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The Relevance of Conventional and Islamic Crowdfunding as Financing Instruments for SMEs

Maryam Sakinah Md Faudzi*, Julienty Abu Bakar, Shuhymee Ahmad

School of Business Management, Universiti Utara Malaysia

**Corresponding author: maryamfaudzi@gmail.com*

Abstract

Small and Medium Enterprises (SMEs) are the backbone of economy in most of the countries across the globe. SMEs support towards the economic growth and development has influenced country's GDP. Despite that, the sector still faces numbers of main constraints including lack of access to credit from formal financial institution. Nevertheless, with the advancement of financial technology, crowdfunding has emerged as an alternative platform that enables SMEs to seek fund for their business. This paper provides an overview to examine the relevance of conventional crowdfunding and Islamic crowdfunding as a financing instrument for SMEs and determine the appropriate model in crowdfunding that best suits to finance SMEs. This research applied the qualitative approach by reviewing the latest key literature in crowdfunding. Hence, the results show that the best model to be adopt as a financing tools among SMEs is equity-based crowdfunding either for conventional or Islamic crowdfunding platform.

Keywords: Islamic crowdfunding, financing instrument, SMES, equity-based crowdfunding

1. Introduction

Covid-19 had given sudden awful impact towards global economic landscape since the year 2020. SMEs had to bear the worst hit in term of financial or non-financial business performance (Hassan et al., 2020). Among the main challenges is the cash flow risk SMEs had to face as they still need to pay numerous fixed expenses despite having little or no revenue at all (Lu et al., 2020). Considering this, multiple financing assistance are proposed including the adoption of crowdfunding platform.

Despite that, crowdfunding which acts as one of the alternative funding channels for projects and campaigns had seen an incredible upsurge despite the pandemic mainly in the donation and reward-based crowdfunding platform. In this context, it is due to the response alert from the society to provide financial and non-financial assistance to the frontliners such as the healthcare workers as well as the vulnerable population, not to forget the financial support needed by the SMEs (Moine and Papiasse, 2020).

Nevertheless, this crowdfunding had also been on demand due to technological innovation and since the repercussion of global financial crisis in 2008 that had restricted the bank credit requirement, which increased constraints facing the SMEs to access for capital fund. The absence of collaterals and unconvincing business proposals also made it difficult for the SMEs to get loan approval from formal financial institutions (Mhoja et al., 2020). Hence this paper aims to address two research questions; what is the crowdfunding concept and its model from conventional as well as Islamic perspective, and which model is the best and most relevance for SMEs as financing tools.

Methodologically, this study is conducted based on selective literature review using keywords of crowdfunding and Islamic crowdfunding. The articles selected were prioritized based on number of citations and validity of them. The analysis was conducted using systematic literature review to answer the research questions. From the literature review, a few examples of crowdfunding platforms were selected according to the crowdfunding models, respectively.

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At the beginning, this paper will highlight the definition and model applicable for the conventional crowdfunding as well as acceptable model of crowdfunding from the Shariah perspective. In the next section, it will discuss the determinants of adoption as well as the performance of SMEs that adopt the platforms.

2. Definition of Crowdfunding

The concept of crowdsourcing has gained main observation from both academics and practitioners. While crowdsourcing is defined as "making an open online call for problem-solving and creative idea or critical evaluation or any other types of related business issue which allow the crowd from the society to submit the solution" (Ribiere and Tuggle, 2010), crowdfunding merely focuses in term of financial support drawn from the crowd to meet specified project goals via internet (Bradford, 2012). Crowdfunding can also be considered as a model of crowdsourcing which is outlined to simplify capital seeking process. The only fine line that differentiates between these two types of crowd is that crowdsourcing provides the labor while crowdfunding provides the fund (Allon and Babich, 2020).

In the past years, crowdfunding has emerged as one of the ways for businesses to seek financial funding as an alternative from traditional avenue for instance capital venture or angel investors without a need of standard financial intermediaries. In light of that, researches have given some definitions for crowdfunding which include a process of securing funds from a relatively small amount of contribution from relatively large number of participants through an online platform (Mollick, 2014).

According to Ley and Weaven (2011) they proposed that crowdfunding from a perspective of a venture capital means that "… source of start-up equity capital pooled via small contributions from supporting individuals collaborating through internet or social media platform". This definition highlights that by adopting the crowdfunding, SMEs in this context needs to be computer literate and have a good access to internet.

On top of that crowdfunding is also considered as "an act of raising capital, typically in small amounts, directly from a large group of investors (a crowd of investors), by passing traditional financing intermediaries (e.g., banks, stockbrokers, exchanges) but typically with the help of an internet- based platforms" (Allon and Babich, 2020). This definition added that crowdfunding also can omit any traditional financial intermediaries, hence favoring any unbanked entrepreneurs.

Most of the definitions above are always being manipulated and have a narrower concept of crowdfunding compared to the more well-known models of crowdfunding. Hence, Forbes and Schafer (2017) had outlined crowdfunding "as the process of taking a project or business, in need of investment, and asking a large group of people, which is usually the public, to supply this investment". In reality, crowdfunding exists in many forms and therefore a definition must be stripped down to describe only the fundamentals of the phenomenon.

Consequently, all the above definitions have the similar three key elements in crowdfunding which include a crowd of investors, an allocation of relatively tiny amounts of fund and the medium of social media or via internet which can facilitate the connection across the globe (Wall Street Journal, n.d.).

3. Model of Crowdfunding

Many perspectives can be considered to sub organize the crowdfunding model. This paper discussed taxonomy on compensation received by the funders which is the most well-known and applied in the current context. However, there are a few other taxonomies that can be applied such as degree of specialization, types of projects or even geographic location that can relate with different regulatory institutions imposing respective legal environments (Allon and Babich, 2020). There are three types of party which engaged directly to crowdfunding. The first party is a person or organization that seeks fund for their projects, or which runs the campaign. They can be referred as entrepreneurs or firms. The second party is a crowd of society that has the potential as the non-accredited investors. They can be referred as funder or backer, and the final party that becomes intermediaries between these two participants in the framework is the crowdfunding platform itself.

The European Commission has proposed that there are seven types of crowdfunding model which include: rewards-based crowdfunding, donation-based crowdfunding, peer-to-peer lending, equity crowdfunding, profit-sharing/revenue-sharing, debt-securities crowdfunding, and hybrid models (Internal Market, Industry, Entrepreneurship and SMEs, n.d.)

Nevertheless, this paper will only focus on four types of the most applicable models of crowdfunding available in the online platform. Firstly, donation based crowdfunding model, which places the funders as a philanthropist. Out of the contributions given, no rewards are expected as an acknowledgment besides the feeling good effect (Mollick, 2014). Post Covid-19 pandemic, there have been an upsurge in the crowdfunding platform mainly in charity-based model due to solidarity and support from the locals in providing financial and non-financial needs towards the frontliners such as healthcare workers and the vulnerable population in society which include medical and education expenses.

For instance, in the case of one crowdfunding platform in France, *Leetchi* had seen almost four times tremendous increase in campaigns launched post pandemic as compared to the Notre Dames fire incident that suffered devastating blaze. This proved that more pronounced contribution have been made by the donors to Covid 19 related campaigns (Moine and Papiasse, 2020). Nevertheless, in Malaysia there are only a few charity-based crowdfunding platforms including Skolafund, Bitgiving and Ekoperasi. These platforms connect both the donors and the recipients through a modest fund injection. Despite that, according to Meer (2014) there are two prevalent factors that play an important role for the donation based crowdfunding platform which are price efficiency and competition in the market.

On the other hand, the second approach is equity-based crowdfunding. Basically, it has the same modus operandi as venture capital works. It is just that the crowd may come from the non-accredited investors which democratize the opportunity of others to invest in the platforms. The UK has been the fastest growing region that legalize the regulatory framework in 2011, followed by the U.S. in 2015 as they approved the regulatory framework for equity crowd-funding by the Securities and Exchange Commission (Vulkan et al., 2016).

On top of that, Malaysia is the first country in ASEAN to introduce a regulatory framework to facilitate equity crowdfunding in 2015. There are six registered equity crowdfunding (ECF) platforms including pitchIN, Ata Plus Sdn Bhd, Crowdo Malaysia Sdn Bhd, Crowdplus Sdn Bhd and Fundnel Technologies Sdn Bhd, Ethis Ventures Sdn Bhd and 1337 Ventures (operated by Leet Capital Sdn Bhd) which have received approval for full operation since 2016. Hence, these equity crowd-funding operators have become the alternative venues for capital-raising sources to SMEs and innovative new businesses.

The third approach, which is commonly known as reward based crowdfunding is quite similar to the lending based as they receive something in return with the exception that the funder will not receive any financial returns or repayment for the capital they provide (Bi et al., 2017). In fact, they might be offered certain rewards for supporting campaigns which include their names being credited to a movie, opportunity to have a creative input in a product, or even chances to meet the founders of certain project (Gerber et al., 2012). For example, Kickstarter website had highlighted the top three most common reward types which are: (a) copies of the thing (e.g., the actual product, an assembled version of a DIY kit); (b) creative collaborations of various kinds (e.g., a backer might appear as a hero in the comic, or she may be painted into the mural); (c) creative experiences (e.g., a visit to the film set, a phone call from the author, dinner with the cast, a concert in the backer's backyard) (Kuppuswamy and Bayus, 2015).

Finally, the fourth model is debt based crowdfunding model. The fund is considered as a loan, with pre-condition of certain rate of return on capital invested. There are some models that collaborate with microfinance institutions to make the platform more reputable and trustworthy. For example, Kiva (www.kiva.org) one of the pioneers in lending platform, have raised almost $1.57 billion since its inception. It integrates the “Field Partners” which are the microfinance institutions across the globe to post at the website any qualified local entrepreneurs who are in need of capital. Next, lender will browse through the platform and pick any entrepreneurs that they wish to fund and make payment through PayPal payment gateway. Once Kiva receives the money, it will aggregate the loan and send it to the Field Partners, which then disburses the money to the selected entrepreneurs (Ibrahim and Verliyantina, 2012).

Despite that, the Muslim society had to limit themselves from adopting the debt based crowdfunding platform as the transactions involve the element of interest (*Riba*) which is prohibited according to the Shariah jurisprudence. Hence, the call is clear for Islamic crowdfunding platform to be available in the market, as an alternative for all the Muslims or even the non-Muslims society.

4. Islamic Crowdfunding Model

According to Bank Negara Malaysia, “Islamic finance and crowd-funding are inherently compatible and mutually reinforcing” to encourage *masalih mursalah* (unregulated public interest). The pillar of Islamic finance is built on Shariah principles that promote competency and sustainability. Besides, there are Shariah rulings that need to be adhered to such as the avoidance of interest (*Riba*), gambling (*Maysir*), uncertainty (*Gharar*) and all other prohibited matters (*Haram*) which includes society destructive activities like betting, alcohol, etc. Besides, it values ethical and highly moral values which are in congruence with Quran and the

Sunnah. Islamic finance upholds it strength with real economic activities. Hence it prevents the financial system from collapsing or at the very least prepares it to withstand moments of crisis (Hendratmi et al., 2019)

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 (*Maqasid al-Shariah*), namely the protection of life, religion, intellect, lineage and wealth. Therefore, Islamic crowdfunding is a special model that lies on the principle that supports financial stability and social inclusiveness.

Table 1 below differentiates all contracts utilized in certain Islamic crowdfunding as opposed to the conventional crowdfunding.

Table 1: Difference between Islamic Crowdfunding and Conventional Crowdfunding

Type	Conventional Crowdfunding	Islamic Crowdfunding
Reward- based crowdfunding	Materialism	May utilize *Bay as-Salam*, which provides specific rewards, services or gifts to investors who fund the projects or businesses via crowdfunding.
Donation-based crowdfunding	Philanthropist	May utilize *Waqf*, *Zakat*, *Sadaqah*, *Hibah* which are based on the Shariah law.
Equity crowdfunding	Angel investors venture capitalist	May utilize *Mudarabah* or *Musharakah*. *Musharakah* crowdfunding is quite the same with equity-based crowdfunding. On the other hand, for *Mudarabah* crowdfunding, the funder will provide the whole amount of capital pledge, and the firm will fully responsible for the management. Once the profit is acquired, the funder and firm will allocate the profit according to the pre-determined ratio. However, in the case of loss, the investor will have to bear the monetary loss, while firm loss their effort.
Debt crowdfunding	Lending is based on interest; also known as P2P crowdfunding	Sale based contracts- *Murabahah* (cost plus), *Tawaruq*, *Ijarah.*

Source: Ibrahim et al. (2018)

Based on Table 1 above, most of the Islamic crowdfunding has adopted specific contracts for each model. All the contracts are based on Shariah law that in congruence with Quran and Sunnah, *Ijma'* as well as *Qiyas* (Ibrahim et al., 2018). However, all the above models can be utilized by Muslim consumers except for the lending-based crowdfunding as it incorporates usury (*Riba*) in the transaction.

5. Islamic Crowdfunding Analysis and Performance

Considering this, Islamic crowdfunding platform, are still in its nascent stage as compared to the conventional crowdfunding. The society perceives it as a complicated structure, and strict rules that may appear less entices to some inventors. Furthermore, some have mistakenly thought the platform is meant to be only for Muslim investors (Kazaure et al., 2020).

In fact, Islamic crowdfunding is open to everyone with the underlying basis similar to any other types of investment. The only key element in this model is that it adheres to all the Shariah jurisprudence and law in Islam. Hence two established Islamic crowdfunding platforms, namely Ethis.co (previously EthisCrowd) and Kapital Boost had been chosen for the analysis in term of the structure and the impact on the society. Ethis.co is one of the pioneers in Islamic crowdfunding which utilizes Shariah-compliant equity based Islamic crowdfunding in Malaysia. It is based in Singapore and is operating in 3 countries; Indonesia, Malaysia and Dubai, which is supervised by each country regulatory bodies respectively. Ethis.co is considered the world's first real estate Islamic crowdfunding platform and one of the first investment Islamic crowdfunding platforms in the world (Mustafida et al., 2021).

It adopts *Murabahah* (cost plus profit) contract in a direct sale and purchase of real estate assets and construction materials. Besides, Ethis has extended the contacts used into an advanced variation of *Murabahah*

(*Istisna'* plus *Murabahah*) model which enables the crowd to order assets such as house from developer and make progressive payments to contractors as these houses are built before selling them to Islamic banks at a profit. Most Ethis crowdfunding projects are affordable housing campaigns (Mustafida et al., 2021).

While Kapital Boost, is a hybrid crowdfunding based platform. It combines equity based and donation based crowdfunding model aims to promote the SME's business to grow and not to mention safeguarding the social welfare of underprivileged community. SMEs can seek asset financing via *Murabahah* structure, or by adopting *Qard* and *Wakalah* contracts or invoice financing (cash advance on unpaid invoice) to inject cash capital immediately. Most of the investments require turnaround of 90 to 360 days. Kapital Boost conducts a robust due diligence screening process to ensure less risk taken and the investments are ethical (Kapital Boost, n.d.).

6. Conclusion

The growth prospect for conventional and Islamic crowdfunding is huge considering the relative number of SMEs expansion throughout world. While traditional financing tools including venture capital or angel investors, both avenues rarely provide capitals for the unbanked SME entrepreneurs. On the other hand, start-up or even seed capital easily get funded through these online crowdfunding platforms which are also exciting as they utilize social media as the marketing platform. However, based on the four models discussed above, the most suitable and applicable financing tool for SMEs entrepreneurs seeking additional funds is the equity-based crowdfunding. With lower cost than the bank and higher accessibility, it is a better option for SMEs to choose for.

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