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Microlending and Non-Accredited RE Investors as a Current Trend

By Jeffrey M. Shepard

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This is due to the growing popularity of crowdfunding. It was in May 2015 that the SEC updated their rules making it possible for more people to invest with ease. There are those who are familiar with crowd funding platforms, like GoFundMe, which they understand to be philanthropic in nature to help those that may be in need. However, some people have not yet realized that crowd funding can apply in the business world, particularly when it comes to real estate. How crowd funding works is that many people give small contributions on an online funding platform so that they can finance something (Freedman, 2015). Within the United States, crowdfunding appears to be slightly more popular than microlending.

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I. Introduction

With billionaires like Donald Trump having made their fortunes from real estate, there is considerable interest from investors to put money in real estate for great returns (Thomas, 2016). For a long time, many were not motivated to invest in real estate, believing it to be an expensive venture, and therefore out of reach. To become an investor, one needed to fit within a certain criterion, thereby becoming known as an accredited investor. This means that investments were limited to only accredited investors. However, things have changed considerably, and now, it is possible for anyone to invest as a non-accredited investor.

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II. History of Borrowing for Real Estate

Donald Trump is now highly popular for being the President of the United States. However, he was highly popular even before this, for making a fortune through real estate and other ventures. It is worth noting that he employed an interesting strategy to make his ventures successful. He borrowed from the bank and used the funds to build his empire. In fact, he even earned the nickname "King of Debt", a moniker which he is rumored to have coined for himself (O'Connell, Fahrenthold, & Gillum, 2018). When he started off with his investments, he had one main philosophy, and that was not to invest with his own funds. This limited the losses that he would incur should the venture not go according to plan. The mistake that Donald Trump made early in his career was taking loans that he could not afford to pay back, which led him to bankruptcy. He corrected this and was able to bounce back and rebuild his financial empire. In 2019, it is possible to work towards getting great returns through real estate with smaller investments through microlending.

There is another real estate mogul who started with a microloan, and ended up making a fortune that amounted to billions. That was Ted Lerner. At the age of 25, and with a law degree that was not giving him the return that he expected, he asked for a loan that was worth $250 from his girlfriend. His intention at the time was to get int real estate. Using this money for investment, as well as his wits, he found a way to become successful, turning himself into a real estate agent. Following his success in this field, he then became a developer and continued on the road to success. Today he is the most successful real estate developer in the United States. Back when microlending did not have the traction that it has today, he started, and succeeded (Lerner, 2013).

III. Microlending in the United States

When it comes to microlending, which definitively falls under microfinance, the very concept was earlier associated with under developed countries that faced significant issues with poverty. Microfinance was made popular by Muhammed Yunus, the founder of the Grameen Bank, with the clear purpose of helping those in Bangladesh gain financial freedom (Counts, 2008). At the time, there were people living all around the lower income areas of the country and they were caught in a web of debt, operated by shylocks. The web was so strong that for many, it would have been impossible to break free of it. Fast forward to several decades later, and what was a tool for developed countries. This tool has finally begun to establish its relevance in the United States of America. Being a highly developed country, one may wonder why it would be relevant to those within the US economy. The reason is quite simply, financial inclusion.

It is incredible the number of people who are living below the poverty lines in the United States, and

Author: Ph. D, United States. e-mail: jshepard@saybrook.edu

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therefore, lack the opportunity to become serious investors. A survey that was carried out by Career Builder established that there are close to 45 million people who are living below the poverty line, and an incredible 78% who are living from paycheck to paycheck. So even though the US is one of the most developed countries in the world, it is also one that has a significant gap when it comes to wealth distribution (Morpeth, 2018).

In any country, especially the United States, economic turbulence means that there are more people who are moving towards self employment. When this is put together with the challenges in financial inclusion, it is clear that there is need for opportunities for financing. However, with economic turbulence comes other issues, such as low credit scores which make it close to impossible to get a loan from the bank. This is where microfinance institutions have been able to find a niche.

Although the growth of microfinance, and microlending is still in its infancy in the US, it is likely to see continued growth moving into the future (Raheb, Fall 2017). One key concern that has been raised is the possible sustainability of microfinance and microlending institutions in the US, due to their being a different financial climate from developing countries. The poverty level in the United States, in many cases, is not comparable with those of developing nations. In developing nations, there are those who are working to raise their families on less than a dollar a day, which may not be the case in the US. That is why when it comes to microlending in the US, for those institutions that do exist, there is a challenge in getting people to come on board, ensuring all loans are repaid as they are expected as well as a regulatory framework. Where there is less need, there is less urgency in making sure one maintains a strong, and long term relationship with the microlending institution. Therefore, the microfinance and microlending institutions that you would find in a developed country would need to be adjusted or altered so that they can thrive in the US and meet the financial need (Wharton, 2011). This means that the driving force behind them needs to be different, to ensure that they are able to get long term participants, who also find the products that are on offer worthwhile.

This hybrid microlending institution can be seen in the real estate industry. This is because within real estate, there is currently a focus on crowdfunding for this market, a form of microfinance that is not so much loans and lending, as it is people coming together to pool resources, and then invest. Real estate is expensive, and many are unable to afford an investment in real estate beyond their personal home. Even when investing in a personal home, it can take years to pay off a mortgage. Microlenders have capitalized on the opportunity to open up real estate investments to those who may not have the large sums required. When on a crowdfunding site, there are some sites that will commit a certain percentage of the investment, showing that they have a stake in the success of the investment as well.

The rich get richer, while the poor get poorer, or at least this seems to be the case when it comes to investments in the USA. Those who are able to invest, are known as accredited investors, while those who struggle to enter the investing game are known as non-accredited investors or small investors. For the small investor to play in the big leagues, they need to have access to some funding, and that is where crowd funding comes in. Furthermore, they need to make sure that whatever funding they have can actually make an impact. This is why they combine resources with others. That is why the investors who will come under the crowd funding umbrella, are normally known as non-accredited investors. These investors are also sometimes given the term everyday investors, since the amounts that they invest are small, that they can fit the every day individual. When one wants to invest, it is essential that they understand a clear difference between the two to make the right decisions (Ippolito, Nonaccredited investor options: Part1: FundriseeReit vs. RealtyMogul.com Reit vs. Rich Uncles, 2017).

IV. Accredited Investors and Non-Accredited Investors

To clearly establish the type of investor one is, one must differentiate between an accredited and non-accredited investor, and the differences extend beyond the amount that can be invested. An accredited investor is one who makes more than $250,000 a year, or has a net worth of more than $1,000,000. When looking at the numbers, one notes that there are only around 3% of the total American population that can become accredited investors. Putting it in clearer perspective, there are only around 300,000 individuals, as well as a total of 500 firms that invest as accredited investors (Scarpf, 2015). Of all the people who could invest, this is the number that has been registered as actually investing. It was back in 2015 that the SEC (United States Securities and Exchange Commission) found it essential to update their rules to open up real estate crowdfunding to non-accredited investors. These non-accredited investors are those that earn below $200,000 on an annual basis, and also have a net worth that falls below $1,000,000.

The non-accredited investors are able to invest from as low as $500 to get started and almost all of their investments are done online. The average amount that most people will invest as a non-accredited investor is around $5000. This is different from accredited investors who will typically need to invest from between $5000 - $500,000. However great this is, there are still those that need a minor boost to improve their investment amount. This is where Microlending comes in. Like crowd funding, most micro funding platforms can be found online, and they are now changing the way finance is approached, particularly for real estate.

There is a point that is worth noting, and that is the accredited investors have better alternatives than the non-accredited investors. There are extremely high fees to contend with, which most accredited investors are excluded from. These may be up to 3% of the investment for organizational expenses as well as marketing. Should one opt out of the investment as a non-accredited investor, they may have to also pay an extra fee so that they can get their money back. Furthermore, when it comes to the returns, for accredited investors they are also higher. It is possible to get returns of between 15 – 25% IRR, as there is additional risk involved.

One disadvantage that the accredited investor will face is the illiquidity of their investment. With the non-accredited investor, the investment tends to be more liquid, and can be converted back into cash faster for a quicker return. This is possible due to the low amount that has been invested. The accredited investor will typically have an investment that will take in excess of a year to mature and get a return (Millionaire, 2018).

a) Reason's That Non-Accredited Real Estate is Continuing to Thrive

Consider being in a group of people, and all of them are invited to a party. You are the only person who is not invited, though you can still see the happy group party through a window. You are on the other side, simply watching and feeling left out. Non-accredited investors are those that have always been outside the party, and finally, have been able to join the large group. For this reason, they are excited to have the chance to actually build up a real estate portfolio, which makes all of the costs incurred worth it.

The non-accredited investors will typically use an online platform that already has a sponsor. The sponsor puts in a large amount, normally up to 10% of the total investment. This is to give the non-accredited investor some reassurance that the risk being taken is worth it, and reveals alignment with the investor. Where there are so many people averse to risk, having this reassurance means that more investors are able to participate in crowd funding opportunities (Ippolito, 2017).

In the US, there are currently more than 100 real estate crowdfunding companies, where you will also find non-accredited investors (Mindham, 2017). In the year 2016, it was established that a total of $2.6 billion had been invested as capital on these platforms, and rapid growth is estimated, reaching $300 billion by the year 2025. Here is what you can expect from some of the sites that are available online: -

- Realty Mogul: This offers interesting alternatives for the investor, including retail properties, multi family units, hospitality properties and even office buildings. It has been in existence since 2013 and has a portfolio of property that is worth more than $2 billion. There are in excess of 175,000 registered members on this platform (Mogul, 2019).
- Fund Rise: Here is another platform where the investor will be spoilt for choice from the number of funds that they can choose from. There are a total of seven available and investors can decide whether they need income or are looking to grow their investment. One can choose between first time home buyer housing, as well as equity and debt options in commercial real estate (Fundrise, 2019).
- Fund That Flip: This is another platform for real estate crowd funding, though it focuses on residential real estate. It also registers people in record time, usually within five minutes for those who want to become investors. The focus of the site is finding homes, flipping them and then selling at a profit. The profit is then shared with the investors (Flip, 2019).
- Blackstone: For any non-accredited investor that is looking for heritage will find what they need at the Blackstone Real Estate Income Trust (BREIT). This is a company that has been around for more than 25 years and has accumulated a massive portfolio. This site offers products that can easily be customized for the individual investor (Blackstone, 2019).
- Lending Home: As a crowdfunding site for real estate, this one focuses on mortgages where non-accredited investor can return of up to 8% of the investment. This means that it focuses on high-yield real estate assets (Home, 2019).

Real Estate crowdfunding offers non-accredited investors the chance to not only create a portfolio for investment, but also to diversify it. Through this, it is possible to invest and benefit from returns without having to go into direct ownership. When it comes to real estate crowdfunding, one can choose between equity or debt investments. Here are the two main differences that you need to note. The one that has the higher risk is the equity investments. Should you choose this type of investment, then you will have an ownership stake in the property. The return on investment comes in the form of a percentage of the rental income. In the event that the property has been put up for sale, then the investor would get some gains from the sale. If a non-accredited investor is looking for a high return on investment, then this would be the preferred option. However, with greater returns come greater risk particularly if there is a sudden reduction in rental income.

When dealing with debt, then you will find that you are investing in a mortgage for example. This would be a commercial property. The return on investment comes into play when the loan is being repaid, as the

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non-accredited investor would be able to benefit from some part of the interest. What this means is that the investor would have put some money into the crowd fund, together with others and someone would then purchase the property. As they pay it back, interest is earned. So, one can choose what type of investment they want to go into so as to receive the highest return possible. The only disadvantage that this type of investment has is that the returns are limited, only to the interest rate. The main advantage is that the investor is not a direct owner, and therefore, does not need to take on the responsibility of property management (Lake, 2018).

The reason that microlending and crowdfunding for real estate will continue to thrive is the low entry point where the minimum investment is often at approximately $500 per month, though it can go lower than this on certain platforms. In fact, there are some platforms that are even willing to take up a daily investment of $25. Considering that the price of real estate can run into the millions of dollars, then this entry point is clearly much more affordable, especially considering the returns.

b) What the Law Says about Accredited and Non-Accredited Investors

There is one main difference according to law between the accredited and non-accredited, and it comes down to ownership. An accredited investor will own a stake within the company that they invest in. In the long term, they have a strong asset that is likely to appreciate in value over time. This is not the case for the non-accredited investor, although they are able to benefit from the returns.

For the non-accredited investor, there are platforms that exist which facilitate them to invest in real estate. The investment does not result in ownership, but, the investor is able to benefit from any revenue generated from the property. This adds some flexibility in the investment, as the non-accredited investor is able to decide to change an investment with ease if they are not getting the return that they are expect. For non-accredited investors, these are more crowdfunding then microlending, which explains the evolution that microlending has in the United States. There is an act known as the Jumpstart Our Business Startups Act (JOBS) which was passed in 2012 (Lake, 2018). The law was put in place to help small businesses raise the capital that they need to spur economic growth as well as to create more jobs. It was in 2015 that it became possible, through some provisions from the U.S. Securities and Exchange Commission (SEC) for non-accredited investors to also be a part of this type of investment.

There are some restrictions that have been put in place for non-accredited investors as well. One may assume since microlending is dealing with small amounts of money, then it is possible for just anyone to become an investor. However, there are criteria that the non-accredited investor need to fit within. Being non-accredited, the main restriction comes in the amount that can be invested within a period of 12 months. There is no blanket limit, each limit is based on the individual's net worth as well as their income.

Here is an example. A non- accredited investor may be making less than $100,000 each year, or the investor may have a net worth that is below this amount. This means that they will only be able to invest greater than $2,000 or they can invest up to 5% of their net income on an annual basis. Should the non-accredited investor be making more than $100,000 in a year, then they will be able to invest up to 10% of their income or net worth, whichever is less, though the total limit goes up to $100,000 for the entire year.

These limits are in place to protect the non-accredited investors, as for many of them, they are investing for the first time. This protection will ensure that their losses are limited and also gives them the opportunity to build up their returns. As they increase their overall net income, it will become easier for them to invest some more.

It is essential to note these restrictions as they do not apply in the same way to accredited investors.

V. Regulations for Microlending Institutions

It should be noted that microfinance, which also includes microlending, is an important sector within the financial market. It has been active within this sector for more than four decades, yet, there are still significant gaps when it comes to the regulation of microfinance institutions (Pierce, 2013).

To date, there is still some development needed when it comes to the laws and regulations that microlenders and microfinance institutions are to follow in the US. Currently, they are in operation as one of three groups. The first is the non-profit organizations, and these are the ones that act as distributors of federal money. The second is non-profit organizations that are operating independently from the government. The third is simply for profit organizations (Pierce, 2013). Even with these three groups, there is no clear regulatory body that is monitoring the activities of microlenders (Raheb, Fall 2017). There are some laws that they need to abide to, and these include banking laws, capital holding requirements as well as usury laws. For example, the Usury laws that are in place are there to protect the customers against interest rates that are exorbitant. It is worth noting that the laws will vary from one state to another, with the main difference being in the investment limit for non-accredited investors (Yield Talk, 2018.)

MFIs face a challenge, and that is to make sure that they get an adequate return on their loans,

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especially as they are dealing with riskier customers. With the usury laws in place, it becomes challenging for these institutions to charge a higher interest rate. This means that there needs to be some attention given to the microfinance regulatory system to cater for the nature of MFI loans (Pierce, 2013).

As regulations are being put in place, it is important that they encourage transparency when it comes to the corporate governance of MFIs. With disclosure regulations in place, more investors will be encouraged to take advantage of the available resources of effectively and efficiency. They will also help to legitimize the microfinance industry.

With the growth of microfinance in the USA, one thing that is essential is a regulatory framework coming into place, so that both the investors as well as consumers are protected. This will help with the growth of the microfinance growth.

There are also learnings that the USA can take from other countries that have strong microfinance institution frameworks. The first thing that needs to be taken into consideration is understanding of risk in relation to the legal and institutional framework of the USA. Microfinance institutions face risk in overall management, ownership and governance, portfolio, and as a new industry (Churchill & Berenbach, 1997).

In South Africa, there are MFI institutions that have come together and created a body that is known as the Alliance of Micro Enterprise Practitioners. Through this body, there is sharing of technologies as well as experiences, and together are able to apply to the government for amendments in laws, such as the usury law. This has helped to enhance the regulatory environment for these types of institutions.

In the Philippines, the situation is similar with microfinance coalitions being available. There are also commercial banks, donor agencies, and private foundations that are involved, which has helped create some guidelines that these and other agencies involved need to follow. From a government perspective, there is the Monetary Board that looks at the approach for regulating these institutions. Then the National Credit Council steps in to ensure that activities are rationalized with existing government credit policies. In addition, the National Economic and Development Authority looks at how microfinance can be incorporated into the national economic policies (Churchill & Berenbach, 1997).

VI. What needs to be done to Create a Microlending Fund

It is possible to begin a microlending fund for those who are interested in investing in real estate. Typically, it will have the following components: -

1. A clear purpose: This would outline the type of real estate that is being invested into, with a plan of how much will be invested and the possible return.
2. The Geographical Area Served: For example, a fund could cover real estate options that are available in New York City.
3. The Loan Criteria and Steps for Approval: It should be outlined who can take the loan and what documentation they need to provide to be considered. Following this, there should be clear details on how the loan will be approved, including the length of the approval process, and what happens once the loan is approved.
4. Composition of the Committee: This is essential to putting a name and a person to the overall microlending entity. Since most of the microlending platforms are available online, it is important that those seeking loans can establish some trust by knowing who they are dealing with.
5. Comprehensive Financing Policies: This involves all costs and requirements involved in getting the loan. They should encompass the fees, as well as the interest rates and terms for the loans.

Once one has people who are interested in taking the microloans for real estate, the work begins with proper management of the funds and the investors as well as the marketing (Bowen-Ellzey, 2011).

VII. Conclusion

From the information available, microlending has some way to grow in the United States, especially if one is referring to the more traditional model of microfinance that is being used in developing countries. There are changes that have been made to existing models, to make them a better fit for the market. This is where crowdfunding comes in, which is the primary option for non-accredited investors who are looking for options for investment.

With the current loophole when it comes to laws and regulations, now is the best time to become an investor. With the passage of time, and the increase in popularity, it is likely that this type of investment may become more stringent. Although this may be good from a regulatory perspective, it may ultimately result in the masses being cut out of being able to make good investments.

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