

# On the Possibility of Crowdfunding in Europe

Presented at the Austrian Ministry of Economy, Family and Youth to Michel Barnier, European Commissioner, Directorate General Internal Market

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## I. Intention of this Paper

We, the European crowdfunding industry as represented by the European Crowdfunding Network, wish to comment on the current debate on regulation in our role as the trade association of the European crowdfunding platforms. In particular, we seek to expound the perspective of the crowdfunding platforms in order to increase the practical relevance of the discussion. Moreover, we want to lay down the prerequisites without which crowdfunding cannot function in Europe. This paper is a reminder of key practical aspects, in order to help the European Commission consider any regarding crowdfunding in Europe.

In particular, our wish is to supplement the current debate with practical experience.

The European Crowdfunding Network has been vital to launch the political discussion on crowdfunding with the European Commission. As a open collaborator to public organisations we have provided detailed insights and research to the European Commission and many other European and national administrations since 2012. In order to create a positive discourse on the potential of crowdfunding and the necessary steps to ensure its potential in job creation, competitiveness and innovation, which are used to its full extend within and for the benefit of the European Union.

## II. Why Crowdfunding Is Urgently Needed in the EU

In this section we do not pursue the aim to cover every detail of crowdfunding. We deliberately limited it to the key aspects of the subject, also knowing that the European Commission and other bodies have already accumulated a respectable knowledge base on this topic.

### 1. Crowdfunding Is a Bridge to Traditional Sources of Financing

According to statistics, some 30% of Europe's 23 million SMEs face liquidity problems and only 30% of SMEs access bank credit at any given time. The availability of bank loans for SMEs has declined by 23% over recent years, while collateral requirements have increased by 34% and interest rates by 54%. Traditional methods of financing such as bank loans are often not available, factoring and other forms of finance do not focus on the majority of SMEs. And public funding is rarely a viable option either.

There is less and less capital available to SMEs and start-ups in particular in any business sector. Private investors in general do not fund non-profit initiatives and the lack of social venture capital and philanthropic funds in Europe is pronounced. Banks will not lend without revenue, assets and customers. The shrinking professional venture capital industry, which focuses nearly only on start-ups with established operations, and the difficulties of growing the business angel community to scale, many only act locally without sufficient capital to provide follow-up investments, call for urgent alternatives. In general, venture capital and

business angels only invest in less than 0.1% of all SMEs. Alternatives are necessary, especially in times of decreasing national budgets.

Therefore, crowdfunding constitutes a bridge to traditional sources of financing for many projects and start-ups. Both, in the social entrepreneurship and non-profit sector as well as in the for profit industries. It also smoothes income for the self-employed and micro-enterprises, a vital function in our economy. Following a successful crowdfunding round, many crowd-financed projects and start-ups have the opportunity to supplement their financing by borrowed capital because of the strengthened capital base.

## **2. Crowdfunding Is Social Engagement and "Entrepreneurship Live"**

In some parts of the world entrepreneurs enjoy a very high reputation. They are seen as change makers and drivers of society. This motivates the best university graduates and the best brains, for example in the US, to found their own companies. Not so in Europe: the best graduates start working for large companies, because entrepreneurship is almost irrelevant if not even discouraged in school and in university education. Entrepreneurs are also not valued by policy makers, who rather align with the interests of large corporations. Those that found companies are still plenty, but how much more competitive and successful would Europe be if they would also be appreciated and welcomed as the economic powerhouse they are?

Crowdfunding changes the public opinion of entrepreneurship. Investors in crowdfunding are both young and old. There is a wide range of investors depending on the type of crowdfunding and the sector. But especially for the many young investors, crowdfunding is the very first time they get in touch with entrepreneurship and start-ups. They learn about being an entrepreneur and an investor at the same time and that this may well be an attractive and realistic perspective for their lives. Crowdfunding is "entrepreneurship live."

## **3. Crowdfunding Combines Marketing, Market Test, creating a loyal customer base and Financing**

However, crowdfunding is much more than just a source of financing. Most importantly, crowdfunding is effective marketing. Experience shows that people only invest/donate in crowdfunding campaigns if the product or project convinces them. Therefore, the supporters of crowdfunding become the first customers of the company or important multipliers for the projects. Since these supporters often participate economically in the company as well, they often – in contrast to normal customers – recommend the product or project to others and voluntarily make suggestions as to how the product or project could still be improved. This creates a very loyal customer base for the entrepreneur with clients that act as ambassadors.

Because of this marketing effect, it can be observed that more and more businesses and projects that would not actually require financing opt for crowdfunding anyway. The primary motivation for these SMEs and projects, then, is to benefit from the manifold marketing effects of crowdfunding. Indeed, crowdfunding is increasingly used for market tests and validation. Businesses have the opportunity to react at an early stage, to change their course

of action instead of moving in the wrong direction for months. For a small business this can be a vital factor in securing financial and operational sustainability.

Moreover, this solves four of the most immediate problems of crowd-financed projects and businesses at the same time: 1) the acquisition of the first customers, 2) the marketing for their new product/project, 3) the financing of their plans/company, and 4) the market test and validation of their product.

#### **4. Crowdfunding Creates Jobs and Stimulates Innovation**

The positive impact that all types of crowdfunding, including donations and reward based crowdfunding, can have (and has already to some part) on job creation and innovation is huge. Job creation does not originate from large corporations in particular, they only represent some 30% of all jobs and only some 20% of all new jobs, the drivers of job creation are small and medium sized companies. These are a significant part of the European economy and should be recognized as such, as should be the entrepreneurs building them.

Behind every crowd-financed project, there are people and jobs. There are first studies that try to analyse the impact of crowdfunding on job creation via quantitative research. While we still need to interpret such work with care, we should use the results as indicative. In this sense we see that more than one third of companies that have gone through crowdfunding hired on average two or more new staff. Where smaller transactions are concerned, which are as is known numerous, we may assume that income smoothing effects help to stabilize the economy.

### **III. Prerequisites for Crowdfunding**

Both the motivations behind it and the participation process distinguish crowdfunding from traditional financial products. It is these differences that make crowdfunding attractive in the first place. Consequently, crowdfunding cannot be marketed in the same way as traditional financial products.

In order for crowdfunding to function on the general level and on the specific level, some prerequisites must be fulfilled:

#### **1. The Process Involving the Investors Must Be Handled Fast and Easy: Online**

The use of web technology allows crowdfunding to be efficient and scalable. At the same time it opens the avenue for transparency, which is missing in many other financial services for SMEs and entrepreneurs. If only part of the investment process had to take place offline, this may inevitably take out the advantage crowdfunding can offer towards incumbent funding solutions. Specifically, moving parts of the transaction process offline, for example the identity verification process for investors, would limit the advantages of crowdfunding to the largest extent.

The digitization of industry sectors has provided rapid change and enormous potential for innovation. Financial services have not yet fully embraced this change when it comes to customer focused services. Crowdfunding is part of this inevitable change that the financial services industry will have to undergo sooner rather than later.

## **2. The Cost Structure of Crowdfunding Campaigns Must Remain Lean.**

Crowdfunding platforms operate usually success-based, they charge a commission on the amount of money raised. The average commissions charged by the platforms can vary, depending on the type of crowdfunding from around 3 % to 10 % of the raised funds. Higher commissions are unlikely to be feasible nor acceptable by the entrepreneur, because they would make crowdfunding a too expensive method of financing.

However, approximately 2 % of the commission are deducted for the processing of payments. In the case of a campaign raising € 100,000, this means that only very small margin remains with the crowdfunding platform, for example € 1,000 or € 8,000 respectively for a commission of 3% or 10%, after the payment processing costs have been deducted. From this left over, the personnel, the marketing costs, the technology, the office, and legal and tax advice must be paid.

Increasing the costs per campaign – for instance if a investment prospectus had to be produced – would thus make crowdfunding unprofitable for any small or niche crowdfunding platforms. In general, soon to be published research by the European Crowdfunding Network indicates that compliance cost are already very high and a hinderance to further growth of the sector and also to innovation and competitiveness.

## **3. Participation Must Also Be Possible with Small Amounts of Money.**

Crowdfunding is such a great democratic success because everybody can participate. Therefore, it should be possible to participate with small amounts of money (for example, starting at as little as one Euro). This also allows to limit and to diversify risk. Women in particular have tended to invest rather small amounts so far. If higher minimum investments were required, crowdfunding would lose popular support, it would also exclude parts of our society from engaging in value creating economic activity. It is the many investors that can and are funding very small amounts of money, in relation to their own acceptable risk profile, that make crowdfunding so viable in defining new markets and innovations.

A legal minimum investment threshold may also force investors in crowdfunding models to invest more than they actually want to only to be able to participate. These investors would then also be unable to build portfolios. In other words, people would be forced to take an increased risk. It might also exclude a large number of potential investors.

#### **4. Crowdfunding Must Not Be Limited to Qualified Investors.**

Crowdfunding is "entrepreneurship live" and a chance to introduce the general public to entrepreneurship. Consequently, crowdfunding cannot exist as an elitist investment club. Crowdfunding gives instead democratic access to the right and opportunity to European citizens to invest in Europe's economic backbone: small and medium sized enterprises from all walks of life.

The financial strength of crowdfunding cannot not come from the small circle of qualified investors either, these prefer to invest their capital in the stock market, real estate or in other financial products anyway. The economic power of crowdfunding comes from the shared risk and funds given by a large number of members of the public who are becoming engaged prosumers, consumers that are at the same time the producers.

#### **5. The Amount of Capital Raised Must Not Be Limited**

Capital requirements vary significantly depending from project to project. The initiators of a crowdfunding campaign specify their individual capital requirements and thus make the process transparent for all participants from the beginning. The experience of crowdfunding platforms shows that the amount invested by an individual does not increase if the crowdfunding round raises a higher total amount for the project. Instead, the total amount is distributed among a larger number of investors, and the average amount invested by an individual remains often the same, though different models on different platforms will show different trends.

If the amount of capital that can be raised by means of crowdfunding were limited, this method of financing would become irrelevant to many projects/start-ups, and the risk for investors would increase. This is due to the fact that projects/start-ups could not raise the total amount required for the implementation despite sufficient demand and support in such a case, which would cause them to depend on additional sources of financing even after a successful round of crowdfunding. The existing European prospectus regulation offers ample room in this regard. A pan European industry might be able to emerge and help support the economy if the European regulation would be treated across Europe the same and adequate level.

## IV. About the European Crowdfunding Network

The European Crowdfunding Network AISBL (ECN) is a professional network promoting adequate transparency, (self) regulation and governance while offering a combined voice in policy discussion and public opinion building. Founded in 2011 as an interest group, we formally incorporated as an international not-for-profit organization in Brussels, Belgium in 2013.

The ECN currently consists of 24 full members from 9 European countries and more than 1200 associate members and supporters from across the Union. Each full member is among the leading crowdfunding platforms in their domestic markets. There is a very broad spectrum of crowdfunding platforms represented in the ECN, notably various types of crowdfunding platforms, such as reward based platforms, equity based platforms, lending platforms, donation platforms etc.

We support our members in carrying initiatives aimed at innovating, representing, promoting and protecting the European crowdfunding industry. We aim to increase the understanding of the key roles that crowdfunding can play in supporting entrepreneurship of all types and its role in funding the creation and protection of jobs, the enrichment of European society, culture and economy, and the protection of our environment.

In that capacity, we help developing professional standards, providing industry research as well as professional networking opportunities in order to facilitate interaction between our members and key industry participants. On behalf of our members, the ECN will maintain a dialogue with public institutions and stakeholders as well as the media at European, international and national levels.

## V. Contact

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fostering transparency, creating  
networking opportunities,  
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