The alternative finance sector's role in building local economic resilience

This qualitative study by the Bauman Institute explores the motivations of the people and companies involved in the alternative finance movement (such as crowdfunding, peer-to-peer lending, and community debenture schemes), and assesses its potential contribution to building a more democratic and resilient financial system.

Key findings

The sector is growing rapidly – in 2015 the total size was £3.2 billion, almost five times that recorded in 2013. The majority of this was in peer-to-peer lending, but there has been a recent surge in peer-to-peer investment.

Alternative finance companies perceived current investors as motivated by a desire to build real social and environmental benefits, as opposed to speculating on abstract financial returns. Mainstream investors have recently shown an interest in the sector, and it is probable that they would have very different investment objectives.

The companies interviewed for the research saw widening participation in the financial system as a key aim of democratising finance. Few interviewees in the study discussed the need for more inclusive governance models. The relative lack of financial literacy among the general public was considered a barrier to the expansion of the sector.

Many alternative finance companies are motivated to deliver social and environmental benefits, primarily through their ability to facilitate financial connections.

The usefulness of the alternative finance sector in building local resilience through investment in local projects could be hampered by regional inequalities, as less affluent areas will have less money to invest locally.

The sector's increasing entanglement with mainstream finance threatens to force compromises on the movement's current goals and ways of working.

Key recommendations

- Central government should consider guaranteeing a certain amount of consumers' investment in alternative finance products in order to encourage wider participation, with the requirement that these be direct investments in 'real economy' local businesses, infrastructure, and community projects.
- Investment is required in civil society organizations that can protect the integrity of the alternative finance sector and help improve public understanding of finance.
- The movement should co-produce and publish 'standards of alternative finance' to establish and protect its status as a moral alternative to mainstream finance.

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Policy and practice context

Organisations operating in the alternative finance sector suggest that they can be inclusive instruments of social change, contributing to sustainable business growth and prosperity, which can in turn foster greater social cohesion and tackle rising inequalities. The sector is growing rapidly, and there is an urgent need to understand the viability and desirability of these schemes, their potential social and ethical impact, and their possible benefits.

About the study

This study, by the Bauman Institute, University of Leeds, analysed alternative finance with specific regard to local economic resilience. Semi-structured interviews were carried out with 12 senior members of alternative finance companies (interviewed between November 2015 and March 2016) to explore their motives, and how they see the relationship between their economic activities and their social impact. Interviewees were drawn from different industry sectors, including SME investments, renewable energy, infrastructure and property. These findings were compared with wider evidence from desk-based research, in order to assess the extent to which the models are successful in achieving their aims.

The UK's alternative finance movement

The alternative finance movement includes both a self-identifying business sector specialising in financial innovation, and an active network of civil society organisations campaigning for progressive change to build a fairer, more democratic, and so resilient financial system.

Alternative finance prioritises direct investment in what is often called the 'real economy' – local businesses, infrastructure, and community projects that are intended to generate social and environmental benefits as well as a financial return. It represents a growing and dynamic social movement sharing a set of common values and aims across a highly diverse set of companies, trade bodies, regulators, civil society organisations and investors.

Although it is still a relatively small part of the overall financial services market, the sector, which is concentrated in the South East of the UK, has grown rapidly – in 2015 the total size was £3.2 billion, almost five times that recorded in 2013. The majority of this was in peer-to-peer lending, but there has also been a recent surge in peer-to-peer investment. Comparing its size with high-street banks, such banks lent £53 billion to SMEs in 2015, and peer-to-business lenders lent £1 billion.

Investor motivations

'[T]hey invest in something they believe in! And then they come back, they see other things, and then they start to develop their portfolio…'

The alternative finance sector has actively promoted itself as a moral actor as well as an economic actor, setting out a range of different visions for what this means for any given company. The overall view is best captured by the slogans 'invest in businesses you believe in' (Seedrs) and becoming 'more directly connected to the business in which you are investing' (Ethex).

The commitment to direct productive investment – building real social and environmental benefits, as opposed to speculating on abstract financial returns – is understood by the sector to be the principal motivation of current and future investors, and they are wary of any threat or compromise to that message.

The sector's capacity to contribute to building economic resilience

The study evaluated alternative finance in relation to two key aspects of resilience: democratising finance; and facilitating productive investment in the 'real economy'.

Democratising finance

'[T]here's a very, very large number of people who have a small amount of money, and that money – if it's aggregated efficiently – can equally fund opportunities, and sometimes do better because of the wave of public support.'

Many interviewees spoke about democratisation in terms of widening participation in the financial system, opening up areas of financial activity that were previously the preserve of a small, wealthy and informed elite of investors. This stops short of an ambition for full financial inclusion, as participation in online alternative finance platforms necessarily presupposes access to the internet and to a bank account.

With notable exceptions, the majority of alternative finance companies seldom see the democratising of finance in terms of more inclusive governance models. Older financial models of cooperatives and credit unions were seen to get closer to the ideals of democratising finance and building local economic resilience, but they were regarded as not always making sound financial decisions or delivering on their business objectives.

Interviewees suggested that a risk to the process of democratising finance is the relative lack of financial literacy amongst the general public. Mainstream finance often enables people to partake in financial activities with very little knowledge by relying on professional experts, but alternative finance strives to break down these barriers and encourage greater inclusion in the financial system.

Investing in the real economy

'[T]he money is being put to work effectively – it is doing good things.'

Many alternative finance companies are motivated to provide a 'moral return' to their investors, i.e. delivering social and environmental benefits to a local or national community. They regard facilitating more diverse financial connections within and across local communities as the most obvious way in which they contribute to local investment.

However, although this emphasis upon the local exists and is regarded as a cornerstone of building economic resilience, many alternative finance companies transcend geographical boundaries. Being overly reliant upon local investment would place very real limits on the amounts of money that can feasibly be raised for projects. Also, wealthier areas are able to invest more funds and so drive more projects to improve their local communities, whereas those who lack resources to invest fall further behind. Focusing upon managing financial flows within a local area can, therefore, further exacerbate regional inequalities (an issue underlined by the sector's predominance in the more affluent South East).

The future of alternative finance

'[I]t has a lot of money, it has a lot of resource and expertise that it can leverage, and I think, beware of someone disrupting the disruptors, it could well happen.'

Three clear themes emerged during the interviews when the future of alternative finance was raised. First, interviewees believed that the recent boom in the sector would continue. However, this was not seen to be a straightforward or smooth process because, second, there was a high risk that the sector would experience a series of mergers amongst alternative finance companies or a series of takeovers by, or increased 'copycat' competition from, traditional mainstream finance. This would result, third, in the growing entanglement of alternative finance with mainstream finance, including increasing investment from mainstream investors. It was felt that the unique selling point of providing a more democratic, empowering, and 'moral alternative' to high-street banks would be extremely difficult to maintain in such circumstances.

This growing entanglement has serious implications for the capacity of alternative finance to contribute to building economic resilience in the ways outlined above.

Some interviewees were more hopeful and optimistic about the role that mainstream finance could play, and expressed the hope that by becoming more entwined with traditional financial institutions there could be an increase in power and influence for the alternative finance sector to drive forward its disruptive mission from within, leading to a more efficient, responsive and inclusive mainstream.

Conclusions

The current structure and future direction of the alternative finance sector offers both opportunities and challenges to its ability to play a role in local economic resilience.

A trade-off may be needed whereby alternative finance companies can partner with local organisations to deliver both democratic business practices and greater effectiveness and chances of good outcomes.

It is doubtful whether alternative finance in its current form can mobilise enough capital within local communities to make them more resilient, and it is unclear how feasible (indeed, desirable) it is for alternative finance companies also to deliver sufficient capital for long-term local investments. However, one of the opportunities presented by the sector's heavy reliance on the internet is the opportunity to build decentralised finance networks, to overcome the limitations of local fundraising.

Alternative finance's ability to deliver on its potential to democratise finance and build economic resilience from within the mainstream is also somewhat doubtful. Increased integration with mainstream financial institutions would decrease the likelihood that there will be a further transformative step towards a democratisation of finance that empowers the public and increases direct productive investment in the 'real economy'.

Recommendations

- Central government should consider guaranteeing a maximum amount of investment in alternative finance products, perhaps up to £5,000 per investor, in order to encourage wider participation. There should also be a requirement that these investments be direct investments in the 'real economy' in a transparent and accountable way. This will empower the sector to democratise finance.
- There should be increased resourcing of the civil society organisations that protect the moral integrity of the alternative finance sector (for example, Finance Innovation Lab, Move Your Money, New Economics Foundation, Positive Money, Share Action), as they are integral to the process of democratising finance. This resourcing should come through a combination of central government and sector support, to establish the public and private sectors as equal partners in this mission.
- A portion of this additional resourcing for civil society organisations should be devoted to a large and coordinated campaign to improve public understanding of economics and finance, as an essential part of any attempt to build resilience through creating an inclusive democratic finance model for productive investment in the 'real economy'.
- The movement should co-produce and publish 'standards of alternative finance' to establish and protect its status as a moral alternative to mainstream finance. These standards should: prioritise direct productive investment in the 'real economy'; deliver more inclusive governance structures; and develop a set of clear objectives for what 'democratic finance' looks like in practice, and what it can deliver for both people and the planet.

Further information

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