Entrepreneurship and Islamic banking: What Islamic finance can add to M&SMEs finance?

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Abstract

Since three decades, financial reports are confirming that Islamic finance is a booming industry, with a constant growth rate varies between 10 to 15%, with assets currently estimated to worth $1.7 trillion. Moreover, Sharia-compliant advisory boards within Islamic institutions have developed products and services that resemble conventional banking products, replacing interest rate payments and discounting with fees and contingent payment structures. In addition, leasing-like products are becoming popular among Islamic banks, as they are directly linked to real-sector transactions. On other hand, entrepreneurship and entrepreneurial activities which are currently booming seem to benefit largely from such innovative financial products and services. This paper discusses Islamic banking products and interprets them in the context of entrepreneurs and SME's needs. Comparing conventional and Islamic banks' products and characteristics, the author tried to discuss the main values Islamic finance can add to the convential M&SMEs finance. Current experience on the ground suggests that support measures to M&SME Islamic banking need to be flexible to fulfill the markets' needs. While the target groups of services provided to M&SME need to be sufficiently broad in order to provide efficient support, the product range also has to be sufficiently wide in order to meet the target groups' needs.

Introduction

Islamic finance has become a mainstream funding source for governments and companies, with both Muslim and non-Muslim societies. During the 2014 annual meeting of the World Bank group, it was announced that the next two years may see Islamic banks and financial institutions investing more than $1.7 trillion in infrastructure as well as small and midsize enterprises (Molly Anders 2014, 4). Countries like Britain and South Africa, for example issued Islamic Sukuk in 2014[2]. More, the most iconic London's recent real estate landmarks, the Shard skyscraper, the Athletes' Village for the 2012 Olympic Games and Battersea Power Station, were funded by Islamic finance. Political reasons can also boot Islamic finance. Recent reports pointed out that Russian banks are developing their expertise in Islamic finance to help broaden funding sources for local firms, though Western sanctions over the Ukraine crisis.

On other hand, last three decades witness tremendous global economic diversification and growth triggered by Micro &Small and Medium-Sized Enterprises (M& SMEs), which support also poverty alleviation endeavors through employment generation process and have become the fastest growing exporters. Contrary to the nineties, large banks are now

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[2] Sukuk: Islamic type of bond representing the ownership the Sukuk holders in the underlying asset

targeting SMEs, the CEO of HSBC-UAE declared in 2015, that: " we have a strong commercial banking strategy aims to serve businesses ranging from the largest multinationals right through to international SMEs." In addition, microfinance programs are implemented everywhere with diversified targets and amount of money. Commercial banks, who were initially excluded from the domain of microfinance, reserved for NGO's and specialized MFI's, are now providing microcredit lines. A program launched by the Deutsche Bank Microcredit Development Fund, provides loans with the size varies between $25,000 to $250,000, with a tenor also varies from 1 to 5 years, however in Bangladesh, Grameen Bank targets poorest of poor with average loan size of $75.

Merging the growth of Islamic finance with the unprecedented entrepreneurship activities can bring vast potential for the world economy. Opportunities for Islamic SME Banking are gigantic worldwide. Only across countries in the MENA region, there is a cumulative SME funding potential opportunity of between $8.63 billion to $13.20 billion, Saudi Arabia, Pakistan and Egypt are the countries with the largest potential for SME financing Mouayed (2014).

The objective of the paper is to critically analyze the major opportunities of Islamic finance for funding M& SME and provide an efficient tool to face internal and external obstacles of M& SME banking. The article will discuss also the major Islamic finance products and their application in project finance.

Entrepreneurship & M&SMEs finance worlwide

M&SMEs are key players in any national strategies for job creation and social cohesion. They are crucial for tracing new paths to more sustainable and inclusive growth, thanks to their role in developing and diffusing innovation and new technologies. In order that M&SMEs can only fulfill their potential, they should be well developed, and obtaining the necessary finance to start and grow businesses is fundamental, Angel Gurria (2012). According to the SME Banking Knowledge Guide edited by the World Bank in 2010, there are 36-44M formal SMEs globally, between 65-70% of formal SMEs are in emerging markets. Microenterprises represent 54-68% of formal SMEs. The SME banking sector is best defined conceptually by its position between large corporations and mostly-informal microenterprises. The development of a commercial banking sector in many countries began with addressing the needs of large corporate clients. This model has historically consisted of managing very high-value transactions for a small number of low-risk clients. Outside of the commercial banking sector, another financial organization mainly called Micro Finance Institutions (MFIs) arose to offer working capital loans to very risky niche of microenterprises. These loans typically ranging from median amounts of $150 in South Asia to $1,600 in Eastern Europe, up to $3,000 in USA.

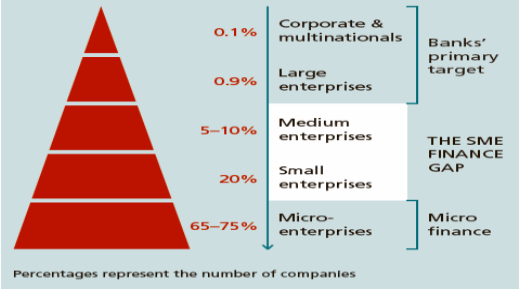

Figure 1 Typical business landscape in emerging economies (world bank-IFC, 2010).

M&SMEs are often consists of small organizational structure, family owned, and in most cases, the owner is the primary financial decision maker. For example, sole proprietorships alone make up at least 52% of SMEs in Egypt and

58% in Taiwan, Angel Gurria (2010). According to the world bank, 2010 guide, the SME sector can be projected as a pyramid, where the largest portion of firms falling into the smallest size category (microenterprises), followed by second largest portions of small and medium, and then the fewest firms falling into the large size category (corporates), see Figure 1.

Despite its role in the economic growth and distribution of wealth, M&SME's are suffering from multiple challenges and drawback everywhere. Main challenges prevent SMEs from operating efficiently and achieving economies of scale are inadequate access to finance and an unfavorable business environment. The concerns and challenges affecting the SME sector outweigh the factors that promote growth, thus preventing the sector from realizing its potential. According to a 2006 study (IFC-report 2014), 19% of SMEs were less than five years old, with just 4% surviving beyond 25 years. This is due to the large number of challenges that they face (internal and external), which affect them at various stages of development, thereby preventing them from evolving into self-sustaining enterprises. The study pointed out that among six major obstacles, financial constrains was ranked highest whereas the second highest ranked obstacles was "corruption", Syed Kamran et al (2013), see figure 2.

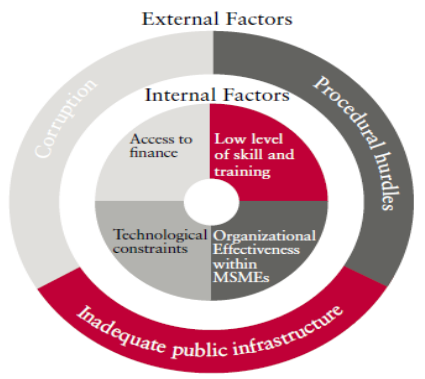

Figure 2 Internal and external constrains for SME Businesses in Pakistan, Syed et al (2013) IFC 2014

Brief background of ISLAMIC banking

Islamic banking refers to a system of banking that is consistent with the principles of the Sharia (Islamic rulings) and its practical application through the development of Islamic economics. A popular belief persists that Islamic banking is simply an interest-free financial structure. However, Islamic economics is a complete system of social and economic justice. It deals with property rights, the incentive system, the allocation of resources, economic freedom and decision-making and the proper role of government. Briefly, Islamic finance is a mode of finance governed by Sharia and its interpretation, in order to provide the ethical framework outlining the essence of economic well-being and the development of individuals in healthy society. This framework does not specifically apply to Islamic banks, but to life and business generally. Fairness, honesty, avoidance of hoarding and avoidance of tort are an integral part of Sharia law, but so are the prohibition of riba, gharar and maysir. The key principles of Islamic finance:

1. Returns to financiers should generally be linked to the profits of an enterprise and derived from the risk taken by the financier. Sharia views money as a means of exchange with no intrinsic value., that is behind the prohibition of Riba (or usury).
2. Sharia principles encourage financiers to become partners in the project to share the profits and risk in the business instead of being pure creditors; profits should not be assured and therefore fixed returns on investment should not be guaranteed.
3. Transactions should be free from speculation or gambling (*maisir*); to prevent speculation which may be considered gambling, specially where there is a possibility of total loss to one party.

4. The existence of uncertainty (gharar) in a contract is prohibited; any transactions where the price, time of delivery or the subject matter are not determined in advance may not be compliant with Sharia principles. Gharar does not apply to business risks such as investing in a company.
5. Investments relating to alcohol, drugs, gambling or other activities prohibited by *Sharia and* are not permitted.

Consequently, in combination with the aforementioned prohibitions, it is not possible for Islamic banks to provide financing in a similar manner to conventional banks. Instead, other structures are applied in which the bank often plays a much larger role in the financing structure and becomes a partner in the project to be financed – rather than just a provider of money.

Despite the fact that the Islamic banks have almost products & services similar to those offered by conventional banks, the two entities differ conceptually and operationally. Differences are numerous; from the main principals, values, ways to earn their money to the services and products. More, the added value of Sharia Governance provides extra control and monitor on banking operation that the conventional banks governance structure.

What Islamic finance can provide to SME's

1- Reinforce the practices of business with ethics

Generally, the term "business ethics", which came into common use in the early 1970s, refers to proper business policies and practices regarding potentially controversial issues, such as corporate governance, insider trading, bribery, discrimination, corporate social responsibility and fiduciary responsibilities[3]. Corporates started highlighting their ethical stature in the late 1980s trying to distance themselves from the business scandals such as the savings and loan crisis[4]. The discussion was back after the 2007-09 financial crisis, as certain banks were pointed out for their lack of business ethics. Elisabeth Paulet et al (2014) identified two major types of banking institutions: conventional banks and ethical banks with two distinct business models. Some banks have tried to anticipate the changes by adopting a responsible financial attitude and other have merely modified their banking practice to comply with the new regulatory framework. The second group of banks, the so-called ethical banks, who have scarcely been altered their behavior by the new financial context. Same conclusions were found by Peter Koslowski (2009) in I famous book "Ethics of Banking: Conclusions from the Financial Crisis (Peter Koslowski 2009, 5),: In fact, Islamic finance values are considered to be such "more advantages alternative", mentioned by Koslowski. Islamic banks often describe themselves as being providers of ethical financial services. Sheeza Ahmad (2013) used the social business concepts to explain the difference between the Islamic banking and conventional banking. He considered that an Islamic banks looks like, as social enterprise, which focuses on environmental, social and economic well-being with a profit-making business model. The primary aim of a commercial business is to maximise shareholder wealth whereas the primary aim of a social enterprise

[3] www.investopedia.com

[4] The savings and loan crisis of the 1980s and 1990s (commonly dubbed the S&L crisis) was the failure of 1,043 out of the 3,234 savings and loan associations in the United States from 1986 to 1995.

is to maximise social value. Rodney Wilson (2012) explained how the Islamic banks can even use their ethical manner to increase their marketing competitiveness. He added (6) "for Islamic banks it not so much a matter of competing on price, but rather in stressing the unique quality of the services they provide. This means they have to be believable, and be able to engage the customer by appealing to his or her conscience".

2- Support eradicating financial services exclusion

Financial industry, especially banks, played an important role in the development of the modern world. Banks, who are working on collecting funds from individuals and investors to undertake investments in form of trade and business, are also responsible for the concentration and distribution of wealth. Recent research by Credit Suisse revealed that approximately 40% of all global banks are owned by only 0.1% of the entire world's population (Sebastian Partogi 2014, 7). Access to financial services by the poorer members of society including potential, or would be, entrepreneurs, is a huge dilemma, as it creates commonly the so-called "non-banked" or "*unbankable*". Usually, convential banks are not be willing to provide financing to those entrepreneurs because of the high cost associated with credit assessment, credit monitoring and the lack of acceptable collateral. The concept of financial inclusion initially referred to the delivery of financial services to low-income segments of society. It has evolved into four dimensions:

1- easy access to finance for all households and enterprises,
2- sound institutions guided by prudential regulation and
3- supervision, financial and institutional sustainability of financial institutions, and
4- competition between service providers to bring alternative finance to customers.

Djibouti, a small country of less than one million inhabitants, is an instructive example on the promotion of Islamic banking to increase overall banking penetration. Policymakers recognized early on that a sizeable share of the population had abstained from conventional financial services due to religious reasons. By promoting Islamic banking services, banking penetration improved from 10% in 2007 to about 17-18% in 2013. Currently, Islamic banks have grown to 15% and are likely to expand further given strong government support increasing customer base (2).

Moreover, there is significant potential in Islamic microfinance to support financial inclusion, especially in countries with a sizeable low-income population. Generally, financial inclusion is weaker in countries with lower-income and even within countries; there are urban-rural disparities. Globally, Islamic microfinance has recorded a robust expansion, from serving just 500,000 customers in 2007 to 1.3m clients in 2013.

3- Boost the Finance for the Development

The concept of development in Islam has three dimensions: individual self-development, the physical development of the earth, and the development of the human collectivity (Mirakhor and Askari, 2010). Economic progress and prosperity is encouraged in Islam since this provides the means by which humans can satisfy their material needs and thus remove the economic barriers on the path to their spiritual progress. It is widely recognized that the central economic value of Islam is to develop a prosperous, just and egalitarian economic and social society. Economic development and growth, along with social justice, are the foundational elements of an Islamic economic system. All members of society must be given the same opportunities to develop themselves; including access to the resources.

In this view, property is not a means of exclusion but inclusion in which the rights of those less able in the income and wealth of the more able are redeemed. The role of Islamic banking in supporting development is big. More than the desire to support M&SMEs but also to support directly the development of the societies through multiple the Islamic Finance Education funds, the Takaful programs, and finally the increasing role of sukuk in providing the required funds for mega development projects in the globe.

4- Providing Risk-Sharing finance

Since the central proposition of Islamic finance is risk-sharing, any debt-based instrument that is structured based on extracting an interest as a percentage of the principle that was loaned for a specific time period and without the full transfer of the property rights over the money loaned to the borrower, is eliminated from the financial system. One result of this type of debt-based transaction is that the risk is borne by the borrower only. In contrast, Islamic finance modes are based on equity and risk sharing. This means that the principle of liability, which states that profit is justified on the basis of taking responsibility, possibly even becoming responsible for the loss and the consequences. This legal frame, "profit comes with liability," implies that Sharia distinguishes lawful profit from all other forms of gain and that entitlement to profit only when there is also the liability, or risk, of loss.
As example, in 2011, the Mauritian government established the Mauritius Business Growth Scheme (MBGS), to support and provide access to Islamic financing for SMEs. The MBGS and the SME enter a contract of profit-sharing. After the 2-3 years, the SMEs a portion on company's incremental revenue growth based on its revenue level before it participated in the MBGS. The repayment period is limited to five years so that if the business is notable to provide the funds back to the MBGS, it will not become forever burdened with repayment, as it would if it received a loan instead. As of May 2014, about 300 firms received financing under the program.

5- Providing globalized funds as vehicles to finance SMEs

In recent years, a number of private foundations and organizations have launched ambitious initiatives to support promising entrepreneurs in developing and industrialized countries, on both a for-profit and not-for-profit basis. From Islamic banking point of view, the sukuk market have grown tremendously and have become mainstream financial system. This fact emphasis one of the most important value proposition of Islamic finance, which is its emergence as new vehicle in bridging economies and contributing to increasing the financial linkages, in particular, the emerging markets. Previously, Islamic finance was domestic centric only. It is now increasingly providing financial solutions for cross border trade and investment Zeti Akhtar Aziz (2012). Progressive liberalization has facilitated the globalization of Islamic finance. This has been reinforced by the dynamic pace of innovation in Islamic finance that has widened the range of financial products and services. This globalization process has thus contributed to the growth and more efficient allocation of funds across borders from centers with surplus funds to regions with investment opportunities and to the diversification of risks. The said growth was supported by government initiatives, as example the Bahrain Economic Development Board (EDB) and the Islamic Corporation for the Development of the Private Sector (ICD), signed a MOU in July 2014 to promote SME growth in **Bahrain** by providing sharia compliant products, and training. Under the terms of this partnership, the ICD will establish an Islamic Ijarah

Company in Bahrain to help SMEs succeed by offering Sharia compliant financing products[5].

Many innovative Islamic finance models are coming to meet the lack of financing for SMEs. For example, new type of Sukuk, some in the form of hybrid asset-backed securities specifically designed for SMEs are tested to be credible alternative to collateral-based debt. Some researchers are suggesting that the traditional bank loans are not adapted to SMEs situation however; the Profit and Loss Sharing approach can work much better for SMEs financing. Anass Patel (2011, 1) presented a creative hybrid structure in the form of participating Mudaraba-Sukuk which was issued by one of the large investment bank in the gulf region, the Saudi Hollandi Bank. Another evidence of the exponential growth of the Sukuk market over the past few years is highlighted by the fact that the total value of Sukuk issuance over a 20-year period up to 2010 amounted to $201.6 billion whilst the value of Sukuk issuance in the last three years (2011-2013) has exceeded $336 billion[6].

6- Focus on the development of real economy

During a financial crisis of 2007-09 the crucial fact that conventional financial system is based on maximizing the profit by any means including speculation and sales of credit derivatives, was highlighted. The Office of the Comptroller of the Currency (OCC) reports that the market for credit derivatives among commercial banks in the U.S. market skyrocketed from $97 billion in notional value at year-end 1997 to $9 trillion at year-end 2006, Yingying et al (2007). Depending on the strategy, credit derivatives allow a bank to reduce risk by purchasing default protection, or to increase risk and generate additional fee income by selling default protection. In contrast to this system, Islam finance prohibits these kinds of derivatives. The Islamic financial system focuses on the real economy; all transactions must be linked to real economic activities, where people have to manufacture and exchange real products and services. Researches elaborated on the crisis shown, over the four years period, i.e. 2007-2009, Islamic banks performed better than conventional banks. This is why, for example, instead of giving farmers interest-charged loans to buy tractors, an Islamic bank will buy the tractor instead and sell it for a profit to its customers. The underlying involvement of "asset" itself in every transaction ensures that the funds are utilized for the purpose for which they were sought, thereby eliminating the risk of their misuse for any other purpose. By constantly engaging banks in real economic activities, the recent the financial crises wouldn't be happen. Maher (2010, 3) presented the result of IMF study comparing the performance of banks during the financial crisis confirming that on average, Islamic banks credit growth was twice that of convential during 2007–09. The strong credit growth suggests that Islamic banks market share is likely to continue to increase going forward and they contributed more to macro stability by making more credit available.

[5] http://www.mifc.com/index.php?ch=ch_thought_leadership&pg=pg_thought_leadership&ac=5519

[6] "Sukuk – An alternative funding method for the SME sector?", http://www.islamicfinanceinfo.co.uk/uk-leads-the-way/sukuk-an-alternative-funding-method-for-the-sme-sector

7- Provide more convenient mode of funding and transaction

Islamic finance is providing a wide range of financial instruments, each with a specific purpose. When entrepreneurs are considering Islamic finance, it is important to ensure that the instrument used is suitable for the purpose that a company seeks to achieve. The common methods used in Islamic financing include sales contracts such as Murabahah (cost-plus sale), leasing (Ijarah), Salam (forward sale) and Istisna (construction or manufacturing sale). They also include Wakalah (agency), Musharakah (joint venture or partnership), and Mudarabah (managed partnership). These contracts are used to manage credit and investment processes. All such instruments have been tested in micro-enterprise and SME markets and all may be used to support trade finance activities. There are two main categories of transaction types:

- Profit- and loss-sharing partnership methods which can be compared with equity investments; and
- Transactions with a predictable or fixed return structure.

Other financial instruments such as foreign exchange, letters of credit, agency contracts and guarantees are also available. The structures of Islamic transactions are unique as they generate cash flow and risks that are distinct from those of a conventional bank. Likewise, the accounting and risk treatments for Islamic instruments need special business activity assessment as well as a specific risk management approaches by both the entrepreneurs and the bank.

8- Revolutionizing the M&SMEs banking Value proposition

The question of value proposition become a central issue in the banking industry, either conventional or Islamic. It will differentiate a bank's products and services from competitors' offerings by highlighting things it can do better for a customer. These might include traditional factors like to provide higher quality of service, more convenient hours, technological availability or lower interest rates, or profit rate in the context of Islamic banks. But it might contain extra factors like adhering to certain values lie Sharia principals, promoting trade and real economy, focus on ethical businesses, etc. A bank's value proposition must create interest in its product or services in a way that prospective customers want to learn more and ask questions. It should align more closely with customer needs and customers' point of view. Joseph Di Vanna (2011) emphasized that a value proposition has to communicate a demonstrated result or clear benefit that will catch the attention of customers. For example, since it shares profit and loss, the Islamic banks pay greater attention to developing project appraisal and evaluations. Their credit department exercise much more efforts than conventional banks in delivering credit decision, where risks are transferred to the borrower and income from the loans is guaranteed. Such credit decision consequences difference gives little importance to developing expertise in project appraisal and evaluations within conventional banks. And so, the value proposition for Islamic finance moves today far beyond simple compliance to sharia principles, and boldly steps into a new dimension of competition on a global scale. The most known value propositions in the Islamic banking industry are the following (Madzlan Hussain):-

1- Adherence To Sharia, Subscribing To Higher ethical Ideals
2- Promoting cross border trade and flow of funds
3- Financial Inclusions of the underserved segments of the community
4- Expansion of a new asset Class

5- More diversification of Risks
6- Unlocking the Values of Idle asset
7- Job Creation
8- Sound Risk Management
9- Closer Support To Real economy
10- Systemic Stability

It's clear that such value proposition are perfectly adapted to M&SMEs sector's needs. Entrepreneurs, who are targeted by such value proposition, will be the first to testifying its validity. Values like the adherence to sharia, should be translated and implemented on ground by a clear description of sharia compliance. A large part of this implementation process is in proving why and how a product is compliant, and how does it keeps that during the lifetime of the financed business or transaction. Entrepreneurs want to be assured that sharia-compliant financial instruments are based on trading in assets rather than debts. Transparency and governance in Islamic banking is no more an internal affair. Entrepreneurs, shareholders and the community want to understand who is on the sharia board, and whether the bank's sharia scholars share the same values. To develop this aspect of their value propositions, banks need to communicate proactively with entrepreneurs on how products are structured and why. Investments and financing mechanism must be made clear as to what, how and why they are designed, developed and implemented, and hence sold to them. Educating customers creates the understanding needed to realize the value of the product to the customer. Customers of Islamic finance are more sophisticated, and demanding a greater array of customized products meeting their diversified needs. Many critics to Islamic banking industry pretending that most Islamic banking products simply try to mimic conventional banking products and services. Unfortunately, considerable portion of these critics might be right; such packaging is what many banks have done since the race for Islamic banking began over the past few years.

Several studies admitted that the value proposition must incorporate customary issues and beliefs that reflect the interpretations of sharia principles in the context of the local community. The interpretive nature of sharia is the real strength behind Islamic finance, in that it enables it to be dynamic and adapt to the communities it serves. Sharia scholars consider numerous factors during the development of financial products and their subsequent audit of compliance. Many of these factors relate to the environment in which the transaction is to take place, the parties involved and the level at which there is a fair and equitable exchange between the parties. Therefore, the value proposition for Islamic finance must contain a dynamic quality to be applicable to many communities across the world.

Conclusion & Recommendation

As Islamic finance activities gain in importance and relevance, adapting the proper resolution framework to the specific circumstances of M&SMEs finance becomes critical to ensure a real impact by the Islamic banking industry in this sector.

This article has reiterated the diversity and heterogeneity of the M&SME Islamic banking sector as now evidenced through the actual implementation. Current experience on the ground suggests - as already concluded in previous research – that support measures to M&SME Islamic banking need to be flexible to fulfill the markets' needs. While the target

groups of services provided to M&SME need to be sufficiently broad in order to provide efficient support, the product range also has to be sufficiently wide in order to meet the target groups' needs.

Based on the developments and insights into the M&SME Islamic banking market so far, the following four pillars appear essential for a successful further market building:

1. Availability of financial instruments with a balanced focus on social impact objective and financial sustainability of the intermediaries.
2. Non financial technical assistance as well as financial capacity building support to M&SME onto the growth curve, and other one to enhance their standards, upgrade operational models, expand.
3. Financial education and mentoring of final beneficiaries and entrepreneurs especially in their start-up phase is also key for reducing default rates for M&SME finance. Such business services are offered by intermediaries, or in cooperation with dedicated service providers and is also supported by the Islamic banks,
4. Spreading of best practices, standards and transparency to create a basis for informed investor decision-making by allowing to filter the profit-only MFIs and, more importantly, predatory lenders from the institutions targeting social impact in a long term sustainability perspective.

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