ISLAMIC FINANCE: BRIDGING THE FUNDING GAPS OF SMES AND MSMES

Being the backbone of both developed and emerging economies, SMEs and MSMEs have limited access to finance, resulting in a funding gap. Islamic finance, with its portfolio of asset and equity-based financing solutions and its foundational philosophy of achieving financial inclusion, is well suited to bridge this gap.

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Role of Islamic Finance in Bridging the Funding Gaps of SMEs and MSMEs

Socio-economic justice which is one of the main features present in the Islamic financial system is critical in achieving financial inclusion. Financial inclusion helps to address slow investment growth, weak productivity and income inequality, exemplified by the present-day modest economic growth.[1] The contribution of Islamic finance towards socio-economic justice among others include the availability of socio-economic tools that could help to improve financial access and foster the inclusion of those deprived of financial services to achieve real economic growth.[2] Various socio-economic tools that Islamic finance can further tap into include zakat, waqf and qard al-hassan (benevolent loan) alongside socio-economic financial instruments that are designed to provide financial assistance to the poor such as Shariah-compliant small and medium enterprises (SMEs) and micro small and medium enterprises (MSMEs).

SMEs and MSMEs – An Introduction

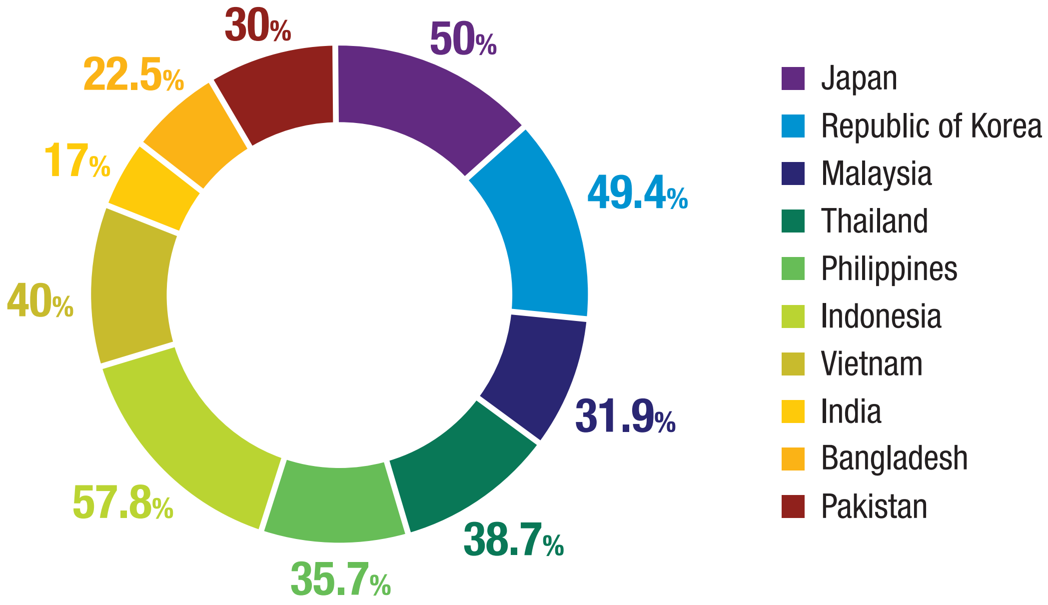
SMEs and MSMEs[3] are the backbone of both developed economies and emerging markets and developing countries (EMDCs) in terms of employment generation, opportunity, sustainability, as well as economic growth. In addition, SMEs and MSMEs have the potential to promote international trade and therefore prioritizing its development is critical for promoting inclusive economic growth.[4] Globally, SMEs and MSMEs approximately contributed to 43.5 percent of total employment and are responsible for 57.8 percent of total new jobs created.[5] In Asia, 98 percent of the business establishments are SMEs with total of 62 percent employment and 42 percent GDP contribution.[6] The sector is an important economic agent for most of the economies, based on its GDP contribution, share of total employment and share of total exports.[7]

Apart from the above, other important factors regarding SMEs and MSMEs are their increased engagement of women and youth, as well as their ability to adapt more quickly to change compared to large corporations, resulting in the creation and enhancement of innovative solutions.[8] However, even though SMEs and MSMEs have a certain level of socioeconomic significance present within the sector, their relevance and impact are not proportionally met with support mechanisms and channels that would facilitate the growth of existing SMEs and MSMEs, as well as the establishment of new ones, and which would increase their economic and social magnitude even further.[9] Presently, SMEs and MSMEs across the world, especially in developing countries are facing various challenges, and access to formal finance is

1 "A Big Step Forward for Bolstering Financial Inclusion", IMF direct, The International Monetary Fund's global economy forum (28th January 2015)
2 ISRA
3 SMEs and MSMEs definition varies by country
4 Joint World Bank-Islamic Development Bank Policy Report October 2015 on "Leveraging Islamic Finance for Small and Medium Enterprises (SMEs)"
5 Joint World Bank-Islamic Development Bank Policy Report October 2015 on "Leveraging Islamic Finance for Small and Medium Enterprises (SMEs)"
6 "SMEs are important economic agents for Malaysia's growth", Borneo Post, 2nd November 2015
7
8 Joint World Bank-Islamic Development Bank Policy Report October 2015 on "Leveraging Islamic Finance for Small and Medium Enterprises (SMEs)"
9 Joint World Bank-Islamic Development Bank Policy Report October 2015 on "Leveraging Islamic Finance for Small and Medium Enterprises (SMEs)"

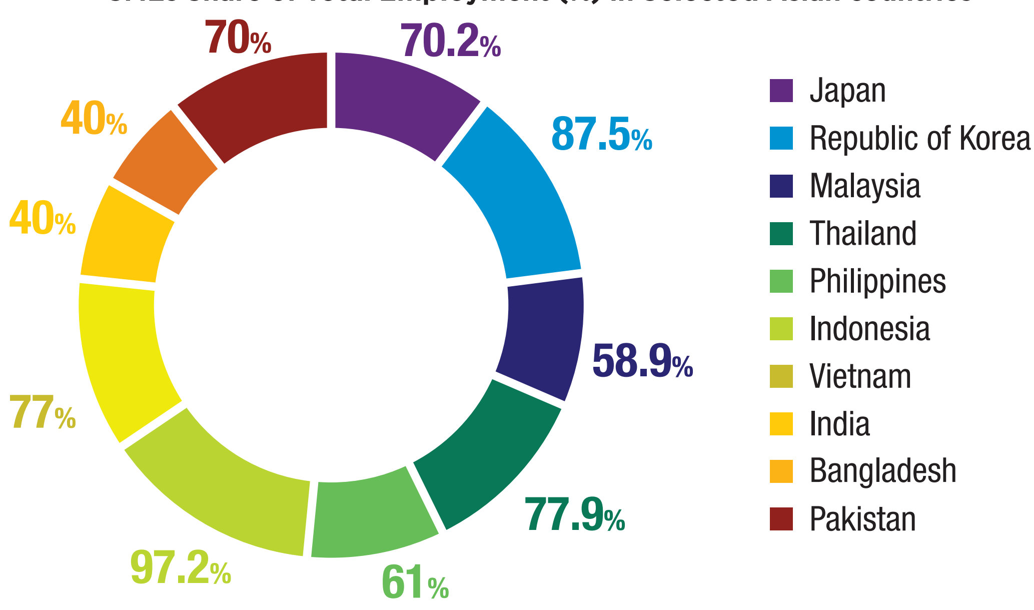
one of the main obstacles that they face. In South and East Asia and the Pacific, approximately 9 million of all formal SMEs do not have sufficient access to finance.[10]

SMEs Contribution to GDP (%) in Selected Asian countries



Source: SMEs Internationalization and Finance in Asia, Asian Development Bank Institute, 2015

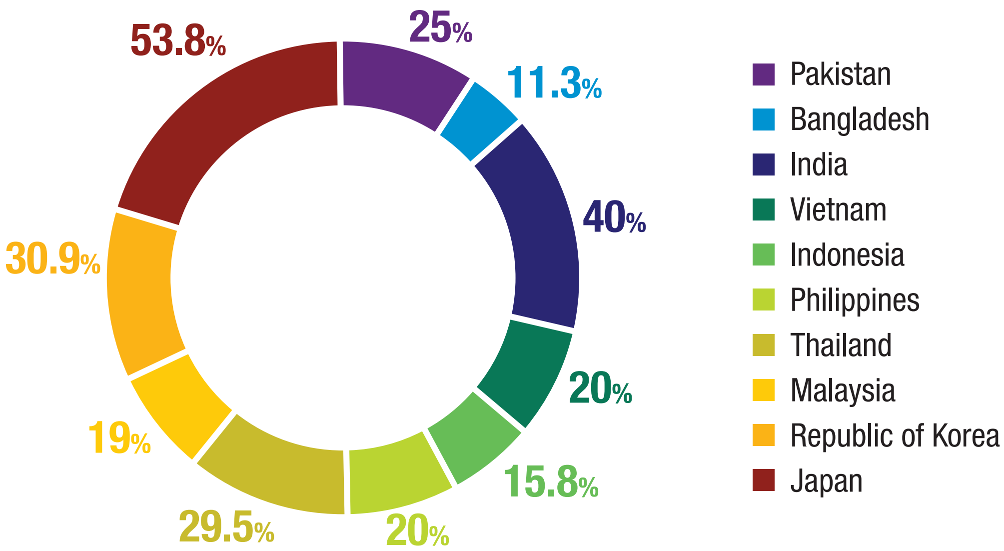
SMEs Share of Total Employment (%) in Selected Asian countries



Source: SMEs Internationalization and Finance in Asia, Asian Development Bank Institute, 2015

[10] IFC, 2013

SMEs Contribution to GDP (%) in Selected Asian countries



Source: SMEs Internationalization and Finance in Asia, Asian Development Bank Institute, 2015

Contribution of SMEs to the Economic Development in the MENA region

Country	Contribution to GDP	Contribution to Exports	Contribution to Employment
Egypt	80% of economic output	-NA-	75% of private sector employment 99% of non-agricultural sector employment
Pakistan	30% of GDP and 35% of manufacturing value added	25% to manufacturing exports	Absorb 78% of non-agricultural workforce
Saudi Arabia	33% of economic output	-NA-	Accounts for approximately 25% of total employment
Jordan	Approximately 50% of GDP	45% of exports	60% of the workforce and 70% of new job opportunities
Morocco	Approximately 38% of GDP, 40% of production, and 50% of investment	30% of exports	50% of population
Tunisia	51% of GDP	-NA-	69% of employment
Yemen	-NA-[11]	-NA-	-NA-
Iraq	-NA-	-NA-	-NA-
Lebanon	Over 99% of GDP	-NA-	82% of employment generated

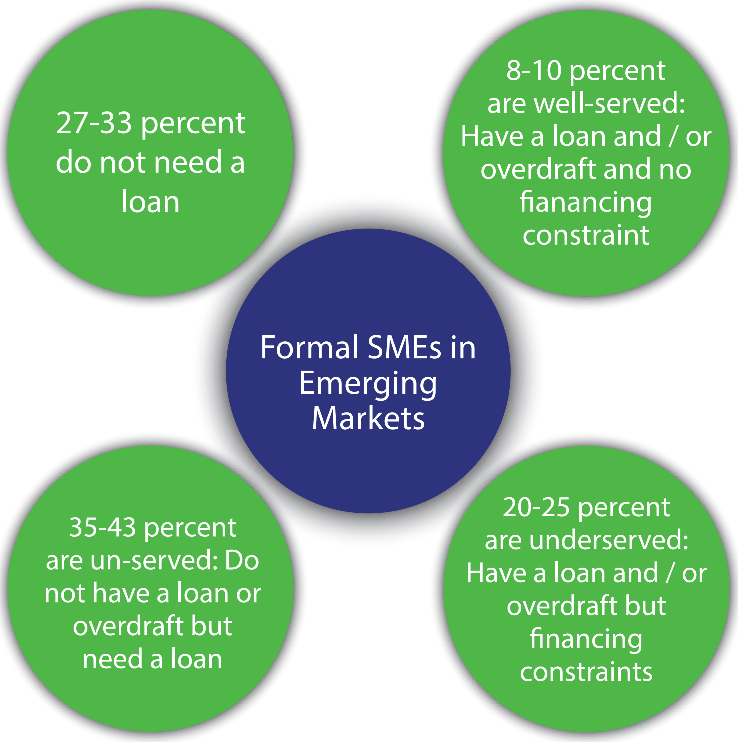
Source: Islamic Banking Opportunities Across Small and Medium Enterprises in MENA, IFC 2014

[11] (NA) signifies data is unavailable

SMEs and MSMEs Access to Finance

Access to finance remains a key constraint to SMEs and MSMEs development. Approximately there are close to 365-445 million micro, small, and medium enterprises in emerging markets of which 25-30 million are formal SMEs and 55-70 million are formal micro enterprises, while the rest (285-345 million) are informal enterprises.[12] According to a similar study, close to 45 to 55 percent of the formal SMEs (11-17 million) in the emerging markets do not have access to formal institutional loans or overdrafts despite a need for one.[13] The finance gap is bigger when considering the micro and informal enterprises – 65-72 percent of all MSMEs (240-315 million) in emerging markets lack access to credit. In addition, about 55-68 percent of SMEs in developing countries are either financially underserved or not served at all, resulting in lost opportunity to realize their full potential.[14]

Access to Finance for Formal SMEs in the Emerging Markets



Source: Joint World Bank-IDB Policy Report 2015

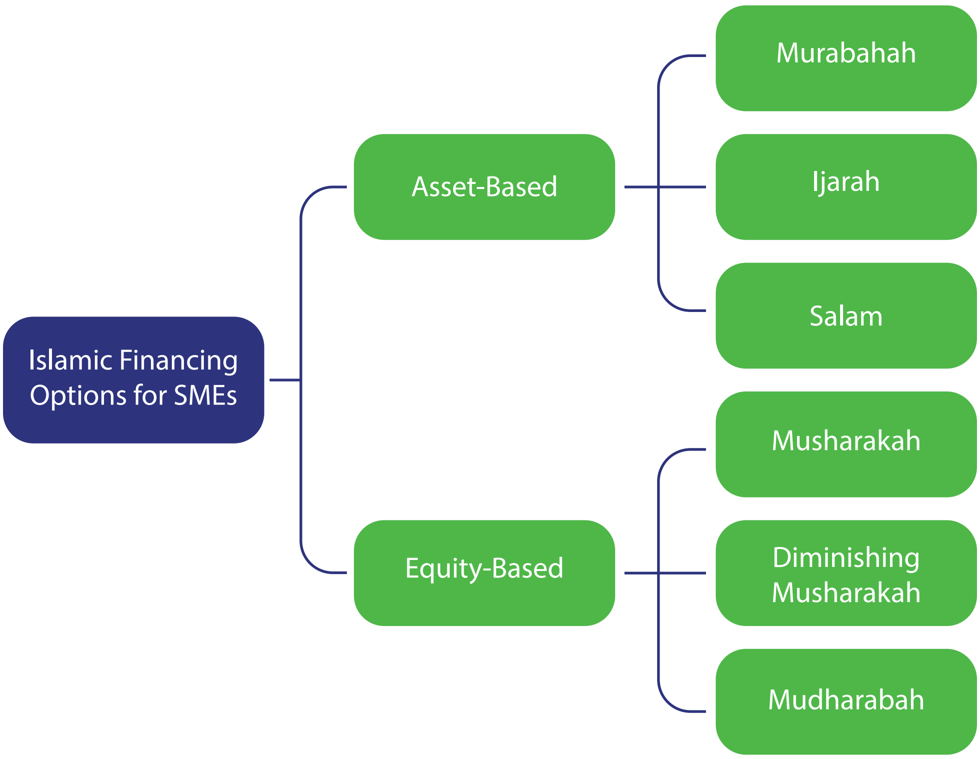
The proportional size of the finance gap varies across regions. The SMEs and MSMEs financing gap is the result of a mismatch between the needs of the small firms and the supply of financial services, which are typically easier for large firms to access.[15] Access to finance is a global challenge that needs to be addressed more thoroughly by various related bodies and agencies. The global challenge can be met through innovative and diverse financial product offerings. In terms of innovative and diverse source of financing for SMEs and MSMEs, one possibility is to identify the strength and potential of participatory finance such as Islamic finance.

[12] IFC and McKinsey and Company (McKinsey)
[13] IFC, 2013
[14] Joint World Bank-Islamic Development Bank Policy Report October 2015 on "Leveraging Islamic Finance for Small and Medium Enterprises (SMEs)"
[15] IFC, 2013

Islamic Finance: A Catalyst for Inclusive Growth

The foundational philosophy of Islamic finance relies heavily on the economic and social development factor, including financial inclusion in the form of servicing the unbankable of the society, such as some of the SMEs and MSMEs.[16] Financial inclusion can be addressed in Islamic finance by promoting asset-based and equity-based contracts as a viable alternative to conventional financing. Of more importance, Islamic finance risk-sharing features and the strong link of credit to collateral that is well-suited for SMEs and MSMEs are known to promote inclusive growth.[17] Therefore through a portfolio of asset-based and equity-based financing solutions for SMEs and MSMEs in Islamic finance, a clear financing gap for this sector can be tackled.[18] This is because through asset-based financing, it fulfils essential requirement of Islamic financial transaction by ensuring that the financial transaction is part of a real economic activity with a close financial linkage to the financial assets.[19] On the other hand, equity-based financing exercises profit and loss sharing between financiers and entrepreneurs which promotes the alignment of their interests, increases risk-sharing, and foster entrepreneurship mainly at the early-stage start-ups which rely purely on equity financing for their ventures.[20]

Islamic Financing Options for SMEs



Source: ISRA

[16] Asutay, Mehmet, and Shehab Marzban. 2012. "Standing Out with Crowd." The Banker, Special Report: Top Islamic Financial Institutions, 28–29 Financial Times Publication, November.

[17] "Unlocking the Promise of Islamic Finance", IMF, 2015.

[18] Joint World Bank-Islamic Development Bank Policy Report October 2015 on "Leveraging Islamic Finance for Small and Medium Enterprises (SMEs)"

[19] Joint World Bank-Islamic Development Bank Policy Report October 2015 on "Leveraging Islamic Finance for Small and Medium Enterprises (SMEs)"

[20] Joint World Bank-Islamic Development Bank Policy Report October 2015 on "Leveraging Islamic Finance for Small and Medium Enterprises (SMEs)"

Notably, the relevance of Shariah-compliant SMEs and MSMEs financing and its risk-sharing characteristics from an economic development perspective have been recognized by various policy makers in various countries and global bodies. For example, Organization of Islamic Cooperation (OIC) has defined SMEs as its main target to "develop appropriate policies to accelerate the convergence between Islamic finance and SME industries where in this context by promoting the utilization of Islamic finance products which are more linked to the real economic activity, to enable SMEs in the member countries to tap into the rapidly growing pool of Shariah-compliant funds."[21] And more recently, General Council for Islamic Banks and Financial Institutions (CIBAFI), the global umbrella of Islamic financial institutions (IFIs) will be conducting a meeting with the Directors of Operations and Investment in IFIs, themed: "Building Technical Capabilities to Generate Sustainable Islamic MSMEs Finance", which is expected to take place on March 2016 in Jeddah, Kingdom of Saudi Arabia.[22] Following its recent Roundtable Meeting in December 2015 in Malaysia, which discussed innovative strategies in Islamic MSMEs and value chain finance, CIBAFI in collaboration with the Islamic Development Bank (IDB), intend to discuss that tackling the challenges in the Islamic MSMEs finance, is one of the key agendas for a sustainable grassroots economic growth.[23]

Islamic SMEs and MSMEs Financing Options

The Islamic financing options for SMEs and MSMEs identified below have a fundamental role to play in increasing the financial inclusion of SMEs and MSMEs.

Islamic Financing Options for SMEs and MSMEs

Type	Shariah Financing Option	Definition	Benefits for SMEs and SMEs (apart from Shariah-compliant)
Asset-Based	Murabahah	A murabahah is a contract between a financier and a client through which the financier purchases assets required by the client and then sells them to the client at a cost that includes a disclosed profit margin to be paid back, usually in installments.	- Fixed financing rate during financing term - Full transparency of the price and mark-up - Useful for short-term financing - SMEs and MSMEs management remain independent - Ideally overcomes collateral requirements by enforcing sale of asset in the case of default
	Ijarah	Ijarah, or Islamic leasing, is a transaction through which one party leases an asset such as equipment to be used by a client for an agreed upon rental fee. Another form of Ijarah –Ijarah wa Iqtina – is a lease to own; a financier leases assets to clients for an agreed rental fee, while only one of the parties unilaterally buys or sells the asset at the end of the lease period.	- Enables financing even with the lack of collateral and credit history since the lessor owns the assets and can repossess assets in case of default - Useful for medium and long-term financing - Simple documentation and processes

[21] Report and Recommendations of the Workshop on "Enhancing the Competitiveness of Small and Medium Sized Enterprises in the OIC Member States", Ankara – Turkey, 2012.

[22] "CIBAFI continues its series of Meetings on MSME Finance in partnership with IDB", CPI Financial (31st Jan 2016)

[23] "CIBAFI continues its series of Meetings on MSME Finance in partnership with IDB", CPI Financial (31st Jan 2016)

Asset-Based	Salam	Salam is a forward sale contract in which an advance payment is made for commodities (mainly agricultural crops) to be delivered at a future date. A Salam can thus be utilized to provide working capital to the SMEs and MSMEs.	- Provision of Shariah-compliant working capital - Beneficial for agricultural import and export - Useful for short-term financing
Equity-Based	Musharakah	Musharakah is a partnership agreement established by two or more parties in which all partners provide capital to a joint venture to share its profits and losses. Profits are distributed among partners based on pre-agreed ratios, while losses must be borne by the partners proportionate to their capital contribution.	- Profit and loss sharing - Ability to receive a percentage of profits higher than entrepreneurs' capital contribution - Useful for long-term financing
	Diminishing Musharakah	Diminishing Musharakah is a Musharakah agreement where the entrepreneur promises to buy the investment shares of the other partner(s) over time until the entrepreneur owns 100 percent of the venture.	- Profit and loss sharing and share buyback based on market rate - Ability to retain SMEs and MSMEs or start-up over long run; especially important for family - Useful for bridge financing; not giving up equity over medium to long term
	Mudharabah	Mudharabah is a partnership between a capital provider (Rab-ul-Mal) and an entrepreneur who is acting as fund manager (Mudharib). Profits may be distributed at any pre-agreed ratio, whereas losses are borne by the capital provider.	- Profit-sharing only - No need to contribute capital to the venture, in contrast to Musharakah - Ability to negotiate percentage of profits - Useful for long-term financing

Source: Joint World Bank-IDB Policy Report 2015

Islamic SMEs and MSMEs Challenges and Recommendations

Even though there is a huge demand for Islamic products by SMEs and MSMEs, Islamic banks are yet to have the full capacity to serve the SMEs and MSMEs largely due to their perceived risks, collateral situation and credit history.[24] For example, 32 percent of such businesses in the MENA region remain excluded from the formal banking sector because of insufficient Shariah compliant products.[25] Apart from that, Islamic banks prefer offering financing in the form of murabahah. Although it is an asset-based financing mechanism, murabahah financing is a dominant and preferred financing mechanism by Islamic banks, mainly due to the

[24] on "Leveraging Islamic Finance for Small and Medium Enterprises (SMEs)"
[25] Islamic Banking Opportunities Across Small and Medium Enterprises in MENA, IFC 2014

fact that it is relatively simple to implement and utilizes similar credit criteria for entrepreneurs as compared to conventional financing.[26] The unmet demand of SMEs and MSMEs through Islamic banks can be attributed to the inability to extend profit and loss sharing equity-based financial instruments such as musharakah and mudharabah to SMEs and MSMEs.[27] This tendency disregards the essential principles advocated by Islamic finance and represents a lost opportunity to financially include SMEs and MSMEs underserved by its conventional counterparty.[28] Furthermore, Islamic banks prefer offering short-term Islamic facilities to the sector due to issues of business continuity and the higher risk involved in lending to SMEs and MSMEs.[29] With that, most small-sized businesses find it tedious to access funds for long-term projects or face with issues in expanding their businesses due to the lack of ability of capital expenditure financing, seed financing, venture capital and etc.[30]

In addition, there are other various set of challenges faced by Islamic banks which need to be addressed by their respective stakeholders.

Challenges Hampering Islamic SMEs and MSMEs

Source: Joint World Bank-IDB Policy Report 2015

[26] Joint World Bank-Islamic Development Bank Policy Report October 2015 on "Leveraging Islamic Finance for Small and Medium Enterprises (SMEs)"
[27] Joint World Bank-Islamic Development Bank Policy Report October 2015 on "Leveraging Islamic Finance for Small and Medium Enterprises (SMEs)"
[28] Joint World Bank-Islamic Development Bank Policy Report October 2015 on "Leveraging Islamic Finance for Small and Medium Enterprises (SMEs)"
[29] Islamic Banking Opportunities Across Small and Medium Enterprises in MENA, IFC 2014
[30] Islamic Banking Opportunities Across Small and Medium Enterprises in MENA, IFC 2014

Islamic SMEs and MSMEs Challenges and Recommendations

No.	Area	Challenges	Recommendations
1	Product Offerings	Product offerings for SMEs and MSMEs are naturally skewed towards debt-based financing such as murabahah, although products such as ijarah, musharakah, mudharabah, and diminishing musharakah are more appealing for specific financing needs and strongly promote the profit and loss sharing foundations of Islamic finance. The lack of diverse offerings can be attributed to the risk perception of the Islamic banks as well as the limited exposure and know-how of their employees in structuring and managing such products.	- Practical education, especially in risk management for equity-based financing - Risk mitigation techniques and systems for equity-based financing - Study tours and knowledge exchange - Supporting the establishment of nonbanking financial services providing ijarah (leasing companies), and mudharabah and musharakah (venture capital companies)
2	Transaction Costs and Taxes	The asset-based nature of transactions in absence of specific tax treatments for Islamic financial instruments results in double taxation and increased costs compared to its conventional counterpart.	- Increased standardization and information-sharing will reduce costs - Knowledge hub for standard Islamic financial documentation - Taxation frameworks and laws that allow for the tax neutralization of Islamic financial instruments
3	Moveable collateral	Banks are reluctant to utilize moveable assets of SMEs and MSMEs as collateral due to the lack of reliable legal framework and collateral registries.	- Legal framework for secured transactions, including movable assets - Reliable collateral registries - Claim enforcement mechanisms - Capacity building and training on processes and systems
4	Information Sharing	There is a lack of knowledge of Islamic finance among institutions and SMEs and MSMEs. While larger financial institutions such as Islamic banks can hire internal and external human resources to provide the essential expertise to structure innovative financial products, smaller non-bank financial institutions are not able to hire a Shariah board and Islamic professioanls.	- Creating the SME Islamic finance forum platform, including standardized documentation, and Shariah standards and operation manuals in multiple languages and based on different jurisdictions to support Islamic SME and MSME financing - Promote interaction among practitioners through a knowledge platform - Providing a database of case studies in the platform, including best practices

5	Human Resources	Shariah personnel with knowledge in both Shariah and banking/finance operations are scarce due to the multidisciplinary knowledge required to determine the compliance of modern financial transactions and financial engineering to Shariah rules. Similarly, banking professionals interacting with SMEs and MSMEs often do not have any experience with respect to Islamic finance.	- Technical assistance for Islamic banking/finance practitioners - Case studies and practical experience exchange, mainly from GCC and Malaysia - Study tours and on-the-job training - Support formal and informal education programs with global/local universities - Accredited "practical" localised programmes for Islamic finance professionals

Source: Joint World Bank-IDB Policy Report 2015

Amidst all the challenges, there is significant potential for Islamic banking in the SME and MSME sector. Apart from the recommendations highlighted above, more importantly, government can play an imperativerole in the development of SME and MSME sector by providing both financial and non-financial support. Financial support generally includes amendments of policies to support SMEs and MSMEs growth, provisions of seed capital, various SMEs and MSMEs schemes and collateral waivers.[31] Non-financial support generally includes business development assistance programmes and SMEs and MSMEs training programmes.[32] For example in Malaysia, as part of the government's initiatives on promoting Shariah-compliant SME and MSME growth, the government in its 2012 budget has allocated RM2bln for the establishment of Shariah-compliant small and medium-sized enterprises (SMEs) Financing Scheme (SSFS).[33] Under the SSFS, the government has undertaken to pay two percentage points of the profit rate charged by participating Islamic banks to SMEs when financing approved projects.[34] Subsequently, in the 2015 budget, the government has backed the newly-rolled out Shariah compliant Investment Account Platform (IAP) with an initial start-up fund of RM150mln (USD45mln), for the IAP to serve as a central market place to finance small and medium-sized businesses.[35] Through the IAP, it is expected to spur a wider use of risk-sharing and equity-based Islamic financial contracts which are currently sparingly used in the global Islamic financial system.[36] Overall, these initiatives can help to boost the performance of Shariah-compliant SMEs and MSMEs in the country, and thus, potentially leading to an increase in the number of enterprises Islamic investors can participate in. Finally, to reach the full potential of Islamic finance in terms of addressing the SMEs and MSMEs and improving financial inclusion, a paradigm shift is essential to ensure that the core values and growth of Islamic finance are achieved.

31 IFC Advisory Services in the Middle East and North Africa – Islamic Banking Opportunities Across Small and Medium Enterprises in MENA (Executive Summary)

32 IFC Advisory Services in the Middle East and North Africa – Islamic Banking Opportunities Across Small and Medium Enterprises in MENA (Executive Summary)

33 "Syariah-compliant schemes to provide further aid to Malaysia's SME growth" Borneo Post online (29th Jan 2013)

34 "Syariah-compliant schemes to provide further aid to Malaysia's SME growth" Borneo Post online (29th Jan 2013)

35 "Planned Malaysia Investment Platform to expand role of Islamic banks", Reuters (10th Nov, 2014)

36 "Planned Malaysia Investment Platform to expand role of Islamic banks", Reuters (10th Nov, 2014)