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THE SCOPE OF SHARI'AH-COMPLIANT CROWD FUNDING IN THE MIDDLE EAST

The concept of crowdfunding is a recent phenomenon that first came into public consciousness in 2006. The UK Government's Parliamentary Commission on Banking Standards defines crowdfunding as an online marketplace which "aggregates many investors (often for very small amounts) to provide funds for investment in a particular project". It is important to appreciate that the term crowdfunding is flexible and not all crowdfunding is the same. There are currently four main crowdfunding opportunities, where it can be used for providing funds by raising debt, providing funds by raising equity, providing funds as a donation or providing funds in return for rewards.

The benefits of crowdfunding are numerous. It provides pretty much anybody with accessibility to greater investment opportunities, without having to break their "piggy bank" to make such investments. It also provides those looking to raise funds with more options, and if the fund raising is successful, then it can be a good indicator that the beneficiary will be more successful in their market. The more options for raising funds also creates greater competition for traditional banks, and arguably as the crowdfunding industry becomes more sophisticated, it has the potential to be less costly than traditional finance. The use of crowdfunding is not married to any specific industry or sector.

It can be an alternative financing solution in many sectors, including for example, small and medium sized enterprises (SMEs), where several Middle Eastern banks have recently reduced their credit lines. There are a number of reasons why some banks have turned their backs on SMEs such as, an increase in defaults, the lack of security that SMEs can typically provide and that many SMEs do not have a track record of performance which then hurts their credit assessments by banks. Crowdfunding may be able to plug that funding gap creeping into the SME market. There are also other businesses which have historically struggled to receive financing solutions, such as those in the cultural or creative sector, as they don't have tangible assets and market demand can be unpredictable. Again crowdfunding may provide a lifeline for such businesses.

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The potential for crowdfunding is therefore very exciting. When US President Barack Obama signed the Jumpstart Our Business Startups Act (the “Jobs Act”), a law that enables crowdfunding, he said that it’s "a potential game-changer" for startups. However, the ability of crowdfunding to blossom into a platform that is an integral feature of the global financing eco-system depends on many factors. The regulatory framework will be critical to its development. Most jurisdictions in the Middle East do not have regulations that deal with crowdfunding in the way that it has been regulated in more mature crowdfunding markets, such as in the US by the Securities and Exchange Commission and the Jobs Act, and in the UK by the Financial Conduct Authority and the Financial Services and Markets Act 2000. For the ongoing development of the crowdfunding industry in the Middle East, regulation should be implemented in each country to attract investors and entrepreneurs, including those who require Shari’ah-compliant solutions. The goal should be to have a framework that protects all parties, without over-regulating the sector and potentially deterring investment.

The main risk in any investment, whether through crowdfunding or more traditional financing methods, is that the investor may lose money. Defaults on payments by the beneficiary to its investors can be more complicated for crowdfunding when compared with traditional financing methods. Queries that will have to be adequately dealt with will include for example: what collateral can the beneficiary provide, who holds the security in favor of the investors, how the platform and investors decide on enforcing that collateral (who makes the decision), will there be any financial guarantees and how are the costs of enforcement covered? As there is no easy answer, many crowdfunded investments are simply unsecured. Additional structural considerations that require being worked-through include determining how the ownership of the loan is transferred between the platform to the individual investors. Questions to consider are whether there is actual lending activity by the platform (which could potentially have further compliance requirements) or does it merely act as a conduit between the investors and the beneficiary, by bringing all parties together in a legal structure that works? Determining how the transfer of the funds occurs, the flow of funds and which accounts are to be used for the investment, will be another key factor to a successful platform.

A crowdfunding platform operator must also have an efficient mechanism to undertake due diligence of the proposed beneficiary, including robust anti-money laundering sign-off and know your customer checks. Further considerations will include a thorough review of the business model, clarification of the purpose of the proposed investment, a determination of the risks of the business and of the potential of its success. This information will need to be adequately and transparently set out on the platform, along with full details of the beneficiary and an honest assessment of the risks of the investment. There should be no cherry-picking of the information. That way the investors can make an informed decision to avoid having an unrealistic picture of the investment.

Blending crowdfunding with Islamic finance is relatively straight-forward. The same structuring issues highlighted above would be applicable, plus additional Shari’ah considerations such as having a Shari’ah Scholar or board signing-off on the structure and a mechanism to review the Shari’ah-compliance of the transactions on an on-going basis. There are many Shari’ah-compliant structures that could be sculpted for crowdfunding including Murabaha (deferred payment), Wakala (agency), Ijara (sale and lease back), Musharaka (partnership) and Mudaraba (silent partnership). The documentation used will be different and will ultimately depend on the Shari’ah-compliant structure chosen.

There will also be different considerations depending on the relevant Shari’ah-compliant structure used. For example: with the Murabaha structure, it will be necessary to find a transparent and straight-forward method of implementing the commodity trades. In relation to equity like structures such as the Mudaraba, it may be that if investors are willing to accept a loss, and that they may not get the return that is anticipated, and that the beneficiary accepts that if things go well, the investors will share in the profits and the beneficiary may have to pay a higher profit rate to the investors. If such Mudaraba becomes one of the main Shari’ah-compliant crowdfunding techniques, then Shari’ah-compliant crowdfunding would have the added benefit of helping the whole Islamic finance industry by removing the shackles of debt based financing and developing into a more mature equity based model, which is the preference of so many Shari’ah Scholars.

There are already some crowdfunding platforms in the Middle East, including a number that provide Shari’ah-compliant solutions. The crowdfunding industry is however, still in its infancy globally, including in the Middle East.

There have been some high-profile fund raisings, such as the famous story of the Caterham racing team in Formula One, who back in 2014 in order to keep the team afloat, managed to raise £2.35 million from crowdfunding so that it could participate in the final race of the year in Abu Dhabi. There was also the huge and successful US$20 million raise for Pebble Time smartwatches, that was completed in March 2015 from over 78,000 backers through Kickstarter. These examples highlight the potential of how such alternative source of funding can play an integral part in the global market, including of course, in the Middle East.