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Opportunity or Threat? The Views of Bankers Towards Crowdfunding

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Abstract. Crowdfunding has emerged as an innovative source of finance for start-ups and small and medium sized enterprises. This paper considers the views of the most important source of small business finance, retail banks, on crowdfunding. The paper identifies four key themes which emerged from interviews with respondents with experience as senior bank employees in the UK and Ireland. Firstly, firms which sought crowdfunded finance were seen as being too risky for traditional bank lending. Second, the respondents did not see crowdfunding as a threat to the business banking sector. Third, the respondents felt that banks provided a wide range of advice and services which protected them from innovations such as crowdfunding. Finally, crowdfunding was seen as a potential complementary product that could be suggested to firms as it would fund risky propositions that the banks would not support. The paper then offers some practical implications before it concludes.

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1. Introduction

Crowdfunding, whereby a collection of individuals, known as “the crowd”, each provide a small amount of funding to meet an organisation’s funding needs has become part of the alternative finance landscape. In turn it has formed a key part of the sharing economy alongside the well-known ridesharing and accommodation services offered by the likes of Uber and Airbnb.

With crowdfunding after registration a request for funding is made on a website along with relevant information on the project and its team. The crowdfunding website provides information about the campaign and its owners and enables individuals to pledge funding. The usual model of crowdfunding is an all or nothing model (though there is an alternative keep-it-all model) meaning that at least the full amount requested has to be raised to get the funds. The argument for this is that a business proposition has been made with funding requirements and if the total funds are not raised then the project would not be able to succeed (Macht and Weatherston 2014).

There are different types of crowdfunding, which include:

- Reward based, often termed pre-ordering, whereby the crowd pay upfront for a product which is yet to be developed in the expectation that they will receive the product. The most well known example is Kickstarter.

- Equity based crowdfunding involves the crowd in the role of an investor (Belleflamme et al. 2014) receiving a stake in the company, or bond like shares after an open call is made on an online platform (Ahlers et al. 2015) with UK examples being Crowdcube and Seedrs and elsewhere, Angelcrunch in China and ASSOB in Australia. Equity based crowdfunding is subject to more control than the other forms noted here and is only open to registered companies.

- Donation based, whereby money is given by the crowd to a charity or to help someone in need (for example, to repatriate someone overseas without travel insurance).

- Peer-to-peer (P2P) lending whereby individuals contribute relatively small amounts to loans, to spread the risk, with an example being Funding Circle, which operates in the UK, Germany, Netherlands and the United States. Peer-to-peer is not accepted in all definitions of crowdfunding as Mollick (2014) discusses.

Crowdfunding has seen significant growth and is seen as offering new opportunities by connecting entrepreneurs with the crowd – the latter have access

to investment opportunities and the former a new source of finance in addition to traditional sources of finance such as bank loans and venture capital/angel investment (Belleflame et al. 2014). Crowdfunding has been presented as a solution to the funding problems which face SMEs and were exacerbated by the economic turbulence from the credit crunch of 2009 and the current Covid-19 pandemic.

Research by the Cambridge Centre for Alternative Finance (2020) estimated the global value of reward based crowdfunding in 2018 to be $877 million, with equity based crowdfunding raising $1515 million whilst peer-to-peer business lending had a value of $50 billion, mainly due to the huge Chinese market which accounted for $42 billion of that.

However, crowdfunding has seen its share of controversy with the UK Financial Times reporting in February 2016 that Rebus, a start-up which had raised over £800,000 on Crowdcube had become the largest crowdfunding failure at that time (Palin and Williams 2016). The same article also cited research which stated that 20% of firms which had raised money through equity crowdfunding had since gone bankrupt but made the (realistic) point that failure was part of the start-up process and also that this failure rate was lower than the UK average for start-ups.

This paper specifically considers the threat that crowdfunding poses to the funding of small businesses by the banking sector, the predominant source of funding for SMEs (small and medium sized enterprises). It looks at the views of bankers towards crowdfunding, whether they see this innovation as a threat to business banking and it also considers the opportunities that crowdfunding may offer to the small business banking sector. It does this through interviews with respondents with experience as senior bankers based in the United Kingdom and Ireland and so focuses on the perspective of the lenders. The structure is as follows. Firstly, the literature on SME funding gaps and the bank sector is covered. The role of crowdfunding for SME financing is then considered. The methodology is then presented, followed by the findings. Finally, the paper then discusses the findings before it concludes.

2. SME Funding Gaps

SMEs have been identified by academics and policymakers as crucial for economic growth (Audretsch and Thurik 2001; Durkin et al. 2013). The UK Competition and Markets Authority reported that "*SMEs are extremely important to the UK economy. They employ around two-thirds of the private sector workforce and produce just under half of all UK private sector turnover*" (Competition and Markets Authority 2016, p. 258). However, it has been widely noted by academics, trade associations and policymakers that the funding needs of the SME sector are problematic.

Bank finance is the primary source of external finance for SMEs in the UK, with 28% of SMEs having an overdraft and 11% a bank loan in the previous year (Department for Business, Innovation and Skills 2012). Fraser et al. (2015) argued that the problem of a funding gap for SMEs has long been a concern of the UK government, noting initiatives going back to the MacMillan Committee (1931) and the Bolton Committee (1971). They point out that the British Business Bank, which was launched in 2014, was an effort to increase the supply of funding to SMEs in the context of the credit crunch. Information asymmetry is central to this problem as many SMEs, in particular the youngest firms, lack a track record of trading, meaning that banks, and other providers of finance, either do not supply funds, or charge higher rates and/or demand harsher terms.

UK government investigations into the UK SME banking market have continued with the most recent review being launched in 2014 by the Competition and Markets Authority which included within its remit bank lending to SMEs. This followed previous enquiries which included the Cruickshank report in 2000, the Independent Commission on Banking, known as the Vicker's review in 2011 and the Parliamentary Commission on Banking Standards (PCBS) in 2012 and 2013. The report which followed from the Competition and Markets Authority (2016) noted that whilst the UK had seen the entry of new competition into the SME banking market, such as Aldermore in 2009 and Metro in 2010 - known as challenger banks - SMEs faced a number of problems. The Competition and Markets Authority report which was published in 2016 noted that the business current account market was highly concentrated with the big 4 providers accounting for 80% of the market, with the same providers controlling about the same percentage of the SME loan market. SMEs tended to approach their current account provider for loans, finding it hard to access bank loans from elsewhere, as another bank lacks the same level of information on them making it difficult to accurately price in risk. 90% approached their current account provider for loans, with the majority also going for invoice discounting and commercial mortgages, thus limiting choice and competition. The report concluded that the reasons for this apparent inertia were the relationships with the bank, "time, effort and convenience" and "barriers to searching".

Fraser et al. (2015) found that rejection rates for bank loans increased hugely after the financial crisis with a 163% increase in rejection rates after controlling for changes in credit risk. Durkin et al. (2013), in a study of entrepreneurs seeking bank loans, found that banks had become far more risk averse since the financial crash, imposing more bureaucratic controls which lengthened the decision-making process. The characteristics Han et al. (2009) notes as being associated with higher loan rejection rates, riskier, smaller firms, with shorter banking relationships, are all interconnected. Although Han's research was based on US data its findings are consistent with Cowling et al. (2012) using UK data as they found "*During a recession lending institutions appear to use firm size as their primary lending criterion, with micro-business in particular being restricted in its*

access to capital" (Cowling et al. p. 794). Lee et al. (2015) found that the credit crunch had increased the likelihood of innovative firms failing in loan applications. Rostamkalaei and Freel (2017) find that high growth firms and small firms who intend to grow through new product lines pay more for credit which they interpret as an outcome of these firms both being seen as higher risk.

The concept of the discouraged borrower, used in the Han et al. (2009) paper cited earlier, has become significant in understanding SME financing issues. It was defined by Kon and Storey (2003, p. 37) as "*application costs mean that a good borrower may not apply for a loan to a bank, because they feel they will be rejected*". The discouraged borrower exists under conditions of imperfect information. Freel et al. (2012) argue that rejection rates for loan applications are not high, it is more a case of firms being discouraged due to a fear of rejection. Those discouraged tended to be smaller, younger firms who were on a growth trajectory. Mac an Bhaird et al. (2016), have similar findings in their study of European states drawing the conclusion that younger, smaller firms with lower reserves were less likely to apply for bank loans, with the older firms benefiting from their closer relationships with banks and being more likely to apply for finance.

3. The Benefits of Crowdfunding for SMEs

Schwienbacher and Larralde (2010) outlined the ability to access finance as a benefit of crowdfunding for entrepreneurs, which is supported in many other studies. One such paper, Eldridge et al. (2019), identifies crowdfunding as having grown in importance since the credit crunch. Agrawal et al. (2014) note that such finance may be available at a lower rate than traditional means, for example, bank finance. In addition Macht and Weatherston (2014) and Lukkarinen et al. (2016) identify crowdfunding as filling the funding gap until venture capital funding becomes more appropriate. Macht and Weatherston (2014) also argue that crowdfunding lowers search costs to find potential investors and widens the pool of potential funders. In terms of a wider pool of investors, Kaminski et al. (2019) find evidence that successful crowdfunding enables access to venture capital investment. Macht and Weatherston (2014) also make the point that crowdfunding offers finance with either no loss of ownership with reward based crowdfunding, or giving up a limited stake with equity based crowdfunding. Furthermore, investment from the crowd means that there will not be a large investor or a group of investors able to exercise control over the firm.

Reward based crowdfunding can also be used as a form of market research and can lower information asymmetry. If customers are prepared to pre-order the product this shows there is demand for a product, and such a process can also generate feedback from potential customers (Agrawal et al. 2014) and can be seen as community building. Equity based crowdfunding can also be seen as a way to

test the interest of the crowd and to find out whether there are a core of investors who believe that the idea being presented is credible. De Luca et al. (2019) describe reward based crowdfunding in this way as a viability test that can lower risk for entrepreneurs as they have not used debt finance to develop a product for which there is uncertain demand. De Luca et al. (2019) also use the term validation, which has been used by many researchers looking at crowdfunding (e.g. Paschen 2017), which describes the process of showing that there is a market for the firm and that there is demand for the specific product within this market.

In addition crowdfunding enables awareness to be generated for firms which take part (Ordanini et al. 2011). Stanko and Henard (2017) argue that backers acquired through reward based crowdfunding are a preliminary category of innovation adaptors as they are buying products which are not yet available. The authors see these backers are highly valuable due to their ability to spread positive word of mouth within their networks of "potential later product adopters". With regard to equity based crowdfunding Wald et al. (2019) find that equity based crowdfunding brings external and internal benefits. The external benefits are increased public exposure and more investors whilst the internal benefits are the skills and knowledge that the investors are able to offer.

Crowdfunding can also provide a vehicle for the commonly used friends and family funding for new business ventures. North et al. (2013) discover that young technology based small firms, which often describe firms looking to crowdfunding, rely far more heavily on friends and family funding than more established firms. Agrawal et al. (2014) state that crowdfunding makes it easier to raise funds from friends and family by providing a formal structure. Such funding can then be used to gain the awareness noted above as the funding is on an openly viewable platform. Friends and family funding through crowdfunding can also attract further funding as it can be seen to be a signal of quality and also provide the momentum, herd effect, that successful crowdfunding requires.

4. Research Methods

As crowdfunding and its impact on bank financing is not an established research area a qualitative approach was adopted following the advice of Miles and Huberman (1994). Interviews were used to explore the boundaries of the subject instead of confirming existing research through quantitative methods. The source of the data for the research was interviews which can provide rich information (Yin 1994).

Interviews were conducted with respondents who have had experience as senior bankers with large retail banks involved in small business lending in the United Kingdom and Ireland as part of a wider study on crowdfunding and small business funding. One of those interviewed was an ex-banker who now managed a P2P organisation which provided unique insights to these two different markets.

In total 5 interviews were used for this current paper and so the work does not claim to be generalisable. Participants were recruited through professional banking associations in the UK and Ireland, the personal contacts of the researchers and also through referral. Therefore, there was no theoretical basis for the sample which is acknowledged as a limitation.

The interviews were conducted through a combination of face to face (pre-Covid) and telephone interviews. Interviews were semi-structured in nature starting off with general questions about the role of the participant and then moved onto their views on crowdfunding. Interviews lasted 60-90 minutes and were recorded and then transcribed with the permission of the respondents.

The respondents can be summarised as follows in Table 1.

Table 1: Description of respondents

Respondent	**Location**	**Role**
Respondent 1	Belfast, Northern Ireland	Retail Bank Manager
Respondent 2	Armagh, Northern Ireland	Branch manager
Respondent 3	Dublin, Ireland	Branch Sales Manager - dealing in foreign exchange.
Respondent 4	London, UK	Former bank employee - now manages a P2P lending organisation
Respondent 5	London/West-Midlands, UK	Area Director for Business and Commercial Banking

The interviews were analysed using template analysis. This is a method of qualitative analysis commonly used in business and management research and seen as suitable when interviews are being analysed (Brooks et al. 2012). Template analysis focuses on identifying themes present in text and makes use of hierarchical codes. A coding template is developed based on a sample of the data and then used on the full data set. A priori codes can be used at the outset, based on existing literature, though this is an optional approach to the use of this method.

Three of the interviews were coded first of all, with discussion to clarify differences of opinion. This led to an agreed template which was then used to analyse all of the interviews, with later differences again resolved through discussion.

5. Findings

The findings from the interviews are expressed as the following themes.

5.1. Risk Levels of Typical Crowdfunded Business Were too High for Business Lending

The respondents all believed that crowdfunded firms did not match the profile of the firms banks would lend to. Whilst the current bank employees stressed that banks would lend to small businesses, all the respondents were of the view that firms which aimed to get crowdfunding were too high risk and lacked the trading history and evidence that was looked for.
In the words of Respondents 1 and 3.

> *I think it [crowdfunding] probably does help people who maybe can't get money the traditional route and maybe because they have bad credit or something like that, you know? Because I know it is something that we would look into, is your credit history. So they have a better chance with it and they can also get their money from a lot of different sources.* [Respondent 1]

> *Yeah well of course, some people might find it more beneficial and instead of going to a bank go to the likes of the open market to get finance instead of going to get money from the bank. It will probably be a lot easier to sell their product where with the bank you would have a strict process of trying to obtain credit.* [Respondent 3]

Respondent 4 identified a lack of knowledge around technology, which many crowdfunded firms specialise in, as a related barrier to small business funding.

> *But no one will put their name to anything which is why for start-ups now funding is really hard and also the tech world has meant that a lot of bank managers maybe don't even understand what they're funding.* [Respondent 4]

5.2. Crowdfunding Was Not Seen as a Threat to Small Business Banking

None of the respondents saw crowdfunding as a threat to banking at the present time. Whilst Respondent 1 felt this may have been because of their more traditional location, this perception of crowdfunding not being seen as a general threat was something which was stated by all respondents. However, Respondent 4, an ex-banker who now managed a P2P start-up believed P2P was a threat to part of the banking product range, though its lack of regulation made it problematic. The following quotes illustrate these views.

> *I think that because it is new that it's just not, people haven't taken as much notice. Especially in Northern Ireland, I think that it takes us a wee while. And you know I think in England that maybe in the mainland they would be more aware of these things.* [Respondent 1]

> *Well I've never had a customer come to us at this stage that has looked at it……It's not something that features at any of our internal management*

> *meetings or whatever, either there as a threat or an opportunity. So, you know, in the job that you are you tend to keep an interest in that type of thing, you know? I don't see it as a threat to the business.* [Respondent 2]

> *The reason why I don't see it as a competitor is that if, if a bank can do it [offer finance] then their customers are always going to do it 'cause the margins and costs is cheaper and not just, not just margin, not just slightly cheaper.* [Respondent 5]

> *What P2P does is, it's never going to take over banking, ever, like as a whole. But what it can do is do one part of banking really well……I think that's why it's taken off but it's the bandwagon that is the risk with P2P and the lack of control on protection that is available.* [Respondent 4].

5.3. Relationship Banking/Depth of Service Was Crucial for SMEs

The banking respondents emphasised the value they felt their banks offered their customers and the community, which was much wider than a transactional approach. This was seen as an advisory role concerning the whole life cycle of a business which enabled them to build relationships with their customers, which could not be easily disaggregated. This broader role was expressed by the following quotes.

> *We spend our time dealing with people. So knowing, I mean it's amazing when you're talking to someone starting up a business they don't know what they need, so they need to come to someone that would be able to give them, I suppose, what they will come across and what they will need at different points in time.* [Respondent 1]

> *Things that we do, do well are along the relationship side. That we are, we have a local management presence, that businesses know who their relationship manager is, where they are, how to get them and that if they walk into the branch that I am here for them, you know?* [Respondent 2]

> *So we would have advised them on what type of account to set up. So that's a sole trader, partnership, limited company, ok? A lot of the accounts wouldn't actually need funding to start off with but some then do require funding, ok? So then we would advise them on what they need to obtain, the likes of your business loan, credit cards, things like that.* [Respondent 3]

However, the outlier here was Respondent 4 who believed the nature of banking had changed, away from personal relationships towards a rules based approach.

> *You can't go to a branch manager anymore with a business plan and say, you know what my dad did where he was like, the bank manager has to take a punt.*

No one, if you go into a bank these days no one wants to put their name to anything. [Respondent 4]

5.4. Crowdfunding as a Potential Complementary Product for Small Banking Customers

Whilst the respondents did not see crowdfunding as a threat to small business banking they did identify the potential value of crowdfunding. Crowdfunding could fill the gap for riskier funding that the respondents felt banks were not able to provide.

In the words of respondents 2 and 5.

It should work as an asset because it should help businesses get to the stage that they need to be where we're able to help them. For the likes of the R&D type stuff where traditionally that's not an area that we fund, you know, we see it more as an equity risk to the business as opposed to a risk to ourselves. [Respondent 2]

Yeah so, there's some deals or some contracts that certainly appetite wise kind of fall out of remit……Yeah I mean specifically on P2P we would promote P2P funding for some of our customers as opposed to necessarily seeing it as a competitor. [Respondent 5]

Respondent 4, with their dual perspective as an ex-banker could see the value of broader crowdfunding including the reward based model and equity based crowdfunding.

I actually like crowdfunding from a start-up perspective I think it's great. So either you buy a gadget in advance or you say 'I'm taking a risk here from an equity stake'. I think that is very different, now I actually like because crowdfunding is providing a platform for start-ups which is so hard. [Respondent 4]

6. Discussion

The research confirms the work of Fraser et al. (2015) as the respondents were wary of lending to new firms which lacked banking relationships and a track record. The respondents believed that these were the types of firms which applied for crowdfunded finance rather than bank lending. The work is also consistent with the idea of the discouraged borrower, at least to some extent, as the current banking respondents here stressed that they were prepared to lend, albeit not to the types of firms which were looking for crowdfunding.

Crowdfunding was also seen here as a more expensive source of finance, which is contrary to the findings of Agrawal et al. (2014). The banking relationships identified by the Competition and Markets Authority (Competition

and Markets Authority 2016) were also seen as crucial in this research for the retention of business customers by the respondents interviewed. However, whilst banks emphasised the value of the services that they offer in this research other researchers have found that banks are seen as insensitive and lacking empathy with their customers (Durkin et al. 2013).

A positive aspect of the research was the identification of crowdfunding as an alternative source of funding for business customers, if the funding need was seen as either too high risk or not the type of proposal that the bank would be willing to fund. The research identified the role of banks in suggesting crowdfunding as an alternative source of finance. This can enable an increase in funding to risky SMEs and enable the economy to reap the benefits of the greater accessibility of more risk capital, as Audretsch and Thurik (2001, p. 305) argue that "*the availability of venture capital and informal capital varies substantially across countries, new ventures flourish where they have the easiest access to finance*".

At a practical level the main implication of the work is that banks, as well as policy makers, can help make their customers aware of crowdfunding, in terms of its availability and how it can either substitute bank funding, when such funding is not available, or as a complementary source of funding. Of course, the views of SMEs may be very different on the role of banks, as suggested by the differing perceptions on the relationships and services that banks offer, as noted in Durkin et al. (2013) above.

7. Conclusion

The paper has confirmed the risk averse views of bankers towards the types of firms which seek finance through crowdfunding. Connected to this point crowdfunding was not seen as a threat to bank lending as it was seen as different to what the banks would provide. Banks were still seen, unsurprisingly as this was mainly research with current bank employees, as providing a valued general service role, though the point was made that this has been questioned by SMEs in other research. Perhaps, the most interesting finding was the openness of the banks towards crowdfunding as a complementary product, though when this is seen through their cautious approach that is logical, as other parties are taking the risk and if the firm is successful the bank will then be prepared to offer finance when the uncertainty has been reduced.

Future research could focus on deepening the current research through a larger sample of interviews and a large scale survey to evaluate whether the themes identified in this research are generalisable. The views of other participants in this sphere of activity could also be considered; firms which are looking for finance, crowdfunding platforms, policymakers and other players in the funding environment.

In the post-Covid 19 environment, small firm funding is going to be even more important as governments aim to achieve growth, innovation and employment. It is also vital that the potentially positive relationships between crowdfunding and the banking sector are understood and made use of. Crowdfunding is now an established part of the alternative finance arena and it is crucial that it enables start-ups to emerge and then grow.

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