

THE SHARIAH COMPLIANCE OF ISLAMIC PEER-TO-PEER (P2P) LENDING PRACTICES IN INDONESIA: IDENTIFICATION OF ISSUES AND THE WAY FORWARD

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Abstract: Shariah compliance is an important aspect of all Islamic financial instruments and transactions. With the growth of innovation in the finance industry, Islamic fintech's presence has added players, such as digital platforms, which need to comply with shariah. Therefore, this study aims to examine Islamic Peer-to-Peer (P2P) financing activity implementation as part of the fintech business model. Through a descriptive qualitative approach, a thorough analysis was conducted of digital contract papers, prospectuses, and the positions of parties involved in six Indonesian Islamic fintech companies. This involved analysing the shariah compliant quantitative characteristics of a company's prospectus, with financial reports related to interest, debt, and non-permissible income screening. The shariah compliance implementation is not only the duty of Shariah Supervisory Boards, but also involved all interested parties, namely investors, providers, partners, and business owners/borrowers. The results of the study show that shariah compliance in Islamic P2P platforms has been well enforced, therefore avoiding usury (*riba*), uncertainty (*gharar*), and gambling (*maysir*), while ensuring that businesses are offering halal products. Also, the results are expected to provide insight into shariah compliant fintech and how it can continue to develop in terms of Islamic financial products and services. In addition, this study can become a benchmark in the implementation of shariah compliant fintech products.

Keywords: Shariah compliance, P2P Lending, Islamic Fintech, Shariah Compliant Commitments

Introduction

Transformation in the financial industry has forced many to adapt quickly from traditional banking practices and financial transactions to technology-based banking. The challenges of traditional banking include collateral, KYC (Know Your Customer) processes, high-interest rates, and access to location.¹ However, with technology advancement, financial innovation has provided wider space for the provision of financial services which are easily accessible,

reliable, affordable,² and financially inclusive.³ A major trend in fintech is peer-to-peer (P2P) consumer lending and peer-to-business lending. P2P lending fintech enables individuals and businesses to lend and borrow from one another through the use of the internet or mobile applications. As a result of its efficient structure, P2P lending fintech has been able to offer low interest rates to lenders while also providing a more convenient loan process for consumers.

The world of Islamic finance has not been left behind in the current financial technology environment. Islamic fintech start-ups have sprung up around the world; currently there are 93 start-ups worldwide, of which 65 focus on the P2P lending business.⁴ According to the 2018 Islamic Fintech Report, Indonesia has the largest number of fintech start-ups in the world with a total of 31. According to a report by Indonesia's Financial Services Authority (Otoritas Jasa Keuangan – OJK), 12 Islamic fintech providers have registered,⁵ while the rest are in the registration and licensing process. The potential for developing fintech start-ups in Indonesia is enormous considering the country is the world's most populous Muslim nation.⁶

In Indonesia, an Islamic P2P lending provider's existence is regulated by the OJK and National Shariah Council (Majelis Ulama Indonesia, MUI). Specifically, POJK no.77/POJK 01/2016 regulates information technology-based lending and borrowing services, describing the mechanism for establishing services, registration, and license requirements for fintech start-ups for both conventional and Islamic fintech.⁷ Meanwhile, the MUI DSN Fatwa no 117/DSN-MUI/II/2018 regulates practices in information technology-based financing services according to shariah principles.⁸ This MUI DSN fatwa is a guide for Islamic fintech start-ups, especially those engaged in P2P lending, when carrying out their operations under shariah provisions.

Shariah compliance is one of the major challenges facing technology-based loan service business practices.⁹ Nevertheless, studies of shariah compliance in the field of Islamic fintech have been rather scarce, especially concerning business models,¹⁰ frameworks,¹¹ and future agendas.¹² Most studies only issue points regarding the approval of technology,¹³ financial inclusion,¹⁴ development of micro-finance,¹⁵ and the real sector of the ideal Islamic economy.¹⁶ The study of shariah compliance in Islamic P2P lending is therefore limited, to the point that it is not apparent which practices are compliant and which not.

This study aims to analyse the shariah compliance of Islamic P2P lending practices in Indonesia by learning about the predominant factors determining the success of its implementation in fintech business model and analysing the overriding challenges and opportunities. This study is also expected to minimise the gaps in the literature on shariah compliance and Islamic fintech, both in theory and practice.

Literature Review

Shariah Compliance in Islamic Financial Institutions

The fundamental difference between Islamic and conventional interest-based financial institutions is shariah compliance. According to Todorof,¹⁷ shariah compliance is conformity with shariah law and constitutes a fundamental element in Islamic financial transactions. Islamic law is based on the Qur'an and hadith; its implementation is therefore carried out daily by Muslims. Furthermore, shariah compliance has a very important position in Islamic financial business practices.¹⁸ Therefore, with Islamic labelling appearing on financial products and services, institutions have to comply with shariah rules.

Firstly, institutions should examine the shariah appropriateness of their prevailing business models, as well as the aspirations of their customers.¹⁹ Some opinions state that shariah compliance opens up large market potential.²⁰ This is reinforced by Cheong,²¹ who states that companies that comply with shariah can significantly capitalise on the Muslim market. D'Alvia²² has stated that authentic shariah-compliant products attract both retail and institutional investors because the latter trust the central Shariah Supervisory Boards that perform the necessary authentication. Furthermore, Pepis²³ stated that Islamic law screening has positive implications for a firm's judgments on managerial strategy.

Shariah compliance information, site aesthetic, efficient and reliable services, as well as fulfilment of promises and transactions, have significant impact on customer satisfaction for fintech services.²⁴ However, how implementation of shariah principles impacts Islamic fintech products in Indonesia is not recognised, since such may require supporting documents during the licensing process.²⁵

Basic Shariah Compliance

Islamic P2P lending in Indonesia should comply with the rules set out in DSN MUI Fatwa No. 117/DSN-MUI/II 2018,²⁶ which outlines shariah compliance as follows:

- a. Sale and purchase agreements are contracts between the seller and the buyer, resulting in the transfer of ownership of the object being exchanged (goods and prices).
- b. An *ijarah* contract is an agreement for the transfer of user rights (benefits) for goods or services in a specific time frame with the payment of *ujrah* (wages).
- c. *Musharakah* contracts are cooperation agreements between two or

- more parties engaged in a certain business. Each party contributes to the business (*ra's al-mal*), provided that profits are shared according to the agreed ratio or proportion, while losses are borne by both parties.
- d. *Mudharabah* agreements are cooperation contracts between the capital owner (*shahibul al-mal*), who provides all the capital, and the manager (*'amil/mudharib*). According to the ratio agreed in the contract, the business's profit is given to the capital owner, otherwise the owner bears the loss.
 - e. *Qardh* contracts are loan agreements that oblige a recipient of money to return said financing to the one who loaned it in accordance with an agreed time frame and method.
 - f. *Wakalah* contracts are agreements to delegate power from a legal attorney (*muwakil*) to a power of attorney (representative) in order to perform certain representable legal actions.
 - g. *Wakalah bi al-ujrah* contracts are agreements accompanied by a reward in the form of *ujrah* (fee).
 - h. Standard contracts are written agreements determined unilaterally by an operator and contain standard clauses regarding the content, form, and method of manufacture of a product. They are used to offer products and services to users/consumers in bulk.

Aside from the above, prohibited transactions are also regulated by the MUI DSN Fatwa:

- a. *Riba* is a supplement given in exchange for *ribawi* goods (*riba fadhil*) or an agreed addition to the principal of a debt in exchange for absolute deferral of payment (*riba nasi'ah*).²⁷
- b. *Gharar* is uncertainty in a contract as regards to quality or quantity and delivery.²⁸
- c. *Maysir* is any contract carried out with unclear purposes and careless calculations, speculation, or profit.²⁹
- d. *Tadlis* is an act of hiding the defects of an object by a seller to trick a buyer.³⁰
- e. *Dharar* is an action that can cause harm or loss to other parties.³¹

In addition to these explanations given by the MUI DSN Fatwa, Biancone³² has identified other specific illicit activities, such as producing or selling

alcohol, producing goods related to pork, pornography, tobacco, weapons and defence, genetic engineering (e.g. cloning), and media and advertising. Some of these activities are mentioned as illicit in the prophetic traditions.³³ Furthermore, Biancone³⁴ divided shariah compliance assessment into two parts: qualitative and quantitative. Qualitative criteria are assessed according to activities carried out, while quantitative are based on financial structures. In determining shariah compliance, it is important to note how activities are carried out according to the provisions of shariah, which include carrying out halal activities and avoiding prohibited (haram) activities. The biggest issue here is the banking system's practice of prohibited actions like interest (usury).³⁵ This was reinforced by Furqani³⁶ and Todorof.³⁷

Quantitative screening criteria are a series of reports and financial levels that need to be examined, and whose results should not exceed the specified thresholds for quantitative control. The three main aspects that need to be assessed are:

- a. The level of leverage (debt ratios). According to the principles of shariah, any debt based on interest is not allowed. Based on an Islamic Index, the level of debt ratio is: $(\text{Total Debt}/\text{Total Assets}) < 33\%$.
- b. The ratio of interest, or the liquidity ratio (cash and credit).
- c. The portion of revenue that is generated by non-compliance.

All these aspects should be respected by Islamic fintech providers in order to guarantee a set of compelling evaluation procedures.³⁸

Methodology

This study used the content analysis qualitative method, which is an approach to gathering and analysing textual information, as well as the systematic identification of its properties.³⁹ Through library study, the research team gathered academic journals, books, contract and report documents, as well as official websites of Islamic P2P lending providers in Indonesia. The data thus uncovered was used to support the facts that occur in the field. Content analysis can be used to determine the meaning of sentences or the content of delivered news. Content analysis is a qualitative technique for systematically and objectively analysing messages. Therefore, this technique is suitable to be applied in the studies of shariah compliance. The content analysis technique used here is the approach to sentences. This technique was also adopted by

Lindsley and Shrives (2006). When approaching sentences, it is considered better to find out the meaning of the report provided by the company. Before carrying out content analysis, the team needed to prepare several things, including:

- a. The research question: in this study, the questions to be answered are related to the assessment of shariah compliance.
- b. Code-able documents: sample Islamic P2P lending provider contracts, prospectuses, and related documents.
- c. Coding unit: sentences.
- d. Shariah compliance categories: qualitative and quantitative screening based on Fatwa DSN MUI.⁴⁰

Qualitative Screening	Quantitative Screening
<ul style="list-style-type: none"> • <i>Ijab Qabul</i> • <i>Aqd</i> • Avoidance of <i>Riba</i> • Avoidance of <i>Gharar</i> • Avoidance of <i>Maysir</i> • Avoidance of <i>Tadlis</i> • Avoidance of <i>Gharar</i> • Halal Business 	<ul style="list-style-type: none"> • Interest screening criteria • Debt Screening criteria • Non-permissible income screening criteria

Table 1: Instruments for Coding Content Analysis for Shariah Compliance
 Source: Fatwa DSN MUI 2018

Table 1 presents the instruments for coding content analysis when shariah compliance, which consist of qualitative and quantitative screening categories. The coding process for content analysis used in this study was carried out by a research team. As a basis for coding in content analysis, the general understanding of shariah compliance formulated by Derigs and Marzban was adopted.⁴¹ In conducting content analysis, a sentence can be considered shariah compliant when “it provides information to readers about shariah transaction and avoids prohibited transaction, or the possibility of failure, which has or will affect the Islamic P2P Lending Provider.”

Results and Analysis

Reviewing existing literature and documentation presents positive evidence for claiming that a selected Islamic P2P lending contract is shariah compliant. Using the basic principles stated in the MUI DSN Fatwa No.117/DSN_MUI/II 2018, the below results represent qualitative evidence about shariah compliance in Islamic P2P lending. A discussion of the analysis concerning shariah compliance follows herewith.

Shariah Compliance in Islamic P2P Lending Practices

The content analysis results on Islamic P2P lending practices are divided into four sources: Investor, Provider, Partner, and Borrower. Meanwhile, the screening aspect of shariah compliance is divided into two parts: qualitative and quantitative. The results of the review can be seen in Table 2, below:

No	Information	A	B	C	D	E	F	Shariah Compliance Review	
								Qualitative	Quantitative
A	Investor								
1	Profile							Avoidance of <i>Tadlis</i> and <i>Dharar</i>	
2	Legal Document	√	√	√	√	√	√	Avoidance of <i>Tadlis</i> and <i>Dharar</i>	
3	Legal Account	√	√	√	√	√	√	Avoidance of <i>Maysir</i>	
4	Source of Funds	√	√	√	√	√	√	Avoidance of <i>Maysir</i> and <i>Gharar</i>	Non-permissible income
5	Contract	√	√	√	√	√	√	Avoidance of <i>Dharar</i> and Halal Business	
6	Unit Investing	√	√	√	√	√	√	Avoidance of <i>Maysir</i> and <i>Riba</i>	

B	Islamic P2P Lending Provider								
1	Profile							Avoidance of <i>Tadlis</i> and <i>Dharar</i>	
2	Legal Document	√	√	√	√	√	√	Avoidance of <i>Dharar</i>	
3	OJK License	√	√	√	-	-	-	Avoidance of <i>Dharar</i>	
4	Shariah Supervision Board	√	√	√	√	√	√	Avoidance of <i>Dharar</i> , <i>Riba</i> , <i>Tadlis</i> , <i>Maysir</i> and <i>Gharar</i>	
5	Financial Report	√	-	-	-	-	-	Avoidance of <i>Dharar</i> , <i>Riba</i> , <i>Tadlis</i> , <i>Maysir</i> and <i>Gharar</i>	Interest, Debt, and Non-permissible Income
6	Contract	√	√	√	√	√	√	Avoidance of <i>Dharar</i> and Halal Business	
C	Partners								
1	Profile	√	√	√	√	√	√	Avoidance of <i>Tadlis</i> and <i>Dharar</i>	
2	Financial Report	-	-	-	-	-	-	Avoidance of <i>Dharar</i> , <i>Riba</i> , <i>Tadlis</i> , <i>Maysir</i> and <i>Gharar</i>	Interest, Debt, and Non-permissible Income
3	Legal Aspects	√	√	√	√	√	√	Avoidance of <i>Dharar</i>	

4	Contract	√	√	√	√	√	√	Avoidance of <i>Dharar</i> and Halal Business	
D	Business Owner/ Borrower								
1	Business Owner Identity	√	√	√	√	√	√	Avoidance of <i>Dharar</i> and <i>Tadlis</i>	
2	Cooperation Scheme	√	√	√	√	√	√	Avoidance of <i>Dharar</i> , <i>Tadlis</i> , <i>Riba</i> , and Halal Business	
3	Legal aspects	√	√	√	√	√	√	Avoidance of <i>Dharar</i>	
4	Shareholders	-	√	√	-	√	√	Avoidance of <i>Dharar</i> , <i>Riba</i> and <i>Gharar</i>	
5	Historical Financing (Character)	√	√	√	√	-	-	Avoidance of <i>Dharar</i>	Debt
6	Capacity	√	√	√	√	√	√	Avoidance of <i>Dharar</i> and <i>Gharar</i>	
7	Condition of Economics	√	√	-	-	-	-	Avoidance of <i>Dharar</i> and <i>Gharar</i>	Debt
8	Capital	√	√	√	√	√	√	Avoidance of <i>Dharar</i> , <i>Gharar</i> , <i>Tadlis</i> , and <i>Maysir</i>	Debt

9	Collateral	√	√	√	√	√	√	Avoidance of <i>Dharar</i> and <i>Tadlis</i>	Debt
10	Budgeting	√	√	√	√	-	-	Avoidance of <i>Riba</i>	Non-permissible Income
11	Project Gallery	√	√	√	-	-	-	Avoidance of <i>Gharar</i>	
12	Financial Report	√	√	√	-	-	-	Avoidance of <i>Riba</i> and <i>Gharar</i>	Interest, Debt, and Non-permissible Income
13	Risk Mitigation	√	√	√	√	√	√	Avoidance of <i>Gharar</i>	

Notes: √= available, - = unavailable

Table 2: Shariah Compliant Review of the Islamic P2P Lending Practices

Source: Prepared by author based on documentation related to Islamic P2P Lending Providers

Generally, every aspect of the documentation relating to Islamic P2P lending practices complied with Fatwa DSN MUI 177/DSN-MUI/I/2018. However, several things need to be analysed in depth as they pertain to the content analysis of the existing documents.

Qualitative Shariah Compliance Screening. The documentation of shariah practice carried out by Islamic P2P lenders with investors, partners, and business owners/borrowers showed that every transaction avoided *riba*, *gharar*, *maysir*, *dharar*, and *tadlis*, with the following details:

No	Qualitative Shariah Compliance Screening	Investor	Provider	Partners	Borrowers	Total
1	Avoidance of <i>Riba</i>	1	2	2	3	8
2	Avoidance of <i>Gharar</i>	1	2	1	6	10
3	Avoidance of <i>Tadlis</i>	1	3	2	4	10
4	Avoidance of <i>Maysir</i>	3	2	1	1	7

5	Avoidance of <i>Dharar</i>	3	6	4	9	22
6	Halal Business	1	1	1	1	4

Table 3: Qualitative Shariah Compliance Screening Findings
Source: Authors

Based on the results of content analysis, it was discovered that Islamic P2P lending implements shariah rules and avoids anything contrary to Islamic law. From Table 3 above, it is seen that avoidance of *dharar* is often carried out by all four parties involved in the Islamic P2P lending business. Avoiding *dharar* in practice prevents harm from other parties.

Quantitative Shariah Compliance Screening: Many P2P lending providers do not disclose their financial reports. Certainly, out of the 12 prospectuses assessed here, four did not correspond to financial reports. As previously stated by Biancone⁴² and Derigs,⁴³ financial reports are an important evaluation tool for determining quantitative data, especially debt, which cannot be more than 33% if interest based. Despite these limitations, the following data was obtained:

No	Qualitative Shariah Compliance Screening	Investor	Provider	Partners	Borrowers	Total
1	Avoidance of Riba	1	1	1	1	4
2	Avoidance of Gharar		1	1	5	7
3	Avoidance of Tadlis		1	1	2	4

Table 4: Quantitative Shariah Compliance Screening Findings
Source: Authors

The analysis clearly shows that all parties, from the perspective of investors, provider partners, and borrowers, are unable to implement shariah compliance from the financial quantitative side. Therefore, according to the results, there are still many things to be completed and disclosed. In terms of interest, debt, and non-permissible income screening, it was shown that the largest potential issue relates to debt. In the practice of Islamic P2P lending, therefore, attention should be on accounts payable, the ratio of which cannot be more than 33% to fall into line with shariah regulations.

Shariah Compliance Commitment for All Interested Parties

One of the unique features of P2P lending platforms as compared to traditional financial transactions is that interested parties, consisting of investors, mediators, and business owners/borrowers, do not meet physically. All parties rely on the applications provided by the platform provider using the internet. High trust between the interested parties is therefore key for this business practice to function. So, too, is high shariah-compliance. Consequently, the practice of Islamic P2P lending is not just jargon but has real applications.

Investors: In *fiqh muamalah*, it has been stipulated that people who execute *muamalah* transactions must fulfil several mandatory requirements, including having reached puberty and not being under duress. Investors in Islamic P2P lending are therefore required to be mature and sane in order to sign contracts. Furthermore, they are required to provide personal data for verification for initial registration. This registration process is included in the *wakalah* contract, which authorises providers to take care of matters related to the business. Personal documents, such as identity cards, tax identification numbers, and investor photographs, are required. Some of these documents should be uploaded online. In addition, data on bank account numbers and sources of investor funds are important entries. This information is required to avoid unfortunate consequences, such as money laundering or the provision of funds from non-halal businesses. The giving of such personal identity data openly shows investors are honest and have good intentions, which is shariah compliant.

Intermediaries (Islamic P2P Lending Providers): Intermediary Islamic P2P lending providers in Indonesia need to be both registered with the OJK and in compliance with the MUI DSN Fatwa. Therefore, there is a commitment to ensuring that every business process complies with shariah. Moreover, intermediaries must consider the following points.

- a. Open information is the first step towards attracting investors who want to invest their funds in P2P lending platforms. By providing complete information on websites, asymmetrical information is avoided. This openness prevents *riba*, *maysir* and *gharar*. Providers issue complete information on partners and borrowers, providing prospectuses detailing legality, financial information, and organisational structure.
- b. Shariah Supervisors. One of the characteristics of Islamic P2P lending providers is the involvement of a Shariah Supervisory Board approved by the MUI National Shariah Council. The function of the Shariah Supervisory Board is to ensure all business processes conform to shariah under the DSN Fatwa.

- c. *Amanah* (trust). Providers should be entrusted with safeguarding all data and information held by them, especially investor data. This mandate is very decisive because, in practice, there are no facilities to meet offline. In addition, several Islamic P2P lending providers also maintain platforms for *waqf* and *infaq*, which is proof that a provider who is trustworthy can be said to have a strong commitment to shariah compliance.

Partner (Shariah Cooperative/Baitulmal Wattamwil): Partners function as counterparts in the context of Islamic P2P lending. In practice, the partner needs to be in the form of a shariah cooperative or *Baitulmal Wattamwil* to help the borrower's provider channel funds. Consequently, this contract is carried out to avoid undesirable situations. This partner will be in direct contact with the borrower. Partners verify the borrower's business, total assets, and financing.

Business Owner/Borrower: Business owners/borrowers are the beneficiaries of Islamic P2P lending. In running a business, borrowers should comply with shariah by avoiding *riba*, *gharar*, *maysir*, and even *dharar*. Also, borrowers need to be entrusted with running their enterprises and halal businesses, as well as providing benefits according to shariah. Furthermore, borrowers should have good management skills and provide information openly to partners, intermediaries, and investors, both operationally and financially. This condition will increase the confidence of all parties by using a *mudharabah* agreement. Borrowers have the opportunity to develop their businesses because profit and risk are shared with the closest party. In cases where borrowers perform well, there will be a high probability of repeat financing as such borrowers will then be judged safe and in compliance with shariah.

Challenges and Opportunities

This study of shariah compliance among Islamic P2P lending providers has produced several thoughts on challenges and opportunities. As an Islamic finance institution that is making breakthroughs in financial technology, the P2P lending transaction format can deliver innovation in products and services, as well as strengthen shariah supervision.⁴⁴ Strengthening supervision of Islamic P2P lending providers is not limited to the role of Shariah Supervisory Boards, but also subsumes every element of the provider that strengthens a transaction. It is unlikely that a Shariah Supervisory Board can oversee the shariah compliance of every contract and transaction. Therefore, this mission needs to be supported by the development of adequate human resources, with providers being trained in high-level shariah compliance. The main agenda

behind strengthening shariah supervision is human development; as generally known, shariah financial literacy in Indonesia is still very low, meaning it is a collective task to improve the competence of human resources in *fiqh muamalah* and Islamic finance more generally, in order to impact awareness of transacting business according to shariah.

Conclusion

Generally, in qualitative terms, Islamic P2P lending platforms produce documents, contracts, and transactions in accordance with shariah. This provides a response to initial study questions about shariah compliance in the Islamic P2P lending business. The practice of avoiding *dharar*, for example, is often carried out by parties interested in this business. Reviewing shariah compliance using a quantitative method, on the other hand, did not yield encouraging results due to limited data disclosure by the parties concerned. In this context, the most important issue is managing “the debt ratio,” which needs to always comply with shariah. For the implementation of compliance, providers cannot work alone; there is need for joint commitment and collaboration between interested parties when implementing contracts, transactions, and business practices in accordance with shariah. Opportunities and challenges are wide open for strengthening shariah supervision in this area.

The limitations of this study revolve around its dependence on limited documentation, in terms of both providers and types of contract. For further study, it is recommended that different qualitative methods be used, such as in-depth interviews with the management of Islamic P2P providers, Shariah Supervisory Boards, or business owners/borrowers. Also, additional documentary evidence needs to be evaluated quantitatively in order to accurately assess shariah compliance.

Notes

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