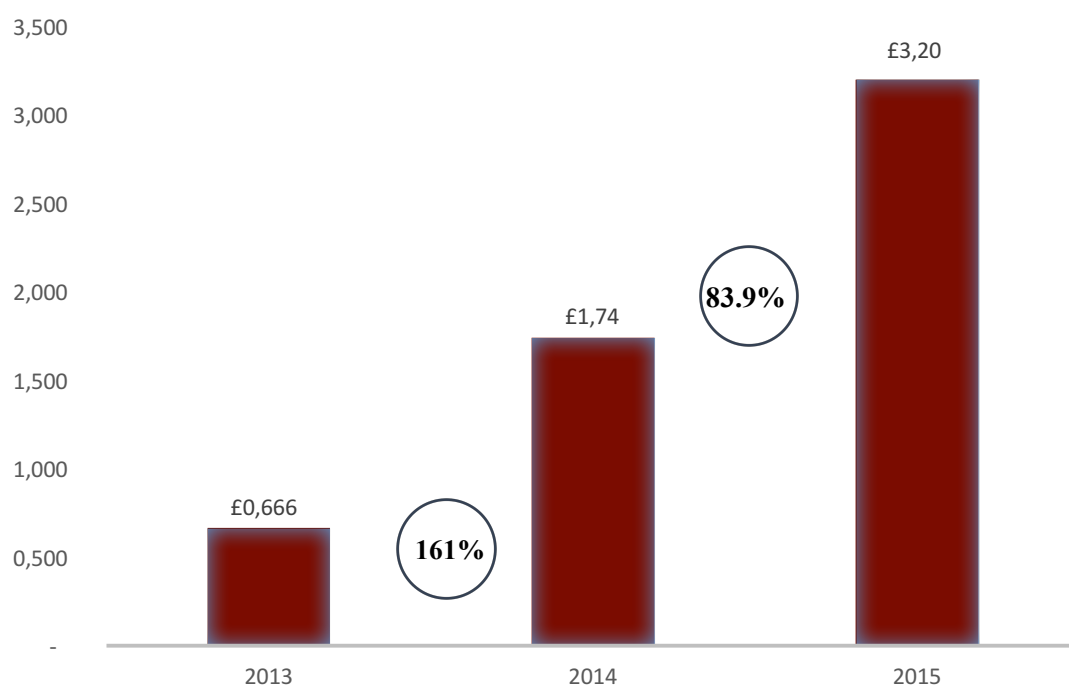
The rest of online platforms is displaced across Europe, especially in **France, Germany** and **Spain**.

A joint report published by the University of Cambridge<sup>10</sup> highlights that by 2015, the total UK online Alternative Finance market grew at **£3.2 billion**, representing a year-on-year growth rate of 83.91% with respect to the industry total of £1.74 billion in 2014.

<sup>10</sup> Zhang B., Baeck P., Ziegler T., Bone J., Garvey K. (February 2016), *Pushing Boundaries: The 2015 UK alternative Finance Industry Report*, available online at [http://www.nesta.org.uk/sites/default/files/pushing\\_boundaries\\_0.pdf](http://www.nesta.org.uk/sites/default/files/pushing_boundaries_0.pdf).

**Figure 13 – Total UK online Alternative Finance raised between 2013 and 2015 (£ billion)**

\*Values in the circles are the growth rates



**Source** - Pushing Boundaries: The 2015 UK alternative Finance Industry Report

By looking at each alternative finance model, in 2015 the UK market witnessed:

- A 62% year-on-year growth rate for **Reward-based crowdfunding** that reached £42 million;
- A 507% year-on-year growth rate for **Donation-based crowdfunding**, which registered the fastest growth amongst all Alternative Finance models, with £12 million distributed;
- Community shares reached £61 million with a 79% year-on-year growth rate, while pension-led funding was almost flat with £23 million for the year. Debt-based securities, which allow investors to invest in both short- term and long-term renewable energy initiatives, achieved a very respectable £6.2 million with a 52% three-year average growth rate;
- Lending-based models such as, peer-to-peer consumer lending and peer-to-peer business lending, remain the largest models by volume of the UK online Alternative Finance market. In particular, the consumer-based segment reached £909 million in 2015, compared with £547 million in 2014. With a 66% year-on-year growth rate and a 78% average growth rate for the period 2013-2015, the peer-to-peer consumer lending

sector is growing fast and continues to provide efficient consumer credit to UK borrowers. The UK consumer origination market is dominated by platforms, like **Zopa** that was the first P2P lender founded in 2005 in the UK and, **RateSetter**, with a respectively market share of new lending in 1Q15 of 18% and 26%.

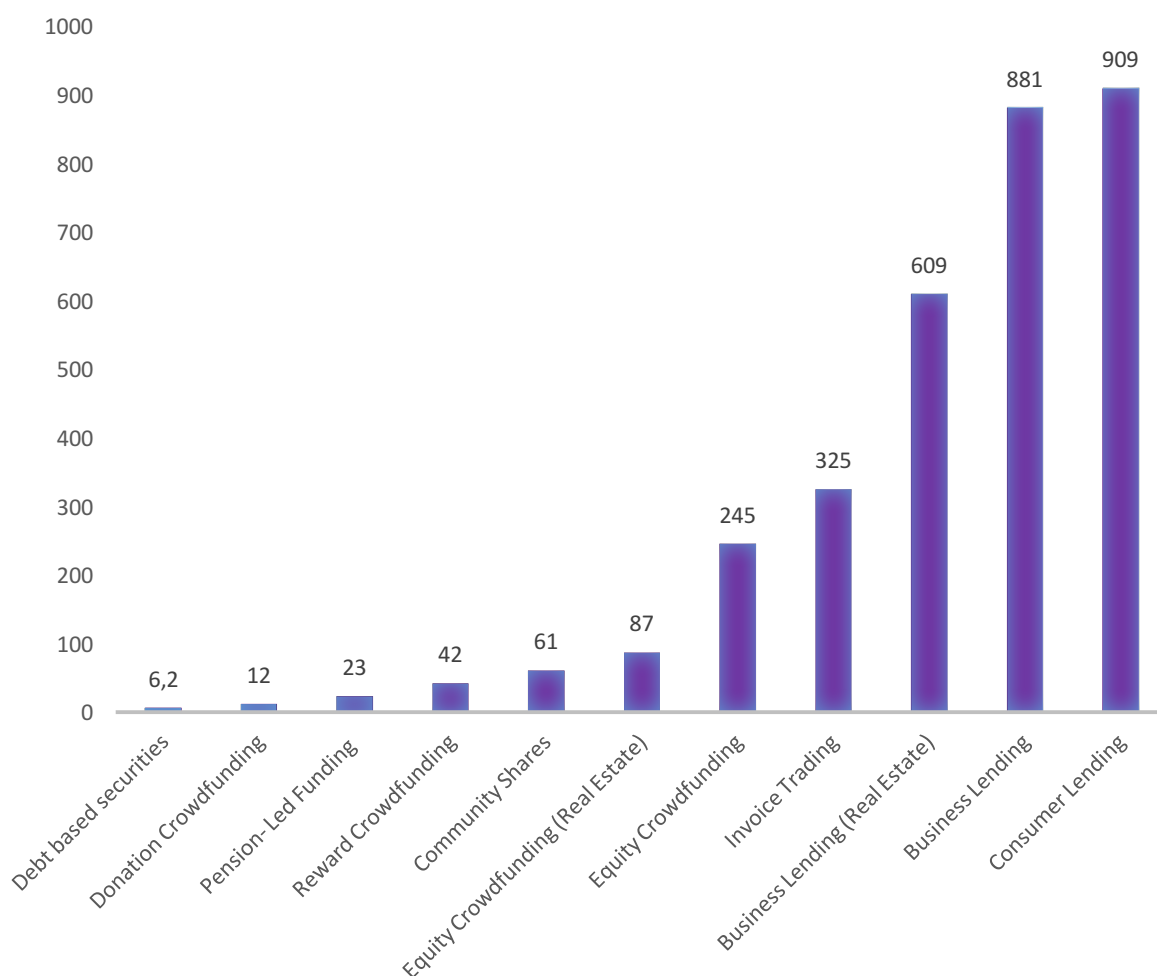
Looking specifically at the small business sector, in 2015 approximately 20,000 UK SMEs raised alternative finance through online channels, such as peer-to-peer business lending, invoice trading debt-based securities, receiving £2.2 billion in business funding.

From 2014, the total online alternative business funding rose by 120% and the total number of SMEs served increased by 185.71%.

In 2015, business lending, Invoice Trading and the Equity-based crowdfunding increased as follow:

- Nearly £1.49 billion was lent to SMEs in the UK. This represents a 99% year-on-year growth rate and 194% average growth rate between 2013-2015 for peer-to-peer business lending. According to the joint report, at least 41% (£609 million) of total peer-to-peer business lending came from the real estate sector, however, even after excluding real estate lending, **peer-to-peer business lending** still recorded a sizable £881 million for the year 2015, which represents **3.9% of new loans lent to SMEs**. The business origination is dominated by the platform **Funding Circle**, which represents the largest SME lending platform in the UK, with £110 million of origination in the first quarter of 2015;
- **Invoice trading** increased by 20% from £270 million in 2014 to £325 million in 2015. Leader in this sector is the platform **MarketInvoice**;
- **Equity-based crowdfunding** grew up by 295%, to £332 million raised in 2015, compared to £84 million in 2014. Platforms such as **Crowdcube**, **Seedr** and **Syndicate Room** are the major online platforms operating within this segment. However, a sizable part, £87 million of the total equity-based crowdfunding volume, is from real estate crowdfunding, dominated by **LendInvest**.

**Figure 14 – The UK Alternative Finance market by Model (£ Million)**



**Source** - Pushing Boundaries: The 2015 UK alternative Finance Industry Report

Geographically, it is possible to recognise a distinct level of variation in where funding and fundraising takes place in the UK.

London remains the most active UK region by total transactional volume, in both volume of funding received and provided with 58 operating platforms, followed by the South East, South West and West Midlands. Scotland represents the fifth most active region for receiving funding in contrast with the East of England that is ranking as the fifth most active region for providing funding.

### **III.4.5| Size and growth of Alternative Finance market in Italy**

A research<sup>11</sup> by the Università Cattolica del Sacro Cuore di Milano, highlights that in 2015, the

<sup>11</sup> Università Cattolica del Sacro Cuore di Milano, *Il Crowdfunding in Italia Report del 2015 - Un completo report del mercato, una mappatura delle piattaforme italiane e un'analisi dei trends emergenti*, available online at <http://crowdfundingreport.telecomitalia.com/download/CrowdfundingItalia-Report2015.pdf>.



Italian Crowdfunding market was composed by **82** platforms, of which **69** were effectively active, while the remaining **13** were in a launching state.

By looking at the market composition of 2014, there has been a remarkable increase of **68%** in the number of active platforms that contributed to an increase of 85% in the total funding volume that reached **€56.7** million.

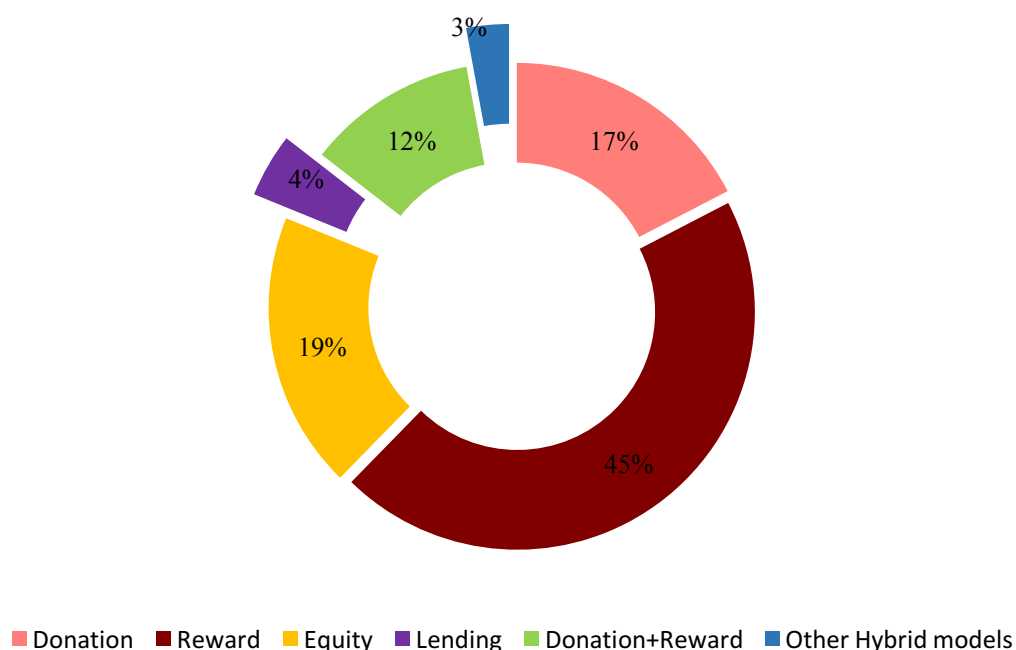
The Italian landscape is characterized by the presence of all traditional models of crowdfunding, such Donation, Reward, Equity and Loan and, so called, “**Hybrid platforms**” that mix the features of two models, for instance Reward and Donation, creating a single model (Reward+Donation) that is able to respond to more specific customers’ requests, thus enlarging the customer satisfaction.

Among 69 active platforms that operate on the Italian market, 45% are Reward-based, 17% operate through donations, 19% are Equity-based and only a small percentage of 4% operate as Lending platforms, such as **Smartika**, **Prestiamoci**, **Borsa del Credito.it** and **Mutui Online**, which serve the consumer and business segments.

For what it concerns the sub-sector of Online Invoice Trading, **WorkInvoice** is the leading platform, while **Instapartners** is now emerging.

Finally, Payment sector is dominated by **Satispay**.

*Figure 15 - The composition of Italian Alternative Finance Market*



Source – Università Cattolica del Sacro Cuore, *Il Crowdfunding in Italia Report 2015*

As shown in Figure 15, there is an evident disparity among models. With respect to the US and the UK markets, the Italian market is dominated by Reward-based crowdfunding, which demonstrates a higher propensity for social and innovative campaigns. Furthermore, in 2015, the percentage of equity-based platforms increased due to the change in the regulation (better explained in the next chapters) that requires the registration of Italian equity platforms within the CONSOB book; while the percentage of Peer-to-Peer marketplace lending is very low.

The small incidence of Peer-to-Peer lending is primarily due to the difficult application of loan-based model within the Italian ecosystem, characterised by banking restrictions and the absence of a proper regulation for Peer-to-Peer marketplace lending.

Geographically, most platforms operate in the North of Italy, with a strong concentration in the city of Milano, which hosts 16 platforms.

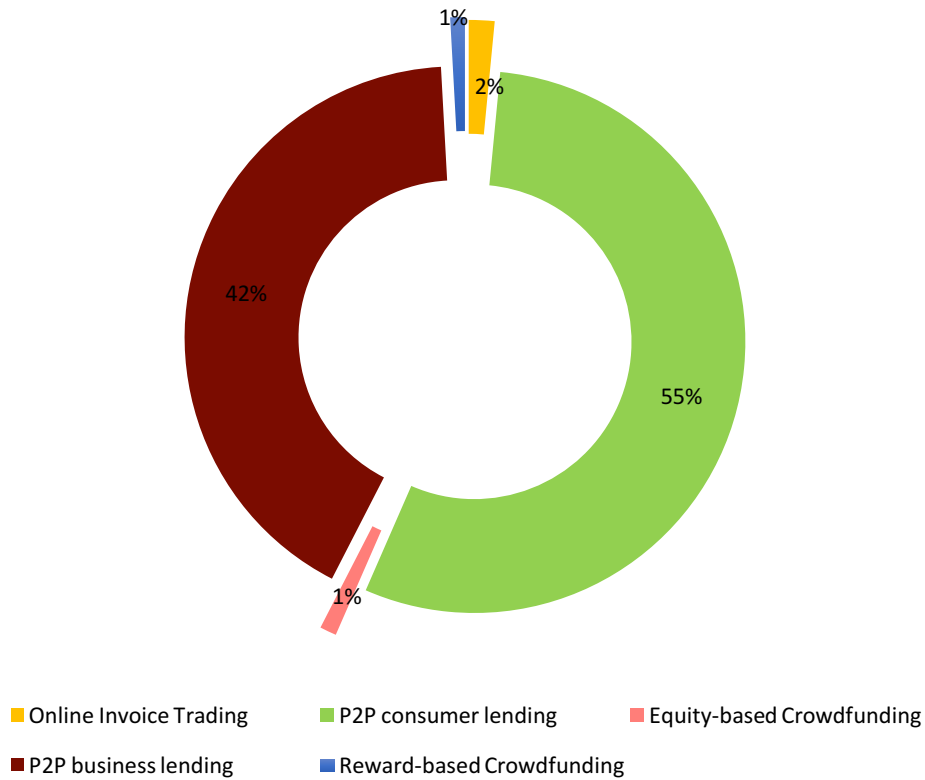
A large majority (74%) of platforms serve the domestic market, mainly addressing private individuals and associations, while small businesses are reached at 67%.

#### **III.4.6|Size and growth of Alternative Finance market in Asia-Pacific region**

In 2015, **China** is the world's largest online Alternative Finance market by transaction volume, recording **\$101.7 billion**. This constitutes almost 99% of the total volume in the Asia-Pacific region. The Chinese online Alternative Finance market grew from a relatively low base of \$5.56 billion in 2013 to reach \$24.30 billion in 2014 and then went on to reach the above mentioned value in 2015, which means that Chinese market grew at an average growth rate of 328% between 2013 and 2015.

**Peer-to-Peer consumer lending** is the largest market segment in China with **\$52.44 billion** lent, followed by **Peer-to-Peer business lending** with **\$39.63 billion** and real estate lending (\$5.51 billion). **Online invoice trading** reached **\$1.46 billion**, **Equity-based crowdfunding** recorded **\$948.26 million** and **Reward-based crowdfunding** rose to **\$829.52 million** in 2015.

*Figure 16 – The composition of Chinese Alternative Finance market*



Excluding mainland China, the rest of the Asia-Pacific region recorded a volume of USD **\$1.12 billion** in 2015 with a 313% year-on-year growth rate from the \$271.94 million raised in 2014. Japan's market accrued \$360.23 million in 2015, followed by \$348.37 million originated in Australia, followed by New Zealand (\$267.77m) that has the highest alternative finance volume on a per capita basis outside of China, South Korea (\$41.18m), in India (\$39.91m) and Singapore (\$39.76m).

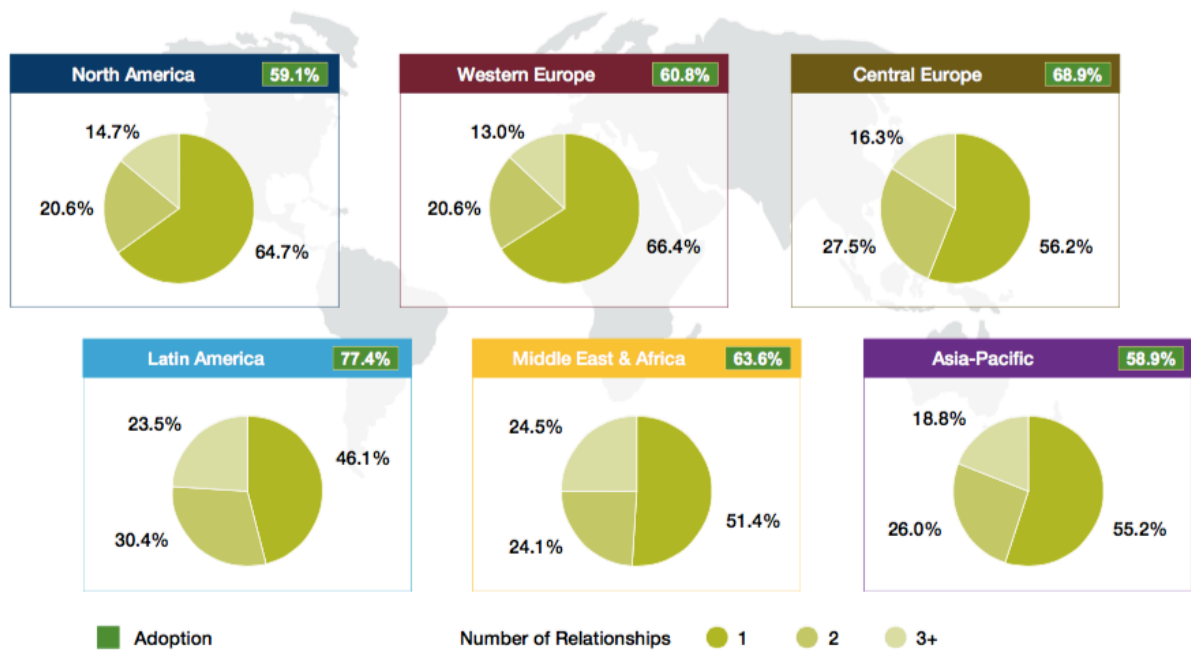
### III.4.7| The Market Penetration

As highlighted in previous pages, we are now entering the phase in which Fintech industry is becoming mainstream.

If a few years ago, Fintech and Alternative Finance were unknown terms, today statistics show an increase in the level of operating platforms, investments in both industries and also higher levels in the global market penetration.

Data points out that nearly two-thirds of customers across the globe are using products or services from challenger firms and that the percentage of penetrated market is very high especially in emerging markets, such as Latin America, Asia Pacific and Middle East & Africa.

*Figure 17 – Market penetration*



Source – The World Retail Banking Report 2016

For what about customers that adopt these solutions as alternative to the banking system, younger population between the ages of 25 and 34 years old (“Millennials”) tends to be more likely to positively respond to Fintech solutions.

Millennials are then followed by those aged 35 to 44 and those aged 18 to 24. Obviously, this is due to the fact that those people are more familiar with digital revolution than aged people.

### III.5| An illustrative Alternative Finance Landscape

**Crowdfunding (Donation, Reward, Equity)**

**Supply Chain Finance**

**E-commerce and Payments**

**Consumer Lending**

**Invoice Trading**

**Business Lending**

## Chapter IV – BREAKING DOWN ALTERNATIVE FINANCE: analysis of the business models and the most relevant show cases

This chapter will go deeply with the analysis of the different Alternative Finance business models, to understand their principal characteristics and working process.

In particular, a specific show case will be attached to the description of every model to compare the theoretical view with a more practical explanation. For some business models, I interviewed some key staff that gave me some relevant information about the marketplace lender they work for.

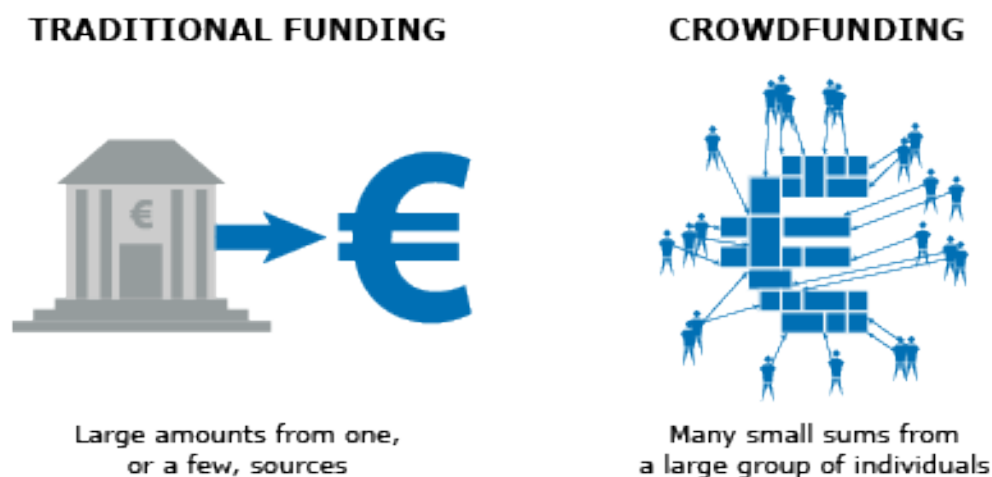
### IV.1| Crowdfunding

#### IV.1.1| What is Crowdfunding

Crowdfunding can be defined as a way in which people, organizations and businesses (from early to mature stage) can raise money to finance or re-finance their activities, through the use of online portals, known as “platforms”.

This process results into a **new form of financing that can substitute the traditional funding system offered by banks.**

*Figure 18 – Traditional Funding vs Crowdfunding*



The process of Crowdfunding is fast and easy and involves three main participants:

- The **project owner**, which is an individual or a business;
- The **funders**, a pool of individuals that act as donors, investors or lenders, depending on the type of crowdfunding business model;
- The **online platform**, which acts as intermediary.

Crowdfunding combines the emotional engagement and dedication of entrepreneurship with the social and financial returns of investments, ultimately aligning the investor and the investee in the early stage of business growth.

#### IV.1.2|Different models of Crowdfunding

Crowdfunding industry includes different business models available to businesses, individual consumers, non-profit organizations and charitable causes. Each model includes different forms of contribution and expected returns that include money as equity, debt, exchange/reward or simply donation, depending on the intrinsic motivation that leads funders and fundraisers to turn to these models. From the point of view of funders, the reasons why they may decide to turn to Crowdfunding can be classified in three macro-categories and depend on the nature of the expected return, which can be:

- *Social motivation*: the return is intangible. The funders are motivated by the nature of the project and the potential to contribute to its realisation, making a positive effect with their money;
- *Material motivation*: the return consists of a product or service as a reward for the investment;
- *Financial motivation*: the fundraisers are motivated by the prospect of getting monetary and financial returns, with less concern for supporting social causes or local businesses.

Nowadays there exist more than ten different types of Crowdfunding models operating in the market, however, the most recognized by literature are described in Table 1.

**Table 1 – The principal business models of Crowdfunding**

Model	Form of contribution	Form of return	Motivation of funder
Donation Crowdfunding	Donation	Intangible	Social
Reward Crowdfunding	Donation/Pre-purchase	Non-financial rewards and intangible benefits	Social and material
Equity Crowdfunding	Investment	Return on investment in time if the business goes well	Financial
Lending Crowdfunding	Loan	Repayment of the loan with interest	Financial

#### **IV.1.2.1| Donation –based Crowdfunding**

The donation-based form is used by individuals or charitable organisations to collect money from a group of people in forms of donations, with the aim to support charitable projects, in exchange for symbolic rewards, like invitations for special events or public recognitions.

Donation based Crowdfunding does not pay financial returns but, the intrinsic motivation of donors to turn to this type of Crowdfunding model is linked to the opportunity to join customer experience.

#### **IV.1.2.2|Reward- based Crowdfunding**

The use of reward-based model increased significantly in recent years. This business model has become the most popular form of Crowdfunding in the support of creative, social and entrepreneurial projects. The model allows people to contribute to projects in exchange of non-financial returns. An important benefit to the entrepreneur is that the rewards cost relatively little to deliver but hold significant value to the backers, in terms of experience or recognition-related rewards, such as getting the first product of an innovative production campaign.

In the last case, the model is similar to a pre-sale agreement, whereby the entrepreneur is able to test the market and get feedbacks about product awareness and the potential of a such product to penetrate a certain market.

The first two models of Crowdfunding have been included within the analysis for completeness, however, they will be left out as they are considered less relevant from the moment that they do not impact financial service sector.

#### **IV.1.2.3|Equity-based Crowdfunding**

The Equity-based Crowdfunding (or investment-based crowdfunding) is generally used by early-stage firms and connects companies and investors that want to contribute to fund small businesses or start-ups.

Within this form of Crowdfunding, investors invest directly or indirectly into new or established businesses by buying shares of equity issued by the companies, thus becoming shareholders of those companies. The financial returns can be generated by share or by “revenue sharing”, which consists of getting part of revenues deriving from the economic activity of the company funded.

This model includes a sub-sector relies on real estate: **Equity-based crowdfunding (Real Estate)**, which can be defined as “a direct investment into a property by individuals, usually



through the sale of a registered security in a special purpose vehicle (SPV)<sup>12</sup>. Individual and businesses that raise capital through equity crowdfunding valued the speed at which they could get money;

#### **IV.1.2.4|Loan-based Crowdfunding**

##### **(i) Definition**

Lending activity is referred to “Peer-to-Peer lending” (P2P) or marketplace lending and represents the most innovative form of alternative finance for small and medium-size businesses. It can be described as the practice of bringing together individuals and institutional investors that have money to lend in the hope of financial returns, with people and businesses that seek to obtain funds without going through traditional intermediaries, such as banks, venture capital and business angels but simply using online platforms in the form of loan agreements.

##### **(ii) Peer-to-Peer lending models**

The reasoning behind P2P loans varies, depending on the different segments that characterise this form of financing. In particular, P2P can be broken down into:

1. **Peer-to-peer Consumer lending (P2C)**, whereby individual borrowers acquire mostly unsecured personal loans from a number of other individual lenders within an online marketplace. Credit card, debt consolidation, medical expenses, weddings, and home repair are some of the most common reasons associated with this type of P2P loans requested. This type of loan is one of the fastest growing segments and makes up the majority of P2P loans due in part to the fact that: they are generally smaller sized loans, have a relatively high number of borrowers with good credit scores, and the time in which an individual can complete an online application and obtain a loan is very low;
2. **Peer-to-peer Business lending (P2B)**, whereby SMEs raise capital directly from a pool of lenders, both institutional and individual, bypassing prolonged and uncertain bank lending processes;

Other forms also include:

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<sup>12</sup> Zhang B., Baeck P., Ziegler T., Bone J., Garvey K. (February 2016), *Pushing Boundaries: The 2015 UK alternative Finance Industry Report*, available online at [http://www.nesta.org.uk/sites/default/files/pushing\\_boundaries\\_0.pdf](http://www.nesta.org.uk/sites/default/files/pushing_boundaries_0.pdf).

1. **Peer-to-Peer Business lending (Real estate)**, which is defined as “a property-based debt transaction, between individuals and/or institutions and businesses, most of which are property developers<sup>13</sup>”;
2. **Student loans**, especially developed in the US lending market and used by young people to finance their student debts.

### **(iii) Marketplace lending**

As reported by Foundation Capital in one of its paper<sup>14</sup>, a more appropriate name to describe Peer-to-Peer lending is “*Marketplace lending...which is fundamentally about creating platforms to connect borrowers with lenders*” with technology making it possible for “...*third part(ies) to match idle supply and demand.*”

However, it is difficult to attribute a proper definition to marketplace lending. Many papers consider this term as a synonym of Peer-to-Peer lending, while others believe it is a misnomer, given the fact that with the development of industry a significant portion of funding also comes from financial institutions and institutional investors, which cannot be considered as “Peers”. The online marketplace can be considered as the virtual place where who wants to borrow money is put in a direct contact with who wants to lend money, through an online platform. In this way, borrowers get access to appropriately priced products, while investors are getting higher yields and more investment choices.

## **IV.2| How do Crowdfunding platforms work?**

Before going into deep with the analysis of specific show cases, it is important to understand how Crowdfunding platforms work.

Despite the presence of a great diversification due to the entrance of many online platforms onto the market, the application process is, basically, standard and it could be described as follow.

### **(i) The borrowing process**

From the borrower’s side, the request for financing starts with an online application. In order

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<sup>13</sup> Zhang B., Baeck P., Ziegler T., Bone J., Garvey K. (February 2016), *Pushing Boundaries: The 2015 UK alternative Finance Industry Report*, available online at [http://www.nesta.org.uk/sites/default/files/pushing\\_boundaries\\_0.pdf](http://www.nesta.org.uk/sites/default/files/pushing_boundaries_0.pdf).

<sup>14</sup> Foundation Capital, Whitepaper: *A Trillion Dollar Market By the People, For the People: How Marketplace Lending Will Remake Banking As We Know It*, available online at [https://foundationcapital.com/assets/whitepapers/TDMFinTech\\_whitepaper.pdf](https://foundationcapital.com/assets/whitepapers/TDMFinTech_whitepaper.pdf).

to guarantee the whole security against the risk of missing payments of the borrower, each applicant is required to send a list of documents that will be analysed by a team of specialists with the aim to check the financial and credit profile of each individual who asks for getting funds, so that it will be possible for the platform to identify and select the most creditworthy borrowers. To do so, the team carefully checks the identity of the applicant, the reason why he/she is asking for money and checks other specific information that will never be publicly available to investors for privacy reasons.

Once the platform has verified the reliability of the applicant, each borrower is assigned a credit score based on the quality of financial data analysed. In this way, the platform is able to match the borrower's demand with the offers updated on the marketplace to create a tailored loan proposal.

Once the match has been done, each applicant will receive a confirmation email with the loan proposal's details. In case of acceptance, the borrower will receive the funds on his/her account and will be committed to repay the loan, increased by the interest rates within a monthly basis. In case of rejection, instead, the applicant could re-apply.

#### **(ii) The analysis of credit history**

Generally, the most important factor to be considered within a lending transaction is the analysis of past credit history, which allows the platform to understand the debt position of a potential borrower.

In traditional bank financing, the decision about credit concession is primarily based on the evaluation of the overall creditworthiness of the borrower. For this scope, banks look at the expected future cash flows of a firm as a primary source of debt capacity. Crowdfunding platforms, whereas, make this analysis more accurate, by gathering borrower's information from different sources of data and advanced analytics.

In order to fix this concept and better understand how the process of credit scoring works for Crowdfunding platforms, I interviewed a Digital Sales Manager and financial analyst of one of the most important Italian operating leading platform. The key points that came to light concern the principal factors characterising credit scoring models, which determine the success of financing requests. Normally, the specificity of factors varies depending on the type of business that asks for funds, whether it is a limited liability company or a corporation, a company with a simplification in accounting or ordinary accounting etc. However, among these factors, there are three categories that the financial analyst I talked to has defined as "The three pillars", meaning that if a company asking for money positively satisfies them, it will obtain a loan proposal by the platform.

The above factors are the following:

- **Quantitative elements**, such as:
  - Percentage revenue increase;
  - Financial ratios, such as: as current ratio (current assets over current liabilities), debt to equity ratio, gross profit percentage (gross profit over gross sales), ROA (net income over total assets), and ROE (net income over net worth);
  - Free Cash Flows.
- **Trend elements**, such as:
  - Rating score given by public credit rating agencies;
  - The presence of potential detrimental.
- **Qualitative elements**, such as:
  - Web scoring;
  - Purpose of financing request;
  - Business activity;
  - Past credit history.

### **(iii) How does the credit score process work?**

In order to check “The three pillars”, each platform operates a due diligence process that consists in checking all information available about a private individual or a business to determine whether to accept him/her at the borrowing process. As previously highlighted in point (i), part of the necessary information is given directly by the applicant during the application phase, however, most of the information is obtained through the consultation of national Credit Rating Agencies that give more financial details and define the merit of credit of the applicant. On the basis of their evaluation, the Credit Rating Agencies assign a credit score depending on the level of risk associated with each applicant.

The next table shows the credit scores and the associated meanings, which are fundamental for the team of analysts of the platforms to decide whether to accept or not the application of a potential borrower and, in case of acceptance, determine a tailored loan proposal.

In fact, the interest rate on the loan is determined on the basis of the risk: the higher is the risk, the higher will be the interest to pay monthly for the borrower.

*Table 2 – Credit rating system*

<b>A1</b>	Excellent company with extreme reliability and ability to repaying financial obligations
<b>A2+</b>	Very good company with very good capability of repaying financial obligations
<b>A2</b>	
<b>A2-</b>	
<b>A3+</b>	Good company with good capability of repaying financial obligations. Very low dependence on possible adverse macroeconomic conditions
<b>A3</b>	
<b>A3-</b>	
<b>B1+</b>	Average company with average capability of repaying financial obligations. Possible adverse macroeconomic conditions or different management or strategies might impact on the capability of repaying debt
<b>B1</b>	
<b>B1-</b>	
<b>B2+</b>	Average company with only enough capability of repaying financial obligations. Possible adverse macroeconomic conditions or different management or strategies might impact on the capability of repaying debt
<b>B2</b>	
<b>B2-</b>	
<b>B3+</b>	Average to instable company with low capability of repaying financial obligations. Vulnerable to possible adverse macroeconomic conditions or different management or strategies
<b>B3</b>	
<b>B3-</b>	
<b>C1+</b>	Instable company with low capability of repaying financial obligations. Very vulnerable to possible adverse macroeconomic conditions or different management or strategies
<b>C1</b>	
<b>C1-</b>	
<b>C2</b>	Poor company with insufficient capability of repaying financial obligations. Company that needs financial restructuring in order to assure operative continuity
<b>C3</b>	
<b>D</b>	Company for which a missed payment on a financial obligation was officially recorded
<b>E</b>	Company under administration
<b>F</b>	Company under liquidation status
<b>G</b>	Company under bankruptcy

Source – <http://www.modefinance.com/it/rating-agency>

#### **(iv) The lending process**

From the point of view of an investor, the process of lending starts by opening an account and give a few personal information and more specific details about the amount of money to lend, the desired interest rate and the duration of the investment.

Basically, each investor participates by placing a bid on a loan request, which corresponds to the amount of money the investor is willing to lend. For this purpose, each platform allows investor to decide whether to set the investment automatically “Automatic way” through the algorithms of the platform or using the so called “Hand-picking business way” that permits the lender to set his/her own criteria of lending by him(her)self. In particular, this form allows investor to decide the businesses to which he/she is willing to lend money, choosing among those that satisfy specific requirements, such as: risk bands, the region in which the borrower operates, the sector of the business, the reason for the loan, company’s financials etc.; and have an independent assessment of the company’s financial position.

In order to minimize the credit risk, a single offer is split into multiple chunks that will finance micro-loans to different borrowers. For instance: an investment of €5,000 may be split into 100 different requests of €50 each. In this case, the risk associated with a single borrower is spread among multiple investors and a potential loss may result in a small share of the total investment. According to the information given by the investor, the platform matches the investor’s proposal with the loan demands which are close to it. Once the match is done, the borrower has the right to choose whether to accept the financing and in case of acceptance he/she will receive the funds. The lender will then receive his/her capital plus the relative interests in monthly instalments.

Finally, the repayment can be recycled into new loans or withdrawn by the lenders. In case of recycling, the new loan will be at the latest interest rate provided by the marketplace, which means that the loan book rates will evolve overtime.

*Figure 19 – The steps of the lending process*



Source - <http://www.lend2fund.com/how-it-works.html>

#### (v) How capitals move between parties

Within the entire process, the money borrowed and lent by the parties is held by the platform on their behalf within a segregated bank account, known as “**Payment account**”, which can be freely opened by the platform in a Correspondent Bank or simply be the parties’ bank account. The account is not part of the platform’s assets, which means that it would not be available to creditors in case of insolvency of the intermediary.

In case of missed payments, most platforms will appoint **debt collection agencies** to pursue the payments due, unless or until a default of the borrower would occur. Furthermore, to mitigate

the credit risk, many platforms provide a “**Contingency Fund**”, which is used to repay capital losses to lenders in the event of borrower’s default. This fund is built up by charges on the borrowers, which normally pay a small percentage fee together with the monthly instalments. Legally the fund is owned by trustees or separated companies.

**(vi) How much does it cost?**

The total cost of borrowing money is determined by two factors: the interests paid to investors and the fees paid to the platform.

The interest rate is typically set by the platform and it is based on the risk associated with the amount of the loan and the length of the repayment term: the higher is the length term, the higher will be the risk. This leads to higher interest rates to pay and consequently, higher yields for the investors.

During the lending process, each loan grade is assigned an annual percentage rate (“**APR**”) that refers to the cost of borrowing money on a yearly basis. An APR allows the borrower to quickly compare different loans and includes the interest rate as well as fees necessary to finance the loan.

Normally, fees are charged on the total loan amount lent and are around 1% per annum across the whole market. Commission or selling fees are charged on either the amount left outstanding on the loan or on the original investment amount. Depending on the type of platform, performance fees can be charged on lenders’ profits.

### **IV. 3 Risks of Crowdfunding**

Although Crowdfunding market is much bigger and characterized by big players, there are a whole range of risks to face. This paragraph will provide the description of the major risks associated with Peer-to-Peer lending and Equity Crowdfunding solutions.

For what it concerns the loan-based option, the main risks are on lender’s side and they can be described as follow:

- **Credit risk:** the biggest difference between putting money into a bank and turning to this alternative finance solution is that the risk of borrower’s default shifts from the bank to the lender, which may have a capital loss;
- **Platform insolvency:** it may happen that online platform blows up due to undisclosed losses, lack of controls or failure of its role of intermediary between lenders and borrowers;
- **Interest rate risk:** in the event of an increase in the interest rates, some longer term loans might become unattractive and this would cause a lack of liquidity, due to the fact



that many investors may decide to move to back to conventional deposits.

However, there is no doubt that Equity Crowdfunding is riskier than the lending solution, especially when it involves unquoted companies.

The main risks associated with this kind of model is related to:

- **Decision making:** through platforms, investors have access to investments easily and it may happen that unwary investors make inappropriate investment decisions because they underestimated the risks and make insensible valuations.

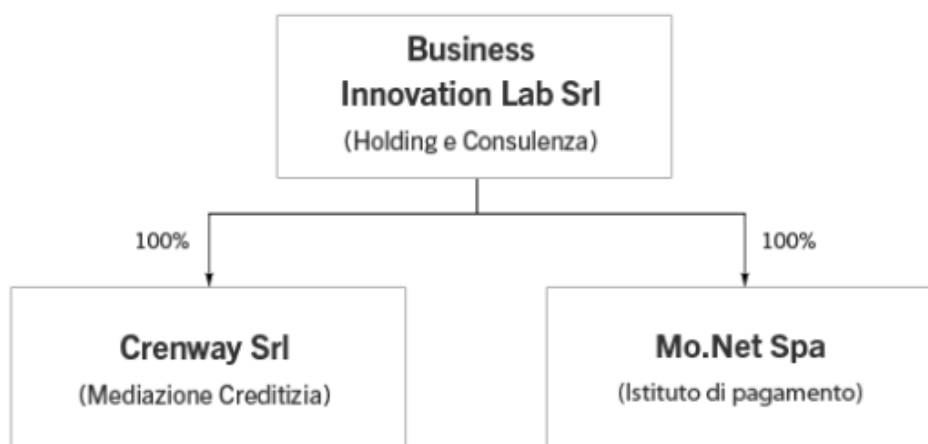
#### IV.4| Show Case: Borsa del Credito.it



In order to understand in practical way what does it mean applying for financing and how a lending process works, I have experienced the loan application of an Italian family business to the leading Peer-to-Business platform “Borsa del Credito.it”.

##### IV.4.1| What is Borsa del Credito.it?

- *Company Information:* Borsa del Credito.it is a 2013 Italian Fintech start-up company that operates as leading company in SMEs financing.
- *Governance information:* the company is run by a Corporate Group, whose holding company is “**Business Innovation Lab Srl**”, which owns 100% of two other companies:
  - (i) “**Mo.Net Spa**”, a Payment Institution, which is authorized under the Italian law, to handle money transfer between parties, and;
  - (ii) “**Crenway Srl**”, a credit broker that lends its activities by making use of the web portal BorsadelCredito.it. Crenway puts in relation banks and other authorized financial intermediaries with potential customers, to encourage the conclusion of credit transactions in any form. However, it cannot perform, on behalf of banks and other banking institutions, loan agreements or other forms of financial products but, it simply manages the delivery of non-transferable checks fully completed by bank partners or clients. Crenway is totally independent from the concession of credit and, because of that, it may be that potential borrowers cannot obtain funding from banks, despite the presence of a credit broker.



Source - <https://www.borsadelcredito.it>

- *Statistics:* to date the company has lent more than € 1 billion to more than 10,000 Italian SMEs.
- *General information:* the platform requires lenders to be at least 18 years old, own a proper bank account and live in a European country. Borrowers can be selected among wealthy businesses that operate within different sectors and geographic areas.
- *Technical information:* the table below shows the length of a loan and the correspondent interest rate got by lenders.

**Table 3 - Duration and composition of loans**

	12 Mesi	18 Mesi	24 Mesi	36 Mesi	48 Mesi	60 Mesi
A	3,40%	3,90%	4,40%	4,90%	5,90%	6,40%
B	3,60%	4,10%	4,60%	5,10%	6,10%	6,60%
C	3,80%	4,30%	4,80%	5,30%	6,30%	6,80%
D	4,00%	4,50%	5,00%	5,50%	6,50%	7,00%
E	4,20%	4,70%	5,20%	5,70%	6,70%	7,20%
F	4,40%	4,90%	5,40%	5,90%	6,90%	7,40%
G	4,60%	5,10%	5,60%			

Source – [www.borsadelcredito.it](http://www.borsadelcredito.it)

#### IV.4.2|Application process: ask for €200.000

In order to experience the process of get financing through an online platform, I have participated to the application process made by an existing company that, for privacy reasons, we will call Company Alfa.

The basic information of Company Alfa is the following:

- *Company type:* Private Limited Company
- *Business:* Clean service
- *Sector:* Wholesale
- *Products:* Vehicle cleaning
- *Length of business:* 10y+
- *Financial information:*

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#### COMPANY ALFA – SIMPLIFIED BALANCE SHEET

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	<i>31/12/15</i>
Current assets	342.052,03 €
Non current assets	70.178,35 €
<b><i>TOTAL ASSETS</i></b>	<b><i>398.844,86 €</i></b>
Current liabilities	(286.926,98 €)
Non current liabilities	(26.039,66 €)
<b><i>TOTAL LIABILITIES</i></b>	<b><i>(31.966,64 €)</i></b>
<b><i>SHAREHOLDERS' EQUITY</i></b>	<b><i>(118.748,61 €)</i></b>
<b>LOSS</b>	<b>(19.484,87 €)</b>

---

As the financial evidences show, at the end of 2015, the company was in trouble and suffered a loss. The financing need of the company is to get €200,000, to be reimbursed in 60 months (the maximum term provided by the platform).

The application process took 10 minutes and the steps we were asked to follow are reported below.

##### 1. Step No.0: SIGN-UP

In order to guarantee the highest level of security, we had to create a proper account and a nickname. The nickname represents the identity of the potential borrower and it is the only

information investors know about him/her, together with more information about the business and the sector whereby the company operates. Any type of sensitive information is made publicly available to investors (and vice versa).

Once the sign-up phase is done, the platform assigned the potential borrower a personal consultant that was available to help the client in making the application or getting some information.

## 2. Step No.1: INSERT PERSONAL DATA

The owner of the company was required to insert her generalities and attach her identity document and fiscal code. She was also asked to confirm whether she is a Political Exposed Person (PEP) under the Anti-Money Laundering law.

**1 Profilo 5 min** → **2 Richiesta 3 min** → **3 Documenti 3 min** → **4 Decisione 24 h**

### La tua esigenza

**FINANZIAMENTO:**

Importo 200.000,00 €

Durata 60 Mesi

**MODIFICA**

Puoi contattare il tuo consulente personale da lunedì a venerdì, dalle 9:00 alle 18:00

**Letizia**  
Tel: 02 86882015  
digitando il codice cliente: 23109  
Mail: richiedenti@borsadelcredito.it

### PROFILO: 1/3 dati anagrafici

Nome

Cognome

Sesso  M  F

Data di Nascita

Nazione di Nascita

Provincia di Nascita

Comune di Nascita

Codice Fiscale

Nazione di Residenza

Provincia di Residenza

Comune di Residenza

Indirizzo di Residenza

Sei una persona politicamente esposta?  
Il sottoscritto dichiara: ⓘ

Di essere persona politicamente esposta  
 Di non essere persona politicamente esposta

**Salva e continua >>**

Furthermore, she needed to insert the same information for the other members that represent the “Beneficial Owners” of the company and in our case they were two.

In Step No.1, the platform run some Anti Money Laundering tests to ensure that the money of the company is not coming from illegal actions. The potential borrower had to insert the origin of capital and how many times she was intended to ask for financing to “Borsa del Credito.it”

during the current year. Finally, under the “Foreign Account Tax Compliance Act” (FATCA<sup>15</sup>) she had to declare that the company is not fiscally resident in the US, so that there is no risk of tax evasion.

1 Profilo 5 min

2 Richiesta 3 min

3 Documenti 3 min

4 Decisione 24 h

### La tua esigenza

**FINANZIAMENTO:**

Importo 200.000,00 €

Durata 60 Mesi

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**Letizia**

Tel: 02 86882015  
digitando il codice cliente: 23109

Mail: richiedenti@borsadelcredito.it

### PROFILO – 3/3: questionario per la conoscenza della clientela

Ai sensi del d.lgs n. 231/2007, BorsadelCredito.it ti invita a compilare il seguente questionario, ricordandoti che ogni risposta ti espone alla responsabilità civile e penale in caso di informazioni false od omesse.

Attività prevalente svolta [Seleziona Valore]

Reddito lordo annuale [Seleziona Valore]

Origine prevalente del capitale [Seleziona Valore]

④ Frequenza stimata di operazioni annuali [Seleziona Valore]

**ADEGUATA VERIFICA AI FINI DELLA NORMATIVA FATCA**

[Cos'è il FATCA?](#)

La società è fiscalmente residente in USA? [Seleziona Valore]

[Cosa significa essere fiscalmente residente in USA?](#)

Continua >>

Once the potential borrower has fulfilled all these sections, Step No.1 is completed and it is possible to move to Step No.2, which is focused on the financing request.

- **Step No.2: INSERT DETAILS ABOUT THE FINANCING REQUEST**

The step No.2 is about giving more details about the financing request. In particular, we had to insert the reason why the potential borrower needed the money (investing, repay a precedent loan, obtain more liquidity etc.) and, based on the scope declared, give a brief explanation.

In our case, we asked the money to acquire a PPE valued at €250,000.

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<sup>15</sup> FATCA is a United States legislation that primarily aims to prevent tax evasion by US taxpayers by using non-US financial institutions and offshore investment instruments.

**1 Profilo 5 min** → **2 Richiesta 3 min** → **3 Documenti 3 min** → **4 Decisione 24 h**

### La tua esigenza

**FINANZIAMENTO:**

Importo: 200.000,00 €

Durata: 60 Mesi

**MODIFICA**

Puoi contattare il tuo consulente personale da lunedì a venerdì, dalle 9:00 alle 18:00

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 Mail: richiedenti@borsadelcredito.it

### DETTAGLI RICHIESTA

Descrivi brevemente la tua esigenza, inserendo i dati richiesti

**Finalità** [Seleziona la finalità] ↓

**1 Dettaglio della finalità** [Seleziona finalità in dettaglio] ↓

**2 Descrizione della finalità** max 500 caratteri

**L'azienda ha legami societari e/o gli esponenti sono soci/titolari di altre imprese** [Seleziona] ↓

**Continua »**

- **Step No.3: DOCUMENT ATTACHING**

The owner of the company was asked to attach the last financial statements of the company, to let the team of specialists of the platform check the financial sustainability of the company and assign a rating score according to the level of risk associated with.

For this purpose, I had a phone call with a financial analyst of Borsa del Credito and I got more information about what are the main financial information they analyse in order to decide whether a company can obtain a loan or not. No matters if the company has a loss. What they are interested in is if the annual turnover of the company is sufficiently high to sustain the costs of a loan and avoid insolvency risks, by looking at the cash flows of the company.

1 Profilo 5 min

2 Richiesta 3 min

3 Documenti 3 min

4 Decisione 24 h

### La tua esigenza

**FINANZIAMENTO:**

Importo	200.000,00 €
Durata	60 Mesi

MODIFICA

Letizia

Tel: **02 86882015**  
digitando il codice cliente:  
**23109**

Mail: [richiedenti@borsadelcredito.it](mailto:richiedenti@borsadelcredito.it)

### ALLEGA DOCUMENTI

Sei all'ultimo passo: allega i documenti richiesti. In questo modo i nostri consulenti potranno comunicarti la disponibilità del finanziamento richiesto in poche ore

**Bilancini/fo provvisorio/fo**

Scegli il file da caricare

Seleziona	Nome documento	Invia
-----------	----------------	-------

**Bilancino provvisorio anno in corso**

Scegli il file da caricare

Seleziona	Nome documento	Invia
-----------	----------------	-------

Clicca qui se non riesci a caricare i documenti e inviali via mail al tuo consulente. Ricordati di farlo altrimenti non potrai finalizzare la richiesta

### ALLEGA DOCUMENTI

Continua >>

▪ **Step No.4: COST ESTIMATE**

At the end of the process we got an estimate of the costs to be sustained in the event of a positive result of creditworthiness check. At this point, the financing request is done and the potential borrower has to wait to know whether he/she has been accepted.

Home Page

Profilo

Dettagli Richiesta

Allega Documenti

### La tua esigenza

**FINANZIAMENTO:**

Importo	200.000,00 €
Durata	60 Mesi

MODIFICA

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digitando il codice cliente:  
**23109**

Mail: [richiedenti@borsadelcredito.it](mailto:richiedenti@borsadelcredito.it)

### HOME PAGE

✔ Complimenti SIMONETTA, hai inserito tutti i dati!

Ora non dovrai far altro che aspettare: siamo al lavoro per analizzare in dettaglio la tua richiesta e nelle prossime ore ti contatteremo per un esito definitivo.  
Se sarà positivo, potrai ottenere il finanziamento che cercavi in pochi giorni!

### RIEPILOGO RICHIESTA E PREVENTIVO

Finanziamento

a partire da  
€ 3.475,01  
mensili

**Tasso:** a partire da 1,65%

**TAEG:** a partire da 2,16%

**Spese iniziali:** € 2.000,00

**Spese ricorrenti:** € 7,42

↗

Il preventivo è da intendersi una simulazione basata sulla fascia di rischio minore. L'offerta finale può variare in base all'analisi svolta.

In base alla richiesta valutiamo la fattibilità di accesso a tutti i prodotti di credito offerti dai nostri partner, come Mutuo, Affidamento, Leasing, Factoring. Se la verifica sarà positiva ti mostreremo le migliori offerte disponibili, in linea con le esigenze della tua azienda.

As the above figure shows, the estimate provides very low interest rates and a lower APR (corresponding to the Italian TAEG) than banks (see Table 4).

*Table 4 – TAEG applied by banks from April to June 2015*

CATEGORIA DI OPERAZIONI	CLASSI DI IMPORTO <i>in unità di euro</i>	TASSI EFFETTIVI GLOBALI MEDI <i>su base annua</i>	TASSI SOGLIA <i>su base annua</i>
Aperture di credito in conto corrente	fino a 5.000	11,66	18,5750
	oltre 5.000	9,96	16,4500
Scoperti senza affidamento	fino a 1.500	16,22	24,2200
	oltre 1.500	15,09	22,8625
Anticipi e sconti	fino a 5.000	9,59	15,9875
	da 5.000 a 100.000	8,04	14,0500
	oltre 100.000	5,28	10,6000
Factoring	fino a 50.000	6,34	11,9250
	oltre 50.000	4,29	9,3625
Crediti personali	intera distribuzione	11,61	18,5125
Altri finanziamenti alle famiglie e alle imprese	intera distribuzione	10,44	17,0500
Prestiti contro cessione del quinto dello stipendio e della pensione	fino a 5.000	12,55	19,6875
	oltre 5.000	11,47	18,3375
Leasing autoveicoli e aeronavali	fino a 25.000	7,97	13,9625
	oltre 25.000	7,10	12,8750
Leasing immobiliare a tasso fisso	intera distribuzione	6,37	11,9625
Leasing immobiliare a tasso variabile	intera distribuzione	4,17	9,2125
Leasing strumentale	fino a 25.000	8,57	14,7125
	oltre 25.000	5,26	10,5750
Credito finalizzato	fino a 5.000	11,81	18,7625
	oltre 5.000	9,72	16,1500
Credito revolving	fino a 5.000	16,70	24,7000
	oltre 5.000	12,79	19,9875
Mutui a tasso fisso	intera distribuzione	4,31	9,3875
Mutui a tasso variabile	intera distribuzione	3,31	8,1375

Source - Bankit



## IV.5|Online Invoice Trading

### IV.5.1| What is online invoice trading?

Business sold on credit remains as outstanding receivables on the balance sheet of a company. For many years, businesses used to sell their receivables to third parties, called factor, to improve their cash position. This transaction is known as “**factoring**” and requires the factor to purchase the receivables of a company at a discounted price against immediate cash payment. However, the traditional factoring does not seem to be the best solution for helping SMEs, as it typically takes long term and complex contracts, involving fixed volumes and consequently low flexibility.

A valid alternative to traditional factoring is represented by online invoice trading, which is a new form of Alternative Finance that allows small businesses to monetize online outstanding receivables, by using an online platform. In this case, **businesses sell unpaid invoices or receivables (individually or in a bundle) at a discount to a pool of individual or institutional investors in order to receive liquidity immediately**, rather than waiting for the natural expiration of the invoices.

### IV.5.2| Benefits of Invoice Trading

The most important benefit associated with Invoice financing is about the problem of **late customer payments** that cause financial distress and liquidity gaps.

By using this system, small and medium-size businesses are able to overcome this critical issue and avoid situation of working capital shortages, without the need of asking for money to banks.

Further benefits consist of:

- **More flexibility:** it is possible to sell even one invoice;
- **Cost advantage:** the parties agreed on the price to pay to each other;
- **No collateral requirements;**
- **Speed:** the seller gets liquidity in a few days;
- **Better working capital situation.**

### IV.5.3|Show Case: WORKINVOICE.it

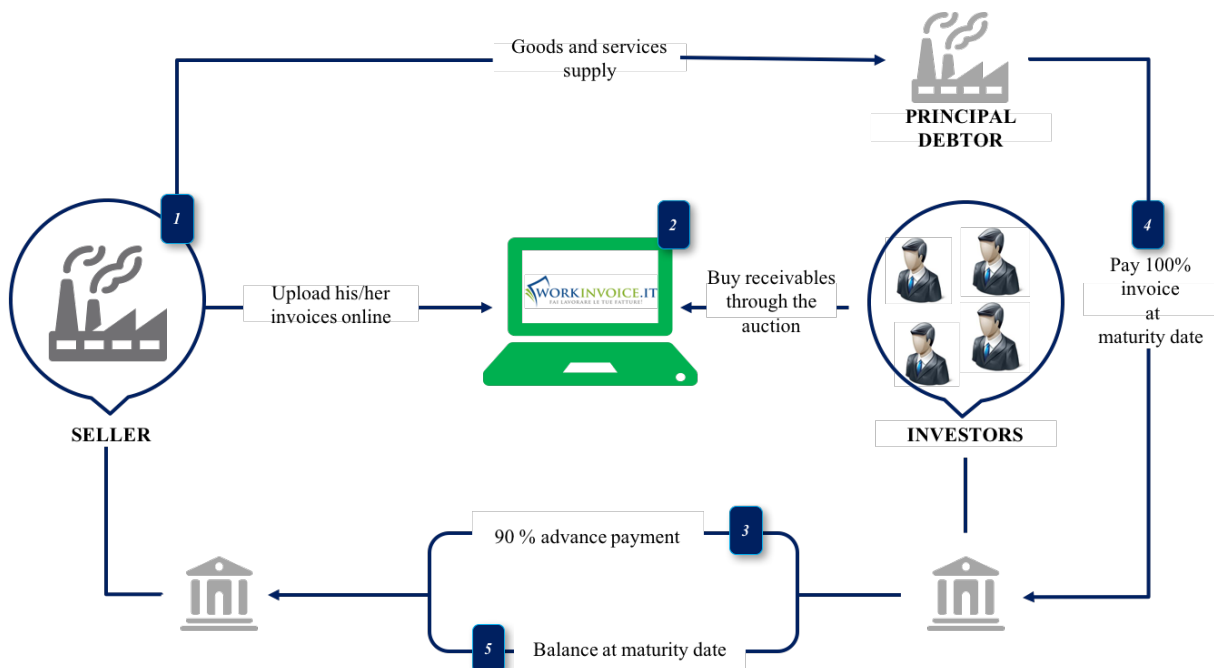
Workinvoice.it is the first Italian invoice-trading platform<sup>16</sup>, providing an alternative pool of liquidity to Italian SMEs. In particular, it helps private and institutional investors finding short-term opportunities by supporting very active Italian supply chains through an online competitive **auction system**.

#### (i) How does it work?

Basically, the process of selling unpaid invoices or receivables is based on six main steps:

1. The seller fixes the minimum amount of money he/she is willing to accept as final payment and the amount he/she would prefer to receive (called “Buy Now”);
2. The buyers compete in an auction and the highest amount proposed for the balance will win the auction. In case there is a “Buy Now” offer, this will win;
3. The seller receives a 90% down payment on the total price of the invoice;
4. At the due date, the principal debtor is committed to repay the invoice to the buyer that won the auction and bought the invoice<sup>17</sup>;
5. If the payment due is done and the buyer has received the money, he pays the last 10% of the invoice minus the amount of money that the parties agreed to represent the remuneration of the investor.

*Figure 20 – The process of Online Invoice Trading*



<sup>16</sup> WorkInvoice.it is not subject to MIFID because Receivables are not classified as financial instruments.

<sup>17</sup> Before going through the process of selling invoices, the seller has to inform the principal debtor that his/her debt will be transferred to the buyer's account.

### (ii) Who can apply?

WorkInvoice.it selects its sellers among Corporations or start-ups that have a good financial position and supply products and services to high quality clients.

In order to guarantee the highest level of security and reduce the risk of credit, the platform carefully checks the payment history of the initial debtors, by interrogating the credit rating agencies and, then, decides whether to accept the associated invoices.

Investors must be high net worth individuals or institutional investors that want to invest at least €50.000.

### (iii) What types of receivables can be sold?

- Invoices whose principal debtor is a firm with a turnover of at least €10.000.000;
- Invoices whose principal debtor has been positively evaluating by credit rating agencies;
- Invoices of at least €10.000 (not expired).

### (iv) How much does it cost?

- *Auction cost*: € 5 each
- *Platform's commissions*: between 0,40% to 0,90% depending on the expiration date of the invoice and on its cost.

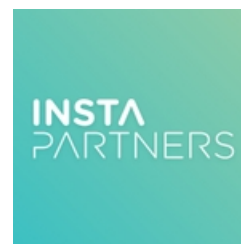
**Table 5 - Example of Pricelist**

Length	60 days	120 days	60 days
(A) Invoice's cost	€10.000	€10.000	€50.000
(B) 90% down payment	€9.000	€9.000	€45.000
(C) 10% (amount that won the auction)	€874	€748	€4.370
(D) Selling price	€9.874	€9.748	€49.370
(E) Auction cost	€5	€5	€5
(F) Selling commissions	€36	€81	€180
Total cost (A-D+E+F)	€167	€338	€815
Investor's return (A-D)	€126	€338	€815

Source – <http://www.workinvoice.it/aziende/>

#### IV.5.4|Show Case: INSTAPARTNERS

Instapartners is an Italian start-up company operating short-term advance invoices and Cash Orders.



##### (i) How does it work?

Differently from other companies like “WorkInvoice”, whose operating model relies on an auction system, Instapartners works through a process of securitization.

Instead of uploading the outstanding invoices/receivable into the platform and lets the auction start, the process implemented by this start-up company is based on the purchase of the outstanding financial products from a selected seller and sell them to a Special Purpose Vehicle (SPV) that will securitize and transform them into debt obligations that will be, then, sold onto the market.

In this way, the risk relapses 95% on the SPV and 5% on the start-up company to prevent the risk of fraud.

##### (ii) What are the main differences between Instapartners and a traditional bank?

Basically, there are a few differences. From a financial perspective, Instapartners manages the same products a traditional bank offers and in the same way. However, the main difference relies on the way how the process of advance invoices and receivables is done.

First of all, the process implemented by Instapartners is more competitive in terms of costs, primarily due to the fact of being totally web-based. Furthermore, it may happen that banks take advantage of their local monopoly power to improve the costs of their services in those regions affected by the presence of single branches.

Second, like any other Fintech company, it offers a customer experience that banks are unable to offer, because of their lack in technology improvements that make the process easier and faster.

Third, there is no credit limit. This allows companies that need liquidity to sell a single invoice, making the whole process more flexible.

From a legal perspective, whereas, Instapartners is authorised under Article 106 of the new Italian register “Testo Unico Bancario” and subject to a prudential supervisory regime equivalent to that of banks, meaning that **Instapartners is a bank and not a marketplace.**

**(iii) Who can apply?**

Instapartners selects its sellers among Italian SMEs that respect the following criteria of eligibility:

- €3 Mln turnover;
- Selling Invoices of €30.000 each;
- Owners positively evaluating by credit rating agencies.

## IV.6| Supply chain finance (SCF): PrimeRevenue



Traditionally dominated by banks, the market of Supply Chain Finance has more recently been SCF operations and help contrast the effects generated by the Financial Crisis and the entering into force of European Regulation that has worsened the payment terms, causing liquidity problems to many SMEs. For this reason, new non-bank players have been entering the market and are changing the way buyers and suppliers think about the market, disrupting incumbent financial systems.

The largest providers of SCF solutions is the global online platform “**PrimeRevenue**”, which operates by providing a tool to companies operating in more than 70 countries and in 30 different currencies, to optimize their working capital and strengthen their financial supply chain.

### IV.6.1| What is supply chain finance?

#### (i) Definition

Supply Chain Finance, also known as “Supplier Finance” or “Reverse Factoring”, can be defined as: “*a set of solutions that optimizes cash flow by allowing businesses to lengthen their payment terms to their suppliers while providing the option for their large and SME suppliers to get paid early*”<sup>18</sup>.

#### (ii) What are the main features?

Supply Chain Finance is characterized by a series of factors that are relevant for the success of this alternative finance solution:

- **It is not a loan:** SCF is an extension of the buyer’s payable outstanding and it is not considered financial debt. From supplier’s perspective, it represents a true sale of their receivables;
- **It does not need to be tied to a single bank:** it provides multibank capability by choosing among more than 50 financial institutions worldwide.
- **It is not factoring:** 100 percent of each invoice (minus a very small transaction fee) is paid to the supplier, and there is no recourse burden on the supplier once the invoice is paid;
- **It is not just for large companies:** It provides value for firms of all sizes and credit ratings, including SME suppliers.
- **It does not require a bank:** SCF programs can be self-funded by the buyer, established without the participation of a bank for funding, or composed of a mixed program where

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<sup>18</sup> PrimeRevenue, *What is Supply chain finance?* available at <http://primerevenue.com/what-is-supply-chain-finance/>.

financing is shared by the buyer, capital markets, and financial institutions.

#### **IV.6.2|How does supply chain finance work?**

The process of SCF is composed by different steps, which vary depending on the subject that firstly turns to a SCF platform, whether it is the buyer or the seller. According to this, it is possible to identify two different solutions:

- **Account Receivable Financing;**
- **Supply Chain Financing/Dynamic Discounting.**

The first solution is generally used by sellers that directly turn to a web-based platform to sell their invoices for early payment well before the actual due date and, in most cases, without any involvement from or disclosure to their customers. This is the case of Invoice Trading solutions, like WorkInvoice platform.

The second, whereas, is used by buyers that invite their suppliers to obtain early-payment terms. This is the case of platforms, like PrimeRevenue. As an invited supplier, he/she can view all approved invoices from his/her customer and select the invoices he/she wants to sell and get paid immediately, by one of more than 50 funders on a multibank platform model.

A multibank financing model is independent from any bank relationship, meaning that the platform act independently from banks, allowing clients to grow their financing programs by adding new funding partners, like banks and non-bank funders or even have the opportunity to fund their program by themselves.

##### *(i) Understanding the operating process for SCF/Dynamic Discounting*

Basically, the process which involves the buyer within the selling of invoices is described below:

1. The supplier sends their invoices to the buyer using the current policy and methodology;
2. The buyer approves the invoices from the supplier and uploads the approved invoice data (its payables as well as any applicable payment offsets such as credit/debit memos) onto the Supply Chain finance platform;
3. The platform offers early payments at discount to the supplier;
4. At this point in time, the supplier has two options:
  - Choose the **Normal process of Supply Chain Finance**, which consists of waiting until the original maturity date to obtain the funds directly on his/her bank account (see Figure A);
  - Choose the **Dynamic Discounting Process**, which consists of selling or ‘trading’

his/her receivables to a funder<sup>19</sup> through the platform in return for advance payment (see Figure B);

5. If traded before maturity, 100 percent of the invoice (minus a small financing fee or discount) is transferred electronically to the supplier's bank account. In most cases, the supplier is paid on the next business day. Since funds from the financial institution are advanced based on the buyer's promise to pay at the original maturity date, financing rates are based only on the buyer's risk, not the supplier's.
6. At maturity, the buyer pays the full invoice amount to the supplier or respective funder.

#### **IV.6.2.1|Supply Chain Finance Vs Dynamic Discounting Process**

Dynamic discounting is a solution that gives buyers more flexibility to choose how and when to pay their suppliers in exchange for a lower price or discount for the goods and services purchased. This process enables both parties, buyers and suppliers, to initiate early-pay discounts on an invoice-by-invoice basis, by let them select trough a web-base platform which invoice should be subject to early payment.

Basically, the “dynamic” component of discounting process refers to the option to provide discounts based on the dates when suppliers will receive payments. In most cases, the earlier the payment is made, the greater the discount.

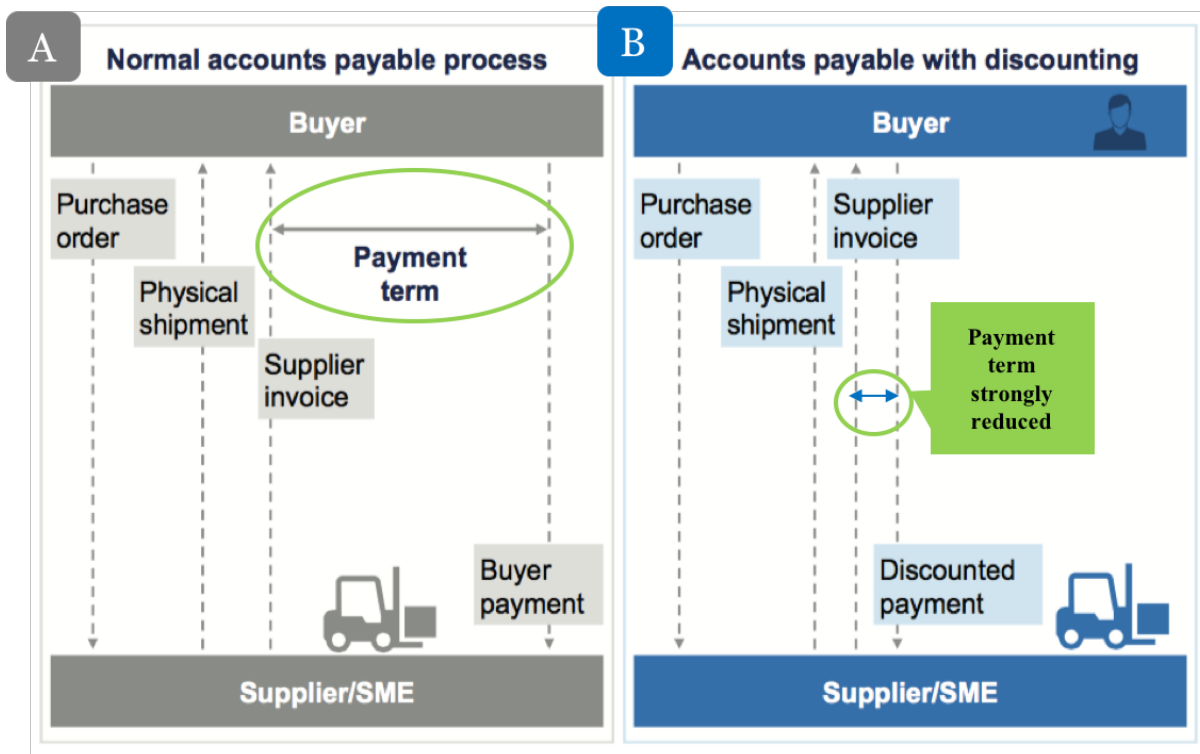
The main difference between the normal SCF process and the dynamic discounting process is based on funding. In SCF the buyer uses third-party funders to finance early payment terms. In dynamic, whereas, the buyer finances his/her suppliers with early payment terms.

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<sup>19</sup> Funders have always been institutional investors, however, working capital finance has been emerging as a playing field also for non-traditional funders. A recently launched venture, PrimeRevenue Capital Management is now providing the mechanisms for non-bank investors to access this booming market and fund supply chain finance programs. PrimeRevenue Capital Management gives non-bank entities such as insurance companies, pension funds, hedge funds, capital market investors and other financial institutions access to working capital finance.



**Figure 21 – Normal SCF process vs Dynamic Discounting Process**



**IV.6.3|Benefits of Supply Chain Finance**

Supply Chain Finance gives parties several benefits, which are described below:

*(i) Buyers' perspective:*

- Gain significant and ongoing working capital improvement;
- Generate free operating cash flow;
- Gain payment term extension;
- Reduce risk of supply chain disruptions;
- No extension fees;

*(ii) Suppliers' perspective:*

- Get early payment of outstanding receivables;
- Compelling alternative to expensive factoring or bank loans;
- No debt, resulting in better balance sheet metrics;
- Full transparency and visibility of all approved invoices;
- Reduced disputes and collection costs;
- Payment visibility and certainty regarding their approved receivables from specific buyers;
- Non-recourse financing.

## IV.7|Merchant finance

In order to face the situation whereby banks stopped to grant loans, a new set of players already operating in e-commerce sector entered the space of small business lending in 2012.

This is the case of technology giants, such as Amazon, eBay, Alibaba, Google, etc. that are redefining customer experience and increasing the playground for financial services. Some of them, in fact, are enlarging their service offering by providing working capital lines and loans, becoming an alternative way to traditional financial institutions.

### IV.7.1|Different providers: how they work?

This sector is characterised by the presence of multiple providers. The World Economic Forum analysed six among the most important players onto this market.

#### 1) Amazon Lending



It was founded in 2012 with the aim to extend credit to small businesses that sell their products on Amazon's platform.

Initially, the company limited its service to US and Japanese sellers but, it is now expanding the lending program to sellers in other seven countries, such as: Canada, France, Germany, India, UK and China.

The process of lending implemented by Amazon Lending is not as the typical as Crowdfunding platforms. The difference lays on the fact that while platforms, like "Borsa del Credito.it" and "Funding Circle" lend money to businesses that ask for it, **Amazon Lending directly offers money to businesses that sell their products on the platform**. Basically, it works by using a huge database and the power of big data to access all information a bank would never have about a customer, such as:

- the frequency at which merchants run out of stock;
- the selling performances;
- the inventory cycles;
- the growth rate;
- shipping time; and

on the basis of this information they search for potential borrowers. If a seller accumulates a certain number of data points, the company will invite him/her to apply for a loan, which can be useful to purchase inventory and increase the sales on Amazon.com.

Amazon offers three-to-six month loans for an amount ranging from \$1,000 to \$600,000 and charges an interest rates ranging up to 13%.



## 2) PayPal Working Capital

PayPal is a leading global company operating in Payment sector that offers to individuals and businesses, who have an email addresses, the possibility to send and receive money payments online. It operates an open, secure and technology agnostic payment platform, used by businesses to make their online payment transactions more secure.

PayPal has recently entered the lending sector with “PayPal Working Capital”, which gives businesses that process payment through PayPal, the capital they need.

Lender determines the eligibility of borrower on the basis of his/her PayPal sales history, without affecting personal credit score. To be eligible to apply for a loan, businesses must respect the following requirements:

- Have a PayPal Business or Premier account for 3 months or more;
- Process at least \$20,000 in PayPal sales annually;
- Pay off any existing PayPal Working Capital loan.

### (i) How the process works?

Basically, PayPal Working Capital offers fixed amount loans, with a single fixed fee, no periodic interest charged and any other fee.

The process of getting a loan is easy and involves the following main steps:

1. Select the loan amount, which varies based on borrower PayPal sales history;
2. Choose the percentage of future PayPal daily sales to go toward repayment of the loan amount and the loan fee;
3. If approved, get the loan amount deposited to PayPal account within minutes to use for the business;
4. Start making repayments as a percentage of daily sales.

### (ii) Repayment procedure

During the application phase, the borrower is required to select the repayment percentage, which is the portion of his/her future daily sales that will go towards repaying the loan balance. Basically, the loan is repaid automatically as the borrower makes sales through PayPal – until your loan amount and fixed fee are paid in full. Daily repayments are taken on the prior day sales, and on days with no sales the borrower pays nothing that day, subject to the minimum payment requirements. The minimum amount required to be paid is at least 10% of the total

loan amount (loan + the fixed fee) every 90 days for the first 540 days of the loan.

Here's an example:

If you borrow \$10,000 (\$9,000 loan + \$1,000 fixed fee), you are required to pay \$1,000 every 90 days thereafter, for the first 18 months of the loan.

### **3) Alipay Financial**

Alipay Financial is an online micro-credit company launched by the Chinese e-commerce platform Alibaba in 2010.

The company offers loans from its own cash to small businesses clients, allowing individuals and businesses to execute online payments in a secure manner. With a registered user base of approximately 43.5 million as of June 2007, Alipay is an accepted online payment method for many online retail websites and service providers in China.

Based on its huge customer base it has developed a complete online wallet which offers many services associated with payments.

Alipay has partnered with some leading Chinese banks including Bank of China, China Construction Bank, Agricultural Bank of China, and the Industrial and Commercial Bank of China.

### **4) Rakuten**

The Japanese platform Rakuten is another online platform that moved into the lending space. In 2013, it started to offer “**Rakuten Super Business Loans**” to its merchants. In contrast to Amazon Lending, businesses are not subject to a pre-selection but are invited by the platform itself to submit loan applications. The “Rakuten Super Business Loans” are intended to provide financial support mainly for business expansion and flexible working capital finance. Loans range from 1 million to 10 million Yen.

### **5) Square Capital**

Square Capital, was founded in May 2014 by Square, a provider of credit card processing and payment solutions and it offers cash advances to small businesses.

Square Capital has already advanced \$225 million in business financing to more than 20,000 businesses over the past year. In April 2015, it advanced nearly \$25 million in capital, at the time a run-rate of \$300 million to \$400 million in business lending per year.

## 6) iZettle

The last entrant in the field of payment processor lending is the Sweden platform iZettle. The company announced its small business loan program “**iZettle Advance**” in August 2015.

The model works slightly differently to the ones offered by its competitors. Repayments are not charged as a fixed interest rate but rather as a flat fee.

Repayment is conducted in daily instalments proportionally to card sales. Borrowers are able to borrow up to two times their monthly sales.

### IV.7.2|Benefits and risks of Merchant and Payment financing

The most significant benefit of merchant and payment finance is represented by the fact that collection and payment processes are facilitated. This is particularly due the **visibility that the above platforms have on a substantial portion of a merchant’s daily transactions**. In effect, they get real-time information about performances, cash flows and other sensible data of merchant companies selling their products on the platform. In this way, the process of select reliable borrowers is easier and faster, with respect to traditional systems of financing.

From merchants’ perspective, the process is more convenient, as payment systems are already integrated.

Furthermore, a contractual relationship is in place so that the extension of credit can be completed in a speedy and efficient manner.

The World Economic Forum highlights the risks associated with this sector as the following:

- The market for online merchant platforms and payment processors is significantly more concentrated among few large players. This could potentially **limit healthy competition**;
- As this form of lending is part of a business relationship, it is **less transparent** from the outside and **harder to regulate**;
- On a micro level, the lack of experience of such players in the lending business has been a source of concern. Extrapolating from internal seller **data may not be enough to properly assess credit risk** over time, especially from a macro perspective. For instance, as Amazon or Rakuten are not set up as banks, those players have less access to the banking network and are excluded from access to credit bureaus in some countries;
- Shareholders may **question the mandate** of an e-commerce platform or payment processor to move into the lending space.

## **Chapter V: THE STATE OF ART OF THE REGULATORY FRAMEWORK ON ALTERNATIVE FINANCE**

Previous chapters show the evolution of alternative finance models and, in particular, the development of specific forms, such as Crowdfunding. This has become more popular over the last years, being a disruptive and revolutionary option for many people and businesses.

The rapid worldwide growth of Crowdfunding has made the legislation unable to be quick in catching it up, leading each jurisdiction to build its own regulatory framework and consequently creating a non-homogeneous landscape for potential investors and borrowers.

While reward-based Crowdfunding received little attention from regulators since it is a form of pre-sale that enjoys the traditional consumer protection, investment- and lending-based Crowdfunding have been receiving more attention from the moment that the former relies on the emission of shares, which often falls under the local national authority's jurisdiction and; the latter competes, in a certain sense, with banks that are regulated.

Despite the interest of regulators on both forms of Crowdfunding, the current regulation is focussing on regulating equity-based Crowdfunding because it presents the biggest risks for fraud and failure, compared to loan-based Crowdfunding.

This section will focus on analysing how current regulation addresses Crowdfunding and the main participants and, how the state of art of the Regulatory Framework differs between Europe and US.

### **V.1| The state of art of European regulatory framework on Crowdfunding**

The current European legal framework is characterised by a number of directives that apply to investment-based Crowdfunding and all the participants involved within the transactions. Among the directives issued by the European Commission, it is possible to identify the most relevant within the financial sector:

- Directive 2004/39/EC “**Market in Financial Instrument Directive**”, known as MiFID, which aims to make it easier for investors to buy financial instruments or investment services in Europe. MiFID can face different interpretations as to whether Crowdfunding platforms performs a regulated activity or not.
- Directive 2003/71/EC as amended by Directive 2010/73/EC “**Prospectus Directive**”, which regulates how companies raise funds;
- Directive 2005/60/EC of the European Parliament “**Anti-Money Laundering Directive**” (AML), on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing;
- Directive 2007/64/EC of the European Parliament “**Payment Services Directive**”

(PSD), on payment services within the internal market;

## V. 2|Market in Financial Instruments Directive (MiFID)

### V.2.1| Authorisation under MiFID

In order to operate, Investment-based Crowdfunding platforms have to be generally authorised under MiFID, which imposes duties about their capacity of Crowdfunding platforms of acting as investment intermediaries. In order to be within the scope of MiFID, platforms need to carry on an investment service or an activity in relation to financial instruments provided by MiFID. In particular, the current Directive applies to the list of “financial instruments” set out at Section C of Annex 1 of the same Directive, which refers to “transferable securities<sup>20</sup>” such as shares and bonds or units of collective investment undertakings (for more details see Appendix B for Section C of MIFID).

Platforms that are carrying out MiFID services and/or activities need to be **authorised** as an investment firm, a credit institution or a tied agent and comply with the minimum **Capital Requirements Directive**, which imposes initial capital requirements to protect investors from the risk of insolvency and ensure operational continuity. The levels of capital requirements vary according to the type of service and activity provided by the platforms. The activity most likely to be carried out by Crowdfunding platforms is the reception and transmission of orders between parties.

The benefit of being under this regulation is that a platform is allowed to carry on a service or an activity for which it is authorised across the European Union (and so getting a **MiFID Passport**) without the need of additional authorisations.

In addition, platforms that operate under MiFID are automatically subject to Anti-money laundering and terrorist financing rules under the **Anti-Money Laundering Directive**.

### V.2.2|The current interpretation of MiFID to Investment-based platforms

However, there are some divergences about how Member States approach the application of MiFID. Some Member States consider that Crowdfunding platforms must be authorised under bespoke regimes. This because it is common though that Crowdfunding platforms **do not provide “investment services and activities”** in relation to transferable securities or other financial instruments, as defined in Section A of Annex 1 (for instance “non-readily realisable

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<sup>20</sup> MiFID defines “Transferble securities” as classes of securities which are negotiable on the capital market, with the exception of instruments of payment’

securities”). According to that, they would fall under the regulation of a domestic bespoke regime developed by each Member State, since they are not in the scope of MiFID.

**Table 6 – MiFID authorisation**

<b>Authorisation under MiFID</b>
Crowdfunding platforms provide investment services (as listed in Annex 1 Section A of MiFID) in relation to investment listed in Annex 1 Section C of the same Directive, in particular transferable securities (shares and bonds) or units of collective investment undertakings.
<b>Domestic bespoke regime under MiFID Article 3 exemption<sup>21</sup></b>
Authorised platforms can carry on crowdfunding-related services and activities at national level also in relation to MiFID financial instruments. However, these platforms are not allowed to passport their activities across the European Union, unless they seek a full MiFID authorisation (in such a case, they would not be authorised under the national bespoke regime).
<b>Authorisation for services and activities not included in MiFID financial instruments</b>
When platforms do not provide services in relation to transferable securities or other MiFID financial instruments, they need not be authorised under the Directive.
<b>Authorisation outside MiFID Framework</b>
Other Member States have developed their domestic bespoke regime outside the MiFID framework because they consider that investors may have access to MiFID financial instruments through platforms which are not in the scope of MiFID because such platforms do not carry out any MiFID service or activity.

**Source** – European Commission, COMMISSION STAFF WORKING DOCUMENT Crowdfunding in the EU Capital Markets Union

<sup>21</sup> Under Article 3 of MiFID, Member States may choose not to apply the Directive to any persons for which they are the home Member State that: are not allowed to hold clients' funds or securities; are not allowed to provide any investment service except the reception and transmission of orders and the provision of investment advice; in the course of providing that service, are allowed to transmit orders only to authorised entities; and provided that the activities of those persons are regulated at national level.



However, it should be noted that MiFID is currently under review. According to MiFID II, which it is expected to apply in 2018 and it will amend the present Directive, Crowdfunding platforms would constitute a new regulated trading venue, known as Organized Trading Facility (OTF), which will fall under the MiFID II regulation.

### **V.3|The Prospectus Directive (2003/71/EC as amended)**

“The prospectus Directive (PD) requires publication of a prospectus before the offer of securities to the public or the admission to trading of such securities on a regulated market, unless certain exclusions or exemptions apply<sup>22</sup>”.

The Prospectus Directive only applies to securities offered to transferable securities as defined in MiFID, therefore, the obligation to publish a prospectus could apply to securities offering through Crowdfunding platforms. However, the current Directive becomes applicable only in the following cases:

- PD only applies to MiFID financial instruments;
- PD only applies to securities included in an offer with a total annual consideration of €5 million. With regard to securities offered to the public or admitted to trading for amounts lower than €5 million, issuers that are willing to offer securities through Crowdfunding platforms may not need to produce such prospectus (depending on Member State’s threshold);
- Offers that are addressed only to “qualified investors” are exempt from the obligation to publish a prospectus;
- Offers that are addressed to fewer than 150 natural or legal persons per Member State (other than qualified investors) are exempt from the PD.

Nonetheless, once an exemption is found, issuers must also comply with the requirements provided by Member States securities laws.

### **V.4| Regulating lending-based Crowdfunding**

For what it concerns lending-based Crowdfunding, national regulatory regime is applied. The authorisation requirements are different by Member State and they range from specific to Crowdfunding to general authorisations and registrations similar to those used at national level to operate as financial intermediaries. Depending on the type of authorisation, crowd-lending as a regulated activity under a bespoke regime is subject to additional rules on capital

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<sup>22</sup> European Securities and Market Authority, *ESMA/2014/1378 Opinion - Investment-based Crowdfunding*, available at [https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1378\\_opinion\\_on\\_investment-based\\_crowdfunding.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1378_opinion_on_investment-based_crowdfunding.pdf), 18 December 2014

requirements, professional qualification and conduct. All Member States with bespoke regimes either in place or underway, with one exception, impose or plan to apply capital requirements. Some bespoke regimes also require platforms to have arrangements in place to ensure that loans continue to be administered if a platform goes out of business and impose on platforms the organisational duty to draft, publish online and enforce policies and procedures in order to ensure business continuity. The standards of professional qualification and conduct rules vary by Member States.

## **V.5| Crowdfunding Framework in EU Member States**

Despite a relevant number of directives issued by the European Commission there is still a lack of a legal harmonisation among European countries, which have provided their own regulation on Crowdfunding. To date, requirements differ by Member State that treat the Crowdfunding activity like a general trade or like a more specific activity

### **V.5.1| Crowdfunding Regulation in the UK**

The United Kingdom is currently the most developed market for Peer-to-Peer lending, with a proper trade association “Peer-to-peer Finance Association” (P2PFA) that represents 90% of the entire UK market.

In the UK, Crowdfunding is regulated by the **Financial Conduct Authority (FCA)**, where it involves activities that fall within the scope of the “Financial Services and Markets Act 2000” (FSMA). Over the last years, Crowdfunding has been a key focus of the FCA and the Government aiming at promoting Crowdfunding as an alternative finance method for individuals and businesses.

According to this, Crowdfunding is regulated by the FCA “if it involves a person carrying on a **regulated activity**” or if it involves the communication of a **financial promotion** for the purpose of Section 21 of FSMA.

#### **(i) Investment-base Crowdfunding**

In order to conduct a regulated activity, platforms operating this business model are required to be **authorised by the FCA** unless an exemption is available.

To ensure a more sustainable regime and limit potential risks for investors, in 2014 the FCA issued a Policy Statement “**PS 14/04 – The FCA’ regulatory approach to crowdfunding over the Internet, and the promotion of non-readily realisable securities by other media**”, whose aim was to restrict the type of investors to whom platforms can offer promotions for unlisted equity or debt securities, called “non-readily realisable securities”.

Under the Financial Promotion Regime, firms promoting these types of products via Equity

Crowdfunding platforms must promote these investments only to investors that understand the inherent risks or have the capacity to bear any losses, such as:

- *Professional clients;*
- *retail clients who confirm that, in relation to the investment promoted, they will receive regulated investment advice or investment management services from an authorised person;*
- *retail clients who are venture capital contracts or corporate finance contracts;*
- *retail clients who are certified or self-certified as sophisticated investors;*
- *retail clients who are certified as high net worth investors;*
- *restricted investors who certify that they will not invest more than 10% of their net investible financial assets in unlisted equity and debt securities*<sup>23</sup>.

In the case that no advice has been provided to investors, platforms have to ensure the investor's understanding of the risks involved. In particular, platforms must run “*appropriateness tests*” where investors must certify that they understand the risks related to the investments.

## **(ii) Lending-based Crowdfunding**

Before 2014, the regulation of platforms offering debt- securities, such as bonds or debentures, was closer to the regulation of platforms that offer equities. Platforms offering non-securities based lending were not treated as carrying on a regulated activity, so that the lending-based model developed quickly as an alternative to bank loans.

However, from 1 April 2014, the Financial Conduct Authority assumed the responsibility of the “Office for Fair Trading” (OFT) to regulate the consumer credit market, including loan-based Crowdfunding platforms.

In order to regulate P2P lending, the FCA applied a new regulated activity of “operating an electronic system in relation to lending” (Chapter 6B, art. 36H of FSMA), which establishes that P2P platforms are carrying out a regulated activity if they are facilitating lending and borrowing between individuals and businesses under an article 36H agreement. Under this rule, firms (previously regulated by the Office for Fair Trading) operating an electronic system become subject to regulation by the FCA under an **interim permission regime**.

The new regulated activity only applies to loans where<sup>24</sup>:

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<sup>23</sup> Financial Conduct Authority, *PS 14/04, paragraph 4.7*, available online at <http://www.fca.org.uk/static/documents/policy-statements/ps14-04.pdf> March 2014

<sup>24</sup> Chapter 6B, art. 36H(6) of Financial Services Markets Act 2000.

- *The lender is an individual or relevant person;*
- *The borrower is an individual or relevant person and:*
  - *The lender provides the borrower with credit less than or equal £25,000 or;*
  - *The agreement is not entered into by the borrower wholly or predominantly for the purposes of a business (...).*

Under this regime, platforms with interim permissions had a time window (between August and October 2015), during which they were required to apply for full FCA authorisation or lose their authorised status; by contrast, new firms entering the market after April 2014, must first register and obtain the full authorisation from the FCA before operating into the P2P market.

Under the Financial Services and Markets Act 2000 (FSMA), in order to conduct a regulated activity, platforms are required to be **authorised by the FCA** unless an exemption is available. Platforms performing loan-based Crowdfunding are subject to the following main tenets of the P2P Regime:

- *Publication of historic performance loan data;*
- *Capital adequacy requirement, which is currently £20,000 but it will be increased to £50,000 or a percentage of the volume of loaned funds by 1 April 2017;*
- *Client money segregation, platforms holding client money must be authorised to hold client money as set out in CASS;*
- *Clear, fair and not misleading communications with lenders, firms must ensure that investors have enough information to take informed investment decisions;*
- *Resolution plans for investor protection in the event of platform's failure.*

The UK regulation limits the amount a fund-seeker can raised to €5 million in a 12-month period.

### **V.5.2|Crowdfunding Regulation in France**

The French Regulatory Framework for Crowdfunding is characterized by the adoption of a new set of rules, the “Ordinance on Crowdfunding activities” detailed in specific provisions by the Decree no. 2014-1053 in 2014. This new regulation amended the General Markets Authority Regulations of the “Autorité des Marchés Financiers” (AFM) that corresponds to the French Financial Market Authority.

The new regulation allows online platforms to rise up to €1 million in financing for businesses, via loans or issuance of securities. Furthermore, it creates two specific statuses appositely for Crowdfunding platforms: the “Conseil en investissement participative” (CIP) and the “Intermediaire en financement participative” (IFP) that refer to the “Crowdfunding investment

advisor” and “Crowdfunding investment intermediary” respectively.

### **(i) Investment-based Crowdfunding**

Equity-based platforms may register with French authorities as CIPs or hold a license as financial services providers and they are subject to the following rules:

- They cannot receive funds from investors (except for their remuneration) and securities from issuing companies;
- They cannot have any other activities except those of IFPs (excluded payment services), advice to businesses relating to capital structure, handlings share subscription forms;
- They must be legal entities established in France;
- They shall be registered with the ORIAS (Register for intermediaries in banking operations and payment services);
- They must join AMF accredited associations which control their activity and comply with the good conduct rules set by AMF;
- They must ensure that clients’ interests are protected and clients receive the adequate level of information to understand the risk connected to the investment;
- Equity investments are limited to investments in ordinary shares and fixed interests bonds (securities such as warrants, convertible bonds etc. are excluded from the scope) up to €1 million per issuer per year;
- Issuers can include businesses organized as “Société Anonyme” (SA) or “Société par action simplifiée” (SAS) or certain kinds of “Sociétés à responsabilité limitée” with two years of approved accounts;
- Investors can be individuals and legal entities.

### **(ii) Lending-based Crowdfunding**

Platforms operating loan-based Crowdfunding must be registered as IFPs. As well as CIPs, IFPs are subject to a series of applicable rules, which include the following:

- They must be legal entities (not necessarily placed in France);
- They cannot have any other activities than banking and credit institutions, payment institutions, electronic currency establishments, agents of EP or CIPs;
- They must be registered with the ORIAS;
- Eligible borrowers are restricted to legal entities and individuals that act in a professional capacity;
- Eligible lenders are individuals that act outside their professional activities;

- Loans are permitted only to finance projects at a fixed rate for a maximum duration of seven years and up to €1 million per lender per project;
- Payments must not transit via IFP unless it has the status of payment establishment;
- They must comply with the good conduct rules;

### **V.5.3|Crowdfunding Regulation in the Germany**

The first drafts of German Regulation about Crowdfunding were published in 2014 and subject to several regulatory changes due to the German Retail Investor's Protection Act (KASG) available from 2015, which affects all types of investment products and Crowdfunding activities.

Under this new regulation, all offering profit loans, subordinated loans and comparable investments are considered "investment products". However, in order to boost these products and encourage investors, German legislator introduced the so-called "Crowdfunding Exception" that excludes Crowdfunding from most regulatory requirements, especially the one related to the publication of a prospectus. However, this exception is only applicable if the following conditions are satisfied:

- Retail investors:
  - If the investor has freely available assets of at least €100,000, they are allowed to invest up to €10,000;
  - If the investor has not freely available assets of at least €100,000: twice the investor's monthly income but in any case no more than €10,000;
  - If the investor does not provide any income/assets statement: €1,000;
- Professional investors and Corporations are subject to investment limit exemption, which means that there are no limits for this type of investors;
- The amount per project shall not exceed €2,5 million;
- Platforms need a license under the German Trade, Commerce and Industry Regulation Act and under the German Banking Act or the German Securities Trading Act;
- In the previous versions of the regulation, investors were asked to manually sign and send via mail to the crowdfunding platform the "Investment Information Sheet". With the entrance into force of the new regulation, this process can be carried out electronically and consequently make investing easier and smoother for all investors;
- An important change of regulation is related to the possibility to advertise crowdfunding

campaigns to media focusing on economic topics, that originally was prohibited. The approved law removes this obstacle and allows for advertising also through other channels, such as social media, provided that the communication includes adequate warnings about the risks associated with the investment.

#### **V.5.4|Crowdfunding Regulation in the Netherlands**

In the Netherlands Crowdfunding has become a serious and recognized alternative for bank financing, so that the Netherlands Authority for the Financial Markets (AFM) published guidelines on the regulatory implications of Crowdfunding.

The current Regulatory Framework falls under the scope of the Dutch Financial Supervision Act that regulates Crowdfunding and all parties involved within the process. Depending on the type of business model, whether lending or equity, license obligations will apply. According to the Dutch Regulation, platforms can be qualified as intermediaries, credit issuers or investment firms and they need to get licensed to operate or, alternatively, an exemption for it.

On April 1, 2016, the Regulation for equity and loan-based Crowdfunding has been amended to provide the following rules:

- Maximum amount to invest in equity-based model put at € 40.000 per investor per platform;
- Maximum amount to invest in lending-based model put at € 80.000 per investor per platform;
- Maximum amount to invest per project put at € 5.000;
- Platforms need to conduct an investor test to ensure the investor's knowledge about investing and the risks associated with investing in start-ups prior to the investment;
- Platforms must send an e-mail to the investor within 1 working day after the initial investment. This e-mail must contain information about the associated risk of the project and give the investor the possibility to change their minds about the investment;
- From the moment that a loan becomes negotiable the platform will be considered to provide investment services if it acts as a broker and, consequently, it will need a license to act as an investment firm and will become subject to MiFID.

#### IV.5.5| Crowdfunding Regulation in Italy

Italy has been the first European country to have a specific regulation for Crowdfunding. However, the Regulation only focused on Equity Crowdfunding, while for Lending model there is not a specific Regulation.

##### (i) Investment-based Crowdfunding

In 2013 the Italian Financial Supervisory Authority, known as CONSOB, published a Regulation for Equity Crowdfunding, introduced by the Italian Government to facilitate the financing of small and medium-size businesses and start-ups.

Through the Law Decree 179/2012 as converted into **Law 221/2012 “the Growth Decree 2.0” and subsequent updates**, the Government introduced the concept of “innovative” start-ups. Within the articles 25-32, the Growth Decree 2.0 defined and regulated the innovative start-ups and introduced:

- *Articles 50-quinquies “Gestione dei portali per la raccolta di capitale per le start-up innovative”;*
- *100-ter “Offerte attraverso portali per la raccolta di capitali”*

of the **Legislative Decree No. 58/1998**, known as “Testo Unico Finanziario”, whose discipline has been implemented by the CONSOB on 14 July 2013 and then amended in 2016.

Since its entering into force, the main obstacle of this regulation was represented by the fact that the scope of its activity was too narrow, since it focused only to a particular type of start-ups and to equity financial instruments.

Because of that, the regulation has been recently amended with the introduction of a new **Law Decree No. 24/2015**, known as “**Investment Compact**”, converted into Law on March 2015. This new Law enlarged the scope of activity of the previous Regulation, by adding to innovative start-ups the category of “innovative” SMEs. According to the new Italian Regulation, in fact, also venture capital companies and undertakings for collective investment, which invest in innovative start-ups or innovative SMEs, are allowed to raise capital online through Equity Crowdfunding.

In the overall design of the legislator, the Equity Crowdfunding is seen as a tool to foster the development of start-ups and SMEs through rules and funding arrangements that are able to exploit the potential of Internet.



**(ii) The “Regolamento sulla raccolta di capitali di rischio tramite portali on-line”**

The current Regulation for Equity Crowdfunding has been implemented by the CONSOB through “*Regolamento sulla raccolta di capitali di rischio tramite portali on-line*” that represents the reference text for the discipline of Crowdfunding in Italy. This Regulation sets rules on the Platforms, on the offers and obligations of communications to the Italian Authority.

**The Regulation provided by CONSOB requires that the management of a platform can be conducted only by investment companies and investment banks, which are automatically enrolled in a special section of the register “Registro dei gestori” or; companies that have the authorisation of CONSOB to provide the investment services and must be registered in the ordinary section of the same register, if they meet certain requirements.**

The register contains a series of information (i.e. registration number, registered office, administrative headquarters, the Internet address and web link etc.) about all investment companies and banks that provide investment services, which must communicate to the CONSOB, before starting to operate, their activity of management of a portal.

Article 13 of the Regulation establishes the duties of platforms, which must:

- work with diligence, fairness and transparency, avoiding that any conflicts of interest that may rise can adversely affect the interests of the investors and issuers;
- make available to investors all correct, clear and non misleading information about the offer, in order to enable them to reasonably and fully understand the nature of the investment, the type of financial offer and the risks attached, as well as take conscious investment decisions;
- ensure that investors, which are not professional investors, can bear the risks attached to the financial investment;
- ensure investors that all information on the portal’s web site are updated and accessible for a 12-month period;
- ensure that investors have the capacity and the experience necessary to understand essential features and risks attached to the investment and in case it deems that the financial instrument is not appropriate for the client, it warns him.

**Under the Italian law and regulation, an offer can be successfully completed only if at least 5% of the offered share capital is paid by professional investors, by banking foundations or start-ups incubators.**

Italian Regulation relies on the action of professional investors to protect the non-professional investors from the possible risks. This means that “Crowdfunding in Italy most likely acts as a substitute for early seed venture capitalists<sup>25</sup>”.

The Italian Regulation limits the amount raised to €5 million in a 12-month period.

### (iii) Lending-based Crowdfunding

Even though the Italian Regulation does not provide a specific Regulation for lending-based Crowdfunding, the existing platforms operating in Italy are subject to the authorization of the Bank of Italy. The article 106 of the Italian **Consolidated Law on Banking**, known as “Testo Unico Bancario”, regulates the financial intermediaries, who are subject to a prudential supervisory regime equivalent to that of banks. In particular, the current article regulates the funding activity and aims at achieving financial stability, stating that:

*“L'esercizio nei confronti del pubblico dell'attività di concessione di finanziamenti sotto qualsiasi forma è riservato agli intermediari finanziari autorizzati, iscritti in un apposito albo tenuto dalla Banca d'Italia”.*

According to that, platforms that operate Loan Crowdfunding have to work as financial institution of payments, such as financial intermediaries authorised by the Bank of Italy.

## IV.6| Overview of European Crowdfunding Regulatory Framework

The following tables will provide a resume of the Regulatory Framework in Europe.

*Table 7 - State of Art of Regulation about Investment-based Crowdfunding*

	UK	France	Germany	The Netherlands	Italy
<b>Bespoke regime</b>	Yes	Yes	Yes	Yes	Yes
<b>Entry into force</b>	1 April 2014	1 October 2014	10 July 2015	1 April 2016	17 December 2012 (Law) and 26 June 2013 (Consob)
<b>Scope</b>	Securities and lending	Ordinary shares and fixed rate	Profit-participating loans,	Securities and lending	Equity

<sup>25</sup> Gabison Garry A., JRC SCIENCE AND POLICY REPORT – *Understanding Crowdfunding and its Regulations – How can Crowdfunding help ICT innovation?*, available online at: <http://publications.jrc.ec.europa.eu/repository/bitstream/JRC92482/lbna26992enn.pdf>, 2015.

		bonds	subordinated loans, or other investment products		
<b>MiFID Passport</b>	Yes for transferable securities as defined in MiFID	Yes if MiFID platforms; No for platforms registered under Exemption Art. 3 MiFID	Yes if MiFID platforms (for transferable securities)	Yes. In anticipation to MiFID II, an inducement ban already applies to investment firms and to equity-based platforms that are considered investment firms	No because bespoke regime is developed under exemption Art.3 MiFID
<b>Authorization by</b>	FCA Regulated Activity Order (RAO)	AMF	Platforms must be investment service enterprises providing investment advice or brokerage services (MiFID) pursuant to Section 32 of the German Banking Act or must obtain an authorisation pursuant to Section 34f of Trade Commerce and Industry Regulation Act from the competent authorities.	AFM	CONSOB (banks and authorised investment companies must be enrolled in the Register of Platforms)

<b>Minimum capital requirements</b>	€ 50,000	None for non-MiFID platforms  For MiFID platforms: depending on the investment services and activities	None	n.a.	None
<b>Services provided</b>	Reception and transmission of orders	Investment advice	Investment advice or reception and transmission of orders	n.a.	Reception and transmission of orders
<b>Financial instruments</b>	Equities and debt securities. Bespoke set of rules for non-readily realisable securities.	Bespoke regime: Ordinary shares and fixed rate bonds  MiFID: Financial instruments as defined in Annex 1, Section C.	Profit participating loans, subordinated loans, investment products	n.a.	Shares or units of the capital of innovative start-ups and innovative SMEs; units or shares of collective investment undertakings or other companies investing at least 70% in innovative start-ups and SMEs.
<b>Anti-Money Laundering checks</b>	Customer due diligence  Platforms may not make direct offer financial promotions	Access to platforms restricted to registered investors who have been warned of and expressly accepted the risks  Suitability tests  Platforms	Checks regarding the suitability or appropriateness of the investment for the investor pursuant to Securities Trading Act or Financial Brokerage Ordinance, AML rules	Investor test to assess whether the investment is feasible for the investor	For retail investors: Appropriateness tests  Investors must read the financial investor education material published on Consob's website and state one's

		<p>need to ensure that investment is in line with investor's experience, financial situation and risk appetite</p> <p>Compliance with AML and terrorism financial legislation</p>			<p>awareness that the entire investment may be lost</p> <p>AML checks performed by banks receiving the orders and payments</p>
<b>Size of offers</b>	Lower than €5 million	Up to €1 million per year per project	€2,5 million per project	€40,000 per investor per platform	Lower than €5 million
<b>Maximum investable amounts</b>	No more than 10% of the net investable assets	-	<p>If the investor has freely available assets of at least €100,000: up to €10,000;</p> <p>If the investor has not freely available assets of at least €100,000: twice the investor's monthly income but in any case no more than €10,000;</p> <p>If the investor does not provide any income/assets</p>	Retail investors cannot exceed 10% of their freely available assets	<p>No limit.</p> <p>Exemption from appropriateness test for investments under:</p> <ul style="list-style-type: none"> <li>-Natural persons: €500 per individual order and €1,000 in annual total orders;</li> <li>-Legal persons: €5,000 per individual order and €10,000 in annual total orders</li> </ul> <p>Based on self declaration by investors.</p>

			statement: €1,000;  Professional investors and corporation are not subject to an investment limit		
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**Source** – European Commission, COMMISSION STAFF WORKING DOCUMENT Crowdfunding in the EU Capital Markets Union

**Table 8 - State of Art of Art of the Regulation about lending-based Crowdfunding**

	UK	France	The Netherlands
<b>Bespoke regime</b>	Yes	Yes	n.a.
<b>Authorization by</b>	FCA	Registration with ORIAS. No ex-ante authorisation is required	n.a.
<b>Minimum capital requirements</b>	€ 50,000	-	n.a.
<b>Type of loans</b>	All types of loans	Loans that do not exceed €1 million with a fixed interest rate and a 7-years duration	n.a.
<b>Size of loans</b>	No maximum	€1 million per year per project (7-years duration)	n.a.
<b>Maximum investable amounts</b>	No maximum	Lenders can finance up to €1,000 per project and €4,000 per project for an interest free loan	€80,000 per investor per platform

**Source** – European Commission, COMMISSION STAFF WORKING DOCUMENT Crowdfunding in the EU Capital Markets Union

## V.7| Cross-Border Activities

Under the European “Market in Financial Instrument Directive”, a financial intermediary may request and obtain the so-called “European Passport” to operate in other Member States upon notice to the local authority.

The same system is not working, however, outside of the European Union and especially from continent to continent.

To date, Alternative Finance is still largely a national phenomenon with cross-border activity still very limited. The principal reason of such limitation is the introduction of bespoke regimes by Member States, which are tailoring Crowdfunding Regulation to the needs and characteristics of their own domestic markets. In particular, the divergences in the harmonization of cross-border activity partly derive from the lack of a common definition of what types of services constitute "Crowdfunding" and from the different thoughts about the subjection of platforms to MiFID.

According to this, it is possible to identify the main obstacles to cross-borders as follow<sup>26</sup>:

- **Large variety of national legislations;**
- **Discretion of Member States in transposing European Directives, as in the case of MiFID;**
- **Adoption of different regulatory solutions that hamper the creation of a future harmonization.**

## V.8| Building a Capital Markets Union

A possible action against the limitation of cross-border activities is the attempt to establish a Capital Market Union. For this purpose, the European Commission has realised a Green Paper “Building a Capital Markets Union” that aims at enhancing the flows of capital from investors to European investment projects, by providing more efficiency in market infrastructure and intermediaries and improving allocation of risk and capital across the European Union, as well as making Europe more resilient to future shocks.

Establishing a Capital Markets Union should help SMEs raise financing as easily as large companies, reduce costs of investing and converge access to investment products across the Union. Furthermore, it should make the process of obtaining finance through capital markets

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<sup>26</sup> Solarplaza, Renewable energy Crowdfunding Conference, *Crowdfunding Legal Framework Overview*, available online at [http://www.kramerlevin.com/files/Publication/76d65e4a-b19d-4d89-9b02-b0c5fbdf306b/Presentation/PublicationAttachment/efae0d4a-095b-43d0-94be-b0d1a1d018c2/151105\\_Renewable%20Energy%20Crowdfunding%20Conference\\_Crowdfunding%20Legal%20Framework%20Overvi.pdf](http://www.kramerlevin.com/files/Publication/76d65e4a-b19d-4d89-9b02-b0c5fbdf306b/Presentation/PublicationAttachment/efae0d4a-095b-43d0-94be-b0d1a1d018c2/151105_Renewable%20Energy%20Crowdfunding%20Conference_Crowdfunding%20Legal%20Framework%20Overvi.pdf), November 2015.

easier facilitate fund seeking in another Member State without the implementation of unnecessary legal or supervisory barriers.

To resume, a Capital Markets Union should be based on the following key principles<sup>27</sup>:

- it should maximise the benefits of capital markets for the economy, jobs and growth;
- it should create a single market for capital for all 28 Member States by removing barriers to cross-border investment within the EU and fostering stronger connections with global capital markets;
- it should be built on firm foundations of financial stability, with a single rulebook for financial services which is effectively and consistently enforced;
- it should ensure an effective level of consumer and investor protection; and
- it should help to attract investment from all over the world and increase EU competitiveness.

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<sup>27</sup> European Commission, *Green Paper: Building a Capital Markets Union*, available online at <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A52015DC0063> 18.02.2015.



## V.9| The US regulatory framework for crowdfunding: the JOBS Act

In the US, the regulation of equity Crowdfunding falls under the scope of the Security and Exchange Commission (SEC), which adopted the Final Rules, known as “**Regulation Crowdfunding**”, under the Securities Act of 1933 and the Securities Exchange Act of 1934. This regulation, which will become effective on May 2016, implements the requirements of the “**Jumpstart Our Business Start-ups Act**” (JOBS Act) and allows companies to offer and sell securities through Crowdfunding.

The final rules provide requirements that:

- Allow individuals to **invest in securities-based Crowdfunding transactions** based on certain thresholds;
- **limit the amount of money** that an issuer can raise using the Crowdfunding exemption;
- impose issuers (companies) to **disclose certain information** about their business and securities offering;
- create a **regulatory framework for intermediaries**, such as broker and dealers;
- introduce a new term for intermediaries, such as “**funding portal**”, better known as Crowdfunding platforms;
- create a **regulatory structure** for regulate the role of intermediaries, either as broker-dealer, as funding portals.

The JOBS Act substantially changed a number of laws and regulations, including provisions that allow small businesses to offer portion of equity to private citizens through the use of online platforms, in order to encourage the funding of SMEs.

The **Title III** of the JOBS Act, which can be cited as the “**Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012**” or the “**CROWDFUND Act**” amends the Section 4 of the US Securities Act of 1933.

The principal amendments on the Securities Act of 1933 can be summarised as follow:

- 1. Crowdfunding Exemption:** Section 4(a)(6) of Title III provides an exemption from the registration requirements of Section 5 for certain Crowdfunding transactions. The Section 4(a)(6) limits the amount that a company can raise through Crowdfunding.

Under the final rules:

- An **issuer** is permitted to raise a **maximum aggregate amount of \$1 million** through crowdfunding offerings in a 12-month period;
- **Individual investors**, over the course of a 12-month period, are permitted to invest

in the aggregate across all crowdfunding offerings up to:

- If either **their annual income or net worth is less than \$100,000**, then the greater of: \$2,000 or 5 percent of the lesser of their annual income or net worth;
  - If both their **annual income and net worth are equal to or more than \$100,000**, then 10 percent of the lesser of their annual income or net worth; and
- During the 12-month period, the aggregate amount of securities sold to an investor through all crowdfunding offerings may **not exceed \$100,000**.

However, there are certain companies that are not eligible to use the Regulation Crowdfunding exemption. Ineligible companies include:

- non-U.S. companies;
- companies that already are Exchange Act reporting companies;
- companies that are disqualified under Regulation Crowdfunding's disqualification rules;
- companies that have failed to comply with the annual reporting requirements under Regulation Crowdfunding during the two years immediately preceding the filing of the offering statement, and;
- companies that have no specific business plan or have indicated their business plan is to engage in a merger or acquisition with an unidentified company or companies;

**2. Requirements with respect to certain small transactions:** In order to guarantee the investor protection, point C of Section 4(a)(6) of Title III requires that offering transactions take place through an intermediary, either as broker or a funding portal. In this context, section 4A, provides a series of requirements regarding solicitation limitations, disclosure obligations and other requirements and prohibitions for intermediaries and issuers involved within the transaction. The key factor for investors' protection is that Crowdfunding transactions must take place through intermediaries that are registered with the Securities and Exchange Commission.

The same section requires them to disclose certain information to investors and potential investors, such as disclosures related to the risks associated with the investments and other educational materials and, to take other actions and measures to reduce the risk of fraud. Furthermore, intermediaries must communicate certain information to the Commission,

within the terms provided.

Issuers have to file certain information with the Commission and disclose it to investors and intermediaries;

**3. Disqualification Provisions:** the Commission established **disqualification provisions** under which an issuer would not be able to avail itself of the exemption for crowdfunding if the issuer or other parties, including intermediary, were subject to a disqualifying event;

**4. Limited exemptions for funding portals:** Section 3 (h) of Title III separately requires the Commission to adopt rules to exempt, either conditionally or unconditionally, “funding portals” from having to register as a broker-dealer under the Exchange Act Section 15(a)(1).

Funding Portals must:

- remain subject to the examination, enforcement and other rulemaking authority of the Commission;
- be a member of a registered national securities association;
- be subject to other requirements appropriately determined by the Commission.

*Table 9 - State of Art of US Regulatory Framework*

	US
<b>Bespoke regime</b>	Yes
<b>Scope</b>	securities
<b>Authorisation by</b>	SEC
<b>Maximum investable amounts</b>	<p>If either their annual income or net worth is less than \$100,000, then the greater of: \$2,000 or 5 percent of the lesser of their annual income or net worth.</p> <p>If both their annual income and net worth are equal to or more than \$100,000, then 10 percent of the lesser of their annual income or net worth; and</p> <p>During the 12-month period, the aggregate amount of securities sold to an investor through all crowdfunding offerings may <b>not exceed \$100,000</b>.</p>
<b>Maximum amount to raise</b>	\$ 1 Million per year

## **Chapter VI: COMPETE OR COLLABORATE? WHAT IS THE BEST STRATEGY BANKS SHOULD TAKE?**

This chapter will provide the analysis of strengths, weaknesses, opportunities and threats of Fintech industry, with particular focus on Alternative Finance sector.

In order to formulate the conclusion of the present study, next pages will analyse how banks may decide to approach these phenomena. Is it better to compete or collaborate? In this last chapter, we will try to answer this question by evaluating what are the main advantages of staying in.

### **VI.1| SWOT Analysis**

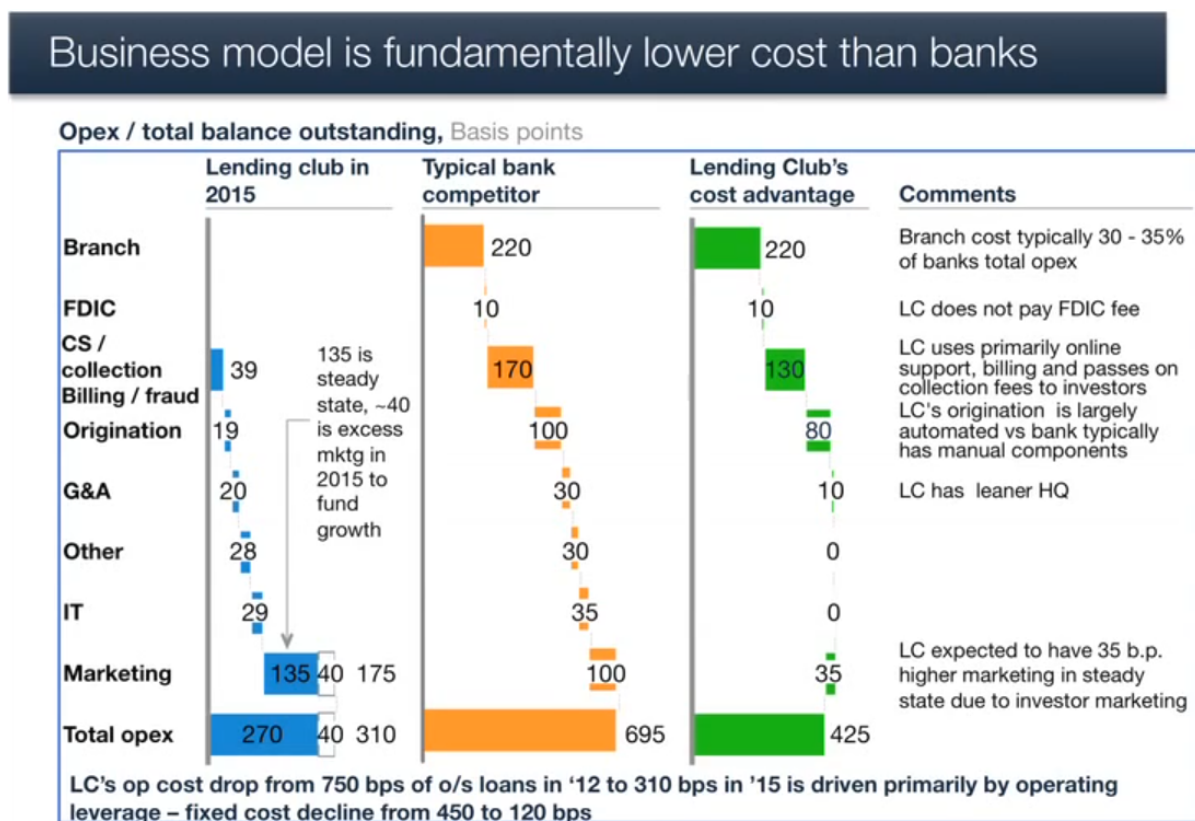
The analysis of different operating business models allows to gather many information about value propositions and competitive advantage that characterize and distinguish Alternative Financial solutions with respect of traditional ones. However, we also got aware about the risks associated with these models.

In order to recap all of the main positive and negative features and outline potential opportunities and threats, next paragraph will propose a SWOT Analysis that mixes the common characteristics of Fintech and Alternative Finance, since they are strictly connected.

#### **VI.1.1|Strengths of Alternative Finance**

- 1) Absence of legacy operating costs:** one of the most important advantages of Fintech companies relies on the cost advantage. Companies operating Alternative Finance do not face operating costs typically linked to banks' extensive branch networks and IT systems. This requires banks to sustain a huge amount of costs that could be saved, as the figure above demonstrates;

Figure 22 - The cost advantage of Fintech marketplace lenders



Source – Lending Club website

- 2) **Regulatory advantage:** in the aftermath of Financial Crisis, banking Regulation has become more stringent, forcing banks to respect certain capital requirements to improve the ability of financial institutions to absorb shocks and avoid further collapses, all resulting in lower efficiency and lack of possible innovation. Fintech companies, instead, are subject to a light Regulation with no capital requirements and, in some cases, platforms operating certain type of Alternative Finance solution will join some exemptions;
- 3) **Higher flexibility:** while banks do not have too much flexibility in terms of opening time, Fintech companies make financial transactions and customer's finances available 24x7 from any place;
- 4) **Speed:** Fintech companies provide more speed in terms of time to process the loan application which approximately takes 12 days against approximately 3 months took by banks. The process includes the process of investigation of the potential borrower, the loan listing into the marketplace and the lending process (see figure 23). This represents

a big advantage especially for situations where businesses need liquidity;

**Figure 23 – P2P loan or Bank loan?**



Source – Funding Circle website

- 5) **Technological advantage:** Fintech companies are totally digital and totally based on technology innovations;
- 6) **No collateral requirements:** Alternative Finance solutions do not require collaterals. Indeed, marketplace lenders offer unsecured lending, favouring small businesses, which very often have stable cash flows but no tangible collaterals that banks could lend against;
- 7) **More efficiency:** Fintech companies do use any paperwork, letting customers stay home and access financial services directly onto the web. This results in no bureaucracy issues and more efficiency;
- 8) **Customer experience:** differently from banks, Fintech is able to offer customers the experience to reach what they need with a few “clicks”, whenever and wherever they want.

### VI.1.2|Weaknesses of Alternative Finance

- 1) **Low customer base:** An element that can negative affects the development of non-banks players’ activity is the lack of existing customers faced by Fintech companies, which may find difficult to acquire them cost-effectively in most cases;
- 2) **Lack of reputation:** From the moment that Fintech is a new phenomenon that is still growing, non-bank players can suffer from a lack of reputation due to the low level of awareness among the public;
- 3) **Information Asymmetry:** a big weakness of the market is represented by imperfect

information affecting SMEs and online platforms, which results in a market failure. Many SMEs only approach the largest banks when seeking finance. Although a large number of these applications are rejected (rejection rate 50%) part of these are viable and are rejected simply because they do not meet the risk profiles of the largest banks. However, there are often challenger banks (smaller institutions) and Alternative Finance providers with different business models that may be willing to lend to these SMEs but in many cases challenger banks and other providers of finance are unable to offer finance as they are not aware of the existence of such SMEs and the SMEs are not aware of the existence of these alternative sources of finance.

### VI.1.3| Opportunities of Alternative Finance

- 1) **Leverage existing infrastructures:** Fintech companies may take advantage from the possibility to join “co-opetition” and find ways to engage with the existing ecosystem of banks (a specific paragraph to argue about this topic will be proposed next);
- 2) **Innovation in the use of big data and credit scoring models:** big data and advanced analytics offer potentials to predict customer’s “next best actions,” understand customer needs and deliver financial services in a new way. Credit underwriting in banks often operates with a case law mindset and relies heavily on precedent. In a world where more than 90% of data has been created in the last two years, FinTech data experiments hold promise for new products and services, as well as evaluates in a more accurate the creditworthiness of borrowers. Marketplace lenders use heavily data-driven and semi-automated risk assessment methods, which banks may not have. Foundation Capital defined the access to new data as a possibility “*to out-FICO FICO. The best loan marketplaces have developed their own data sources and algorithms to evaluate potential borrowers. New insights can be gleaned from data sources that incumbents have not even begun to consider...*”<sup>28</sup>.

Retail banks do not have access to these data but, as Foundation Capital pointed out: “*they lack the analytics and organizational focus to lead or even keep up with this growing field. New marketplaces, on the other hand, recognize that integrating new*

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<sup>28</sup> Foundation Capital, Whitepaper: *A Trillion Dollar Market By the People, For the People: How Marketplace Lending Will Remake Banking As We Know It*, available online at [https://foundationcapital.com/assets/whitepapers/TDMFinTech\\_whitepaper.pdf](https://foundationcapital.com/assets/whitepapers/TDMFinTech_whitepaper.pdf).

*sources of data is their competitive advantage. By figuring out ways to use additional data to improve upon FICO, the most exciting marketplaces are underwriting better, more predictive loan pools than retail banks”;*

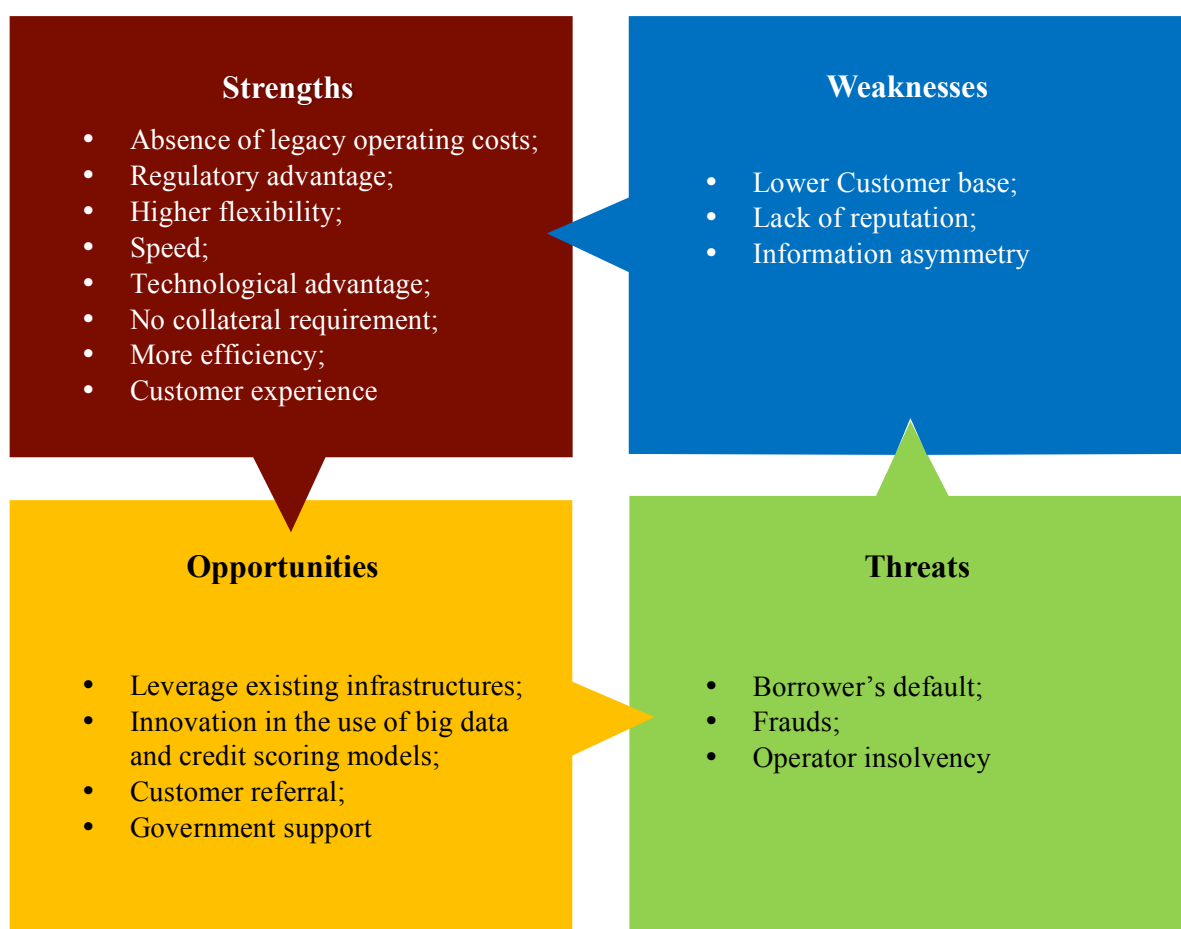
- 1) **Customer referral:** after the Financial Crisis, banks have lost a big portion of customer trust. Today, the number of people that would recommend friends and family Alternative Finance platforms rather than banks is increasing;
- 2) **Government support:** in some country, Government initiates to launch a series of initiatives intended to support the development of non-bank players, to help match SMEs rejected for loans by large banks with Alternative Finance providers.

#### **VI.1.4|Threats of Alternative Finance**

- 1) **Borrower’s default:** the biggest risk associated with Alternative Finance solutions is the risk that borrower defaults and investors will lose money;
- 2) **Frauds:** a serious threat is the risk of turning to fraudulent platforms. A recent case of fraud affected the US leading company Lending Club, which sold non-conforming loans to a single, accredited institutional investor for \$22 million (\$15 million in March and \$7 million in April). The loans in question failed to conform to the investor’s express instructions as to a non-credit and non-pricing element;
- 3) **Operator insolvency:** a real concern lies in a platform blow up due to undisclosed losses, poor cost control and/or failure to keep originating lenders and borrowers.



*Figure 24 - SWOT analysis*



## **VI. 2|An opportunity or a threat for banks: How banks respond to Alternative Finance?**

Financial institutions have multiple approaches to respond to the potential disruption of Alternative Finance.

While some years ago the great attitude of banks was to avoid the rise of such a new phenomenon, today things have changed, let a new trend emerging.

In particular, there are more strategies that banks are taking into account for remaining competitive into the new space of financial services and they are analysed as follow:

### **1) Competing**

Depending on its strategic goals, a bank may decide to develop its own Alternative Finance platform, thus, becoming a direct competitor of existing marketplace lenders.

In this way, a small business owner that does not meet the bank's credit and/or profitability criteria and, consequently, sees his/her loan application rejected, can obtain the funds as well.



In particular, with hybrid lending strategies, the bank can guarantee part of the loan on its balance sheet based on its risk appetite, while listing the rest on its online lending platform, where investors lend the money off balance sheet, at a slightly higher interest rate.


However, deciding to approach the competing solution may have some difficulties, such as the risk for bank to cannibalise its own products and higher costs of implementation.

## 2) Collaborating

The collaborative solution provides the banks to act as investors, by purchasing loans from Alternative Finance players. In this case, banks make contractual arrangements with online platforms to buy their loans and diversify their investments into segments that are not normally subject to traditional lending.

Examples of existing partnerships between marketplace lenders and financial institutions include:

	<p>The British Business Bank (a development bank wholly owned by the UK Government) has provided RateSetter with an investment and for each loan that qualifies under agreed criteria, the Bank will be one of the investors for this loan.</p>
	<p>They agreed to create a strategic alliance, under which Union Bank purchases personal loans through Lending Club platform. The two companies work together to create new credit products to be made available to both companies' customer base.</p> <p>This strategic relationship brings together Lending Club's low operating cost and Union Bank's strong balance sheet and large customer base. Both companies focus on responsible lending and customer service, which helps unlock lower rates and superior service to both companies' customers.</p> <p><b>From Lending Club's perspective, this strategic alliance is the way to leverage Union Bank's strengths, consisting of high reputation for transparency, high</b></p>

	<p><b>quality products and customer service. From Union Bank’s perspective, instead, this is the chance to invest in high quality assets and new products.</b></p>
 <p><b>Deutsche Bank</b></p> <p><b>BorsadelCredito.it</b></p>	<p>While the core business of “BorsadelCredito.it” is just the P2P lending, for amounts that they do not lend (given their role of intermediary) or higher than those imposed by the Bank of Italy, there are support from the partner banks, in this case Deutsche Bank, that provides such payments. The platform limits itself to make a first investigation on potential borrowers, then it passes the practice in the bank that eventually meets the customer to provide the funding.</p>

### 3) Partnering

Create a partnership is an attractive opportunity for many institutional investors and works in two ways that involve partnership programs with the local Government and other governmental institutions or creating partnership agreements between a bank and a platform.




The first partnership requires financial institutions to refer customers who do not meet traditional lending criteria to marketplace lenders. In this way, customers can apply for loans on a co-branded website. This mutually beneficial arrangement enables platforms to access more borrowers while banks can leverage the platform’s technology to screen their current customers for consumer loan refinancing. The UK is the country whereby the above partnering solution is the most developed, also thanks to the government’s action of establishing the mandatory “**Referral Scheme for high street banks**”, which is being implemented under the Small Business Enterprise and Employment Act. This program **obliges the most higher street banks to refer on any small and medium-size business, whose loan application has been rejected, the option to turn down for credit alternative finance platforms.**

The second way of partnering requires financial institutions to institute a process in which borrowers fulfil a loan application on a lending platform infrastructure and receive a loan from the financial institutions.

To date, a range of banks, from small to large national and international institutions are partnering with many existing marketplace lenders to help make smaller loans and take

advantage of low cost structures. Others, instead, partnering with the aim to join products development.

Examples of existing partnerships between marketplace lenders and financial institutions include:

 <p>The image shows the Funding Circle logo (a purple circle with two arrows) and the British Business Bank logo (a red and blue flag-like graphic with the text 'BRITISH BUSINESS BANK').</p>	<p>Funding Circle is supported by the British Business Bank<sup>29</sup>.</p> <p>The British Business Bank and its subsidiaries do not offer bank accounts, take deposits or provide regulated banking services but provides its financial support to smaller businesses through its delivery partner. Any decisions to provide finance to smaller businesses are made by Funding Circle not by the British Business Bank.</p>
 <p>The image shows the Funding Circle logo and the Santander Corporate &amp; Commercial logo (a red rectangle with a white flame icon and the text 'Santander CORPORATE &amp; COMMERCIAL').</p>	<p>They work together to help UK businesses accessing the day-to-day banking solutions.</p>
 <p>The image shows the BancAlliance logo (a blue square with a white dot) and the LendingClub logo (a red grid pattern with the text 'LendingClub').</p>	<p>Lending Club has made a partnership with Alliance Partners, which manages the BancAlliance network, a national consortium of community banks. Through this partnership, members of BancAlliance are able to offer access to co-branded personal loans to their customers through Lending Club platform, as well as purchase certain of these consumer loans and others for their portfolios. This program is designed to give community banks and their customers access to Lending Club's benefits, relying on low cost of operations compared with the banks' low</p>

<sup>29</sup> The British Business Bank provides finance to smaller businesses by deploying funds through partner intermediaries that now include alternative finance platforms, such a Funding Circle, Zopa, RateSetter, MartkeInvoice and Urica. To date, the British Business Bank has supported £2,5 billions of finance to small businesses.

cost of capital to help drive down the cost of credit for consumers.

Mark Pitkin, President & CEO of BancAlliance member Sugar River Bank, commented "***By partnering with Lending Club through BancAlliance, our bank can offer access to a responsible product to our customers while at the same time acquiring assets with which we are very familiar and that offer higher returns than many alternatives. As a former regulator, I also appreciate having access to the legal, regulatory, compliance and credit experts at BancAlliance that helped us vet the Lending Club program<sup>30</sup>.***"

According to the program, the banks are committed to buy a certain amount of loans from Lending Club, which will check borrowers' ability to repay. The borrowers come either from the bank's own customers, who the bank send to a Lending Club website, or come directly to Lending Club. Now, instead of analysing the loans on their own, the banks rely on Lending Club's software, which uses a data-driven process to evaluate a borrower's ability to repay. This helps small banks extend credit to borrowers with lower credit scores than they previously served, and build a pool of those loans.

The effort is aimed at helping small banks overcome the cost of underwriting a large pool of loans while also meeting regulatory requirements.

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<sup>30</sup> The Wall Street Journal, [www.wsj.com](http://www.wsj.com)



JP Morgan Chase turned to On Deck platform to provide loans to SMEs. Through this partnership, JP Morgan Chase offers small-dollar business loans to many of its four million small business accounts, by using OnDeck's underwriting technology to be able to give quick approvals and funding for their loans.

In short, loans are Chase branded and kept on Chase balance sheet but OnDeck provides the loan servicing in a special white label program for Chase. In exchange, OnDeck receives an origination fee as well as a servicing fee on each loan.

#### 4) Acquiring

Acquiring a Fintech company is another option that a bank may decide to consider. Choosing the current option requires all to carefully manage the risk that are brought closer to the parent company, hampering growth and killing the viability of the product.

Examples include:



Simple is working as an independent business operating in parallel with BBVA's US banking operations, BBVA Compass Bancshares, Inc.

Working together allows BBVA and Simple to combine Simple's expertise in user experience design and technology with the operational expertise and global reach of BBVA. This will help Simple develop new innovative products and services while enabling the company's expansion.


#### 5) Transforming

The advent of digital disruption has changes the ecosystem and all banks know that if they want to survive, they have to change, transforming into digital companies that are able to stay closer to the needs of "digital customer".

To date, the number of financial institutions that have taken this strong re-organisational decision is still very limited, because this operation requires banks to invest much money into

technological processes.

The example of a successful transformation is the follow:

	<p>After seven years of work, BBVA has finally transformed itself and achieved the state of art of platform, including all products and services and employees that are now working digitally.</p> <p>This results into an increase in the number of transactions processed daily (from 90 million in 2006 to 250 million in 2013).</p>
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### 6) Incubating

Other strategies follow the principle of “if you can’t beat them, join them”. Many banks are not launching incubators or accelerators, such as spaces where startups can grow and collaborate with third parties to gain better insight into their technologies.

Examples include: **Barclays Tech Accelerator** and **Intesa SanPaolo Startup initiative**.

### 7) Investing

A number of financial institutions are establishing venture funds to actively invest in startups. One of the most recent case includes **UniCredit**, one of the leading European commercial banks, and **Anthemis Group**, the leading financial services technology venture and advisory firm, which have announced a new joint investment venture: **UniCreditevo**.



“UniCredit evo” is a dedicated initiative focused exclusively on **identifying and investing in best-in-class financial technology startups.**

With an initial capital commitment of €200 million from UniCredit, the initiative targets mid stage start-ups and follow-on investments in more mature and established FinTech businesses, as well as early stage digitally native financial services start-ups working on more pioneering solutions.

The aim of the investment is to help UniCredit accelerate the digitalization of its banking Group.

Through the investment partnership, UniCredit and Anthemis will cover the entire lifecycle of emerging FinTech companies, with a primary focus on Europe and North America. The initiative will span across the early start-up ideas phase to maturity and apply to different fields of retail banking and consumer finance; investment and corporate banking; wealth and asset management; capital markets and trading; payments and financial data; technology and infrastructure.

\*Source: Unicredit Website

The COO and Deputy General Manager of UniCredit, Paolo Fiorentino, noted: "Thanks to this partnership, we are ramping up our digital transformation, building a new business model to maximize the combined strengths of traditional market players and newcomers. As a bank we have the resources, financial expertise and large customer base that can complement startup innovation. This will in turn boost our digitalization, enabling us to better adapt to the ever-evolving needs of our customers. Today, Anthemis becomes a key partner on this journey. By leveraging their wide expertise, Anthemis will help us identify top class players and opportunities that will drive innovation and ultimately help us to better serve our customers."



## CONCLUSIONS

The aim of this thesis is to understand how the evolution of disrupting Alternative Finance is reshaping the sector of financial services and what are the major impacts on incumbents.

For decades, major banks have faced minor disruptions, from the invention of the “Automated Teller Machine” (ATM) to the arrival of new technologies. The difference is that, while those innovations came from within the large banks and most were driven internally, by banks themselves, the current revolution is more profound.

Today banks live in a global economic and financial context characterised by a more strictly Regulation and the after-effects of the Financial Crisis that led banks to reduce their lending activities, principal cause of financial troubles of SMEs.

In this situation, individuals and business consumers have begun to approach financial products and services in a different way, by embracing new challenger platforms to get financing and satisfy their financial needs. **Customer needs are changed and aim at a direct access to their capitals everywhere and at any moment, overthrowing physical distances and bureaucracy issues. Customer expectations rely on a fast and painless digital banking experience and expects incumbents to offer something similar.**

Most banks, instead, are not prepared to meet these expectations from the moment that they are still strictly linked to the traditional concept of banking, characterised by the presence of a **huge amount of branches, inflexible opening times and paper documents**. These factors, together with a **stringent regulatory framework**, which continues to pile pressure on, to ensure that banks develop sufficient protection to prevent further financial collapses and; **poor data management systems**; hamper financial institutions to quickly respond to consumer needs. All of this, results in an **increase of costs of infrastructures, loss of efficiency and lack of the opportunities** for banks to invest in technology and customer experience.

On the contrary, Fintech challengers (and in particular Alternative Finance solutions) provide everything banks are not able to offer, becoming more agile in efficiently responding to customer expectations. Indeed, they have built a business based on a **total digitalisation** that allows non-bank players to dismiss the physical presence of infrastructures and paper documentation and; the possibility for customers to access their capitals and financial transactions **24x7 wherever they are**, in a context whereby payment system has lost its physicality. Furthermore, Fintech companies rely on **technological advanced data-driven approach** that permits to gather a significant amount of personal data, such as level of education, current and previous jobs, living situations, hobbies and interests (etc.), different from those accessed by banks, to better assess worthiness of clients.

To date, there almost 2,000 online platforms operating alternative banking solutions. The total amount of investments in Fintech is nearly \$23 billion and it is growing fast across the years, as well as the level of awareness associated with the Fintech companies.

This is the time where financial institutions have to choose how to approach this phenomenon: whether to compete or collaborate. If at the time where disrupting evolution was in its infancy, banks tended to move toward the competition approach, facing the risk to cannibalise their own products; now that the industry is maturing and becoming mainstream, the attitude of incumbents is changing too.

From this study, it emerges that the number of large financial institutions that are approaching alternative finance solutions in a collaborative way is increasing and a significant number of **integrating and strategic partnerships** between incumbents and challengers have been developed, resulting in a **win-to-win situation**.

Banks figured out the importance of being technological advanced and got aware that Fintech players are not their direct substitutes but can be their partners to enhance and accelerate the level of digitalization of banking sector.

Partnering means leverage each other strengths to create the best possible ecosystem, where banks get the opportunity to fill their gaps and reduce the risk of being marginalized within the sector. **Being proactive would allow banks to improve technical innovations, get the speed of responding to customer needs, expand credit, lower operating expenses and, finally, increase the level of creativity, so that they would become able to offer customers the experience they are looking for. These online processes reduce the loan-close cycle while improving accountability, transparency and efficiency. Furthermore, providing better customer experiences will also increase revenue and harden loyalty among the customer base.**

At the same time, developing integrating partnerships would give **Fintech companies the opportunity to get the features they need. In particular, what alternative finance solutions need is capitals** (since Regulation forbids the possibility to lend own money), **more liquidity, operating license and a good reputation to reach a broad range of customers.**

Based on the above evidences, questions about the future of banks and financial services are coming to light.

To date, it is difficult to state for sure what will be next because the phenomena of Fintech and Alternative Finance are still more recent and many countries are starting to experiencing them now. However, the results of the present study give an important contribution to fix what are

the future actions that should be taken to ensure the success of a new market that involves a collaboration between both, the sector of financial services and digitalized players.

From Fintech perspective, the analysis of the whole Regulation currently in force highlighted some weaknesses of the system, based on a non-homogeneous Regulatory Framework among European countries, most of which use their local legislation to regulate the development of the different forms of Alternative Finance. Furthermore, in other countries, like Italy, the study shows that there is still a poor regulatory structure for what it concerns certain type of financing solutions. All of this results in a lack of efficiency and opportunities to join from international capital flows and cross border activities that we have seen to be very limited.

Another relevant obstacle that emerged from this study is the level of awareness among customers about the existence of Alternative Finance players. Although, statistics show a big increase in the level of global investments, there are still potential customers (investors and borrowers) that are not aware about the potential of Fintech companies. By the contrary, there are even challenger banks that do not know about individuals and SMEs in troubles.

In order to solve these serious gaps, initiatives from local Governments and International Authorities are needed to sustain the development and success of such these new phenomena. In particular, for what it concerns the non-homogeneous Regulatory Framework, the effort of the European Commission to build a Capital Markets Union can be considered only a primary step that will surely bring some economic and financial opportunities.

For what about increasing the level of awareness among customers, whereas, a further institutional way to sustain growth and success of Alternative Finance models may rely on the effort of Governments to invests into promoting campaigns and the implementation of some programs, as in the case of the UK that implemented the “Referral Scheme for high street banks”.

From banks perspective, the primary actions to take rely on innovation. Those banking institutions that wish to survive in the future, will have to launch innovation campaigns and digitalization programs, through which it will be possible to reach the new customer targeting.

## **Appendix A - The impact of Basel III: the principal innovations introduced by the regulatory framework**

Basel III is a global comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector.

The global Financial Crisis revealed several deficiencies in the financial regulation, so that it became necessary to develop a new regulatory framework to compensate those lacks.

Basel III is intended to strengthen global bank capital requirements, built on the three pillars of Basel II and, liquidity rules with the goal of promoting a more resilient banking sector. The objective of the reforms is to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spill over from the financial sector to the real economy<sup>31</sup>.

The most important innovations introduced by Basel III refer to:

- **Increase the quality of Minimum Common Equity Capital:** the crisis demonstrated that credit losses and write-downs come out of retained earnings, which is part of banks' tangible common equity base. Furthermore, it revealed the inconsistency in the definition of capital's quality across jurisdictions and the lack of disclosure that would have enabled the market to fully assess and compare the quality of capital among institutions. In this context, Basel III increased the minimum Common Equity requirement from 2% to 4.5%, reached in 2015;
- **Add a Capital Conservation Buffer:** starting from January 2016, banks are required to hold an initial Capital Conservation Buffer of 0.625% that will reach a definitive 2.5% value (after the application of deductions) in 2019. This capital serves to ensure that banks maintain a buffer of capital that can be used to absorb losses and resist during periods of financial and economic stress. In this way, the total Common Equity requirements reaches 7% at the end;
- **Add an extensive countercyclical buffer:** a countercyclical buffer within a range of 0% – 2.5% of Common Equity or other fully loss absorbing capital will be implemented when authorities judge credit growth is resulting in an unacceptable build up of systematic risk;
- **Increase of Tier 1 Capital:** Tier 1 capital is the base capital which includes common

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<sup>31</sup> Basel Committee on Banking Supervision (December 2010, rev June 2011), *A global regulatory framework for more resilient banks and banking systems*, available online at <https://www.bis.org/publ/bcbs189.pdf>.

equity and other qualifying financial instruments based on stricter criteria. With the introduction of the new regulatory reform it has been increased from 4% to 6% in 2015;

- **Provide a non-risk-based leverage ratio:** it serves as a backstop to the risk-based measures. The minimum Tier 1 leverage ratio has been fixed to 3%, however any final adjustments would be carried out in the first half of 2017.
- Finally, the total capital requirement has remained at its previous level that reaches 10,5% by adding the 2,5% buffer.

**Figure 25** – Principal innovations introduced by Basel III

<b>Calibration of the Capital Framework</b>			
Capital requirements and buffers (all numbers in percent)			
	<b>Common Equity (after deductions)</b>	<b>Tier 1 Capital</b>	<b>Total Capital</b>
Minimum	4.5	6.0	8.0
Conservation buffer	2.5		
Minimum plus conservation buffer	7.0	8.5	10.5
Countercyclical buffer range*	0 – 2.5		

\* Common equity or other fully loss absorbing capital

Source - Basel Committee on Banking Supervision (September 12, 2010), Press release

**Appendix B** - Pursuant to the Section C of MiFID I Directive financial instruments are:

- (1) Transferable securities;
- (2) Money-market instruments;
- (3) Units in collective investment undertakings;
- (4) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash;
- (5) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event);
- (6) Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF;
- (7) Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in C.6 and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls;
- (8) Derivative instruments for the transfer of credit risk;
- (9) Financial contracts for differences;
- (10) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls.

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