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FINTECH IN ISLAMIC FINANCE
THE JOURNEY BEGINS

Fintech (financial technology) developments in the Islamic finance space are still very nascent, but key Islamic finance markets like Malaysia, UAE and Bahrain are seeking to support and grow Shariah-compliant fintech.

Islamic finance (IF) players are boarding the fintech train, but the application of fintech within the Islamic finance space is still extremely new.

"Fintech in Islamic finance is very far behind compared to fintech in the conventional finance space. Islamic finance fintech is still in its infancy and growing although not very rapidly. The number of fintech players specialising in IF is still considerably low," explained Othman Abdullah, Managing Director (Islamic Banking / Public Sector Solutions), Silverlake Group of Companies.

Whereas the fintech revolution in the conventional space emerged shortly after the 2007-2008 financial crisis, fintech in Islamic finance has only just begun testing the waters. In conventional finance, more than USD50 billion has been invested in almost 2,500 companies since 2010, according to the Accenture Fintech Evolving Landscape 2016, whereas no figures are directly available for Islamic finance.

Just like in conventional finance and banking, fintech solutions for Islamic finance aim to improve the customer experience and deliver better products and services.

"Fintech innovation seeks to bridge possible gaps between banks and the market by taking an 'out of the box' approach - the 'box,' in this case, being traditional banking methods," said Md Ali Abdul Aziz, Chief Technology Officer, Bank Kerjasama Rakyat Malaysia Bhd (Bank Rakyat).

At its most basic, the digital disruptors are usually associated with mobile functionality, simplicity, big data, accessibility, agility, cloud computing, contextuality, personalisation and

convenience, clarified Md Ali. "Most traditional banks have few of these qualities, but instead are associated with trust and security, significant capitalisation and customer indifference."

Marrying the two could thus result in a sweet spot for Islamic finance institutions. Similar to vanilla fintech, the emerging strategy is to co-operate and collaborate rather than to compete with fintech innovators. "When fintech first came up, most people thought that it was going to be a disruption to the banks." However, both realised that fintech is more complementary. "Now, most fintech firms are complementing the banks' operations to improve efficiency as well as enriching banks' offering to their customers. As of now, almost all banks treat fintech firms as potential collaboration partners; hence, you can see banks setting up specific units to work with fintech companies," explained Nazlee Khalifah, Chief Executive Officer, Affin Islamic Bank Bhd via e-mail.

Generally, the different types of fintech specialisations are Money Transfer, Mobile Payment, Trading Platforms, Wealth Management, Credit Scoring, Peer-to-Peer (P2P) Lending and Crowdfunding. "In Islamic finance, fintech innovations are mainly in the forms of Crowdfunding and P2P Financing platforms," said Othman.

Meanwhile, Mohamed Izam Mohamed Yusof, Chief Executive Officer, IAP Integrated Sdn Bhd observed different trends at play in the different segments of the financial sector. "In the Islamic capital markets, crowdfunding platforms such as equity crowdfunding and peer-to-peer lending platforms are making it more accessible for retail investors to fund small-scale financing or ventures. In the banking sector, there is an increasing usage of fintech to enhance efficiency in delivery and outreach, as well as to improve quality of customer experience."

LEADING MARKETS

"As of now, there are no Islamic banks or countries/markets that are really leading in Islamic fintech yet," surmised Othman. Meaning, leadership is anybody's game. However, Malaysia, UAE and Bahrain may potentially take the lead in IF fintech because they are striving to facilitate growth. Locally, the Regulatory Sandbox discussion paper issued by BNM in July 2016 included a

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provision on Islamic finance. Abu Dhabi and Dubai are known to have been striving to support and develop their local technology start-ups. In Bahrain recently, Finocracy and CH9 announced their Future Finance 2030 initiative, which they claimed would position Bahrain as the first Global Islamic Fintech Hub and the Islamic Fintech Capital.

MARKET POTENTIAL

The consensus from the e-mail replies is that opportunities for fintech in IF are significant as the industry is very new and largely untapped.

Datuk Mohd Redza Shah Abdul Wahid, Chief Executive Officer, Bank Muamalat Malaysia Bhd cited recent World Bank statistics whereby more than two billion people around the world are unbanked and about half of them are in the Muslim world. "Fintech may be the answer to more inclusive banking whereby the new generation technologies will help break down economic and social barriers," he said.

Meanwhile, Othman surmised that: "From the consumer perspective, it is estimated that by 2020 two to three billion new consumers will be entering the digital finance space, and that 80% of these new consumers will be Muslims."

As a means to an end and a tool for efficiency and effectiveness, fintech is poised to drive IF's continuing maturity, while enabling lower costs and efficiency. Fintech offers a cost-efficient means for Islamic financial institutions (IFIs) to tap a wider consumer base and enhance their visibility in the market despite their smaller scale. "This enables IFIs to compete at a more level playing field with their conventional competitors," said Izam.

Fintech also enables IF to play catch-up, where IF institutions are beginning to explore risk-sharing modes of financing in addition to the traditional debt financing and evolving from being product-driven towards offering customised solutions to its customers, remarked Izam. "Stronger emphasis is increasingly seen on the quality of customer experience amongst the new generation of financial services clients. Similar to other financial institutions, fintech offers a competitive edge for IFIs in customising their offerings based on the preferences of their target customers."

Datuk Mohd Redza pointed out that certain fintechs offer product engineering solutions which would enable IF institutions to introduce new products and services in shorter turnaround time. "This could be a breakthrough to IF as the current process requires several layers of processes which can be lengthy."

The scope of IF would gain further from the advancement of technology and fintech, continued Datuk Mohd Redza. Emboldened by technology, IF institutions could potentially penetrate into newer growth areas including: green, ethical and environmentally-friendly development projects; international risk management through *Shariah*-compliant hedging instruments; funding the growing international halal trade business; funding international infrastructure projects; and enhancing liquidity management and capitalisation of Islamic financial institutions in line with newer regulatory requirements, for e.g., Basel III standards. Meanwhile, Affin's Nazlee singled out Islamic credit cards in the payments space as being ripe for innovation. "The concept of Islamic credit cards is rather limited. As such, banks should be able to work with fintech firms to broaden this area."

CHALLENGES SPECIFIC TO ISLAMIC FINANCE

But fintech in IF is not without its hurdles. Othman singled out paralysis in innovations and ignorance of *Shariah* guidelines and compliance as barriers to fintech in IF. "Lack of innovation is the same syndrome that has been faced by Islamic finance in general. Most of the Islamic finance products in the market today are the 'Islamised' version of conventional products."

While fintech is an agnostic tool, fintech start-ups also need to improve their familiarity with *Shariah* guidelines in developing financial services products for Islamic finance to ensure *Shariah* compliance. "Unlike traditional Islamic financial institutions where there are *Shariah* teams well-versed with *Shariah* requirements who participate in product development to ensure *Shariah* compliance, fintech start-ups do not have such a facility," remarked Othman.

GENERIC CHALLENGES

Given that fintech is a secular tool, deploying fintech in the IF space is subject to similar constraints on conventional fintech. For example, the reluctance of institutions to fund or invest in fintech initiatives without the certainty of being able to deliver returns could stunt growth, noted Izam.

Another heightened risk is cybersecurity. "Reliance on fintech in facilitating banking services would pose digital risk on IFIs in the form of potential cyber attacks on the banks' system or users. As customers' confidence is crucial for a bank to thrive, IFIs are cautious to grow in this area," added Izam.

Nazlee identified the "main challenge" as "integrating specific fintech capabilities within the existing bank operations." Md Ali cited "organisational culture - the ability to adopt a collaborative approach with new innovators and start-ups" as a challenge as well.

Harmonisation and compliance pose barriers too. "Based on our own experience in developing a shared infrastructure such as IAP, a significant challenge lies in the level of standardisation needed and incorporation of regulatory compliance required on the part of participating Islamic banks, to enhance ease of use by customers," said Izam.

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THE NAMES TO KNOW

Which entities are leading the flight to fintech? Among the key start-ups in Islamic finance are Singapore-based EthisCrowd and Kapital Boost, US-based LaunchGood, Dubai-based Beehive, and Blossom Finance based in the USA and Indonesia. Beehive Finance and Blossom Finance both provide *Shariah*-compliant crowdfunding platforms which aim to provide low-cost alternative financing to small and medium enterprises.

Other IF fintech start-ups are Narwi, Easi-up, FundingLab, SkolaFund and Ata-plus.

Local examples of fintech start-ups that have been working with some major banks in Malaysia are Startupbootcamp and L337 Ventures, noted Datuk Mohd Redza.

"The most outstanding is probably EthisCrowd which received the Best Islamic Crowdfunding Platform Award at the 6th Global Islamic Finance Award 2016 held in Jakarta and the Islamic Economy Award at the Global Islamic Economy Summit 2016 held in Dubai recently," said Othman.

Datuk Mohd Redza singled out Malaysia's MarketplaceIF as an innovative Islamic finance e-market platform for those in search of Islamic finance solutions and services. The platform will pair customers with financial services providers who are able to match their requirements.

PLAYING IN THE SANDBOX

Currently, there are no specific regulations or laws governing fintech for IF. IF fintech should aim to comply with existing regulations and laws governing vanilla fintech. However, the consensus from the e-mail replies was that while fintech is an agnostic tool, IF fintech solutions must be *Shariah*-compliant in accordance with the prevailing *Shariah* rulings of the jurisdictions in which the IF fintech entity is operating.

Here in Malaysia, *Shariah* compliance looks set to be a tenet of any upcoming legislation for fintech in IF. Notably, Bank Negara Malaysia's proposed regulatory sandbox framework, which aims to stimulate fintech innovation in a controlled environment, stated that one of the intended outcomes was to ensure that innovative solutions for Islamic financial services are consistent with the prevailing *Shariah* standards. Bank Negara issued the Financial Technology Regulatory Sandbox Framework on 18 October 2016.

As one of the players that provided feedback for the regulatory sandbox framework, Othman proposed that the guidelines be made more specific, less general and less high-level to facilitate *Shariah* compliance, especially since smaller fintech players might not be well-versed with the *Shariah* requirements.

Moving on, it will be interesting to see what new products and services emerge from this controlled environment, and how fintech could do more to reshape the existing landscape of Islamic finance to scale it up and make it more competitive and sustainable.

IAP – A VEHICLE FOR FINTECH IN IF

When asked about fintech in the Malaysian Islamic finance scene, people invariably point to the IAP initiative. But what is IAP?

IAP is the abbreviation for Investment Account Platform, a *Shariah*-compliant fundraising and investing intermediary online platform owned by a consortium of Islamic financial institutions in Malaysia, Raeed Holdings Sdn Bhd. In the simplest terms, this is a crowdfunding platform, with the difference that the platform is bank-owned.

Initial members of the consortium were Bank Islam, Bank Muamalat, Affin Islamic and Maybank Islamic, and they were subsequently joined by Bank Rakyat and BSN. "IAP is currently owned by six shareholder banks and efforts are being made to increase the numbers of Islamic banks to join IAP and become sponsoring banks, which currently stands at four. The increase in the number of sponsoring banks that are allowed to list ventures on IAP is crucial to ensure the sustainability of the IAP business," said Mohamed Izam Mohamed Yusof, Chief Executive Officer, IAP Integrated Sdn Bhd via e-mail.

Launched on 17 February 2016, IAP will serve as a central marketplace to finance small and medium-sized enterprises. "The key difference is that IAP is the first bank-intermediated fintech platform. It is considered as fintech for Islamic finance because IAP is backed by Islamic financial institutions and both the fundraising and investment activities are in accordance to Islamic finance principles," clarified Othman Abdullah, Managing Director (Islamic Banking / Public Sector Solutions), Silverlake Group of Companies, via e-mail.

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The IAP will benefit banks and improve liquidity and risk management by enabling the domestic Islamic banks to market investment accounts, which are a new product offering in the Islamic banking industry. "IAP could thus become an avenue for participating Islamic banks to fund their financing assets in the form of investment accounts (IA) opened by the investors, either individual, corporate or institutional," explained Mohamed Izam. More importantly, these investments entail the sharing of risks and returns from the identified assets between the sponsoring bank and also the investors, which is in line with the Islamic principle that rewards must commensurate with risks.

In terms of the mechanics, on a periodic basis, profits on the principal paid by the ventures to the sponsoring banks that act as investment intermediary are then shared with the investors under a contract of *mudharabah* (profit sharing) or *wakalah* (agency).

IAP is a step forward in an uncertain landscape, especially in the IF strongholds of the Gulf states and Malaysia which are suffering due to oil and commodity price volatility. "IAP signals the entry of several Malaysian Islamic banks and development financial institutions into the fintech market at a time where domestic banks in general are facing decreased margins, loan growth and profitability in view of the decline in world's major commodities and oil prices," commented Mohamed Izam.

IAP also telegraphs the growing dominance of the sharing economy, where cooperation rather than competition – coopetition - makes business more sustainable. "A single shared platform was therefore the best answer in times of uncertainty as costs can be shared among the players and more importantly,

more heads are better than one when it comes to workable ideas and solutions to develop IAP, " said Mohamed Izam.

The IAP enables cost savings and efficiency, by migrating functions online. For instance, functions that are traditionally done at the bank's premises – registration of users, suitability assessment, listing of ventures by bank as well as selection and booking of ventures by investors during the campaign period – are now available online on IAP.

Below, Mohamed Izam tells more about the IAP and its progress to date:

How are the ventures to be listed on IAP assessed? What are the criteria for listing? Who does the assessment?

The ventures will be assessed by the banks before the bank lists them on IAP to raise funds.

The assessment is primarily done on the payment capability of the venture that seeks financing facility from the bank either to: purchase new assets for its business (factory, machinery, vehicles, etc.), fund its working capital, refinance existing financing with other banks, or to fund a specific project the venture is currently undertaking.

Other criteria that are being assessed are the past financial performance of the venture and the main financial ratios, its future cash flow and assumptions, payment records with its other bankers and suppliers, past projects undertaken, the state of the industry the venture is in, the experience of the main directors/shareholders and key technical personnel, as well as whether there are any outstanding legal proceedings instituted against the venture or its directors.

The banks and their internal committee would have to be satisfied with all of the above criteria, including the factors that would mitigate all the inherent risks, before the proposed financing is approved and offered to the venture.

Before listing is finalised by the banks, the venture will have to undergo a rating process by a rating agency. In some cases, the banks may impose a minimum rating to be accorded to the venture (a rating of 'bbb' or above, for instance) as an additional listing criteria.

How has the response been from the consumers for this IAP account? How is IAP educating consumers on this new product?

The response has been quite encouraging.

Being new to the market where this marks the first time where banks (Islamic or conventional in Malaysia) are funding their financing / loan assets via investments from the public, a lot of awareness and educational activities need to be undertaken.

From the investors' point of view, IAP allows them (individual or corporate investors) to channel their investment into a chosen venture of their choice, which is also a first, based on the venture's risk-return profiles via a product called investment account. The returns on their investments are very competitive and are much higher than the returns from the normal term deposit products like Fixed Deposit (FD) that are currently offered by local Malaysian banks.

Awareness and education programmes are being planned to cover both investors and ventures.

Efforts are being undertaken to create awareness on IAP as a new asset class through talks and meetings with both retail and sophisticated investors, companies with excess cash and also corporate as well as institutional investors such as EPF and KWAP.

For the ventures, we prefer to plan our engagement activities through seminars, pocket talks, events and roadshows via government agencies that have access to SMEs such as SME Corp, MDEC, Biotech Corp, MTDC etc. as well as SME associations, either state or industry-based.

In addition, we are also working with the sponsoring banks to market IAP to their existing network of non-SME clients.

What is the estimated rate of return on the IAP account? Is there a benchmark in the broader market for returns on the IAP account?

Since the investment in IAP is made to fund the financing/loan assets of the sponsoring banks, returns are therefore benchmarked against the pricing of the facility approved by the bank.

To determine the pricing of the facility, banks will consider several factors such as type, tenure and payment structure of the facility, the venture's overall risk rating as per the bank's internal credit rating as well as the type of security(ies) offered for the facility.

For instance, if the facility is being priced at BFR (or base financing rate which is currently at 6.6% p.a.) plus a credit spread of 1.5% p.a., giving an all-in-rate of 8.1% p.a., the end return to the investors will then depend on the profit-sharing ratio (PSR) determined by the bank (assuming that the contact between the bank under the investment account is *mudharabah*).

If the PSR is set by the bank at 80:20 (investor:bank) and the investors are agreeable to it, then the investors will stand to receive around 6.4% p.a. from the investment in that venture.

If there is any benchmark in the broader market for IAP returns, then the closest one would be the term deposit product such as FD with similar tenure that is offered by the local banks. ✱

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