

THE ROLES OF ISLAMIC FINANCING TOWARDS THE SUCCESSFUL OF ISLAMIC MICRO ENTREPRISE: A STUDY IN LABUAN

Ahmad Aizuddin Hamzah
Lecturer in Islamic Finance
Labuan Faculty of International Finance
Universiti Malaysia Sabah. Address line 2
Email: aizuddin@ums.edu.my

Haneffa Muchlis Gazali
Labuan Faculty of International Finance
Universiti Malaysia Sabah

ABSTRACT

This paper aims to investigate the roles of Islamic financing on the performance of Islamic Micro Enterprise (IME). The Strategy theory used to confine the factor of financing source as to determine the successful of the Islamic Micro Enterprise performance. Islamic Financing is a source of fund which based on Shariah law for the Islamic Micro Enterprise which can be categories into three parts namely sale based, equity based and lease based. The linkages between these two segments are important as both shared the same value which is Islamic thought. This article will discuss the previous study on this relationship as to generate the hypotheses and It will ended with the proposing the framework for the further research. At the end, it will conclude that, both industries are in significant relationship as having the same objective which is to perform as accordance with Maqasid Al-Shariah

Key words: Islamic Micro Enterprise (IME), Islamic Financing

Introduction

Micro enterprise is also synonym with the term Small Medium Enterprise (SME). The words small and medium of the word Small Medium Enterprise (SME) are refereeing to the size of the company or organization. It is to give clear picture on the overall operation, financial background and human resource on the organization. While, according to Arbaugh, Camp and Cox (2008), enterprise is a firm which aims to maximize profit by where of bringing the new economic activity with the solid business package to enter marketplace opportunities. So, the Small Medium Enterprise (SME) can be simplified as a business or company which the operation are limited in term of their size, human resource, capital and financial obligation. However, many country's have their own criteria to identify the meaning of Small Medium Enterprise. (World Bank 1978, p.18). For example, in United States, a business so called Small Medium Enterprise (SME) is a type of business with the number of staff is below than 500. (Cavusgil, Knight & Riesenberger, 2008). For Malaysia perspective, effective from January 2014, business falls under SME must have full-time employees below 200 workers or the sales turnover not exceeding RM 50 million for manufacturing sector, while for services and other sector the full-time employees not exceeding 75 workers or the sales turnover below RM 20 million. (Guideline New SME Definition, SME CORP, 2014). For microenterprise, sales turnover for manufacturing, providing transport services and Agro-based Industries should be less than RM250, 000 with less than 5 or full-time employees (Husin and Ibrahim, 2014). Furthermore, for the services, primary agriculture and information communication technologies (ICT), sales turnover of less than RM200, 000 and full-time employees less than 5.

Islamic micro enterprise is not new ideology for the SME industry. The definition of the Islamic micro enterprise is actually an idea and perspective from Islamic point of view on the firm and enterprise. Most of the Islamic scholars agree that Islam and business are inter-related. In Al-Quran has mention on the relation of Islam and business which focus on the ethics, roles, responsibility, prohibition and benefit. One of the example is from Surah Al-Baqarah[275] "Allah prohibit riba and permissible trading". Based on Sarker & Awal (1999), firm from Islamic context have two objective which is work for the falah or known as welfare obligation and at the same time looking on the profit maximation. The author also list down some of the rules for the firm when it operated based on the Islamic perspective. The rules are priority on community welfare and prohibition on of unfairness activities during the trading.

The ideology of Islamic business firm can be extended to the establishment of Islamic banking and finance institutions into the market. Throwback of 40 years establishment of the industry since the modern Islamic banking setup by Dubai Islamic Bank in 1975, the Islamic bank and finance now having a fast moved with spreading the market into the non-muslim country. There are much experience gained by the industry although the conventional counterpart still dominated the financial market. It can be looked into the changes on the products, regulation, shariah issues, professional man power and political support which was helped the institutions more strength and perform.

One of the objective of Islamic banking exist into the market is to give an alternative banking facilities especially to the muslim consumer as the prohibition of conventional banking system by the Islamic law. Riba, Ghara and Maisir are the three major

components in the operation of conventional banking which impermissible in Islam. The system also provides facilities same as the other financial institutions like financing and deposit. To be different, Islamic banking and finance will use contracts under the Shariah such as Mudharabah, Ijarah, Murabahah and others to be implemented on the banking operation. This was also the way of Islamic banking to avoid *riba* in their operation. In Malaysia, the growth of Islamic banking can be looked into the past 30 years.

The tremendous development of Islamic Finance industry and Shariah compliant business sectors promotes the economic expansion as a new source income. As the demand of Shariah-compliant products and this matter shows that more people are aware of Islamic products and services. Islamic finance define as financial service or product that in-line with Shariah rulings. There are five features that highlights in Islamic finance, for instance *riba* (interest), *haram* (forbidden) or *halal* (permissible), *gharar* (speculative) or *maisyir* (gambling), *zakat* (purifying alms) and Shariah (Islamic) board (Lewis and Algaoud, 2001). The concept of financing in Islam is different with western financing. A profit and lost (PLS) scheme is the unique features of Islamic banks, it is a combination between two principles namely *mudharabah* (profit-sharing) and *musyarakah* (joint-venture). Theoretically, there is an assets and liabilities of lenders and borrowers involved in this unique scheme. It allows Islamic banks to lend in longer period with higher risk-return profiles. But, many Islamic economic and finance experts suggests that profit/sharing scheme use *murabaha* (cost-plus sale) like many Islamic institutions in Indonesia implement (Huda, 2012).

One of the financing criteria provide by the Islamic banking is to finance business which undergo on the Shariah purpose only. The financing can be drawn into the providing the capital, lease an equipment and selling a commodity. A business such as trading pork, alcohol, entertainment and gambling consider non-Shariah compliant. Meanwhile, the performance of SME business in Malaysia also was given a good result for each year. According to SME Corp, in 2014, the performance of Malaysian SMEs remained encouraging despite the difficult business environment. In 2013, GDP growth of SMEs picked up further to 6.3% versus 6% in 2012. SME growth also exceeded the overall GDP growth of the country of 4.7%. However, despite of the shining growth of both industry, was the banking facilities really help the performance on SME especially on the Islamic entrepreneur. The answer for the question is the aim of this article. The ultimate objective of this academic writing is to look the relationship between the performance of Islamic Small Medium enterprise and the Islamic banking financing. The following section will discuss on the previous studies on Small Medium enterprise and also the Islamic banking facilities. At the end of the article, a research framework to continue the study is developed based on the literature review.

Literature Review

Impact of source of fund with the successful of Micro enterprise

Finance microenterprise is a new-paradigm in bringing up the economic expansion and at the same time eradicating poverty (Ahmed, 2002). The growth of microenterprise is important to generate employment and to help the development of poor countries. Furthermore, microenterprise have advantages in increasing the aggregate output, it offers the efficient use of capital and labor, instigating indigenous enterprise and management skills, transporting a regional balance and most importantly enlightening the dissemination of earnings (Bank study, 1978). Despite the advantages, microenterprise also face the problems like low pays, lack of infrastructure, scarce of resources and this such problems hinder the growth of small enterprise.

In a developing economic perspective, Bennet (1998) highlights the occurrence of physical and socioeconomic barriers between financial institutions and clients. Bennet claims the problems can stressed the asymmetric information problems. Thus, the physical obstacles like limited of markets, roads, power and communication will conflict the problems of selection and moral hazard. From the socioeconomic side, the clients are likely to have low mathematical skills because of illiteracy. Status, culture and gender aspects averting contribute to the hostile selection problem. On the other hand, (Ayyagari, Demirgüç-Kunt, and Vojislav, 2005) use the firm level survey data to report the present the different setting of business environment, shows that finance, crime and political imbalance give a direct impact of the firm growth and emphasized that finance gives the powerful contributor. This findings supported by Beck & Demirguc-Kunt (2006) that the access to finance become the essential of growth barrier for SMEs. In capitalism, interest is the form of reward from capital production (Hanif and Iqbal, 2010). The industry offers savings and loans on interest basis, however, chagrining interest is forbidden for many religions including Islam, Christianity and Judaism. Consequently, Muslim left no choice, yet to establish financial institutions that comply with Islamic rulings.

In the case of microenterprise, Garmeen Bank in Bangladesh become the pioneer to provide financial support for the poor (Ahmed, 2002). Therefore, they established the microfinance as a new concept in banking that has certain criteria to get the finance. An empirical research by Beck and Demirguc-Kunt (2006) shows that access to finance is the essential elements for growth constrain for SMEs. Beck and Demirguc-Kunt suggests that financial and legal institution play an important role to release this constraint and innovative financial instruments would able to access finance to facilitate SMEs. Evidently, bank usually not interested giving financing to micro entrepreneurs due to high credit of transaction cost per unit.

Linkage of Islamic Financing with the performance of SME

Many studies have been conducted to survey the impact of source of financing towards the successful of SME industry. One of the sources of financing is from the program of Microcredit. A study conduct by (Copestake et al., 2001; Kuzilwa, 2005, Carter and Shaw, 2006; Hietalahti dan Linden, 2006), shows that, there is positive relationship between the Microcredit scheme towards helping to those SME entrepreneurs. The program was proved with resulted on the impact of their income, output and welfare.

This microcredit scheme was changing their social life which previously in a poor condition. However, the study only conducted the impact from the source of financing of conventional microcredit.

Most of the research on the Islamic financing and microenterprise was looked on the theoretical part of the both concepts. According Dusuki (2008), the element of Shariah practice in Islamic banking and finance was help to reduce the issue of poverty, promote the social justice and fairly contribution of wealth on the society. The objective of Islamic banking needs to be shifted from the business mode into the social benefit. This was also one of the modes of Islam where the relationship between man-to-man are highly demanded. Dusuki (2008) also recommend that the implementation of SPV by the Islamic financing instrument is the best mechanism to channeling to the poor. With the features of bankruptcy remote on the SPV, the Islamic banking interest was protected from any losses from the micro financing activities.

Other than that, a study conduct by Ahmed (2002), suggest few things on the development of Islamic microfinance institutions (IMF). The used of waqf, zakah, charity as the alternative for the Islamic microfinance institutions to boost of their source of fund. There three instruments can be best alternative as to give the assistance on alleviate of the poor income. Business oriented by the Islamic microfinance institutions can use any type of Islamic business contract which suit with the purpose of financing. A contract from sale transaction, partnership oriented and loan mechanism is benefit to the IMI as having a lot of financing tools. IMIFs respond to many problems such as to good/assets too costly, moral hazard arising from the underreporting account of micro entrepreneur, monitoring such as lack of personnel and equipment as physical barriers (Ahmed, 2002). Additionally, Ahmed claims lack of fund especially from external sources hindered the expansion of IMFIs. Besides, the efficient operations also will determine the successful of IMFIs.

On the study also, Ahmed (2002) conduct a research on the performance of one of the Islamic microfinance institution in Bangladesh. As to compare with the conventional counterpart (Grameen Bank), the IMI was performed better than the Grameen bank. The value and principle of Islam give impact to both institutions and customers. Employees of the IMI were working hard as to help for those needed or the poor to change their economy. Thus, it makes the institutions reduce the cost and increase the productivity. On the other side, customer was thinking that it is a responsible to them on the repayment of the financing as it is a religious obligation. This was reducing the credit risk of the institutions and positively impact on the revenue.

On the other study, Hanif and Iqbal (2010) evaluate the suitability of Shariah compliant instrument of the existing business environment in Pakistan. Their respondents among entrepreneur claims that there are 7 hurdles in popularity of Musharakah Financing namely, earning manipulation, lack of confidence, riskiness, conventional accounting framework, higher taxes, dominant conventional banking and weaker auditing. The most dominance of that hurdle is conventional banking, yet it can be settled with the growth of IFIs. Furthermore, the other obstacle mentioned above can be removed through develop the awareness, tax incentive and capacity building of IFIs.

Figure 1: Proposed a research framework



Conclusion

The fast movement of Islamic banking industry particularly in Malaysia is not totally benefit especially to the academic point of views. From the aspect of academic writing, the study on empirical study on Islamic finance is still left behind as to the conventional counterpart. Most of the previous study is looking on the original concept of Islamic banking and there are few studies on the practical impact. Thus, a study of Islamic banking towards the business environment is a must as to look the different angel of Islamic finance and at the same time will support for the Islamic finance literature.

References

- Ahmad, H. (2002). Financing Microenterprises: An Analytical Study of Islamic Microfinance Institutions. *Islamic Economic Studies*, 9(2), 27- 64.
- Asyraf Wajdi Dusuki, (2008), "Banking for the poor: the role of Islamic banking in microfinance initiatives", *Humanomics*, Vol. 24 Iss 1 pp. 49 - 66
- Ayyagari, M., Demirgüç-Kunt, A., & Vojislav, M. (2005). How Important Are Financing Constraints ?
- Beck, T., & Demirguc-Kunt, A. (2006). Small and medium-size enterprises: Access to finance as a growth constraint. *Journal of Banking and Finance*, 30(11), 2931–2943. doi:10.1016/j.jbankfin.2006.05.009
- Edwards, P., & Turnbull, P. W. (1994). Finance for small and medium-sized enterprises: Information and the income gearing challenge. *International Journal of Bank Marketing*, 12(6), 3-9.

- Hanif, M., & Iqbal, a. (2010). Islamic Financing and Business Framework: A Survey., 15(4), 475–489. Retrieved from http://www.eurojournals.com/ejss_15_4.htm
- Huda, A. N. (2012). The Development of Islamic Financing Scheme for SMEs in a Developing Country: The Indonesian Case. *Procedia - Social and Behavioral Sciences*, 52, 179–186. doi:10.1016/j.sbspro.2012.09.454
- Husin, M. A., & Ibrahim, M. D. (2014). The Role of Accounting Services and Impact on Small Medium Enterprises (SMEs) Performance in Manufacturing Sector from East Coast Region of Malaysia: A Conceptual Paper. *Procedia - Social and Behavioral Sciences*, 115(Icicies 2013), 54–67.
- Iqbal, Z. (1997). Islamic financial systems. *Finance and Development*, 34, 42-45.
- Lewis, M.K. and Algaoud, L.M. (2001), *Islamic Banking*, Cheltenham: Edward Elgar.
- Obaidullah, M., & Latiff, H. S. H. A. (2008). Islamic finance for micro and medium enterprises. *Islamic Research and Training Institute Islamic Development*.
- Rosman Mahmood, M. Mohd Rosli, (2013) "Microcredit position in micro and small enterprise performance: the Malaysian case", *Management Research Review*, Vol. 36 Iss: 5, pp.436 – 453
- Sarker, M. A. A. (1999). Islamic business contracts, agency problem and the theory of the Islamic firm. *International Journal of Islamic Financial Services*, 1(2), 12-28.
- SMIDEC (2008). Promoting Innovation – led and Technology – Driven SMEs. Paper Presented in Asia Pacific Conference of Technology and Technology Entrepreneurship.
- Sarker, M. A. A. (1999). Islamic business contracts, agency problem and the theory of the Islamic firm. *International Journal of Islamic Financial Services*, 1(2), 12-28.