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The Role of Islamic Banks In Enhancing SMEs' Access to Financing Via Musharakah Financing

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Abstract

Most Islamic banks' operations are dominated by debt based financing, which limit SMEs' access to financing due to their inability to provide adequate collateral, oblige high-profit payment, and provide sufficient track records. In relation to this, many past studies have discussed that Musharakah financing would be functioning as a viable alternative financing for SMEs to overcome this problem. However, most of the Islamic banks are reluctant to operate Musharakah financing as it is vulnerable to agency problems which expose the banks to high financing risks. Moreover, SMEs' unwillingness to allow banks to take part in their business operations also impede the application of Musharaka financing. In view of this problem, this study is conducted to evaluate bank's participation in Musharakah financing with a view to determining its viability as an alternative financing for SMEs. Using survey questionnaire administered on SMEs in Malaysia, data elicited was subjected to statistical analysis using structural equation modeling. The results demonstrate SMEs' agreement on the bank's participation in their business operations thus indicating the potential of Musharakah as a viable financing for SMEs.

Keywords: Musharakah, , SMEs

1. Introduction

Musharakah, as Islamic equity financing method operated based on the profit and loss sharing (PLS) principle seems to be the least applied in the operations of Islamic banks. Most of the financing products offered by the banks are in a form of debt, which is difficult to access by a certain segment of borrower namely Small and medium sized enterprises (SMEs), due to their inability to provide collateral and oblige high-interest payment (Berger & Udell, 1998). Such limitations prevent the growth and expansion of the SMEs, which is an important segment in the economic growth of many countries around the world. In relation to this, many past studies suggested Musharakah financing as an alternative financing for SMEs as it does not put heavy burdens on SMEs with high interest/ profit payment and collateral requirement. and provides the SMEs with a greater access to financing (Veelaiporn Promwichit, Shamsher Mohamad and Taufiq Hassan; 2013), (Fara Madeha; 2007), (Chapra; 1992) and (Al Harran; 1990). Apart from this, scholars such as Chapra (2007), Siddiqui (2006) and Usmani (1998) are of the opinion that Musharakah financing is the true spirit of financing in Islam as it promotes justice which is the primary vision of Islam. This is because Musharakah financing apply risk-sharing principle so that the business risks are not shifted solely to the entrepreneur. Moreover, there is an equitable distribution of financing since it is not restricted to those who have collateral and strong financial back up to pay the predetermined profit payment.

Despite the above advantages, it is noted that application of Musharakah financing is very minimal in most of the countries around the world. One of the explanations for this phenomenon is that it is commonly associated with agency problems which result in moral hazard and adverse selection problem thus exposing the banks to high financing risks (Dar & Presley, 2000), (Aggarwal & Tarik,2002) and (Bashir 1999). In this situation, the entrepreneur that has more information about the business may hold back accurate information about the business operations for personal interest, thus resulting in the banks being faced with high financing risk. Due to this problem, debt financing has since become the dominant instrument of financing in the economies that is characterized by agency problems (Rajesh, Aggarwal and Tarik Yousef; 2000). In view of the above, Al Jarhi (2002) pointed that agency problems in financing can be reduced with close and effective monitoring of the firms. In order for the monitoring to be effective, Aoki Masihiko (1994) highlighted that three kinds of monitoring, namely ex-ante, interim and ex-post monitoring must be exercised. In relation to this, the banks require direct access to the business operations and information to facilitate them in conducting effective and close monitoring. Having said this, in Musharakah financing, the banks as the equity holder and partner to the firm have a right to get direct access to the business information and also to actively participate in the business matters. This will significantly assist the banks in conducting effective monitoring and supervision of the business operations as suggested by Aoki Masihiko (1994). towards reducing the risks of agency problem (Ahmed, 2008; Al Jarhi, 2002 and Iqbal, 1997).

Even though in the theory of Musharakah financing, the banks are allowed to actively participate in the business operations, until today, it remains a question whether it can be practiced in the real SMEs business operations. This is because few past studies highlighted that most of the firms do not agree to allow the banks to participate in their business operations as it will dilute their power as the founder of the business (Hussaini and Malami; 2014), (Jalaluddin, 1999) and (Bandar and Presley; 1996). On the other hand, it was also argued that for the banks to offer Musharakah financing, it is important for them to participate in the business operations as this will secure their position as the financier in lieu of collateral and predetermined profit payment (Ahmed; 2008) and (Al Jarhi; 2002).

In view of the above, this study is conducted to investigate the preference for bank's participation in SMEs' business operations, which subsequently determine the viability of Musharakah as an alternative financing for SMEs. For this purpose, this study is organized into five sections. Section two discusses the literature review, followed by section three which discusses the research methodology. The results of the study are presented in section four and further discussed in section five. Finally, section six concludes the study.

2. LITERATURE REVIEW

Musharakah financing offers equity participation in the business venture where the banks hold ownership and become a partner in the firms. One of the main differences between Musharakah and debt based financing is that provides the banks with a right to participate in the business operations of the firm financed by the banks. According to Ahmed (2008), Al Jarhi (2002) and Iqbal (1997), this gives the banks a right to have a direct access to the business information which will significantly assist the banks to conduct effective monitoring and supervision of the business. Moreover, by participating in the business operations, the bank will be able to monitor the use of funds by the project more closely and this may reduce the moral hazard problem (Khan and Ahmed; 2011).

The advantages of close monitoring and direct participation by the banks in the business financed by them was experienced by the Agriculture Bank of Iran (ABI) in the early 1990s, as explained by a case study conducted by Sadr and Iqbal (2002). At that time, ABI implemented several initiatives to improve its service, enhance efficiency and increase returns. Among the initiatives taken was an investment in a close supervision and monitoring of the financing accounts. It was found that close supervision and monitoring results in few advantages to ABI, which are (i) establishing a solid and trusting relationship between the bank and the customers (ii) enhancing the banks’ ability to learn about profitable investment opportunities in various business segments (iii) knowing more about the entrepreneurial and moral characteristics of its customer and (iv) enabling the bank to gain up-to-date information about the projects.

Besides these advantages experienced by ABI, Khan (1997) highlighted that the banks' participation in the business operations made them understood the business condition which resulted in a continuous technical support and efficiency towards the business. With the active participation of the bank in the business venture, agency problems can be mitigated and therefore, a collateral requirement usually imposed in debt financing can be tolerated by the banks. This will provide SMEs with a greater access to financing to assist their growth and expansion. However, these advantages of bank's participation will only be materialized if the banks play an active participatory role in the business. For this purpose, the banks need to be represented by a qualified staff who is an expert and that has adequate experience and knowledge in the business area. The expert must be able to perform additional supervisory and monitoring roles as compared to debt based financing (Ahmed; 2008 and Abdalla, 1999). In this regard, past studies have highlighted that one of the main problems faced by the Islamic banks is the lack of an expert in Musharakah financing and this restricts the bank's role to participate actively in the business operations (Farooq and Ahmed; 2013, Mohd Daud Bakar; 2002 and Ahmad Zafarullah et al 2013). According to Ahmad Zafarullah et al (2013), it was found that the banks have difficulty in hiring experts to monitor Musharakah financing. Even if the banks are able to get the expertise, the cost involved in hiring them is too high.

From the above discussion, for Musharakah to be functioning as a viable financing for SMEs, it is crucial for the banks to participate actively in the operations of the business venture. However, banks' participation needs to be supported by the availability of the expertise who will represent the banks in the business venture. This gives the bank's comfort to offer Musharakah financing, which will subsequently provide SMEs with a greater access to financing. This relationship is illustrated in Figure 1 below where participation becomes the independent variable, access to financing is the dependent variable and expertise availability moderates the impact of participation towards SMEs' access to financing. It is therefore hypothesized that: -

H1: Bank's participation in Musharakah financing will positively enhance SMEs' access to financing.
H2: Availability of expertise will significantly strengthen the effect of bank's participation in SMEs business operations towards SMEs' access to financing.

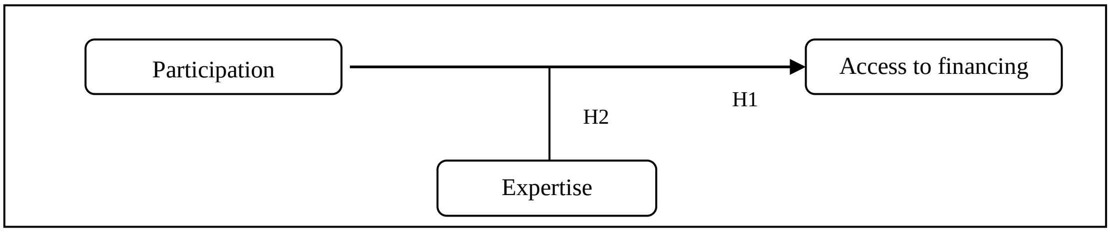


Figure 1: Relationship between participation. Expertise and access to financing

3. RESEARCH METHODOLOGY

This study adopts the quantitative research method by way of a survey questionnaire. Primary data collected from 411 SMEs are further analyzed using Statistical Package for Social Science (SPSS) version 23. Subsequently, to test the hypotheses, this study uses Structural Equation Modelling (SEM) with Analysis of Moment Structures (AMOS) software. SEM is a statistical modelling technique used to examine the relationship between latent independent constructs and dependent constructs. Furthermore, the interaction effect of the moderating variable is tested using SEM AMOS (Zainuddin, 2012). Thus, SEM is a suitable method to achieve the objective of this study. The results are discussed in the following section.

4. RESULTS

4.1 Demographic Analysis

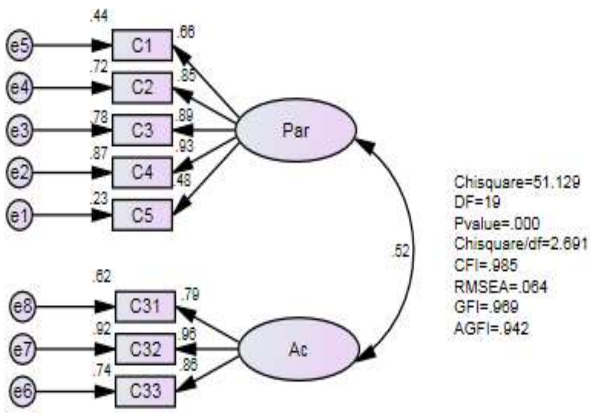
Most of the respondents, are the business owners cum operators of the business. This group accounts for42.1% of total respondents consistent with the characteristics of SMEs which is mainly operated and managed by its owners. In terms of gender, it is observed that respondents in this research are quite balanced between males (45.5%) and females (54.5%). Most of the firms that participated in the administered survey have been in operation for between 1 to 5 years (36.5%). This is followed by those 29.5% with more than 10 years, 20.7% with 6 to 10 years, and 13.6% with less than 1-year operation. In terms of sales, about 53.3% most of the firms recorded sales below RM300,000, indicating that most of the firms are micro business. This is in line with SMEs' population in Malaysia which is dominated by micro business that account for about77%. The remaining 46.7% of the firms recorded sales between RM300,001 to RM50 million and falls under small to medium scale SMEs. Most of the participants have less than 5 employees (53.8%) while only 4.1% of the firms have between 75 to 200 employees. Summary of the demographic information is as presented in Table 1 below: -

Table 1: Demographic Information

Demographic Information		**Frequency**	**%**
Business owner/ manager/ owner and manager	Business Owner	85	20.7
	Business Manager	153	37.2
	Business Owner and Manager	173	42.1
	Total	***411***	***100.0***
Sex	Male	187	45.5
	Female	224	54.5
	Total	***411***	***100.0***
Years in Operations	< 1 year	56	13.6
	1 - 5 years	150	36.5
	6 - 10 years	85	20.7
	> 10 years	120	29.2
	Total	***411***	***100.0***
Annual Sales	< RM300,000	219	53.3
	RM300,001 - RM2,999,999	114	27.7
	RM3,000,000 - RM14,999,999	30	7.3
	RM15,000,000 - RM20,000,000	25	6.1
	RM20,000,001 - RM50,000,000	23	5.6
	Total	***411***	***100.0***
Number of employees	< 5 employees	221	53.8
	5 - 29 employees	104	25.3
	30 - 74 employees	69	16.8
	75 - 200 employees	17	4.1
	Total	***411***	***100.0***

4.2 Measurement Model

This study proceeded with the process of testing structural equations model (SEM) which involves the measurement and structural models. The measurement model in this study is developed based on the extant literature which need to be further tested with confirmatory factor analysis (CFA). CFA tests the validity of the individual construct in the model, namely participation (labelled as "Par' as a dependent construct) and access to financing (labelled as "Ac" as an independent construct) as illustrated in Figure 1 above. The independent construct and dependent construct are measured by five and three measurement items respectively, using five-point Likert-scale. The results of the measurement model as presented in Figure 2 below shows that based on the value of fit indices, the model fits the data (chi-square/ df = 2.691 , CFI = 0.985, RMSEA = 0.64 , GFI = 0.969 , AGFI = 0.942).



1. Figure 2: Measurement Model

Subsequently, convergent validity was performed and results are presented in Table 2 below. Results show that all items have complied with the minimal requirement for standardized loadings, Cronbach alpha, construct reliability and Average Variance Extracted (AVE). With this, it can be concluded that all items are valid and reliable.

Table 2: Convergent Validity

CONSTRUCTS	ITEMS	STANDARDIZED LOADING	CRONBACH ALPHA	CR	AVE
Participation	C1 - *Banks participation results in more effective monitoring*	0.66	0.867	0.878	0.603
	C2 - *Banks' participation makes them understand business condition*	0.85			
	C3 - *Banks participation result in continuous technical support*	0.88			
	C4 - *Banks need to participate in SMEs' business operations*	0.93			
	C5 - *Banks have right to impose conditions for the use of the fund*	0.48			
Access to financing	C31 - *Musharakah enhance SMEs access to financing*	0.80	0.877	0.907	0.766
	C32- *Musharakah promotes growth and expansion of SMEs*	0.95			
	C33- *Musharakah is more suitable for new start up business with small capital.*	0.87			

4.3 Structural Model

Given that the validity and reliability of the measurement model are confirmed, the study performed structural equation modelling in order to answer H1 which is to examine the relationship between banks' participation in SMEs' operation and access to financing. Results are as shown in Figure 3 below.

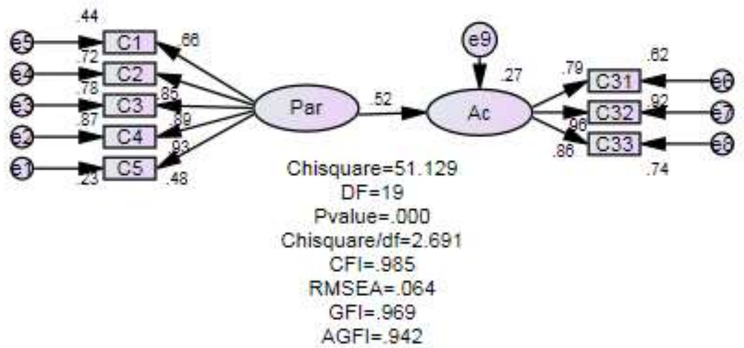


Figure 3 : Structural Model

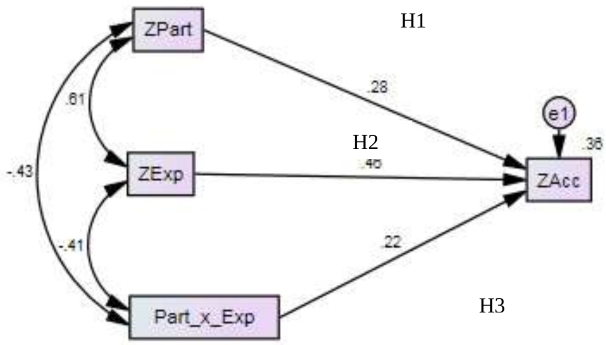
Overall, the model achieved most of the cut point of the fit indices indicating the model fits the data (chi-square/ df = 2.691, CFI = 0.985, RMSEA = 0.064, GFI = 0.969, AGFI = 0.942). As shown in Table 3, the value of C.R is greater than 1.96 indicating that the probability of getting a critical ratio as large as 3.478 in absolute value is less than 0.001. Banks' participation in Musharakah financing in the prediction of SMEs access to financing is significantly different from zero at 0.001 level. Thus, it can be concluded that banks' participation in SMEs' operations has a significant and direct effect on SMEs access to financing and therefore, H1 is supported.

Table 3: Results of Hypothesis Testing

Hypothesized Path	Estimate	S.E	C.R	P	Notes
H1	.101	.029	3.478	***	The hypothesis is supported

Finally, the model is cross-validated to assess the moderating effects of expertise and banks' participation towards SMEs access to financing. According to Baron & Kenny (1986), the moderator is a construct that alters the direction or strength of the relation between the independent construct and dependent construct. The model below illustrates the causal effect between participation (ZPart), expertise (ZExp) and access to financing (labeled as ZAcc). To test the causal and moderating effect, three hypotheses were developed based on the model as presented in Figure 4 below: -

H1: 'Participation' in Musharakah financing has significant causal effects on SMEs' access to financing.
H2: Element of 'expertise' has a significant causal effect on SMEs' access to financing.
H3: Element of 'expertise' moderates the causal effects of participation on SMEs' access to financing.



2. Figure 4: Moderating Effect

The results of the hypothesis testing using SEM AMOS are as presented in Table 4 below. For H1, the results show that the probability of getting a critical ratio as large as 5.357 in absolute value is less than 0.001. In other words, the regression weight for "participation" is significantly different from zero at the 0.001 level. In this case, the hypothesis that the causal effects of participation on SMEs access to financing is significant and supported. With regards to H2, the probability of getting a critical ratio as large as 9.052 in absolute value is less than 0.001. In other words, the regression weight for Exp is significantly different from zero at the 0.001 level (two tailed). In this case, the hypothesis that the causal effects of expertise on SMEs access to financing is significant and supported. For H3, the probability of getting a critical ratio as large as 4.969 in absolute value is less than 0.001. In other words, the regression weight for "participation and expertise" in the prediction of SMEs access to financing is significantly different from zero at the 0.001 level (two-tailed). In this case, the hypothesis that the moderating effects of expertise on relationship participation and SMEs access to financing are significant is supported. This finding suggests that the effect of banks' participation in SMEs' business operations on SMEs' access to financing is affected by, or moderated by, the existence of the requisite expertise in the financial institution. With reference to Figure 4, the regression co-efficient of "participation and expertise" on SMEs' access to financing is positive, indicating that the expertise strengthens the positive relationship between participation and SMEs' access to financing.

Table 4 : Results of Hypothesis Testing for Participation (Standardize Estimates)

Appendix A. Hypothesis	**Appendix B. Relationship**			**Appendix C. Estimate**
Appendix D. H1	**Appendix E.** ZAcc	**Appendix F.** <---	**Appendix G.** ZPart	**Appendix H.** 0.276
Appendix I. H2	**Appendix J.** ZAcc	**Appendix K.** <---	**Appendix L.** ZExp	**Appendix M.** 0.463
Appendix N. H3	**Appendix O.** ZAcc	**Appendix P.** <---	**Appendix Q.** Part_x _Exp	**Appendix R.** 0.130

Appendix S. S.E.	**Appendix T. C.R.**	**Appendix U. P**	**Appendix V. Label**
Appendix W. 0.052	**Appendix X.** 5.357	**Appendix Y.** ***	**Appendix Z.** Significant
Appendix AA. 0.051	**Appendix BB.** 9.052	**Appendix CC.** ***	**Appendix DD.** Significant
Appendix EE. 0.026	**Appendix FF.** 4.969	**Appendix GG.** ***	**Appendix HH.** Significant

The main effect of the primary predictor as explained in the above paragraph does not fully characterize the relation between banks' participation and SMEs' access to financing in the presence of significant moderation of expertise. Thus, as suggested by Cohen et al (2003), simple slope test was performed to examine the specific relation between banks' participation and SMEs' access to financing. With a simple slope test, this relationship is further analyzed at the different level of expertise (moderator construct) in order to fully understand its association. The test as demonstrated in Figure 5 shows that the relationship between participation and SMEs' access to financing is always positive, but it is far more so for participation when high expertise is involved (as shown by line with a small squares) than for those with low expertise involvement (as shown by line with diamond shape). With this, it can be concluded that the banks' high participation in SMEs business operations with a higher level of expertise will significantly enhance SMEs access to financing.

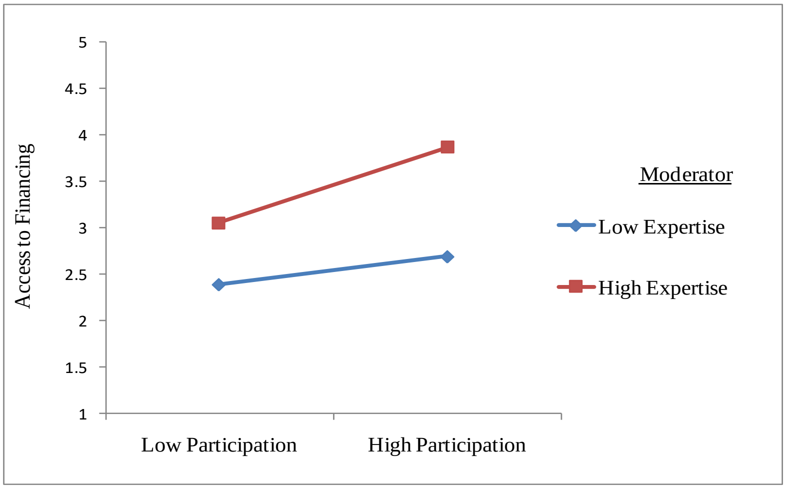


Figure 5: Simple Slope Test Participation and Expertise

5. DISCUSSIONS

The results of this study shows that the banks' role as business partner by participating in the SMEs business operations has positive implications for the latter's access to finance. This potential is likely to be optimized when complemented by provision of expert advisory and oversight functions by the banks. The element of participation in Musharakah financing is found to have a significant causal effect towards SMEs access to financing, which supports the previous theoretical studies of Chapra, Siddiqui and Khan (year) with regards to the potential of Musharakah financing. Furthermore, expertise is found to have a moderating effect towards SMEs access to financing. This finding empirically supports previous studies of Farooq and Ahmed (2013), Mohd Daud Bakar (2002) and Ahmad Zafarullah et al (2013) which emphasize the importance of expertise in promoting equity based financing. In this regards, the banks need to resolve the issues of non-availability of expertise for them to venture into Musharakah financing. When the effect of expertise is further examined, it is found that high level of expertise will strengthen the relationship between banks participation and SMEs access to financing.

Furthermore, this finding signifies SMEs' acknowledgment and agreement on the banks' participation in their business operations when Musharakah financing is offered to finance their business. This finding empirically supports previous studies of Ahmed (2008) and Al Jarhi (2002) which highlighted the importance of bank's participation in Musharakah financing. The results also show that the expert plays an important role as a moderating factor that strengthens the impact of bank's participation in SMEs business operations. To participate in the SMEs' business operations, the banks have an option either to involve at a high level, which involves banks active role in management, decision-making and business operations or low level participation, in which participation involves minimal activities such as to appoint the banks' staff in a monitoring capacity without executive power (Sadique,2008).

SMEs' agreement towards the banks' participation in their business operation as found in this study validates the potential of Musharakah financing for SMEs. Surprisingly, this finding is in contrast to the results of previous studies which found that SMEs are not agreeable to the banks' participation in their business operations. Studies by Hussaini and Malami (2014), Jalaluddin (1999) and Dar and Presley (1996) found that small businesses are not interested in PLS based financing due to the bank's participation which allows them to interfere in the management of their business. Some possible explanations of SMEs' agreement on the banks' participation in their operations as found in this study could be due to the assistance they will get from the banks' expertise, particularly in providing financial management assistance. As highlighted by Sadique (2008), lack of financial management is a crucial weakness faced by SMEs and a significant percentage of SMEs fail during the early period itself due to incompetence in managing their finances and lack of adequate planning. Furthermore, the availability of the expert in such participation will also assist the business to take timely action in facing business problems thus either avoiding totally or reduce the effect of such avoidable failures. This will enhance the success rate of the business and make SMEs more confident to obtain financing. Moreover, as highlighted by Jalaluddin (1999) the banks as a partner will have an incentive to provide business support such as network and resources which would strengthen the small business especially during the economic downturn.

6. CONCLUSION

This study is valuable in providing a better understanding on how Musharakah can be operationalized in SMEs financing when the banks play its role as the business partner by participating in the SMEs' business operations. This study suggests that the banks' participation in SMEs' business operations plays an important role in providing SMEs with a greater access to financing. However, the banks' participation must be represented by an expert who has good experience in Musharakah and the specific industry. Currently, there is an apparent lack of such expertise in most banks the posing a challenge for the banks to venture into Musharakah financing. With this, serious effort needs to be taken to overcome those challenges so that Musharakah financing for SMEs can be widely introduced. This will provide SMEs with a greater access to financing to facilitate their growth and development.

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