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PUBLIC EQUITY CROWDFUNDING: WHAT ISLAMIC MICROFINANCE NEEDS TO PONDER

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By : Bayu Taufiq Possumah (senior lecturer at STEI Tazkia Indonesia and a Research Fellow at Islamic Economic Studies and Thoughts Center. He can be contacted at bayupossuma@tazkia.ac.id)

PwC in their report titled 'Financial Services Technology 2020 and Beyond: Embracing disruption' put Fintech as the top key theme and revealed that Fintech will drive the financial services industry on a new business model. Another report by McKinsey Global Institute titled 'Digital Finance for All: Powering Inclusive Growth in Emerging Economies' claims that digital financial services can provide access to 1.6 billion people who do not have a bank account to enter the formal business sector. A total of 95 million new jobs could be created, and GDP of

developing countries could increase by US\$3.7 trillion. In its latest study titled 'Supply Chain Finance (SCF): The Emergence of a New Competitive Landscape', McKinsey & Company also reported that Fintech controls an estimated 10-15% of the SCF market, which makes it a relatively neglected area in global supply chain despite the fact that late payments can cripple the entire supply chain for microfinance in particular, where margins and working capital are stretched and a missed payment can lead their venture to nowhere. This indicates that Fintech was proven to open up greater access to formal financial services and promote economic growth and inclusive and sustainable development. The challenge for the development of a country's financial industry is to make the development process and public services adaptable to fintech. This in the future must already be included in the process of development planning.

On the development of microfinance institutions, fintech will stimulate the revival of easy-to-use commerce and online business and change the complexities in how the market operates. Technological advances have encouraged innovative financing and market-based financing solutions that allow for more financial democratization for small businesses and entrepreneurs that have an innovative business idea. Currently, in terms of regional solidarity, Indonesia, Malaysia, Thailand and Singapore are expected to become the new Fintech powers in the Asian region. In that way, fintech not only represents a component of financial services innovation but it can also fill the financing gap for more than 200 million microfinance businesses in Southeast Asia worth nearly US\$300 billion per year.

The emergence of Fintech has certainly changed the landscape of Islamic microfinance in reducing the cost and time to access financing as well as enabling Islamic microfinance to access formal funds either at the start-up stage or the early stages of growth. Considering this fact, access to financing for Islamic microfinance has been given a new lease of life by concentrating on the development of more non-banking channels and financing platforms such as venture capital (VC), angel investment, equity crowdfunding frameworks, investment account platforms and peer-to-peer where debts are issued to borrowers for interest in return. The availability of electronic agreement documents, legal counsel to facilitate online transactions, online risk assessment, online billing information and online loan status information and the provision of escrow accounts and virtual accounts in banking to all parties involved are expected to meet the need for express cash funds that are easily available and improve the competitiveness of microfinance institutions.

It has been suggested that Islamic microfinance should use an equity crowdfunding platform which is more Shariah compliant and allow for more control over businesses with reduced capital requirements. Islamic microfinance can also diversify more easily than ever before, such as spreading small investments through different businesses in different industries at different stages of maturity. Diversification is key to responsible investment. Another benefit of equity crowdfunding to Islamic microfinance, according to the National Federation of Independent Businesses, is that investments do not need to be repaid if the business fails unlike debt-based funding where bankruptcy may have to be declared in the case of a failed business venture.

Equity crowdfunding is essentially a community fundraising concept. Crowdfunding is an innovative fundraising mechanism to pool together funds from contributors or investors through online platforms which came into existence in the early 2000s, upon the rising penetration of the internet and the robust development of fintech. Crowdfunding not only can facilitate the automatic assessment of credit risks and selection of investment portfolios, but can also widen financing channels for small businesses (including entrepreneurs who are not interested or able to access traditional bank, VC or business angel funding) and offer new investment products to investors. Capital formation then can be evaluated by a group of individuals or the people through the internet, according to Massolution. That is why equity crowdfunding arguably is an alternative financing option that benefits all parties.

Equity crowdfunding financing can be categorized and applied in various forms such as equity shares (where investors acquire shares of a business investment for financial returns), profit-sharing and revenue-sharing. As of 2014, the amount of public equity funds raised was as much as 6.9% and the rate of development was 182%, according to Massolution (2015). In 2015, the total equity crowdfunding volume worldwide was US\$2.56 billion, according to the annual Massolution Crowdfunding Industry Report 2015. The World Bank has estimated that the global equity crowdfunding sector will be worth more than US\$93 billion by 2020 and this does not include equity financing in real estate crowdfunding. Hence, in terms of equity crowdfunding for Islamic microfinance development, the following are some points that need to be pondered by Islamic microfinance industries.

Consistency as a community-based institution

Since microfinance institutions are born from a community base, three microfinance development priorities should be driven on the right track through the Fintech landscape. *Firstly*, there must be capital mobilization to increase the economic activities of underserved groups such as low-income communities. The capital is from community to community. Since no returns are expected by contributors, the philanthropy component of funds then will significantly reduce the financial costs and improve financial viability of the institution. *Secondly*, community-based capital mobilization should be used to finance basic infrastructure such as sanitation and electricity. *Thirdly*, community-based capital mobilization should be used to encourage sustainable infrastructure development, such as clean energy, or to fund important innovations in order to increase agricultural and fishery production. Fintech has the capability to fill the enormous market potential and improve the welfare of poor households through business financing, access to household basic needs (such as clean water and electricity) and financial management for education and healthcare. All these can only be achieved by reinforcing a mutual network, synergizing marketing and the provision of raw materials and various other needs. Islamic microfinance certainly has a great responsibility to improve public understanding through literacy and education.

Shariah issues

There are several structures applicable to public equity crowdfunding, depending on the type and level of institution development. Looking at the structures, it is possible that there are structures that would not be acceptable to some Shariah advisors or not in line with Shariah requirements. Several Shariah points need to be

fulfilled in equity crowdfunding such as contract structures, Shariah advisors, specific Shariah parameters as reference when creating financing platforms, the buyback price and moral issues. However, the problem is how far are Shariah advisors able to monitor in detail the platforms of each fundraiser involved. This is because the assessment of public crowdfunding activities is quite complex. Continuous supervision requires strict monitoring to ensure that Shariah compliance is not compromised.

Innovative Collaborations

Islamic microfinance must continue to innovate in terms of technology as an alternative financing source especially in the Fintech era. Collaboration in Islamic microfinance between start-ups and the financial industry should always be encouraged and is a key factor in creating value-added Fintech for Islamic microfinance growth. These collaborations act as new disruptive models to existing industries like real estate and transportation, leveraging on automation and the internet to create massively scalable businesses. For Islamic microfinance, an important collaboration is also on how to use its own data to develop solutions through Fintech with start-ups. Having good collaborations is a signal that the product and/or business strategy could be viable. Therefore, education and the dissemination of fintech products and services to the community are crucial to the growth of Islamic microfinance. With innovative collaborations, the expansion of Fintech to the wider community is increasingly valuable and has a significant impact in moving the economy to the grassroots.

Regulation

The absence of regulations regarding the business activities of Fintech services can negatively impact investors. Hence, regulators have to set up specified regulations to strike a balance between the objectives of financial innovation and investor protection. In this case, Islamic microfinance needs to pay attention to these financial regulations which include provisions to minimize credit risk, protection of investor interests (misuse of funds and user data), money laundering, national interest protection, terrorism financing prevention and disturbance to the stability of the financial system. Islamic microfinance must also be involved in Fintech innovation hubs established by regulators, coordination among ministries and institutions, drafting of regulations that meet the needs of the community, the development of sandboxes for new Fintech business models, and lastly, the provision of communication facilities between Fintech regulators and industries.

Reducing Financial Risk with supply chain finance model

Supply chain finance (SCF) is one of the methods to improve the ability of IMIs to overcome liquidity shortages and improve the working capital situation (World Economic Forum, 2015). SCF refers to a range of financing and business processes that provide short-term credit to optimize working capital throughout the supply chain for both buyers and sellers (EDC, Canada). Although short-term credit is not used in case of IMIs, connecting financial transactions to the movement of value through a supply chain is at the heart of SCF to ensure public trust in Islamic microfinance's business. There are at least three parties to the SCF transaction: a company purchasing goods, the supplier of the goods and a financial institution (EDC, Canada). The supply chain processes that link

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