Islamic Crowdfunding: Fundamentals, Developments and Challenges

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Abstract

Purpose:
As financial activities become more sophisticated, financial markets become more sensitive to shocks resulting in unpredictable impacts on the real sector. Banks, the leading player in the financial system, use their financial strength to make economies volatile due to excessive risk transfer and money creation. To stabilise markets, Islamic finance offers an alternative model of a financial market and economy with its *Shariah* concepts and adoption of Fintech innovation, which in this case is crowdfunding.

Design/methodology/approach:
This paper details the foundations of Islamic finance that differentiate between conventional and Islamic crowdfunding. Secondly, the viable and innovative structures of crowdfunding are examined. This is followed by discussing the challenges of Islamic crowdfunding in the financial system.

Findings:
We have proposed two different Islamic P2P models, namely *Mudhārabah* (equity-based) and *Murābaḥah* (sale-based) based crowdfunding models. Also, we identified several challenges in Islamic P2P crowdfunding consisting of regulatory issues, project management, secondary market, fraud cases and *Shariah* issues.

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Originality/value:
Future research is suggested to explore Islamic crowdfunding further and in greater depth since the resources of these particular issues are limited whereas its potential is significant.

Keywords: P2P lending, Islamic crowdfunding, Islamic Finance

Introduction

Islamic finance is founded on *Shariah* concepts of justice and public interest. This creates its significant appeal and has driven its rapid growth, especially after the events of the 2008 financial crisis for which many are still recovering. In spring 2009, Queen Elizabeth of the United Kingdom raised the simple question, "Why did no one see it coming?" and nobody at the Economics Department of the London School of Economics could give a satisfactory answer (Turner, 2016). What the event does tell us is that the current financial activities, instruments and money creation, can have unpredictable and far-reaching impacts on society.

The debt contract plays a vital role in financial activities as evidenced by the industrial revolution in the mid-nineteenth century. However, according to Bank of England, in 2012 only 14% of bank lending went to the real business sector, and the other 79% went to mortgages and real-estate loans, and the remaining 7% was used for ordinary consumer credit. Such practices are risky, but despite such risks, banks continue to be the backbone of the economy. Perhaps this very character that makes them harmful is also what makes them valuable. One must remember that a debt contract in the conventional system is interest-based meaning that it does not depend on the value of the underlying asset. It also means that it can create a sudden stop in economic activity and result in depression and a deflationary debt overhang effect (Turner, 2016).

Banks have evolved from household savings to power purchaser by creating credit and intangible money. It has expanded its reach from households to businesses by making all transactions through the banking system. As a result, the bank has a significant influence on economic activity since they make all the decisions concerning the allocation of financing. This enormous influence creates an unsuitable relationship to empower real economy given that the banks' tendency to loan to sectors other than the real economy.

This paper argues how the Islamic financial system supports a sustainable and valid real economy, in addition to adopting current innovation and technology in the financial industry to achieve its mandate. With the rise of online fundraising platforms, Islamic finance has embraced peer-to-peer (P2P) crowdfunding. This paper explores the current development, viability and challenges of the Islamic version of P2P crowdfunding to embrace the financial market which as a result adds value to the real economy.

Foundation of Islamic Finance

Compared to the conventional financial system, Islamic finance must comply with the *Shariah* principles that promote competency and sustainability. It also has to comply with the *Shariah* rulings to avoid interest (*Ribā*), gambling (*Maysir*), uncertainty (*Gharar*) and all other prohibited matters (*Haram*). It promotes competency in the sense of having clear resources in the form of the *Quran* and *Sunnah*, and sustainability as per the five higher objectives of the *Shariah*, namely the protection of life, religion, intellect, lineage and wealth.

In Islamic banks, the *Ribā* on a conventional loan is transformed into a return from financing as a consequence of risk sharing and the utilisation of profit-and-loss (PLS) between Islamic banks and their business partners. Thus, Islamic modes of financing that take the form of debt (like *Murābaḥah, Tawarruq, Ijārah*, etc.), equity (like *Muḍārabah, Mushārakah*) and service financing (like *Wakālah, Hawālah, Kafālah*, etc.) should support real economic activities. One Islamic banking model takes the following form (Ismal, 2013):

$$IPI = f(FIN, DEP, PLS)$$

Where IPI stands for industrial production index that is used as economic output, FIN refers to total financing of Islamic banks, whereas DEP is the variable of total deposit of Islamic banks. Lastly, PLS is the profit-sharing ratio for the depositor as an indicator by the banks to control their financing performance.

Ismal (2013) found that there are strong long-run relationships between IPI and the movement of DEP, FIN and PLS which means that Islamic banking financing channels do exist and support the real sector. Secondly, there appears to be a positive response from the findings that any innovation in financing and real sector activities are responded to positively by the banks' depositors which means Islamic banking business pay careful attention to the progress of the economic performance. Lastly, this finding is a warning to regulators to consider PLS as a potential source of Islamic monetary policy since it relates closely to the other variables.

Conventional and Islamic Crowdfunding

New business requires resources to succeed, and one of the most fundamental aspects is capital (Gompers and Lerner, 2004). Conventional bank financing is becoming more and more difficult due to stricy regulations and high collateral requirements. For that, entrepreneurs try to find new sources of financing. In recent years, crowdfunding has emerged as an original means for an entrepreneur to secure funds without having to look for venture capital or other traditional sources of venture investment (Mollick, 2014).

Conventionally, the four forms of crowdfunding are rewards-based crowdfunding, donation-based crowdfunding, equity crowdfunding and debt crowdfunding. Table 1 defines the various types of crowdfunding.

Table 1: Definitions of the various types of crowdfunding

Type	Definition
Rewards-based crowdfunding	The crowd investors contribute typically small amounts of money in exchange for a reward such as a watch, an album or a film.
Donation-based crowdfunding	The donors generally donate small amounts.
Equity crowdfunding	The investors invest more significant amounts of money. The investors have a small piece of equity in the company by giving money. As a result, equity crowdfunding is typically used to raise money to fund the launch or growth of a company.
Debt crowdfunding	As the name indicated, the investors lend money to companies.

Source: Ethiscrowd.com

Lending via crowdfunding has been the fastest growing mode of lending with the total crowdfunding market of 22.2% in 2012 rising to 68.3% in 2014 globally (Massolutions, 2015). The *Shariah* accepts the first three types of crowdfunding (reward, donation and equity-based). However, conventional debt crowdfunding is not permissible in Islamic because it is based on interest (*ribā*). Table 2 summaries the differences between conventional and Islamic crowdfunding:

Table 2: The differences between conventional and Islamic crowdfunding

Type	**Conventional crowdfunding**	**Islamic crowdfunding**
Rewards-based crowdfunding	Materialism	Materialism, it may also include the element of al-Falah.
Donation-based crowdfunding	Humanitarianism	Based on religious belief such as Waqf, Zakah, Sadaqah, etc. The ultimate objective is al-Falah.
Equity crowdfunding	Angel investors, Venture capitalists	Based on *Muḍāarabah, Mushārakah*. The *Mushārakah* based crowdfunding is may similar to equity-based crowdfunding, However, the beauty of *Muḍārabah*-based crowdfunding is that the crowd provides the entire capital and the company is responsible for the business operations. In the case of profit, the crowd and company share the profit based on the pre-determined ratio. However, in the case of loss, the crowd is responsible for all losses.
Debt crowdfunding	Lending based on interest; also called P2P crowdfunding	Sale based contracts - *Murābaḥah, Tawarruq, Ijārah.*

Source: Authors

In response to this prohibition of interest in Islam, Islamic finance comes up with Islamic P2P crowdfunding based on Islamic contracts in the transaction not only to avoid interest but also to serve as an alternative pathway to grow the real economy. The statement can be verified by deriving the formulation of Islamic banks' functions (Ismal, 2013):

$$IPI = f(FIN, DEP, PLS)$$

Except for intermediaries in the Islamic P2P crowdfunding, there is no need for a deposit account as well as financing in the transaction. The European Banking Authority (EBA) in its published *Opinion of the European Banking Authority on lending-based crowdfunding* in 2015 pointed out that crowdfunding platforms seek to limit their role merely to that of an intermediary bringing the investor and business together. Thus, the econometric function can be shown as follows:

$$IPI = f(PLS)$$

This new function depicts that the industrial production index is equal to the profit-and-loss sharing that happens in the transaction. Since there is no 'holding' of a fund that will be transacted into the business account, every transaction that occurs in Islamic P2P crowdfunding will affect the economic activity directly.

With that equation, it proves that the correlation between Islamic P2P crowdfunding and economic activity is strongly positive. However, the practices of this financial model are hard to find since crowdfunding is very challenging and requires a considerable commitment of time and resources, especially in places where crowdfunding is a new phenomenon. Therefore, it is important to understand the development, viability and challenges of crowdfunding before understanding the concept of Islamic P2P crowdfunding.

Development of Crowdfunding

Since the rise of Fintech, peer-to-peer (P2P) financing has become a popular model in the financial service industry. It channels funds with the help of the technology that can create a decentralised communication model in which both parties have the same capabilities and equal treatment for the service given. One of the rising stars in this P2P model that has successfully disrupted the current financial system is crowdfunding.

Schwienbacher and Larralde (2010) identify crowdfunding as an open call through an online platform for the provision of financial resources either in the form of donation or in exchange for several forms of reward or voting rights in order to support initiatives for specific purposes. There are various sub-types in the crowdfunding market which include lending, equity, and mortgage-backed models, as well as non-profitable types such as charitable donations and rewards crowdfunding.

Regarding market development, the total volume in the online alternative finance market in Europe as of 2015 reached EUR 5.4 billion, up from EUR 2.8 billion in 2014 with an annual growth rate of 92% according to the Cambridge Centre for Alternative Finance in 2015. The UK remains the largest market for alternative finance within Europe, providing EUR 4.4 billion for 2015, followed by France at EUR 319 million (Zhang et al., 2014). Developing countries also have significant potential with the World Bank report in 2013 titled *Crowdfunding's Potential for the Developing World* estimating a crowdfunding market in the developing world valued at USD 96 billion by 2025.

In the Islamic financial system, the Securities Commission Malaysia in its *Islamic Fund and Wealth Management Blueprint* awarded six P2P licences, one of which was the world's first licence for *Shariah*-compliant P2P lending. This particular licence was awarded to EthisKapital.com and licenced Islamic P2P crowdfunding that focused on funding small businesses and real-estate development projects. The growth prospect for Islamic P2P crowdfunding is vast considering the relatively small market and massive demand for crowdfunding type of financing. As a comparison, according to KapitalBoost.com, the estimated total Islamic crowdfunding in 2015 reached USD 30 million versus the total crowdfunding market of SGD 34 billion.

1. Viability of Islamic Finance in Crowdfunding

The rapid growth of this kind of Fintech extends beyond the innovative use of technology. Fintech platforms provide the customer with a seamless experience with easy accessibility, especially in crowdlending sectors. There are four distinct advantages for P2P lending (Milne and Parboteeah, 2016). It has higher returns than bank deposits for lenders with low fees, easier access to finance borrowers who are not bankable; it offers ethical and social perception and accessibility on a variety of devices with no time limitations. These attributes make a compelling case for Islamic finance to offer P2P lending products through Islamic P2P crowdfunding.

This disruption is also a chance for Islamic crowdfunding to answer to the public as an economic multiplier. According to Cortese (2011), money spent directly to business, as opposed to a traditional banking chain, circulates locally rather than being leaked out of the community to coffers of a distant headquarters. As Islamic crowdfunding influences economic activity directly, it creates an economic boost which impacts not only the entrepreneur but also the local economy.

Moreover, Islamic crowdfunding can reach a wider community, is not limited by geography, and is a crucial enabler to support and mobilise wealth. As such, it supports community participation in developing businesses. With this concept, there is a huge potential for Islamic crowdfunding to offer unique value to the Muslim Ummah. As a reminder, nine out of the ten companions of the Prophet Muhammad (PBUH) who were guaranteed heaven were entrepreneurs.

2. The Innovation of Islamic P2P Crowdfunding

With this potential, Islamic finance needs to explore crowdfunding further since it is mathematically proven to impact real sectors. Although there are many doubts in this sector as to whether crowdfunding is revenue-intensive or not, Islamic finance has to aggressively penetrate the market to match the momentum (Cowen, 2011).

Lending-based crowdfunding is treated differently in this case since it is clear that Islam prohibits interest at all cost. With *Muḍārabah* (equity-based) and *Murābaḥah* (sale-based) based crowdfunding models, Islamic finance is responding to that in the two most prominent Islamic crowdfunding platforms, namely Kapitalboost.com and Ethiscrowd.com. Both companies will screen every project and give a risk rating as well as the expected return for each investment activity. Based on the principle of *Muḍārabah*, all capital is unguaranteed, and in the case of default, all the materials in the business will be liquidated and returned to the investor.

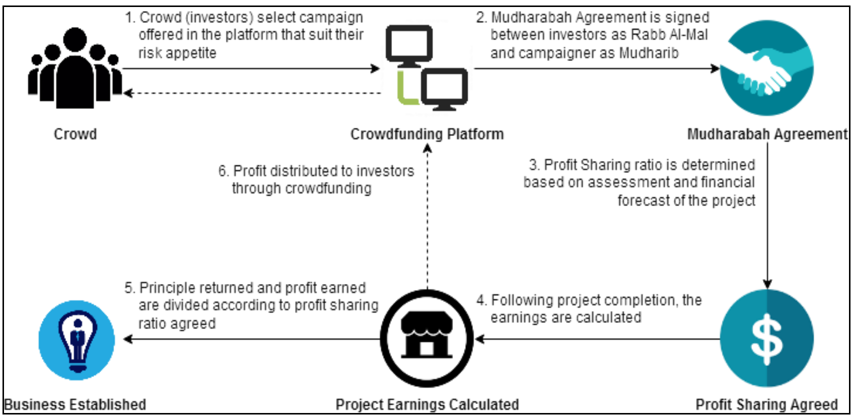

Figure 1: Partnership through Muḍārabah

On the other hand, in *Murābaḥah* crowdfunding, capital from the crowd will be collected as the fund to buy all assets necessary to establish the campaigner's business and sell it to campaigners with the cost-plus methodology. This methodology is a safer way to become involved in P2P lending, yet there will be no interest involved, and it complies with all *Shariah* requirements. With this concept, there will be real profit-and-loss sharing within the business since all of the parties bear the risk.

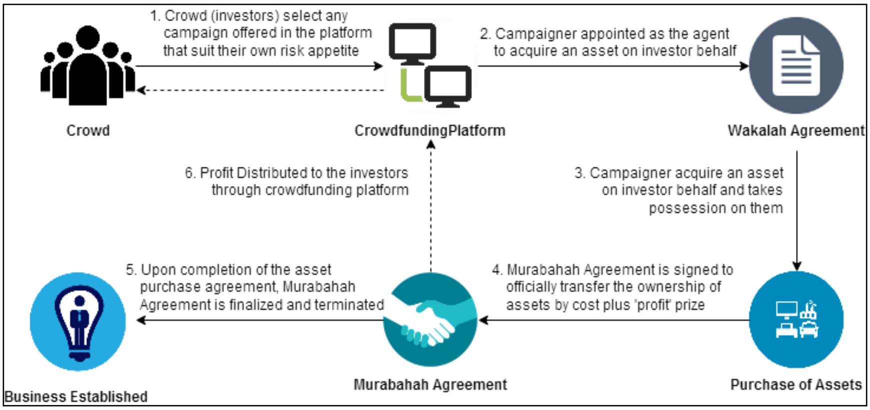

Figure 2: P2P Lending through Murābaḥah

Although the risk exposure in Islamic crowdfunding tends to be higher, the demand to participate in this kind of investment is surprisingly high. According to the Ethiscrowd's website, total investors already reached 17,000 private investors within two years who invest mainly in affordable housing, commercial projects, commercial property and eco-housing in emerging Asia. As for Kapitalboost.com, their central investment segmentation is for SME business and private crowdfunding where it provides a lot of job creation across all economic sectors.

3. Challenges of Islamic P2P Crowdfunding

There are several challenges in Islamic P2P crowdfunding as illustrated in Figure 3 such as regulatory issues, project management, secondary market, fraud case and *Shariah* issues. In this section, we elaborate on these issues and challenges.

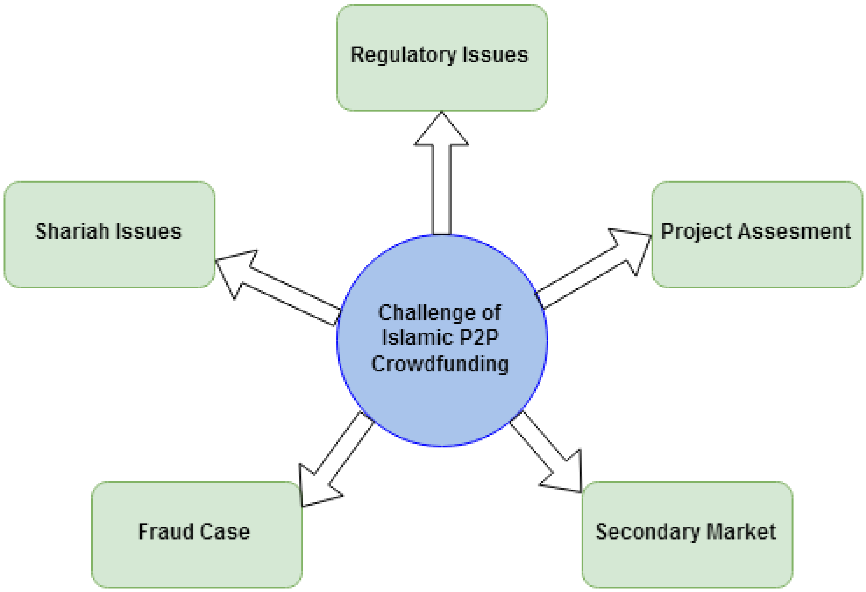

Figure 3: Challenge of Islamic P2P Crowdfunding

4. Regulatory Issues

Of all the issues raised by crowdfunding, regulatory issues are the most challenging. The US Securities and Exchange Commission (SEC) has established regulatory principles on crowdfunding which cover four main points; crowdfund limit, investor's financial background, intermediaries' role, investment eligibility. Meanwhile in developing countries like Indonesia, however, the regulation on crowdfunding or Fintech appears to be stricter where ten points are proposed in its *Financial Service Authority Regulation 2016 No.77*. Malaysia has regulated the Islamic crowdfunding in the *Guidelines on Recognised Markets* by Securities Commission (SC) where it states that all the Islamic financial service must comply with IFSA 2013.

Looking at the regulation, Islamic crowdfunding has its potential and challenges in its various conditions. For example, the *Financial Service Authority Regulation 2016 No.77* mentions risk mitigation is required in the credit risk where the crowdfunding operator shall take credit insurance or credit guarantee. Since Islamic crowdfunding uses the *Muḍāarabah* model, it is a big question as to how the model can guarantee the profit returned to comply with the law.

Also, in Malaysia's *Guidelines on Recognised Markets*, the SC regulates the fundraiser as well as fundraising limit in P2P crowdfunding business. This guideline creates an underlying perception that P2P crowdfunding should not overlap the existing banking business. Therefore, rather than becoming a solution to support real economic development, this regulation holds back the P2P business to contribute more to society.

5. Shariah Issues

The business activity is the first concern in *Shariah*-based crowdfunding. Some of the businesses proposed in the current crowdfunding are not *Shariah*-compliant such as liquor businesses found on Indiegogo.com. Thus, there is a need for *Shariah* screening of crowdfunding campaigns to comply with the *Shariah.*

In lending-based crowdfunding, the primary challenge for Islamic crowdfunding is replacing the interest rate and guaranteed capital. Since this type of crowdfunding is the leading practice in the market where the Massolution report in 2015 stated that it holds USD 25.1 billion over a total of USD 34.44 billion, Islamic crowdfunding should be concerned with this particular type of funding. One solution practised by Ethiscrowd.com and Kapitalboost.com is changing the interest-based model with the *Muḍāarabah* and *Murabaha* models. However, since the capital is not guaranteed, there can be huge differences of perception in the market.

6. Project Assessment

For project assessment, Islamic crowdfunding mainly uses the banking concept of financing. The business should involve an underlying asset that is publicly known and market suitable such as clothes trading. This is established in Ethiscrowd.com where it involves more significant projects like property business. Thus, it is still a challenge for Islamic crowdfunding to select an innovative and out of the box project like Oculus Rift which has raised ten times more than its USD 250,000 which was funded on Kickstarter.com in 2012.

Nevertheless, some online-based credit assessments have been established to complete the demand of rating agencies in the crowdfunding campaigns such as CreditMonk.com or modefinance.com. However, the perception of investors of the business is still in the stage of 'ability to pay' not 'intention to pay'. Therefore, it is still difficult for crowdfunding entities to create a trust-based transaction in its platform.

7. Fraud Cases in Crowdfunding

One of the most notable issues in crowdfunding is scams. Because crowdfunding is built on trust, it is challenging to maintain trust in the event of fraud. The most well-known example of crowdfunding fraud occurred in the US, where an oil and gas company named Ascenergy raised USD 5 million from crowdfunding platforms. About USD 1.2 million of that was spent by the founders on non-business materials as well as payments to other companies. In late 2015, SEC froze the assets of the company for fraud.

Another example in August 2016 which revealed that Skully, a San Francisco start-up, designed a motorcycle helmet using augmented reality and used fraudulent bookkeeping practices designed to trick investors. The start-up had raised USD 2.5 million from Indiegogo.com and an additional USD 11 million in a succeeding round of venture financing. It is alleged the company's founders used the funds to cover personal expenses, and it has since filed for bankruptcy.

These situations reveal the natural risk for investors of start-up companies that do not demonstrate the same operational controls as an established and more tightly-regulated organisation. Many 'campaigns' websites are being established for unveiling scams in crowdfunding and related online financial markets such as Kickscammed.com, Facebook's GoFraudMe pages and AndroidPolice.com. However, since the *Shariah* is all about prevention rather than treatment, it emphasises the significance of robust due diligence in the fundraising process as well as the need for risk management controls and assurance.

8. Need for Secondary Market

Since the crowdfunding platforms launched, the need for a secondary market to trade as liquidity management was recognised as being essential.

However, currently, there is no fully functioning and competent secondary market leaving crowdfunding investors with no options to trade their shares or credit line. This condition will result in a detested state of play for investors who do not like their money to be tied up for the long-term.

According to Crowdfunding Hub (2016), there are currently two scenarios on how this secondary market can be developed. Either the leading platforms will establish an internal market to trade liquidity from campaigns on their platform, or specific secondary markets will be launched. However, due to strict regulations, these initiatives will most probably be created or backed by existing stock exchanges. If the existing stock exchanges successfully create the secondary market; Islamic finance may be at a disadvantage since compliance with the current secondary market is already an issue. In the near term, it is likely that these models will co-exist where it will create fragmentation within the industry and continuing difficulties for investors seeking to trade their assets.

Conclusions and Recommendations

Islamic finance has the capacity to face the unpredictable impact of current financial activities on the economy. With the help of technology, Islamic finance can compete for neck-to-neck with the conventional system. Crowdfunding can be one of the main game changers in this industry since it has disrupted the financial systems. By introducing Islamic P2P crowdfunding, Islamic finance can promote the real value of the *Maqasid Shariah* in the current financial market by promoting a real impact, sustainability and competency in the real economy.

Islamic crowdfunding also faces many challenges to compete with the current crowdfunding system since the regulators are more concerned with the majority of industry players. For example, Malaysia regulates crowdfunding business as a second-class player in the market by limiting the funds raised and the fundraiser. Therefore, it is recommended to have regulation supporting both banking and crowdfunding players and combining the expertise in technology and financing business.

Furthermore, one of the strengths of Islamic financial institutions is the presence of *Shariah* members. This strength impacted the public greatly since all solutions are derived from *Shariah* principles. With the presence of *Shariah* members in Islamic crowdfunding, it can make their platform more interactive with distinguishable engaging interactions. For example, engaging the *Shariah* department staff to give real-time feedback on issues that arise within a transaction or give real-time *Shariah* screening on each business offered. Thus, one of the strengths of Islamic finance is its *Shariah* workforce which can be utilised effectively in Islamic crowdfunding.

To protect investors from fraudulent crowdfunding campaigns, crowdfunding institutions should carefully screen the business offered in its webpage. Regulators can introduce regulations for crowdfunding to make periodic checks on the campaigns offered to the public. Other than that, the crowdfunding entity can create a stricter application or use unique credit scoring available to Fintech business to prevent scams. Crowdfunding can also create an open discussion on the platform for the investor as well as the entrepreneur to produce a transparent system of investment.

Crowdfunding players could also create a secondary market as an exit strategy in the business. Regulators could create an online platform as a secondary market for crowdfunding investors. This could include two sections which are equity-based and debt-based crowdfunding. In this platform, the crowdfund holders could market and trade their assets. Due to transparency in the crowdfunding instrument, speculative activities can be minimised in this particular market since all trading depends on business activities that occur in the real world.

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