Question time: Werner Bijkerk, head of research, IOSCO on crowd funding

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Werner Bijkerk is head of the research department of the International Organisation of Securities Commissions. He is behind the launch and development of IOSCO's programme to address systemic risk and financial stability. He also serves as an IOSCO representative at the Financial Stability Board's Standing Committee on Assessment of Vulnerabilities and the FSB/International Monetary Fund's early warning exercise. He is also the secretariat coordinator of the IOSCO committee on emerging risk.

Bijkerk was previously responsible for IOSCO's new strategy, and was involved in coordinating its policy work in the secondary markets, including derivatives. Before joining IOSCO in 2009, he worked in economic research and strategy consultancy at Nyenrode University and at the Netherlands Authority for the Financial Markets (AFM) for more than a decade. He launched a business desk and innovation room at the AFM which helped to guide financial firms through the regulatory process.

Bijkerk is a leading expert in the design and implementation of regulatory strategies to improve investor protection and market efficiency. He has led various supervisory and research projects, the most successful of which concerned unit-linked products and resulted in profound market change and multi-billion dollar compensation for investors. Bijkerk has extensive knowledge of markets, products and regulation. He has written numerous articles, reports and columns, and is a frequent speaker and trainer. He is an economist and art and architectural historian by training.

Bijkerk was a speaker at last week's IOSCO board meeting, which was held in Kuala Lumpur, Malaysia.

Why is crowd funding gaining the attention of IOSCO and how important is it in the global financial system?

There are four main types of crowd funding: donation crowd funding, reward crowd funding, peer-to-peer lending and equity crowd funding. IOSCO's research focused on the latter two.

Crowd funding functions as a market-based financing vehicle. It is a virtual market because it is always available online. Technology enables crowd funding, while social networking allows it to flourish. It is very much retail-driven.

Crowd funding platforms are run by third-parties who manage them and make them stable. Sometimes these platforms function like a bank, sometimes like a stock broker platform or as an exchange. In some countries, former bankers have set up crowd funding platforms. It is really ex-banker trying to run a credit function but on a virtual platform. It is not surprising that ex-bankers are trying to enter this space. Crowd funding is more common in Europe, although it is also found in the U.S., Australia, Argentina and China.

Crowd funding is not huge; globally it involves about $8-$9 billion worth of loans issued through crowd funding platforms, of which around $80 million comprises equity crowd funding. It appears to have started about 10 years ago, but it has really taken off since the crisis, especially for small businesses, which find it one of the easiest ways to raise capital.

As a regulator, IOSCO recognised the importance of crowd funding as a market-based financing vehicle, and that it has the potential to grow substantially in the longer term. One the other hand, IOSCO sees the need to monitor this emerging industry very closely. We are concerned about how such platforms guarantee the quality of loans, how they ensure disclosure is properly made and how retail investors are protected.

U.S. regulators have put strict measures in place to ensure investor protection. The Securities and Exchange Commission has imposed a limit on the amount of money that investors can invest in crowd funding.

At the IOSCO board meeting held last week in Malaysia we talked about developing tool kits for regulators on how to handle the growth of crowd funding. The tool kits are instruments that regulators can use for investor protection purposes, such as ensuring the quality of information on the crowd funding platforms, and they may eventually evolve into guidelines.

How does crowd funding affect banks and is it competing with them?

Banks have certain threshold when accepting loans. For instance, a small company may need $50,000, and if the bank doesn´t know the company, it may give the $50,000 as a personal loan rather than as a corporate loan, which reduces its cost of funding. Crowd funding appears to be an efficient solution. A firm puts a project on the platform and interested investors will start sending money to fund the project. Collectively, the firm can raise $50,000 quite rapidly and that is the power of crowd funding.

Crowd funding will be competing with banks in terms of the small loans that it is able to make available to businesses that need funding, but it does not compete with banks on the larger loans that they provide to big corporates.

Banks are not big on crowd funding at the moment, but those banks which have already dipped their toes into this area tend to follow the notary route, which involves taking money from investors, who in turn give the money to the firm that is raising capital. Banks are becoming increasingly interested in crowd funding and some are considering acquiring existing platforms.

Banks are looking at crowd funding because it may give them access to companies that they currently do not serve, but which may be interesting additions to their client base. In Spain, one of the big banks is looking to acquire a crowd funding platform and other banks have already moved into the market.

Based on the research which IOSCO carried out in September 2013 in the mainland Chinese market, banks there are not interested in crowd funding at the moment. The Chinese social structure has traditionally involved acting in groups, but some of the up-and-coming crowd funding platforms in China have grown out of such a social way of operation.

What are the risks of crowd funding?

The crowd funding platform is a new business model. It's an innovation and innovation comes in shocks and waves. Crowd funding develops organically.

In some jurisdictions, crowd funding is governed by existing regulations, but in others it is unregulated. Crowd funding platforms also follow different practices. For instance, in terms of disclosure, some platforms disclose more information to investors than others. Regulators need to ensure that disclosure is consistent and complete. For instance, there was a case where a UK crowd funding platform had collapsed and investors lost all their money. That would not happen in a normal stock exchange. Although crowd funding may look small from the outside, it is actually quite a big industry.

There are also money laundering and fraud risks. Although crowd funding platforms facilitate intermediation, they do not go so far as to check how a business which is receiving the funding is performing, and whether it is profitable. The firm that needs funding has to secure a credit rating, which provides information about the firm's credibility.

There are also cyber security issues. Last week one of the platforms based in the U.S. was hacked. Like stock exchanges, these platforms are vulnerable to cyber attacks. Stock exchanges have spent a lot of money on IT to ensure that their infrastructures are sufficiently protected. Investors should be aware that crowd funding platforms, especially the smaller ones, may not have the resources to protect their platforms.

We also haven't seen very high default rate, and that's probably because the crowd funding industry is very young. Some crowd funding platforms do publish their default rate. It is therefore important to ensure those platforms are consistent in disclosing default information, which is important information to both regulators and investors. Regulators are concerned about investor protection so they have to make sure that crowd funding platforms are professionally run.

Another risk is that there is no secondary market liquidity. This means that investors will not be able to sell their stake or loan. In some models like the notary and equity crowd funding model, investors get a note [that pays yield] or an equity stake. They might expect to sell them but they are not able to do so.

For equity crowd funding there might be implicit or explicit expectations among some investors that a company or a project that they invest in will eventually do an IPO, in the hope that they are investing into another Facebook. But in reality, they have no influence over the company that they are investing into and there is no guarantee that they will get their money back. It is the most risky form of investment from our point of view.

The market has to find a balance, and regulators must play a strong role in this process. In the U.S., the UK and China, politicians have talked about the importance of crowd funding, with Obama referring to it in the U.S. JOBS Act. In the UK, the government has focused very much on the growth of crowd funding and has invested in that area. Many politicians see crowd funding as a way to aid economic recovery.

Why do investors choose to invest in crowd funding?

Our research did not give a clear reason why investors go into crowd funding. Some may do so because they want to invest in start-up companies. But our research findings based on a UK crowd funding platform showed that investors who go into equity crowd funding typically invest £50 in various crowd funding platforms - a small amount of investment but one which spreads out the risk well. In peer-to-peer crowd funding, which potentially gives higher yields because the risk is higher, investors also spread out their investments into various platforms. The ease of the internet makes crowd funding very easy to do in a rainy afternoon.

Our research also sheds light on the profile of crowd funding investors. Eighty-three percent of the investors are male and between the ages of 40 and 60. These are people who have been working for 15 to 20 years and who perhaps want to play with a bit of their savings.

Crowd funding offers investors an opportunity to invest in new businesses. It gives them high returns compared to what they may receive from deposit rates, bond funds and sometimes mutual funds. This is what makes crowd funding attractive to investors. In peer-to-peer lending, investors get a fixed yield of about 8 to 12 percent. Some crowd funding platforms allow investors get back both their principal and the yield.

- ***Patricia Lee** is South-East Asia editor at Compliance Complete in Singapore. She also has responsibility for covering wider G20 regulatory policy initiatives as they affect Asia*