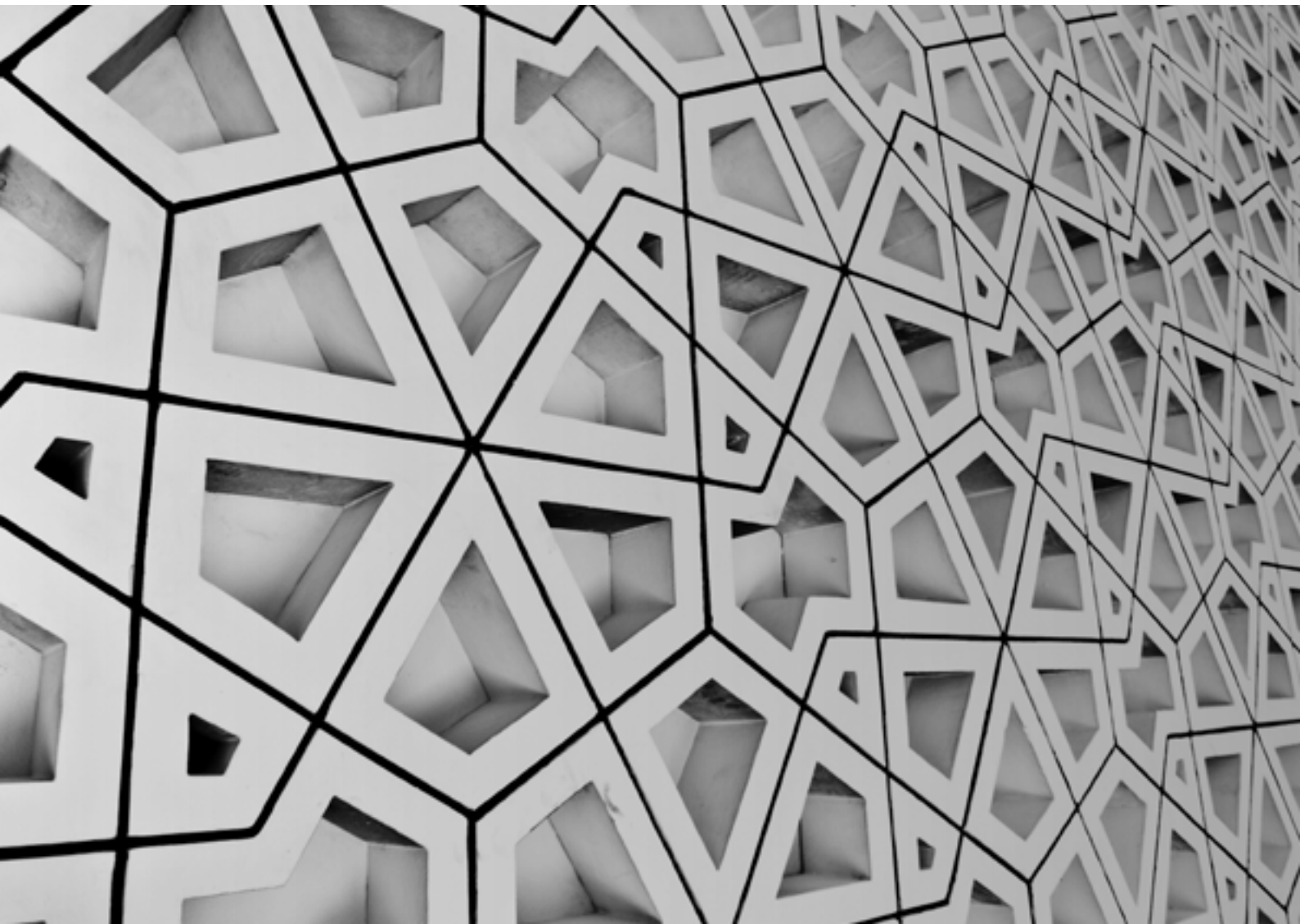


CAPCO

CAPCO ISLAMIC FINANCE CAPABILITY

APPLICATION OF PEER TO PEER (P2P) LENDING MODEL
IN ISLAMIC FINANCE / SHARIAH-COMPLIANT FORM



INTRODUCTION

Islamic finance is growing in prominence globally owing to strong interest from consumers due to both theological reasons and its strong ethos of ethical investing. In this environment it is imperative that participants in this sector consider avenues that help with growth acceleration and expanding consumer interest. One of the most interesting avenues for potential expansion is within the alternative finance market, specifically in the P2P lending segment.

This paper aims to explore the viability of deploying the P2P lending model in a manner that remains true to the framework of Islamic finance principles such as RIBA (prohibition of interest) and Shariah (prohibition of certain product types).

WHAT IS P2P LENDING?

P2P lending is a form of finance that enables the exchange of capital without the reliance on a conventional financial institution to oversee and manage the transactions. This format enables the borrowers and lenders to interact directly, usually facilitated through a web application or platform.

P2P lending online can trace its origins to the UK with Zopa being the first firm to market this concept, followed by firms such as Prosper and Lending Club in the US.

The alternative finance market, dominated by the big names of peer-to-peer (P2P) lending, has experienced turbo-charged growth in volumes. In the UK, which is the largest P2P market in Europe, more than £6bn was advanced to consumers, small businesses, and property developers during 2018, and the 'big four' lenders now have around £5bn of loans outstanding.¹

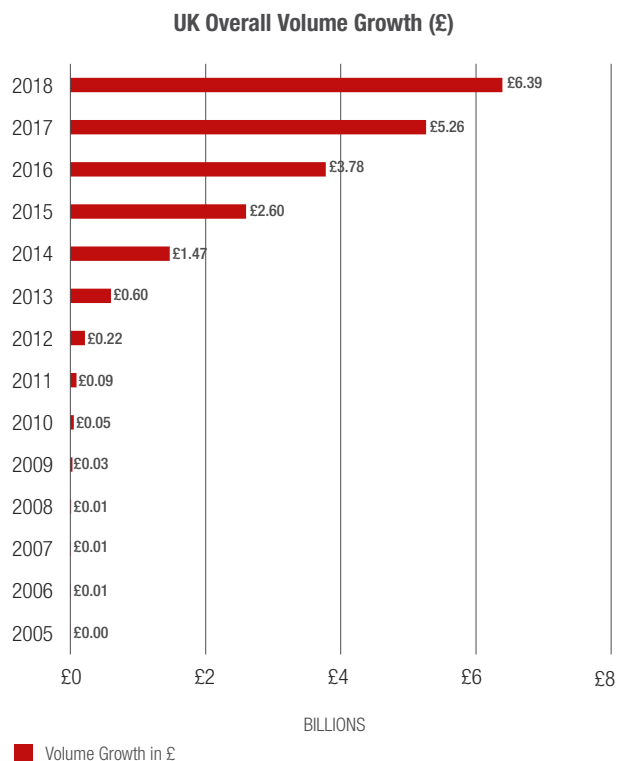
Globally this figure was around £46bn as at the end of 2019.

The P2P lending market can be broadly categorised in to 4 distinct sub-categories as follows:

- Business lending, i.e. firms such as Funding Circle, Folk2Folk etc.
- Property lending, i.e. firms such as LendInvest, Landbay etc.
- Consumer lending, i.e. firms such as Zopa, Ratesetter etc.
- Invoice lending, i.e. firm such as MarketInvoice.

In the years past, the majority of transactional volume originated from both the consumer and business lending categories,

however there has been a significant uptick in the invoice lending category for the last three years (From ~£310 million in 2016 to ~£1.1 billion in 2018)², this is due to the strong demand for this service from small to medium sized enterprises (SMEs) and is likely to surge due to the impact of the socio-economic factors of the past year.



FACTORS CONTRIBUTING TO THE SUCCESS AND GROWTH OF P2P LENDING

The simple business architecture of P2P lending has been one of the primary reasons for its rapid growth and acceptance, unlike traditional financial institutions which have significant cost allocations to human capital, technology is the only considerable investment for the P2P model.

P2P lending platforms do not take on the credit risk of counterparties, and unlike banks, which have interbank settlement functions, P2P lending platforms do not participate in deferred net settlement systems.

This technology-driven growth and scalability has helped P2P firms contribute towards creating a credit market that is more accessible to borrowers by offering the relatively low interest rates and access to the required funds at a quicker pace in comparison to traditional financial institutions. At the same time, P2P lending is beneficial to lenders as it offers a higher yield than deposit rates under the current low interest rate environment.

Islamic finance can be best described as the application of faith based norms and principles derived from the SHARIAH when dealing with financial transactions.

The fundamental distinction between Islamic and conventional finance is the **prohibition of interest** – known as 'RIBA' – which is forbidden in the Quran.

This presents an alternative option for financing, risk mitigation and diversification, especially for the **ethically-minded investor**.

However, to grow and remain competitive there is an increasing need to embrace **innovation and digital solutions**.

This segment is preparing for a quantum leap in relevance due to favorable factors across the globe making it an ideal segment for Capco to branch out into.

5 CORE PRINCIPLES OF ISLAMIC FINANCE

01

ETHICAL

No investments are permitted in forbidden industry's 'HARAM' – alcohol, gambling, pornography and weapons.

02

JUST

No speculative exploitation from legal uncertainty or abuse of unfair advantages.

03

CERTAINTY

There can be no elements of uncertainty in asset quality, price or delivery.

04

RIBA

'Interest' is not permitted to be paid or received.

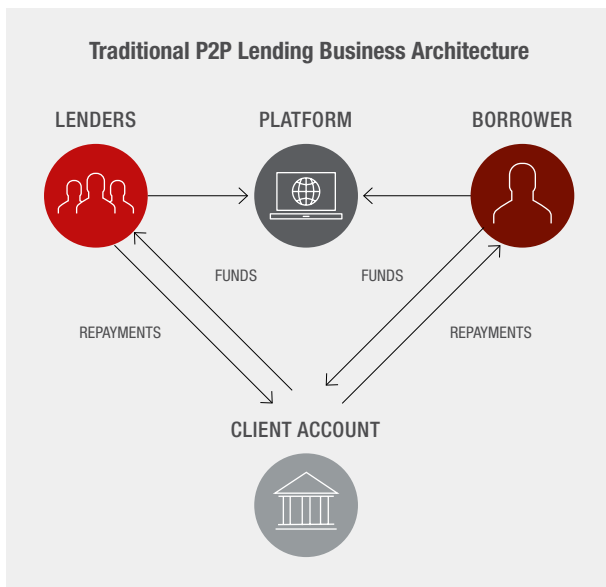
05

TANGIBLE

All financial products must be tangible or asset-backed.

ISLAMIC FINANCE AND P2P LENDING

In its basic format P2P lending cannot be considered as Shariah-compliant due to the open nature of interactions between borrowers and lenders. The open nature of the concept allows borrowers to access funds regardless of their intended utility with the only caveat being the ability to prove their credit worthiness to pay back the loan. This is vastly different from Shariah-compliant lending which is very much tethered to the concepts of Islam. However, despite this fundamental difference it is quite feasible to apply the P2P lending concept in a Shariah-compliant manner as detailed below:

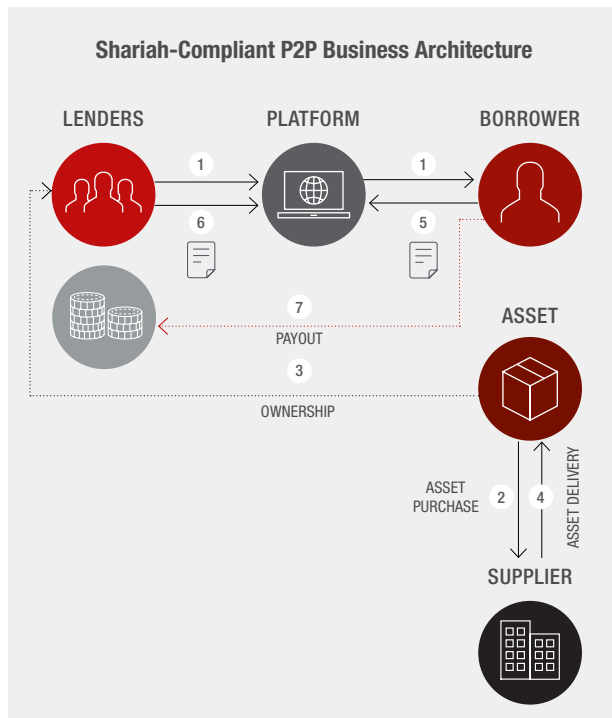


In the most traditional form of the P2P model, the lenders directly interact with the borrowers and they choose their own counter parties. This is known as the client segregated model and is detailed below:

1. The borrower submits a loan request on the P2P platform.
2. The loan request is then listed on the P2P platform for prospective lenders to identify and fulfil.
3. Once the lender assesses the loan requirement, the credit worthiness and other potential factors related to the borrower and is satisfied they then release the funds to the borrower, which is subsequently deposited into the borrower's client account maintained with the P2P platform.

4. In terms of repayment, the borrower repays the amount by depositing the same into its investor's client account within the P2P platform as per the agreed frequency.

While these accounts are operated by the lenders and borrowers themselves usually, the information pertaining to flow of funds is routed through the P2P platform.



The applicability of the P2P format is most relevant for asset backed investments for it to be Shariah-compliant as debt backed investments are counter intuitive to the concept of RIBA (prohibition of interest).

This is illustrated above in the case of using the P2P format for asset financing in a Shariah-compliant form using a "Murabaha" contract (also referred to as cost-plus financing, is an Islamic financing structure in which the seller and buyer agree to the cost and mark-up of an asset):

1. The prospective borrower logs in to the platform submits a loan request which is then validated by the Shariah function (individual or board) of the platform provider as being

compliant and added to the pool of investment options within the platform. On the other end, the prospective investor logs on to the P2P platform and views all options for investment on the platform which have been pre-qualified as Shariah-compliant by the platform provider.

2. The Investor selects an option that they are interested in, signs a Murabaha Master Agreement and transfers the funds to the borrower (business/individual), using the platform's payment gateway, who then uses this to purchase the asset they wanted to buy from a supplier once the funding round is complete.
3. The supplier would then transfer the ownership of the asset to the investor(s) who have participated in the funding round for this project/opportunity.

4. The asset's delivery is made to the borrower as they are the end user with respect to the asset's utility.
5. The borrower issues an offer to buy the ownership of the asset to the investor(s) as per the terms of the Murabaha agreement.
6. The investor(s) accept the borrower's offer to purchase the asset, as the value of the total asset plus the profit margin are clearly articulated in the Murhabha Master Agreement which was signed by the investors prior to transfer of funds to the borrower.
7. At acceptance of the offer, the asset's ownership is transferred to the borrower, who pays the investor(s) in an agreed format – weekly, monthly, lumpsum etc. until the completion of the contract.

CONCLUSION

The progression for P2P lending firms expanding in to Shariah-compliant offerings or for IF specialist firms to offer a P2P platform to its clients is an intriguing one; P2P lending transactional volume has grown at a phenomenal rate for the past decade owing to the spread of technology and a strong user base. The same can be observed for Islamic finance which has shown an increase in demand for both Islamic finance as a service and product globally.

By using the P2P business architecture, IF firms have a unique opportunity to tap in to a completely new product that has a high potential for growth in both developed and developing markets, at the same time the P2P lending industry stands to gain access to a new user base of over a billion people globally if they decide to service the IF client base making this a mutually beneficial relationship for both sectors.

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ABOUT CAPCO

Capco is a global technology and management consultancy dedicated to the financial services industry. Our professionals combine innovative thinking with unrivalled industry knowledge to offer our clients consulting expertise, complex technology and package integration, transformation delivery, and managed services, to move their organizations forward.

Through our collaborative and efficient approach, we help our clients successfully innovate, increase revenue, manage risk and regulatory change, reduce costs, and enhance controls. We specialize primarily in banking, capital markets, wealth and asset management and insurance. We also have an energy consulting practice in the US. We serve our clients from offices in leading financial centers across the Americas, Europe, and Asia Pacific.

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