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## Working Paper

# Leveraging Islamic banking and finance for small businesses: Exploring the conceptual and practical dimensions

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## **ADB Working Paper Series**

### **LEVERAGING ISLAMIC BANKING AND FINANCE FOR SMALL BUSINESSES: EXPLORING THE CONCEPTUAL AND PRACTICAL DIMENSIONS**

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**Abstract**

Small businesses are considered one of the sources of innovation, productivity and dynamism in many countries. Thus, to translate innovative ideas into sustainable businesses, access to capital becomes a part and parcel of their business lifecycle. Despite their potential importance for economic development, small businesses are facing difficulties in attracting external finance at the early and middle stages of the entrepreneurial lifecycle in many countries, including developed and developing countries. As a response, the Addis Ababa Action Agenda on Financing for Development (2015) recognized the role of additional financing, in particular using innovative mechanisms, instruments and modalities. It encourages mechanisms based on models combining public and private resources (blended finance) and joint ventures that bring significant impact investing. In line with this, Islamic banking and finance is a broad framework that has great potential for supporting development finance particularly related to small business, given their fundamental criteria emphasizing generating positive societal impact. The main objectives covered by this paper are: (i) to perform a landscape analysis of financing small business for selected Asian countries, particularly Malaysia and Indonesia; (ii) to identify and unpack innovative financing opportunities within Islamic banking and finance instruments such as Mudharabah (profit-sharing), Musharakah (profit-loss sharing), Murabahah (sale with cost plus profit margin, Ijarah [Islamic leasing]), and Salam (forward sale) as potential solutions for addressing small businesses' funding gaps; and (iii) to initiate the development of systematic principles for the utilization of Islamic banking and finance instruments in financing small businesses.

**Keywords:** small businesses, financing, Islamic banking and finance, Malaysia, Indonesia

**JEL Classification:** E5, G2, L26

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# 1. INTRODUCTION

Small businesses or micro-based businesses are considered one of the best potential platforms for innovation, productivity, and dynamism that support many economic sectors through employment creation, output expansion, export orientation, and income increases (Wong and Aspinwall 2004). Furthermore, these businesses are also dominating various strategic business service subsectors, including services related to computer software and information processing, research and development, marketing, business organization, and human resource development (OECD 2000). It is estimated that small businesses represent about 95% of the companies providing more than 65% of the jobs as well as more than 50% of the gross domestic product globally (World Trade Report 2016). Hence, these businesses occupy a prominent position in the development agenda and essentially become a part of the overall national development strategy in most countries (Abdullah 1999). Both developed and developing countries acknowledge the role of small businesses as the primary contributors to the growth and development of an economy.

Despite their potential importance for economic development, it is widely recognized that small businesses are facing difficulties in attracting external finance at the early and middle stages of the entrepreneurial lifecycle in many countries, including developed and developing countries. According to the World Bank Report (2015), small businesses in developing countries are lacking of financial support to reach their optimal capacity. Some empirical studies have been conducted to examine the small businesses' challenges in managing external finance in both developed and developing countries. Some of these challenges are related to collateral condition, legal status, transaction cost, information and documentation, financial track record, nature and quality of business, and financing procedure and options (Hashim, 1999; Aris, 2006; Saleh and Ndubisi 2006; Abdullah and Manan 2010; SME Masterplan 2012–2020; Thaker et al. 2013; Thaker 2015; Duasa and Thaker 2016). In addition, small businesses are characterized as high-risk businesses and take many years to generate returns to their investors. In addition, lack of attraction and the uncertainty of cash flows are also becoming limitations for them in accessing external finance (Block, Colombo, and Cumming 2018). Due to such constraints, most formal investors, such as retail investors, angel investors, and sophisticated investors, are unwilling to make proper investments at the pre-seed stage and focus their attention on later-stage business ventures with a proven business model.

Given the constraints of accessing traditional financial institutions by small businesses, The Addis Ababa Action Agenda that initiated Financing for Development (2015) emphasized the significance of financing support through innovative financial mechanisms without losing the spirit of businesses in developing countries. This action agenda calls for innovative financial mechanisms comprised of both public and private resources termed as blended finance and joint venture to increase the flow of financing.

Accordingly, the Islamic banking and finance industry is a broad framework that has great potential for supporting development finance particularly related to small business, given their fundamental criteria emphasizing generating positive societal impact. It has achieved remarkable success in terms of steady growth and product diversification across the world. According to a report by the Islamic Financial Services Board (2018), the industry has experienced a compound annual growth rate of approximately 17% over the past five years and managed approximately \$1.87 trillion worth of total assets by the first half of 2014. To be more specific, Islamic banking alone expanded by about 16% in 2013, whereas global banking (comprised of assets of the

world's top 1,000 banks) grew by only 4.9% in 2012 and 0.6% in 2013 (Islamic Financial Services Board 2018). The two most notable features of Islamic banking and finance that contribute to social and economic development via entrepreneurship are asset-backed financing and risk-sharing.

According to the policy paper jointly released by World Bank Group, Islamic Development Bank and the G20 in 2015, the Islamic financial industry should be asset-based so that it can boost real economic activity that will be directing factors of production to the growth of financed assets and eliminating the stigma of "financialization" of a particular economy. Another key financial mechanism of the industry is that it is based on equity suitable for small businesses because the entrepreneurs can share profits and losses. This risk-sharing mode is a fundamental support for entrepreneurial development, particularly small business entrepreneurs relying on equity financing for their new ventures.

In Malaysia, a number of institutions participate in fostering financing accessibility, focusing on SMEs which include commercial banks, Islamic banks, merchant or investment banks, and development finance institutions (Bank Negara Malaysia 2019). According to BNM, the total amount of RM2.17billions of total loans/financing disbursed recorded by the entire participant banks as of November 2019. Meanwhile, in the last five years, Indonesia's Shariah banks have seen its assets grow by 38% compared to 15% for conventional banks (Bank Indonesia). The sector is currently dominated by two leading players, namely Bank Mandiri Syariah and Bank Muamalat, that count for 50% of total Shariah financing between them (Global Business Guide-Indonesia 2011). Indonesia appears to be a natural growing market for Shariah-compliant banking services, given the size of the Muslim majority population; however, the character of the market is starkly different from that of neighboring Malaysia or the Middle East. The majority of Indonesia's potential Islamic banking customers fall under the "rational market" as opposed to that of the "spiritual market". Islamic banking products are therefore pitted against their conventional counterparts and judged on their commercial merits as opposed to being chosen on the basis of faith. Furthermore, since Islamic banks in Indonesia are relatively new as they were established two decades ago, there is the domination of the conventional banks, which cover almost 70% of the industry.

Considering the importance of small businesses and the scope for Islamic financial services, the present research aims to achieve the following objectives:

- (i) to perform a landscape analysis of financing small businesses in selected Asian countries particularly Malaysia and Indonesia;
- (ii) to identify and unpack innovative financing opportunities within Islamic banking and finance instruments, such as Mudharabah (profit-sharing), Musharakah (profit-loss sharing), Murabahah (sale with cost plus profit margin, Ijarah [Islamic leasing]), and Salam (forward sale) as potential solutions for addressing small businesses' funding gaps; and
- (iii) to initiate the development of systematic principles for the utilization of Islamic banking and finance instruments in financing small businesses.

## **2. LITERATURE REVIEW**

### **2.1 Issues of Financing Small Businesses**

The extant studies have shown that small businesses are facing the most common problem, which is financial challenges. In general, the majority of the studies have

indicated the factors that prevent small business from access to external financing are strict collateral requirements, high transaction costs, lack of response from financial institutions that consider the small business as a risky business, insufficient documents to support the loan application, and no financial track record. .

In his study, Das (2007) claimed that Indian small businesses have for decades continued to be hindered by constraints, particularly access to loan financing. According to him, the commercial banks were only interested in channeling funds to selected small businesses after they were instructed by The Reserve Bank of India (RBI) and the Ministry of Finance to do so. The author pointed out that there were inadequate flows of funds, causing a specific bias against small loan portfolios that interrupted the normal flow of finance to small firms. The two most responsible factors—collateral condition and the lack of transparency—are identified as the main impediments to small businesses' receiving external financing.

Aris (2006) studied various challenges of external finance for small businesses in Malaysia, which are lack of collateral, insufficient documents to support loan applications, no financial track record, the nature of the business, and long loan processing time. These factors causing them to rely much more on internal financing rather than external financing.

Pirvu, Giurca Vasilescu, and Mehedintu (2008) revealed a number of challenges of micro and small business entrepreneurs in getting finance from conventional commercial banks in Romania: stringent banking and legislative environment, bureaucratic banking structures, an apathetic nature towards disbursing micro and small credits, and the condition of creditworthiness.

Ganbold (2008) found that external financing for small businesses remained a major obstacle in Mongolia. He noticed that the large firms can easily access finance compared to small businesses. It restricted the latter from making capital investments and funding daily operational activities, and the main causes were high interest rates, limited or no access to long-term credit, collateral constraints, and lack of market research and business planning.

Stephanou and Rodriguez (2008) examined the financial challenges of small businesses in Colombia, which include the lack of proper financing for smaller, industrial and younger firms to develop or diversify their economic activities. The authors identified some other constraints related to the rate of interest, loan maturity, collateral conditions, and lending process.

Rahman (2010) discussed the potential constraints faced by small businesses in Bangladesh. Among them was financial constraints. In Bangladesh, the small businesses were facing difficulties in raising fixed and working capital because of the reluctance of banks to provide loans to small businesses. This reluctance was caused by the government policy that removed the interest rate subsidy, which led the financial institutions to provide less finance to small businesses. In addition, the author also found that the high requirements for collateral and improper project planning also resulted in the lack of access to finance for small businesses in Bangladesh.

Hassan et al. (2010) described the various financial challenges of micro entrepreneurs in Malaysia and observed that most of the micro entrepreneurs experienced extreme financial difficulties in the initial stage of their business. Only 13% of the micro entrepreneurs received financial support from government-operated programs. In addition, they also found that the rigidity of the procedures for accessing financial programs also prevented the smooth success of the programs.



Subramaniam (2010) investigated the challenges faced by the youth in microenterprises in Malaysia. She collected primary data through personal interviews conducted with young people who operated microenterprises. The results revealed that lack of access to external financing was a major factor that led them to rely more on internal financing.

In another study on Thailand, Punyasvatsut (2011) illustrated that most of the financial sources of small businesses came from personal funds, such as borrowing from relatives and friends, and only 30% was obtained from external sources such as banks. In addition, the entrepreneurs exhibit overdrafts as a backdoor means of fulfilling the working capital requirement of the bank for obtaining loans. It is estimated that only 40% of small Thai firms received formal credit while the rest were excluded from formal financial services. The author mentioned a number of obstacles related to financing that arose from both entrepreneurs and financial institutions. Regarding the financial institutions, SME entrepreneurs claimed to have inadequate information, insufficient advice from financial institutions, as well as complex and cumbersome loan application processes, whereas the entrepreneurs were observed to have constraints related to collateral, business experience, business plans, loan history, and transaction costs that prevented them from accessing finance.

Kyophilavong (2011) examined the financial constraints of small businesses in the Lao People's Democratic Republic and identified that all entrepreneurs of SMEs more or less experienced critical problems in accessing required finance at the early stage of their businesses. The author explored a gap between small businesses with no financial constraints and those with financial constraints and showed that the latter performed relatively poorly. It is notable that the domestic firms with sound capital and established business enjoyed higher access to finance. Moreover, about 20% of the 198 small businesses could access finance while roughly 80% of the entrepreneurs were dissatisfied with the existing terms and conditions of the financial institutions, and most of them had common complaints about the institutions' collateral conditions, lengthy and complex application processes, and insufficient information.

Ung and Hay (2011) focused on the various financial challenges faced by small businesses in Cambodia. They revealed that based on the survey of 180 randomly selected firms consisting of 156 micro and 24 small enterprises, the businesses with larger sales and higher profits had easy access finance while the small entrepreneurs were kept mostly out of the financing mechanism because of nonfulfillment of collateral conditions. Furthermore, the authors identified a few other negative factors responsible for financial inaccessibility, such as loan amount, interest rate, and repayment periods. It was suggested that unbiased lending principles of financial institutions can support the expansion of micro-sized firms in Cambodia.

Thanh et al. (2011) investigated the factors responsible for slow development of small businesses in Viet Nam, especially in the textiles and garment, electrical and electronics, and automotive components manufacturing industries. The authors found that capital inadequacy was one of the major obstacles to the development of small businesses. Similar to many other studies as outlined above, the authors also indicated a number of constraints related to accessing finance by the entrepreneurs of small businesses such as collateral, age of the enterprise, businesses experience, small size, and production networks.

Machmud and Huda (2011) explored the important characteristics and financial challenges of small businesses in Indonesia and claimed that nearly 56% of small business owners have external financial access, whereas the rest of them rely on internal financial sources such as their own savings and retained earnings. They claimed a major challenge for their entrepreneurial development was the rising costs

of business. The authors also identified three key causes of unsuccessful loan applications which were related to: (i) business plan; (ii) sales, revenue, and cash-flows; and (iii) credit history.

Aldaba (2010) highlighted the difficulties faced by small businesses in accessing finance in the Philippines. The author surveyed a total of 97 firms in the textiles, garments, electrical and electronics, automotive, and food manufacturing industries. The author found that financial challenges were one of the most important ones that restricted the growth of small businesses. In most cases, small business entrepreneurs manage their start-up capital by using internal sources, and the rest of the capital comes from the banks.

In his study, Tambunan (2011) critically examined the constraints of small businesses in Indonesia. By using secondary data of small businesses, the author pointed out that lack of financing is one of the top constraints, followed by lack of marketing, innovation, and skilled human capital resources. The study claimed that financial institutions were mainly responsible for the limited access to finance by small businesses. The author noticed that the weak financial market structure and lack of innovative financial products and competition among the financial institutions were the main causes of sluggish supply of capital to small businesses.

In their study, Hassan et al. (2011) argued that most of the micro enterprises in Malaysia were restricted from access to external financing because of no collateral and insufficient documents to support their loan applications. The authors also noted that the financial providers were reluctant to increase the initial loans due to the risk and uncertainty involved in business. Moreover, it was observed that financial institutions offered relatively smaller credit to micro or small farms, which actually failed to satisfy the real business needs.

Meza (2012) examined the financial barriers to financial assistance by micro enterprises in Malaysia and Cost Rica by conducting in-depth personal interviews with micro entrepreneurs. The author found that public banking institutions in both Malaysia and Costa Rica failed to provide sufficient financing without collateral needed to meet the financial requirement to run microenterprises. As a result of this, micro entrepreneurs most of the time depended on their own or informal sources of financing.

## **2.2 SME Policies in Malaysia**

The initiation of the National Economic Plan (1971) of Malaysia provided a platform for realizing the importance of SMEs, particularly in achieving the goal of poverty alleviation and social welfare by eliminating economic imbalances among ethnic groups. The NEP enabled the Bumiputera, Malaysians of indigenous Malay origin, to become involved in small businesses with the direct and indirect assistance of government-supported programs. A number of plans have been launched so far to support the development of country's SMEs, such as the Malaysia Industrial Plan and Small and Medium Corp (SME Corp.), operated under the Ministry of International Trade and Industry (MITI), etc. (Ziaul, Che, and Said 2009).

Due to the changing nature of the economic and business environment, the NEP was replaced by the National Development Policy (NDP) in 1992 (Menon 1999). The main goal of the new NDP was to reduce the ethnic differences through several government agencies and organizations. This attempt was made mainly to impart necessary skills in entrepreneurship, managerial capability, and technical know-how to the Bumiputra. In 1996, the Small and Medium Industries Development Corporation (SMIDEC) was established by the Ministry of International Trade and Industry (MITI) to upgrade

the SME sector to comply with the global market. To do so, a number of schemes were carried out, for instance, training to increase the capability and competitiveness of SMEs via easing financial accessibility, capacity building, market penetration, brand development, human capital development, technology and innovation enhancement, and advisory services.

Afterwards, a further initiative was taken by the government to uplift SMEs by creating the National SME Development Council (NSDC) in 2004, which marked a new chapter in the history of SME development in Malaysia. The main objective of the NSDC was to take various policies and strategies to develop SMEs, covering all sectors of the economy. It was aimed at making sound linkages among respective ministries, concerned agencies, and the private sector. The council used to provide many services in this regard related to financing, advising, restructuring, notifying, training and marketing, coordinating, creating complete SME databases, and lastly, monitoring the SMEs (SME Corp. 2017).

In 2009, SMIDEC was restructured and renamed as the Small and Medium Enterprise Corporation Malaysia (SME Corp. Malaysia). The SME Corporation used to provide all types of support, particularly sharing the latest information and advising services to the SME entrepreneurs through its One Referral Centre (ORC). This corporation has now become one of largest key contributors to the SME sector through its continuous support in making the industry innovative, resilient, and globally competitive.

SME Corp. Malaysia was also entrusted with developing and implementing the SME Master Plan 2012–2020, providing the policy direction for SME development in order to achieve high-income nation status by 2020. It is expected that this master plan will boost the growth of SMEs with joint cooperation between the public and private sectors. The government in its 2017 budget has given special attention to the SMEs and declared 2017 as the start-up and SME promotion year. A sum of RM70 million was allocated for the SME Master plan for the purpose of implementing the High Impact Programmes. In this budget, the government also announced a reduction in the corporate tax rate from 19% to 18% for the first RM500,000 for SMEs, and the relatively lower tax will be imposed on the increased revenue (Goh 2011). In the budget, RM350 million was allocated to assisting and supporting SMEs in accessing foreign markets, of which RM130 million was allocated for promotional purposes to be carried out by SME Corp. Malaysia and MIDA MATRADE, and RM200 million was allocated for financing the SMEs sector where the provision of insurance coverage up to RM1 billion was supported by the EXIM Bank. In addition to this financial support, a 2% rebate amounting to RM20 million was allocated for the scheme of “Syarikat Jaminan Pembiayaan Perniagaan” (SJPP).

In order to enhance the income of Bottom 40 (B40) households, RM290 was allocated to encourage the development of B40 entrepreneurs under various programs, such as the Agropreneur program (RM100 million), the eUsahawan and eRezeki programs under MDEC (RM100 million), and the Mobilepreneur Programme (RM30 million). In addition, a total of RM5,000 was distributed per taxi driver to buy new vehicles in cases where an individual taxi permit's given worth was RM60 million. Moreover, as a part of financial support to Bumiputera entrepreneurs, a total of RM1.4 billion was allocated through a number of government agencies, including Amanah Ikhtiar Malaysia (RM100 million), TERAJU (RM600 million), TEKUN (RM300 million), MARA (RM120 million), PUNB (RM200 million), and SME Bank (RM100 million). To create a balance among ethnic groups, the government also allocated a total RM200 million (to Indian entrepreneurs) and RM90 million (to Chinese entrepreneurs). Furthermore, a sum of RM2 billion was distributed to the women entrepreneurs via Women Career Comeback programs I-KeuNita and I-KIT (Ministry of Finance Malaysia 2017).

Apart from the SME scenario in Malaysia, the industry is becoming a significant contributor to Asian economies. According to an estimation, SMEs industry represented about 98% of all the enterprises that supported on average almost 66% of the total national labor force from 2007 to 2012 (Yoshino and Taghizadeh-Hesary 2016). The Association of Southeast Asian Nations (ASEAN) has created a number of associations to develop and spread the practice of SMEs, including the ASEAN SME Agencies Working Group (SMEWG) and SME Development (SAPSMED 2016–2025). It is expected that these associations will play a significant role in rapidly transforming the SEMs in the region by 2025. The goal will be achieved by initiating an appropriate policy and regulatory environment, providing financial support, encouraging innovation and adoption of modern technology, access to local and international markets, and promoting programs to develop entrepreneurial skills and human capital (SME Annual Report 2017).

The ASEAN SME Agencies Working Group (SMEWG) took a number of steps, including the Digital Economy Action Plan and Work Agenda (DEAP), and it organized various workshops to ensure Internet accessibility among entrepreneurs so that they could share information and get solutions to the many challenges of doing business. It also enabled entrepreneurs to learn from the best practices of SMEs and raised the awareness level on integrating businesses into regional and global markets. In this regard, an initiative was taken by APEC in 2016 called “New Era of Growth for APEC SMEs through Online-to-Offline (O2O) Business Models”, with the joint cooperation of eBay, Amazon, and Alibaba to expand the opportunities of SME entrepreneurs in the global markets.

## **2.3 SME Policies in Indonesia**

Indonesia has the advantage of having the largest manpower in ASEAN countries, with a total of 258.7 million people (ASEC 2016). It is endowed with abundant natural resources and substantial amounts of hidden metals and minerals, including gold, nickel, tin, copper, coal, oil, and gas reserves. The country is also one of the major suppliers of agricultural commodities such as palm oil, rubber, and grains. It is located in a very strategic position where it has one of the world’s busiest shipping routes. For instance, almost 40% of the annual total global sea trading takes place by passing through this channel. The country has the largest economy in the ASEAN and the seventh largest GDP (PPP) globally, with \$1,042.17 billion in 2018 (The World Bank 2019).

In Indonesia, there are about 57.9 million enterprises, of which 99% (57.2 million) are considered micro enterprises, and these micro enterprises created 89% of total employment and contributed to 10% of the country’s GDP in 2016. In addition to these estimates, there are other forms of enterprises operating across the country, i.e., small enterprises (0.645 million), medium-sized enterprises (106), and large enterprises (5,066). Despite its large population, with a relatively higher micro, small, and medium enterprise (MSME) density (about 22.1), Indonesia had a relatively lower number of large enterprises in comparison with Thailand (7,156) and Malaysia (13,813) in 2016 (OECD 2018).

SME entrepreneurs in Indonesia are mostly agro-based, and it would be interesting to observe the actual numbers of micro, small, and medium enterprises (MSME) by excluding the agro-based sector. According to Badan Pusat Statistics (BPS) estimates, MSMEs contribute to 61% of GDP and create 87.8% of total employment, whereas micro enterprises alone contribute to 10% of GDP and 58.4% to employment (BPS statistics, 2015). The composition of MSMEs is mostly wholesale and retail businesses (46% of

non-agro based), followed by the manufacturing sector (17%) and hospitality and catering (17%).

Indonesia had to take a welfare-based approach in formulating SME policy to place more emphasis on equity than efficiency. This is because the country had to emerge from its past colonial sentiment to adopt modern nationalist and socialist views toward economic development after independence in 1949. Many other revolutionary policies were taken to rebuild the national economy mainly based on state-owned capital (state-owned enterprises), and the SME sector was promoted by including the ethnic underprivileged and economically disadvantaged segments of the population (pribumi).

Suharto during his tenure as the president of Indonesia has initiated many approaches to reform the economy, popularly known as “Suharto’s New Order reforms of 1966.” This reform also included the development of the SME sector under Indonesia’s Competition Law (Article 50). By virtue of the law, some protective polices enabled entrepreneurs of small-scale enterprises to sustain market competition. Another notable outcome of this law was that all large and medium enterprises were required to create partnerships with micro and small enterprises in order to obtain government support. The present financing program of MSME (e.g., subsidy and mandatory lending schemes) was originally initiated and successfully implemented under the regime of Suharto. Kredit Usaha Rakyat (KUR), one of the largest and most popular programs established to cater to SMEs’ financial needs, allocated approximately \$1.3 billion during the period 2007–2014, and it also distributed MSME credit worth about \$13.4 billion. The country achieved dimension score 3 out of 4.58, which indicated that financial inclusion was still a long way from achievement. It also signified the importance of further strengthening the existing legal and institutional framework in order to extend the financial services through proper monitoring and evaluation of government and nongovernment schemes.

Bank Rakyat Indonesia (BRI), one of the largest financial contributors to MSME, constituted about 63% of all its formal credit in 2014. Due to its early establishment and wider network in terms of branches across the country and particularly in rural areas, BRI used to dominate the credit market. BRI is the largest recipient of Kredit Usaha Rakyat (KUR). In an estimation, BRI allocated credit that was 65% of the total KUR program during the period 2009–2014 (OECD 2018). According to the World bank report, the MSME loans constituted about 17% of total unsettled commercial bank loans in 2017. The country had launched two policy tools to expedite bank lending to MSMEs: i) expansion of KUR by repayment assurance and an interest rate subsidy component in 2015; and ii) a compulsory lending program in 2009 that directed commercial banks to disburse loans (20% of total loan portfolio) to MSME by 2018. KUR kept the provision of guarantees, previously covering 70%–80% of the disbursed amount, which was normally negotiated between the partner banks and the scheme, and an interest rate subsidy of 9%, which capped the interest rates backed by KUR loans (OECD 2018).

### **3. THE PHILOSOPHY OF ISLAMIC BANKING AND FINANCE**

Principles and practices of conventional banking and finance (based primarily on the Western worldview) may be inconsistent with the Islamic worldview, since the Islamic worldview is different from the Western one. The Islamic worldview is based on the Quran and Sunnah (practice of Prophet Muhammad [pbuh]). In addition, the philosophy of

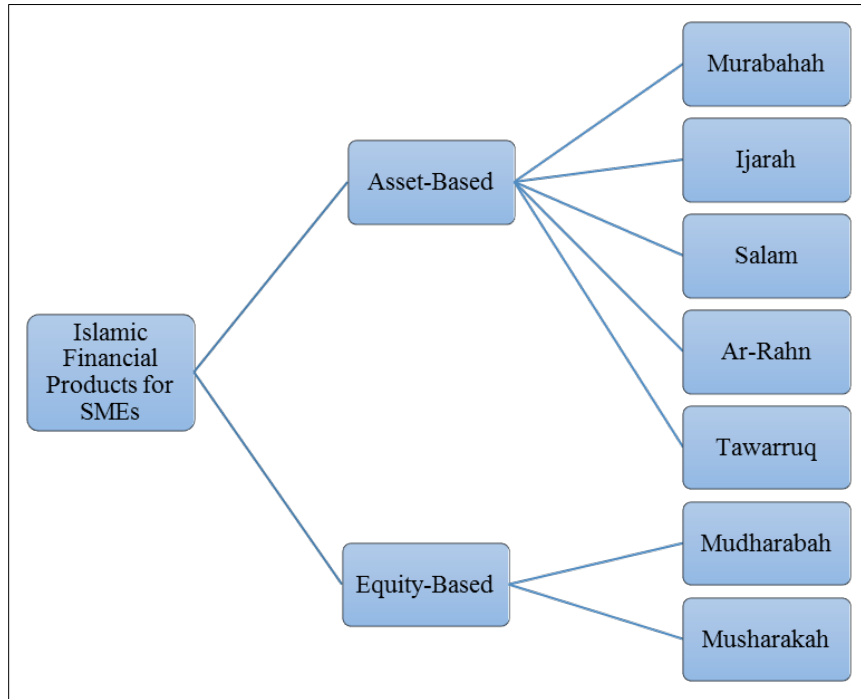
Islamic banking is in accordance with the Shariah (Islamic law/jurisprudence) (Haron and Nursufiza 2009). According to Shariah, Islamic banking and finance cannot deal in any transactions involving interest/riba (an increase stipulated or sought over the principal of a loan or debt). Further, they cannot deal in the transactions having an element of Gharar (uncertainty) or Maisir (gambling). Moreover, they cannot deal in any transaction that has a subject matter that is invalid (prohibited in the eyes of Islam). Islamic banks focus on generating returns through investment tools that are Shariah-compliant as well. Operating within the sphere of Shariah, the operations of Islamic banking are based on sharing the risks that may arise through trading and investment activities using contracts of various Islamic modes of financing. The prohibition of a risk-free return and permission of trading, as enshrined in Verse 2:275 of the Quran, makes the financial activities asset-backed in an Islamic set-up, with the ability to cause “value addition” (Haron and Nursufiza 2009). As a result, asset-based and equity-based contracts are promoted by Islamic finance as viable alternatives to conventional financing, which merely relies on an interest-based system. In addition, the philosophy of Islamic banking and finance emphasizes on ethical, social and dimensions of financial transactions which enhance equity and fairness for general benefit of the society.

## **4. THE PRODUCTS OF ISLAMIC BANKING AND FINANCE FOR SMALL BUSINESS**

The Islamic financing options for small businesses can be divided into two categories, namely (i) asset-based financing, and (ii) equity-based financing. These financing categories have been part and parcel of boosting the financial inclusion of small businesses and attracting prospective capital providers and sources. Asset-based financing instruments consist of Murabahah, Ijarah, Salam, Ar-Rahn, and Tawaruq. Meanwhile, equity-based financing instruments include Mudharabah, and Musharakah. Each of the instruments is illustrated graphically and briefly explained below.

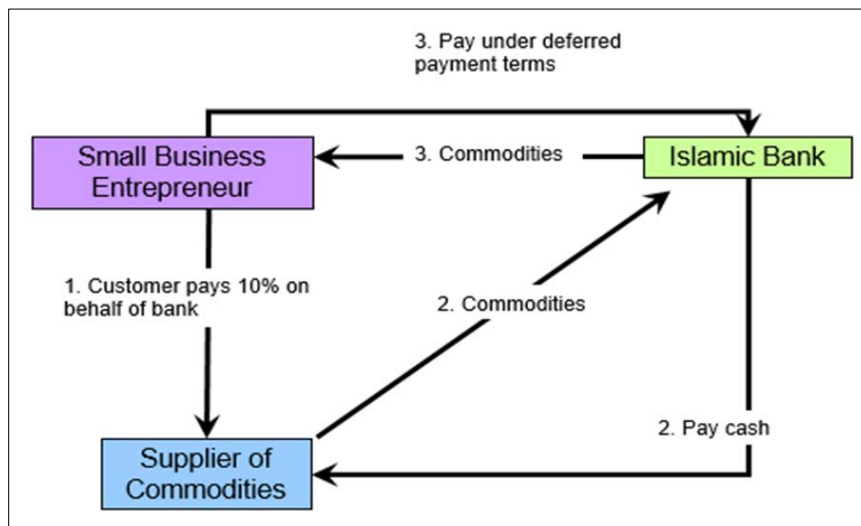
### **4.1 Murabahah Financing**

Murabahah is one of the most-applied forms of Islamic financial contracts made between a financing institution and a client whereby the financier buys assets (usually at a lower price) specified and required by the client and then sells those assets (usually at a higher price) to a client; the profit margin is the difference between the buying and selling prices of the assets that are paid by the clients mostly on an installment basis. Among the benefits of this product are (i) a fixed rate of financing throughout the period of financing; (ii) the disclosure of the price and mark-up; (iii) its use for short-term financing; and (iv) getting rid of collateral requirements.



Source: Author's illustration.

**Figure 1: Modus Operandi of Murabahah Financing**

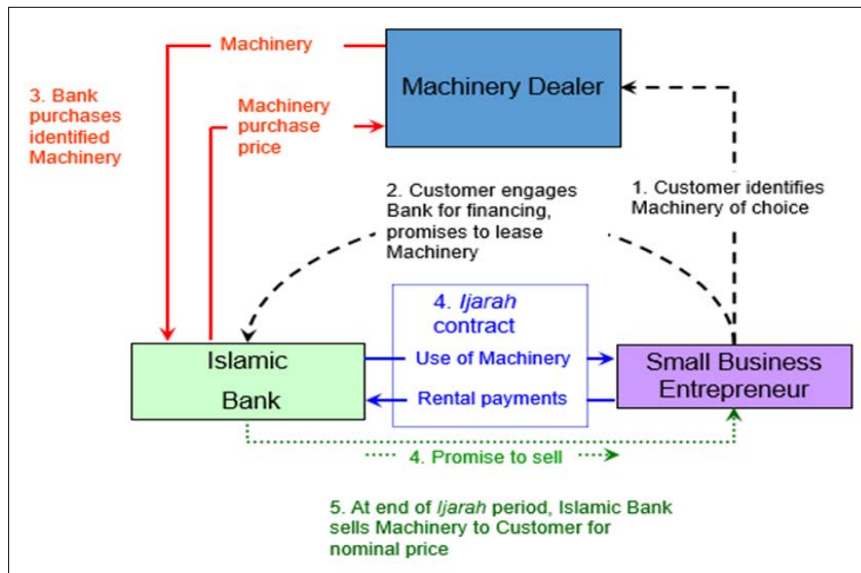


Source: Author's illustration.

## 4.2 Ijarah (Ijarah Muntahiya Bi Tamleek Financing)

Ijarah Muntahia Bi Tamleek (IMBT) is a form of leasing contract. This is a special leasing contract whereby legal title of a leased asset is transferred to the lessee after the expiry of the leasing period. At the end, as a lessor, the financial institution or the bank hands over the ownership of the leased asset to the lessee, the client. The lesser here is entitled to claim all accumulated rental income, including the profit. The IMBT is adopted in several arrangements where the asset's ownership can be transferred, for example, the sale and transfer of the equity claim (from lessor to lessee).

**Figure 2: Modus Operandi of Ijarah Muntahiya Bi Tamleek Financing**

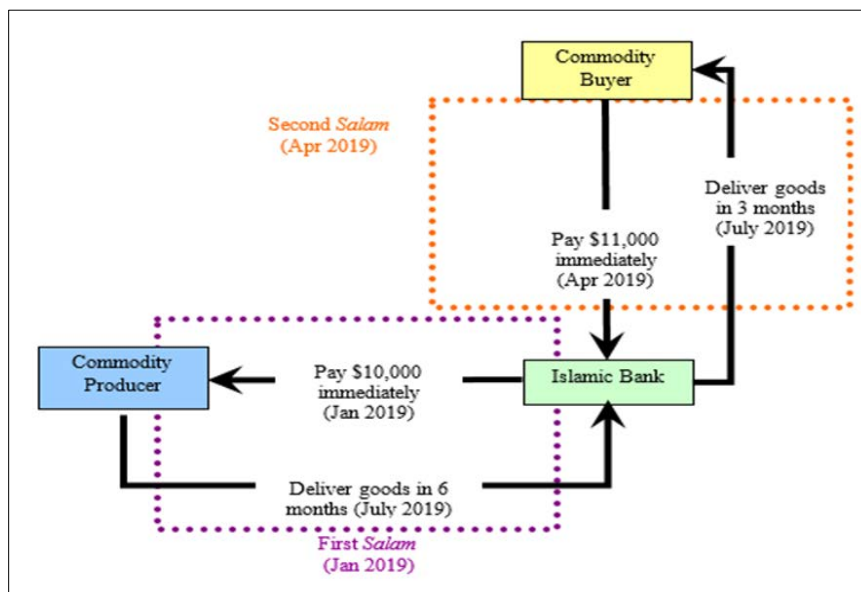


Source: Author's illustration.

### 4.3 Salam (Parallel Salam Financing)

*Salam* is another form of Islamic financial forward sale contract whereby the payment of the goods or commodities is paid in advance (present) (mostly agricultural goods) and the delivery takes place on the stipulated date (future). This kind of contract is beneficial for small agro-businesses that need working capital. Salam provides several benefits for small businesses: (i) provision of Shariah-compliant working capital, (ii) usefulness for short-term financing, and (iii) beneficial for the agricultural industry.

**Figure 3: Modus Operandi of Salam (Parallel Salam Financing)**



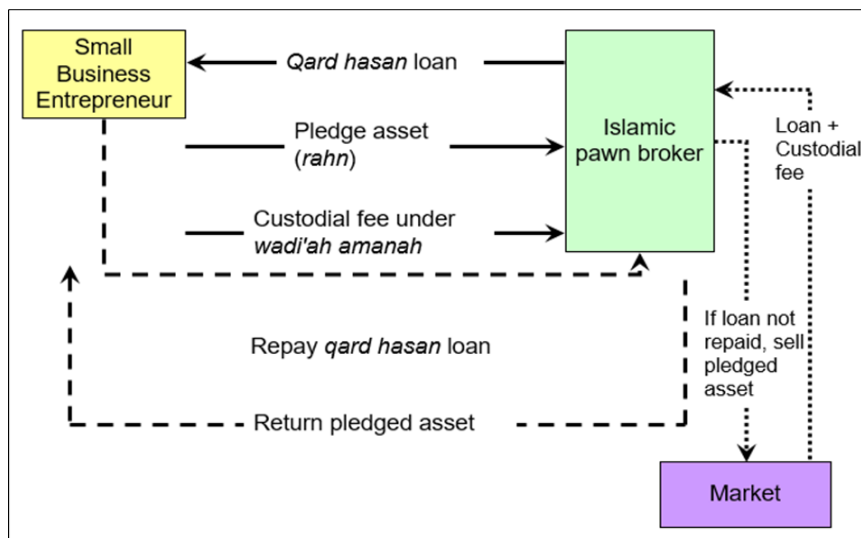
Source: Author's illustration.



### 4.4 Ar Rahn

Ar-Rahnu is one type of short-term credit or loan (termed as Qardh in Arabic). The client will pledge gold or other valuable metals accepted as security, which acts as the collateral for the loan. This special kind of contract is based on the principle of Islamic law (Shariah) under savings with guarantee or safe-keeping (Rahn and Wadi'ah Yad Dhamanah). Ar Rahn provides benefits such as (i) no interest, (ii) short-term financing for small businesses, and (iii) surpluses to be returned after auction in the case of default.

**Figure 4: Modus Operandi of Ar Rahn**



Source: Author's illustration.

### 4.5 Tawarruq Financing (organized Tawarruq)

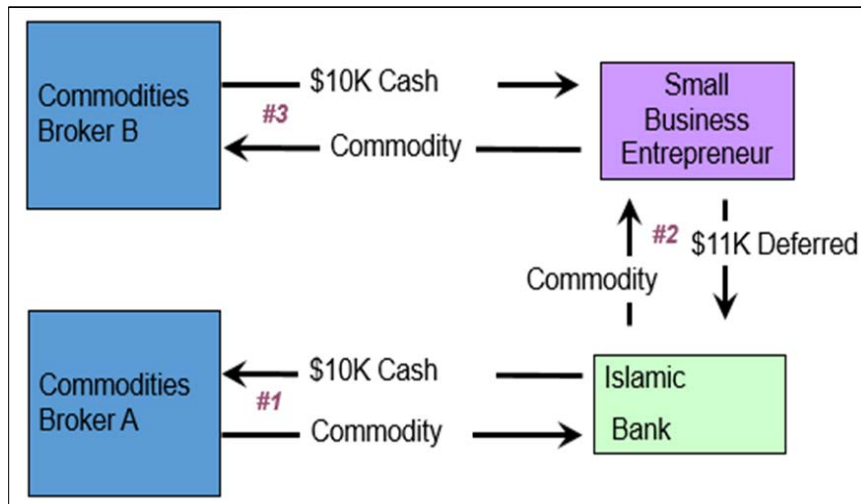
Tawarruq is another Islamic financing mode in which a series of sales contracts are involved in the entire transaction process. Here, a client buys a commodity from a seller (on a deferred basis) and afterwards sells the commodity to a third party (not the original seller and on a cash basis), to obtain liquidity. This instrument provides benefits in terms of (i) liquidity management, (ii) suitability for meeting the needs of small business' working capital, and (iii) no collateral requirement.

### 4.6 Mudharabah Financing

Mudharabah is one of the ideal and most recommended Islamic financial modes of operations in which the business or project is managed/organized/run based on partnership. One party provides capital (called the capital provider or Rab-ul-Mal) and the second party manages the business (called the entrepreneur/fund manager or Mudarib). The profits (if any) are distributed based on the pre-agreed ratio, and the losses (if any) are borne solely by the capital provider except in the case where the fund manager has fulfilled all the responsibilities bestowed on him/her. If there is negligence in managing the funds or business, the fund manager or Mudarib is also liable for the loss amounts. The Mudharabah contract is very appropriate for small businesses because there is (i) profit sharing; (ii) the entrepreneur does not have

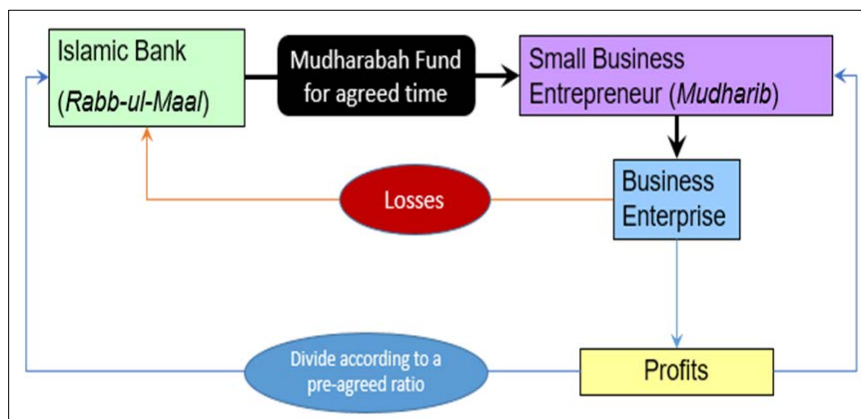
to contribute capital to the joint venture; and (iii) there is the ability to negotiate the profit ratio.

**Figure 5: Modus Operandi of Tawarruq Financing**



Source: Author's illustration.

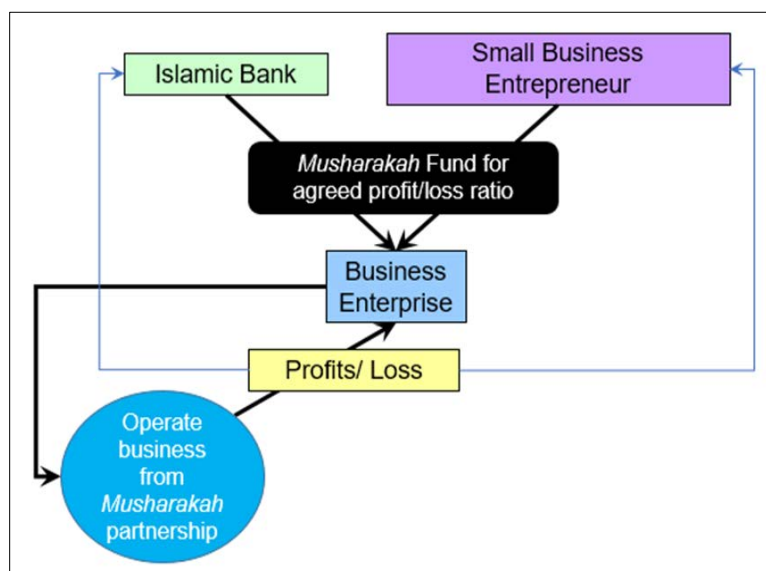
**Figure 6: Modus Operandi of Mudharabah Financing**



Source: Author's illustration.

## 4.7 Musharakah Financing

Musharakah is another ideal Islamic financial contract whereby two or more parties are involved, all of the parties provide capital to a joint business or venture, they share the profits based on pre-agreed ratios, and losses (if any) are borne by all the parties proportionate to their capital contribution. The benefits of this particular instrument are (i) profit and loss sharing, and (ii) ability to receive the highest percentage of profits.

**Figure 7: Modus Operandi of Musharakah Financing**

Source: Author's illustration.

## 5. MOBILIZATION OF ISLAMIC BANKING AND FINANCE TOWARDS SMES IN MALAYSIA AND INDONESIA

The RAM Rating (2019) revealed that Islamic banks in Malaysia maintain strong growth as Islamic banks continue to expand at a much faster pace than their conventional counterparts with 11% in 2018 and comprising about 32% of the overall system's financing. Islamic banks are seen as a robust platform for assisting SMEs in accessing financing as BNM statistics in early 2019 indicated that Islamic banks in Malaysia held total assets amounting to RM682,048.4 million.

Recent research by the Association of Islamic Banking and Financial Institutions Malaysia (AIBIM) indicate that about 10,000 SMEs received more than 10 billion in funding (Kamel, 2019). A key indicator of the BNM reports is that RM4,716.2 million of total financing was disbursed as of November 2019 solely by Islamic banks for several sectors (Bank Negara Malaysia 2019). The AIBIM asserts that Islamic banks granted RM20 billion worth of financing access to SMEs (Kamel 2019). However, despite that, SMEs are seen as not fully utilizing various solutions provided by Islamic banks because a lack of awareness persists among SME entrepreneurs regarding the financing options obtainable.

A number of financing activities were traced to supporting the prodigious growth of the SME industry. Bank Negara Malaysia (2019) data depicted a steady growth of SME financing by type of Islamic product. For instance, Bai Bithaman Ajil's (BBA) products totaled RM64,488.9 million, Ijarah RM9,910.7 million, Ijarah Thumma Al-Bai RM72,423.0 million, Murabahah RM208,532.9 million, Musyarakah RM50,904.2 million, Mudharabah RM57 million, Istisna' RM2,059.8 million and others RM103,284.0 million. Table 1 shows the total financing and increments in total financing disbursed by Islamic banks in support of SMEs' gradual advancement.

**Table1: Total Financing**

| <b>Year</b> | <b>Total Financing (in RM million)</b> | <b>Increment in Percentage</b> |
|-------------|--|--------------------------------|
| 2014        | 335,385.1                              | –                              |
| 2015        | 393,956.9                              | 17.5%                          |
| 2016        | 436,708.4                              | 10.9%                          |
| 2017        | 481,247.3                              | 10.2%                          |
| 2018        | 511,660.5                              | 6.3%                           |

These financing products are found to be used for a number of productive purposes such as purchase of securities (RM316.2 million), purchase of transport vehicles (RM3,112.5 million), purchase of landed property (RM27,824.2 million), purchase of fixed assets other than land and buildings (RM1,189.1 million), personal uses, credit cards, purchase of consumer durable goods, and construction (RM6,280.8 million), mergers and acquisitions (RM22.8 million), working capital (RM38,019.5 million), and other purposes (RM3,820.0 million). Therefore, it is evident that a number of sectors are enormously aided through the financing facilities provided by Islamic banking and finance institutions to SMEs in Malaysia. For instance, the Bank Negara Malaysia (2019) reported these sectors included agriculture, mining and quarrying, manufacturing (including agro-based), electricity, gas and water supply, wholesale and retail trade, restaurants and hotels, transport, storage and communication, finance, insurance, real estate and business activities, education, health and others, household sector, and other sectors.

Meanwhile, Islamic banks in Indonesia were established in 1991 and pioneered by Bank Muallamat. According to Otoritas Jasa Keuangan (OJK) data on June 2018, there were 13 Shariah commercial banks, 21 Shariah business units, and 168 Shariah rural banks. The largest providers of Islamic microfinance in Indonesia are 150 Islamic rural banks (BPRS) and more than 3,000 BMTs (Baitul Maal wat Tamwils), which is a network of Islamic financial cooperatives. Bank Rakyat Indonesia Syariah (BRI Syariah) is an important player. It is a subsidiary of Indonesia's largest microfinance institution, Bank Rakyat Indonesia (BRI).

In the last five years, Indonesia's Shariah banks have seen assets grow by 38% compared to 15% for conventional banks (Bank Indonesia). The sector is currently dominated by two leading players, namely Bank Mandiri Syariah and Bank Muallamat that account for 50% of total Shariah financing between them (Global Business Guide-Indonesia 2011).

The development of Islamic banks in Indonesia started two decades ago, and the conventional banks still covered almost 70% of the industry at that time. However, the trend of subsidiaries and the promotion of rational behavior in this industry will trigger more Shariah-based banking in the near future.

In terms of the financing contracts, more than 80% of the financing at the full-fledged Islamic banks in the country is based on three contract types—Murabahah (54%), Musharakah (34%) and Mudharabah (6%), adhering more closely to the classical Islamic model of economics than possibly any other country.

Figure 8: Usage of Islamic Finance Product

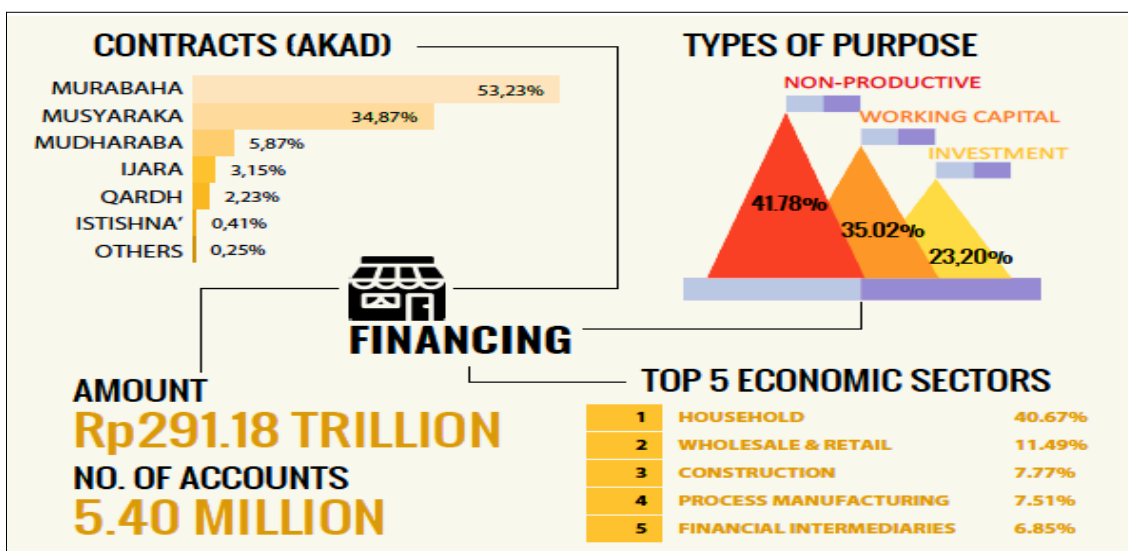


Figure 8 shows that most of the financing of Islamic banks is for the household sector. The financial intermediaries are the best indicator of usage of Islamic financial products in the economic sectors. Thus, real usage of the microenterprises in Indonesia is still the lowest, and this may be influenced by various factors such as the scale of borrowing within the five economic sectors. Most of the time, the usage of SMEs is less compared to the above five sectors. In addition, these indicators also explain that expansion and demand for Islamic finance products in Indonesia is significant in the top five economic sectors.

Indonesia appears to be a natural growing market for Shariah-compliant banking services, given the size of the Muslim majority population; however, the character of the market is starkly different from that of neighboring Malaysia or the Middle East. The majority of Indonesia’s potential Islamic banking customers fall under the “rational market” as opposed to that of the “spiritual market.” Islamic banking products are therefore pitted against their conventional counterparts and judged on their commercial merits as opposed to being chosen on the basis of faith.

## 6. POTENTIAL OF ISLAMIC BANKING AND FINANCE FOR FOSTERING TECH START-UPS

Islamic banking and finance are widely known as banking systems focusing their operations and activities purely based on Shariah rules and regulations. Since 1960, the progression of Islamic banking and finance has been undeniably significant and continues to growth at peak levels and to compete against conventional counterparts who have been in existence for the last 420 years.

One unique feature of Islamic banking and finance is the profit-and-loss scheme whereby all assets and liabilities are integrated, and with this arrangement, Islamic banking and finance are able to lend on a longer-term basis for projects or start-up businesses that have higher or lower return characteristics. This will also promote economic well-being and growth. The most common types of financing used by Islamic banking and finance to support long-term businesses are Mudharabah (profit sharing) and Musharakah (joint venture). Existing literature highlighted that in view of the preference for profit/loss

sharing scheme over other trading modes, Murabahah can also play a role as financing facility, given its permissibility. In addition, under the Murabahah scheme, the buy-and-sell financing, given equal instalments, is flexible, easier to understand, and simple to monitor (Suzuki and Uddin 2016).

Kessler, Allocca, and Rahman (2017) mentioned that SMEs or start-ups encourage entrepreneurship and obviously will enhance economic expansion under the Islamic banking and finance setting. The products such as Murabahah, Mudharabah, and Qardhul Hasan under IB seem to be most suited for start-up businesses and other equivalent businesses. Interestingly, Qardhul Hasan, Murabahah, and Ijarah financing are flexible in usage and easy to implement in determining capital needs (Qardhul Hasan), equipment and assets (Murabahah), and leasing (Ijarah) for SMEs (World Bank-IDB 2015; Dhumale and Sapcanin 1998). Thus, plenty of financial schemes can be suitable for start-up businesses, but they are also subject to the risk profiles of those particular businesses. For example, in the case of SMEs, the study by Hussein, Noordin, and Taherdoost (2015) shows that 95% of all financing of SMEs in 2003 were approved based on Ijarah, Bay Bithaman Ajil, and Murabahah financing schemes.

Looking at the offering patterns of Islamic banking and finance facility, start-up businesses can utilize this facility, which will be useful for accelerating their businesses. The availability of these types of financing to various businesses, including start-ups, have been recognized by various parties, such as policy makers in many countries, as it is consistent with Shariah principles. The Organization of Islamic Cooperation (OIC) emphasizes the importance of the development of SMEs and start-up businesses via active usage of Islamic financial products linked to real economic activity. Thus, it allowed various businesses in member countries to tap into the rapidly growing pool of Shariah-compliant funds. Nevertheless, the General Council for Islamic Banks and Financial Institutions, together with the Islamic Development Bank (IDB), keep finding the best innovative ways of financing to further accelerate the growth of businesses worldwide and promote the role of Islamic finance, especially the social finance aspect.

## **7. ISLAMIC BANKING AND FINANCE'S RISK MANAGEMENT OF SMES**

The partnership-based, long-term Islamic financing products have higher risks compared to the debt-based, short-term products. Islamic financial institutions need to practice both, depending on the demand and the context. As discussed earlier, the principle of risk-sharing is the key element of equity or partnership contracts. In order to use these financial products, it is necessary to have some moral or ethical values, including justice, trust, truth, honesty, and responsibility.

Islamic financial institutions cannot claim any gain or profit if there is no risk. Thus, it is up to institutions to bear various risks such as default risks, which are capital risks, market risks, and economic risks. The institution cannot shift the risk to the partner or make a risk-free contract and gain a fixed rate of income as profit. To avoid this, the institution makes sufficient effort to minimize the risk factors involved in any contract that is allowed in Islam.

According to the Islamic principle of financing, the risk should be shared by the capital providers and the borrowers, and it does not allow shifting the risk solely to one party. It should be borne in mind that the goal and motivation of Islamic finance is the creation of wealth and development of business. These common goals help increase the level of cooperation and decrease the flow of asymmetrical information, adverse selections,

moral hazards, and speculations among the parties involved in Islamic financial contracts. The practice of moral values particularly by the borrowers or entrepreneurs can mitigate various risks involved in the transactions, and in many cases, the collateral requirements and credit assessment can be less important. However, this does not allow Islamic financial institutions to be involved in any financial contracts without proper evaluation, monitoring, and supervising of the businesses or projects, particularly in the case of SMEs.

## **8. CHALLENGES OF IMPLEMENTATION OF ISLAMIC FINANCE FOR SMALL BUSINESSES**

Some of the challenges involving in Islamic finance implementation for small business are as follows:

### **(i) Product Offerings**

The Islamic financial products offered to small businesses are skewed more toward debt financing such as Murabahah. Although there are other products such as Musharakah, Mudharabah, and Ijarah, Murabahah is more suitable for specific financing purposes, and these products come with better profit and loss sharing. Thus, there is no diversity in offering different financial products to support small businesses' financial needs. There is a need to move towards equity-based financing instead of just relying on debt-based financing.

### **(ii) Regulatory Framework**

One of the crucial challenges for Islamic finance, regardless of whether it is for small businesses or other platforms, is the lack of a regulatory framework for financial products. Looking at conventional financing, the regulation standards are more harmonized and standardized, which makes their products more marketable and easier to follow. In Islamic finance, the products are less standardized since there are no approved standards per se for Islamic finance. Most of the Islamic finance products follow the conventional banking rules and regulations.

### **(iii) Transaction Costs and Non-movable Collateral**

As far as Islamic finance for small business is concerned, the transaction costs and taxes involved are relatively higher compared to their conventional counterparts in financing. Possible reasons for this may be the Shariah verification processes and complicated taxation guidelines. Furthermore, small businesses generally facing the problem of non-movable collateral cause the Islamic banks to be reluctant to finance small businesses in general. Thus, a strong legal standard is needed in order to allow small businesses to use utilize their movable tangible assets.

### **(iv) Knowledge and Information**

The knowledge and availability of Islamic finance products to entrepreneurs, especially at the start-up level, is still at a low level. This may be due to the limited number of Islamic finance products offered, and this industry is still at the beginning stage, compared to conventional banks. The Muslim majority countries such Malaysia, Indonesia, and others are moving toward full-fledged Islamic finance institutions, and this will lead to a better Islamic finance eco-system.

### **(v) Smart Collaboration**

Currently, the government and private sectors that offer Islamic finance products to small businesses are executing their roles individually. Smart collaboration such as shared capital, risk, training, and other responsibilities will attract more stakeholders, such as investors, to participate in the SMEs' investments as capital providers.

## **9. CONCLUSION AND RECOMMENDATIONS**

To sum up, small businesses are playing a vital part in economies as they create employment and contribute to the national income. However, this sector faces many challenges, particularly in accessing financial services in many countries, including Malaysia and Indonesia. This research has compiled the findings of a number of empirical studies that can be viewed from the financier's as well as the entrepreneur's perspectives. It has been observed that the financier is quite reluctant to provide finance to the entrepreneurs of small businesses. The main causes for most of the loan applications of entrepreneurs to be denied are their early stage of business establishment and lack of proper business experience, no collateral security, higher transaction costs, improper business planning, small size of loans, limited or lower production networks, lower sales, revenue, and cash-flows, and bad credit history. On the other hand, the entrepreneurs of small businesses criticized the financiers because of their rigid terms and conditions of loan approval. In addition, there are many other objections regarding the financiers that are related to inadequate information, insufficient advice, collateral requirements, transaction costs, loan amounts, interest rate and repayment period, loan maturity, lending processes, etc. Apart from highlighting these financing challenges, this research also discussed the government policies and programs of small businesses in Malaysia and Indonesia for the development of the industry. As can be realized from the discussion, these programs are not fully satisfying the financial needs of the small businesses.

The SME sector has many challenges, and one of the most important ones is the lack of required financing either to start up or to expand the existing enterprises. In this paper, we have presented a number of Islamic financial products such as Mudharabah, Musharakah, Murabaha, Ijarah, and Salam which can be adopted to meet the financial needs of the entrepreneurs. Among these products, there are some short-term in nature, i.e., Murabaha, which is particularly appropriate for financing day-to-day business activities and for satisfying the requirement of working capital which has higher risks than some of the long-term products, i.e., Mudharabah, Musharakah, Ijarah, and Salam, which are most appropriate for the economic viability of the businesses. Ideally, Islamic financial institutions should be focusing more on non-borrowing and long-term Islamic products or contracts to finance the long-term projects. As a possible solution for those challenges, the present research presents a few innovative Islamic financing modes, i.e., Mudharabah, Musharakah, Murabahah, Ijarah, and Salam.

Islamic financial products can be better alternatives or substitutes for conventional financial contracts, but they are not complementary to each other. This is because of the underlying fundamental principle involved in Islamic financial contracts that is guided by Islamic law or Shariah. The key difference between these two financial systems is the practice of interest or *riba*, uncertainty (*Gharar*), gambling, and speculation, which are not accepted under any condition by the Islamic financial system. In addition, the current practice of conventional financing in most of the cases is not based on partnerships with profit-and-loss sharing principles.



In real situations, there are many uncertainties that make businesses either profitable or failures. An entrepreneur who starts a new enterprise can face many business uncertainties. The entrepreneur can share the risks of conducting business with an Islamic financial institution as the partner. In this case, the institution can create a risk-sharing investment account on its liability side based on Mudharabah or Musharakah, whereas on its assets side, there could be the underlying contract with various Islamic finance products. Along with this, Islamic financial institutions, including banks, can get necessary support from government and its policymakers to fruitfully use equity-based financing contracts to better serve the SME sector.

The present research recommends that a successful implementation of the innovative Islamic financing mode of operations can not only mitigate the existing financial challenges of small businesses, but it can also bring solutions to varieties of problems faced by the financiers in financing to small businesses. Further research can be conducted on the suitability of each of the financing modes in different contexts, i.e., the nature of project or business, type of sector (agriculture or industry), market condition, and infrastructural and technological capacity. It is also hoped that after the successful assessment of all the possible factors, selecting the most appropriate Islamic financial modes can elevate the small business sector not only in Malaysia and Indonesia but also in some other parts of the world and thus contribute to economic growth and social welfare.

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