Equity Crowdfunding in Shariah Compliant Nations: an outlook in the middle-east

Uruba Andaleeb\textsuperscript{1} and Dr. A.K Mishra\textsuperscript{2}

\textsuperscript{1}M.Com(Finance), DAV PG College, \textsuperscript{2}Vice Principal, DAV PG College

E-mail: \textsuperscript{1}uruba.rahman@gmail.com, \textsuperscript{2}akmishra@davpgcvns.ac.in

Abstract

As per the conference paper presented at Harvard Islamic Finance Forum, At Boston, USA in April 2014, ‘Crowdfunding as an alternative to financing Micro Entrepreneurs, Small Enterprises, and startups exhibits the rationale of promoting the core values of Islamic finance and thereby achieving its targets of socio-economic development in regions of Shariah compliance.’ With the given potential of Entrepreneurial Supply in such regions and its limitations, the ability of redefining the crowd as a pool including small and large investors with limited capital as well as different types of development institutions and corporations will enrich the access to capital market without compromising on the basic ethics of Islamic finance. This paper intends to study the scope of Equity Crowdfunding as an alternative source of financing small and newly established ventures that have limited access to institutionalized financial sources. Also, the progress made in the Shariah compliant Middle Eastern nations of the world that are digging into Equity crowdfunding and providing bigger platforms to the young entrepreneurs to pitch their ideas in order to make their projects financially feasible, has been scrutinized.

INTRODUCTION

Crowdfunding is a financing alternative to conventional financing methods that involves funding a project with relatively smaller contributions from a large group of individuals often the common public, rather than seeking substantial sums from a small number of Institutional investors. The fund raising and transactions involved are typically conducted online through special crowdfunding websites, often in conjunction with the most popular social networking websites. Depending on the
project, campaign contributors may be making donations, investing to earn a fair future return on investment (ROI), or prepaying for a product or service.

According to the core ethics of Islam, all forms of Interest (Riba) based transactions including securities offering fixed interest incomes such as Debt instruments are prohibited and thus fall outside the purview of Islamic Finance. Since it defeats the basic principle of avoiding all forms of transactions involving Riba, these transactions and instruments do not receive the approval of the Shariah Board which is a mandate before raising finance in most of the Islamic countries. In case of a Shariah compliant Islamic financial instrument, which is most commonly approved by the Shariah Board, any return must be directly relatable to an asset and risk-taking in a joint enterprise (such as partnerships). A debt security is replaced with an asset-tied security, direct financing of an existing and real asset, accompanied by different forms of partnerships especially equity financing.

An evaluation of Crowdfunding, as a means of alternative financing in most of the Middle Eastern countries having a fully functional and developed Islamic finance platform, suggests that the preference of debt over equity in Islamic Finance is indeed a green signal for Crowdfund Investments. The basic nature of capital raised through crowdfunding absolutely fits the propagations of Islamic Finance.

**Financing SMEs: Crowdfunding and other Shariah compliant fund-raising alternatives**

According to the data published by World Bank on its website in September 2015, there is a large credit gap existing between the funds required by SMEs and the funds available from various financial institutions. The situation is even worse in case of MSMEs. The number of MSMEs in the Middle Eastern and North African countries including unserved & underserved MSMEs is around 10 million. The credit gap in Middle Eastern countries exclusively accounts for around 50%, thus facing constant threats to their survival and growth.

On the other side, the other major challenge that the Middle East is facing is Youth unemployment. According to recent surveys by the World Bank, youth unemployment in the region is around 21%, one of the highest in the world. However, the region is full of entrepreneurial talent and has had a rich heritage of burgeoning startup ventures and SMEs. Despite this, there is lack of availability of sufficient funds to invest in young businesses, due to some of the following reasons:

1. Difficulties in obtaining bank financing besides bearing the burden of debt repayment in the initial stages of development in the form of profit sharing (Shariah Compliant banks in middle eastern countries run on the principles of Islamic Banking, therefore, they do not charge interest on the amounts lent. Most common practice is to share the rewards of the business as their return on investment).
2. Obtaining a bank loan in such countries is not only time-consuming and cumbersome resulting into involvement of a lot of paperwork, but for small firms and startup units, it also means unreasonably high rates and a high chance of being rejected as there are huge risks involved.

3. There is a general trend of risk aversion in the region among all investors, whether it be the retail investors, or the institutional investors, this is especially the case after the Global Financial Crisis of 2008.

4. Also, many investors look for collaterals before funding in a high risk project, and for obvious reasons, it is indeed very difficult for the SMEs to provide them the same.

**Benefits of Crowdfunding for Investors**

Crowdfund investing offers a cooperative, transparent and economical way to invest in Shariah-compliant equity financing. Since it requires the entrepreneur to pitch the business idea on the social networking sites, such information comes handy to the investors thereby enabling them to evaluate the potentials of the business soliciting funds, to arrive at decisions regarding which businesses to invest in and the quantum of investments to be made. Not only are the investors able to invest a subtle amount to reduce the overall risk of losing huge amounts of their savings, but they are also able to earn higher returns on their investment, besides having a fair share in the stake of the SMEs that they are investing in. These returns are, in most cases, substantially higher than the other Shariah compliant Investments. The investors are also able to invest into a number of profitable ventures by diversifying the portfolio of their investment and thereby hedge against high risks of failure of Startups without compromising on the principles of Islamic Financing.

**Benefits of Crowdfunding for Entrepreneurs**

There are no hassles of obtaining a sanction from Banks for having funds credited to the account of the Entrepreneur, thus crowdfunding saves a lot of time, effort and money. Also, the fund raising campaign is simple and realistic as the Entrepreneur pitches the product idea on the Crowdfunding website and all the interested investors contribute their share of investments. As long as the business activity is considered ‘Halal’ (permissible), obtaining fund by this mode is easily approved by the Shariah Board. Thus, the funds can be raised from Muslim dominant regions as well as other parts of the world, thereby providing a larger investor base to the Entrepreneur.

Besides, when an idea is introduced all around the globe via the Internet, it does not take longer for it to go viral among the investors, provided the right strategies follow at each step of Crowdfunding. The entrepreneur might also gain the benefits of Market surveys just by pitching the product development idea over the internet and soliciting the response of its target market. It enables them to innovate and customize the product further from all valuable feedbacks received from its target audience. It also saves them huge sum of money to be spent on market researches before the product launch and also shields them from product failure in the market. Thus, even
before the product is released in the market, the potential market and the buyers are
duly recognized.

However, given the size and scale of operations of Islamic Banks in regions of Middle
East, the prominent ones being located in Saudi Arabia, Kuwait, Dubai, the share of
lending to SMEs of the total lending of these banks is relatively very small. Despite
the fact that SMEs are globally recognized as economic growth boosters, and key
contributors to the National GDps, especially in these regions, SMEs are facing huge
credit gap and a fund crisis. oOne of the core ethics of Islamic Finance, being
accessibility of funds to all Shariah compliant businesses, irrespective of the size of
the organization, is ruled out in these Shariah compliant nations.

Thus, Crowdfunding has been able to diligently solve the problems of asset financing
and expansion of capital base of the business due to the very nature of the entire
process of fund raiser activity. Crowdfund Investing has made noticeable leaps in
filling the credit gap existing in the Middle eastern Countries’ economies pertaining to
investments in SMEs. It also broadens the scope of Islamic Financial services
available to SMEs in these regions as well as other parts of the world.

INFERENCES
From time immemorial, Islamic commercial law has strongly favored equity
instruments of raising finance over debt financing. Given the nature of Crowdfunding
and its success rate across the globe, it is inarguable that it is apt for Muslim-majority
countries that as Shariah compliant as well. In such nations, Crowdfund investing and
Islamic financial services are undoubtedly compatible, besides being mutually
reinforcing. Both of these concepts have similar objectives and foundations in
Finance. Some of the landmarks achieved by a few dominant crowdfunding platforms
in the region includes the Indiegogo, Zoomal & Eureeca. A study of the most popular
Shariah compliant Crowdfunding regime brings us to the following sets of
conclusions:

Crowdfunding & Islamic banking
Despite the region having quite popular and some of the biggest Islamic Banks that
function on the Shariah principles of avoiding all forms of Riba (Interest), there
continues to be a major credit gap between the quantum of funds required by the
newly established ventures and the actual amount of funds made available. After the
Financial Crisis of 2008 and the global meltdown, the banks have become risk averse
and are not much willing to invest in innovative business ideas that may be profitable,
but weigh heavy on the risk-scale. Even if the businesses that are able to obtain bank
financing, the entire procedure of having the funds transferred to them is cumbersome
and involves too much of paperwork and collaterals to be furnished. On the other
hand, crowdfunding is pretty simpler approach to finance the business ideas.
However, it is yet to become as popular as it is in other Shariah compliant nations
such as Malaysia, offering one of the largest crowdfunding platforms.
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Startups and SMEs
It can also be deduced from the unemployment rate in the region, that the problem can mostly be tackled with providing financial support to young entrepreneurship projects, startups and SMEs. The major hurdle for a newly established business or project is to arrange finance. In its unavailability and access, even the most innovative projects that could have been turned into extremely profitable and large businesses, die at its nascent stage. In order to help the young Arabs develop into fine entrepreneurs and create further jobs in the Middle Eastern region, it is required that sufficient startup funds be made available to anyone who has a promising business model and product idea. This can easily be taken care of by opening more crowdfunding platforms in the region.

Regulatory Framework
In 2012, JOBS (Jumpstart Our Business Startups) Act, was signed into law by the US President. The Act required the SEC (Securities and Exchange Commission) to adopt rules and formulate laws that will allow and provide for crowdfunding in the country. It not only led to opening up of big and small crowdfunding platforms, but also resulted in creation of job opportunities in the country besides bringing an inflow of required capital or finance to the startups and SMEs.

However, an insight into the Middle Eastern countries governed mostly by the Shariah laws for regulating their finances, shows the absence of proper laws and regulations that would provide for financing through Crowdfunding, let alone incentivizing the entire regime. In a recent study conducted, it was found that although USA was the first country to have immensely successful crowdfunding platforms such as Indiegogo and Kickstarter, however the growth rate of Crowdfunding platforms in the UK became higher than USA. One of the reasons being the tax benefits provided to the investors investing in startups and SMEs using the Crowdfunding portals. They had the liberty to deduct the amount of such investments from their total income. Although, some of these middle eastern countries are included in the list of Tax Havens (such as Bahrain), even then, these incentives whether in the form of deductible investments or other tax benefits for investors might boost the level of investments in the country. Also, existence of laws and regulations in place and an awareness of the same shall help the economies to allow startups to open and flourish. This would not only contribute to the GDPs of Shariah compliant nations, but would also help them curb unemployment in the region by creation of job opportunities and providing funds to young entrepreneurial talent.

In some of the regions such as the UAE and Oman, there is ambiguity regarding whether the fund raised through Equity Crowdfunding would result into issue of Capital and would be governed by the Securities and Contracts Laws of these nations. A specified act or a law providing clear guidelines addressing such issues and governing Crowdfunding Investing would be truly a great step.
The Arab Markets and Crowdfunding ecosystem

Many studies by organizations such as World Bank have revealed that Crowdfunding has got untapped potentials in the markets of Shariah compliant nations particularly in the countries of Middle East. It reaches out to reduce the credit gap in the region despite having some of the largest Islamic banks. Although, there has been an upsurge regarding debates and discussions over Crowdfunding and its potentials to expand the scope of finance for Startups and SMEs facing funding crisis, however the growth and progress has been relatively slow paced in comparison to various developed economies of the world. But over the years, the Middle East’s under developed markets are now aware of a powerful financing tool that would enable the promising businesses and entrepreneurial talent to become some of the most successful business projects. It is upto the regional governments to take actions to accelerate Crowdfunding into their capital markets to be able to reap most benefits out of its early development and surge.

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