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ISLAMIC FINANCING FOR SMALL MEDIUM ENTERPRISES IN MALAYSIA: A PROPOSED FRAMEWORK

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Abstract: *Small Medium Enterprises (SMEs) is an essential sector contributing to the economic growth in Malaysia. Government agencies established a comprehensive plan for SMEs especially to provide funds to all SMEs form start-up firms to large corporations. The growth of SMEs is in line with the growth of Islamic finance and Muslim entrepreneurs' need to determine the best sharia-compliant financing for their business. However, some of them are unaware with regards to the eligibility and the procedure to apply for the financing. Most unsuccessful applicants lack a robust business plan as well as has a bad financial record that is a basic problem in their application. Therefore, this study proposed a framework for SMEs in application for Islamic financing at Islamic banks to enhance SMEs understanding and heightened awareness on what should be done for pre and post-application in financing application.*

Keywords: *Islamic financing, Small Medium Enterprises (SMEs), Islamic banking*

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Introduction

The preference and demand for sharia-compliant products from financial institutions are significant in both the local and international market. Malaysia has a dual financial system that works in parallel which is the main backbone to provide Islamic or conventional financing for individual or business purpose. Small Medium Enterprises (SMEs) is one of the organizations that play an important role which seeks Islamic financing from various financial institutions for their business growth. The application of a diverse spectrum of Sharia contracts by Islamic financial institutions continues to trend higher in recent years, which demonstrates its viability as alternative tools, supported by a comprehensive ecosystem. In Malaysia, Islamic financial institutions play significant roles in assisting SMEs.

Islamic SME financing is one of the schemes that has been introduced by the government since 2012 and Malaysia has been promoting it by providing rebates to participated parties. Recent issues discuss the importance of SMEs sector towards economic growth. According to the Annual Report SME 2015/16, Islamic financial institutions have accounted for 96 per cent of SME growth. The statistic shows that the total funding for business financing has increased from 43.8 per cent to 46.6 per cent from 2014 to 2015. With the growth of SMEs in the marketplace, the demand for the Sharia compliance financing also increase and lead to the importance of small and medium enterprises (SME) sector towards economic growth.

The preference for sharia-compliant products is very high based on the report by (SMECorp, 2019; World Bank, 2015). Thus, having a proper framework and guidelines for Islamic SME financing is a must since the growth of Islamic SME financing is very encouraging. According to (Iqbal, 2014), having a good framework for SME financing is important to strengthen the Islamic SME financing for all Islamic institutions of the nation. (Hasan, 2015) also has highlighted several challenges faced by SME which are, adverse legal and regulatory framework, insufficient bank policies that utilize movable collaterals and insufficient branding strategies for banking products and services. All of the challenges can be managed by providing a proper framework that could solve several problems faced by the institutions and also SME entrepreneurs. In a report published by Islamic Development Bank (IDB) in 2006, there is an issue on harmonization related to operational and Sharia standards, and the development of a common regulatory regime to support cross-border transactions.

In addressing these issues, IDB has given support to strengthen the institutional framework of the Islamic financing which focuses on the implementing strategy involving developing and using innovative Sharia-compliant instrument. Besides, a masterplan by the Malaysian government recommends increasing financing access to SMEs. The most eligible as well as a huge support for Islamic financing for SMEs is Islamic banking. Thus, this study highlights an overview of Islamic banking in providing funds to SMEs in Malaysia and a proposed framework for the future direction of Islamic banking in becoming a preferred funder to SMEs especially for Muslim entrepreneurs.

Literature Review

The global growth of SMEs has led to increased demand for SME financing. One of the most popular Islamic products in Malaysia is SME Islamic financing, which supports the financing needs of SMEs at all stages of the business lifecycle, from the seed/start-up companies to large corporations. The upward trend of SME globally leads to the demand for financing especially

Islamic SME financing from Muslim entrepreneur. Thus, the demand for financing access has increased over the years. The institutions involved in providing the fund to the SMEs are Amanah Ikhtiar, Tekun Nasional and Islamic banks.

Islamic banking is a system where any activity and operation under the Islamic banking industry should comply with Islamic law also known as Sharia's law. Islamic banks must provide their products and services to potential customers permissible in Islam that refer to the reliable and fundamental sources in Islamic law, namely Al Quran and Hadith. Any operation and activities in Islamic Banking should strictly comply Sharia and prohibit riba (interest) (Abbas & Ali, 2019). The prohibition in riba is mentioned in the Al Quran; for example, in Surah Al Baqarah, verses 275, Allah (S.W.T) says: "Allah S.W.T has permitted trade and has forbidden riba". The prohibition from riba mentioned in the Al Quran is important for Islamic banking in ensuring that operational activities in the banking system should avoid riba transactions. However, Islamic banking practises not only limited to riba but also prohibits others element such as maysir (gambling) and gharar (speculative trading) in line with Sharia.

The birth of modern Islamic Banking started with the establishment of Mit Ghamr Savings Bank in Egypt in 1963 (Haron & Wan Azmi, 2009). Nowadays, Islamic banking has grown rapidly over the past decade since it first emerged in the 1970s. The development of Islamic banking has led to a new trend in the way business and economics are being conducted. According to Alaudin, Shantapriyan, & Adler (2015) indicated that the tremendous growth of Islamic finance will yield the current and management assets of Islamic banking in the global to reach around USD750 billion and it is expected to increase around USD 1 trillion by 2010. At the current moment, Islamic banks operate in most Islamic countries and up until the end of 2008, there are more than 300 Islamic banks or financial institutions in operations in Muslim and Western countries worldwide across 75 countries, leading countries are Malaysia and Bahrain as the biggest centres (Haron & Wan Azmi, 2009).

Globally, in Pakistan, it shows that the total asset of Islamic bank in Pakistan grew by 1.3% in the third quarter of 2014, while the total deposit and profitability of Islamic bank in Pakistan showed that it recorded Rs 934 billion and reported at Rs 9.4 billion respectively. It can be proved that the Islamic banking sector in Pakistan is growing at a fast pace (Ali, Syed Ali, & Chin-Hong, 2015; Hasan Raza, Ahmed, Osama, & Ahmed, 2017; Shaikh, 2018). In Sudan, the Islamic banking industry has shown a rapid increase in growth since the concept of Islamic banking was introduced in 1997 (Haron & Wan Azmi, 2009).

Malaysia is considered as an international Islamic financial centre with full government support to strengthen the dual banking system where the Islamic banking practise runs in parallel with the conventional system (Amin, Abdul Rahman, Sondoh Jr, & Chooi Hwa, 2011). According to Echchabi & Olaniyi (2012), Malaysia is one of the pioneering countries implementing the dual banking system namely the conventional and Islamic banking that operates side by side. Presently, in term of growth, BNM (2007) data indicates that Malaysia's Islamic banking assets reached around USD65.6 billion with an average growth rate of 18-20% annually. Basically, in Malaysia, there are several similarities and differences between Islamic banking and conventional banking. The similarities between dual banking systems are both of it, provide a diversity of Islamic products and services to its customer. However, the difference is in term of transactions based on the interest rate and other operational requirement implemented by the

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bank. Thus, the speciality of Islamic financial institutions should be seized by related parties given the opportunity provided by the government.

Review of Islamic Banking and SMEs in Malaysia

The increasing number of SMEs in global as well as in Malaysia shows the urgency of certain sectors in providing a fund to the SMEs especially financial institutions. As Malaysia has a majority of Muslim entrepreneurs, the demand for Islamic financing has become a priority among them. Islamic banking becomes a priority place to apply for business financing. However, there is a limitation on financing which is not achieved on what businesses' needs Based on Figure 1, total loan applied from 2015 to 2019 shows an increasing trend which is followed by approved total loans. However, the gap between the applications and approved applications is significant.

The application of financing among SMEs aims to add their working capital, upgrade their production process, product development and lease/purchase of equipment to complete the operation of their business (Haron & Ibrahim, 2016). According to The Star (2013), the Association of Banks in Malaysia (ABM) exposed that unsuccessful applicants among SMEs are due to their bad record of credit history, poor business plan and paperwork, inadequacy collateral and others based on the checklist provided by the bank. Thus, it shows that several SMEs doesn't have an excellent plan for business and lack of knowledge to apply for the loan. These problems persist until 2019 which SMEs that experienced rejection in their loan application provide insufficient cash flow to meet a repayment, poor documentation and bad business plan as the main reason of rejection (Haron & Ibrahim, 2016; The Star, 2019). Bank Negara Malaysia (BNM) has outlined several challenges that financier need to face in evaluating the loan application such as poor financial management, no expertise has been mentioned for the plan provided, bad past performance, lack of robust business plan and no proper business record BNM (2015).

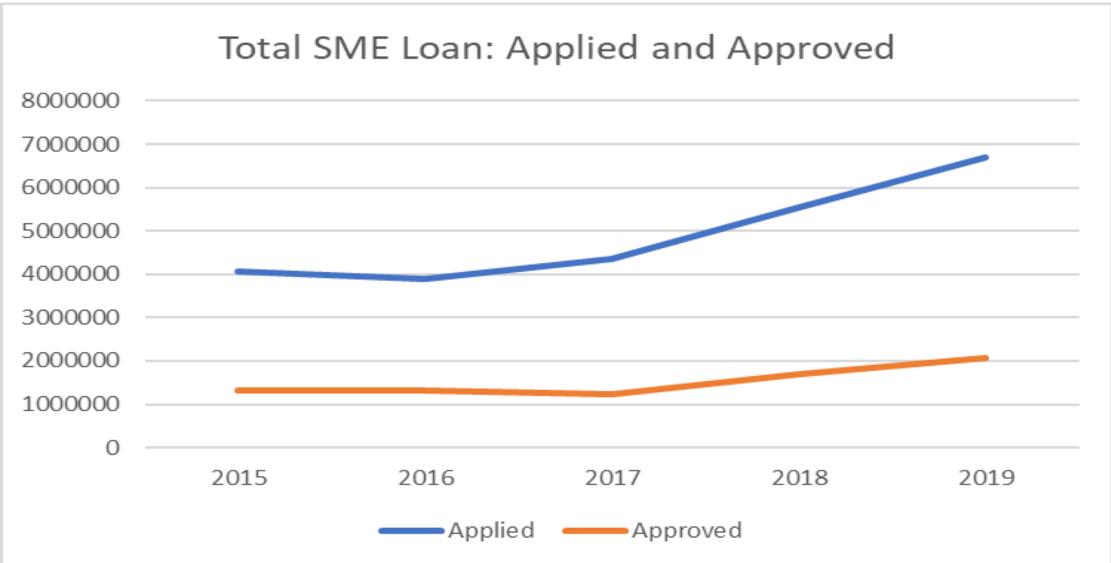

Figure 1: Islamic Banking: Total SME Loan/Financing Applied and Approved
Source: Bank Negara Malaysia

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Other than that, according to SME Corporation Malaysia, the percentage of women-owned SMEs accounted for about 20.6 per cent of total SMEs in 2015 and the growth rate is 8 per cent annually. However, female-owned firms experienced a lower approval rate of 83% (The Star, 2019). The reason for rejection is due to lack of track record, poor documentation, and lack of knowledge about the application of financing since they are first timers in borrowing money from financial institutions.

There are a lot of deficiencies in the application of financing either at conventional or Islamic bank. The same cycle continues on an annual basis. Although bankers had given their statements as well as discuss the loans' rejection, it's still not done there since SMEs has grown bigger in number in Malaysia. Bank Negara Malaysia has provided advisory services to SMEs to refer for the rejection and the bank itself is required to provide an explanation in rejecting the financing applicants (Shen, 2019).

Major applicants for Islamic SME financing in Malaysia are Muslim entrepreneurs and they prefer Islamic financing instruments cause it is easy to manage, can satisfy risk-sharing and capital needs (Haron & Ibrahim, 2016). Apart from that, Muslim entrepreneurs are seen as a role that contributes to the ethical economy as a guideline by Islamic banking itself. According to Yaacob & Azmi (2012) and Ilhaamie, Siti Arni, Rosmawani, & Hassan Al-Banna (2014), entrepreneurs in Malaysia are committed to fulfil social responsibilities as its draw oneself closer to Allah and can fulfil the need of others such as assisting people in providing job opportunities as well as provide ethical and halal products. Thus, Islamic SME financing presents a crucial agenda to be focused on and having a proper and details framework on SME financing is a trigger issue to be solved by the government and practitioners to provide a clear vision to SMEs on what should they do to succeed in their loan application and eligibility for the loan.

Proposed framework of Islamic SME financing in Malaysia

Based on the discussion above, there are several deficiencies in Islamic SME financing in term of SMEs knowledge with regards to the eligibility of financing application and also the standard procedure for the application. This poses a challenge because there will always be emerging SMEs in the economy to set up a business with additional capital. Old SMEs has more knowledge on the procedure to apply for the financing but not for new SMEs. The knowledge and information should be renewed annually to support SMEs to run their business that will increase the country's income. Islamic SME financing is the leading choice for Muslim entrepreneurs which is in line with the Islamic principle to prioritise Islamic loan compared to a conventional loan.

The halal industry run by Muslim entrepreneurs should be prioritised by practitioners in order to enhance the business and at the same time would improve the growth of Islamic finance in the country. The lack of finance, demand and location problem (Ilhaamie et al., 2014) is a trigger issue among SMEs that should be solved by the government. Due to lack of knowledge, many SMEs financing applications are rejected due to poor business plan and documentation. According to Kamel (2019), there are many solutions provided by Islamic banks but not fully utilized by SMEs due to lack of awareness. Additionally, Islamic banks are ready to provide financing to SMEs with the given grant about twenty million worth of financing access in September 2019 during the National Entrepreneurship Week. Therefore, the lacking side from

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SMEs should be made transparent to the government as well as SME itself to enhance and find the best solution for financing matters. Successful SMEs should rely heavily on efficient steps before financing application to ensure all necessary documentations are in place.

Pre-application: Documentation

For pre-application process, SMEs should approach Islamic banks for guidance on the details of the financing offered by Islamic banks. The guidelines established by Bank Negara Malaysia summarised on principles of lending. According to Haron et al. (2013), potential borrowers should have a good knowledge of the business experience and past project that has been done by the firms, records should be disclosed to complement the reputation and commitment of the business, a proper plan for the business and good health record as supporting documents. Then, banks also look into the business's potential to repay the loan by referring to business cash flow and other supporting documents related to the financial position of the business. The most important section in the application procedure is about collateral that presents the guarantee for the loan borrowed to avoid any moral hazard problems after loan approved to the borrower (Osano & Languitone, 2016).

Thus, the documentation about all the required records and paperwork should be attached by SMEs in ensuring no document left for the application and to convince that the business is run well. Bankers need to ensure that loans can be well repaid after the loan is approved. This loan application procedure is applied to all banks including Islamic banks. SMEs should equip themselves with all the required knowledge when submitting their loan to Islamic banks (Haron et al., 2013).

Pre-application: Choice of Islamic financing scheme

There are three preferred schemes offered by Islamic bank which are leased equipment (*Ijarah*), equipment (*Murabahah*) and capital needs (*Qardhul Hasan*). These three schemes are effortless to manage and monitor by the banks (Suzuki & Uddin, 2016). However, the application of every scheme should tally with the business's risk profile. SMEs should consider choosing a scheme that is suitable for their business because it is also one of the factors in ensuring loan application success. The need for the business should be documented in a business plan in ensuring that at the time of loan assessment for a specific scheme, all information is coordinated with the business needs. Clear vision and mission of the firms should be acknowledged properly to convince the bank about the need of the firm to move forward with a good plan. Thus, the choice of Islamic financing scheme is essential to SMEs in projecting the best planner part of the business.

Post-application: Approval or Rejection

Once the entrepreneur applies for the financing, they are ready for the result to the next action for both sides of SMEs and Islamic banks. SMEs should scrutinise the risk to repay the loan once it approved and plan to use the financing wisely. It is an important move to them in ensuring that the loan can be settled unless the problem comes from the government or a country's situation that need to hold any business to run. However, if the loan application is rejected, SMEs should get advisory services provided by organizations such as Khidmat Nasihat Pembiayaan (MyKNP) at Credit Guarantee Corp Malaysia Bhd (CGC) and Credit Counselling and Debt Management Agency (AKPK) as recommended by Bank Negara Malaysia (Shen, 2019). This one-stop centre should be seized its opportunity by all SMEs to seek clarification and obtain apparent information from the organization on what should be done next for the sake of their business. Additionally, Islamic banks that reject the loan application should explicitly mention in supplementary document on the reason the application is rejected so that SMEs could step forward to refine their documentation or paperwork to reapply the loan strategically.

Conclusions

The proposed framework is crucial for SMEs to act and not as a preparation in the phase of the pre-application process. The loan application would be successful if all necessary documentation is attached and clearly explained. Government has provided much access to finance for SMEs. Thus, the chances should be seized by all SMEs that need financing to enhance their business that can increase the income of the country as well as benefit to other people in many ways. However, this framework as a precautionary step to be successful in the loan application. It is not guaranteed to get the loan and SMEs should not give up for the negative result but should put more effort to get something worth to their business. For post-application, unsuccessful applicants should be more aggressive to find out what is lacking in their application so that they could improve for the next action when reapplying the loan in an efficient manner.

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