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REGULATING ISLAMIC P2P FINANCING IN NIGERIA: A CASE FOR A COMPLIANCE FRAMEWORK

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Abstract

This study looks into Nigeria's need for a robust compliance structure to regulate Islamic peer-to-peer (P2P) financing. Building on the fundamentals of Islamic finance and taking cues from global best practices in P2P financing regulations, this study suggests a thorough compliance framework customized for the Nigerian environment. A robust framework guarantees the adherence to Shari'ah, safeguard investors, and advances financial stability. This study examines the regulatory gaps in the existing compliance environment, analyzes the difficulties in enforcing compliance, and foresees probable opposition from industry stakeholders. The study adopts a qualitative research methodology approach. It relies on primary data sourced from interviews, and official publications, as well as secondary data from articles, websites, and online resources. This study finds that although the Islamic finance industry in Nigeria has overtime developed, there is nevertheless the need for an end – to – end Shari'ah compliance framework (from initiation to execution and post – execution) for the effective regulation of Islamic P2P financing. Additionally, a suggested model for a compliance framework is presented in this study. It evaluates the framework's effect on the sector and offers insightful information about its effectiveness. This study fills a significant vacuum in literature while also providing policymakers, regulators, and business stakeholders with useful advice for navigating the rapidly changing environment of Islamic P2P financing in Nigeria. This study concludes by emphasizing on the significance of a compliance framework in promoting the expansion of P2P financing in Nigeria that ensures adherence to Shari'ah principles and the protection of the interests of all parties. It adds to the continuing discussion on regulatory innovation in Islamic finance and lays the groundwork for further study and the creation of new policies in this emerging area.

Keywords: *Islamic P2P financing, Compliance Framework, Regulation, Financial Inclusion.*

INTRODUCTION

With the turn of the 20th century, technology has continued to play increasing role in daily life of people. One of the areas impacted is the economic and financial activities. While the financial institutions have rapidly taken up the use of technology in their service delivery, there have been further disruptions in the guise of financial technology (Fintech). Added to this is the increasing global drift towards Islamic financial services, perhaps due to the impact of the successive global recessions and the Covid-19 pandemic. These events and developments have cumulatively changed the global financial landscape forever (Abdulkadir et al., 2022; Abdullah & Umar A. Oseni, 2017).

The Fintech is said to be consisted of varied forms, which includes payment modalities, peer to peer financing (P2P), peer-to-business financing (P2B), investment management, crowdfunding or joint venture funds. Islamic P2P financing is a relatively novel in Nigeria. It is a type of crowdfunding that makes it possible for people to provide funding to one another directly. The absence of a Shari'ah compliance framework in Nigeria, however, has raised questions regarding the adherence of Islamic P2P financing activities to Shari'ah principles. Even though Shari'ah compliance is the cornerstone of Islamic financial legislation, insufficient supervision and low Shari'ah compliance continue to be major obstacles in the implementation of Islamic Fintech and consequently, Islamic P2P financing. A strong Islamic Fintech ecosystem requires supportive laws and policies, a Shari'ah Supervisory Board, and Islamic Fintech standards (Muryanto, 2022). A review of the literature on Islamic finance in relation to Shari'ah non-compliance in its transactions reveals that there are regulatory gaps for Islamic P2P financing due to underdeveloped policies, guidelines and regulations (Mustapha et al., 2021). The seeming regulatory gaps can be appreciated in view of the fact that the P2P financing arrangement started around 2005 (Zulkefli & Habibi, 2021). That notwithstanding, there are climes that have experienced a success in the operations and regulation of this fledging alternative means of sourcing finance. These climes include Malaysia, Singapore, United Kingdom, Indonesia and the GCC States, notably the Kingdom of Bahrain (Sa'ad et al., 2019). For example, in Malaysia, P2P and Equity Crowdfunding (ECF) platform providers are licensed by the Securities Commission of Malaysia (SC) and are regulated under the Recognised Market Operator (RMO) Guidelines of 2015 (Zulkefli & Habibi, 2021).

Sequel to the success recorded in other climes, the Securities and Exchange Commission of Nigeria (SEC) in 2021 issued regulatory incubation guidelines targeted at Fintech entrepreneurs developing financial service solutions, among which is the operators of crowdfunding and P2P financing platforms (SEC Regulatory Incubation, 2021). The objective of the guidelines was to accelerate licensing of Fintech platforms and to ensure the adequate regulation of the budding sector.

By releasing guidelines for crowdfunding activities, the SEC has made steps to provide a control over activities of Fintech (Rules on Crowdfunding, 2021), however, these regulations have yet to sufficiently taken care of the Islamic P2P financing regulatory needs. A unique regulatory structure is therefore required for Islamic P2P financing. Issues including transparency, disclosure, risk management, and investor protection and most importantly Shari'ah governance and compliance should be covered under the framework.

METHODOLOGY

This study adopts a qualitative method to assess the state of the current Shari'ah regulatory framework for Islamic P2P financing in Nigeria. The data is sourced from primary sources; which are essentially semi-structured interviews of experts drawn from a global Islamic fund manager, a multilateral standard setting body, and domestic regulatory bodies. This was required in order to extract expert standpoint on addressing gaps in the current conventional framework in order to offer a new customized framework specifically Islamic P2P financing. Expert views will shape the framework in the perspective of the Nigerian market. However, review of multilateral standard setting body international standards, the Islamic Financial Services Board (IFSB) and Accounting and Auditing Organization for

Islamic Financial Institutions (AAOIFI) international standards and exposure draft; and domestic regulatory bodies guidelines on Islamic finance i.e the Nigerian Securities and Exchange Commission (SEC) and Central Bank of Nigeria (CBN) guidelines. The international standards and domestic guidelines will serve as a guidance towards adaptation and successful development of the framework. Also, data for the study were sourced from various secondary sources; such as journal articles, periodicals and websites.

LITERATURE REVIEW

Islam typically distinguishes between religious (*Ibadaat*) and worldly (*Muamalaat*) pursuits. While actions connected to the former must rigorously follow unambiguous instructions, those relating to the latter are generally permitted, so long as specified prohibitions are not broken. Among other un-Islamic practices, these prohibitions cover usury (*riba*), gambling (*maysir*), uncertainty, excessive and destructive risk-taking (*gharar*), and harmful endeavors (*dharar*). Therefore, it is encouraged to engage in commercial operations for the benefit of people's socioeconomic well-being. Such actions, however, must adhere to the rules of Islamic Commercial Jurisprudence (*Fiqh-ul-Muamalaat*). (Taqi Usmani, 1998). P2P crowdfunding falls within the category of permissible worldly activities, as long as it is conducted in a way that complies with Shari'ah regulations. Islamic P2P Financing can be defined as the utilization of modest sums of money received from a large number of people or organizations, in accordance with the Shari'ah principles, to support a project, a business or personal financing, and other needs using an online web-based platform. The fact that Islamic P2P financing appoints an internal or external Shari'ah committee to monitor and evaluate all business activities is one of the key distinctions between it and traditional P2P lending. (Takidah & Kassim, 2022).

By creating an exposure draft Standard on Islamic crowdsourcing in June 2021, AAOFI has been highly proactive in setting the stage for addressing considerable concerns of fraudulent practices and Shari'ah non-compliance in the crowdfunding industry. This helps to prevent any harm and reputational risk to the Islamic finance sector while also ensuring sound governance in the sector of Islamic crowdfunding (AAOIFI, 2022). The standard on Islamic crowdfunding offers a thorough framework for good governance that will direct crowd funding sites and other participants as well as increase public trust in the embryonic Islamic crowdfunding sector. AAOFI is optimistic that the Islamic crowd funding sector will encourage Shari'ah-compliant investments at the retail level and also spur MSME development, particularly start-ups (AAOIFI, 2022).

Instead of a credit intermediary obtained through traditional P2P lending that operates on a credit model with interest, an Islamic P2P platform is regarded an information intermediary that complies with Shari'ah standards (Azganin et al., 2021). Islamic contracts or agreements serve as the foundation for the Shari'ah-compliant P2P financing, which allows people to provide and avail funds from one another. In Islamic finance, the contract is typically referred to as an '*aqd*. In addition, the following categories of '*aqd* pertain to the application of Islamic P2P financing: *Al-bai, ijarah* (sale and buy), *mudharabah* (transfer of the right to use something for a specific amount of time in exchange for a fee), and *al-bai*; a contract for partnership between two or more companies in a given enterprise, wherein each party invests money in the latter, *wakalah bi al ujrah* and *quardh*, a loan contract requiring the borrower to repay the loan fund in accordance with the agreed time and manner. *Musharakah* is a collaboration contract between a funder and manager of a business in which the profit will be shared in a way that is agreed upon and the loss is borne proportionately (Takidah & Kassim, 2022).

Researchers, financiers, business owners, decision-makers, and other MSME eco-system stakeholders have paid close attention to identifying the numerous risks associated with P2P crowd finance. This is due to the fact that it is a forthcoming, worthwhile initiative in the finance sector that is vulnerable to a number of inherent risks associated with cutting-edge Fintech products. Shari'ah compliance risk is classified by (Worthington, 2007) as a permissible risk and Shari'ah non-compliance risk as a non-permissible risk. The typical risk that comes with financial transactions, such as purchasing a good to be sold again for a profit or a loss, is what he went on to explain as permitted risk. There is a strong likelihood that the transaction will either result in a profit or a loss. Like any other business, P2P Islamic crowd funding based on Fintech has related inherent risk that you must consider as you make investments. According to the Prophet (SAW)'s statement in the hadith (At-Tirmidhi - 1232) that “you cannot sell what you have not paid for,” a permitted risk is linked to and inseparable from actual transactions, value production, and ownership. Based on the work of (Bouslama & Younes Lahrichi., 2017), who present three criteria that can typically distinguish between the permitted risk and the non-permissible danger. Sani, (2022) studied the risk from an Islamic perspective. These criteria are the;

a) Probability: Every initiative has some degree of risk, which is frequently specific to the industry—in this case, P2P financing—and is therefore inevitable.
b) The level of risk: this means that the likelihood of the initiative succeeding, as determined by a feasibility assessment, must exceed the likelihood of failure. As a result, gambling is not permitted due to the high level of risk.
c) The intentionality of it, which means that the return must be correlated with the danger—the larger the risk, the higher the return

P2P lending can be seen in two different ways. Small firms search for low-cost sources of financing for their enterprises in developing economies. However, investors find it difficult to find investment sources that would be sufficiently lucrative in mature economies like the European society. These could put each of the climes at particular risk (Ofir & Tzang, 2021).

Petersone & Kreituss, (2021) and Bavoso, (2020) articulated risks from the supply side, i.e. the investor side, in developed climes to include Psychological risk, Concentration risk, Credit risk, Platform risk, Fraud risk, Legal and Tax regime risk. Other risks include selling into a loss, liquidity risk due to inability to sell out early, cash drag (inability to lend), inflation risk, foreign currency risk (mitigants: pre-entry due diligence, effective cash flow forecast)

Suryono et al., (2019) identified the risks and corresponding mitigants from the supply side, i.e. the investor side, in developing climes to include: Information asymmetry with the utilization of Big data as mitigant; Ascertaining Borrower’s Credit score. He identified as a mitigant, the need for lenders to source credit history from credible and regulated Credit Bureau; Moral Hazard, suggested mitigant in this regard include; improvement on credit scoring method and obtaining credit history from regulated and credible Credit Bureaus; Investment decision, to mitigate this, third party certification, pre-investment due diligence was proposed; Operational risk. Mitigants that were recommended include; adequate corporate governance, registration and custodial requirement, information disclosure requirements and limit on the volume of advances. The above was reinforced by a study conducted by (Indonesia & Cina, 2022).

DISCUSSION AND ANALYSIS

The Islamic P2P financing platforms emerged as a child of necessity to take care of the funding needs for nMSMEs who may not be able to access funds from traditional financial institutions within global financial industry. This development has thus spurred a new kind of sector or subsector for which Shari’ah compliance regulation frameworks has to be developed (Abdulkadir et al., 2024).

Although there are regulations on Fintech and crowdfunding, none is currently available for P2P financing generally within the Nigerian environment. It is in this light that (Umar Habibu Umara & Umar, 2022) suggested that there was the need to provide motivational regulations for establishing Islamic fintech companies to revive nMSMEs' going concerns during and post COVID-19 pandemic Nigerian environment. It was equally suggested that, where an Islamic P2P regulation is to be developed, it would most likely ride on the extant legal frameworks, either of banking, insurance or capital market, which would be tweaked to accommodate the peculiarities of Islamic P2P financing (Benni, 2021).

Shari'ah compliance in Islamic P2P financing requires adherence to specific principles, such as the prohibition of interest (*riba*), avoidance of uncertainty (*gharar*), and prohibition of investment in *haram* (forbidden) activities (Binti Shahariman et al., 2024). These principles often conflict with conventional financial norms, which allow interest-based transactions and certain speculative activities. To reconcile these differences within regulatory frameworks, it is essential to emulate from other jurisdictions best practice on Islamic P2P financing and also adapt conventional regulations by excluding non-compliant provisions and incorporating Shari'ah-compliant alternatives, ensuring that the financial products and services align with Islamic ethical standards while remaining effective within the broader financial system.

Monye, (2021) surmised that regulating the Islamic P2P financing space will among others, engender benefits such as foreign direct investments, provide assurances to the investors and financially includes the financially excluded based on religious conviction. The basic purpose of regulation, it has been argued, is to help the country ensure that things are done properly in the industry, consumers are protected, and all the players actually play within the rules and regulations provided. While the absence of dearth of regulations in any kind of financial environment, exposes such environment of vulnerabilities such as fraud, consumers' apprehension and in market instability (Biju & Thomas, 2023).

The regulatory models of self-regulation and co-regulation offer distinct advantages and disadvantages. Self-regulation, where industry players create and enforce their own rules, allows for flexibility and industry-specific expertise but may lack accountability and robust enforcement. Co-regulation, on the other hand, combines the strengths of both industry and government by amalgamating rules from regulators and industry players, ensuring greater compliance and oversight (Fellow, 2016). This model has been successfully implemented in jurisdictions like the US, Canada, and Malaysia, where it balances industry autonomy with regulatory rigor (Finck, 2017). Co-regulation may be particularly suitable for Nigeria, as it can foster collaboration between regulators and industry stakeholders, ensuring that the unique needs of the Islamic finance sector are met while maintaining regulatory integrity.

FINDINGS

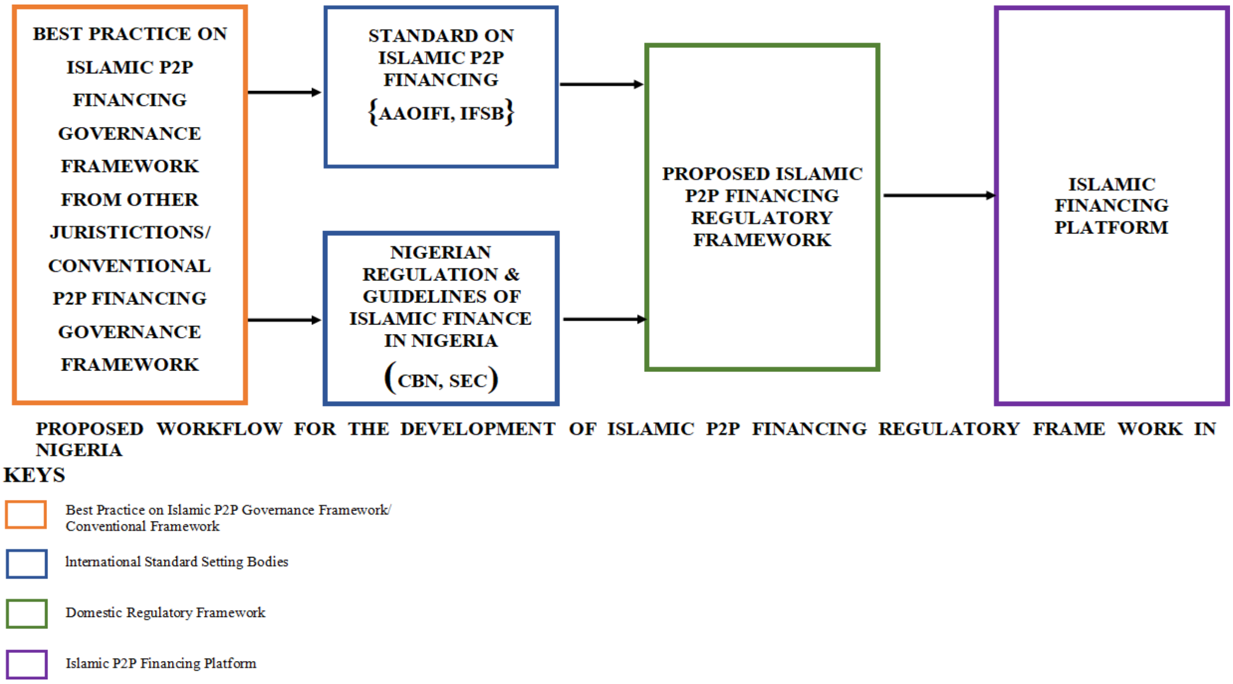
Sequel to the semi-structured interviews and other qualitative endeavours, the study's findings include;

Fiancial regulatory agencies in Nigeria (SEC and CBN) shouldn't reinvent the wheel but should mirror best practice on Islamic P2P financing from other jurisdiction and also adapting conventional regulations for Shari'ah compliance by integrating relevant provisions and removing non-compliant elements. To achieve this, regulators should revise and supplement existing frameworks, collaborating with international bodies like the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) for guidance. An end-to-end comprehensive Shari'ah governance framework, covering all phases of Islamic P2P financing, including dispute resolution, is necessary to ensure adherence to Shari'ah principles, and clear enforcement mechanisms should be established to address non-compliance.

For industry stakeholders, maintaining Shari'ah compliance in P2P platforms is crucial for credibility and market growth. It is recommended that these platforms establish Shari'ah Supervisory Boards (SSBs) and collaborate with global standard-setting bodies to align with international standards. This will not only ensure compliance but also enhance the reputation and trustworthiness of Islamic P2P financing services in the market.

Policymakers have a pivotal role in creating a supportive legal and policy environment for Shari'ah-compliant financial products. They should focus on formulating and advocating for policies that facilitate the development and integration of Islamic P2P financing within the national financial system. By doing so, they will help create a more inclusive financial sector that accommodates the needs of those seeking Shari'ah-compliant investment opportunities

Figure 1.0: Proposed workflow for the development of Islamic P2P financing regulatory framework in Nigeria



Source: Author's own illustration

CONCLUSION & RECOMMENDATION

This study concludes by emphasizing on the significance of a compliance framework in promoting the expansion of Islamic P2P financing in Nigeria that ensures adherence to Shari'ah principles and the protection of the interests of all parties. Additionally, the study makes a case for a Shari'ah compliance framework's actual implementation in Nigeria's Islamic P2P finance sector.

The study thus recommends as follows:

1. There should be an inter-agency collaboration among the regulating bodies which would assist in evolving a robust regulatory framework for the industry e.g., collaboration between SEC and the CBN, FIRS and Pencom, among other relevant agencies.
2. The Islamic P2P financing regulation should be crafted in such a way that it will further provide assurances for a sub-sector that further enhances financial inclusion, brings societal benefits, and reduces unemployment through avenues for entrepreneurial engagement that complements national economic development.
3. The SEC should put in place requirements for Shari'ah governance, such as Shari'ah Advisory guidelines, facilitate capacity building for Shari'ah scholars to be able to handle capital market transactions, set up of Shari'ah Unit within the firmament of SEC, and (Investment and Securities Tribunal (IST) dispute resolution frameworks, and standardizing the Sharia governance of Islamic Fintech.
4. Areas to be given specific attention by the SEC in the regulation should include; disclosure practices, information asymmetry, business performance, investor

protection, customer protection, data protection, pricing disclosure, dispute resolution, liquidity and risk management.

5. Islamic P2P Financing platforms should establish Shari'ah Supervisory Boards (SSBs) and collaborate with global standard-setting bodies to align with international standards. This will not only ensure compliance but also enhance the reputation and trustworthiness of Islamic P2P financing services in the market.

The study believes that above insightful information would surely open the path for the suggested Shari'ah compliance framework to be implemented successfully.

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