

EBA/Op/2015/03

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26 February 2015

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# Opinion of the European Banking Authority on lending-based crowdfunding

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## Introduction and legal basis

1. One of the tasks of the EBA, in accordance with Article 9 of Regulation (EU) No 1093/2010<sup>1</sup> (EBA Regulation), is to monitor new and existing financial activities and to adopt guidelines and recommendations with a view to promoting the safety and soundness of markets and convergence in regulatory practice.
2. The EBA has identified the recent innovation of crowdfunding, and in particular lending-based crowdfunding, as a new form of financial activity which falls within its area of competence. The EBA has focused its work on the assessment of risks arising for market participants as well as the drivers of these risks; and the extent to which these could be addressed in existing EU directives and regulations and in any regulation, specifically regarding crowdfunding, that may already be in place, or is envisaged, at a national level.
3. The EBA's power to deliver an opinion in its area of competence is based on Article 8(2) and Article 34(1) of the EBA Regulation. As provided in Article 9(4) of the EBA Regulation, the analysis which follows was conducted with a view to achieving a coordinated approach to the regulatory and supervisory treatment of an innovative financial activity.
4. In addition, this Opinion is based on the tasks specified in Article 8(a) and (b) of the EBA Regulation, which require the EBA to contribute to the establishment of high-quality common regulatory and supervisory standards and practices by providing opinions to the European Union institutions based on the legislative acts referred to in Article 1(2) of the EBA Regulation; as well as ensuring the consistent application of legally binding Union acts, in particular by

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<sup>1</sup> Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 21.11.2010 establishing a European Supervisory Authority (European Banking Authority) amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).

contributing to a common supervisory culture, ensuring the consistent, efficient and effective application of the acts referred to in Article 1(2) and preventing regulatory arbitrage.

5. In accordance with Article 34(1) of the EBA Regulation, this Opinion is addressed to the European Parliament, the EU Council and the Commission.
6. In accordance with Article 14(5) of the Rules of Procedure of the Board of Supervisors<sup>2</sup>, the Board of Supervisors has adopted this Opinion.

## General comments/proposals

7. The EBA started its analysis of lending-based crowdfunding in autumn 2013, with a view to determine the potential risks to participants in this market (i.e. lenders, borrowers and platform providers); the drivers of these risks; and to assess the extent to which regulation would be required to ensure that market participants can have confidence in this particular market innovation. The EBA also identified business models and assessed the extent to which the identified risks are addressed in existing EU directives and regulations or national regulatory frameworks that are already in place or planned.
8. The EBA concludes that the convergence of practices across the EU for the supervision of crowdfunding is desirable in order to avoid regulatory arbitrage, create a level-playing field, ensure that market participants can have confidence in this market innovation, and contribute to the single European market.
9. At this early stage of market development, the EBA considers that this convergence should be based on existing EU law, and recommends that EU legislators provide clarity on the applicability of said law to lending-based crowdfunding. Lending-based crowdfunding services are provided using a large number of different business models, which is why different pieces of EU financial regulation could potentially apply.
10. Should EU legislators consider developing a possible regulatory framework, the Opinion proposes several regulatory measures and also recommends that existing national regulations for crowdfunding be considered.
11. The EBA concludes that the Payment Services Directive (Directive 2007/64/EC)<sup>3</sup> is the Directive that is most feasibly applicable to lending-based crowdfunding, covering the payments-related aspects of crowdfunding activities. However, the lending-related aspects are not covered by

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<sup>2</sup> Decision adopting the Rules of Procedure of the European Banking Authority Board of Supervisors of 11.12.2013 (Decision EBA DC 001 (Rev3)).

<sup>3</sup> Directive 2007/64/EC of the European Parliament and of the Council of 13 November 2007 on payment services in the internal market amending Directives 97/7/EC, 2002/65/EC, 2005/60/EC and 2006/48/EC and repealing Directive 97/5/EC (OJ L 319, 5.12.2007, p. 1–36)

EU law, leaving several risks and risk drivers that the EBA had identified unlikely to be addressed. This includes a lack of or insufficient requirements on any due diligence processes and assessment of borrowers' creditworthiness conducted by a platform, and a lack of or insufficient safeguards against platform default. For these risks and risk drivers, the EBA suggests potential ways to address them, including requirements regarding due diligence procedures on projects advertised on a crowdfunding platform, and requirements regarding internal procedures and to address platform defaults.

12. More specifically, with regards to the Payment Services Directive, the EBA concludes that there is a need for EU legislators to provide clarification regarding:

- the scope of the distinction between 'regular' and 'main' activity, allowing for a common interpretation of the Directive's application;
- the application of the exemptions listed in the Directive, in particular the use of commercial agents (Article 3(b)); and
- the definition of the payment services listed in the Annex of the Directive.

13. In addition, the EBA concludes that the business models of lending-based crowdfunding platforms do not fall inside the perimeter of credit institutions and their typical business model as defined in the EU legislation. The funds provided by lenders with crowdfunding platforms would therefore not qualify as deposits eligible for protection under a deposit guarantee scheme, taking into account the definition of 'deposit' in Article 2(1), point 3, of Directive 2014/49/EU (the Deposit Guarantee Schemes Directive).

14. The EBA will, however, continue to monitor the market and will revise its conclusions as and when required. For the risks and risk drivers identified in the analysis that are potentially left unaddressed, the EBA proposes additional requirements to mitigate those risks.

## Specific comments/proposals

15. A detailed analysis of lending-based crowdfunding is presented in the annex.

This opinion will be published on the EBA's website.

Done in London, DD Month YYYY

[signed]

Andrea Enria

Chairperson  
For the Board of Supervisors

# Annex

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## Report on lending-based crowdfunding: risks, drivers and potential regulatory approaches

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## Reasons for publication

1. In accordance with Article 9 of its Founding Regulation (Regulation (EU) No 1093/2010)<sup>4</sup>, one of the tasks of the EBA is to monitor new and existing financial activities and to adopt guidelines and recommendations with a view to promoting the safety and soundness of markets and convergence of regulatory practice.
2. The EBA has identified the recent innovation of crowdfunding, and in particular lending-based crowdfunding, as a new form of financial activity that falls within its area of competence. The EBA would like to ensure that all market participants can have confidence in this new innovation and market segment. To that end, the EBA has identified the risks arising for market participants as well as the drivers of these risks, and assessed the extent to which these are mitigated in existing EU Directives and Regulations as well as in any crowdfunding-specific regulation that may already be in place, or is envisaged, at a national level.
3. The EBA's power to deliver an opinion in its area of competence is based on Article 8(2) and Article 34(1) of the EBA Regulation. As provided in Article 9(4) of the EBA Regulation, the analysis which follows was conducted with a view to achieving a coordinated approach to the regulatory and supervisory treatment of an innovative financial activity.

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<sup>4</sup> Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 21.11.2010 establishing a European Supervisory Authority (European Banking Authority) amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).

## Background

4. The EBA started its work on lending-based crowdfunding in autumn 2013. The first stage consisted of a preliminary analysis of risks for borrowers and lenders, which was submitted to the European Commission as the EBA's response to the Commission's consultation on crowdfunding in 2013.
5. The second stage was a joint survey of national supervisory authorities carried out by the EBA and the European Securities and Markets Authority (ESMA) in October/November 2013 to identify and map existing national approaches, to both lending-based and the related variant of investment-based crowdfunding that is of interest to ESMA.
6. Following their consultation, the EC issued a Communication on crowdfunding on 27 March 2014.<sup>5</sup> Also, in order to support policy development in this area, the Commission has set up the European Crowdfunding Stakeholder Forum, and intends to hold regulatory workshops in which ESMA and the EBA would take part.
7. The EBA has identified the risks arising for market participants as well as the drivers of these risks, and assessed the extent to which these are mitigated in existing EU Directives and Regulations as well as in any crowdfunding-specific regulation that may already be in place, or is envisaged, at a national level.

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<sup>5</sup> [http://ec.europa.eu/internal\\_market/finances/docs/crowdfunding/140327-communication\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/crowdfunding/140327-communication_en.pdf)

## A working definition of lending-based crowdfunding

8. In its Communication of 27 March 2014, the Commission refers to crowdfunding as generally open calls to the public to raise funds for a specific project. In its typical form, an online platform gathers fund seekers (project owners) and fund givers (backers). Project owners publicise their requests for funds via the platform to contact potential backers.

9. Crowdfunding models are generally grouped into four types:

- Donations,
- Rewards,
- Lending, and
- Investment.

10. In the donations model, backers give their money and do not expect any return. In the rewards model, the returns are usually non-financial, e.g. a copy of a book or a ticket to an exhibition. The other two models involve some kind of financial return. In the lending-based type, project owners typically commit to return funds to backers over a specified time period and with interest (although in some cases without interest). Finally, in investment variants, project owners are willing to offer partnership in the project (equity-based crowdfunding), to issue bonds, or to share profits (profit-sharing crowdfunding) to backers. EBA is aware that some crowdfunding platforms may offer more than just one type of crowdfunding model.

11. Of these four types of crowdfunding, and considering the EBA's scope of action, this Opinion focuses on the lending-based variant. A working definition for this model is:

'Open calls to the wider public by fund seekers through a third party, typically an on-line platform, to raise funds for a project or for personal purposes, in the form of a loan agreement, with a promise to repay with (or in certain cases without) interest. The fund raisers may include individuals, start-up companies or existing SMEs that are seeking an alternative means of funding, rather than the traditional credit market.'

12. For the lending-based variant of crowdfunding, project owners are often referred to as borrowers, and backers are often referred to as lenders.



## Business models for crowdfunding

13. Based on a non-exhaustive analysis by the EBA, crowdfunding business models generally involve a platform that acts as a meeting point through which fund seekers advertise their projects to potential fund contributors.
14. Lending-based crowdfunding is commonly referred to as peer-to-peer lending or P2P although, when individuals lend to businesses, many refer to it as peer-to-business or P2B.
15. In the more typical business model, project owners advertise their ideas and state the terms they are willing to offer, on the basis of a loan agreement, as a return for a lender's contribution. The platform-operating firm would provide a framework for the contractual terms and conditions, sends contracts to the parties, and coordinates (re)payments.<sup>6</sup>
16. Another business model sees lenders approaching the platform before any projects are presented, stating the returns they are seeking. The platform will then identify a suitable borrower/project that is willing to accept the funds and repay on those terms.
17. Another model involves the platform applying funds from lenders to different projects based on criteria such as risk levels or the potential return. The platform chooses the projects.
18. Finally, some other, less common business model variants can be found, such as:
  - Auction-based crowdfunding, where lenders bid between themselves in an auction to be able to offer the lowest interest to the borrower. Some models only have a single lender that provides a loan to the borrower, while others have multiple lenders contributing tranches of a loan.
  - A platform mediating loans from lenders to borrowers, without an underlying project. Lenders' funds are directly transferred and captured in a loan agreement. Multiple lenders and borrowers may exist and rates are set by the platform.
  - A platform cooperates with a credit institution which provides the loans. As soon as the campaign target is reached, loans are then passed on to the lenders who become entitled to the repayments<sup>7</sup>;
  - A sponsored platform obtains from a credit institution loan applications that it has assessed but turned down (typically on grounds of high risk). The assessment

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<sup>6</sup> In one Spanish platform SMEs contact the platform asking for loans; the application is analysed in order to give it a rating; lenders bid amounts at a chosen interest rate (they have to transfer 10 % of the bid amount); offers are rejected if the 100 % of the requested funds is not reached; once the 100 % is reached, the platform prepares the documents and lenders transfer the funds to the SME (90 %).

<sup>7</sup> This is the case in Germany, for example. "Because of regulatory restrictions in Germany a bank needs to be involved in this process. The bank grants the loan to the borrower and then splits and assigns the loan to the Crowd (lenders).", in European Crowdfunding Network (2014), "Review of Crowdfunding Regulation 2014"

information is posted on the platform and the credit institution commits to managing the payments.

19. Lending-based crowdfunding commonly refers to consumer credit and SME funding. In some Member States, the renewable energies companies have been more active in resorting to crowdfunding. Recent developments suggest the development of factoring solutions, where businesses use the crowd to anticipate revenues of future payments; and of real estate crowdfunding.

20. When framing lending-based crowdfunding, it should be noted that there is a general link between different forms of alternative funding, as they provide access to capital for a segment of the population that cannot (or might not want) access through traditional channels. However, as noted by the World Bank, there are significant differences between crowdfunding and another common alternative funding mechanism, micro funding, which includes microfinance and social (peer-to-peer) lending.<sup>8</sup>

### Handling of money/payments

21. Business models also differ with regard to money handling arrangements, which are an important part of crowdfunding business models. The most common variants are the following:

- The platform uses an authorised Payment Services Provider (PSP) to perform money handling and remittance services;
- The platform opens an account in its own name (in an authorised PSP), through which lenders' contributions and borrowers' (re)payments flow<sup>9</sup>;
- The platform is a PSP and directly processes money flow transactions between borrowers and lenders.

### Platforms' services and fees' structures

22. Platforms have been noted to perform different roles when providing services to participants. The range of services covers project evaluation, assigning ratings, credit assessment, and payments (and repayments) handling, among others. In some Member States platforms are considered credit intermediaries. In a few countries, a specific status has been created for crowdfunding platforms.<sup>10</sup>

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<sup>8</sup> World Bank (2013), "Crowdfunding's Potential for the Developing World"

<sup>9</sup> Some Member states have noted that some platforms handle money without being aware that they act as a PSP, which led to regulatory actions.

<sup>10</sup> For example, in France lending-based platforms are called "Intermédiaire en financement participatif (IFP)".

23. In countries where lending-based crowdfunding is already regulated, some disclosure requirements are in place.<sup>11</sup> Platforms in other countries are noted to have a flexible approach regarding disclosure. While some platforms do not provide any disclosure, some others disclose rating information only. Others still disclose information as provided by borrowers, and others give out a more complete package with contract documentation, due diligence procedures, fees and charges, and terms and conditions of the use of lending based services.
24. With regard to credit assessment processes disclosed by some platforms, some resort to external credit rating companies, others perform own assessment and assign ratings to projects advertised. Where regulation is already in force, some requirements are in place (as described in the final section of this report).
25. The pricing structure typically involves fees charged to borrowers. Borrowers are typically charged either a set monetary amount for listing the application, on completion of the loan, or a percentage of the amount borrowed<sup>12</sup>. However, in some cases there are fees for both lenders and borrowers.<sup>13</sup> When the platform offers options to re-sale the loan, fees are usually charged to lenders also.

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<sup>11</sup> Firms operating loan-based crowdfunding platforms in the UK are required to follow rules for the fair, clear and not misleading communication of information. These rules apply to communication on the web platforms themselves, and to marketing material communicated elsewhere.

In France, lending-based platforms have to ensure that lenders are aware of the potential risks of crowdfunding operations, including the risk of total or partial loss of the capital invested, the risk of not obtaining the expected return, and the risk of lack of liquidity. These risks shall be clearly disclosed on their websites. Furthermore, the websites are required to contain clear information on projects, borrowers and the financing mechanism.

<sup>12</sup> Some of the examples of percentage fees went up to 4% of the amounts borrowed. Other cases reported fees of 2% of the outstanding amounts per year.

<sup>13</sup> One platform in France indicated that some of the fees were for contributing a credit default guarantee scheme in case a project defaults and inkasso was not possible.

## Risks to market participants and risk drivers

26. The EBA has identified a set of risks for borrowers, lenders and platform operators, as well as the respective risk drivers, which provide indications as to the regulatory tools that may be required to mitigate the risks. The risks have been broken down into the following categories: counterparty (or credit) risk; risk of fraud; lack of transparency/misleading information; legal risk; liquidity risk; operational risk; and money laundering. An overview of the assessment is presented in Table 1 overleaf.

27. In what follows below, each of the risks stated in Table 1 is described in greater detail, using the column headings (risks to lenders, risks to borrowers, and risks to crowdfunding platforms) as headers.

### Risks to lenders

#### A) Counterparty (or credit) risk

*A1: A lender is enticed to invest by the promise of an unrealistically high rate of return on investment*

28. Several drivers can create this risk. Firstly, the assessment of an investment opportunity requires a profound analysis as well as a thorough understanding of the project or business of a potential borrower. Accordingly, a lender would need a certain level of financial literacy to be able to make a fully educated decision about a specific investment opportunity. Secondly, a risk can arise if a crowdfunding platform fails to make available understandable and reliable explanations about a project, financing mechanisms and other investor education material.

*A2: A lender loses the capital invested (and potential interest) if a borrower is unable to meet its repayment obligation*

29. This credit risk can arise because a borrower becomes insolvent, behaves negligently or has insufficient funds to repay the lender as agreed. This credit or counterparty risk is inherent in any investment or loan. However, failure to assess or an insufficient assessment of the creditworthiness of a borrower before investing can create a higher risk. This applies, in particular, if a platform does not check the creditworthiness of borrowers using the website.

*A3: A lender does not receive the funds collected from borrowers*

30. This risk arises if a lending-based crowdfunding platform is not required to apply for a licence or permission to provide payment services/money remittance and furthermore does not have adequate arrangements in place to safeguard participant's money.

**Table 1: Risks and risk drivers of lending-based crowdfunding**

		Risk description		Drivers	
Risk category	Risk ID	Risks to lenders	Risks to borrowers	Driver ID	Driver description
A) Counterparty (or credit) risk	A1	Lender is enticed to invest by the promise of an unrealistically high rate of return on investment	n.a.	a	Lack of insufficient financial literacy of lenders and high complexity risk analysis is necessary to evaluate projects
	A2	Lender loses the capital invested in the event the borrower is unable to meet its repayment obligation	n.a.	c	Insufficient assessment of the creditworthiness/risks by the platform
	A3	Lender does not receive the funds back / repayments	Borrower does not receive the funds collected from lenders	l	Missing requirement for platforms to follow money remittance provider authorisation
	A4	Lender suffers loss because a crowdfunding platform defaults	Borrower could be held liable by the lender in the event of failure of the Crowdfunding platform	d	Without a platform co-ordinating loans and repayments, the borrowers may not have adequate records setting out their payment commitments; insufficient financial safeguards against platform default
B) Risk of fraud	B1	Lender suffers loss when a borrower acts fraudulently	n.a.	f	Lack of insufficient background check on a borrower by the platform
	B2	Lender is uncertain about the reputation and the security of a crowdfunding platform	Borrower is uncertain about the reputation and the security of a crowdfunding platform	i; e	Lack or insufficient disclosure requirements of platforms; no obligation for the crowdfunding platform to obtain a permit from Financial Supervisors Authorities
	B3	Lender's personal data may be stolen or misused	Borrowers face the risk that personal data may be stolen or misused	g	Lack or insufficient internal document handling processes of platform provider
C) Lack of transparency / misleading information	C1	Lender is unable to identify conflicts of interests of the crowdfunding platform, its shareholders, managers and key employees	n.a.	h	Lack of insufficient information disclosure requirements of platforms on potential conflicts of interests
	C2	Lender is misled by an opaque pricing structure or misleading information about other terms and conditions applicable to the parties	n.a.	i	Lack of insufficient contract information disclosure requirements
	C3	Lender wrongly assumes that offerings advertised on a crowdfunding platform have been subject to an appropriate risk assessment	n.a.	b; c	Lack of insufficient due diligence requirements on platforms; Lack of insufficient customer due diligence process on the borrower by a crowdfunding platform; Lack or insufficient information regarding the ability or willingness of lenders to pay the committed amounts
	C4	Lender has not been provided the information necessary to assess a certain project [and/or the reputation of the borrower]	n.a.	b; c	Lack of insufficient customer due diligence process on the borrower by a crowdfunding platform; Lack or insufficient regulatory requirements for crowdfunding platforms regarding the performance of a due diligence on the offerings
	C5	Lender is uncertain about his rights to withdraw or to cancel an investment prior to its maturity	n.a.	j	Insufficient termination rights for the lender/Misleading explanations on applicable termination rights
	C6	Lender is not in a position to assess a certain crowdfunding platform's reputation and probity	n.a.	h	Lack of insufficient information disclosure requirements of platforms on potential conflicts of interests
	C7	n.a.	Borrowers cannot be certain that a risk assessment of their project is conducted pursuant to generally applicable standards and rules	c	Insufficient assessment of the creditworthiness/risks by the platform
	C8	n.a.	Borrowers may not receive committed funds because lenders are not able or willing to pay as agreed	c	Insufficient assessment of the creditworthiness/risks by the platform
D) Legal risk	D1	Lender is uncertain about his rights and obligations vis-à-vis the parties involved	Borrower is uncertain about his rights and obligations vis-à-vis the parties involved	i	Inappropriate or misleading information about the contractual rights and obligations of the contracting parties
	D2	Lender faces an inappropriate complaints handling mechanism on a crowdfunding platform	Borrowers can be affected by inappropriate complaints handling mechanism on a crowdfunding platform too	k	Unclear complaints handling rights and regulations of market participants
	D3	Lender's funds might not be transferred to the Borrower	n.a.	l	Missing requirement for platforms to follow money remittance provider authorisation
	D4	n.a.	Borrowers' project ideas could potentially be copied	m	Lack or insufficient project ideas' safeguard clauses
E) Liquidity risk	E1	Lenders can face liquidity problems if, after the loan is given out, the repayments do not follow the agreed plan	Borrowers can face liquidity problems if, after the project's financial approval, the provision of funds is delayed, thus undermining the success of the project	n	Lack or insufficient timeline of fund availability requirements on platforms
F) Operational risk	F1	Lender suffers loss when a crowdfunding platform experiences technical issues	Borrowers might face liquidity problems if platforms have technical difficulties	o	Lack or insufficient corporate governance arrangements; A particular platform is technologically faulty

  

		Risk description		Drivers	
Risk category	Risk ID	Risks to platform providers		Driver ID	Driver description
B) Risk of fraud	B4	Crowdfunding Platforms face the [reputational] risk that loans will not be repaid by borrowers intentionally		f	Lack of insufficient disclosure requirements of platforms; no obligation for the crowdfunding platform to obtain a permit from Financial Supervisory Authorities; lack or insufficient background check on a borrower by the platform
F) Operational risk	F2	Crowdfunding platforms are threatened with hackers' attacks		p	Lack or insufficient requirements on safeguards against hackers' attacks
G) Money laundering	G1	Crowdfunding platforms might be misused for fraudulent or money laundering activities		b; q	Lack of insufficient customer due diligence; Anti-money laundering regulations are not applicable to crowdfunding platforms
	G2	Crowdfunding platforms might be shut down due to fraudulent or money laundering activities of borrowers/lenders		q	Platforms are not subject to comply with KYC/AML/TF regulations

*A4: A lender suffers loss because a crowdfunding platform defaults (also relevant for borrowers)*

31. This risk can arise because a borrower may not have adequate records setting out their payment commitments without a crowdfunding platform coordinating and processing the loans. Consequently, the risk can arise due to insufficient financial safeguards against platform default such as loan follow-up requirements.

## **B) Risk of fraud**

*B1: A lender suffers loss when a borrower acts fraudulently*

32. This risk can arise due to the fact that the anonymity of the internet provides opportunities for individuals to act under false pretenses, by offering fake investment opportunities via a crowdfunding platform. It is therefore extremely important to ensure that crowdfunding platforms obtain identification and contact information about borrowers, including evidence. Furthermore, the risk of fraud could increase if a platform fails to conduct a thorough background check on a borrower e.g. their former career, financial status and criminal records.

*B2: A lender is uncertain about the reputation and the security of a crowdfunding platform (also relevant for borrowers)*

33. It might be difficult for lenders and borrowers to find independent information about the reputation of crowdfunding platforms because a platform is not required to comply with legal information or disclosure requirements. Furthermore, crowdfunding platforms do not necessarily require permission from a national financial supervisory authority and are therefore not subject to financial supervision.

*B3: A lender's personal data may be stolen or misused (also relevant for borrowers)*

34. This risk can arise if a crowdfunding platform lacks a sufficiently robust document handling policy or if the policy is not implemented properly in practice, leading to the loss of data.

## **C) Lack of transparency or misleading information**

*C1: A lender is unable to identify conflicts of interests of a crowdfunding platform, its shareholders, managers and key employees*

35. This risk arises if a crowdfunding platform or its shareholders, managers or key employees have financial interests in the business of a borrower. The same is true where the structuring of a compensation agreement leads to a conflict of interest.

*C2: A lender is misled by an opaque pricing structure or misleading information about other terms and conditions applicable to the parties*

36. A lender is not able to foresee the contractual rights and obligations linked to his investment without full disclosure of the contractual terms and conditions on a platform's website. The same applies if the conditions are not formulated in unambiguous and understandable language.

*C3: A lender wrongly assumes that opportunities advertised on a crowdfunding platform have been subject to an appropriate risk assessment*

37. This risk arises where a crowdfunding platform is not obliged to conduct due diligence on the projects that are advertised on its website and this fact is not properly disclosed on the website (i.e. there is no information available if and/or to what extent a due diligence procedure has been conducted).

*C4: A lender has not been provided with the information necessary to assess a certain project (and/or the reputation of the borrower)*

38. Appraising the risk-reward ratio of an investment in a company or business usually requires detailed information about that company or business. Institutional as well as strategic investors usually conduct a so-called due diligence procedure prior to investment to collect the necessary information. A private lender however does not usually possess the resources to undertake a costly due diligence procedure. Nevertheless, there is currently no legal obligation for crowdfunding platforms to conduct project due diligence on behalf of potential lenders.

*C5: A lender is uncertain about his rights to withdraw or to cancel an investment prior to its maturity*

39. Lending-based crowdfunding usually means that lenders enter into loan agreements with a borrower which is, in many cases, a start-up enterprise. Whether a lender is entitled to cancel a loan agreement depends on the applicable statutory law and the contractual terms. A lack of consumer information about the applicable cancellation rights may as a result create a high level of uncertainty for lenders about their exit opportunities. Furthermore, the applicable law or contractual termination rights may turn out to be insufficient from a lender's perspective.

*C6: A lender is not in a position to assess a certain crowdfunding platform's reputation and probity*

40. It might be difficult for lenders to find independent information about the reputation of crowdfunding platforms because a platform may not be required to comply with legal obligations concerning information and disclosure. Furthermore crowdfunding platforms do not necessarily require permission from a national financial supervisory authority and are therefore not subject to financial supervision.

## D) Legal risks

*D1: A lender is uncertain about his rights and obligations vis-à-vis the parties involved (also relevant for borrowers)*

41. This risk arises if a crowdfunding platform fails to disclose understandable information about the services that will be provided by the platform and a description of the contractual rights and obligations that would apply to lenders and the borrowers.

*D2: A lender faces an inappropriate complaints-handling mechanism on a crowdfunding platform (also relevant for borrowers)*

42. This risk arises because of the absence of a well-structured complaints-handling regulation applying to the participants.

*D3: A lender's funds might not be transferred to the borrower*

43. This risk arises if a certain lending-based crowdfunding platform is not required to apply for a license or permission to provide payment services/money remittance and does not have adequate arrangements in place to safeguard its customers' money.

## E) Liquidity risk

*E1: Lenders can face liquidity problems if, after the loan is given out, the repayments do not follow the agreed plan or if its position cannot be unwound before the term of the contract*

44. This risk arises due to a lack of or an insufficient timeline of fund availability, and when the lender does not have the possibility to access the provided funds before the term of the loan.

## F) Operational risks

*F1: A lender suffers a loss when a crowdfunding platform experiences technical issues (also relevant for borrowers)*

45. This risk arises if corporate governance arrangements to support a crowdfunding platform do not exist or are insufficient. Another causal driver is that a particular platform is technologically faulty.

## Risks to borrowers

### A) Counterparty (or Credit) risk

46. Risks A3 and A4 have already been described above in the 'Risks to lenders' section.

### B) Reputation risk/Risk of fraud



47. Risks B2 and B3 have already been described above in the 'Risks to lenders' section.

### C) Lack of transparency or misleading information

*C7: Borrowers cannot be certain that a risk assessment of their project has been conducted pursuant to generally applicable standards and rules*

48. The risk to borrowers is that they could be assessed incorrectly therefore attract less interest from potential lenders.

*C8: Borrowers may not receive committed funds because lenders are not able or willing to pay as agreed*

49. This risk can arise if a crowdfunding platform does not have processes that ensure that lenders commit money to projects in a timely fashion. For example if a platform does not have a mechanism to collect the money or to require lenders to provide direct debit authorisation.

### D) Legal risks

50. Risks D1 and D2 have already been described above in the 'Risks to lenders' section.

*D4: Borrowers' project ideas could potentially be copied*

51. This risk arises because borrowers have to disclose their ideas on crowdfunding platforms to promote their business and to attract potential lenders.

### E) Liquidity risks

*E1: Borrowers can face liquidity problems if the provision of funds is delayed after the project has met the required financial threshold, thus undermining the success of the project*

52. Similarly to risk E1 for lenders, this risk arises due to a lack of or an insufficient timeline of fund availability.

### F) Operational risks

53. Risk F1 has already been described above in the 'Risks to lenders' section.

## Risks to crowdfunding platforms

### B) Reputational risk/Risk of fraud

*B4: Crowdfunding platforms face the [reputational] risk that loans will not be repaid by borrowers intentionally*

54. This risk can arise due to the fact that the anonymity of the internet provides opportunities for individuals to act under false pretences to offer fake investment opportunities on a crowdfunding platform. It is therefore extremely important to ensure that crowdfunding platforms obtain identification and contact information about borrowers, including evidence. Furthermore, the risk of fraud could increase if a platform does not conduct a thorough background check on a borrower e.g. their former career, financial status and criminal records. In the long run, if a platform offers very bad lending opportunities (which typically will only become apparent over time through high loan-default rates) then this credit risk will rapidly transmit into reputational problems for the crowdfunding platform, potentially even lead to the failure of a platform.

#### F) Operational risks

*F2: Crowdfunding platforms are at risk of attacks by hackers*

55. This risk arises if corporate governance arrangements on a crowdfunding platform do not exist or are insufficient. Another causal driver is that a particular platform is technologically faulty.

#### G) Money laundering

*G1 and G2: Crowdfunding platforms might be misused for, or shut down due to fraudulent or money laundering activities.*

56. This risk arises due to a lack of or insufficient customer due diligence with regard to addresses, creditworthiness, criminal records, etc. Furthermore, a lack of applicable anti-money laundering regulation can be a causal driver for the risk that a particular platform will be misused for such purposes.

## Potential regulatory measures to address the risks and risk drivers

57. This chapter outlines the potential regulatory measures that would need to be put in place to address the risks and the risk drivers identified above.

### Disclosure requirements on the general risks of lending-based crowdfunding

58. In order to address risk driver **a** in table 1 above, i.e. that lenders might not have sufficient financial literacy to conduct a risk assessment of a particular crowdfunding initiative, crowdfunding platforms should have to comply with certain disclosure requirements. Accordingly, the website of the platform should contain information on projects, borrowers and financing mechanisms. Information about the risks for lenders – including the risk of total or partial loss of the capital invested; of not obtaining the expected return; and of the lack of liquidity – must also be provided on the platform's website. Generally, all information must be clear, understandable and not misleading.

59. Risk driver **a** could also be addressed if crowdfunding platforms were required to conduct risk analysis, at least to a certain extent. Such services could comprise, for example, an analysis of the project financing provided by a borrower, the assessment of the level of risk for lenders and the establishment of the prior determination of any other variable that could be useful for a lender to take a decision to invest. However, such services must not necessarily constitute, and should not be construed as, investment advice or investment recommendations.

60. Another way still to address risk driver **a** would be a requirement for platforms to establish categories of lenders, and by specifying criteria to be considered for categorisation (e.g. institutional, professional or retail lenders). A platform could be required to check and evaluate the financial literacy, experience and knowledge of dealing with financial products of particular lenders and to categorise them accordingly. A lender would only be permitted to invest in opportunities that are intended for lenders of his risk categorisation.

61. Before a lender would be permitted to invest in a certain offering, a website should ensure that a potential lender receives specific information about the risks for lenders, the risk of total or partial loss of the capital invested, the risk of not obtaining the expected return, and the general risk that the borrower might become illiquid or insolvent. This information must be clear, understandable and not misleading. Finally, lenders should only be permitted to invest after confirming acknowledgment of this information.

62. Risk driver **a** could also be addressed by establishing investment limits for lenders, or per category of lenders. For example, a lender could only be permitted to invest a maximum amount per project, within a certain period of time or depending on his income or wealth. To ensure adherence to these investment limits, any crowdfunding platform would be obliged to ask lenders to confirm that they comply with the statutory limit and will not exceed the limit due to the intended investment in a particular offering.

### Regulatory requirements regarding due diligence procedures on projects advertised on a crowdfunding platform and Know your customer/customer 'due diligence'

63. Risk driver **b**, i.e. the risk that a lender underestimates the risks of an investment assuming that every project advertised on a platform is subject to due diligence, could be addressed by requiring crowdfunding platforms to disclose detailed information of the extent to which a risk assessment has been performed. Any information gained should be made available to lenders. In particular, crowdfunding platforms would be required to disclose the checks that have been performed during the selection of projects to strengthen the ability of lenders to make informed decisions.

64. In any event, a platform should be required to disclose, in a way that is fair, clear and not misleading, if it does not undertake risk assessments for projects at all.

65. It is also conceivable to address risk driver **b** by introducing a regulatory requirement that crowdfunding platforms must conduct an effective, proper and clearly defined due diligence procedure on any project/investment opportunity, possibly above a certain threshold, before advertising an opportunity on a platform's website. Furthermore, any results of due diligence procedures performed in relation to a project would have to be disclosed.

66. To address risk drivers **b** and **f**, i.e. the risk that individuals acting under false pretences might use crowdfunding platforms to collect money for fake offerings, would require background checks of borrowers to be carried out. Platforms should therefore be obliged to request identification information, addresses, information about financial status/creditworthiness and potential criminal records from borrowers/lenders. Furthermore, a crowdfunding platform should be required to deny access to its website if it has reason to believe that a borrower/lender might potentially act fraudulently.

### Assessment of the creditworthiness of lenders and borrowers

67. To address risk driver **c**, i.e. a lack of or insufficient assessment of creditworthiness and risks, platforms could be required to establish lender protection services/facilities themselves, for example, to retain a certain amount of the charges to ensure repayments in the event of default.

68. Borrowers could be required to provide important data regarding their creditworthiness to crowdfunding platforms and/or to lenders. Furthermore, platforms could be obliged to reject projects from borrowers with insufficient creditworthiness. Finally, platforms would in any event be obliged to provide disclaimers regarding the credit/counterparty risk on the platform. This risk driver could also be mitigated if crowdfunding platforms were required to cooperate with a bank, either in the way that the bank processes the assessments on a professional basis or takes over any credit risk by contracting with each borrower directly. Some business models are already set-up in this way.

### Protection for participants in case of platform failure

69. To address risk driver **d**, a crowdfunding platform could be required to have organisational arrangements in place to ensure that loans would continue to be administered if the platform goes out of business. Those arrangements could envisage setting up a compensation scheme, insurance coverage for default, or similar provisions.

### Authorisation or registration of the crowdfunding platform

70. To address risk driver **e**, platforms should be required to be authorised by a national financial supervisory authority or at least be registered with an authority. This could include checking that the natural persons who manage a crowdfunding platform meet appropriate standards for competence, capability, integrity and financial soundness.

71. Platforms should be required to disclose their authorisation or registration details on their website.

### Data protection measures

72. To address risk driver **g**, i.e. the misuse of customers' personal data, crowdfunding platforms should be required to have an appropriate document-handling policy in place and clearly state this in their terms and conditions.

### Requirements to address conflicts of interests

73. To address risk driver **h**, crowdfunding platforms, their shareholders, managers or key employees could be prohibited from having or acquiring financial interests in a borrower's business. In any case, crowdfunding platforms should be obliged to implement measures to identify and manage potential conflicts of interest. Furthermore, these measures should be unambiguously disclosed on their websites. These disclosure requirements may also be required if the structuring of a compensation agreement leads to a 'conflict of interest'. This could be the case, for example, if a borrower is not obliged to pay any fees to a platform if the target amount is not collected.

74. In any event, crowdfunding platforms should be required to disclose, if a platform, its shareholders, managers, and/or key employees have financial interests in the business of a borrower.

### Fair and transparent contracts clauses and fee structure

75. To address risk driver **i**, crowdfunding platforms should be required to clearly describe the rights and obligations of the parties, the financing process and all costs and other features applicable to contracting parties. In addition, a draft contract should be made available on the website to both borrowers and lenders, and customers should confirm their acknowledgment of the terms and conditions prior to the conclusion of any contracts.

### Measures to address unclear or insufficient exit opportunities

76. To address risk driver **j**, a crowdfunding platform could have to ensure that lenders are aware of their rights to cancel a contract prior to its maturity. Crowdfunding platforms should offer a true, clear and complete explanation of the termination rights applicable under statutory law and, where necessary, pursuant to their contractual terms. A platform would accordingly be required to explicitly disclose on its website the exact point in time at which it would no longer be possible to terminate an investment prior to maturity.

77. Furthermore, platforms could be required to offer a lender the right to withdraw from a crowdfunding commitment, provided that the funding goal/target amount has not been reached and the project owner has not yet received the money.

### Complaints handling procedures

78. To address risk driver **k**, platforms could be required to set up an appropriate complaints handling mechanism. A clear and flexible open policy on complaints handling should also be explicitly described in the terms and conditions of the platform.

### Account segregation and other money-handling requirements

79. To address risk driver **l**, platforms that hold money from lenders or borrowers (e.g. repayments) could be required to segregate their clients' money from their own money. When platforms perform money transfer services, they could be required to be registered with the NSA, in accordance with the Payment Service Directive's (PSD) requirements. Exemptions or reduced requirements based on the annual amounts involved in such payment activities could be considered for these platforms. When platforms use a third-party payment provider, this should be a registered and authorised payment service provider. All these requirements and safeguards are in place in the PSD.

80. Two potential regulatory approaches could be considered. The first approach would relate to a situation where a supervisor would forbid platforms from carrying out money-handling activities themselves, with the need to use an authorised PSP for such purpose. Alternatively, if a platform wished to carry out these activities itself, it would have to be registered as a payment services provider.

### Protection of project ideas

81. Risk driver **m** could be addressed by requiring platforms to disclose all risks, including the risk of project ideas being copied.

### Requirements to address liquidity risk

82. Risk driver **n** could be addressed by requiring platforms to take reasonable care to establish and maintain systems and controls that are appropriate to their business, including in relation to the timely transfer of agreed funds. Platforms must also disclose all risks, including the risk that pledged money may not be paid when it is due, in a way that is fair, clear and not misleading.

### Requirements to address IT risks

83. IT risks for lenders and borrowers may arise in particular from the unavailability of systems, networks, or data, or from a loss of data integrity. Addressing risk drivers **o** and **p** and mitigating these risks requires a sound IT organisation, reliable IT systems, processes and resources, and effective IT controls.

### Requirements to address anti-money laundering concerns (G1; G2)

84. To address risk driver **q**, platforms could be included in the scope of the Anti-Money Laundering Directive (AMLD). Payment service providers are already included in the scope of the AMLD.

85. The risks of money laundering, terrorist financing and financial crime are primarily related to the borderless nature and potential anonymity of borrower/lenders carrying out transactions on a peer-to-peer basis that do not require personal identification. Companies should take reasonable care to establish and maintain appropriate controls in that sense (including when using a payment service provider).

## Applicability of existing EU law

86. Using the risk analysis and the business models as a basis, the EBA assessed the extent to which existing EU directives and regulations may potentially address the risks identified.

87. The directives that fall within the EBA's scope of action and are subject to further scrutiny for the purposes of this opinion are as follows:

- Directive 2013/36/EU (the Capital Requirements Directive, CRD)<sup>14</sup>;
- Regulation (EU) No 575/2013 (the Capital Requirements Regulation, CRR)<sup>15</sup>;
- Directive 2014/17/EU (the Mortgage Credit Directive, MCD)<sup>16</sup>;
- Directive 2007/64/EC (the Payment Services Directive, PSD)<sup>17</sup>;
- Directive 2009/110/EU (the Electronic Money Directive, EMD)<sup>18</sup>; and
- Directive 2005/60/EC (the Anti-Money Laundering Directive, AMLD)<sup>19</sup>.

88. On a general overview of crowdfunding platforms, there were very few regulated entities involved in offering crowdfunding services at the time this Opinion was being written. This Opinion therefore aims to assess the applicability of those legislative acts to lending-based crowdfunding in light of the currently prevailing market practices of the sector. From the list outlined above, the EBA considers the CRD/CRR, MCD, PSD, EMD and AMLD to be the most relevant directives to this analysis. In addition, this report outlines the applicability of the Consumer Credit Directive (CCD), although this is not a directive that falls within the scope of the EBA, as well as other miscellaneous directives. These directives are assessed in more detail below.

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<sup>14</sup> Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (*OJ L 176, 27.6.2013, p. 338–436*)

<sup>15</sup> Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (*OJ L 176, 27.6.2013, p. 1–337*)

<sup>16</sup> Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010 (*OJ L 60, 28.2.2014, p. 34–85*)

<sup>17</sup> Directive 2007/64/EC of the European Parliament and of the Council of 13 November 2007 on payment services in the internal market amending Directives 97/7/EC, 2002/65/EC, 2005/60/EC and 2006/48/EC and repealing Directive 97/5/EC (*OJ L 319, 5.12.2007, p. 1–36*)

<sup>18</sup> Directive 2009/110/EC of the European Parliament and of the Council of 16 September 2009 on the taking up, pursuit and prudential supervision of the business of electronic money institutions amending Directives 2005/60/EC and 2006/48/EC and repealing Directive 2000/46/EC (*OJ L 267, 10.10.2009, p. 7–17*)

<sup>19</sup> Directive 2005/60/EC of the European Parliament and of the Council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing (*OJ L 309, 25.11.2005, p. 15–36*)



## Capital Requirements Regulation and Directive (CRR/CRD)

89. The EBA's analysis of the applicability of the CRD and CRR has focused on credit institutions.

The CRR defines credit institutions as an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account - Article 4(1), point 1. The cumulative nature of the elements making up the definition of credit institution (accepting deposits/other repayable funds and granting credits) excludes various types of persons from the definition of credit institution because both activities must be carried out in order for the person concerned to be a credit institution under the CRD/CRR<sup>20</sup>.

90. In light of the business models the EBA has assessed, typical crowdfunding platforms providing the lending based variant do not seem to hold deposits or repayable funds, and simultaneously to grant credit for its own account. Therefore, they would not fall under the scope of the CRD/CRR.

91. As the business model of crowdfunding platforms does not appear to fall inside the perimeter of credit institutions and their typical business model as defined in the EU legislation, the funds provided by lenders with crowdfunding platforms would not qualify as deposits eligible for protection under a deposit guarantee scheme, taking into account the definition of 'deposit' in Article 2(1), point 3, of Directive 2014/49/EU (the Deposit Guarantee Schemes Directive). According to this definition, deposit "means a credit balance which results from funds left in an account or from temporary situations deriving from normal banking transactions and which a credit institution is required to repay under the legal and contractual conditions applicable [...]".

92. As observed in some envisaged business models, where a platform is run by a credit institution (or in cooperation with a credit institution), the requirements set out in the CRD-CRR would apply to the credit institution administering the platform or to which the operation of the platform is externalized. However, this in itself does not imply that funds held for the crowdfunding activity would be considered deposits.

## Mortgage Credit Directive (MCD)

93. The Directive's scope is over: i) credit agreements which are secured either by a mortgage or by another comparable security commonly used in a Member State on residential immovable property or secured by a right related to residential immovable property; and ii) credit agreements the purpose of which is to acquire or retain property rights in land or in an existing or projected building.

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<sup>20</sup> See also 'EBA Opinion on matters related to the perimeter of credit institutions (EBA/Op/2014/12)' and the 'Report to the European Commission on the Perimeter of credit institutions established in the member States, 27 November 2014'. This Opinion and Report indicate there are some variations in the interpretation of the term 'credit institution' at a national level

94. At the time of this assessment, very few platforms provided lending-based crowdfunding solutions for real estate investment. Where the platforms would be considered to provide mortgage credit in the course of their trade, business or profession, it could be acting as a creditor (as defined in the MCD) to whom the obligations of the Directive apply. Where the function of the platform is simply to provide a meeting point, it could potentially be subject to the Directive requirements on credit intermediaries unless its actions are limited to 'merely introducing' the consumer and the creditor.

95. Furthermore, the MCD applies to credit agreements offered by creditors, i.e., natural or legal persons who grant or promise to grant credit in the course of their trade, business or profession. Therefore, the lender, be it the platform itself or a contributor to the platform, would have to be a professional lender for the MCD to be applicable, which is not usually the case.

### **Payment Services Directive (PSD)**

96. The money-handling aspect is likely to be present in all types of crowdfunding (donations, rewards, lending, and investment). This highlights the relevance of the PSD and its application to crowdfunding in general.

97. Given the business models identified above and the money-handling variants involved, platforms could be said to be providing the following services as defined in the PSD:

- services enabling cash to be placed in, or withdrawn from, a payment account as well as all the operations required for operating a payment account (points 1 and 2 of the Annex of the PSD);
- the execution of payment transactions, including transfers of funds on a payment account with the users' payment service provider or with another payment service provider (point 3);
- issuing and/or acquiring payment instruments (point 5); or
- money remittance (point 6).

98. Where crowdfunding platforms intend to provide directly the services listed above, they could be regarded as payment service providers (PSPs) - such as credit institutions, e-money institutions, or payment institutions as referred to in Article 1(1) or under waiver under Article 26 of the PSD. Therefore platforms would have to be licensed or registered with the competent authorities. When platforms are not credit or e-money institutions, they would need to be authorised as payment institutions or registered. In some markets crowdfunding platforms appeared to act as agents of payment institutions. Article 17 of the PSD requires those payment institutions to communicate to the competent authorities in its home Member States:

- the name and address of the agent;

- a description of the internal control mechanisms that will be used by agents in order to comply with the obligations in relation to money laundering and terrorist financing under Directive 2005/60/EC; and
- the identity of directors and persons responsible for the management of the agent to be used in the provision of payment services and evidence that they are fit and proper persons.

99. The PSD provides different thresholds of initial capital requirements for payment institutions. The requirements specified in the PSD covering initial capital, own funds, and safeguarding requirements, could cover risks A3, B2, C1, D2, D3, F1, F2, as well as parts of C7 (because information requirements only cover the provision of information related to payment services, whereas risk C7 describes wider risks related to disclosure).

100. Among other requirements, payment institutions are required to have proportionate, appropriate, sound and adequate governance arrangements and internal control mechanisms (Article 5(c) PSD). More generally applicable for all the categories of payment services providers listed in Article 1(1) of the PSD, Title III specifies transparency of conditions and information requirements for payment services providers in relation to payment services users. Title IV establishes rights and obligations in the provision and use of providing payment services. In particular, Article 75 introduces the obligation of the payment services provider to the payer and the payee, depending on who has initiated the payment transaction respectively, and also provides for the consequences of non-execution or defective execution of a payment order, including restoration of the amount of the payment transaction.

101. Article 26 PSD provides that the procedures and conditions for the authorisation of payment institutions may be waived, for entities of a specific type, allowing natural or legal persons to be entered in the national registers or payment institutions when the following conditions are met:

- “the average of the preceding 12 months' total amount of payment transactions executed by the person concerned, including any agent for which it assumes full responsibility, does not exceed EUR 3 million per month. That requirement shall be assessed on the projected total amount of payment transactions in its business plan, unless an adjustment to that plan is required by the competent authorities; and
- none of the natural persons responsible for the management or operation of the business has been convicted of offences relating to money laundering or terrorist financing or other financial crimes.”

102. The persons performing payment services according to the conditions of Article 26 PSD are considered as payment institutions, although they are not allowed to provide their services in a Member State other than its home Member State, and can be subject to limitations in engaging in the activities listed in Article 16, among which the most relevant for lending

based crowdfunding platform is in point c of paragraph 1, ‘business activities other than the provision of payment services, having regard to applicable Community and national law’.

103. Article 3 PSD provides the negative scope, from which the following could be relevant for crowdfunding activities<sup>21</sup>:

- payment transactions from the payer to the payee through a commercial agent authorised to negotiate or conclude the sale or purchase of goods or services on behalf of the payer or the payee (letter b);
- services provided by technical service providers, which support the provision of payment services, without them entering at any time into possession of the funds to be transferred, including processing and storage of data, trust and privacy protection services, data and entity authentication, information technology (IT) and communication network provision, provision and maintenance of terminals and devices used for payment services (letter j);
- services based on instruments that can be used to acquire goods or services only in the premises used by the issuer or under a commercial agreement with the issuer either within a limited network of service providers or for a limited range of goods or services (letter k).

104. Where a crowdfunding platform is considered to act as a payment institution, another important provision affecting the treatment of the contributions received from lenders (or alternatively, from borrowers when repaying a loan), would be Article 16(2) of the PSD: “when payment institutions engage in the provision of one or more of the payment services listed in the Annex, they may hold only payment accounts used exclusively for payment transactions. Any funds received by payment institutions from payment service users with a view to the provision of payment services shall not constitute a deposit or other repayable funds within the meaning of Article 5 or Directive 2006/48/EC”.<sup>22</sup>

105. Payment institutions which provide payment services and, at the same time, are engaged in other business activities referred to in Article 16(1)(c) (so called hybrid PSPs) only in payment services activities, must comply with the safeguarding requirements mentioned under Article 9 of the PSD:

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<sup>21</sup>The EBA is aware of additional clarifications provided by the Commission on <http://ec.europa.eu/yqol/index.cfm>. However, given their legally non-binding nature, EBA suggests a more solid clarification to be provided.

<sup>22</sup> The Directive has been repealed by Directive 2013/36/EU.

- [funds received] “they shall not be commingled at any time with the funds of any natural or legal person other than the payment services users on whose behalf the funds are held..., and
- they shall be insulated in accordance with national law in the interest of the payment service users against the claims of other creditors of the payment institution, in particular in the event of insolvency;
- or they shall be covered by an insurance policy or some comparable guarantee from an insurance company or a credit institution (...).”

106. Where PSPs only provide payment services, not engaging in other business activities, Member States may ask PSPs to comply with the safeguarding requirements mentioned in the previous paragraph.

### Interpretation issues

107. With regard to the scope of application, in general, Article 1(2) of the PSD refers to the “provision of payment services as a regular occupation or business activity”; whereas Recital 6 of the PSD mentions that the application of the directive “should be confined to payment service providers whose main activity consists in the provision of payment services to payment service users”. The definition of ‘main’ and ‘regular’ business activity is not provided by the Directive. This may have consequences in determining the potential scope of application of the PSD to lending based crowdfunding, for which the provision of payment services will not be the main business activity although at the same time it is also provided on a regular basis. This lack of definition could lead to different approaches among Member States determining different regimes with regards to the application of PSD requirements to crowdfunding.

108. Regarding the application of exemptions under Article 3 of the PSD, some Member States consider that the commercial agent exemption might be applicable because crowdfunding platforms act on behalf of the payer or the payee (the lender or the borrower). By contrast, other Member States consider this exemption is not applicable, because the platform acts on behalf of both the lender and the borrower without any margin to negotiate or conclude a sale or purchase of goods or services.

109. Concerning the payment services provided by the crowdfunding platforms, some Member States consider the money handling performed by platforms as money remittance (point 6 of the Annex to the PSD), while others consider that platforms provide services enabling cash to be placed in or withdrawn from a payment account (points 1 and 2 of the Annex) or acquiring payment instruments (point 5) and the execution of payment transactions, including transfers of funds on a payment account with the users’ payment service provider or with another payment service provider (point 3). While money remittance is defined in the PSD (in

Article 4(13)<sup>23,24</sup>), the other services are not so precisely defined, as a result of which it is difficult, for example, to determine the capital requirements for platforms<sup>25</sup>.

110. Concerning the 'limited network' exemption, there are also divergent opinions: some Member States consider this exemption might be applicable while others consider that in lending based crowdfunding the conditions referred to Article 3(k) PSD are not fulfilled since this exemption is applicable to services based on instruments that can be used to acquire goods or services, with a view that there is no instrument and/or the payment services are not used to acquire a good or a service, rather are used to execute a service, i.e. a loan.

### **E-money Directive (EMD)**

111. Considering the analysis of lending based crowdfunding business models, when the platform receives and keeps funds (until the required funding level for a specific project's financing is reached), after which the funds would be paid out via an electronic wallet service, it could be considered to be issuing e-money providing, and thus qualifying as e-money institutions according to the EMD.

112. The EMD defines electronic money as "electronically, including magnetically, stored monetary value as represented by a claim on the issuer which is issued on receipt of funds for the purpose of making payment transactions as defined in point 5 of Article 4 of Directive 2007/64/EC, and which is accepted by a natural or legal person other than the electronic money issuer". The contributions from lenders into a crowdfunding platform could potentially amount to e-money, which according to the EMD has to be prepaid and issued at par value on receipt of funds, and therefore fit in the first part of this definition. However the second part of the definition could be interpreted as potentially excluding lending-based crowdfunding from the EMD, as the funds received by lenders are to be used only with borrowers inside the platform for financing purposes.

113. The EMD may be relevant for lending-based crowdfunding for another reason: in addition to issuing electronic money, electronic money institutions<sup>26</sup> are entitled to engage in the

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<sup>23</sup> "Money remittance means a payment service where the funds are received from the payer without any payment accounts being created in the name of the payer or the payee, for the sole purpose of transferring a corresponding amount to a payee or another payment service provider acting on behalf of the payee, and or where such funds are received on behalf and made available to the payee".

<sup>24</sup> And also in Recital 7 of the PSD "money remittance is a simple payment service that is usually based on cash provided by a payer to a payment service provider, which remits the corresponding amount for example via communication network to a payee or to another payment service provider acting on behalf of the payee.

<sup>25</sup> See Article 6 of the PSD, which sets up initial capital requirements for payment institutions to hold according to the service provided.

<sup>26</sup> Which according to the EMD are legal persons authorised to issue electronic money. Credit institutions are the other relevant category of electronic money issuers, although in this case the issuing of electronic money is to be considered as part of the banking business described in Annex I to the CRD which a credit institution can engage in, whose primary activity has been defined in paragraphs 84 et seq.

provision of payment services listed in the Annex to the PSD, which as considered above in paragraph 98 appear to be relevant in defining money-handling aspects of crowdfunding.

114. In this respect, the same considerations covered under the study of the applicability of the PSD to crowdfunding apply. In line with the provision of Article 16(2) of the PSD, Article 6(3) of the EMD provides that “any funds received by electronic money institutions from the electronic money holder shall be exchanged for electronic money without delay. Such funds shall not constitute either a deposit or other repayable funds received from the public within the meaning of Article 5 of Directive 2006/48/EC”.

115. However funds collected from clients by electronic money issuers have to be safeguarded in accordance with article 7 of the EMD, which makes reference to the safeguarding requirements under Article 9 of the PSD.

### **Anti-Money Laundering Directive (AML)**

116. Risks G1 and G2 could be covered by the AMLD. The AMLD applies to the natural or legal persons listed in Article 2 of the AMLD. The Directive applies if crowdfunding platforms fit into any of the types listed in that article, which also includes unregulated institutions. In particular, subparagraph (3)(e) of Article 2 of the AMLD specifies that any natural or legal persons trading in goods, to the extent that payments are made in cash in an amount of €15,000 or more, are subject to the directive. However, the EBA’s remit covers the AMLD’s scope only to the extent that credit institutions or financial institutions are concerned as defined in Article 4(1) of the EBA Regulation. It is the EBA’s view that AML risks are of high relevance in crowdfunding activities, as there are no requirements on platforms to perform checks on participants and origin of funds.

117. Finally, when a platform is a PSP or a PSP agent, the AMLD rules apply.

### **Consumer Credit Directive (CCD)**

118. The CCD is unlikely to be applicable to lending-based crowdfunding, at least in most cases, as the CCD applies to credit agreements in which a creditor, defined as a “natural or legal person who grants or promises to grant credit in the course of his trade, business or profession”, grants or promises to grant credit to a consumer “natural person who (...), is acting for purposes which are outside his trade, business or profession”. Therefore, for typical lending-based crowdfunding, the CCD would not be applicable to crowdfunding platforms, as the platform typically does not act as a lender or borrower.<sup>27</sup>

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<sup>27</sup> However, if a crowdfunding platform performs activities that might be considered as acting as a credit intermediary, as defined in letter (f) of Article 3 of the CCD, the pre-contractual information requirements apply (Article 5 and 6) and some additional information concerning the intermediation (Article 21 of the CCD). Point (f) of Article 3 of the CCD defines credit intermediaries as a natural or legal person who, in the course of his trade, business or profession, for a

119. Should a platform itself provide credit to borrowers, or should it lend funds to consumers for them, in turn, to lend on to borrowers, the CCD's provisions concerning creditors would apply to the platform.

### Miscellaneous EU directives and regulations

120. Directive 2002/65/EC concerning the distance marketing of consumer financial services would be applicable where financial services are granted by a 'supplier', which means any natural or legal person, public or private, who, acting in his commercial or professional capacity, is the contractual provider of services subject to distance contracts. However, the EBA's remit only covers the scope to the extent that credit institutions or financial institutions are concerned as defined in Article 4(1) of the EBA Regulation.

121. The Unfair Commercial Practices Directive [2005/29/EC] regulates business-to-consumer commercial communications/practices pre- and post-sale, in particular, those which are misleading or aggressive and applies to all sectors including financial services. Therefore, the Directive could potentially be applicable.

122. Information society services provided by electronic means from a distance and at the individual request of a recipient of services fall within the scope of the E-Commerce Directive [2000/31/EC]. Where an information society service provider is established in another Member State, the host state cannot restrict the information society service provider's freedom to provide the service into the host state from another Member State (Article 3(2)). This may be relevant for the assessment of whether national approaches are sufficient to address risks where cross-border business takes place.

### Risks and risk drivers potentially left unaddressed

123. Having assessed the existing EU legislation considered above, the EBA concludes that the PSD is the Directive most feasibly applicable to lending-based crowdfunding, covering the payment side of the activities of these platforms. However, as a result, the lending side is not necessarily covered, leaving several risks and risk drivers that the EBA had identified as arising in crowdfunding unlikely to be addressed. From these, the EBA considers the following to be particularly relevant:

- a lack of or insufficient information regarding lenders' and borrowers' rights, duties and risks that can arise from crowdfunding;

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fee, (i) presents or offers credit agreements to consumers; (ii) assists consumers by undertaking preparatory work in respect of credit agreements other than as referred to in (i); or (iii) concludes credit agreements with consumers on, behalf of a creditor.



- a lack of or insufficient requirements on any due diligence processes and assessment of borrowers' creditworthiness conducted by a platform;
- a lack of or insufficient requirements on platforms' complaints handling procedures;
- a lack of or insufficient internal platform procedures (related to document handling processes and records setting);
- a lack of or insufficient safeguards against platform default; and
- a lack of or insufficient project safeguard clauses.

## Regulatory convergence across the EU

124. The convergence of practices across the EU for the supervision of crowdfunding is a desirable goal to avoid regulatory arbitrage; create a level-playing field; ensure that market participants can have confidence in this new market, and to contribute to the single European market.

125. As an internet-based activity, crowdfunding has the potential for cross-border activities. The different framework within the EU is one of the key challenges posed to international platforms outside the EU, and that wish to enter the European market.<sup>28</sup>

126. At this early stage of market development, the EBA is of the opinion that convergence should be based on existing EU law, and recommends that EU legislators provide clarity on the applicability of said law. Lending-based crowdfunding services are provided using a large number of different business models, which is why different pieces of EU financial regulation may potentially apply.

127. Should EU legislators consider developing a crowdfunding-specific regulatory framework, the potential regulatory measures (stated in the chapter above) as well as existing national regulations for crowdfunding (stated in the chapter below) should be considered. However, the EBA will continue to monitor the market and will revise this conclusion if required.

128. The EBA considers the PSD to be the Directive that is most feasibly applicable to lending-based crowdfunding. Regarding the application of the Directive, the EBA identifies the need for the EU legislators to clarify: the scope namely regarding the distinction between regular and main activity, allowing for a common interpretation of the Directive's application; the application of the exemptions, in particular the use of commercial agents (Article 3(b)); and the definition of payment services listed in the Annex of the PSD.<sup>29</sup>

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<sup>28</sup> Tonic & European Crowdfunding Network (2013), "crowdfunding for impact in europe and the usa"

<sup>29</sup> The EBA is aware of projects of future Directives and regulations, such as the ongoing discussions at this stage of the Payment Services Directive's revision (PSD2), where there might be a clarification of the use of commercial agents' exemption.

129. The EBA also concludes that the PSD can be applicable to all types of crowdfunding when platforms engage with payment services.

130. As seen in some Member States, there seems to be an opportunity for platforms to choose between the PSD and the EMD in some cases, therefore providing opportunities for regulatory arbitrage. More clarity is needed by the EU legislators on where the crowdfunding activities best fit.

131. In addition, as the business models of lending-based crowdfunding platforms do not appear to fall inside the perimeter of credit institutions and their typical business model as defined in the EU legislation, the funds provided by lenders with crowdfunding platforms would not qualify as deposits eligible for protection under a deposit guarantee scheme, taking into account the definition of 'deposit' in Article 2(1), point 3, of Directive 2014/49/EU (the Deposit Guarantee Schemes Directive).

132. At this stage, the business models do not fall under the definition mentioned above. However, should the market evolve to the direct participation of credit institutions in providing loans through lending-based crowdfunding (as some indications already suggest), the provisions in the CRR/CRD will be determinant to rule out a number of risks identified. Additionally, for the lending activity, the CCD and the MCD would become applicable if those credit institutions provide loans through the platform.

133. As lending is not being carried out by professional entities, lending-based crowdfunding falls outside the scope of both the CCD and MCD. The lending side of crowdfunding, and the corresponding risks that the EBA has identified, are therefore left unaddressed. For these risks and risk drivers, the EBA suggests potential ways to address them. The chapter on potential regulatory approaches above has identified the drivers of the risks. This includes possible ways to address the risks that would be left unaddressed, namely by establishing:

- disclosure requirements on the general risks of lending-based crowdfunding;
- requirements regarding due diligence procedures on projects advertised on a crowdfunding platform;
- the provision of an appropriate complaints-handling mechanism;
- requirements regarding internal procedures, and to address platform defaults;
- disclosure requirements regarding risks related to project ideas.

134. To that end, one possible way for the EU legislators to achieve a coordinated approach to crowdfunding across the single market is to communicate how existing EU law should be applied to lending-based crowdfunding, and, at the same time, to provide indications on how the additional requirements listed in the previous paragraph could be given effect to.

135. However, considering that crowdfunding platforms typically fund small or medium sized companies, and that some platforms themselves may be small or medium sized companies

and having been set-up very recently, a proportionate potential regulatory approach should be considered, to both promote the growth of crowdfunding, as an alternative source of funding, and ensure market confidence and provide safeguard for the participants.

136. These conclusions are based on the limited availability of data. The EBA acknowledges that it is necessary to carry out a thorough assessment of market data for lending-based crowdfunding to gather more information about the business models and the set of contractual relationships and practices and of risks materialising (if possible).

137. This information could potentially be gathered through a mapping exercise involving the Commission, the competent authorities and crowdfunding companies. This could, of course, contribute to a more in-depth analysis of the actual risks involved and to a better determination the most applicable and suitable framework for lending-based crowdfunding maintaining the balance necessary to promote the growth of crowdfunding, as it 'complements traditional sources of finance and contributes to the financing of the real economy',<sup>30</sup> and to ensure a safe environment for participants, borrowers, lenders and platform operators. However, apart from the fact that this requires time and resources, the markets seem to be dynamic and adjust their business models with regard to the current legal framework and the national characteristics.

138. The EBA stands ready to assist the EU institutions in their future work around crowdfunding as needed.

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<sup>30</sup> As referred in the Commission's Communication on Crowdfunding.

## National regulation specific to lending-based crowdfunding

139. Some Member States have created specific regulations to address risks arising from crowdfunding. This is the case for France, Italy, Spain and the UK. Italy's regulation only covers investment-based crowdfunding. In Spain, the draft law is in the final approval stages. These national regulations are explained in detail below.

### France

140. The French Order dated 30 May 2014 deals with the following risks and drivers:

#### Disclosure requirements on the general risks of lending-based crowdfunding

141. To address risk A1, lending-based platforms in France have to ensure that lenders are aware of the potential risks of crowdfunding operations, including the risk of total or partial loss of the capital invested, the risk of not obtaining the expected return, and the risk of lack of liquidity. These risks shall be clearly disclosed on their websites. Furthermore, the websites are required to contain clear information on projects, borrowers and the financing mechanism. Pursuant to the Order, to diversify the risk, lenders are only permitted to lend a maximum amount of €1,000 per project for loans with interest and €4,000 per project for loans without interest.

#### Regulatory requirements regarding due diligence procedures on projects advertised on a crowdfunding platform

142. In order to address risk C4, a crowdfunding platform will have to disclose detailed information regarding the extent to which a risk assessment has been performed. A crowdfunding platform will be required to disclose the controls that have been performed during the selection of projects to strengthen a lender's ability to make an informed decision.

#### Assessment of the creditworthiness of the lender and borrower

143. Lending-based platforms are required to put at lenders' disposal a tool to assess their funding capacity. Platforms have to benchmark and select the projects, and should therefore be able to assess the creditworthiness of borrowers (risks A2, C3, C7-8). Finally, platforms are obliged to provide disclaimers on the credit/counterparty risk on the platform.

#### Know-your-customer due diligence

144. In order to avoid fake offerings, platforms are required to conduct background checks on their customers. Platforms should therefore be obliged to request from borrowers/lenders: identification information, address data and information about their financial status (risks B1, C4, and C5).

### Protection in the event of the failure of a lending-based platform

145. Platforms are required to have arrangements in place to ensure that loans continue to be administered if a platform goes out of business (risk driver E).

### Registration of lending-based platforms

146. Platforms are required to be registered with a national competent authority which is in charge of assessing the fit and proper requirements of the natural persons that manage a lending-based platform (risk driver f).

### Fair and transparent contract clauses and fee structure

147. Platforms are required to clearly describe the rights and obligations of the parties, the financing process, all costs and all other features applicable to contracting parties (risks C2 and D1). In addition, a draft contract has to be made available on the website to both borrowers and lenders, and customers will have to confirm their acknowledgement of the terms and conditions prior to the conclusion of any contracts.

### Clear and sufficient exit opportunities

148. Crowdfunding platforms have to ensure that lenders are aware of their rights, if they exist, to cancel an investment prior to its maturity (risk C6). A platform has to offer a true, clear and complete explanation about the termination rights applicable under statutory law and, if applicable, pursuant to the contractual terms. Furthermore, platforms may offer lenders the right to withdraw from an investment commitment provided that the funding target amount has not been reached and the project owner has not received the money. If the funding amount is reached, platforms must mention whether there is a possibility or not to withdraw before the end of the financing.

### Provision of an appropriate complaints handling mechanism (D2)

149. Lending-based platforms are supposed to put in place the appropriate arrangements to provide access to an appropriate complaints procedure. Contracts between lenders and borrowers have to mention the full address and details of the relevant service.

### Money handling (A3; D3)

150. Depending on the business model, as soon as a platform wishes to perform money transfer services (e.g. repayments), a licence as a payment services provider is required. Nevertheless, reduced requirements based on the monthly amounts involved in payment activities have been implemented.

## Spain

151. With regard to crowdfunding activities, the Spanish draft law on business financing tries to achieve a balanced approach to the different regulatory trade-offs: not hampering the development of an activity, preserving a high level of consumer protection, as well as ensuring the impartiality of platforms. The scope of the law is limited to activities within the Spanish territory. The envisaged regulation for the lending-based models includes the elements detailed below.
152. First, the law establishes a regulated activity for the taking up and pursuit of the business of financial crowdfunding. Platforms are defined as companies authorised to match up, in a professional capacity via websites or other electronic means, investors, offering loans in exchange for monetary return, with natural and legal persons, requesting funding on their own behalf which is used for a crowdfunding project. If a platform wishes to act as a payment service provider, it is required to obtain a licence as a hybrid payment service provider.
153. Second, the law establishes an authorisation requirement, and a regime for registration, inspection and supervision. The authority overseeing the authorisation and registration is the Comisión Nacional del Mercado de Valores (CNMV), regardless of whether the vehicle used is a security investment or a loan, but a system of collaboration between the CNMV and the Banco de España is foreseen for lending-based models (for authorisation, supervision and inspection).
154. Third, the law also establishes suitability requirements similar to those of credit institutions, and specific capital requirements, depending on the funding obtained by a platform over the previous 12 months, as well as due diligence requirements.
155. Fourth, investor typologies as accredited and non-accredited investors have been established, which specify the criteria to be considered for the categorisation (natural persons, legal persons, level of income). A platform must assess the experience and knowledge of its clients in relation to lending operations, verify that he/she can take their own investment decisions, and understand and prioritise information risks.
156. Fifth, the law establishes general disclosure requirements, in particular for non-accredited investors, to try to make it clear that investing in this kind of project is an inherently risky venture because borrowers might be unable to repay or provide a return on the funds invested, as well as the fact that a platform cannot ensure that the information provided for publication is reliable.
157. Specific regulatory measures have been established as a result: the information regarding projects, borrowers and the financing mechanism must be easily available and worded in clear and understandable language; platforms should offer clear information on their websites about the risks for lenders as well as the risk of total or partial loss of the capital

invested, the risk of not obtaining the expected return, and the risk of lack of liquidity of the investment. The services to be provided by crowdfunding platforms include an analysis of the project finance received by borrowers, an assessment of the level of risk for lenders, and establishing any other variable that could be useful for a lender to take the decision to invest. Prior to undertaking any lending agreements platforms will require non-accredited investors, lenders and natural persons to express, in writing, that they have been properly warned of and clearly understand the risks. Platforms must set investment limits for non-accredited investors.

## United Kingdom

158. Legislation has been introduced in the UK to create a new regulated activity: operating an electronic system in relation to lending. The principal requirement is that an electronic system be used to match the needs of investors and borrowers, to enable one party to lend to another.

159. This regulated activity covers many (but not all) forms of lending-based crowdfunding.

- Loans from one large company to another are not within scope of the regulated activity, but all other variations are (companies lending to individuals, individuals lending to individuals and individuals lending to companies).
- Loans where capital is returned to the investor but there is no interest payment (as is sometimes the case in micro-finance platforms with a social objective), are not within scope of the regulated activity.

160. The UK FCA has introduced a national regime for the regulation of lending-based crowdfunding. The key organisational requirements are as follows (text in brackets shows which of the risks identified above are addressed by each requirement):

- prudential requirements apply to the firms running the platforms (A4);
- firms must have appropriate systems and controls in place to manage the business (A2, B1, B3, C1, C7, C8, D3, E1, F1, F2, G1, G2);
- firms must employ competent staff with the requisite levels of knowledge (B2, B4, C6);
- resolution plans must be in place that mean, in the event of the platform collapsing, loan repayments will continue to be collected so those lending to firms do not lose out (A4);
- firms must follow rules on the segregation and regular reconciliation of client money accounts (A3, D3);
- firms must have dispute resolution processes in place. Where consumers who complain are dissatisfied with a firm's response, they may ask the UK Financial Ombudsman Service to consider the complaint (D2);

- firms are obliged to report information at regular intervals to the FCA. These reports cover: complaints experience, capital resources, client money holdings and details of the loans arranged. The information will assist in the ongoing monitoring of the market.

161. The key conduct of business requirements to protect investors are as follows:

- Firms must inform prospective clients of certain information, including: expected and actual default rates on loans, a description of what due diligence is performed and the level of risks associated with loans, whether loans are secured, how returns are taxed, the procedures for dealing with loans in late payment or default, whether it is possible to withdraw money early and details of what would happen if the firm fails (B2, C2, C5, C6, D1);
- All communications must be fair, clear and not misleading and be presented in a way that the intended customer will understand. Platforms must not downplay risks or warnings (A1, C4);
- Where firms do not provide access to a secondary market, investors can cancel without penalty and without reason within 14 calendar days (C5);
- Individuals who borrow money are protected under the Consumer Credit Directive requirements (C7).

162. Regarding payments, if the payment activity is ancillary to a main business activity (such as the funding of loans) the FCA does not seek to regulate the payment service.