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IFSB 7th PUBLIC LECTURE
ON FINANCIAL POLICY AND STABILITY

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Islamic Finance
and SME Financing

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Professor of Finance and Hibernia

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Entrepreneurship, Islamic Finance and SME Financing

Professor Dr M. Kabir Hassan

INTRODUCTION

An in-depth treatment of entrepreneurship viewed through an Islamic lens is missing from current field research on Islamic development. This paper rectifies this conspicuous absence by delineating the function of Muslim entrepreneurs in economic development, with an emphasis on exploring how Islamic ideals and values shape business decisions, such as business operations and financing.

Earlier claims that an ascendant secularism would gain primacy in public life at the expense of religion seem to be premature. Religion has proven to be resilient, surviving the challenges of modernisation, materialism and technological innovation to remain relevant. In fact, Iannaccone (1998) contends that religion has actually gained ground on secularism, citing a revival of religious sentiment spreading across nations, especially in Islamic countries (Voll, 2001).

Religion's compelling comeback in modern society has even prompted Voll (2001) to audaciously pronounce the "end of secularism". Secularism should no longer be assumed the inevitable endpoint of modernisation, the universal philosophy that underscores and animates society. It is imperative also to appreciate the importance of religion in shaping people's belief systems. Religion has a profound and abiding role in people's daily lives and economic behaviour, a role that demands further study.

Seymour (2003) states that studies with "adequate depth" are needed in order to investigate the relationship between religion and entrepreneurship. Dodd and Seaman (1998) are two of the few researchers who have studied this subject. Their study was composed of three levels: first, the relationship between society, religion and entrepreneurship (the attitude of religion regarding the creation of new firms); second, the relationship between individual faith, religion and entrepreneurship (the motivation to decide to become an entrepreneur, the entrepreneur's conduct and work ethics, and the entrepreneur's network); and finally, the relationship between theory, religion

and entrepreneurship (the envisioned role of religion in entrepreneurship development). Dodd and Seaman's article concludes that the relationship between religion and entrepreneurship should be considered "complex and interdependent". They also find a comparably low level of religiosity among the surveyed British entrepreneurs and the non-entrepreneurial surveyed samples.

There are four broad views on the nature of the relationship between religion, economic development and entrepreneurship that are derived from academic literature (Dodd & Seaman, 1998; Wilber & Jameson, 1980). The first view proposes that religions, including Islam, are each in their own way developmental in nature. Each religion's ultimate goal is for humankind to strive to become better human beings, by "having more" instead of "being more". All religions expect that their adherents will behave in an ethical and moral manner, especially when participating in business activities (Baydoun, Mamman & Mohmand, 1999; Sherman, 1997). Gutierrez (1973) recognises the developmental role of religion and how development is then linked to liberation.

A second view considers religions, especially Islam, as being "outdated, unnecessary and divisive" (Perkins, 2003, p. 6; Sutcliffe, 1975), and as interfering with development and progress. This view generalises the role of religion in development by presenting oversimplified arguments in broad terms and "either/or" statements. Goody (2003), on the other hand, has a more impartial view, suggesting that religions have a dual effect on development. Despite this, Goody (2003) still considers religion more of an obstruction for development and progress, and argues that religion stifles the individual's capacity for critical thought and rational inquiry. He concludes: "It is possible that the very absence of a world religion, with the various restrictions that implies, was in part responsible for the enormous expansion of intellectual horizons in Greek thought" (Goody, 2003, p. 67).

The third view holds that religion and spirituality are purely personal matters and should be strictly separate from human interaction and, especially, economic activity (Lewis, 2002). This secularly oriented view supports religion being excluded from state affairs, since, it holds, religion and business should not be combined. A large number of Western countries have adopted this belief and have incorporated it into their constitutions.

The fourth view, built upon Max Weber's thesis, examines religions separately and suggests that certain religions are pro-development and pro-

entrepreneurship, while other religions are anti-development. The Weberian thesis is the foundation of the majority of studies and intellectual forums that debate the role of religion in development. The amount of impact religion has on supporting or hindering entrepreneurial activity within a specific culture is disputable.

The literature concludes that the methodological tools to test causality and measure the impact of cultural values (i.e., religion) on entrepreneurship have not yet been established (Dodd & Seaman, 1998). Nonetheless, looking at a religion's view of entrepreneurship in a certain culture can indicate how entrepreneurial activities are viewed within that culture. This is especially relevant in religion-based cultures. The theories built upon Islamic entrepreneurship are still in their early stages and available literature on the subject is very limited in its breadth and depth. This paper strives to help fill this gap.

THE ISLAMIC WORLD-VIEW OF ENTREPRENEURSHIP

Chapra (2000) engaged in a similar debate in which he questioned the need for a separate "Islamic economics", since conventional economics is highly developed and already enjoys widespread use. He concluded that Islamic economics would be needed only if conventional economics was unable to conform to the Islamic ideal of proper allocation and distribution of scarce resources.

Muslim scholars including Siddiqi (1979), Alam (1965) and Kahf (1978) acknowledged a disparity between the logic of Western economics and the core of the Islamic value system and moral code of conduct. These scholars asserted that Western economics was unsuitable for Muslims because it did not accommodate their economic concerns or attest to the complexities of their religiously based culture. Therefore, the need arose for the development and application of an Islamic economics that would be compatible with the Islamic world-view.

The logic used in the debate regarding Islamic economics versus conventional Western economics can be similarly applied to the Islamic entrepreneurship/ Western entrepreneurship debate. Is it necessary to construct a separate Islamic entrepreneurship model even though Western accounts of development

and entrepreneurship already exist? A distinct Islamic entrepreneurship model would only be justified if the current Western model cannot satisfy the requirements of the Islamic entrepreneur. If this is the case, an alternative model would add theoretical and practical value and would be a catalyst for the development of Islamic entrepreneurship.

ENTREPRENEURSHIP IN THE ISLAMIC PERSPECTIVE

In general, a religion that has a positive approach towards work and productivity is more likely to facilitate the creation of effective business entities and the advancement of a favourable entrepreneurship environment. The beneficial impact of such an approach would be magnified if accompanied by political assistance and positive engagement from the government.

The idea that religion plays a key role in shaping the mode and level of entrepreneurial activity in a given society is not a new one, nor is it an obscure one. It has widespread acceptance and has been examined in Dodd and Seaman (1998); Guiso, Sapienza and Zingales (2002); Hirschman (1983); Sood and Nasu (1995); and Wienen (1997).

One of the essential human rights that all individuals should be entitled to is access to income. Chapra (1985) explained that socio-economic justice, based on the theory of “social equilibrium”, requires that people have equal opportunity but does not require equality of outcomes. Earning a lawful (*halal*) living is possible either through being employed and working for others, or by being self-employed and employing others. The latter case constitutes entrepreneurial activity. Islam supports working for others for a fixed compensation, but it encourages Muslims to become entrepreneurs, as entrepreneurship is the preferred means of *halal* income.

Beg (1979) documented the community-building aspect of Islamic entrepreneurship. Not only does Islam encourage entrepreneurship; it further requires entrepreneurs to work diligently to earn *halal* income that will fulfil the entrepreneur’s needs as well as help support the community and the Muslim at large. This type of responsible entrepreneurship aids others and deters people from exploiting public wealth. It also discourages individuals from becoming reliant on the state. Public wealth is associated with the Muslim, so it should be appropriated to projects that serve the community.

Sadeq (1997) noted that Islam holds entrepreneurship in high regard, and argued that Islam incentivises entrepreneurship and provides the framework for economic development. Sadeq based his argument on his interpretation of the *Qur'anic* verse, "And when prayer is over, disperse in the world and search for the bounty of Allah" (*Qur'an*, 62, 10) and on the many traditions of the Prophet Muhammad (Peace Be Upon Him). The *Qur'anic* verse, "It is He Who made the earth manageable for you, so traverse ye through its tracts and enjoy of the sustenance which He furnishes: but unto Him is the resurrection" (*Qur'an*, 15, 67) has also been cited by others in support of this interpretation. Sadeq (1992) characterised "entrepreneurship" as a means of searching for new horizons and discovering new opportunities that will benefit humankind. This search requires risk taking and innovative thinking, two qualities that define "entrepreneurship".

The Holy *Qur'an* and the traditions of the Prophet Muhammad (PBUH) are replete with instances that encourage and exemplify moral entrepreneurship. One such example is the *Qur'anic* verse, "But Allah hath permitted trade (*Bay'*) and forbidden usury (*Riba*)" (*Qur'an*, 2, 275). The term for profit (*Bay'*), which is earned through the process of buying and selling in an economy, implies the existence of entrepreneurship. It is chronicled that the Prophet Muhammad (PBUH) proclaimed, "A faithful and trustworthy businessperson will be resurrected at the Day of Judgement with the prophets, the truthful, and the martyrs" (Ibn Majah; al-Tirmithi). Furthermore, the Prophet Muhammad (PBUH) and many of his close companions were trustworthy and successful entrepreneurs. He unequivocally articulated the significance of entrepreneurship and emboldened Muslims to participate actively in business activity. Nu'aym Ibn Abd Al-Rahman narrated that the Prophet (PBUH) said, "Nine-tenths of the sustenance (*rizq*) is derived from trade (business ventures)." The second Muslim *Khalifah*, Omer bin Al-Khattab (May Allah be pleased with him), also was a trader who liked to say, "Nothing is more beloved to me than to earn my living through my own hard work and efforts."

In Islam there is the important concept of collective obligation (*Farḍ Kifayah*), which is the commitment that society has in meeting the minimal needs for a specific activity or the national demands based on the society's ability to meet those needs and obligations. An adequate segment of the Muslim population should choose to pursue entrepreneurial endeavours in order to ensure the nation's economic viability. If this is not done, then the Islamic government will need to intervene to fulfil its legal and moral obligation to offset the deficiency of the private sector.

Perkins (2003) examined how the role of Islam affected the process of “wealth creation”, and affirmed Weber’s conclusion: “There is no doubt that Islam is an economic hindrance and barrier to prosperity and fulfilment of human ambition, potential and welfare” (Perkins, 2003, pp. 5–6). However, Weber’s (1963) conclusion that Islam hinders development and McClelland’s (1961) statement that Muslims are low in achievement have been criticised by Western intellectuals. Several Western thinkers and Muslim scholars disagree with such dire assessments and instead attest to the progressive nature of Islam. They acknowledge Islam as a progressive religion that actually encourages prosperity and entrepreneurship.

There are a number of scholars who have recognised Muslims’ vital contributions to the world’s civilisations, including Hooker (2003). Pelletreau (1996) acknowledged both the contributions of Islam as well as the value system that led to their manifestation. Zapalska, Brozik and Shuklian (2005) asserted that Islam predominantly has a positive relationship with entrepreneurship and the rights of ownership. Wilson (2006) confirmed the uniqueness of the Islamic code of business ethics and claimed that it could contribute positively towards the credibility of economic activity through cost effectiveness and organisational competence.

THE MOTIVATION BEHIND ENTREPRENEURSHIP

The motivation behind entrepreneurship is an important issue. The capability of a nation’s entrepreneurs to create businesses that benefit the economy and induce positive effects in the cultural, social and economic structures of the country depends on their motives. Entrepreneurs’ personal motivations for starting a business can indicate the economic climate of a country. These motives act as guidelines for how policymakers govern when deciding how to allocate resources in order to incentivise the development of growth-oriented businesses that generate new job opportunities.

There are various reasons why entrepreneurs start businesses: to earn more money, to be creative, to build a social position, to increase their social status, to become independent, to have greater control over their work, to have a comfortable lifestyle, to fulfil the need for a job, to counter the prospect of unemployment, etc. These motives have been categorised into the following general but distinct groups by researchers: economic and lifestyle reasons,

creativity of small firms, social aspects of being self-employed, and small businesses as a means of employment.

The motives of entrepreneurship have also been examined through the prism of “push”/“pull” analysis. This approach has gained acceptance in the research community and is widely circulated in the academic literature (Dean, Meyer & DeCastro, 1993; Granger, Stanworth & Stanworth, 1995). “Pull factors” are positive motivators such as when individuals start their own businesses based on an affirmative choice and are “attracted by the opportunity or the ‘pull’ of perceived profit” (Storey, 1982, p. 110). “Push factors” are negative motivators such as unemployment or the threat of it (Sage, 1993) and career dissatisfaction (Brockhas & Dixon, 1986). These negative situations “push” individuals into entrepreneurship, since that is seen as the entrepreneur’s best or only option to improve their current situation.

ENTREPRENEURSHIP IN ISLAM

Whether the motive is opportunity or necessity, Islam endorses entrepreneurship as long as it is morally and ethically sound and in compliance with the Islamic code of conduct. The stimulus of entrepreneurship in Western societies is driven mainly by potential profit. By contrast, business ventures by Muslim entrepreneurs, while of course encouraged to create a profit, carry with them the important added stipulation that every business undertaking be a form of *Ibadah* intended primarily to please The Almighty Allah. Business activities should strengthen Muslims’ faith (*Iman*) by committing them to the remembrance of Allah and attending to His religious duties. “*By men whom neither traffic nor merchandise can divert from the remembrance of Allah, nor from regular prayer, nor from the practice of regular charity*” (Qur’an, 24, 37).

The moral code of Islamic entrepreneurship regulates profit accumulation by prohibiting dishonesty, greed, exploitation and monopoly. The Prophet (PBUH) explained that anyone who stockpiles commodities, anticipating an increase in prices with the intention of making an unlawful profit is a sinner. Islam aspires to create successful Muslim entrepreneurs of high moral calibre who will have a positive impact not only on the nation’s economy, but on society as a whole. Therefore, Muslim entrepreneurs are authorised to be involved only in morally and socially accepted business activities. Activities that involve alcohol, drugs, usury, prostitution, gambling and highly speculative business

behaviour are strictly prohibited, despite their potential profit and potential financial contributions to the national economy.

Religious and altruistic influences are significant motives behind Islamic entrepreneurship. These factors are mainly absent from Western entrepreneurship literature. Islamic entrepreneurship is considered as being *Fard Kifayah* on the Muslim *Ummah*: it is a form of worship that brings Muslims closer to fulfilling their religious duties and completing their faith (*Iman*). Islamic entrepreneurship is the means by which assistance is offered to other members of the Muslim community and the development of the Muslim nation is secured. The Muslim entrepreneur's concerns must be directed outward and encompass much more than merely satisfying immediate needs and personal interests. The "pursuit of self-interest" (Smith, 1776) and self-centred wealth creation (Say, 1816; Schumpeter, 1934) are not the primary motives behind Islamic entrepreneurial activity. Altruism is more important than self-interest, and the common welfare is thus elevated.

Entrepreneurship in Islam is both a means of thanking The Almighty Allah for His countless blessings and a way to help others:

But seek, with the (wealth) which God has bestowed on thee, the Home of the Hereafter. Nor forget thy portion in this World: but do thou good, as God has been good to thee, and seek not (Occasions for) mischief in the land: For God loves not those who do mischief (Qur'an, 28, 77).

Numerous *Qur'anic* verses and traditions of the Prophet (PBUH) encourage Muslims to be philanthropic to promote the spirit of cooperation and spread socio-economic justice among Muslims.

One can argue that starting businesses with the motivation of helping others through job creation is a form of giving or spending in the way of The Almighty Allah. This serves to reward the Muslim entrepreneur in the hereafter while providing satisfaction and a high return on investment in this life. The positive implications of helping fellow Muslims earn *halal* income far exceed the benefits of simple charitable giving.

The Western system uses material incentives to motivate individuals to engage in entrepreneurship, while Islam mainly uses moral incentives before material stimulus. Sheikh Odeh (2004) pointed out that although the Muslim

entrepreneur is mostly motivated by the divine incentive system, Islam is the only religion and/or system that offers such an incentive while accepting and endorsing all other conventional motives. There is an expectation of Muslims to work diligently with all their physical, financial, moral and intellectual resources to seek the good pleasure of The Almighty Allah. This will advance their own cause both during their life on Earth and in the hereafter. Muslim entrepreneurs earn *halal* income and profit that enable them to fulfil *Ibadat* of a “financial nature”, such as giving *Zakah* and charity while meeting their own and their extended families’ needs, for which they will be rewarded generously in the hereafter. In order for the Islamic entrepreneurship model to be effective, an accommodating environment and supporting institutions need to be present.

AN ISLAMIC ENTREPRENEURSHIP MODEL

The Western entrepreneur is driven towards starting a business mainly by self-interest and the desire for individual profit. In contrast, the Muslim entrepreneur starts a business with the intention of pleasing The Almighty Allah. Literature on Islamic entrepreneurship emphasises that the Muslim entrepreneur is not animated by a personal desire to maximise material gains for one’s own self-interest. Siddiqi (1979, pp. 141, 151) defined the goals of the Muslim entrepreneur in terms of realising *halal* profits and contributing to social services for the wider community. Muslim entrepreneurs are motivated to earn wealth for their own reasonable and moderate consumption and to allocate income in the way of The Almighty Allah by helping the needy and contributing to the well-being of the *Ummah* at large. “*Make not thy hand tied to the neck, nor stretch it forth to its utmost reach, so that thou become blameworthy and destitute*” (*Qur’an*, 17, 29). Wealth is considered an economic necessity and a means of generating ongoing rewards for the Muslim entrepreneur by contributing to altruistic needs.

The realities of the modern world have increased the prestige and importance of the role of entrepreneurs. The idea that entrepreneurs are the true ambassadors of their countries to the world at large has gained more traction in the era of globalisation, where technology has torn down communication barriers and entrepreneurs have no choice but to be active leaders in the global marketplace in order to sustain and grow their businesses. Through their deeds and actions, Muslim entrepreneurs have the opportunity to

represent Islam and “spread the word of Allah”. Early Muslim entrepreneurs understood this and thus lived their lives in a way that was a testament to Islam. Their actions fulfilled the two broad aims of Islamic entrepreneurship: Islam spread to new territories; and Muslim entrepreneurs were successful in building prosperous economies. Another significant potential role for the Muslim entrepreneur is promoting Islam among Muslims and non-Muslims alike. The Muslim entrepreneur can do this by simply practising Islam in a true and heartfelt way while being a helpful and concerned member of the community, thus putting Islam in its best light.

In their dogged pursuit of development, the majority of Arab Muslim countries tried a plethora of different modernisation and development models during the latter half of the 20th century, unwisely overlooking the Islamic model. Muslim countries have implemented all sorts of “isms”; certain countries embraced nationalism, others have adopted one form or another of socialism, while the majority have pursued a broader policy aimed at accommodating “Westernism” while attempting to limit its cultural impact. All three approaches have proven unsuccessful. Decades of reliance on imported models of development did not bring economic prosperity or result in the establishment of social order in a single Arab/Muslim country (Mahdi, 1990).

Because of this, Muslims are returning to Islam for answers to contemporary issues that directly affect their everyday well-being. Mahdi (1990) noted the immense lack of intellectual work by Muslim scholars in the field of social science. He presented a strong and well-argued case for the urgent need for Muslim scholars and social scientists to focus on the issue of Islamic model building in economics and other social sciences. Chapra (2000) explained that the lack of serious work in Islamic social science disciplines was due to the attitudes of some Muslim political establishments.

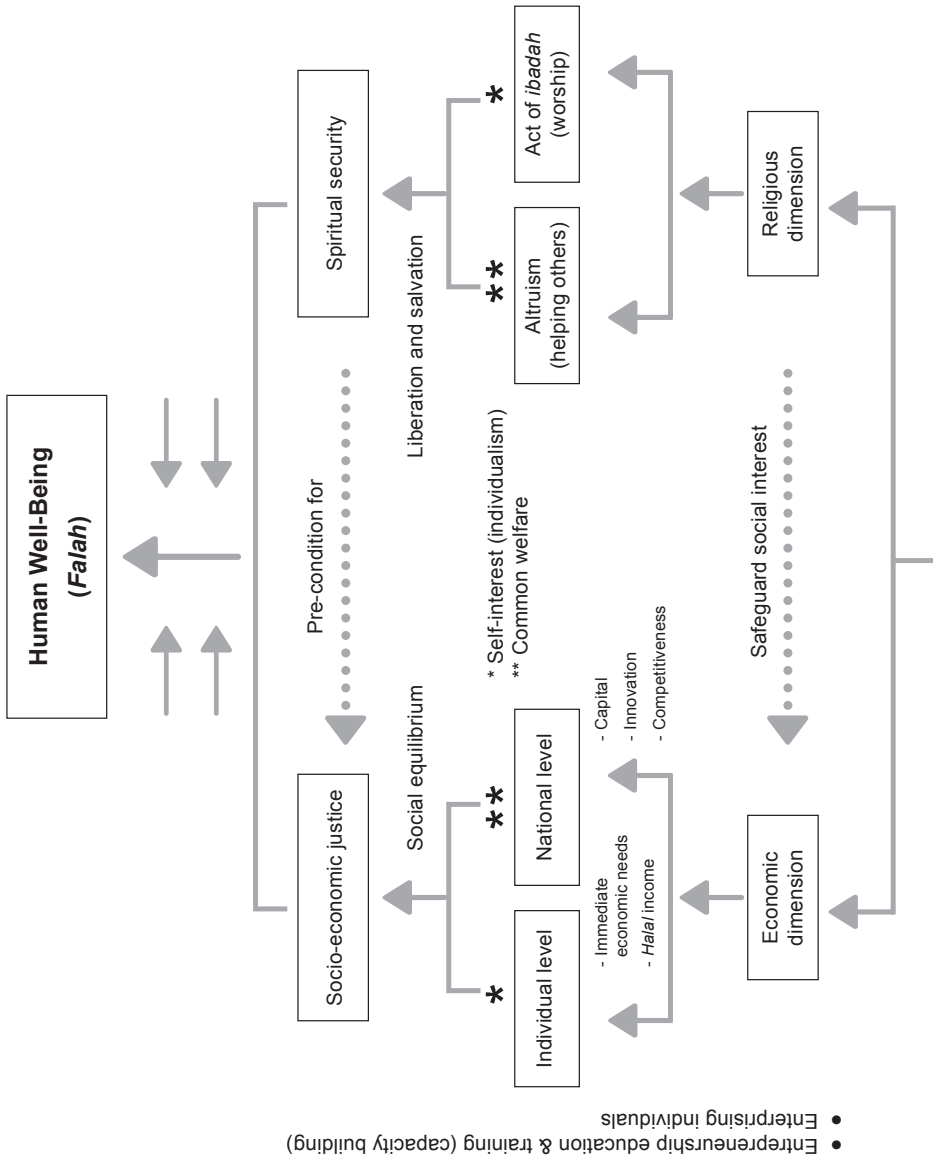
Since Islam is an eternal and universal religion, it needs to modernise at all times. Islam must be adaptable to the unique circumstances and necessities of the present day without contradicting or compromising its fundamental principles. Islam has provided the world with broad moral guidelines and boundaries. Modern Muslims can work within these guidelines and boundaries, and in most cases leave the details for future Muslim generations to work out according to their existing circumstances (Al-Sader, 1982). The Holy *Qur’an* and the Noble *Sunnah* clearly distinguished what is *halal* and what is *haram*, and differentiated between what is considered legal and productive

business activity and what is not. Therefore, every socio-economic model is accepted in Islam as long as it complies with the concept of “unity of God” and abides by the basic Islamic principles of utilising *halal* financing, employing ethical business practices, and working towards the common welfare of the Muslim *Ummah*. Any system that follows these Islamic principles is legitimate and acceptable. Each Muslim country is entitled and encouraged to create developmentally driven legislation that harmonises with its particular customs and environmental conditions and is within the general guidelines of the Islamic world-view.

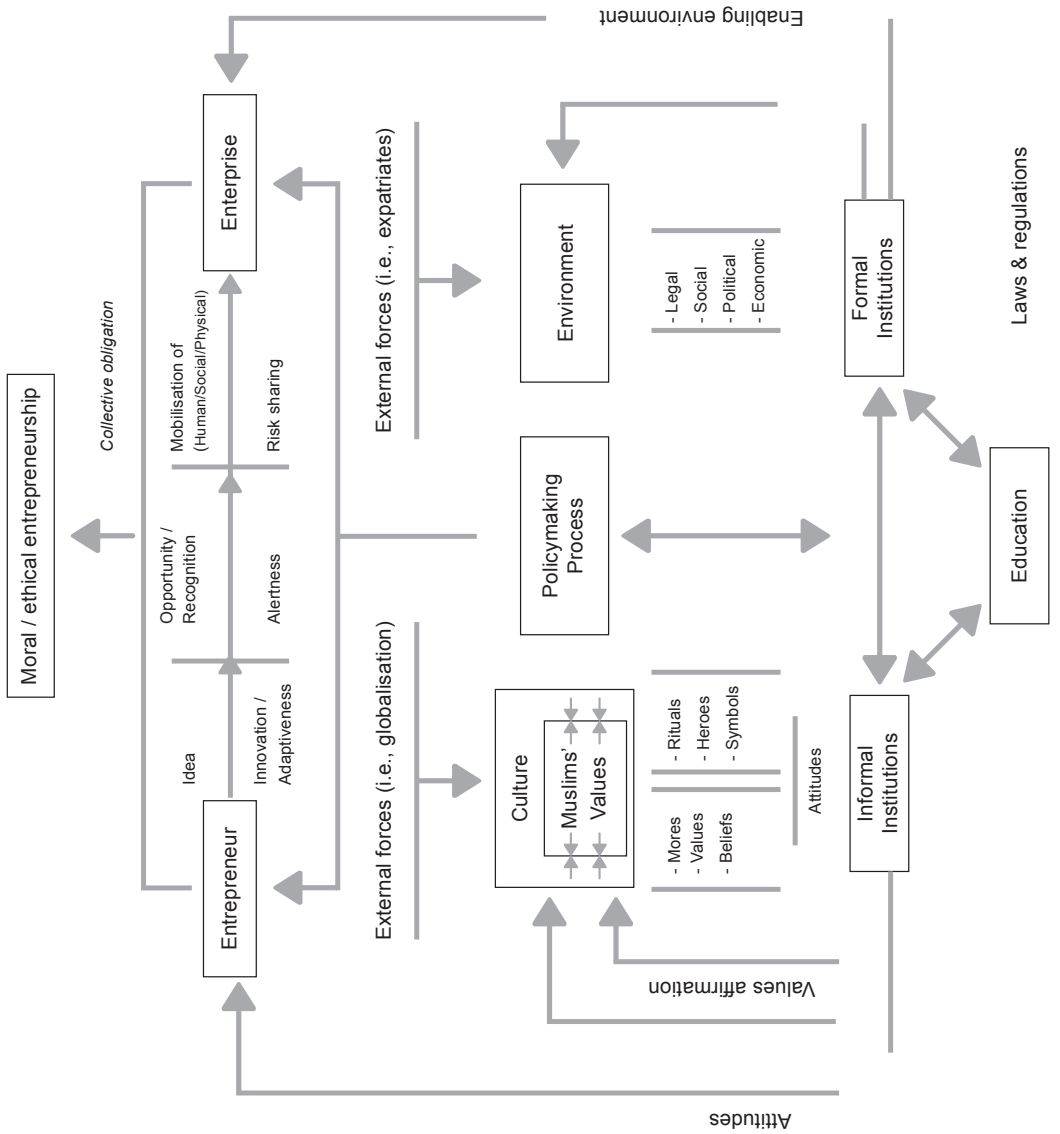
The proposed Islamic model of entrepreneurship (Figure 1) builds upon the conceptual general Western model. While both of these models share many features and assumptions, the proposed Islamic model highlights the differences between the two perspectives and accounts for the specific attributes of the Islamic view of development and entrepreneurship. The Western and Islamic models differ in their definition of development, their view of the relationship between religion and culture, and their stance on the role of religion in development. Therefore, their attitudes and approaches towards cultural transformation and values affirmation differ as well. The application of the Western model entails a cultural transformation towards the Western style of institutional framework as a means of increasing entrepreneurship within a country. The Islamic model promotes the affirmation of religious values and requires formal institutions to be a true reflection of the Islamic value system. Thus, the Islamic model calls for institutional transformation in accordance with Islamic values.

The two models also differ in their approach to risk taking and risk sharing with regard to the financing of entrepreneurial activity. The one-dimensionality of the Western model of development renders it incompatible with Islamic entrepreneurship. The two-dimensional Islamic model emphasises morality in business and includes a mechanism to safeguard the social interest while preserving personal well-being. Chapra (2000) argues that the concept of the hereafter should be at the heart of any Islamic model. The fear of God’s punishment and the hope for His mercy create an effective motivation for individuals to act morally for their own interest as well as the interests of their community and the Muslim *Ummah* at large.

Figure 1: An Islamic Entrepreneurship Model



- Entrepreneurship education & training (capacity building)
- Enterprising individuals



CURRENT STATUS OF ISLAMIC BANKING IN SME FINANCING

The banking sector in Middle East and North Africa (MENA) countries has undergone astonishing growth and diversification in recent times. In 2013, the Islamic banking sector's growth far outpaced that of the rest of the world, reaching 16% while the overall global banking sector grew by 0.6%.¹ The Islamic banking and finance industry swelled to include more than US\$1.87 trillion in assets by 2014.² Consequently, the Islamic banking sector has been able to provide some growth for the small and medium enterprises (SME) sector.

SMEs contribute greatly to employment, GDP, sustainability, and economic growth in both developed and developing countries. On a global scale, SMEs have created approximately 57.8% of the total new jobs created. This is of vital relevance, because in order for employment to keep up with the growth of the labour force, 600 million jobs will need to be created internationally by the year 2030. SMEs have the potential to contribute substantially to this greatly needed employment growth. For this to occur, challenges that hinder SME growth need to be addressed.

Challenges Facing SMEs

There are several challenges that SMEs are facing that hinder further growth. These challenges include the following:

- increased transaction costs;
- lack of skilled human resources;
- adverse legal and regulatory environments;
- insufficient access to technology;
- lack of market accessibility;
- lack of product standardisation;
- insufficient bank policies that utilise movable collaterals;
- lack of information sharing between financial institutions;
- lack of financial literacy of both clients and personnel; and
- insufficient branding strategies for banking products and services.

¹ Joint World Bank Group–Islamic Development Bank G20 Islamic Finance Policy Paper, *Leveraging Islamic Finance for SMEs*, Istanbul, 2015, p. 7.

² Ibid.

The biggest challenge is access to capital. Banks in developing countries consider SMEs to be too risky – in particular, because these enterprises have insufficient collateral and credit history. SMEs of developed countries also face a similar problem. Policymakers, development agencies, private sectors and researchers should address this problem more thoroughly. Offering innovative and diverse financial products to SMEs on a global scale can improve the access to finance and reduce the enormous financial gap. Determining alternate means of assessing the potential viability of SMEs will provide a further framework of providing funding to the SMEs that will contribute to the growth of the community and the economy. SMEs are incubators for innovation, as they are usually more responsive and adaptable to local conditions than are large corporations.

Islamic financing institutions focus highly on social welfare. These institutions can contribute to financing SMEs significantly and reducing the gap. Islamic banks can use the existing products and develop new products to finance entrepreneurial ventures, as the profit-loss-sharing (PLS) model is very suitable for SME financing. Also, asset-based and equity-based financial products from private equity (PE), venture capital (VC) and capital markets can be used to finance these enterprises.

The Credit Gap for SMEs

Islamic SMEs are still considered to be underfunded based on the amount of loans and deposits created by the banking sector. This shortage does not bode well for the development prospects for MENA countries, as SMEs are absolutely vital to economic growth, particularly in developing countries.

Table 1 shows the substantial credit gaps seen in selected G20 countries. This shows the opportunity cost incurred due to lack of financing to SMEs. The smallest credit gaps are found in Indonesia and South Africa at 15%, and Korea at 17%, while the largest credit gaps are in Brazil and Saudi Arabia at 42% and Russia at 44%. There are no countries that have credit gaps lower than 15%, which indicates that there is room for substantial improvement in increasing the access to capital for SMEs in all of the selected countries.

Table 1: MSME Credit Gap in Selected G20 Countries

Country	Number of Enterprises (in thousands)	Total Credit Gap (US\$ billions)	Access to Finance as Major/Severe Barrier (%)
Argentina	2,133	67	34
Brazil	16,030	237	42
China	103,548	338	18
India	49,634	140	23
Indonesia	41,116	28	15
Korea	4,644	114	17
Russia	3,605	50	44
Saudi Arabia	1,843	237	42
South Africa	2,213	13	15
Turkey	4,120	73	20
Total	228,886	1,297	

Source: Joint World Bank Group–Islamic Development Bank G20 Islamic Finance Policy Paper, *Leveraging Islamic Finance for SMEs*, Istanbul, 2015.

Upwards of 68% of SMEs in developing countries are underserved worldwide, and this trend is unfortunately also exhibited in MENA countries.³ MENA countries possess reasonably well-developed banking in both conventional and Islamic sectors, although SMEs have typically remained underfunded. The problem of low penetration is assumed to be related to economic factors, such as supply and demand or interest rates, which prevent SMEs from obtaining financial intermediaries. Figure 2 shows that SMEs across the MENA region report high interest rates, arduous bureaucracies to navigate, and burdensome collateral requirements once they initiate access to financing from formal institutions.

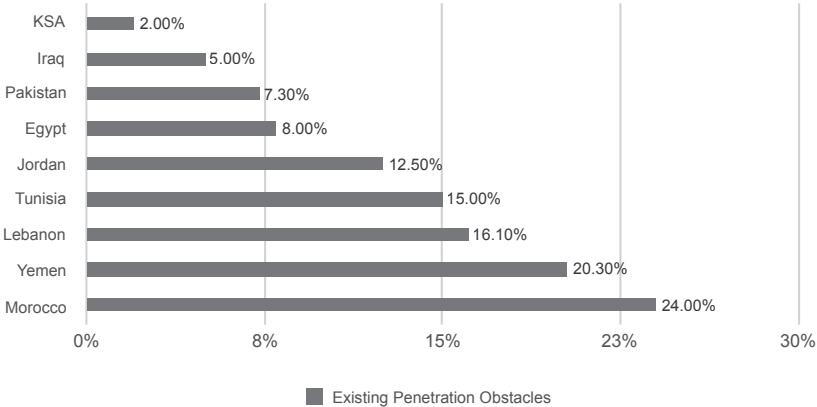
As a result, many financial institutions have not yet introduced products that meet the requirements of the SME sector⁴. This can be remedied by modifying bank policies to encourage SME expansion. Increasing the SME sector's access to finance should be a priority for MENA countries, as Islamic

³ Ibid, p. 13.

⁴ International Finance Corporation, *Islamic Banking Opportunities across Small and Medium Enterprises in MENA*, May 2014, p. 33.

entrepreneurship places emphasis on “participatory finance” arrangements⁵, such as the asset-based and equity-based financing found in the *Mushārah* and *Muḍārabah* arrangements outlined above. Furthermore, Islamic entrepreneurship, having spiritual and moral components that often outweigh material concerns, should strive for financial inclusion if it is to remain true to itself. Readily offering finance to wealthy individuals while neglecting to serve the “un-bankable” segment of society runs counter to Islamic economics’ central tenet of socio-economic justice for all.⁶

Figure 2: SME Sector: Existing Penetration Obstacles



Source: International Finance Corporation, *Islamic Banking Opportunities across Small and Medium Enterprises in MENA*, May 2014, p. 33.

Demand and Supply Side of Islamic SME Financing

The supply of *Shari’ah*-compliant SME loans lags far behind the demand. Nasr and Rostom (2013) found that, on average, SME lending comprises only 7.6% of the portfolios of MENA banks. Table 2 shows the enabling environment and supply side analysis for both SMEs and Islamic SMEs.

⁵ Leveraging Islamic Finance for SMEs, op. cit., pp. 14–15.

⁶ Mehmet Asutay, “Conceptualising and locating the social failure of Islamic finance: Aspirations of Islamic moral economy vs. the realities of Islamic finance”, *Journal of Asian and African Studies*, 11(2) (Special Issue), 2012, pp. 93–113.

The highest enabling environments are found in Jordan and Saudi Arabia, with Saudi Arabia having moderate SME and Islamic SME offerings, and Jordan having low SME offerings and very low Islamic SME offerings. This shows the great potential present for increasing Islamic SME offerings.

Figure 3 shows that a large gap exists between demand and supply of Islamic SME financing. The gap is largest in Egypt, with 20% demand for *Shari'ah*-compliant loans and only 7% supply. The presence of a large number of Islamic banks in Saudi Arabia is responsible for the smallest gap, with 90% demand and 67% supply. While the size may vary, there is a gap between the demand and supply of Islamic SME financing across MENA countries.

**Table 2: Enabling Environment and Supply Side Analysis
(SME and Islamic SME)**

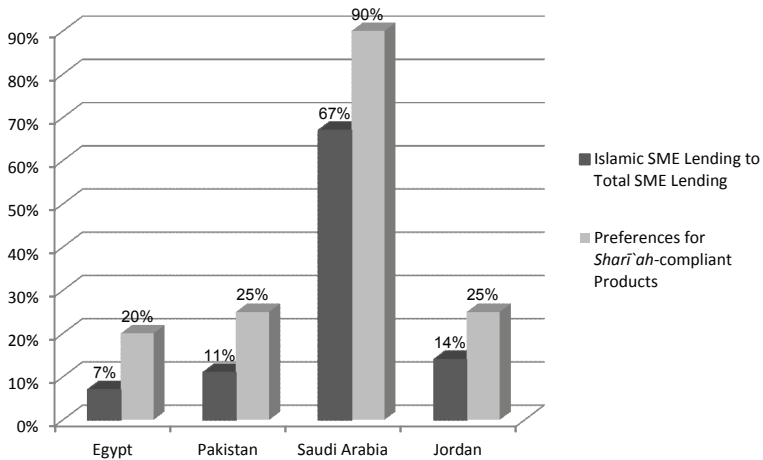
	SME Offering	Islamic SME Offering	Enabling Environment
Egypt	Low	Very low	Low
Pakistan	Moderate	Low	Medium
Saudi Arabia	Moderate	Moderate	High
Jordan	Low	Very low	High
Morocco	Moderate	Very low	Medium
Tunisia	Very low	Very low	Medium
Yemen	Low	Very low	Low
Iraq	Very low	Very low	Low
Lebanon	Low	Very low	Medium

Source: International Finance Corporation, *Islamic Banking Opportunities across Small and Medium Enterprises in MENA*, May 2014, p. 41.

The lack of *Shari'ah*-compliant products is the most probable reason for this gap. Banks, especially Islamic banks, in developing countries are “risk averse” by nature. This leads the banks to keep their range of offered products very limited. Financial inclusion standards require Islamic banks to provide financial products to individuals or institutions regardless of their religious or cultural preferences.

Thus, the large gap is a challenge for financial inclusion as some entrepreneurs are only willing to deal with *Shari'ah*-compliant financial products. The G20 agenda should target the removal of such “faith-based barriers” because preference for *Shari'ah*-compliant products is involuntary. These individuals or institutions can be brought into financial inclusion by offering them *Shari'ah*-compliant products.

Figure 3: Demand and Supply Side of Islamic SME Financing in Sample Countries



Source: International Finance Corporation, *Islamic Banking Opportunities across Small and Medium Enterprises in MENA*, May 2014; Joint World Bank Group–Islamic Development Bank G20 Islamic Finance Policy Paper, *Leveraging Islamic Finance for SMEs*, Istanbul, 2015.

Having a label of Islamic financing is not imperative as long as the financing solutions provide the core values of promoting economic development by offering equity-based and asset-based portfolios. After all, the foundation of Islamic financial products is the nature of asset-based transactions together with the equity-based risk-and-profit sharing. Asset-based financing ensures less “financialisation” by promoting real economic activity linked with the financial assets that is the core requirement of Islamic financial transaction (Askari, Iqbal & Mirakhor, 2014).

Some non-banking *Shari'ah*-compliant financing options are available for SMEs, such as SME funds, a few venture capital and private equity funds, crowdfunding platforms and angel investment networks. Moreover, new options can be developed for SMEs, and these should be checked for *Shari'ah* compliance on a case-by-case basis. By offering all of these Islamic banking and non-banking financial services, the financing gap for SMEs can be reduced.

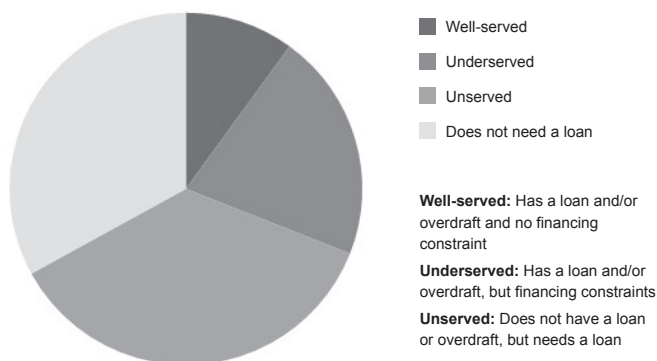
As mentioned earlier, both Islamic banks and conventional banks have failed to provide financing to SMEs, because such enterprises lack collaterals and sufficient credit history. The situation is particularly frustrating on the part of Islamic banks, as the core principle of Islamic finance demands that the SMEs underserved by conventional banks should be included. The Islamic banks are violating this principle as they are failing to promote PLS equity-based financial instruments such as *Musharakah* and *Mudharabah* to SMEs.

Almost 400 Islamic financial institutions in more than 70 countries are contributing to the Islamic banking and finance industry. The industry is operating even outside the region of Organisation of Islamic Cooperation (OIC) countries, with Islamic financial institutions based in countries such as Germany, Luxembourg, Mauritius, Singapore the United Kingdom and the United States. The Islamic banking and finance industry is relatively small in size compared to conventional banking and finance, but the industry is experiencing strong growth and increased global outreach, indicating high potential in the long term.

Financial Exclusion of SMEs

SMEs are substantially unserved in emerging markets, which can be seen in Figure 4. There was an estimated financial gap of US\$2.4 trillion in developing markets, as found in the IFC Enterprise Finance Gap Database (2011). The G20 countries account for US\$1.3 trillion of this enormous gap. About 55–68% of SMEs in these countries suffer from lack of funding. The inability of these countries to serve these enterprises results in substantial opportunity costs, as they cannot live up to their full potential.

Figure 4: Percentage of Formal SMEs Underserved in Emerging Markets



Source: Joint World Bank Group–Islamic Development Bank G20 Islamic Finance Policy Paper, *Leveraging Islamic Finance for SMEs*, Istanbul, 2015.

A working group of OIC countries set its aim in 2012 to “*develop appropriate policies to accelerate the convergence between Islamic finance and SME industries*”. This context makes the promotion to SMEs of Islamic financing products, linked to real economic activity, a high priority in member countries that would enable enterprises to tap into the rapidly growing pool of *Shari’ah*-compliant funds.

In 2015, a number of priorities to support SMEs were developed in the G20 presidency of Turkey (Joint WB–IsDB G20 Islamic Finance Policy Paper, 2015):

- Ensuring growth and prosperity of all segments, including SMEs, of society by accomplishing domestic and global scale inclusiveness.
- Ensuring investments in SMEs and reforming private sector investments to increase availability.
- Forming a World SME Forum that would address the expectations and concerns of SMEs to related parties such as B20 and the governments of G20.
- Assisting SMEs to integrate into global value chains, especially in developing countries.
- Promoting non-traditional financial products (asset-based and equity-based).
- Initiating promising innovations and technology for SMEs.

These priorities can be further supported by determining the strengths and opportunities present in Islamic finance that will aid in SME expansion. Islamic banking and financing can contribute substantially to achieving target growth, long-term investment and financial inclusion.

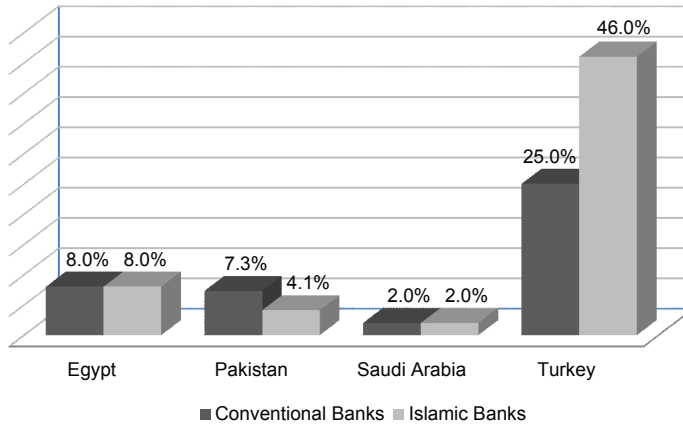
SME Bank Lending by Conventional and Islamic Banks

The ratio of SME bank lending to total bank lending is relatively small for both conventional and Islamic banks in Egypt, Pakistan and Saudi Arabia (as seen in Figure 5). However, Turkey provides a significant share of its bank lending to its SMEs. More interestingly, SME lending by Islamic banks is almost double that of conventional banks in Turkey. It is imperative that further research is conducted on the Turkish SME financing model in order for it to be considered as a potential role model.

Similar to conventional banking, Islamic banking is failing to contribute to the financial inclusion of SMEs despite having great potential. Islamic banking is facing a number of challenges in general, including the following:

- Product offerings for SMEs are mostly limited to *Murābahah*. There is a clear shortage of diversified products to address the unique needs of SMEs.
- Standardisation of contracts is needed in order to ensure a clear definition of *Shari'ah* compliance.
- Transaction costs and taxes are higher for Islamic finance products, because of cumbersome *Shari'ah* verification processes and adverse taxation frameworks.
- SMEs lack non-movable collaterals, and only a strong legal framework can allow SMEs to use their movable collaterals.
- Information sharing is needed to improve knowledge of Islamic finance among practitioners and clients. This has been considered a major drawback to the enhancement of Islamic finance.
- Banks face a significant lack of human resources trained in Islamic financing practices for SMEs.
- Participants lack sufficient Islamic finance literacy as compared to conventional finance.
- Labelling of Islamic banking might exclude non-Muslims. Branding should ensure that entrepreneurs know that Islamic finance is not Muslim specific.

Figure 5: Ratio of SME Bank Lending to Total Bank Lending in Sample Countries



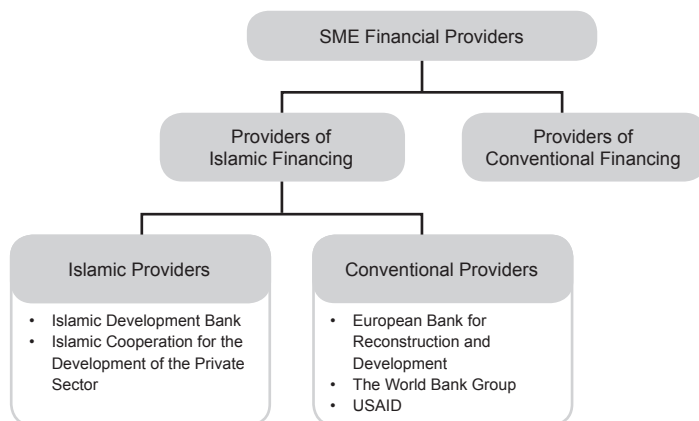
Source: International Finance Corporation, *Islamic Banking Opportunities across Small and Medium Enterprises in MENA*, May 2014; World Bank, *IBRD Project Appraisal Document Report No. 86307-TR*, 2014.

International Development Organisations and their Impact on Islamic Finance

International development organisations (IDOs) are having a positive impact on the evolution of the Islamic finance industry, and this has occurred over the past 20 years. Most IDOs are not *Shari'ah*-based. Despite this, several of their products are *Shari'ah*-compliant, which ensures universal access to finance. Providers of Islamic financing for SMEs can be either purely Islamic refinancers or conventional refinancers, although both operate to provide Islamic finances to end beneficiaries, which can be seen in Figure 6.

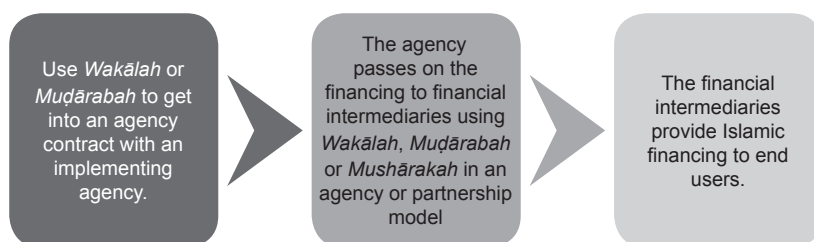
Islamic refinancers, such as the Islamic Development Bank (IDB), follow a three-stage process to provide Islamic financing, which can be seen on the following page in Figure 7. Existence of strong credit guarantee institutions can cover some risks faced by financial institutions due to the lack of sufficient collaterals. These institutions can contribute significantly by providing guarantees in international trade with Islamic markets.

Figure 6: IDOs as Islamic SME Financing Providers



Source: Joint World Bank Group–Islamic Development Bank G20 Islamic Finance Policy Paper, *Leveraging Islamic Finance for SMEs*, Istanbul, 2015.

Figure 7: IDB's Three-stage Process for Islamic Financing



Source: Joint World Bank Group–Islamic Development Bank G20 Islamic Finance Policy Paper, *Leveraging Islamic Finance for SMEs*, Istanbul, 2015.

Islamic Capital Markets

There is a great amount of potential in Islamic capital markets (ICM), which can be further utilised in raising capital and managing risk. This can be seen in Table 3, which shows the different levels of potential in different Islamic financial products issued in the ICM. Bond issuances by other SME lenders as

well as SME covered bonds, and bonds issued by SMEs via private placement, have very high potential for the Islamic finance sector. Bonds issued by banks, bonds issued by SMEs via alternative markets, SME bond funds, and SME loan securitisations offer moderate potential for Islamic finance. SME funds based on receivables and SME loan funds offer low potential. Thus, high and moderate potential Islamic financial instruments should take precedence.

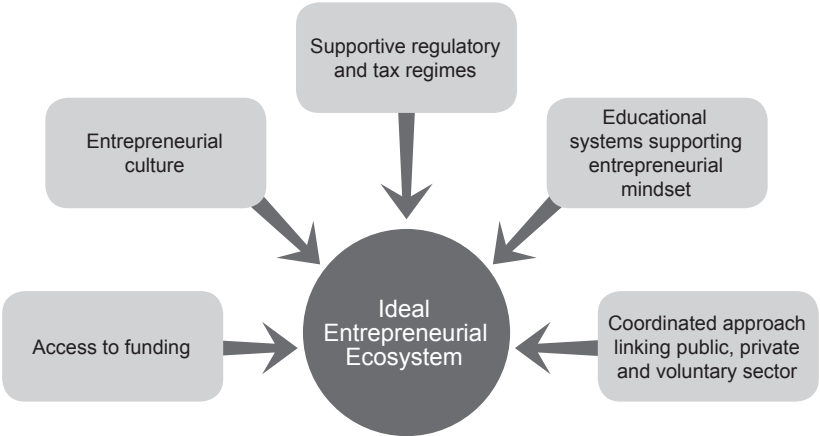
Table 3: Potential to Mobilise Institutional Investors for SMEs through Islamic Finance

INSTRUMENT	DESCRIPTION	POTENTIAL FOR ISLAMIC FINANCE
BOND ISSUANCES BY BANKS	The issuance of bonds by either public or private offerings.	<i>Moderate</i>
BOND ISSUANCES BY OTHER SME LENDERS	Includes corporate bond issuances by SME lenders as a refinancing mechanism.	<i>High</i>
BOND ISSUED BY SMEs VIA ALTERNATIVE MARKETS	Alternative markets for debt that provide SMEs access to the public (retail) markets, under a proportionate framework that makes it easier for them to comply with disclosure requirements.	<i>Moderate</i>
BOND ISSUED BY SMEs VIA PRIVATE PLACEMENT	Use of private offerings and tailor-made regimes of private offers for SME bonds, mainly addressed to institutional investors.	<i>High</i>
SME BOND FUNDS	Collective investment schemes that pool together bonds issued by SMEs, usually structured as closed-end funds.	<i>Moderate</i>
SME FUNDS BASED ON RECEIVABLES AND FACTORING	The funds that invest in factoring companies. The fund typically purchases these receivables from SMEs, providing them with immediate financing at an implied interest rate that is lower than comparable bank rates.	<i>Low</i>
SME COVERED BONDS	Debt securities by a credit institution that are backed by a pool of high-quality assets.	<i>High</i>
SME LOAN SECURITISATIONS	Securitisation of SME loans (transformation of illiquid instruments to liquid tradable securities).	<i>Moderate</i>
SME LOAN FUNDS	Collective investment schemes that pool together SME-related assets (e.g., loans and receivables) and offer returns to the investors of the fund.	<i>Low</i>

Source: Joint World Bank Group–Islamic Development Bank G20 Islamic Finance Policy Paper, *Leveraging Islamic Finance for SMEs*, Istanbul, 2015.

As illustrated in Figure 8, there are five pillars of an ideal entrepreneurial ecosystem that fosters the growth of entrepreneurial ventures. Venture capital and private equity funds are significant components of this ecosystem, as they contribute to the development of innovative and growth-oriented start-ups. The PLS model of Islamic finance makes venture capital and private equity funds natural fits for SMEs and start-ups.

Figure 8: Ideal Entrepreneurial Ecosystem Pillars



Source: Ernst & Young, Megatrends 2015: Making Sense of a World in Motion, Ernst & Young, 2015.

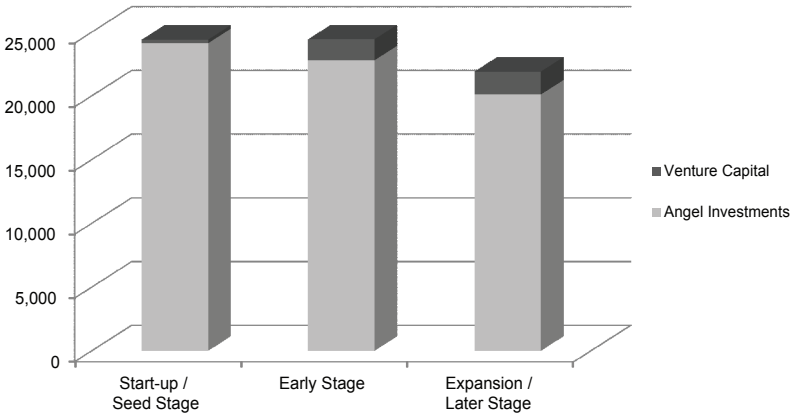
Angel investors provide financing to start-ups, particularly in the seed and early stages of development, whereas venture capital financing becomes available in the later stages. As shown in Figure 9, in 2012 in the United States, nearly all financing in the initial development stage was provided by angel investors. The impact of angel networks is similar in G20 countries, Canada and the EU (Ernst & Young, 2015). Islamic finance takes a moral and values-oriented approach that aims to fulfil the social and material needs of all members of a community by utilising economic and financial resources. In this aspect, different crowdfunding models that are not based on interest rates can be utilised.

Crowdfunding is a promising financing method. It involves many individuals coming together over the internet and social media to each put in their desired amount of investment. Crowdfunding pools numerous small investments,

thereby allowing entrepreneurs to bypass institutional investors. Furthermore, would-be investors who might have previously considered their limited means to be insufficient to contribute to any investment can feel as though even their small contribution is meaningful in getting a proposed start-up off the ground. Extending the scope of the definition of “investor” will, in turn, increase the total amount of funds available for investing. The proliferation of non-banking financing options such as crowdfunding is a boon to SMEs, which have been underserved by banks until now. As long as these sources of funding are *Shari`ah*-compliant, which can be achieved with a modicum of effort and planning, SMEs in MENA countries will benefit from the increased funding that they have sought for decades.

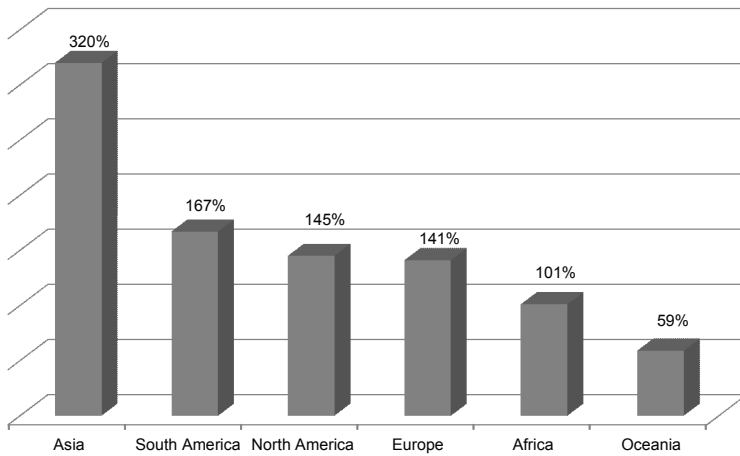
As Figure 10 shows, crowdfunding has grown significantly in 2014, irrespective of region. According to Massolution (2015), the market grew by 167%, with total funding of US\$16.2 billion raised globally in that year. If this industry in developing countries receives favourable regulatory measures and enabling factors, it can contribute significantly to the reduction of the financing gap. Figure 11 shows the substantial growth in lending in 2014 by funding model. The equity-based funding model can be applied as an Islamic financing option for SMEs. This model already has a profit-and-loss-sharing nature. It just has to maintain *Shari`ah* compliance. As the figure shows, the equity funding model has experienced an outstanding growth of 182% that is surpassed only by the lending-based model.

Figure 9: Number of Deals in the United States (2012)



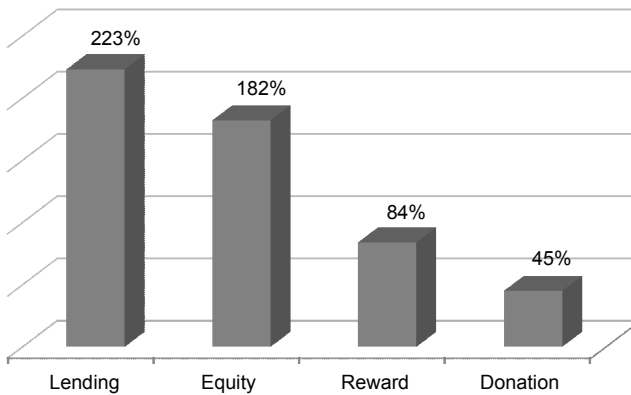
Source: Jeffrey E. Sohl, Center for Venture Research, 2013 NVCA Yearbook.

Figure 10: Crowdfunding Growth by Region in 2014



Source: Massolution, *Crowdfunding Industry Report*, New York, 2015.

Figure 11: Crowdfunding Growth by Funding Model in 2014



Source: Massolution, *Crowdfunding Industry Report*, New York, 2015.

Table 4 addresses a number of proposed *Shari'ah*-compliant crowdfunding models. These models can be used as funding alternatives for SMEs. As can be seen, these types of funding include asset- and equity-based models as well as a reward-based model for product financing. These types of funding are geared towards start-ups and small enterprises that have high growth potential.

Table 4: *Shari'ah*-compliant Crowdfunding Models and Instruments

Financing for	Crowd Model	Potential Beneficiary	Instrument with End Client
Products	Reward-based	Small enterprises Start-ups	Sale
Investments	Asset-based	Small enterprises	<i>Murābahah Ijārah</i>
	Equity-based	Small enterprises	<i>Diminishing Musharakah Musharakah and Qarḍ Muḍārabah</i>
		Start-ups	<i>Musharakah and Qarḍ Muḍārabah</i>

Source: Joint World Bank Group–Islamic Development Bank G20 Islamic Finance Policy Paper, *Leveraging Islamic Finance for SMEs*, Istanbul, 2015.

Recommendations for SME Growth and Expansion

From these challenges, recommendations have been determined by which Islamic banks can be incorporated into SME development, as well as ways in which governments, banks and regulators can develop initiatives to solve the challenges SMEs face with obtaining financing (see Table 5). These recommendations detail the tasks in which governments, regulators and bank management can work together to streamline regulation, infrastructure, training and funding that will increase SME growth and expansion.

Table 5: Recommendations for Building SME Growth and Expansion

Challenge	Recommendations
Develop innovative product offerings	<ul style="list-style-type: none"> • Further utilise and develop additional product offerings in PLS arrangements. • Create additional products that move towards equity-based financing.
Standardise financial products	<ul style="list-style-type: none"> • Create a streamlined process for loan procurement. • Develop an efficient, reliable and credible <i>Shari'ah</i> screening process. • Adopt international standards so that products can be efficiently and reliably assessed.
Decrease transaction costs	<ul style="list-style-type: none"> • Adopt new technologies that increase operations efficiency in order to reduce operations costs, with the savings being passed on to bank clients. • Work with regulators to update regulations to support bank operations' efficiency in order to further reduce costs due to inefficient regulation.
Refine policies to use movable collaterals	<ul style="list-style-type: none"> • Update bank policies to include movable collaterals. • Develop efficient means of assessing value of movable collaterals. • Create contracts that incorporate movable collaterals, assessment of liability, and claim enforcement policies.
Promote sharing of information	<ul style="list-style-type: none"> • Create campaigns that promote information sharing between financial institutions to improve businesses' processes and bank policies.
Strengthen human capital and financial literacy	<ul style="list-style-type: none"> • Develop financial literacy training programs for finance personnel in order to best serve bank clients, and for bank clients so that they can understand the financing application process. • Develop incentives programs for bank personnel to pursue additional training and continuing education to maintain a high level of industry knowledge.
Strengthen branding	<ul style="list-style-type: none"> • Increase public outreach throughout the MENA region and beyond by developing and implementing effective marketing campaigns about Islamic banking's goal of financial inclusion, enabling the community to have access to capital for their entrepreneurial endeavours. • Promote success stories of Islamic bank clients. • Promote Islamic finance as being ethical-based finance.

Source: Joint World Bank Group–Islamic Development Bank G20 Islamic Finance Policy Paper, *Leveraging Islamic Finance for SMEs*, Istanbul, 2015.

The best financial products to offer SMEs, from an Islamic entrepreneurship perspective, are the equity-based PLS arrangements *Muḍārabah* and *Mushārah*. Currently, however, asset-based financial instruments known as *Murābahah* dominate the Islamic financing landscape, accounting for 75% of total Islamic financing in MENA countries as of 2008.⁷ *Murābahah* are cost-plus financial instruments that are constructed specifically to simulate the return and risk features of traditional interest-based loans.

As such, *Murābahah* fail to enhance financial inclusion in any meaningful way. The Islamic banking sector must shift away from such debt-based financing and towards equity-based instruments that give both the financier and the entrepreneur the power and responsibility to influence business operations in a manner consistent with Islamic principles. PLS arrangements such as *Muḍārabah* and *Mushārah* ensure that both parties bear reasonable and fair amounts of risk and reward for their contributions. The spread of such partnership structures will make financing more available to potential entrepreneurs and focus their business activities in a way that safeguards the interests and well-being of society at large, as dictated by Islamic principles.

One common complaint echoed by SMEs throughout the MENA region is the frustration caused by attempting to navigate the complex bureaucracy of the Islamic financial industry. This can discourage would-be entrepreneurs from starting their own businesses. To simplify the loan procurement process, central organisations such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) should set universal industry standards so that consumers know exactly what *Shari'ah*-compliant instruments are offered.

Another problem brought about by an overcomplicated bureaucracy is increased transaction costs. This issue adversely affects *Muḍārabah* and *Mushārah* in particular, as these arrangements require thorough vetting of potential entrepreneurs in the form of feasibility studies and exhaustive due diligence, both of which carry high transaction costs. An emphasis on standardisation would result in increased information sharing, which would reduce redundancies and lower transaction costs.

Another obstacle SMEs have to face when trying to attain financing is that they are commonly subjected to unduly burdensome collateral requirements.

⁷ Salman Syed Ali, *Islamic Banking in the MENA Region. Financial Flagship Report*, The World Bank and Islamic Development Bank, February 2011.

De la Campa (2010) gets to the crux of the problem by noting that banks are hesitant to accept movable assets as valid collateral, but 78% of the assets of businesses in developing countries consist of movable resources such as machinery, equipment and vehicles. MENA countries must put in place a legal system that lets SMEs put up their movable assets as collateral if they truly want to expand their SME sectors' access to financing.

Currently, the banking personnel infrastructure in MENA countries is unsuited to maximise Islamic lending to the SME sector. Banking professionals simply do not have the necessary expertise of Islamic financing or *Shari'ah* compliance to determine what financial instruments are *Shari'ah*-compliant. Thus, they are not able to offer *Shari'ah*-compliant products to a market that increasingly demands them. To cultivate the Islamic finance knowledge base in the banking sector of MENA countries, on-the-job training should be offered to banking professionals. Knowledge should be shared from countries that have had experience in successfully expanding *Shari'ah*-compliant financing in SMEs (Malaysia, for instance) to countries that have not yet had such success. These measures should be supplemented by partnering with universities and other institutions of higher education to establish both formal and informal education programmes about Islamic financing.

The spread of knowledge regarding Islamic financing should not be limited to banking professionals. The general public in MENA countries often lack literacy in Islamic finance. Some are unaware of Islamic financing options and thus neglect to ask for them. Others suffer from common misconceptions about Islamic financing that make them either reluctant to ask for *Shari'ah*-compliant products or refuse *Shari'ah*-compliant financing altogether under the false assumption that it is not *Shari'ah*-compliant or is prohibitively more expensive than conventional banking products. Promotional campaigns, improved branding, and public outreach from banking professionals are all measures that can improve Islamic financial literacy throughout society.⁸

If the aforementioned recommendations are heeded, the SME sector throughout MENA countries will enjoy increased funding. In fact, many financial institutions in the MENA region have the potential to provide sufficient funds to SMEs. As shown in Table 6, Saudi Arabia, Egypt, Jordan and Pakistan are the leading countries with significant depository potential that could be tapped by Islamic banks.⁹

⁸ *Leveraging Islamic Finance for SMEs*, op. cit., pp. 36–37.

⁹ *Islamic Banking Opportunities across Small and Medium Enterprises in MENA*, op. cit., p. 43.

Table 6: Islamic Depository Potential by Country

Countries	Depository Potential
Egypt	\$3.46-5.18 billion
Pakistan	\$2.52-4.56 billion
Saudi Arabia	\$1.80-2.30 billion
Jordan	\$0.90-1.30 billion
Morocco	\$0.47-0.74 billion
Tunisia	\$0.22-0.43 billion
Yemen	\$0.15-0.29 billion
Iraq	\$0.04-0.07 billion
Lebanon	\$0.15-0.22 billion

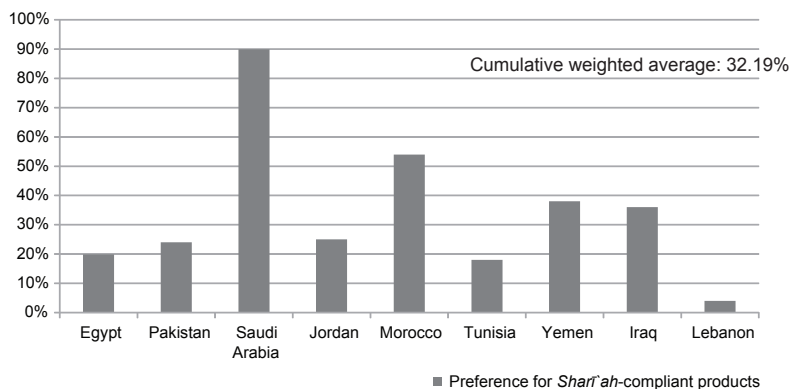
Source: Islamic Banking Opportunities across Small and Medium Enterprises in Mena, World Bank Group, p.43

Crucially, the potential of SMEs in the MENA region has been evolving over time. Financial institutions have been working to meet the needs of SMEs in terms of Islamic liability products. Banks are serving SMEs through the provision of deposits, savings and current accounts, since the requirements of SMEs are generally limited.

However, there are still gaps with respect to non-borrowing services. Countries such as Pakistan and Saudi Arabia are sustainable enough to provide services such as cash management, payroll services and cash delivery to SMEs. As the SME sector develops across the MENA region, their needs and requirements are likely to evolve and improve. Hence, the development of the SME sector could introduce a demand for more long-term and financially sophisticated products.

Figure 12 shows the preference for *Shari'ah*-compliant products in the MENA region. This figure reflects the diverging perceptions of Islamic banking by each country's population. One conclusion is that these preferences were influenced by the population of the country, as well as by the degree of religious consciousness. SMEs in Morocco and Jordan were found to have strong preferences for Islamic banking, which may signal a substantial funding opportunity. Other countries in the region also exhibit a potential preference for Islamic banking among SMEs.

Figure 12: Percentage Preference for *Shari'ah*-compliant Products in the MENA Region



Source: International Finance Corporation, *Islamic Banking Opportunities across Small and Medium Enterprises in MENA*, May 2014, p. 39.

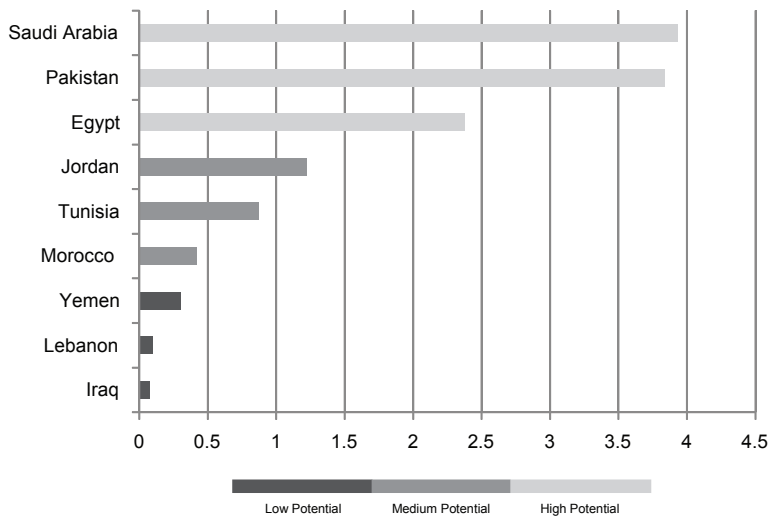
Another essential point regarding the SME sector is that it reflects a great opportunity for potential funding across countries with Islamic banking and *Shari'ah*-compliant products. The IFC found in a 2014 study that the ratio of *Shari'ah*-compliant SME financing to total SME financing in MENA countries was considerably smaller than the expressed preference for *Shari'ah*-compliant products in those countries.¹⁰

Similar to SME funding potential, Islamic funding opportunity varies greatly from country to country in the MENA region, as shown in Figure 13. For example, Jordan is the most capable country among the medium-potential countries, since it is more developed compared to Tunisia and Morocco. Jordan also has a well-developed financial system to sustain the growth of the Islamic banking sector. Morocco and Tunisia are developing markets that are likely to realise their potential in a long-term horizon. Yemen, Iraq and Lebanon are somewhat low-potential markets that are adversely affected by their uncertain political and social environments.¹¹

¹⁰ Ibid.

¹¹ Ibid., p. 42.

Figure 13: Comparative Islamic Funding Opportunity



Source: International Finance Corporation, *Islamic Banking Opportunities across Small and Medium Enterprises in MENA*, May 2014, p. 42.

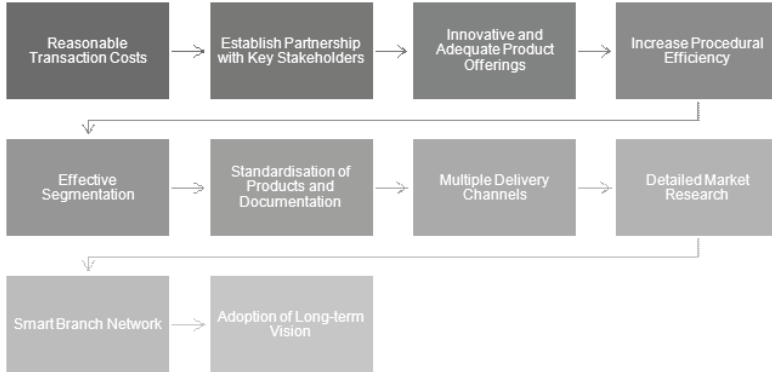
There are numerous strategic operational adjustments that MENA countries can make in order to successfully target SMEs. To develop capitalised funding and improve their depository potential, Islamic banks need to look further than the conventional “one-size-fits-all” approach and should be encouraged to provide SMEs with specialised value additions, similar to what many conventional banks are now increasingly offering. Islamic SMEs should be carefully revised for strategy segmentation, risk management, organisation systems with advisory services supported by a strong product, and sales and delivery channels. The competition framework is currently significantly below where Islamic banks would need it to be in order to obtain the requirements for building and managing a successful “Islamic SME banking” business.¹²

Islamic banks should implement a long-term strategy to manage, develop and sustain the framework illustrated in Figure 14, since regulatory changes are capital intensive and take long-term measures which require a great deal of effort to complete. There is no “one-size-fits-all” approach that can be introduced, since each bank has a different operational option and working environment. Moreover, banks should formulate self-evaluation and self-

¹² Ibid., p. 47.

control steps, create a pathway, define goals and be determined to achieve them. By following such a well-developed road map, Islamic banks will be able to grow and control the “new to bank” and “cannibalisation” SME potential across MENA and Pakistan.¹³

Figure 14: Road Map for Islamic SME Banking



Source: International Finance Corporation, *Islamic Banking Opportunities across Small and Medium Enterprises in MENA*, May 2014.

Non-banking Financing Sources for SMEs

Complex financial instruments that benefit Islamic entrepreneurs do not necessarily even have to be limited to the banking sector. There is a wide range of financing options available from non-banking financial service providers that SME entrepreneurs can avail themselves of when seeking financing. Funds can be obtained from international development organisations, credit guarantee institutions, leasing companies, capital markets, VC and PE funds, and crowdfunding.¹⁴

International development organisations such as the Islamic Development Bank and the World Bank’s Global Islamic Finance Developmental Center have provided valuable funding for SMEs over the past 20 years.¹⁵ These IDOs can provide refinancing in the form of conventional loans which are then directed through *Shari’ah*-compliant intermediaries (which may be governmental)

¹³ Ibid., p. 51.

¹⁴ *Leveraging Islamic Finance for SMEs*, op. cit., p. 72.

¹⁵ Ibid., pp. 43–46.

and finally reach SMEs, all the while conforming to the principles of Islamic economics. The beneficial impact of IDOs goes beyond providing funding for business ventures; they also provide technical know-how, training, and support that help build up the infrastructure of Islamic finance and create an environment where Islamic entrepreneurship will flourish.

SMEs often lack the necessary collateral to get financing from conventional financial institutions, as we have seen above. Credit guarantee institutions have arisen as a way to help SMEs overcome this obstacle by providing the lending institution with the guarantees required on behalf of the SME. *Shari'ah* councils around the world are split as to whether it is permissible to charge a fee for such guarantees, but where credit guarantees are permitted, they boost SME financing substantially. Helping SMEs overcome difficult collateral requirements is an advantage also provided by leasing companies. As long as an SME can show that it can generate cash flows sufficient to satisfy the lease payments, a leasing company will lease it the assets it needs to carry out its intended business activities, which must be situated directly in the real economy to uphold the aims of Islamic entrepreneurship.

Shari'ah-compliant capital markets also represent an important and viable avenue for SME financing. Islamic capital markets are permitted to issue securitised asset-based securities and equity-based stocks.¹⁶ Capital markets allow SMEs to circumvent the sometimes-unwilling banking sector to more easily expand their financial capacity. Islamic capital markets have more rules and regulations than conventional capital markets, but by no means are these excessive. For example, one common requirement is that any company to be invested in must not derive more than 5% of its income from forbidden sources such as alcohol, insurance, gambling, weapons, pornography, etc. Islamic capital markets have significant growth potential but are not as diversified as their conventional counterparts.

Islamic capital markets are particularly deficient in the health and technology sectors.¹⁷ These sectors are hotspots of innovative growth, so any vibrant economy must pay special attention to them. Since existing capital markets in MENA countries do not serve certain innovative sectors well, VC and PE funds are ideal candidates to pick up the slack. VC and PE funds focus on financing early-stage and growth-stage start-ups. Such businesses are more likely to be novel and innovative. Islamic entrepreneurialism highly esteems

¹⁶ Ibid., p. 52.

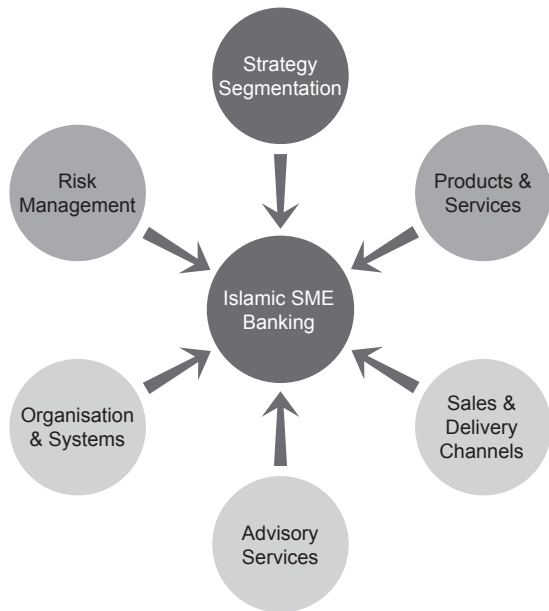
¹⁷ Ibid., p. 57.

PLS partnerships that are centred on using real economic activities to promote the greater good. As such, VC and PE investments are a “natural fit” for *Muḍārabah* and *Mushārah* arrangements.¹⁸

Strategic Operational Adjustments to Target SMEs

There are numerous strategic operational adjustments that countries can make in order to successfully target SMEs. To develop capitalised funding and improve their depository potential, Islamic banks need to look further than the conventional “one-size-fits-all” approach and should be encouraged to provide SMEs with specialised value additions, similar to what many conventional banks are now increasingly offering. As shown in Figure 15, Islamic SMEs should be carefully revised for strategy segmentation, risk management, organisation systems with advisory services supported by a strong product, and sales and delivery channels.

Figure 15: Strategic Operational Adjustments to Target SMEs



Source: International Finance Corporation, *Islamic Banking Opportunities across Small and Medium Enterprises in MENA*, May 2014.

¹⁸ Ibid., p. 58.

CONCLUSION

Islamic finance goes beyond simply displaying a positive attitude and passive encouragement for entrepreneurship, to profoundly attaching a vital religious significance to entrepreneurial activity. Islamic finance considers entrepreneurial activity to be *Fard al-Kifayah* on the Muslim *Ummah* intended for pleasing The Almighty Allah, and to contribute to the spiritual as well as socio-economic well-being of Muslims. This sentiment shows that Islamic finance puts in place the framework for a model that creates a supportive environment where SMEs can grow.

Information revealing the potential, opportunity and current status of both SMEs and the Islamic banking industry has been examined in this report. This information provided the basis for the road maps and recommendations given here, which detail the framework in which Islamic finance can further SME expansion. This information is useful for government, regulators and bank management to determine and implement the needed initiatives that will support SME growth through updating legislation and bank policies, strengthening Islamic finance brand recognition, developing government and bank initiatives, and strengthening human capital and infrastructure.

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Professor Dr. M. Kabir Hassan is Professor of Finance and Hibernia Professor of Economics and Finance in the Department of Economics and Finance, University of New Orleans.

Professor Hassan received his B.A. in Economics and Mathematics from GustavusAdolphus College, Minnesota, USA, and his M.A. in Economics and Ph.D. in Finance from the University of Nebraska-Lincoln, USA. He is a financial economist with consulting, research and teaching experience in development finance, money and capital markets, Islamic finance, corporate finance, investments, monetary economics, macroeconomics, and international trade and finance.

Professor Hassan has done consulting work for the World Bank, International Monetary Fund, African Development Bank, Transparency International-Bangladesh (TIB), Islamic Development Bank, the Government of Turkey and many private organisations.

He has 169 papers published in refereed academic journals. The number of publications would put Professor Hassan in the top 1% of peers who continue to publish one refereed article per year over a long period of time, according to an article published in Journal of Finance. He has also been cited as one of the most prolific authors in finance literature in the last 50 years, in a paper published in Journal of Finance Literature.

Professor Hassan has won 23 Best Paper awards for academic conference presentations, along with numerous awards for outstanding teaching from the University of New Orleans and outside academic organisations.



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