ADAPTING CROWDFUNDING FOR SME FINANCING IN MALAYSIA

BY

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ABSTRACT

Traditionally, financing for small and medium enterprises (SMEs) was raised by entrepreneurs using personal savings and contributions from family and friends. Inevitably, the average person's personal savings and those of their immediate social circle will not be able to sustainably finance the company over the long run, therefore bank financing is the most heavily relied upon source of financing businesses. Although banks have no shortage of funds to lend, they have extensive lists of requirements that a borrower must abide by in order to acquire a loan. The requirements are so burdensome that many SMEs cannot fulfill them, and those that do are saddled with high interest rates when repaying the loan. All these factors indicate the need for an easier method for SMEs to acquire financing to expand and develop their businesses. This study proposes crowdfunding as an alternative financing mechanism for Malaysian SMEs. Particular focus is given to reward based and equity based crowdfunding. The study is exploratory in nature and investigates the history and functions of crowdfunding globally and in Malaysia. A brief portion discusses the Shariah compliant nature of crowdfunding in order to clarify how it is even more ideal for Muslim business owners. Finally, the paper discusses the latest development in crowdfunding regulation in Malaysia followed by recommendations on how to further improve the local crowdfunding industry.

خلاصة البحث

عادةً كان يقوم المقاولون بتمويل المؤسسات الصغيرة والمتوسطة من خلال المدخرات الشخصية والمساهمات التي تأتيهم من الأسرة والأصدقاء. عاجلا أو آجلا فإن متوسط المدخرات الشخصية للفرد وتلك التي تأتي من الدائرة الاجتماعية المقربة لا تفي بتمويل الشركة على المدى البعيد. لذلك يتم اللجوء إلى التمويل المصرفي بشكل أساسي لأجل تمويل الشركات. بالرغم أن المصارف لديها من الأموال ما تكفي للإقراض إلا أنها تحتفظ بلائحة مطولة من الشروط التي يجب على المدين الالتزام بها حتى يحصل على قرض. تعتبر هذه الشروط مجهدة لدرجة أن الكثير من المؤسسات الصغيرة والمتوسطة تعجز عن استيفائها، وأما تلك التي تفي بها فترهقها النسب العالية للفائدة حين سداد ذلك القرض. يشير كل هذه العوامل إلى الحاجة لطريقة أسهل للمؤسسات الصغيرة والمتوسطة للحصول على التمويل كي تتوسع وتتطور. يقوم هذا البحث باقتراح التمويل الجماعي كآلية تمويل بديلة للمؤسسات الصغيرة والمتوسطة في ماليزيا. يتم التركيز بشكل خاص على التمويل الجماعي القائم على الهبة وعلى المساهمة. يتبع هذا البحث المنهج الاستكشافي حيث يدرس تاريخ التمويل الجماعي ووظائفه على المستوى العالمي والماليزي. يقوم جزء موجز من البحث بشرح التمويل الجماعي المطابق للشريعة حتى يبين مدى ملاءمة هذا النمط للمسلمين من أصحاب الشركات. في الختام يقوم هذا البحث بمناقشة آخر التطورات في ضوابط التمويل الجماعي داخل ماليزيا وتعقب ذلك توصيات حول كيفية تطوير صناعة التمويل الجماعي بشكل أفضل محليا.

APPROVAL PAGE

I certify that I have supervised and read this study and in my opinion, it confirms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Sciences in Islamic Banking and Finance.

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This research paper was submitted to the IIUM Institute of Islamic Banking and Finance and is accepted as a fulfilment of the requirement for the degree of Master of Sciences in Islamic Banking and Finance.

……………………………………
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DECLARATION

I hereby declare that this research paper is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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Signature .... Date ....

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This thesis is dedicated to my mother and father for motivating and supporting me from start to finish

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CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF STUDY

The backbone of employment in most countries is the Small Medium Enterprise (SME) sector. The case in Malaysia is no different. The findings of the economic census 2011 conducted by SME Corp Malaysia find that there are 645,000 SMEs operating in Malaysia, which equals a 97.3% of the total national business community (SME Corp Malaysia, 2011). The SMEs of Malaysia are also major contributors to the GDP. The local SMEs contribute at least 30% of GDP and are expected to contribute more than 40% by 2020 (Moha Asri, 2002) and (SME Corp Malaysia, 2011). The importance of the Malaysian SME sector is further highlighted by the various government initiatives and policies to support them such as the Shariah-compliant SME Financing Scheme (SSFS) which provides financial assistance to eligible Malaysian SMEs via participating Islamic Banks (SME Corp Malaysia, 2011)**.**

The smallest of SMEs, known as micro enterprises, could be a single person selling food from a cart. In contrast, the definition varies in each country for the maximum size an SME is allowed to be. In Malaysia there is additional segmentation of the definition of an SME depending on the sector. The largest SMEs are in the manufacturing sector and are allowed 150 employees. Meanwhile, primary agriculture and services sectors are limited to 50 employees. Despite the variance in size, what many of these companies have in common is the need for financing to assist growth. While some SMEs can qualify for bank loans, most on average will face great difficulty in accessing loans and other forms of financial assistance (Mohammad Ziaul Hoq et. al., 2009)and (Saleh, Caputi, & Harvie, 2008).

An additional challenge when seeking financing faces the Muslims in Malaysia in the form of the religious prohibition of paying or accepting interest (Riba) in Islam as stated in *The Qur'an* (Al-Baqarah, 2: 275). Since more than 60% of Malaysia is Muslim, the issue of Riba affects the majority of the population. The complications in acquiring suitable forms of financing cause most entrepreneurs to depend on their own savings and the financial support of family and friends to start and support their businesses (Nurbani Binti Hassan, Susan Tee Suan Chin, Jian Ai Yeow, Noor Ashikin Binti Mohd Rom, 2011). This form of financing is only efficient and functional for those who have financially stable family and friends, but it is not scalable because these networks are limited in resources and can only be tapped for a limited time. In addition, those who don't have financially stable friends and family are in a further disadvantaged situation when seeking start-up capital. Therefore an ideal solution to these problems would be one that expands access and scalability of financing in a Shariah compliant manner.

An alternative means that can be used by SMEs to raise funds is crowdfunding. The term Crowdfunding refers to the gathering of small amounts of funds from a large group of people. Some contributors may give large amounts but the common feature in most successful crowdfunding campaigns is small donations from a large group of people. Although most of what is considered crowdfunding today happens on the internet, there are some examples of what experts consider examples of crowdfunding that pre-date the internet such as the funding for the completion of the Statue of Liberty in New York in 1885(Kazmark, 2013). When the funding for the construction of the Statue of Liberty fell short by more than a third and the New York Governor refused to use city funds to complete it, the famous publisher Joseph Pulitzer decided to do a fundraiser through his newspaper. The campaign encouraged people to donate by offering six inch replicas of the Statue of Liberty to those who donated 1 dollar and 12 inch replicas to those who donated 5 dollars. In five months the international community of readers who saw the advertisement in Puliter's New York World newspaper raised over 100,000 Dollars. The number of donors was over 120,000 and the average amount given was less than a dollar(Clarkson, 2015).

In modern times the trend of crowdfunding online was by a British rock band named Marillion. The band raised funds for a US tour by raising nearly $60,000 via online donations from fans(Sale, 2014). The success of that online fundraising was followed by the creation an online platform called ArtistShare.com in 2003 which is dedicated to assisting fans to raise funds for musicians and allowing the donors to have access to the creative process and productions as a reward. ArtistShare.com also claims to be the internet's first crowdfunding platform ("ArtistShare - About Us," 2013). In 2009 Kickstarter.com (Kickstarter) came into the crowdfunding arena and provided a unique platform for anyone with a creative idea to raise funds. Since its launch Kickstarter has grown to be one of the largest online platforms in terms of number of hosted projects and funds raised. Kickstarter has a unique rule of "all or nothing" funding, which means that a campaign can reach or exceed its targeted funding, but if it falls short all money is returned to the project "backers". The above examples are of just one of several types of crowdfunding known as reward based crowdfunding. Further understanding of other forms of crowdfunding such as equity and debt based will bring to light the vast amount of potential this financial tool holds.

In recent years major statistics have been collected that document the growth of the crowdfunding industry. According to the annual report of Massolution (2015), The number of online crowdfunding platforms globally has grown from a mere 100 in 2007 to more than 1,200 in 2014. The amount of money raised globally through crowdfunding was 2.7 billion USD in 2012, 6.1 Billion in 2013 and in 2014 there was a 164% increase in funding volume to reach 16.2 Billion USD. The rate of growth this industry has been experiencing definitely proves it is worth paying attention to. With the Islamic finance industry also being young and growing there could be a potential opportunity for the two industries to leverage each other's strengths and foster even further growth as well as expansion into new demographics.

This research aims to provide an exploratory analysis of crowdfunding and its potential application to SME financing particularly in Malaysia. The features of crowdfunding in general appear to have no contradictions with the principles of Islamic finance except in the case of interest charged on crowdfunded loans, also known as peer-to-peer (P2P) loans. For this reason it is believed that in addition to democratizing access to finance, crowdfunding can also be a Shariah compliant alternative form of financing.

This research aims to contribute to the body of Islamic finance knowledge by investigating the use of crowdfunding as an alternative form of financing. By doing so it will contribute to the understanding of non-banking alternative Islamic financing solutions as well as the growth of the crowdfunding industry in Malaysia and beyond.

1.2 PROBLEM STATEMENT

The level of difficulty in securing bank funding at the start up or expansion levels for SMEs has been proven to be generally high. The barriers and challenges are largely due to systemic issues. The need to dedicate officers to evaluating financial statements to approve the loans, the need for special officers to follow up and monitor loans, the practice of charging high interest rates to SMEs due to companies not having collateral, the slow process of disbursement of loans, the short term period and small size of the loans all are issues that obstruct the growth and development of SMEs. As such new ideas are needed to help facilitate the financial well-being and growth of the sector of the economy that provides more than 90% of employment for the country's citizens. As the concept of crowdfunding has already proven its potential as an effective alternate means of finance worldwide, it is essential to explore the possibilities of using crowdfunding as one of the financing alternatives for SMEs in Malaysia.

While many forms of SME financing exist in Malaysia as well as internationally, most of them contain elements of interest (Riba). The common external finance options such as term loans and overdrafts. All the above mentioned facilities provide short term debt financing that involves lending a principal amount of money to a borrower with a percentage of interest stipulated to be paid in addition to the principle during the repayment period(Siti Khadijah bt. Ab. Manan, 2010). This creates an additional barrier of major concern for any Muslim business owner who wishes to abide by the principles of the religion. The facilities provided by the Malaysian government for SMEs are mostly debt based with varying interest rates. Therefore many SMEs in the start up phase have to consider going into debt and more seriously Riba in order to start off their business.

In the environment of risk averse banks and products that charge interest on debt, alternative forms of finance become more attractive for both Muslim and non-Muslim entrepreneurs. Within the various models of crowdfunding rewards based and equity based crowdfunding, contain the least Shariah issues of contention within their structures, in fact they appear to be Shariah compliant by default. The Shariah issue for consideration in both reward and equity based crowdfunding is the screening of the activity or subject matter in which the funds were being gathered for. It would be a matter of concern if people are using Shariah compliant structures but at the same time raising funds for activities or businesses that are not. The compliance with Shariah standards is of primary concern in the Malaysian context as the country wants to promote itself as a leader in establishing companies with end-to-end Shariah compliance. So an ideal Islamic finance based crowdfunding platform must have both Shariah compliant structures for raising funds, and screening methods in place to make sure the projects themselves are Shariah compliant.

At this juncture, studies on this particular area remain scarce. For this reason the researcher is presenting the current paper to propose crowdfunding as a potential solution and fill the research gaps by providing an overview of how crowdfunding functions and the key factors for a successful industry.

1.3 RESEARCH OBJECTIVES

a) To provide an exploratory overview of the concept of crowdfunding.

b) To document all related efforts to operationalize crowdfunding in Malaysia.

c) To provide recommendations for improving the quality of the Malaysian crowdfunding ecosystem.

1.4 RESEARCH QUESTIONS

a) What is the general concept of crowdfunding?

b) What are the efforts from past to present aimed at operationalizing crowdfunding in Malaysia?

c) What are the possible manners to improve the quality of crowdfunding in Malaysia?

1.5 RESEARCH METHOD

This research is exploratory in nature. It uses qualitative information gathered through content Analysis based on the review of literature; annual reports and articles. The doctrinal analysis of regulatory framework was used as well to clarify the methods in which crowdfunding will be operationalized in Malaysia. Since crowdfunding is a very new industry the number of references available is quite limited. For this reason their annual certain reports are frequently quoted in this research.

1.6 SIGNIFICANCE OF THE STUDY

The crowdfunding model removes several of the financial barriers to financing that exist in the conventional financing model such as the need for collateral, high interest rates and an extensive amount of supporting documents. The qualifying requirement of collateral is substituted by allowing an entrepreneur to leverage his or her social capital to prove their creditworthiness. This means that a person's reputation and qualifications will hold value in similar way that traditional collateral would in the process of seeking funds for their business in the conventional model. This gives an advantage to those who may not have tangible assets or collateral, but are honest, talented and able to build large networks of supporters.

The history of growth and international expansion of crowdfunding have shown that it will compete with banks in providing certain financial services. It is the opinion of the researcher that it is imperative that Islamic finance academia as well as industry players give attention and consideration to this new form of financing to ensure they are not left behind when the shifts in consumer demands arrive. Rather, there should be substantial research and preparation made so that the tools of crowdfunding in specific and financial technology in general can be used to position the industry and principles of Islamic finance in a competitive position to compete in the market as well as influence it. With Malaysia being one of the major hubs of Islamic finance as well as the home of the best Islamic finance academic institutions, it seems very suiting for its society to create and make use of new innovations that can help the country and the industry. This research therefore aims to provide an introduction to crowdfunding to the body of Islamic finance research. To achieve the stated objective a novel approach has been taken to access the possibility and feasibility of Malaysian SMES to make effective use of crowdfunding.

1.7 SCOPE AND LIMITATIONS OF THE STUDY

The scope of this study is to explore the applicability and possible benefits of expanded use of crowdfunding in Malaysia to provide an alternative form of financing for the local SMEs. Greater focus will be placed on reward based crowdfunding and equity based crowdfunding as these two forms have shown greater promise for the near future. A general discussion of the nature of crowdfunding in terms of Shariah compliance will be included as well. The analysis is undertaken based on a review of articles, reports and other secondary sources.

CHAPTER TWO

IMPORTANCE OF SMES TO THE MALAYSIAN ECONOMY

As mentioned earlier there are 645,000 SMEs operating in Malaysia, which equals a 97.3% of the total national business community (SME Corp Malaysia, 2011). The SMEs of Malaysia are also major contributors to the GDP . The local SMEs contribute at least 30% of GDP and are expected to contribute more than 40% by 2020 (Moha Asri, 2002) and (SME Corp Malaysia, 2011). Small and Medium Enterprises (SMEs) in many high income countries all over the world also constitute a large percentage of their total number of business establishments. In USA, Canada, Australia, South Korea and China, 99% of the enterprises are SMEs (Yuhua, 2013). SMEs also continue to play a major role in the growth of the national economies of both developed countries like the USA and developing countries like Indonesia. In Indonesia and Singapore their SMEs contribution to GDP were 59% in 2012 and 47% in 2013 respectively. Employment statistics of SMEs in developing countries are also very encouraging as they have the largest shares of job creation(Ayyagari, Demirguc-Kunt, & Maksimovic, 2011). For instance, in Indonesia 92% of total employment comes from SMEs, in Korea 87% and in Singapore 70% of employment is provided by SMEs. Such strong figures indicate the substantive contribution SMEs continue to make to global economies.

To support the growth of local SMEs and facilitate their access to financing, the Malaysian government has launched several programs through ministries and governmental institutions such as the Ministry of International Trade and Industry (MITI) and the Malaysian Central Bank (BNM). MITI is conducting a number programs including the Soft Loan Schemes for the Service Sector, (SLSSS) program to assist companies and enterprises in the services sectors to increase their capabilities and capacities, and also the Shariah-compliant SME Financing Scheme (SSFS) which provides financial assistance to eligible Malaysian SMEs whereby the Government will cover 2% of the profit rate charged on the financing provided by participating Islamic Banks (SME Corp Malaysia, 2011). In pursuit of achieving similar goals of financial assistance for SMEs, the Central Bank of Malaysia (BNM) has launched three major programs to assist SMEs: Firstly, the New Entrepreneur Fund 2 (NEF2) which promotes the growth of Bumiputera SMEs through access to financing at a reasonable cost. Secondly, the Fund for Small and Medium Industries 2 (FSMI2) which is designed to ensure eligible SMEs have access to financing at a reasonable cost. Lastly, the Micro Enterprise Fund (MEF) which provides micro enterprises continuous access to financing (SME Corp Malaysia, 2011). It is apparent that a large part of the Malaysian government support to SMEs has focused on access to financing, which implies that financing still remains one of the most critical and constant challenges to SMEs.

There is an additional category of enterprise within the SME industry known as the Micro enterprise which according to definitions set by the Malaysian government consists of 1 to 4 people and has less than RM 250,000 annual sales turnover. Although the term SME usually denotes the meaning "Small Medium Enterprises", for the purpose of this research we will assume Micro-Enterprises to be included within the same term. This is partly because the term MSME is tedious and unfamiliar and also due to the fact that throughout different regions the definition of an SME or a micro-enterprise varies. The main source of variation in definition lay in the distinct differences different countries set for the minimum and maximum number of employees an enterprise may have to qualify as being part of a particular category of SME. For example in New Zealand the maximum number of employees is 20 whereas in China it is 1000 (Yuhua, 2013).

Although the number of employees within a Micro-enterprise is quite small by definition, their share of the SME market is quite large. MSMEs constitute over 70% of the whole SME sector but have little if any access to financing from formal financial institutes (Stein, Goland, & Schiff, 2010). While MSMES are in fact the largest group within the SME sector they frequently do not have the resources to overcome the financial barriers to acquiring financing like collateral, documentation etc., nor can they afford the high cost of lending. Considering that these barriers are innate in the conventional financing models which MSMEs are heavily dependent upon, it may suit the interests of MSMEs better to be accommodated by a financing model inspired by ideas outside the conventional banking paradigm that require less constraints when approving loans to small businesses. Such a model should ideally minimize the impact of high interest rates to the extent of even providing interest free financing. The procedures to qualify for such financing would be based partially on non-financial factors such as proof of talents and experience. In addition, the financial requirements may include the display of a solid business plan and recommendation from a guarantor or active entrepreneurs in their community.

Evidences from the extant literature show that SMEs have difficulties accessing financing due to barriers that can be financial in nature or non-financial. Stein et al., (2010) have identified five non-financial components of the business environment that SMEs in developing countries most frequently rate to be major obstacles such as lack of electricity, high tax rates, practices of competitors in the informal sector and corruption. The difficulties placed on SMEs by these factors create an environment that is unaccommodating for the development of their enterprises. The second group of barriers SMEs face in acquiring financing is financial in nature. The most common barriers are: high interest rates, the need for collateral, a lack of an extensive list of official documents, a lack of a solid business plan and a lack of a good profitability track record. When banks or micro-finance institutions want to lend, they usually want to take collateral as a security to ensure repayment of the loan. Research shows that SMEs that lack collateral are much less likely to get funding compared to those that do. If collateral were available the next challenge would be to prove that the business is worthy of the loan. Many SME owners in developing countries have very limited financial documentation capacity which complicates the process of providing valid evidence of their venture's viability, stability and profitability. If a bank cannot clearly see that a business has a good track record of earning profit they will prioritize avoiding default risk and turn down the loan application. In the case an SME does have the needed documentation, there is the challenge of high interest rates charged on the loans offered. These high rates are charged because the borrowers are considered "high risk" and so the cost of funds is higher in order for the lender to guarantee themselves a quick full return of their capital.

In the case of several governments there are plenty of lendable funds that are available for MSMEs, but the outcome of how well they are disbursed lies in the degree to which they are accessible. The term outreach is often used in literature regarding poverty alleviation when discussing efforts to reach the poor who have no access to banks or credit. The credit provided by outreach projects is meant to be used to help them establish income generating business (Hermes, Lensink, & Meesters, 2011). For the sake of this research the term outreach will be used to refer to the effort of banks to reach and transact with impoverished borrowers who may live in remote areas. One of the causes for the lack of outreach on behalf of banks charged with lending to MSMEs is the high transaction, screening and monitoring costs involved with lending small amounts of money to the impoverished. The extent of outreach efforts made by SME financing programs has a large impact on their success when targeting growth in terms of total borrowers. According to one research, only 33% of Malaysian SMEs have accessed the credit and financing facilities that are available specifically for them (Moha Asri Abdullah & Siti Khadija Ab. Manan, 2010). One of the reasons for the small number of SMEs applying for the financial assistance is the notion that the application process is very long and complicated. In addition there is a high probability of being rejected if any of the loan requirements are not fulfilled such as; having a guarantor, business plan, business records, qualifications and experience, etc. The fear of being rejected during the loan application process encourages SMEs to isolate themselves and rely on internal funds and those of friends and family, which is an unsustainable model that can leave the entrepreneur indebted.