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RISK MITIGATION BETWEEN INVESTMENT ACCOUNT PALTFORM AND EQUITY CROWDFUNDING

BY

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A research paper submitted in fulfilment of the requirement for the degree of Master of Science (Islamic Banking and Finance)

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ABSTRACT

This paper aimed to study Investment account platform in comparison to equity crowdfunding in the risk mitigation side. Equity finance holds a big interest because it has a substantial amount of risk in moral hazard and market risk. This paper aims to focus at the moral hazard side. The approach of this paper will be based on document analysis and organization comparison based on the premise that risk mitigation in equity finance is different from risk mitigation in credit finance. Holding that assumption, the paper finds that Investment Account platform despite the remarkable achievement in terms of mitigating risk still need more development to substantiate it form credit financing that is used in the banking sector. In these regard, this paper suggest to incorporate a committee in Rating Agency Malaysia that is specialized in investment analysis so that the assessment of start-ups become more relevant rather than having the credit assurance like collateral and credit record. The significance of this paper comes from the pioneering examination of IAP as the first paper to do so and from its recommendations to develop risk mitigation in Islamic equity finance that will allow more institutions to embark on this type of finance to further enhance the value proposition of Islamic finance as opposed to conventional finance.

خلاصة البحث

سعى هذا البحث إلى تحديد مدى التشابه والاختلاف بين منصة حسابات الاستثمار التي أطلقها البنك المركزي الماليزي مع ستة بنوك محلية وبين منصات التمويل التشاركي الجماعي وبالتحديد في جهة تحجيم إمكانية الاحتيال التي تكون موجودة عادة في عقود التمويل التشاركي يحمل التمويل التشاركي أهمية خاصة من جهة المخاطرة التي يحملها سواء من ناحية المخاطر الأخلاقية أو المخاطر التجارية وهذه الورقة تسعى إلى التركيز على الجهة الأخلاقية لهذه المخاطر. تعتمد منهجية البحث على مراجعة الوثائق والمقارنة المؤسسية بناء على المقدمة المنطقية بأن المخاطر التي يحملها التمويل بالدين تختلف عن المخاطرة التي يحملها التمويل التشاركي وبالتالي ستختلف الطريقة المتبعة في تحجيم هذه المخاطر. بناء على هذه المقدمة وجدت الورقة أن منصة حسابات الاستثمار رغم ما تمثله من تقدم كبير في اتجاه تنويع الأصول الاستثمارية للبنوك الإسلامية إلا أنها مازالت تحتاج إلى مزيد من التطوير لتتميز بشكل كاف عن وسائل تقليل المخاطرة المستخدمة في التمويل بالدين. في هذا الاتجاه تقترح الورقة من بين أمور أخرى تكوين لجنة متخصصة في التحليل الاستثماري تحت وكالة التصنيف الائتماني الماليزية تكون قادرة على مراجعة الشركات الصغيرة وتحديد أهليتها للاستثمار بعيدًا عن الوسائل المستخدمة في التمويل بالدين كالرهون والضمانات والسجلات الائتمانية. تكمن أهمية هذه الورقة في أنها أول ورقة تدرس منصة حسابات الاستثمار وفي الاقتراحات التي تقدمها التي يرى الباحث أن من شأنها تسهيل التمويل التشاركي وجعله أكثر أمانًا وانتشارًا ما سيعزز القيمة المضافة التي تقدمها البنوك الإسلامية التي تميزها عن البنوك التقليدية الربوية.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Science (Islamic Banking and Finance).

.....

Razali Bin Haron
Supervisor

This research paper was submitted to the IIUM Institute of Islamic Banking and Finance and is accepted as a fulfilment of the requirement for the degree of Master of Science (Islamic Banking and Finance).

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DECLARATION

I hereby declare that this research paper is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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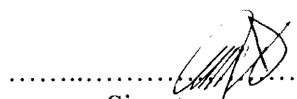

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CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Islamic banking since inception has gained tremendous growth. It is estimated that by 2015 year end, total assets under Islamic financial institutions' management will reach USD $2.143 trillion on average growth of 16.5% yearly. This figure is expected to reach easily USD $3 trillion if the current trend continues. Banking sector accounts for the lion's share of this figure; 75%. The achieved growth and the potential of the industry are not a topic of argument. However, since inception the directions of industry and its functions has been a fertile subject of arguments among stakeholders.

Critics about Islamic banks reliance on debt instruments and replication of conventional products has been prevalent since inception. It is undeniable fact that Islamic banks, like conventional banks, have debt as their main product. To get a sense of the problem, one needs to refer to any published Islamic bank's financial statement to see how much of profit sharing products are used in extending financing. For instance, Maybank Islamic has profit sharing schemes representing around 3% to 5% of its financing and advances from 2013 to 2015 [1] other banks' figures hover around the same percentage if not less. Several approaches have been adopted to analyze the problem. While some has demanded a mere shift to profit and loss sharing system with banks refusing withdrawals (Usmani 2002) as cited by (Azmat, Skully, & Brown, 2015a), some has attributed the problem to the lack of management control and the agency problem in profit and loss

[1] See: http://www.maybank.com/en/investor-relations/reporting-events/reports/subsidiary-reports.page

sharing schemes (Dar & Presley, 2000; Bacha, 1997). Other approach suggest that banks are an organ of the financial system that the main function of is credit creation not profit and loss sharing financing; Azmat et al. (2015) suggest that other types of financial institution have the competency and the responsibility of profit and loss sharing like venture capital and private equity. These institutions nevertheless are so much exclusive to the extent that they will not achieve the goal of robust investment intermediation. Usually, 99% of applications for venture capital get rejected (P. A. Gompers, Lerner, Silviera, & Wright, 2007) and private equity is subject to some critics about predatory acquisitions and extreme layoffs and cost cuts let alone the limitations of investment liquidity. It is needless to emphasize that banking sector is the dominant organ in the financial body. This situation of credit banking or fractional reserve banking system control over the financial system seem to be impenetrable up to the recent years where the emergence of new financial technology start to represent a substantial threat to the existing system.

Financial technology or Fintech as it has been known for in recent years is the provision of financial services without the physical existence of the customer using new technologies to facilitate financial services. To give a glimpse on this new emerging industry one need to know that Global investment in Fintech ventures tripled to USD $12.21 billion in 2014 compared to USD $4.05 billion in 2013. Investment in Fintech companies grew by 201% globally in 2014, compared to 63% growth in overall venture-capital investments, confirming this sector as a hot ticket (Skan, Dickerson, & Masood, 2015). It saw a further increase in 2015 to USD $22 billion (Gach & Gotsch, 2016). As for equity crowdfunding, the most desired mode of finance for Islamic finance stakeholders, it has been reported that start-ups worldwide has raised USD $88 million through equity crowdfunding platforms in 2011 (Crowdsourcing.org, 2012). Until 2015 this figure has

skyrocketed to USD $ 2.5 billion a small chunk of the whole industry of crowdfunding that stand at USD $32 billion[2]. The emergence of this new sector has led to a great deal of attention by regulators and bankers alike especially here in Malaysia; Bank Negara Malaysia the central bank of the country is on the last stages of issuing a guideline on Fintech (THE STAR, 2016). The guideline is intended to provide the ground basis of developing technology-based financial services.

The threat or opportunity represented by Fintech startups is that the new financial tools could mitigate the prevailing concerns about information asymmetry and moral hazard in profit and loss sharing schemes. In fact, financial services provided by Fintech companies are more diversified, efficient and easy to access. They represent a wide range services, from lending, fund remittance, equity financing, payment tools and systems, market places, and many others.

It is then understandable that financial authorities would react to these changes. The authority response is not limited to regulative effort; along with six banks in the country BNM has launched Investment Account Platform (IAP) the first Fintech-based-bank-intermediated fund raising and investment platform in the world. IAP is the response to both Fintech threat and the demand for diversified Islamic banking asset. This paper will examine, by comparison with other equity schemes, the level of effectiveness of IAP in response to the stated issues and weather it is on the right way to achieve the announced goals or it is just another credit tool used by the banking sector to meet the requirement of the time.

[2] See (Crowdfunding Industry Statistics 2015 2016 - CrowdExpert.com, 2016)

1.2 STATEMENT OF THE PROBLEM

Since Islamic finance inception there was no scheme of equity finance that is both inclusive and sustainable. Islamic banks focus on the core banking business and they do not offer sufficiently distinctive services form their conventional counterparts. The excessive reliance on debt has led to limited access of Small and Medium Enterprise to financial services subsequently leading to limited participation by Islamic banks in the real economic growth.

However, these critics on Islamic finance do not solve the substantial causes leading to them; like the asymmetry information inherited in equity finance leading to adverse selection and moral hazard let alone the nature of banking business as demand-deposit accepting institutions.

Nevertheless, a new comer to the financial sector namely Fintech is promising to change the situation that the above argument could no more be relevant. IAP is the industries' internal response to this threat that needs to be examined thoroughly to determine its level of effectiveness in extending financing and generating income adhering to the equity principles.

1.3 PURPOSE OF THE STUDY

This study will identify the risk problem associated with equity finance through literature review and relate it to the current practice by equity crowdfunding platforms in order to compare it with the policies obtained by IAP to perform risk mitigation requirements. The study in this approach will determine the level of success of IAP in providing genuine Islamic profit-and-loss sharing platform. By assessing IAP the aim of the study is to set out the criteria to test the risk mitigation policy of equity finance schemes and set the ground to further development to make equity finance more viable.

inclusive and efficient. Also, the study will recommend the changes needed to rectify any shortcoming in IAP.

1.4 RESEARCH OBJECTIVES

The study aimed to achieve the following objectives:

1- To identify the main risks involved in equity finance especially Islamic schemes like Mudharaba and Musharaka.

2- To identify the main policies obtained by current equity crowdfunding platforms.

3- To test IAP against these policies in risk mitigation and the principles of Islamic equity finance.

4- To recommend the changes needed to make IAP more viable and closer to its goal to achieve inclusive and efficient equity finance platform.

1.5 RESEARCH QUESTIONS

1- What are the main risks involved in equity financial schemes?

2- How does existing equity crowdfunding platforms mitigate such risks?

3- Are IAP policies relevant to equity crowdfunding?

4- What are the recommendations to further develop IAP?

1.6 SCOPE OF THE STUDY

The study is focusing on Malaysia, which is the jurisdiction of Investment Account Platform the first Fintech-based-bank-intermediated equity platform in the world initiated by Bank Negara and six local banks. The special thing about this platform is that it is one of the most sought after responses to the demand for more diversified

Islamic financial services and its first of its kind that need an academic effort to examine its potentials. Also, the focus is on the operational side not the economic benefits; we will focus on the operational characteristics that mitigate the risk of equity finance and differentiate between equity risk and credit risk.

1.7 ORGANIZATION OF THE RESEARCH

This paper will be laid out in five chapters; first chapter the introduction will introduce the topic in its context, its significance, importance and its objectives. Second chapter the literature review will survey the literature on the risk associated with equity finance and the policies to mitigate it especially by equity crowdfunding schemes. Chapter three the methodology will pronounce the methodology used in the research which is qualitative document review and comparison. Chapter four the findings and discussion will set out the criteria to which Investment Account Platform will be examined against to determine the level of achievement it has come to. Chapter five the conclusion will conclude the paper with the verdict about IAP and further recommendations to enhance its position as an equity platform.

1.8 SIGNIFICANCE OF THE STUDY

This study will be an academic review of Investment Account Platform the promising new initiative that aim at enhance Islamic banks' participation in equity finance and financial technology. Also, the study will be of a good reference in differentiation between equity finance risk mitigation and credit risk mitigation. In addition to that, the study will lead the academic effort towards formulating a conceptual structure of Islamic equity finance platform.

1.9 LIMITATIONS OF THE STUDY

The limitation of this study is due to the language limitation has focused on well-established English speaking jurisdictions like US, UK and Australia. Further research is required to construct the optimal Islamic equity finance organizational structure. Also, the study only focused on the qualitative side of risk mitigation it is therefore worthwhile to further enhance the literature on the quantifiable equity crowdfunding side.

CHAPTER TWO

LITERATURE REVIEW

PART ONE: THEORETICAL REVIEW

2.1 INTRODUCTION

The main distinctive feature of equity finance is the risk involved, which is compensated by the benefit of potential gain unlike conventional debt finance where the return is fixed as opposed to the guarantee and relatively low risk involved. In Islam, debt finance cannot generate income as it is against the Hadith and legal maxim: "الخراج بالضمان"[3] the income is by the expense (not literal but approximate meaning); in other words debt finance has no commercial risk therefor, it is not entitled to the profit generated. The acceptable way to generate income in Islam is the commercial activity that implies potential gain and potential loss. However, the risk undertaken in this commercial activity could and should be mitigated. By studying these risks in nature and causes one can come up with policies and regulations to prevent unintended conflicts.

The closest concept to our topic is venture capital and recently the new emerging sector; equity crowdfunding therefor, it is justifiable to examine both of them so that we arrive to a clear understanding that we can compare to IAP.

2.2 RISK IN EQUITY FINANCE

There is ample literature on moral hazard in equity organizations that is the result of asymmetric information leading to adverse selection. Bacha, (1997) started with the contemporary stock company to illustrate the conflict of interest that leads to moral

[3] Abu Daud 3510

hazard articulating that while the shareholders interest is the maximization of entity's value, the interest of company's management is the maximization of utility to increase their benefit. Mudharaba venture according to him, has more severe risk as it is a combination of debt and equity. This could be explained by highlighting the features of Mudharaba that it is the profit cannot be accounted for until realization and capital recovery because the entrepreneur is obliged to return the capital upon winding up if the profit is realized. with no control to the capital provider, according to Bacha (1997), the risk in Mudharaba is more severe than contemporary stock company. Except, this is not accurate according to the Sharia references of all past jurist schools[4] as the capital provider has the right to specify the mandate for the entrepreneur, which the breaching of can hold the entrepreneur liable. Also, capital provider can easily insure his risk by tracking the asset as Mudharaba generally involve a purchase of an asset on behalf of capital provider and the sale of this asset. These characteristics of Mudharaba can easily cap the possible expenses and gains limiting the possibility of fraud or the usage of accounting loopholes. In short, the asset collateralizes Mudharaba and the capital provider could retain the ownership title until the profit is realized making mudharaba one of the safest modes of equity investment.[5]It is therefore more worthwhile to investigate the risk in contemporary stock company by highlighting the practice in equity crowdfunding firms.

The stock corporation is the main scheme of equity organizations; therefore, it is a considerable part of equity crowdfunding activities. The practice of current crowdfunding platforms in dealing with agency problem is a good guidance to future development of Islamic equity finance products.

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[4] Badai' Assanai' of Kasani V6 P98, Almuqadimat Almumahidat V3 P11, alhawy Alkabir V7 P314, Almughni V5 P49.

[5] Same previous references.

2.2.1 The agency problem:

The agency problem is an inherent problem in any delegation contract. It has been a problem since human beings started to form partnerships but in the contemporary corporate structure it has been highlighted by researchers since (Berle et al., 1932). As we saw earlier, Mudharaba has an agency problem as it involves delegating the business activities to the Mudharib and as far as the control is concern we suggested according to the Islamic legal reference that agency problem could be mitigated by preserving assets title. However, other types of agency contracts does not necessarily link to tangible asset; the main type of this agency is the contemporary stock company.

According to Dyl (1988) agency problem arise in any contract where one or more persons engage another person or persons in performing some tasks or services on their behalf. The problem arises when the agent do not find it impulsive to act in the best interest of the owners. Dyl (1988) also suggest that the wider the range of shareholders in a company the more its agency problem is evident. From the previous discussion, one can categorize the main methods to mitigate agency problem in two categories; disclosure to reduce information asymmetry and governance to reduce misconduct.

2.2.2 Information asymmetry and signaling theory:

Prior to the emergence of crowdfunding, information asymmetry has been a substantial concern for financial markets especially in equity finance where Leland & Pyle (1977) has explained that the average quality of projects offered to venture capitalists would affect the market existence. If venture capitalists cannot find a worth investing projects, intuitively, the market will not exist hence, the need for responsible and proper

disclosure. Also the problem of information asymmetry and agency cost become more prevalent in startups where the information has not been compiled and the firm's structure has not been stabilized especially when the firm in question is a technological one (Gilson, 2003; Ibrahim, 2015).

In our context, according to Ahlers et al. (2015), information asymmetry will be more advent in equity crowdfunding as most of the investors are novice about investment assessment and therefore, wrong decisions could be more frequent leading to investors' loss or startups with insufficient funding. Therefore, equity crowdfunding need a robust and standardized disclosure system so that investors has equal opportunity to appraise the projects. Except that some literature has implied that the market will move rather spontaneously to the point where all entrepreneurs will be inclined to disclose the most possible information because investors will perceive every project that disclose less to be less worth investing (Grossman, 1981)

In every commercial deal, there is a potential of asymmetry information; in a sale transaction, the seller would probably know more about the goods. The same goes with hire transaction; the hirer might know more about the service compared to the hiree and in investment transaction, the entrepreneur will definitely have more knowledge and appreciation of the venture. This fact has led to the development of signaling theory which explain how the sender (entrepreneur) send information to the receiver (investor)(Connelly, Certo, Ireland, & Reutzel, 2010).

Signaling theory has been formed to reduce these information asymmetries between two parties (Spence, 1973). In our context, signaling is concerned about how entrepreneurs or managers could signal their qualities to potential investors.

For instance, Zhang & Wiersema (2009) found that attributes of the CEO send a significant signaling to the market as to whether the CEO is fully qualified for the post

or not; the more credible CEO certificate the better the market reaction. Other literature have examined the role that management reputation play in the perception of the firm among investment communities (Yatim, 2011; Certo, 2003).

In the context of crowdfunding, Ahlers et al. (2015,2) have found that potential investors try to evaluate unobservable factors; they found that startups with:

1- Startups with board members with better education credentials are likely to attract more investors. The study found that firms with higher number of directors holding MBA degree are likely to attract more investors.

2- Startups with board members who have a better network are likely to attract more investors.

3- Investors perceive startups who are aiming to exit through IPO or trade sale more positively.

4- The longer the firms the history the better its odds in attracting investors.

5- Firms that provide neither financial forecast nor disclaimers are less likely to attract investors.

6- Firms that retain less shares after funding request are less attractive to investors.

Some listed companies on crowdfunding platforms include in their offering documents the patents that they have obtained, government loans, endorsement by angel investor or venture capitalist.

Before embarking on crowdfunding, it is worthwhile to set the ground with a review of traditional equity finance institutions to see how the new comers are or are not changing the landscape.

2.3 TRADITIONAL EQUITY FINANCE

Venture capital could be described as an intermediary in equity finance usually it involves a limited partnership agreement between institutional investors like investment banks and pension funds whereby the venture capital as fund manager engage in as a general partner (GP) and the investors as limited partners. Upon the offering the fund manager will issue a document disclosing the fund strategy and its targeted portfolio with a mandatory liquidation tenure and profit sharing ratio with agency fees to the GP (Gilson, 2003). All in all, it is almost a contemporary Mudharaba venture.

Venture Capital (VC) is a financial intermediary providing financing to firms that otherwise might find it hard to raise fund. These firms are usually small firms that operate in small markets; they have a potentially high return with possibly high risk. (NVCA, 2016; P. Gompers & Lerner, 2001). Along with angle investors they were the main players that financed startups that lately became multi-billion companies like Google, Facebook, Twitter or any other tech giant that come to your mind is venture capital and angel investors (Ibrahim, 2015). These two institutions has played the role that equity crowdfunding today seek to paly therefor, it is worthwhile to investigate the treats that made these institutions successful in changing the market place and taking the game to another level.

According to Ibrahim, (2015) the main reason to this success is the close social knit between VC and entrepreneurs as most of the time the geographic location is close.

Joint venture capitalists mitigate the adverse selection risk by obtaining a stringent mechanism so that only 1% of the applications will be approved (P. A. Gompers et al., 2007). This methodology include assessment of the management team, the concept, the marketplace, fit with the fund's objectives, the value added potential for the firm, and the capital needed to build a successful business (NVCA, 2016). Other

means to protect VC investment include a gradual conditional disbursement on some performance criteria and some control or step-in rights in case of indications of misconduct (P. A. Gompers et al., 2007). This was also highlighted by (Ibrahim, 2015; Gilson, (2003) i.e. the fact that VCs use detailed contracts and conditional staged fund disbursement as well as taking a decisive interest in the firm that they have the power to appoint the board. In fact, it is to the extent that some literature say that in contradiction with Berle-Means concept that owners have less control in corporate structure venture capitalist have more control than what usual in contemporary corporation (Gilson, 2003).

Other policies include taking preference shares in the company indicating that they expect the firm to be performing more that the preference (Ibrahim, 2015). This particular policy however is a topic of controversy among Shari'ah scholars where AAOIFI disallowed them explicitly (AAOIFI, 2015, p. 341) while Securities Commission Malaysia Shari'ah advisory council allowed preference shares provided that shareholders agree on the issuance (Securities Commission Malaysia, 2007, p. 92).

This was about the VCs where mainly formal policies are used however, Angel investors use mainly informal means to protect their investment in fact, it somehow could be viewed as unrelated to our topic as most of Angel investors invest within a social circle that they become mentors for the startups. The lack of this close relation led to the failure of the first internet based fundraiser ACE-Net even though investors in the platform were mainly accredited investors. This failure lead to another argument as to whether crowdfunding will become a mere alternative for bad companies that failed to obtain VC as the norm goes that most high potential companies will succeed in obtaining professionals' approval leading to a companies of remaining apples in the basket going to crowdfunding creating a market of lemons (Ibrahim, 2015).

2.3.1 Summary of risk mitigating procedures in venture capital:

Venture capital is subject to the information asymmetry and agency problem mentioned earlier therefor, it needs some special technics to mitigate these risks. These technics according to Gilson (2003), can be summarized in five categories; Staged financing, allocation of element of controls, form of compensation, the role of exit method, and reliance on implicit contracts.

The coming paragraphs are paraphrased from Ronald J Gilson's *Engineering a Venture Capital Market*" and Thomas Hellman's" the allocation of control rights in venture capital contracts" as they summaries the main features of venture capital contracts:

- Staged financing:

  Staged financing is pegging the disbursement of funds needed to grow the company with specific mile stones in the business plan. The first stage of financing will give the investor the ability to appraise the potential of the company especially if it is a technological startup that needs to transfer its science into a commercial product. This will give the chance to investors to abandon failure ideas before committing big funds. It also indicates that no company will pass the initial screening without a clear business plan.

  Staged financing perform multiple roles; it reduces in formation asymmetry by revealing the companies potential, it reduces agency cost by creating incentives for the management to meet the target in the next mile stone and it creates a substantial control feature to investors by controlling the money injected in certain projects.

- Control:

  This contractual technique as its precedent, acts as mitigation of agency cost, information asymmetry and uncertainty. Although the staged financing act as a