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INNOVATIVE FINANCING MECHANISMS IN THE PACIFIC

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INNOVATIVE FINANCING MECHANISMS IN THE PACIFIC

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ABBREVIATIONS

ECF	equity crowdfunding
IGCF	investment-geared crowdfunding
P2P	peer-to-peer
PIC	Pacific island country
PNG	Papua New Guinea
PSDI	Pacific Private Sector Development Initiative
SMEs	small and medium-sized enterprises
UNCDF	United Nations Capital Development Fund

CURRENCIES

In this report, “$” refers to United States dollars, unless otherwise stated. Other currencies used:

A$	Australian Dollar
F$	Fiji Dollar
NZ$	New Zealand Dollar
K	Papua New Guinea Kina

INTRODUCTION

Small and medium-sized enterprises (SMEs) require access to finance to be able to start, grow, and sustain their businesses. However, globally, access to simple and affordable forms of finance remains a key challenge for SMEs. In the Pacific region, finance is typically sourced through traditional financing mechanisms; for example, bank loans through financial institutions, as well as debt and equity funding, both privately and sometimes through the capital markets.

Many SMEs in the Pacific are unable to access traditional forms of finance without a proven revenue stream, monetization strategy, credit history, or collateral. This has created a significant financing gap, which ultimately hinders the growth of the SME sector.

There is an opportunity to narrow this funding gap through alternative sources of financing, including small-scale offers (or "small offers") regimes as well as investment-geared crowdfunding (IGCF), collectively Innovative Financing Mechanisms. These forms of alternative financing can provide a "lower barrier" to access finance.

Ultimately, the utility and overall success of such forms of finance in the Pacific require the introduction of an appropriate legal and regulatory framework, intermediaries who have the expertise to manage such new mechanisms, as well as a locally sourced pool of investors who have sufficient investment knowledge and a willingness to invest.

Historically, the Pacific Private Sector Development Initiative (PSDI) has focussed on improving business environments in Pacific island countries (PICs) through reforms that increase access to finance, such as the secured transactions regimes and, more recently, with assessing the potential for Innovative Financing Mechanisms.

This policy brief intends to provide a high-level overview of some of the different forms of innovative financing across the Pacific with a particular focus on small offers and IGCF. It sets out findings for policy makers and stakeholders on the potential benefits and issues to consider with these Innovative Financing Mechanisms in the Pacific, having regard to the unique nature of the island economies.

The Innovative Financing Mechanisms that are being discussed in this policy brief require some finance and technology-related sophistication, and therefore will not be applicable to businesses in the informal sector in general.

II PACIFIC CONTEXT

Culturally, Pacific nations have a strong sense of community, which makes community-based projects as well as funding mechanisms quite common. These can take the form of "solesolevaki" in Fiji or "sefuluai" in Samoa; wheelbarrow fundraising for community projects in Vanuatu or a school walk-a-thon in Solomon Islands to support missionaries. These cultural practices highlight the large entrepreneurial potential in social and communal groups and the opportunity to create formalized systems for Innovative Financing Mechanisms.

It is also common for entrepreneurs to turn to families and friends for early-stage investment in the Pacific. This form of raising money through personal networks sometimes extends to other stakeholders who are familiar with the entrepreneur or the product, such as suppliers and customers. Such financing may happen informally without the complexities of formal shareholder or loan agreements, and largely based on trust and relationships. A framework which provides greater structure, streamlined processes, and safeguards could further unlock their potential.

The SME sector in the Pacific is growing and contributes materially towards national and regional economies. However, SMEs face barriers in accessing traditional finance to start, grow, and sustain their businesses. In their early stages of development, many SMEs rely on their existing cash flows and limited personal investments from friends and families, but find it very difficult to secure further finance beyond this.

The inability to secure financing for their businesses can be attributed to several factors:

i. **Onerous requirements to access traditional financing.** Existing infrastructure in traditional forms of both debt and equity financing impose several constraints, which limit access to these forms of financing:

   a. **Debt financing constraints**. SMEs that are able to access external finance must choose from everyday banking products, such as secured loans and overdraft facilities. Often, these products come with high transaction costs and high interest rates. The debt obligations linked to such products also frequently do not align with the SMEs' growth projections and cash flow, particularly their working capital needs. While state-owned development banks in the Pacific tend to be more active in channelling finance to the SME sector, their effectiveness is often dependent on their ability to operate commercially while creating additionality.[1]

   Asset-based finance is the most widely used tool for SMEs in the Pacific and, over the last two decades, several credit guarantee schemes have been rolled out along with the secured transactions collateral reforms with the objective of enhancing access to finance by SMEs. However, such schemes and regimes have failed to materially alter how lending institutions assess credit

[1] Asian Development Bank (ADB). 2019. *Finding Balance 2019 Benchmarking the Performance of State-Owned Banks in the Pacific.* Manilla. https://www.adb.org/sites/default/files/publication/521901/finding-balance-2019.pdf.

risk of SMEs. The effectiveness of such credit enhancement modules have been impeded by the lack of legal, regulatory, and supervisory frameworks, which discourage lending institutions from extending credit to the SME sector and results in lower credit additionality.

From an institutional perspective, SME lending is regarded as quite costly and risky, which has been evident as credit to SMEs has remained tight even in times of high liquidity in the banking system.

b. **Equity financing constraints**. The number of venture capital and private equity investment transactions is limited, while sporadic and institutional investors generally consider larger investments only in established companies. The developing capital markets in Fiji and Papua New Guinea (PNG) also enable public offerings and listing on stock exchanges, but are generally more appropriate for established companies and come with their own complexity of regulations and higher costs as well as illiquidity with relatively low trading volumes.

Often, business owners may have reservations on taking on debt until revenue streams have grown and stabilized to ensure debt serviceability, as well as equity where questions of ownership dilution and control may arise.

ii. **Limited financial skills.** Commonly, the ability of SMEs to access finance is linked to their ability to present clear business strategies or proposals that would attract finance. This requires preparation of financial information, predicting future cash flow, proving market accessibility, presenting process efficiencies, and overall business model sustainability. These are skills that many SMEs lack. While there are several programs that provide support in developing the entrepreneurship ecosystem in the Pacific, such programs are accessed only by a limited number of SMEs.

This policy brief explores IGCF and small offers regimes as financing mechanisms that can offer a simpler and less onerous pathway to access finance for some SMEs in PICs that face challenges in accessing finance through traditional means. The suitability of Innovative Financing Mechanisms will depend on several factors, including the capabilities and willingness of the companies that are seeking finance, the savviness of investors being targeted, and the legal and regulatory framework within which they can operate.

III INNOVATIVE FINANCING MECHANISMS

A. SMALL-SCALE OFFERS REGIME

Small-scale offers (or "small offers") regimes enable companies to raise funds through a limited number of investors without the costly and onerous disclosure obligations, which are required when making a public offer to invest in securities.

Usually for public offers, retail investors are provided with a prospectus, which is a detailed disclosure statement to help retail investors assess the risks and returns associated with an offer of securities.

By contrast, small offers operate as a "carve-out" under legislation. They do not require a prospectus and other product disclosure documents under most securities regulations because they are not considered public offers to retail investors. The rationale is that the amounts that are raised under small offers are usually limited to a certain number and type of investors. The offers are made to specific people who do not require detailed disclosure because of either their familiarity with the affairs of the business, financial capacity, financial experience, or wholesale investing status.

In New Zealand, a small offer allows businesses to raise up to NZ$2 million in a 12-month period from a maximum of 20 investors.[2] These offers can extend beyond family and friends to persons who are not associated with the business provided they have an annual gross income of at least NZ$200,000 for the previous 2 income years.

Similarly, in Australia, a disclosure statement is not required if an offer is a personal offer being made to fewer than 20 people over 12 months, and the amount being raised does not exceed A$2 million.[3] A certified wholesale or sophisticated investor that meets the prescribed gross income or net asset level can take part in such offers as well.[4]

While the small offers do not require disclosure, there are obligations that offerors need to meet, including a prominent prescribed warning statement about the financial risks of the offer. Small offers are also subject to advertising restrictions where the offer can be made only to qualified people.

Additionally, in some jurisdictions, there is a requirement for notification to be made with the industry regulator within 1 month after the end of the accounting period in which the offer is made.[5]

B. CROWDFUNDING

Crowdfunding raises money for a specific project or business from a large "crowd" of people. It is popular because it can be accessed by individuals, businesses, start-ups, and charities; and because of the flexibility that it offers through the types of "incentives" that are offered to investors.

Under the crowdfunding model, large groups of people contribute money towards a campaign to fund a project or business in return for rewards

2 Financial Markets Conduct Act 2013 (New Zealand). Clause 12, Schedule 1.

3 Corporations Act 2001 (Commonwealth of Australia), Section 708.

4 In Australia, to be certified as a sophisticated investor or wholesale client, one must have a gross income of A$250,000 or more per year in each of the previous 2 years or net assets of at least A$2.5 million, as per the Corporations Regulations 2001 (Commonwealth of Australia) Reg 6D.2.03

5 Financial Markets Authority, New Zealand. Offers of Financial Products. https://www.fma.govt.nz/business/services/offer-information/offers-under-the-fmc-act/.

(for example, a product in the business or the ability to purchase product at a discount), interest payments, equity in the business or as little as acknowledgement for a contribution to a cause.

The different models within crowdfunding can be grouped into four categories: (i) donation-based; (ii) rewards-based; (iii) debt-based, which is also known as peer-to-peer (P2P) lending; and (iv) equity crowdfunding (ECF).

Crowdfunding is generally driven by three main participant groups: (i) the initiator of the project who is proposing the idea or project to be funded, (ii) the funders who support the idea, and (iii) the moderating organization (intermediary) that connects the parties.

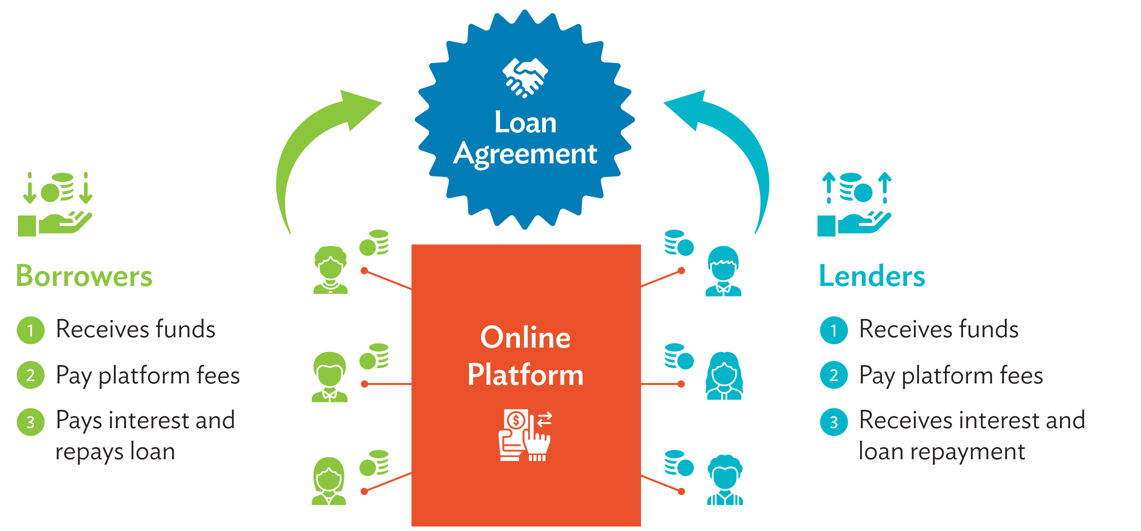
ECF and P2P lending, together referred to as IGCF, address some of the barriers faced by SMEs in accessing finance through shifting the power dynamics and enabling the enterprise to source finance from a multitude of small investors rather than from a single large financial institution or shareholder. These two types of crowdfunding are subject to some level of regulation in most jurisdictions because they involve offers of securities to or borrowing from the public.

C. INVESTMENT-GEARED CROWDFUNDING

ECF raises funds though issuing company shares to a large number of investors in return for small to medium-sized investments via a licensed platform; for example, Snowball Effect in New Zealand.[6] Similarly, P2P lending is a debt-based crowdfunding model that connects borrowers directly with people who choose to lend some of their money, and the borrower commits to repaying the loan at a particular interest rate and within a certain time frame; for example, Kiva.[7]

An overview of the P2P lending structure is in Figure 1, where the technology-based platforms intermediate between the funders and the users of the funds. ECF operates in a very similar way with investors who are expecting dividends and capital growth on their investment.

FIGURE 1: **OVERVIEW OF PEER-TO-PEER LENDING STRUCTURE**



Source: Pacific Private Sector Development Initiative.

6 Snowball Effect. https://www.snowballeffect.co.nz/.

7 Kiva. https://www.kiva.org/lend-by-category.

Under both these forms of crowdfunding, there are various eligibility and disclosure requirements as well as a fundraising ceiling on these platforms.[8]

In both ECF and P2P lending, businesses can raise funds from a wider pool of wholesale and retail investors (when compared with small offers) and, usually, retail investors have a cap on the amount that they can invest. For example, in Australia, retail investors can invest up to $10,000 in any single offering.[9] For larger investments, investors are required to be qualified.

The disclosure requirements are less stringent for businesses that are raising funds through IGCF in comparison with public offers and are guided indirectly through the licensing requirements of platform providers. Given the lighter regulatory compliance path it presents, the platform provider must act as a gatekeeper and conduct relevant checks and due diligence on the offering company, while also ensuring that the investors are aware of the risks. Some jurisdictions require investors to acknowledge the risks affirmatively before investing to ensure that well-informed investment decisions are being made.[10]

The IGCF model can be attractive because of the faster (although less thorough) assessment of business proposals, minimal ongoing monitoring, as well as reduced fixed costs (office space, staff) because of digitization, which make overall financing and transaction costs lower.

Empirical evidence also indicate that such models may help in alleviating gender constraints that are faced by women entrepreneurs where direct communication with investors and relationship building reduces information asymmetries, while reaching out to a more balanced investor base, gender wise. However, gender biases continue to exist because investors prefer firms that are led by entrepreneurs of similar gender, especially where women operate in male-dominated industries. In PICs, women entrepreneurship is on the rise, but the limited access to traditional finance because of the industries where women generally operate in will remain a challenge for alternative financing mechanisms as well.

Specific laws and regulations governing IGCF (and small offers) vary. However, in all cases, finance sector regulators are tasked with balancing the ability of SMEs to raise funds from specific types of investors without onerous and expensive processes, while at the same time safeguarding the interests of the general public as investors.

In Australia and New Zealand, this has been achieved through tailored IGCF legislation; whereas, in countries such as Singapore, this has been effected through amending the existing securities laws to extend to alternative financing by redefining exemptions and exclusions.

Finance sector supervision typically rests with government regulatory bodies that are responsible, through one body or multiple bodies, for regulating companies, markets, financial services, and even consumer credit. However, it has been common to see regulation through licensing of the crowdfunding platform service providers who themselves ensure compliance through their oversight of investments on their platform.

These Innovative Financing Mechanisms present alternatives for companies, especially SMEs, to access finance but the identification of the best method for a company depends on a broader range of factors, such as the amount to be raised, the purpose of the funds, and the current stage of the business to name a few. A summarized comparison between these mechanisms is in Table 1 (page 7).

[8] In Australia, the issuer cap is A$5 million over a 12-month period as per the Corporations Act 2001, Section 738G. In New Zealand, the issuer cap is at NZ$2 million over a 12-month period as per the Financial Markets Conduct Regulations 2014, Section 186.

[9] Corporations Act 2001 (Cth), Section 738ZC.

[10] Australia Securities and Investment Commission. 2020. *Regulatory Guide 261 Crowd-Sourced Funding: Guide for Companies*. https://download.asic.gov.au/media/5702668/rg261-published-19-june-2020-20200727.pdf

TABLE 1: COMPARISON OF INNOVATIVE FINANCING MECHANISMS

	Small-Scale Offers	Equity Crowdfunding	P2P Lending
Process	Cheaper and faster than traditional financing mechanisms	Cheaper and faster than traditional financing mechanisms	Cheaper and faster than traditional financing mechanisms
Target financiers	Limit on number of investors	Open to public	Open to public
Investment amounts	Limit on minimum amount that can be invested	Minimum amounts can be as little as $50; maximum amounts may also be introduced.	
Regulations	Carve out of existing securities regulations	Exclusions from existing securities regulations or through specified regulations	
Investor types	Friends, families, and allies extending to those familiar with the business such as customers, suppliers, and soft business networks	Anyone who can understand the business rationale, wants to support the entrepreneur, and enables investors to support local or social causes that align with their values and interests	
Finance types	Equity	Equity	Debt
Channels	Traditional	Online platform	Online platform
Intermediary	Financial adviser	Licensed platform service provider who should be able to assist in vetting businesses, help them furnish the right information, and be able to market their story to raise the capital	
Information required	Basic information package includes business activity, management, and ownership (lighter compliance)	Information on purpose of the funds and the value of the business before and after capital has been raised. Templates usually simplify the process.	Information on purpose of the funds and how the company's cash flow will enable the loan to be repaid. Templates usually simplify the process.
Time horizon	Long term in nature similar to any equity investment		Shorter term, depending on repayment terms
Risks	Greater risk of failure of business, illiquidity, limited information, speculative valuation, and dilution	Illiquidity, failure of businesses, limited information, fraud and cyber security, and speculative valuation, dilution	Loan defaults and late repayments, illiquidity where secondary markets do not exist, fraud, and cyber security
Returns and exit strategy	Dividends, capital gains on equity investment as company value grows through share buyback, or when the company goes public, merges with, or is acquired by another company		Interest and principal repayment based on pre-agreed terms
Difference from traditional financing	Avoids lengthy processes, due diligence, disclosure, and other stringent requirements of banks and traditional equity investors		
Costs	Cheaper way to access finance compared to public offering, but still requires valuation and corporate advisory support to furnish information to investors, ongoing investor relations costs	Intermediation cost from crowdfunding platform providers tend to be lower than the traditional finance costs because of online technology platforms and streamlined templates that can reduce transaction costs. However, the cost of investment readiness could be high for some businesses.	
Suitability	Easy and cheaper access to capital, suitable for early-stage companies, and lighter compliance	Easy and cheaper access to capital, suitable for early-stage companies, lighter compliance, public exposure, and voids dilution from a single large shareholder	Looking to finance asset or working capital where banks may not lend because of lack of collateral or equity threshold

P2P: peer-to-peer.
Source: Pacific Private Sector Development Initiative.

IV REGULATORY OVERVIEW

A. OVERVIEW OF CURRENT REGULATORY FRAMEWORKS

Securities regulation differs between each of the Pacific island economies. Fiji and PNG, for instance, are the only two PICs that have securities legislation that sets out the requirements for offering securities to the public. These two countries also have securities exchanges, several managed investment schemes, and a community of licensed intermediaries.

In Fiji, securities laws form part of the Companies Act 2015 and, along with all supporting regulations, fall under the ambit of the Reserve Bank of Fiji. The laws contain a small offer exemption, enabling offers to be made to no more than 20 investors raising up to $1 million in a 12-month period without a prospectus, but with no provision or exclusions specifically for crowdfunding.[11]

Similarly, in PNG, the Capital Market Act 2015, which is administered by the Securities Commission of PNG, provides exclusions for a range of offers, including where minimum investment amounts are set at K250,000 or where offers are made exclusively to persons outside of PNG.[12]

Samoa has a unit trust established under the Unit Trusts Act 2008, and currently administered by the Ministry of Finance. It also has a securities legislation, Securities Act 2006, which is administered by the Ministry of Commerce, Industry and Labour, but has not been used for any public offer of securities in Samoa to date. Vanuatu also has legislation on unit trusts even though it does not have any established unit trusts, and a Financial Dealers Licensing Act which licenses and regulates dealers in securities and is enforced by the country's financial services regulator, the Vanuatu Financial Services Commission.

There are no specific securities laws in other PICs. However, most companies laws contain a general restriction on persons who are engaging in conduct which is misleading or deceptive in relation to offers for securities in a company.

The relevant companies laws also limit the number of shareholders that private companies can have before they must convert to a public company. It is apparent that companies looking for funding through IGCF, in particular, will have to convert from private to public companies. Consideration may need to be given to simplifying such requirements in order to make such Innovative Financing Mechanisms viable.

Overall, there is a need for a better legislative infrastructure to support Innovative Financing Mechanisms in PICs. PSDI is currently assisting regulators in Fiji and PNG in drafting legislation and regulations to help shape and enhance the development of such mechanisms.

B. REGULATORY CONSIDERATIONS GOING FORWARD

The development of a legal and regulatory framework as well as the technical infrastructure will be crucial, and consideration must be given to how and to what extent amendments will need to be made to the existing legal and regulatory frameworks.

[11] Companies Act 2015 (Fiji). Section 26.

[12] Capital Markets Act 2015 (Papua New Guinea). Schedule 6.

1 Small-Scale Offers

While the small-scale exemption exists in legislation in Fiji and PNG, this form of financing is underutilized in both countries. Private placements and other small-scale transactions usually fall below the regulatory radar, but PSDI believes that there may be a case to strengthen the framework around small-scale offers to increase their utility as a financing mechanism.

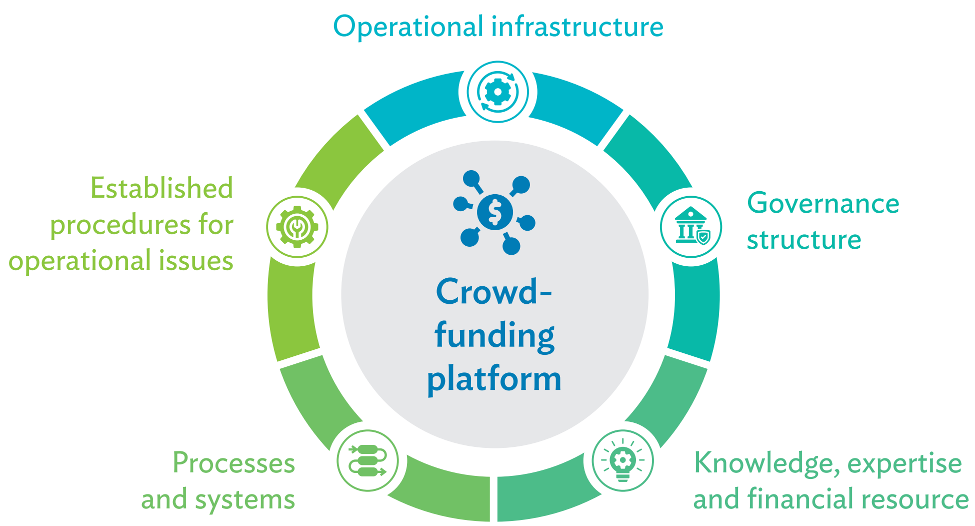
This could be in the form of introducing some regulatory oversight on such offers and simplifying the process to make it easier for companies that are seeking finance; for example, having templates for basic information packages that companies can use with information on the main business activity, use of funds, and the main people behind the company. This would ensure a sufficient level of disclosure to investors, while enabling SMEs to broaden their investor audience. In PICs with no securities law, the legislation may need to be further simplified to distinguish between different investors who have varying levels of sophistication.

2 Investment-Geared Crowdfunding

Given the important role of the crowdfunding platform service provider as gatekeeper and conduit between businesses and the public, such providers need to be regulated. Regulations generally contain organizational and operational requirements, such as technical knowledge and the infrastructure needed to effect fundraising activities.

Where legislative frameworks already exist for licensed financial advisors, such as in Fiji and PNG, this could extend to a new category of intermediaries for crowdfunding platform service providers. Because there is a level of responsibility, platform service providers would need to ensure that their own directors and senior managers are fit and proper, and have the relevant capabilities and competencies to provide such service. Any regulation or condition for licensing would need to ensure that the intermediary has certain cornerstone infrastructure in place as seen in Figure 2.

FIGURE 2: **CORNERSTONE REQUIREMENTS FOR PLATFORM SERVICE PROVIDERS**



Source: Pacific Private Sector Development Initiative.

In Fiji and PNG in particular, the role of the crowdfunding platform service provider closely resonates with that of an investment adviser, with the scope of work dependent on the internal capabilities of the companies that are seeking funds. While some may need minimal investment readiness support, most SMEs in the region are likely to seek more corporate and strategic advice before they are able to use such platforms for financing. The nonfinancial advisory gap that exists in PICs will warrant a stronger community of advisers, whether it sits within or beyond the role of the crowdfunding platform service providers as intermediaries and gatekeepers.

Regulation should be moulded having regard to the current and future digital landscapes in the Pacific, specifically around identification, payment, and accessibility of infrastructure and data. Given the reliance on fintech for the IGCF regimes, it will be crucial to consider the digital landscape, especially in light of 'legacy' regulation, dated security processes, as well as cumbersome and outdated protocols that come with the financial services industry in the Pacific. While the growth in mobile money transactions and social media is catalyzing digital transactions, the Pacific economies remain largely cash-based so any changes in regulations will need to accommodate this.

Consideration must also be given to ensuring that the regulatory framework keeps up with fintech advancements; for example, cybercrime and blockchain which will be crucial for future proofing and to protect the public. In this regard, strengthening the Know Your Customer (KYC) and anti-money laundering/combating the financing of terrorism (AML/CFT) legislation will also be critical, ensuring the crowdfunding platform service providers are able to comply with the requirements effectively.

In those PICs with no existing securities laws, developing regulatory architecture to support traditional financing and Innovative Financing Mechanisms could be difficult and impractical. However, an opportunity exists to "leapfrog" legacy systems and traditional financing methods through leveraging emerging technology and business processes.

In introducing or amending any legislation or regulation, the aim will be to make the regulatory requirements for raising capital through such Innovative Financing Mechanisms less onerous to enable SMEs to access finance, while also providing adequate oversight over new financial technologies and players for investor protection. Any assessment of the architecture of a regulatory framework must be holistic, ensuring the financial regulator has the capacity and resources to provide oversight, and consider the evolving financing and technology ecosystems.[13]

[13] ADB. 2022. Fintech Policy Tool Kit for Regulators and Policy Makers in Asia and the Pacific. Manila.

BOX 1: CROWDFUNDING IN NEW ZEALAND: A MODEL FOR THE PACIFIC ISLAND COUNTRIES

New Zealand presents a good example framework for developing a customized environment for investment-geared crowdfunding within the existing securities law.

Under the New Zealand model, crowdfunding can be carried out through a licensed crowdfunding service provider, if the company raising the funds (the issuer) prefers lighter compliance obligations than that required for a public offer.

Licensing of the intermediaries is not too prescriptive, which shifts the gatekeeping responsibility to crowdfunding platform service providers who, in turn, ensure that the proper checks and balances are implemented with the issuers in order to manage their own reputational risk.

This model can work in the Pacific because it (i) moves the day-to-day responsibility away from regulators, and (ii) provides greater flexibility to the key actors, which is crucial to develop such evolving financial markets while also avoiding unnecessary compliance costs.

However, because this model places a large onus on intermediaries to take on the responsibility for meeting regulatory requirements, such as disclosure and record keeping of issuers, it will be crucial to have strong and capable intermediaries that can take on these roles.

Source: Pacific Private Sector Development Initiative

V ISSUES TO CONSIDER

Innovative Financing Mechanisms have a global track record for financing SMEs and companies that are seeking early-stage capital. This policy brief has outlined how small offers and IGCF can allow easier, cheaper, and faster access to finance for SMEs; and can be established as more effective interventions than those that already exist in PICs. In considering how such mechanisms will work in the Pacific, it is also important to consider whether there is sufficient market-based demand for these products.

For Innovative Financing Mechanisms to operate efficiently, there is a need for a sufficient investor base in PICs because, without the "crowd" of investors, there is no funding. The Pacific has a relatively small and nascent investor base that actively saves and invests. Even in Fiji, PNG, and Samoa, where securities are offered in various forms to the public, the investing public makes up a fairly small portion of the population.

In assessing the appetite for investment in innovative financing mechanisms in the Pacific, it is essential to look at the following factors:

A. AFFORDABILITY

Lower minimum wage levels across the Pacific mean that disposable income for savings and investment is limited. As the culture of saving and investment penetrates PICs, people with supplementary incomes are keen to make calculated decisions on how best to get their money to work for them. Traditionally, while these choices have been limited to term deposits, high liquidity in the banking systems can drive interest rates below inflation rates, which compels investors to seek better returns.

Small offers and IGCF regimes offer relatively low minimum investment thresholds, allowing the public to invest much smaller amounts than what the stock market or mutual funds would require.

B. ACCESSIBILITY

E-commerce and online transactions have jumped in the Pacific following the coronavirus disease (COVID-19) because of the general penetration of smart phones. Overall, penetration of mobile subscribers for PICs stood at 47% in 2022 with countries like Fiji, Niue, and Palau having penetration rates of more than 70%, while countries like Micronesia and Tuvalu were still below 30%.[14] While the more developed Pacific economies are transitioning to the digital economy, the same cannot be said for all countries in the region. It is also interesting to note that according to a recent survey by the

[14] GSM Association. 2023. *The Mobile Economy Pacific Islands 2023*. London. https://www.gsma.com/mobileeconomy/wp-content/uploads/2023/05/GSMA-ME-Pacific-Islands-2023.pdf

United Nations Capital Development Fund (UNCDF) on Fiji's digital access, while the penetration of smartphones is relatively high, the majority of the use is for social media and news rather than actual payments or transactions.[15] If communities continue to operate in a largely cash-based way and if technology platforms are unable to get around some of the deeply rooted cultural norms related to doing business in person, the success of Innovative Financing Mechanisms could be challenged. This is evident in most of the social fronts such as church fundraising, which largely remain cash-based and in-person activities.

C. INVESTOR AWARENESS

A retail investor's awareness and understanding of securities, shareholder rights, expected returns, and risks will be more limited in jurisdictions where securities markets do not exist.

Ensuring that investors understand that the returns are not guaranteed will be important in the Pacific, and this will need to be more than a box-checking exercise. The inherent nature of investing in private companies is high risk as the securities are illiquid, and there is significant reliance on the founders to generate a decent return.

D. AFFILIATIONS

Further, while donation-based crowdfunding is quite popular in the Pacific because of religious and social affiliations and contributions are made with no expectation of return, it would be incorrect to assume that the public will contribute to someone's business the same way he or she contributes to their church (for example). While IGCF would allow people to be part of projects or activities that are community focused, there is no guarantee that cultural norms would translate to IGCF activities.

E. EQUITY-BASED MECHANISMS VERSUS PEER TO-PEER LENDING

Given the lower levels of understanding of share ownership, the rights attached to such ownership, associated risks, and longevity of an equity investment in most PICs, small offers, and ECF may face some challenges in uptake over and above the general reluctance of entrepreneurs to dilute their ownership.

In Fiji and PNG, it is unlikely that any secondary markets could offer reliable and timely exit strategies for equity investors, although examples of over-the-counter price matching services exist for some of the unlisted public companies.[16]

Arguably, with a developed banking industry in most PICs, borrowing and loan repayments are better understood concepts. With pre-agreed terms and shorter payback periods, P2P lending products are likely to be more attractive to an investor base with lower risk tolerance.

[15] United Nationals Capital Development Fund. 2023. *Assessing Digital and Financial Literacy in Fiji, A survey on Knowledge, Skills and Access.* Suva, Fiji: United Nations Capital Development Fund Pacific Office. https://www.uncdf.org/article/8317/assessing-digital-and-financial-literacy-in-fiji-a-survey-on-knowledge-skills-and-access

[16] Few unlisted public companies offer over-the-counter price-matching services for their shares through licensed broking firms in Fiji.

F. INTERMEDIARIES

There is a notable resourcing gap in terms of business advisory services in PICs. Given the broad role of the intermediaries, which may require marketing, technological, administrative, financial, and investment attributes, it will be important to consider existing institutions with a greater outreach such as local fintech companies, share registry businesses, and finance companies, while also considering the possibility of intermediaries from abroad who will bring their existing technology, expertise, and processes.

G. EXPANDING INVESTOR BASE

An opportunity worth exploring for IGCF is the role that the Pacific diaspora could play. Remittances provide significant capital inflows into most Pacific economies.[17] Currently, the bulk of the capital inflow from remittances goes into consumption with very little diverted towards wealth-building. Tapping into the overseas diaspora investor base through crowdfunding platforms could be an alternative way to access capital for SMEs in PICs.

The key challenge in this model is that members of the Pacific diaspora will be bound by the securities regulations of the countries where they are based, which makes it difficult to get a crowdfunding or small offers regime exclusion from the public offering requirements in those countries. However, this could be a matter of discussion with regulators of various jurisdictions (principally Australia and New Zealand where the majority of the Pacific diaspora reside).

Another way to tap into the diaspora investor base would be through international lending platforms that are already positioned in those countries to raise funds from the diaspora to channel funds through to Pacific companies and projects; for example, Lend for Good which is an Australian P2P lending platform, but facilitates loans from Australians to projects in developing countries.[18]

H. RESPONSIBILITIES

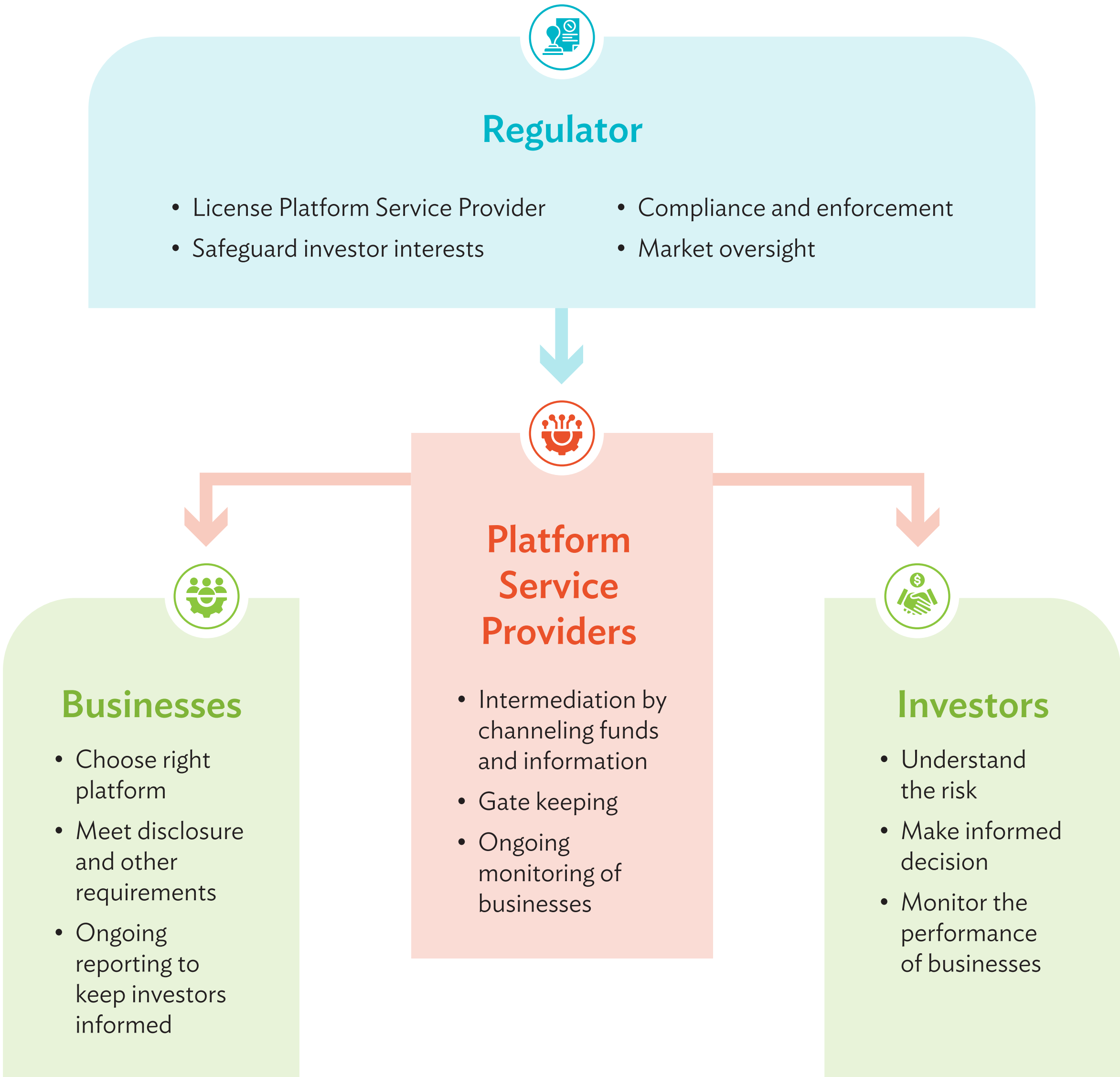
For crowdfunding as a new financing mechanism in PICs, it will also be important to have clarity on how the roles and responsibilities of actors lie within the system including the regulators, the crowdfunding platform service providers, as well as the businesses that are seeking funds and the investors. In the Pacific context, the regulators may even consider a more prominent role initially as these mechanisms develop.

Figure 3 (page 15) shows some of the key responsibilities in IGCF.

[17] Fiji recorded F$1 billion in registered remittances for 2022.

[18] Lend for Good. https://lendforgood.com.au/.

FIGURE 3: **RESPONSIBILITIES OF EACH PLAYER IN INVESTMENT-GEARED CROWDFUNDING**



Source: Pacific Private Sector Development Initiative.

VI CONCLUSION

Both crowdfunding and small-scale offers regimes are very participative in nature, decentralizing investment and power, to enable the public to support projects and businesses that provide broader community benefit. These Innovative Financing Mechanisms provide the potential to democratize capital and allow PICs to better develop wealth-building activities that underpin economies, driving growth, employment, and productivity.

However, Innovative Financing Mechanisms do not offer a collective solution to all SMEs that are unable to access finance. As many SME businesses operate in the informal sector, they would be precluded from accessing these products.

In considering the opportunities and challenges for Innovative Financing Mechanisms, each PIC will need to undertake a holistic assessment of their domestic financing landscape. There is no regional model solution. This assessment needs to go beyond simply a review of the laws that may need to change, but must also include an assessment of whether there are businesses that are at an appropriate stage to access Innovative Financing Mechanisms, the current capabilities of these businesses, the advisory support needed to make them 'investment ready', and the willingness of such businesses to use Innovative Financing Mechanisms.

Policy makers will have to ensure that any introduction of Innovative Financing Mechanisms is accompanied by appropriate updates to the regulatory architecture to protect the investors. At the same time, policymakers must ensure that any laws and regulations are not too cumbersome, costly, or unattractive for SMEs.

To develop a successful ecosystem for Innovative Financing Mechanisms, strong and capable intermediaries are required to drive the market. This is the case particularly with IGCF where intermediaries have a broader set of responsibilities.

In determining the viability of Innovative Financing Mechanisms, each Pacific country will also need to assess the willingness, ability, and financial competency of investors in their respective markets as well as any technological barriers that may need to be overcome. Although the investor base in PICs may be small, there could be an opportunity to scale this with the Pacific diaspora who are already funding economies through remittances.

On a country-by-country basis, Fiji and PNG in particular provide an easier pathway to implement Innovative Financing Mechanisms (when compared with countries who lack securities laws) because it is possible to build on or amend the existing securities laws and tap into a higher rate of financial literacy and awareness. In these countries, the small offers and IGCF regimes could offer a logical progression for businesses that are seeking capital in the financing gap—being too large for micro and small funding avenues and too small for public offerings and listings, while also lacking sufficient equity threshold or collateral to secure commercial loans.

Equity-based raising such as small offers regimes and ECF require more trust building, deeper financial analysis, better understanding of equity and shareholder rights, and a higher risk element for investors and so may be more challenging to introduce. P2P lending, on the other hand, may be better understood because of the existing lending and financial services infrastructure in PICs. P2P lending could potentially serve as an introductory alternative financing product where investors are eager to obtain slightly higher returns, but also want a fixed investment period and more well-defined terms around interest and principal repayments, as opposed to long-term and arguably more speculative equity-based investments.

Policymakers must collaborate with stakeholders to map the path forward by formulating and implementing policy levers that enable such development. Ultimately, the impact of such financing mechanisms will be different for each PIC. It is important to develop a localized understanding of the role and level of foundational infrastructure, as well as the evolving technology and financial systems, to design interventions that may close the financing gap faced by SMEs in a meaningful manner.

PACIFIC FINANCE SECTOR POLICY PAPER SERIES

This Pacific Finance Sector Policy Paper is the third of a series published by the Pacific Private Sector Development Initiative (PSDI) covering topical issues in Pacific finance, with the combined aim of assisting Pacific policymakers to alleviate the constraints faced by Pacific businesses when trying to access finance.

About PSDI

PSDI is a technical assistance program undertaken in partnership with the Government of Australia, the Government of New Zealand, and the Asian Development Bank. PSDI supports ADB's 14 Pacific developing member countries to improve the enabling environment for business and to support inclusive, private-sector led economic growth. The support of the Australian and New Zealand governments and ADB has enabled PSDI to operate in the region for 15 years and assist with more than 300 reforms.

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