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From Islamic Finance toward the successful of Malaysian SMEs performance

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Abstract:

The purpose of this paper is to investigate the effect of Islamic financing on the SMEs performance. The Strategy theory used to confine the factor of financing source as to determine the successful of SMEs performance. Islamic Financing is a vital source of fund which based on Shariah law which can be categories into three parts namely sale based, equity based and lease based. The integration between these two segments is crucial as both shared the same value which is Islamic thought. This paper review and illustrate that Malaysia has a very encouraging history of Islamic banking and has big potential to succeed in this area. However, some areas need to be improved, as suggested in the paper. It also found that the Malaysian model in developing Islamic financial industry can be taken as a benchmark in the development of such industry in other countries.

Key words: SMEs performance; Islamic Financing; Success

1. Introduction

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

Islamic micro enterprise is not new ideology for the SME industry. The definition of the Islamic micro enterprise is actually an idea and perspective from Islamic point of view on the firm and enterprise. Most of the Islamic scholars agree that Islam and business are inter-related. In Al-

Quran has mention on the relation of Islam and business which focus on the ethics, roles, responsibility, prohibition and benefit. One of the example is from Surah Al-Baqarah[275] “ Allah prohibit riba and permissible trading”.Based on Sarker & Awal (1999), firm from Islamic context have two objective which is work for the falah or known as welfare obligation and at the same time looking on the profit maximation. The author also list down some of the rules for the firm when it operated based on the Islamic perspective. The rules are priority on community welfare and prohibition on of unfairness activities during the trading.

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

One of the objective of Islamic banking exist into the market is to give an alternative banking facilities especially to the Muslim consumer as the prohibition of conventional banking system by the Islamic law. Riba, Ghara and Maisir are the three major components in the operation of conventional banking which impermissible in Islam. The system also provides facilities same as the other financial institutions like financing and deposit. To be different, Islamic banking and finance will used contracts under the Shariah such as Mudharabah, Ijarah, Murabahah and others to be implemented on the banking operation. This was also the way of Islamic banking to avoid

riba in their operation. In Malaysia, the growth of Islamic banking can be looked into the past 30 years.

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

One of the financing criteria provide by the Islamic banking is to finance business which undergo on the Shariah purpose only. The financing can be drawn into the providing the capital, lease an equipment and selling a commodity. A business such as trading pork, alcohol, entertainment and gambling consider non-Shariah compliant. Meanwhile, the performance of SME business in Malaysia also was given a good result for each year. According to SME Corp, in 2014, the performance of Malaysian SMEs remained encouraging despite the difficult business environment. In 2013, GDP growth of SMEs picked up further to 6.3% versus 6% in

2012. SME growth also exceeded the overall GDP growth of the country of 4.7%. However, despite of the shining growth of both industry, was the banking facilities really help the performance on SME especially on the Islamic entrepreneur. The answer for the question is the aim of this article. The ultimate objective of this academic writing is to look the relationship between the performance of Islamic Small Medium enterprise and the Islamic banking financing. The following section will discuss on the previous studies on Small Medium enterprise and also the Islamic banking facilities. At the end of the article, a research framework to continue the study is developed based on the literature review

2. Overview of Islamic finance

Currently in Malaysia, there were many factors that led the government to decide to introduce an Islamic financial system. The riots that occurred in 1969 were one of the internal factors that led to an active discussion regarding this issue, followed by a set of government policies launched in 1971, the so-called New Economic Policy (Horii 1987, Torii 2003). As the riots were caused by income and wealth disparities between Malays and non-Malays, the government realized that balanced development should be the most significant element in a multi-ethnic country like Malaysia. For balancing economic development, the government announced two strategies: raising income and reducing absolute poverty by giving opportunities for employment, and achieving economic balances among ethnic groups. In particular, the government had to take relatively poor ethnic groups, including the Malays, the so-called Bumiputera (the owner is Malaysian origin) into consideration.

As for external factors, in the 1970s the Islamic Resurgence movement arose in the Middle East. Another noteworthy event was the Iranian Revolution, known as the Islamic Revolution,

in 1979. These occurrences influenced Muslims throughout the world and the voice and political power of Muslims within Malaysia also gradually increased. Thus, the Malaysian government was required to manage the country with serious consideration toward Muslims.

3. Factors Affecting the Establishment of an Islamic Bank in Malaysia

Due to the pressures of Islamic political groups, the government understood the importance of Islamic values and considered applying those values to social and economic systems within the country. In 1980, the government held a meeting to discuss significant issues with regard to the introduction of an Islamic financial system during the next year the government set up the National Steering Committee on Islamic Finance under the initiative of the Central Bank, Bank Negara Malaysia. After a one-year study by this committee, the results were submitted to the government and provided the government with supportive opinions for the establishment of an Islamic bank. Based on this study, the government decided to legislate an Islamic financial system into existence. In 1983, the government enacted the Islamic Banking Act 1983 and Bank Islam Malaysia Bhd. (BIMB) was established

There are two different views with regard to why the Malaysian government was so positive about the introduction of the Islamic financial system in the country. The Central Bank indicated that the government was merely responding to the strong needs of Muslims. (Bank Negara Malaysia 1983, p 16). The other view, presented by Torii (2003), stated that it was due to the strategic efforts of “Islamization” promoted by Dr. Mahathir, former Prime Minister. According to Torii, the government intended to involve Muslims in the process of economic development. This may be related to the savings rate of Muslims. It was often said that the savings rate of Muslims particularly in rural areas, was not high (Zakariya 1988, p. 86).

Several reasons have been considered: their customs, religion, or unfavorable location of banks. However, for whatever reason, the government needed to take action to promote the national savings of Muslims. For the government, savings were essential to build a basic infrastructure and stimulate economic activities in the private sector and also to achieve the government's overall goal of becoming a developed country. If Muslims were avoiding making deposits into their accounts in conventional banks because these banks were under the interest-based system, the most effective way to improve savings was the establishment of an Islamic bank.

4. leverage of Islamic Financing with the performance of SME

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

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

Most of the research on the Islamic financing and microenterprise was looked on the theoretical part of the both concepts. According Dusuki (2008), the element of Shariah practice in Islamic banking and finance was help to reduce the issue of poverty, promote the social justice and fairly contribution of wealth on the society. The objective of Islamic banking needs to be shifted from

the business mode into the social benefit. This was also one of the modes of Islam where the relationship between man-to-man are highly demanded. Dusuki (2008) also recommend that the implementation of SPV by the Islamic financing instrument is the best mechanism to channeling to the poor. With the features of bankruptcy remote on the SPV, the Islamic banking interest was protected from any losses from the micro financing activities.

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

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

thinking that it is a responsible to them on the repayment of the financing as it is a religious obligation. This was reducing the credit risk of the institutions and positively impact on the revenue.

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

5. Conclusion: Islamic finance in Malaysia and its challenges

This paper reviewed the development of Islamic Finance in Malaysia. As has been noted, the government has taken a strong initiative in the development of an Islamic financial system. The government set a target share to be achieved by 2010 in the Financial Sector Master Plan, so the Islamic financial sector is expected to develop even further. Moreover, the government implemented preferential tax treatments for the Islamic financial sector. As a result, Malaysia has succeeded in promoting a comprehensive Islamic financial system, banking and insurance sectors and capital markets. However, in order to promote stable development of the Islamic financial sector, there are some problems that need to be solved. The Islamic financial sector needs more professionals who have balanced knowledge regarding both Islamic concepts and financial technologies. Malaysia has established an educational institution to train experts

in Islamic Finance; however, the number of professionals is still insufficient. In addition, the reasons for the share of contracts under the profit-sharing system being small need to be analyzed. The question is whether the Islamic financial system itself has flaws or whether there are institutional problems within Malaysia. One possibility is that asymmetric information exists in the Islamic financial market which leads Islamic banks to be risk averse and to avoid reward-system lending. If that is the case, a more transparent-information providing system is needed. In order to understand the Malaysian Islamic financial system better, further study on this issue is needed.

Finally, it has to be noted that the rapid progress of Islamic banking over the last two decades would not have been possible without the pioneering efforts of the Islamic financial institutions and all those who have put tremendous effort in building up a successful and vibrant industry. Despite that, the opportunity and prospect for a greater future success lies in the hand of all.

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