The Perfect Financial Storm: Emerging Innovation in SME Alternative Finance

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Introduction

In one generation, the world has shifted much of its behavior onto technology enabled social platforms and networks. Academics have been focused on how this digital economy is changing relationships, communication and marketing. What isn't receiving enough attention is Finance 2.0 - the revolution in financial models being driven by innovation from outside the traditional banking and financial world.

Alternative Finance is the term used to describe socially driven models of cooperative financial activity that are not mediated by institutions. This includes peer-to-peer lending, consumer-to-business lending, crowdfunding, crowd finance, and even foreign currency exchanges and hedging done without traditional institutions. The global market for these services is still small - probably just under 10 billion USD in 2015 - but with growth rates being measured in 10-15% per month for some platforms, these models will evolve into substitutes for some forms of traditional finance and force changes in the behavior of banks and lending institutions.

These platforms hold particular promise for SMEs due to their lower transaction costs, speed of transactions, and favorable interest rates. It is not known how many SMEs are currently using the platforms - this is the subject of ongoing research - but the total volume of SME loans in the past 6 years in the US is greater than $1.5 billion. With this sector growing at more than 100% a year in the US, the potential disruption to small business lending could be significant.

Small businesses can now use online loan platforms to secure business loans and receive a decision in less time that it would take them to drive to a bank. Small businesses will soon be able to arrange lines of credit, trade invoices, secure loans, lease equipment, swap currency, and even hedge risk without ever engaging with or needing a bank or traditional lender.

Previous research into the effect of successful crowdfunding on SMEs has show both immediate and long-term effects from using alternative finance. Simply put, crowdfunding combines a marketing effort with a funding round and can lead to substantial media exposure, new employee or partner recruiting, and seems to affect the confidence and business plans of existing firms. Research also shows that non-equity crowdfunding success yields immediate increases in revenues (not including funds from the crowdfunding) of over 20%. Those firms who are successful also find themselves on the onramp to further funding - angel groups, VCs, and lending institutions pay close attention to crowdfunding and more than 28% of firms who had been successful at crowdfunding had closed a subsequent financing round within six months of their crowdfunding. For these firms to move from having no access to capital to having investors invite them to pitch literally transforms these businesses. With this increase in revenues the average firm hires 2.2 new employees - a statistic that has been found in more than one study. Alternative finance seems to be the most efficient way to accelerate SME growth and lead to job creation.

Alternative finance emerged in the UK, in part due to their highly monopolized banking system. It quickly spread to Europe and then to the US. There are now nearly 100 active alternative lending platforms and over 1,000 crowdfunding platforms worldwide with multiple platforms emerging each week. Governments have varied substantially in their reaction - from the passage of the JOBS Act in the US which allows for general solicitation of private investments -- and which will eventually allow equity crowdfunding from average consumers, to a fairly hands off approach in parts of Europe who treat this as merely a new form of cooperative firms.

The promise to disrupt traditional finance and spur innovation and job creation has not been lost on Europe and the UK. The British Government is considering legislation that will mandate that banks refer potential borrowers to alternative finance if the bank turns them down. The EU has launched several major projects studying alternative finance and will soon invest tens of millions in Euros to spur financial innovation and help small businesses. The countries with the longest history of watching alternative finance emerge see its potential and are literally investing in these platforms. They see the disruption about to occur and believe that alternative finance is key to economic growth.

These platforms - really emerging new markets - do carry risks. The business models assume rapid uptake by consumers willing to either invest in firms or lend these firms money. There is literally an insatiable demand from institutional investors to supply loans - but the retail side of the market is slowly evolving. There is also political risk inherent in the possibility that major banks and financial institutions will lobby for legislation that create excessive regulatory burdens for these new marketplaces and removes much of their financial advantage.

Lenders may not understand if these loans should be treated as cash accounts or bonds. There is almost no data about the expectations of lenders. As the markets mature, more and more institutional actors are entering it - by investing in the firms, securitizing loan portfolios, and by creating partnerships with these firms. The question remains how a multi-trillion dollar loan market and tens of billions of dollars early stage equity market will tolerate a massive threat to their business models. Alternative finance is like Uber or AirBNB - creating massive opportunity and rendering traditional models obsolete. The difference is that much of the “traditional” business models here are required by regulation - will these institutions claim unfair competition? Will the government want financial markets disintermediated?

The landscape of small business financing is changing. Today, for a startup in the US, especially one with a consumer-facing product, the first finance option being considered by many founders is crowdfunding. Angel networks and venture capital firms are starting dozens of syndicated investing networks and crowdfunding platforms, and the landscape of seed finance has been forever altered by crowd funding. These changes deserve focused attention, and carry with them significant changes in the way risks are shared and managed. This white paper, commissioned by the Markle Foundation, lays a foundation for discussing and debating the meaning of these changes.

The Perfect Storm

Alternative Finance emerged as a reaction to technological innovation in finance - mostly in the UK and Europe in 2006 and 2007, but the hyper-growth of the industry is due to a perfect storm -- a calamitous economic collapse coupled with dramatic changes in the use of technology by consumers, resulting in both the rise of the collaborative economy and what may well be the first generation that prefers entrepreneurship over employment.

For the first time since the 1930s, the economy of the United States came close to collapse in 2008 and 2009. The financial system literally stopped working, and without extraordinary interventions that will be debated for generations, the entire system could have collapsed. The Great Recession was caused by policies and practices of major banks, the Fed and the mortgage industry. However, its effects have mostly been felt by average consumers and small businesses.

The Great Recession resulted in widespread layoffs, business failures and historic levels of unemployment across the US. The cascading series of layoffs, business failures and mortgage defaults led to the collapse of dozens of banks and credit unions - mostly smaller community based institutions.

Even those businesses that survived entered a several year period of tepid to little growth. The SME sector was hit especially hard. Banks were forced to tighten credit requirements when existing businesses were most in need of access to credit. This tightening became a noose around the necks of many smaller firms who perished due to a lack of access to credit.

Governments worldwide have responded to these events by passing regulations that require banks to maintain large loss reserves, strengthen internal auditing and compliance procedures, and to do extra diligence on potential loans. All of these requirements have increased costs for banks and traditional lenders, and some banks are in the paradoxical position of having money they literally cannot loan due to the requirements they face. The lending costs are so high that the Chief Investment Officer of one of the world's largest banks recently told the author that they cannot absorb more than a 1% default in their lending portfolios - which results in overly restrictive lending.

With under-performing bonds, limited profit in the equity markets for average consumers, and little to no prospects for employment many older Americans are becoming entrepreneurs out of necessity. The American Association for Retired Persons reports that the second fastest segment of society starting businesses is now those persons 50-65 years old. Spouses and partners are forced to start part-time businesses in order to survive - giving new meaning to the term "lifestyle businesses."

Web 3.0

While the economy was on the brink of collapse, changes were happening at institutional, generational and structural levels in business models, technology, and expectations for employment. We are entering the era of Web 3.0 - socially driven innovation and business models.

The good news for entrepreneurs is that the cost of starting a business is incredibly low due to change in technology. Hardware and storage are cheap, business services can be outsourced or web-based, officing can be in co-working space - essentially a whole new model has emerged that allows startups to launch their firm for thousands or tens-of-thousands of dollars, rather than hundreds of thousands or more. Elance-Odesk predicts that by 2020, 50% of the American workforce will be working independently - powered by technology and social technology, but without the infrastructure and “protection” of working in a large firm.

We have also seen a wide-spread adoption of web-based financial transactions. People now trust banks, merchants and payment gateways like PayPal with their personal information and to conduct transactions. While e-commerce only represents 6% of sales, it has fundamentally altered the way products are sought, sold and sent. It is inevitable that these same consumers will want financial services and investment opportunities through the web.

Generational Shifts

Our most current generation in the workforce, the Millennials - are altering the workplace and have a radically different set of attitudes and expectations about work and employment. They may be the first generation in America to mediate nearly all aspects of their lives through the web. They are in the market as consumers, small business owners and social innovators. Their attitudes in some ways predict the shape of finance to come.

Millennials show a strong preference for self-employment. This is a factor of limited hiring by firms, economic uncertainty, and also a desire for meaning and impact in their lives. Many recent college graduates are starting firms because they either cannot find a job or fundamentally don’t believe that taking a job leads to economic security. They are seeking and demand access to startup capital and engage in forms of collaboration to finance their enterprises.

They represent the first generation in America that fundamentally distrusts institutions. They prefer to do their banking online and many of them have no relationship with a telephone company, printed media or traditional banks. Their entire communication, media and financial lives are mediated through the web and social networking. They trust each other (through the social web) more than they trust institutions.

All of these factors are creating intense pressure on banks and financial institutions to operate in a transparent and open manner. Millennials demand transparency. Most citizens want accountability and access to extensive information. Institutions are expected to expose information about their lending practices, investments, social impact and relationships to the local economy in ways that would have been unimaginable 10 years ago. As Millennials age into management, and as the financial world continues to move to a web-based model, transparent business practices will be a requirement for staying in business.

Instant Gratification

Another social change is the demand for nearly instant information. Alternative finance is capitalizing on this by providing fully transparent marketplaces for loans and investments. Lenders often provide decisions in 7-15 minutes. The traditional loan review, loan committee and underwriting model will not survive in its current form due to pressure from borrowers for finance occurring in web-time, not banking time.

Alternative Financial Models

Alternative Finance models have emerged across the world offering services as diverse as financing housing developments in Bogata, to shared investments in race horses in France, to invoice trading in the UK, to financing student loans in the US. For the typical US SME, there are four forms of alternative finance that may help these business owners. Each is briefly introduced and then implications for SME finance are discussed below.

Many business owners are saddled with personal debt, credit card debt and are financing their operations with cash from savings and debt. Given the risky nature of entrepreneurship, many of these owners have moderate credit scores and have a difficult time securing credit. For those that have good credit scores and a high credit card balance, using Peer-to-Peer lending sites such as Prosper and LendingClub to refinance existing debt may help reduce their interest payments. This form of alternative finance is best described as online consumer finance.

Peer-to-business lending is also known as marketplace lending. This involves making small business loans or securing a line of credit through an online marketplace. OnDeck and Kabbage are the best known in the US and have made over $1.3 billion in loans. Prosper and LendingClub allow small business owners to take out personal loans for their businesses, although this form of finance represents only about 3% of total activity on these platforms.

Perks or reward based crowdfunding is what most people consider crowdfunding. Starting in 2008 here in the US, this model allows almost anyone to raise money for a project or to pre-sell inventory. Approximately $57,000 is given to individuals or organizations each hour in the world. The US market is about $600 million and growing at least 120% in 2014. Startups can use these models to sell inventory to customers before it is manufactured.

Equity crowdfunding represents the public sale of a private stock through an online platform. In the US only accredited investors can currently invest in firms through crowdfunding, though the SEC is soon to issue rules allowing for firms to raise investments from average citizens. Since becoming law on September 23, 2013 76% of the firms raising investments through equity crowdfunding are existing SMEs who are using this as an alternative to a typical private placement or securing funds from Angel investors.

Emerging Marketplaces

The main disruption in alternative finance is the creation of new markets. These firms are not just innovating around the edges of traditional banking and investing - they have created a new marketplace with radical transparency - essentially an online auction or marketplace where latent demand and supply for small business capital can meet. Bill Gates famously quipped in 1994 that banking is needed, but banks are not, and several thought leaders including Charles Moldow of Foundation Capital believe these alternative markets are the end of traditional banking.

Prosper and LendingClub have already made over $4 billion in loans to consumers. In May of 2013 Prosper made just over $5 million in loans. In May of 2014 Prosper issued $98 million in loans. They predict that they will be issuing over $125 million a month by September of 2014. This hypergrowth is occurring worldwide - leading some to call this the next tech bubble - but one occurring in finance. A more optimistic view is that these platforms have tapped into a demand for financial activity online with the speed, efficiency and transparency that only web-enabled finance can provide.

One indication of the seriousness of these markets is the entrance of well known Wall Street leaders into this space. Daric is a peer lending platform recently started by a Wells Fargo Executive. LendingClub and Prosper both have former senior executives of global top 5 banks on their boards. Some argue that these platforms are no-longer "peer lending" since the majority of the funds being loaned come from institutional sources. They may be more accurately described as institution-to-peer finance - with an online front end and an offline backend servicing the loans through existing institutions. If this trend continues, then we are seeing a move towards hybrid small business lending models where banks and institutions invest tranches of money into loan portfolios on these platforms without incurring the costs of direct underwriting.

Several community banks in the United States have stopped doing small business lending and are now sending SME clients to Prosper - and the bank then buys the loans back from Prosper once it is issued. Simply put, they can't comply with Dodd-Frank, the new stress test capital requirements and continue to profitably issue smaller loans.

There is early evidence that this competitive pressure is forcing some lenders to offer better terms and larger loans. An example is Fundation, a New York lender that offers loan products that compete with the rates of peer lenders but which receives its loans wholly from a partner investment group.

Dr Alicia Robb, Senior Fellow at the Kauffman Foundation, has analyzed this market and sees the first wave of disruption being the innovative use of social media metrics and online interactions to assess the health of a business. This is a radical departure. Lending decisions made in large part of non-financial data. Lending based on a firms or individuals social identify and interactions. Lending based on customer reviews of a businesses. None of this would pass a traditional lending committee.

These firms believe that FICO and Dunn and Bradstreet rankings have far less information value than they used to. Part of their efficiency is the ability to use social data to make nearly real time decisions about an applicant. Complex risk algorithms involving hundreds of data points analyze a wealth of information about a company and make underwriting decisions in a few minutes. Based on loan performance data, it appears that this socially driven underwriting is at least as effective as traditional means.

OnDeck has given out more than $1 billion in loans to small businesses. These range from $5,000 to $250,000 with an average term of under one year. Part of the innovation in their model is that through ACH technology they automatically take payments from the small business on a daily basis. Their terms of service and technology allow them anytime access to business banking balances - a radically transparent model. Businesses use these services primarily due to their speed advantage.

Kabbage uses unconventional data from firms - specifically targeting online merchants where there is a wealth of analytic data - and uses metrics like shipping data to determine loan or line of credit limits. Their software monitors online sales and shipping to assess the health of the business - not historical financial performance data.

CAN Capital is a hybrid between direct lenders and peer lenders. In operation since 1998, it has given out more than $4 billion in loans or merchant cash advances. It does have physical offices but leverages web-based applications and scoring mechanisms. Its core is providing working capital to existing businesses based on cash flows, not credit scores.

Via Media

Via Media means the middle road and is an apt description for the next stage of development in alternative markets that came with the development of true term loans driven by highly innovative technology. These firms provide an alternative to banks who prefer stable and highly creditworthy firms, and the cash advance/pay day lenders that target subprime borrowers. Banks also prefer to lend more than $1 million dollars to small businesses in order to justify their costs.

FundingCircle started in the UK and has now expanded to US operations. It offers small business loans up to $500K. Part of their innovation is that they have made arrangements with a number of franschise companies including Blimpie, ColdStone Creamery, Dickeys BBQ, Johnny Rockets, and others. The ability of a potential franchisee to secure financing within one business day is a significant advantage to the franchisor.

DealStruck takes the underwriting process and makes the decision criteria transparent. Potential borrowers see which factors are affecting the loan decision and also the rate of the loan. It also allows users to customize a loan product online in real time though selecting term, rate, and other factors. It is essentially on-demand customizable small business lending. Its rates can be high - and it offers both secured, asset backed and term loans. Its Asset Backed Lending is essentially a line of credit against accounts receivable and the loan is adjusted weekly basis depending on new accounts receivable coming into the business.

Models are also emerging to intermediate a web-based platform between the lender and the bank - similar to a Kayak for small business lending. Boefly is the best example of this model which allows small businesses to connect with its lender base of 3600 lending institutions. Institutional lenders and loan buyers can access a portal 24/7 with constantly updated loans - basically an ecommerce portal for loan buyers. Community banks can resell their loans on this platform - essentially creating a non-securitized secondary market for small business loans. To date, $3.76 billion US has been transacted through this platform.

Alternative Sources of Equity Investing

Early stage firms have two paths to raising capital in the US using alternative finance. The first is using tradition 506(d) private placements, but where the deals are screened and presented to potential investors through a closed platform. The recent JOBS act also allows the use of equity crowdfunding to accredited investors using the new 506(b) registrations.

The best known and most active online equity platform is AngelList. It has helped more than 2,000 firms raise money and is the first stop for many startups seeking angel investing. It essentially creates a marketplace for accredited investors to find companies. In 2014 they added a syndication feature allowing investors to follow the investments of well-known investors who are active on the platform. In an average month, approximately $10 million is raised for startups on this platform - and much of that is funding to companies in Silicon Valley.

CircleUp is a great example of a highly verticalized platform. It only focuses on firms in the consumer products space and it rejects well over 99% of applicants. They do traditional 506(d) deals and every investor is listed on the cap table. What is unusual about this model is that it allows accredited investors to make very small investments - sometimes as little as $5,000 - into a carefully screened firm. Their due diligence processes are so efficient that other platforms are now subcontracting due diligence to CircleUp.

Another mechanism for early stage fund raising is FundersClub - portal that only allows Accredited Investors to participate in funding startups through convertible notes. Based on the structure of these notes, investors can put in as little as $2,500 to a deal. By allowing both diversification and co-investing with major venture capital firms like First Round Capital, Sequoia Capital, Andreessen Horowitz, Y Combinator, Spark Capital, Union Square Ventures, DFJ, Intel Capital, and 500 Startups, the platform provides access to early stage deals that are usually reserved for high-net worth venture capitalists, and provides less risk to investors.

Title II of the JOBS Act creates a new asset class and registration option - a 506(b) offering, a private stock publically offered to accredited investors. In practice there is little observable difference in the function of the older 506(d) websites and the new 506(b) sites. The key difference is that the new provisions allow for general solicitation of investors. Example platforms are WeFunder and Crowdfunder, though literally dozens will enter the market soon. WeFunder's current model allows investment of as little as $100 in a company.

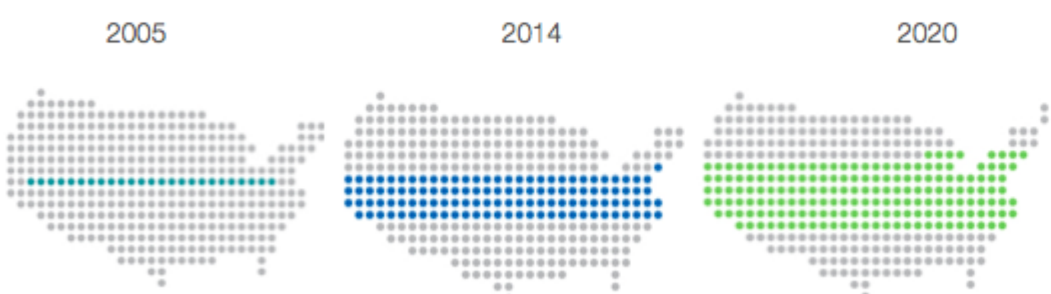
Why Alternative Finance Matters to Small Business

Does Alternative Finance Matter to SMEs? This is the question being asked by regulators and policy makers worldwide. In this section we will consider the potential for alternative finance - and why governments with more experience with alternative finance are supporting it with policy, regulation and direct investment. New technologies are changing the game of small business finance, and governments essentially need to get out of the way and allow the disruption to occur.

The Coming Generation of Self-Employment

Small businesses are America's job creators - creating 2 out of 3 new jobs in the past 15 years. They contribute about half of both private sector payroll and GDP.

According to data from Elance-Odesk, in 2005 only 7% of the American workforce was independent or self-employed. By 2013 that number has grown to 33% of the workforce, and estimates are that by 2020 - 50% of all American workers will be independent.



Of the 28 million Small Businesses in the US, only 5.7 million are employers - showing the huge amount of independent or microenterprises in the US. This drive to self-employment is due to several factors - the impact of new technologies, the entrance of 50+ former employees into self-employment, the fact that small businesses were the hardest hit by the great recession and have been slow to rehire, and other factors.

The Decline in Entrepreneurship and Lending

More troubling, according to data from the Brookings Institution, the rate of entry of new firms into the US market has been steadily declining for nearly the past 40 years, but since 2006 the number of firms exiting the market has surpassed the number of firms entering the market - meaning the the engine of job creation is getting smaller with each passing year. Despite the belief that the US is an entrepreneurial powerhouse, the actual data shows fewer and fewer firms being created.

Unlike larger companies, small firms are heavily dependent on bank credit lines to maintain cash flow - and lack of cash flow is one of the main causes of small business failure. The private equity markets and debt capital markets are not really open to small firms - these firms have historically been dependent on bank loans, with some researchers citing figures as high as 60% of all small business depend on access to bank loans for survival.

Yet, according to the Small Business Credit Survey taken in the spring of 2013 by the Federal Reserve, only 17% of small business felt that they had sufficient financing. In this survey, 43% were re-applying for credit in 2013 because they had been turned down for credit or received only partial funding. In a Dun and Bradstreet survey from 2013, 75% of small businesses believed it is "difficult to raise new business financing"

While banks may claim to be actively making small business loans, the percentage of small business loans as a percentage of bank loan portfolios has been in steady decline since the 1980s. More than 20% of those small business who start to apply for a bank loan are so discouraged by the process that they simply quit before they have a chance to be rejected by the bank. In this same Federal Reserve study 42% of respondents stated that due to their lack of credit they could not expand their business and 16% could not hire new employees.

How the Game Is Changing

Banking is the last major consumer industry that is yet to be digitized and transformed by technology empowering consumers. From ecommerce, to travel sites, to real estate and payment solutions, established business models have been forever transformed by technology. Consumer expect access to a wide-range of products, on-demand, with robust search features. They want 24/7/365 access. Alternative finance lending companies are responding to this pent-up demand and are experiencing triple digit yearly growth.

Alternative lending is poised to succeed because they can and will lend to small businesses. They rely on alternative data including balance sheets, cash flows, order history, web and social data to allow them to be better at understanding the creditworthiness of small businesses than traditional bank underwriting. This allows them to lend to "riskier" firms than a bank will lend to.

The level of technological innovation is astounding - some firms tap into their customer's online quickbooks accounts on a daily or hourly basis - literally measuring the health of their business in real time. They aggregate data from dozens of sources including census data, big data providers, CRM systems, social metrics, and others. Their algorithms are more powerful than traditional business models of risk - which have not really changed in decades despite the explosion of new data sources available to lenders.

The current regulatory environment, coupled with stress test imposed capital reserves, Dodd-Frank and other issues cause banks to be slow to innovate, conservative to lend, and frankly unable to keep up with technology, let alone changes in social behavior and networking. The alternative lending market is essentially the consumer PC maker starting to take on established mainframe computer companies - threatening not only their business models, but the reason for their existence.

How Small Businesses Can Use Alternative Finance

Perks Based Crowdfunding: SMEs can use rewards crowdfunding for market validation, to attract investor interest and as an onramp for later equity or debt raises. Early research data shows that it can also lead to increased chances of later bank financing. For many just launching firms, crowdfunding will be the onramp to future funding.

Equity Crowdfunding: Both existing and soon to launch equity based crowdfunding can reduce search costs for firms seeking first financing rounds. By bring the deal flow online, they are starting to disrupt the 150 mile rule of most Angel investors - meaning that investors can come from outside their limited geographical region. Think of these models as Cloud Based Angel Investing.

Debt Platforms: For existing firms with data to share with providers, debt based alternative finance can evolve into a form of on-demand loans or lines of credit. SMEs will be able to tap these models for the relatively small amounts of debt they typically raise when faced with liquidity and cash flow problems. Too often banks take so long to make credit decisions that small cash flow challenges evolve into business ending liquidity crises. These can function as nearly instant debt finance vehicles, even for firms with limited to no collateral that are unable to secure traditional finance.

The Promise and the Peril

For the promise of alternative finance to make a significant impact on small businesses, a number of challenges have to be faced and potential landmines avoided. These are briefly summarized below:

- Markets need Customers: There is very limited awareness of alternative finance - the first challenge is educating consumers, small businesses and potential lenders that this new market exists.

- Keep Markets Pure: With the influx of massive amounts of debt capital from institutional actors, the marketplace lenders are struggling to maintain their peer-to-peer focus and ensure that they provide value to both lenders and borrowers. The pressure from this multi-billion dollar pool of available debt capital may radically transform these markets.

- Meeting Market Demand: LendingClub, Prosper and other peer lenders are expanding their small business models, but so far offer a maximum of $35,000 loans. OnDeck and other balance sheet providers are growing rapidly, but the majority of the growth is coming from the "peer" lenders, who cap small business lending. Will they be able to maintain their profitability and extremely low default rates if they increase SME lending?

- Market Transforming New Players: Given the wealth of data available to companies like Amazon, eBay, Facebook and PayPal, it is highly likely that many established social networks, e-commerce providers and payment gateways will enter this market. The industry quips that you need "about a billion" in loan revenues to be profitable, but with the hypergrowth in the markets, established players will start to see a real opportunity and pivot or spin off a fintech company to meet these demands.

- Keeping Interest Rates Low: While a point of contention for some in the industry, it is generally believed that these platforms have flourished due to the low yield in cash and money market accounts. Will growth continue as yield increase?

- Securitization: Market forces will create securitization of loan portfolios by the alternative lenders. How will this affect lending decisions? How might it affect risk and the willingness of regulators to allow growth?

- Killing the Angels: Law requires that the Securities and Exchange Commission re-evaluate the definition of an accredited investor every five years. There is discussion at the SEC of dramatically increasing income requirements to be considered an accredited investor. This policy decision would immediately eliminate the majority of investors supplying risk and early stage capital in the United States and would have dire consequences for our economy.

- Crowdfunding's Three F's: There are three risks to the growth of crowdfunding that may impair the market's growth.

- First, the fact that most small businesses fail. Will investors understand that equity crowdfunding is high risk investing in a volatile part of the economy? How will the media react of the coming slew of predictable business failures?
- When rewards crowdfunding works, products have to be manufactured, shipped, and there are a host of possible problems with fulfillment. Since many firms using crowdfunding are new firms, they often lack processes, systems, experience and sometimes essential business sense that causes significant delays in fulfillment.
- Then there is the risk of fraud. To date, globally, there has not been a single documented instance of equity crowdfunding fraud. There have been several campaigns pulled from platforms when potential backers started asking the right questions. There will be fraud in this financial market, as there is in every other financial market. However, the consumer protection lobby in the United States has mounted an outsized and highly effective campaign to convince the SEC and Congress that crowdfunding will be rife with fraud, despite the fact that most fraud relies on secrecy, time pressure, claims of inside information and other forms of psychological manipulation that are between extremely difficult to impossible to carry out in an open transparent platform.

Summary

This brief white paper has shown that the US economy relies on access to small business capital for its growth, yet that lifeline is being choked off by regulation, policy and macroeconomic conditions. Entrepreneurship itself is dwindling in the US at the same time as generational and technological shifts are increasing social support for entrepreneurship and lowering costs for launching firms.

Despite a robust ecosystem of support, the one tangible factor that no meetup, co-working space or mentor can fix is access to small business capital - when it is needed by the firm. Traditional small business lending is too restrictive, too slow, and too cumbersome. The financial markets are about to be transformed by web enabled new marketplaces for debt and equity products. Small business owners will start to gravitate to these new markets as awareness grows and as they realize that non-traditional sources of data drive decisions, not just available collateral and FICO scores.

Large institutions will not take this disruption without mounting a regulatory battle. To say that alternative finance will be chaotic will be an understatement - between mergers, lawsuits, technological innovations and regulatory pressures, this emerging market will itself be disrupted. Ongoing research is attempting to understand where alternative finance can best serve SMEs. As these markets evolve, and data becomes available, it is hoped policy can be fashioned to allow the Kayak and Amazon of small business finance to emerge and empower millions of SMEs across the US.

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