

The new investment instruments developed in the international financial market

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Abstract

The development of an economy in general is conditioned by the investment and business environment of a country. The investment activity has an increasing impact on the level of competitiveness and performance of an economical agent that may contribute to the business expansion, providing and selling higher qualitative services and goods. In the same time, taking into account that the participants of the financial market become sometimes more cautious in their activity as a result of different events, as financial crisis that take place, the financial market may be very flexible and may develop extremely fast without even having a support from the regulatory and supervisory authorities. In this regard, the article aims to reflect the new investment instruments that have been developed all over the world as a result of the world financial crisis, instruments that are rapidly expanding in the financial markets lately, and what are the main difficulties and problems related to these instruments.

Key-words: investment, financial market, lending, risks, financial resources, field.

Introduction

The market evolution and development depends on the actions of the market participants and its regulators. From all the times, the functions performed by the financial markets are constant:

- transferring financial resources across time and space;
- clearing and settling payments;
- pooling resources and sharing ownership;
- price discovering;
- managing risk;
- dealing with asymmetric information problems.

The functions performed by the financial markets remain the same over time, but the instruments, institutions and players who carry out these functions change and evolve. In the same time, the financial markets affect and are affected by the rest

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of the economy and the regulatory framework.

One of the factors that made the world's financial market to change is the financial crisis. Its consequences may have unpredictable influence on the market's development. Following the financial crisis from 2000 that took place all over the world and as a result of it, the banks' reluctance of expanding their credit portfolio, there have been developed new financial and investment instruments on the world financial market like peer-to-peer lending and equity crowdfunding [9].

Peer-to-peer lending

Peer-to-peer lending (P2PL) is a process of lending money to unrelated persons (peers), without needing a traditional financial intermediary such as a bank or other traditional financial institution. This lending process takes place online on peer-to-peer lending companies' websites using various lending platforms and credit checking tools. Peer-to-peer lending is also known as crowd lending.

Early, peer-to-peer lending was also characterized by disintermediation and reliance on social networks but these features have started to disappear. While it is still true that the development of internet technology and e-commerce makes it possible to do away with traditional financial intermediaries and that people may be less likely to default to the members of their own social communities, the emergence of new intermediaries has proven to be time and cost saving. Extending crowd resources to unfamiliar lenders and borrowers opens up new opportunities for both sides.

Most peer-to-peer loans are unsecured personal loans. Secured loans are also offered by using luxury assets such as jewelry, watches, vintage cars, fine art etc. as collateral. Such loans are made to an individual rather than a company. Other forms of peer-to-peer lending include student loans, commercial and real estate loans, payday loans, as well as secured business loans, leasing and factoring [6].

Particularities of peer-to-peer lending

Peer-to-peer lending does not fit cleanly into any of the three traditional types of financial institutions like deposit takers, investors, insurers, and sometimes it is categorized as an alternative financial service. The key characteristics of peer-to-peer lending are:

- it is conducted for profit;
- no prior relationship between lenders and borrowers is needed;
- intermediation by a peer-to-peer lending company;
- transactions take place on-line;
- lenders may choose which borrowers to invest in;
- the loans are unsecured and are not protected by government insurance;
- loans that can be sold to other lenders [8].

Investing through a peer-to-peer lending platform is not the same as putting the money in a deposit account with a bank, building society or credit union. The Government guarantee on deposits, that applies to savings products such as a term

deposit, does not apply to funds invested in peer to peer lending.

Unlike bank depositors, peer-to-peer lenders can themselves choose whether to lend their money to safer borrowers with lower interest rates or to riskier borrowers with the prospect of higher returns.

An investor decides how much he wants to invest and depending on the lending platform - how his money will be used. For example, an investor may be able to choose to fund one loan in particular or be able to invest in a portfolio of loans. In addition to this, investors may be able to choose the minimum interest rate and select a loan period that fits their needs.

However, in some cases, the investment decisions are made by the platform operator or the investment manager.

Regarding the borrowing process, when borrowers apply for a loan, the platform operator evaluates their suitability by checking their credit history and their capacity to repay the loan. These factors allow the platform operator to assess the lending risk. Not all platforms disclose the lending risk of each borrower. Repayments from borrowers are collected through the lending platform and passed on to the relevant investors at predetermined intervals. The investor's capital can be returned as part of the repayments or at the end of the loan period.

One of the main advantages of peer-to-peer lending for borrowers consists in getting better rates than traditional banks can offer. The advantages for lenders are higher returns than those obtained from a savings account or other investments. The interest rates related to peer-to-peer lending also have a lower volatility than other investment types [4].

In the same time, the interest rates are set by lenders who compete for the lowest rate on the reverse auction model, or are fixed by the intermediary company on the basis of an analysis of the borrower's credit. Borrowers assessed as having a higher risk of default are assigned higher rates. Lenders mitigate the individual risk that borrowers will not pay back the money they received by choosing which borrowers to lend to, and mitigate total risk by diversifying their investments among different borrowers [5].

In this context, it is necessary to mention that the interest rates and the methodology for calculating the rates have varied among peer-to-peer lending platforms, ranging from 5% - 36%, depending on loan terms and borrower ratings.

Peer-to-peer lending intermediaries

The lending intermediaries are the ones on which is based the whole process of peer-to-peer lending. These intermediaries work for profit generating revenue by collecting a one-time fee on funded loans from borrowers and by assessing a loan servicing fee to investors - either an annually fixed amount or a percentage of the loan amount.

Because many of the services are automated, the intermediary companies can operate with lower costs and can provide the service more cheaply than traditional financial institutions, so that borrowers may be able to borrow money at

lower interest rates and lenders may be able to earn higher returns. Compared to stock markets, peer-to-peer lending tends to have both less volatility and less liquidity [4].

Most peer-to-peer intermediaries provide the following services:

- on-line investment platform to enable borrowers to attract lenders and investors, to identify and purchase loans that meet their investment criteria;
- development of credit models for loan approvals and pricing;
- verifying borrower identity, bank account, employment and income;
- performing borrower credit checks and filtering out the unqualified borrowers;
- processing payments from borrowers and forwarding those payments to the lenders who invested in the loan;
- servicing loans, providing customer service to borrowers and attempting to collect payments from borrowers who are in default;
- legal compliance and reporting;
- finding new lenders and borrowers [2].

In the peer-to-peer lending process, the platform operator keeps the personal details of all investors and borrowers confidential. Also, some platforms do maintain a fund that may compensate the investors that suffer losses due to borrower defaults. However, if there are a large number of defaults, the fund is unlikely to have enough money to compensate all the investors [1].

Making an analysis of the peer-to-peer lending companies and according to the data exposed in the Table 1, it can be seen that United Kingdom is the only country that has so many peer-to-peer lending platforms which means that the peer-to-peer lending industry is quite developed. This development may be explained by the fact that it's the first country in which first appeared this kind of financial service.

Table 1. The world's peer-to-peer lending platforms and their appearance all over the world

No.	Country	Year of appearance	Main P2PL platforms
1.	United Kingdom	2005	Zopa, Funding Circle, RateSetter, Lending Works, MarketInvoice, Assets Capital, Unbolted, LendInvest, Ablrate Funding Knights, Rebuildingsociety, Thincats, Folk2Folk
2.	United States of America	2006	Prosper, Lending Club, Zidisha, Upstart
3.	Sweden	2007	Trustbuddy AB, Lendify AB, Toborrow AB
4.	Estonia	2009	Bondora, Omaraha, Estateguru, Crowdstater, MoneyZen, Investly, Fundwise

5.	China	2010	CreditEase, Lufax, Tuandai, China Rapid Finance, DianRong
6.	India	2012	i2ifunding, Lendbox
7.	Poland	2013	GiveTake
8.	Germany	2013	Auxmoney, Lendico, Smava, Zencap
9.	Australia	2014	SocietyOne, DirectMoney, RateSetter
10.	New Zealand	2014	Harmony
11.	Singapore	2014	Funding Societies, CapitalMatch, Entreeexchange, Crowdo, Fundacity, MoolahSense, New Union, Kyepot
12.	United Arab Emirates	2014	Beehive
13.	Israel	2014	eLoan, Tarya, BLender, CreditPlace, Incredita
14.	Canada	2015	Grouplend
15.	Latvia	2015	Mintos, Twino
16.	Brazil	2015	Biva

Source: Elaborated by the author based on www.wikipedia.org

Also, in the last two years (2014 – 2015) a lot of peer-to-peer lending operators have emerged in many other countries like Australia, New Zealand, Singapore, Canada, Latvia, Brazil.

Factors that influenced growth of the peer-to-peer lending companies

Several factors influenced the rapid growth of the peer-to-peer lending platforms. First of them is the banks' refuse to increase their loan portfolios after the financial crisis. In this way, the public turned to peer-to-peer companies for lending and borrowing. The environment for peer-to-peer lending was already ripe around 2005-2006 as it may be seen from the table 1, during the time of the subprime lending boom. Many borrowers were left out of the subprime lending market because they didn't own a home or had very weak credit scores. Only the „better” subprime borrowers could actually qualify for mortgages. The main source of loans for these individuals was credit cards, but these were expensive, with interest rates typically ranging from 15% - 21% annually. Payday loans were an even more expensive option and would only lend up to a few hundred dollars at a time. This left many people without reasonable borrowing options.

Second, interest rates that fell to very low levels in the mid-2000's, leaving investors frustrated by the lack of higher yielding investment opportunities, especially in the credit markets. People typically talked about „search for yield” and „yield compression” – the fact that interest rates on riskier loans were close to the rates offered on safe loans.

Another factor that influenced peer-to-peer lending's growth is the invention

of the internet, that is a technological improvement and makes it possible for individual borrowers to present their cases to individual lenders. Borrowers were now not only able to present the usual credit information required, they were also able to tell their own personal stories about why they were in need of a loan and what they intended to do with the money. In addition, the process of gathering and processing credit information has become cheaper and more automated with the development of credit-scoring algorithms.

Besides this, taking into consideration the new generation that raised with Internet and new technologies, having access to different services online, very few people actually go to a bank, market etc. every transaction, purchase and acquisition being summarized at a click. This thing also caused the rapid growth of such type of financial service.

Thus, peer-to-peer lending greatly attracted borrowers who, because of their credit status or even the lack of it, did not qualify for traditional bank loans. This is why peer-to-peer lending has become of the fastest growing investment vehicles of the latest times. It has enabled the possibility of better rates for borrowers than traditional banks have been able to offer.

The specific risks of the peer-to-peer lending platforms

The financial market in general and all the financial institutions and intermediaries are exposed to different risks in their activity and peer-to-peer lending industry is not an exception. Further, there are presented the main risks that are appropriate to peer-to-peer lending.

✓Lending risk

In most cases, the company operating the lending platform does not lend its own money, so all the lending risk is taken by the investors. This means that the lender is more likely to lose some or all of his money if the borrower does not repay the loan.

This risk is reflected in the comparatively high returns that are likely to receive for an investment. However, there is the possibility to still lose your money even if it is chosen a loan that has been listed as low risky one.

✓Assessing credit risk

The operators of peer-to-peer lending platforms often make claims about a borrower's ability to repay the loan and, in this regard, they may also rate or grade borrowers by their level of creditworthiness.

It's important to keep in mind that these ratings are based on a point in time assessment only and are not the same as the ratings used by an external credit rating agency or even consistent with the ratings used by other peer to peer lending platforms.

Before a person invests, he should understand and feel comfortable with how borrowers are assessed before they are given a loan. A high number of defaults or late repayments by borrowers could be an indicator of the platform operator's poor

credit assessment process.

In addition, it's important to remember that a borrower's ability to face the repayments can change over time, for example, because of illness, unemployment or a change in their financial circumstances. If a borrower can't keep up the repayments, he has the right to apply for a „hardship variation”, which presumes the possibility to modify the terms of the loan by changing the amount or timing of the repayments.

If a person has invested in a loan that is the subject of a hardship variation, it may mean that the term of his investment is extended and the returns may be less than originally expected [1].

In addition to this, other risks that are related to peer-to-peer lending are the lack of Government's guarantee, which means that in case of a borrower's default, or even bankruptcy of the peer-to-peer lending operator, the lender loses all his investment in the loan without getting anything. Besides, not all the platforms have compensation procedures for lenders in case an investment is lost due to fraud or an error within the lending platform. In this situation, the lender is bearing the full risk of not getting his money back.

Equity Crowdfunding

Equity crowdfunding is a term that refers to open calls to the public in order to raise funds for a specific project. These calls are often published and promoted through internet and with the help of social media. The funds typically raised generally come from a large number of contributors in the form of relatively small contributions.

Originally, crowdfunding was based on donation principle. A person or a business who wanted to finance a project would ask for donations to help fund the project. Donors frequently received rewards related to the project, based on the amount donated. For example, some authors used crowdfunding to finance the printing of their novels and reward the donors with signed copies of the book. Thus, crowdfunding of commercial projects generally relies on mutually beneficial exchanges to ensure success.

Nowadays, the equity crowdfunding is the online offering of private company securities to a group of people for investment. Because equity crowdfunding involves investment into a commercial enterprise, it is often subject to securities and financial regulation. Equity crowdfunding is also referred to as investment crowdfunding, crowd investing or crowd equity.

In this regard, the equity crowdfunding may be defined as a mechanism that enables broad groups of investors to fund startup companies and small businesses in return for equity. Investors give money to a business and receive ownership of a small piece of that business. If the business succeeds, then its value increases, as well as the value of a share in that business. Coverage of equity crowdfunding indicates that its potential is greatest with startup businesses that are seeking

smaller investments to achieve establishment, while follow-on funding, that is required for subsequent growth, may come from other sources [3].

Lately, crowdfunding rapidly evolved in several directions, including raising money through issuance of debt and equity to donors, which is called securities-based crowdfunding. In equity-based crowdfunding, each backer receives shares of a company in exchange for money they pledge. The first robust case of equity crowdfunding was the formation of the Australian Small Scale Offerings Board in 2007, which has raised 138,478,362 dollars so far.

Equity-based crowdfunding currently differs from an initial public offering in several key aspects. First, there is no underwriting involved, since shares are issued directly to donors and do not pass through the hands of brokers or dealers. Second, the shares are considered to be privately placed equity rather than publicly traded equity. Finally, shares issued are typically not traded on a secondary market.

The fact that equity crowdfunding is currently considered to be privately placed equity has important consequences for its issuance and trading. The sale of privately placed equity to unprofessional investors creates legal liabilities for the issuing company related to the return on this investment. In fact, issuing privately placed equity to unprofessional investors is not legal in many countries unless specific regulation is put in place to allow it.

Main issues and constraints regarding peer-to-peer lending and equity crowdfunding

Global regulators have been examining peer-to-peer lending as they explore its potential. In mid-May 2014, the Federal Reserve Bank of New York hosted a meeting to discuss the role that the new investment instrument could play in the United States of America's economy. Other organizations have questioned whether this phenomenon may be the next evolution of inclusive banking or simply a new financial instrument in need of tougher surveillance.

There has been an increasing interest in peer-to-peer lending on the part of professional investors, especially since 2013. Hedge funds and large wealth managers are making huge loans through United States of America's peer-to-peer lending platforms, tempted by yields of up to 24% at a time when returns on cash and government bonds are stuck at very low rates. Nevertheless, most of the money for the peer-to-peer lending now comes from institutional investors such as hedge funds, rather than from the general public.

The enthusiasm that professional investors show for peer-to-peer lending raises a serious issue: as professional investors squeeze out individual lenders, will they leave the market later if it produces disappointing results? In other words, do professional investors in peer-to-peer loans only represent „hot money” that is chasing the latest trend? Another issue consists in the fact if the peer-to-peer lending is truly „peer to peer” since the lenders become more and more institutional investors? Peer-to-peer lending market has not been tested by any downturn or a

negative shock yet, so how it will perform remains an open question.

However, the regulation of cross-border loans is untested and could be complicated. There is no common European framework for supervision and the European Commission, International Monetary Fund are still in the process of carrying out further research on the sector. There are differing opinions about how best to conduct supervision, some experts saying that regulation for borrowers and lenders could be split between different countries and others saying that a single point of contact would be needed [7].

This leads to the question of how and to what extent peer-to-peer lending may possibly spread to other markets. This is especially appropriate for the European markets and South East Asia, where the countries are smaller and issues related to cross-border lending could cause a lot of problems.

Regarding crowdfunding, one of the main unresolved challenges at the moment is a practical one: if an investor buys shares in a crowdfunded company today, how are those shares converted back into cash later? In the very short run, this may not be a concern, since the companies anticipate high growth for several years. In addition, some countries require minimum holding periods on crowdfunded equity. For example, in the United States of America, equity crowdfunding investors must hold their investment for a minimum of one year. The meaning of this rule is to prevent investors from buying stock in a company and then trying to inflate its worth in a „pump-and-dump” scheme. But the lack of a clear exit strategy discourages potential investors from purchasing crowdfunded equity.

One option for an investor exit strategy is to sell equity on the secondary market, which in the case of crowdfunded investments are private exchanges that act similarly to public exchanges. Examples of these are Gate Global Impact and Second Market. These are not exchanges, but instead – private and more informal marketplaces.

The secondary market for crowdfunded securities is in its nascent stages, so it is harder to sell crowdfunded investment stock on the secondary market than it is to sell the stock of a public company on a public exchange. There aren't enough buyers available to make shares very liquid on the private secondary market. In addition, crowdfunded equity is still considered privately placed equity, which creates legal liabilities for sellers of equity who sell to unprofessional investors. This also creates obstacles for trading.

A second exit strategy option would be the sale of the company through a merger or buyout by a private equity investor. If the majority owners in a company vote to allow a buyout, there is an opportunity to sell one's shares and one may experience a gain on one's investment. Professional investors may prefer to buy out all equity investors, in which case the investors gain their exit.

A third exit opportunity is for the company to go public and list its shares on a stock exchange for the general public to purchase. Initial public offerings can be the exit of all exits – they are what investor's dream of when they invest in startup

companies.

The only option that offers the investor any degree of control, however, is selling on the secondary market. All the other options, including mergers and acquisitions, are decided by the majority stockholders. For instance, Groupon - the well-known group-buying website, was offered 6 billion dollars to sell the company, but the majority shareholders turned down this offer and unfortunately, the minor shareholders had no control and many of them were frustrated by this decision. Thus, there exists an element of lack of control over the means by which investors exit crowd-funded investments.

Equity crowdfunding has generated a great deal of excitement because it is a new concept. The challenge to regulators is to put regulations in place that provide sufficient investor protection, but not so costly and not discouraging the market development. In addition, regulation needs to be implemented quickly, before investors either become frustrated and leave the market, or they decide to push ahead without regulations, which often leads to problems later.

A final challenge for policymakers regards the incentive to use regulation to shape the market or push it in a certain direction. Governments appear to be of the mentality that equity crowdfunding should be conducted in the context of long-term, patient, buy-and-hold investments. But no one still knows if that's the correct vision for the future of equity crowdfunding.

Conclusion:

In conclusion, it may be stated that the development of these two instruments proves that the financial market is very volatile and sensitive and can evolve in different directions without having even any support from the competent authorities.

The peer-to-peer lending and crowdfunding market has evolved substantially from its beliefs in better decision-making by the crowd in 2005. Besides, the new technologies' development and the banks' frustration to extend their credit portfolio facilitated the growth and extension of the new alternative financial services.

However, despite of the increasing number of peer-to-peer lending companies, the number of people (lenders and borrowers, investors and entities) that call for financial resources, the higher profits and returns that people get from such lending and businesses, there are a lot of problems and issues related to such forms of financial services as the lack of regulation, cross-border lending, default, covering the risks, exiting from a crowd-funded company etc. that must be settled. And taking into account that these two markets are developing extremely fast, the solution of these problems must be found as soon as possible.

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