EASE OF DOING BUSINESS WITH INTEREST FREE BANKING (Islamic Banking) a special Reference to SMEs.

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ABSTRACT

Need of finance is of utmost importance for the successful operation, sustainable growth and profitability of any business. Timely availability of finance at lower cost facilitates the creation of new businesses and nurturing the innovation process as well as promoting the growth and development of existing businesses, which in turn, boost national economic growth. The main motive of this paper is to explore how Islamic sources of finance significantly helps in starting, nurturing and expanding businesses Hence, the purpose of this paper is to review the literature on Islamic source of finance for the smooth start and expansion of businesses with special regards to SMEs.

Keywords Interest free banking, Islamic source of finance, SMEs etc.

1. INTRODUCTION

Small and medium enterprises (SMEs) and high-growth start-ups are the backbone of both developed economies and emerging markets and developing countries (EMDCs) in terms of employment generation, opportunity, and sustainability, as well as economic growth. Formal SMEs contribute up to 33 percent of GDP in developing countries (IFC 2010) and up to 51 percent in high-income countries (SME Corp 2015). Globally, SMEs contribute 43.5 percent to total employment and are responsible for 57.8 percent of total new jobs created (Ayyagari, Demirgüç-Kunt, and Maksimovic, 2011). The relevance of these figures must be considered against the need to create about 600 million jobs around the world by 2030 to keep up with the growth of the labor force (World Bank, 2014).

The major challenge faced by SMEs is access to finance. The total financing gap for micro, small, and medium enterprises (MSMEs) in developing countries is estimated to be $2.4 trillion; of this total, a gap of about $1.3 trillion exists in G20 countries covered within the IFC Financing Gap database. The financing gap in EMDCs is even more severe, since financial institutions such as banks widely consider SMEs as being too risky due to such factors as lack of collateral and insufficient credit history. About 55–68 percent of SMEs in developing countries are either financially underserved or not served at all, resulting in lost opportunties to develop their SMEs.

What is interest free banking or finance?

The banking system where interests are not used. In this system, banks do not offer a fixed rate of return on deposits and do not charge interest on loans. Since this principal is based on the Islamic law that forbids acceptance and charging of interest, this mode of banking is also known as Islamic finance or banking

Islamic banking and finance has shown remarkable global success in terms of growth, expansion, and institutional and product diversification. Over the past five years, the Islamic banking and finance industry has grown by a compound annual growth rate of about 17 percent, reaching more than $1.87 trillion in total assets by the first half of 2014. The Islamic banking sector grew by 16 percent in 2013, according to the IFSB, compared to the overall global banking growth (based on the assets of the top 1,000 global banks) of only 4.9 percent in 2012 and 0.6 percent in 2013).

The asset-backed finance and risk-sharing nature of Islamic financial products aims to contribute to social and economic development by promoting entrepreneurship. Asset-based financing ensures that the transaction is

financing real economic activity based on close linkage to the financed assets, ensuring less *"financilization"* in the economy. Equity-based financing, on the other hand, promotes profit and loss sharing between financiers and entrepreneurs, resulting in increased alignment of interests and increased risk sharing. It also fosters entrepreneurship, especially of seed and early-stage start-ups, which rely purely on equity financing for their ventures.
The purpose of this paper is to study and explore the literature of various financing options available in Islamic finance that caters the need of SMEs.

2. LITERATURE REVIEW

Islamic finance is defined as a financial service or product principally implemented to comply with the main tenets of *Sharia* (or Islamic law). In turn, the main sources of *Sharia* are the *Holy Quran, Hadith, Sunna, Ijma, Qiyas* and *Ijtihad*. The *Holy Quran* is the book of revelation given to the Prophet Muhammad; *Hadith* is the narrative relating the deeds and utterances of Muhammad; *Sunna* refers to the habitual practice and behaviour of Muhammad during his lifetime; *Ijma* is the consensus among religion scholars about specific issues not envisaged in either the *Holy Quran* or the *Sunna*; *Qiyas* is the use of deduction by analogy to provide an opinion on a case not referred to in the *Quran* or the Sunna in comparison with another case referred to in the *Quran* and the *Sunna*; and *Ijtihad* represents a jurists' independent reasoning relating to the applicability of certain *Sharia* rules on cases not mentioned in either the *Quran* or the *Sunna*.

In brief, the principles of Islamic finance are as follows: (i) the prohibition of *Riba* (usually interpreted as usury or interest) and the removal of debt-based financing; (ii) the prohibition of *Gharar*, encompassing the full disclosure of information, removal of asymmetric information in contracts and the avoidance of risk-taking; (iii) the exclusion of financing and dealing in activities and commodities regarded as sinful or socially irresponsible (such as gambling, alcohol and pork); (iv) an emphasis on risk-sharing, the provider of financial funds and the entrepreneur share business risk in return for a pre-determined share of profits and losses; (v) the desirability of materiality, a financial transaction needs to have 'material finality', that is a direct or indirect link to a real economic transaction; and (vi) consideration of justice, a financial transaction should not lead to the exploitation of any party to the transaction [see El-Gamal (2000), Warde (2000), Lewis and Algaoud (2001), Iqbal and Llewellyn (2002), Abdul-Gafoor (2003), Obaidullah (2005) and Iqbal and Molyneux (2005) for suitable introductions to Islamic finance]

In practical terms, these prohibitions and recommendations manifest themselves as the following commercial products and services offered by Islamic financial institutions: (i) *Mudarabah*, the provision of capital to a partial-equity partnership in return for a share of profits, but where the losses on funds lent are borne by the lender; (ii) *Musharakah*, full-equity partnerships where the provider of funds and the entrepreneur directly and wholly share in the business, (iii) *Murabaha*, an instrument used for financing the purchase of goods and services where the financial institution purchases these on behalf of the customer; (iv) *Bai muajjall*, deferred payments on products encompassed under *Murabaha*; (v) *Bai Salam*, advance or pre-paid sale contracts of goods and services; (vi) *Istisna*, or manufacturing contracts to cover work in progress and paid by the financial institution on behalf of the customer; (vii) *Ijarah*, lease financing in the form of operating leases only; (viii) *Takaful* or Islamic insurance in the form of cooperative self-help schemes, and (ix) *Quard Hassan*, benevolent loans offered interest free.

In turn, these commercial products and services underlie the various depositor and investor accounts offered to retail customers. In terms of Islamic banks, these are again very similar to the products and services offered by conventional banks with the exception that Islamic financing principles apply to the underlying bank assets and liabilities. For example, unlike a conventional savings account, interest is forbidden on balances in Islamic accounts. Depositors can, however, obtain benefits in the form of 'voluntary prizes', whose value depends, in part, on the deposit's balance and the bank's profitability. These services are often offered fee-free to depositors.

Islamic products and services also increasingly manifest themselves as mutual funds underpinned by investments in *Sharia*-compliant equity or property, *Sukuk* (Islamic bonds), *Takaful* (Islamic insurance) or *Ijarah* (Islamic leasing) constructed with Islamic principles in mind. For example, a *Sharia*-compliant equity mutual fund would, through a process of sector screening and dividend 'purification', normally exclude: banking, insurance or any other interest-related activity; alcohol, tobacco, gambling, armaments; any activity related to pork; other activities deemed offensive to Islam; and any sectors or companies significantly affected by any of the above.

3. RESEARCH GAP

Few researches have been done that really address the finance issue for the start of business with a special regard to SME. While some of the studies concluded that since SME are more risky, Conventional financial institutes are reluctant to finance SME however alternative finance have been not suggested to start a SME.

4. NEED FOR THE STUDY

The paper has two major objectives

1. To explore the potential of SMEs in the developing nations.
2. To address the finance issues for the start and expansion of SMEs and looking to the options of Islamic finance for SMEs

5. SMEs Characteristics

In general, the characteristics of SMEs affect their financial decisions and behaviour and ultimately the firm's performance and growth. In this context, the literature has identified several characteristics peculiarly related to the SMEs sector as factors influencing the financial behaviour of firms in this sector. These include firm size andage, ownership type and legal form, geographical location, industry sector and asset structure (reflecting the ability to provide collateral).

5.1 Size and Age

Even though there is no consensus amongst researchers about the criteria that should be employed to measure the size of the firm (typically total assets, sales or the number of employees), the notion that firm size has an effect on SME's activities and its potential to expand appears to receive general agreement. A firm's size is usually coupled with its age as they tend to have similar influence on the firm's life cycle. This influence can be strongly observed in the decision making process in the firm about whether one particular sort or another of finance should be chosen and utilized (Cassar, 2004). Studying firms financing and capital structure using a sample consisted of 292 Australian firms, Cassar (2004) concluded that the "larger" small firms are, the more they rely on long-term debt and external financing, including bank loans. This is consistent with Storey (1994) who found that in the case of SMEs, the owner–manager's personal savings are more important as a source of funds during the start-up stage than outside finance such as loans and overdrafts from banks. From another angle, the extent to which firm size can impact the availability of finance to the firm was measured by Petersen and Rajan (1994). They argued that as firms grow, they develop a greater ability to enlarge the circle of banks from which they can borrow. They then provided evidence that firms dealing with multiple banks and credit institutions are nearly twice as large as those with only one bank. As younger firms are usually characterised by informational opacity (Berger & Udell, 1998) as a consequence of not having an established track record, this may lead to the reluctance of banks and other financial institutions to lend to these firms. According to Klapper, Sarria-Allende and Sulla (2002), younger enterprises (those established less than four years), are more reliant on informal financing and far less on bank financing. This is supported by Quartey (2003) who concluded the significant positive effect of firm age on the ability to access external finance. In addition, in their investigation of the impact of firm and entrepreneurial characteristics on SME access to debt finance in South Africa, Fatoki and Asah (2011) observed that SMEs established more than five years have a far better chance to be successful in their credit applications compared with SMEs established for less than five years.

5.2 Ownership Type and Legal Form

There is a positive relation between SME leverage and the type of organisational structure (Coleman & Cohn, 2000). This is in line with Abor (2008) who identified the form of business as one of the factors explaining the capital structure decisions of Ghanaian SMEs. In addition, ownership structure and the type of firm were found to have a significant impact on the use of bootstrap financing. Van Auken and Neeley (1996, p. 247) state that: "Owners launching firms organised as either a sole proprietorship or non-construction/manufacturing firms should be prepared to use more bootstrap financing than other firms. Owners of these types of firms should beprepared to develop a financial plan that incorporates the use of greater variety of financing alternatives thanowners of firms organised other than a sole proprietorship non-construction/manufacturing firms. As such, a sole proprietorship of non-construction/manufacturing firms should recognize the potential for the associated greater number of constraints and difficulties in raising start-up capital". From the financier's point of view, as SMEs are by nature characterised by concentrated ownership and control in the same owner–manager, which leads to maximizing the information asymmetry problem, the reluctance in lending to SMEs and the extensive use of collateral are understandable and

justified (Hutchinson, 1999). Consistent with this, Petty and Bygrave (1993) inferred that the lack of separation between the firm and the owner affect the financing preferences of the firm. In terms of legal form, Cassar (2004) notes that incorporation may be perceived by banks and other finance suppliers as an encouraging sign of the firm's formality and creditability. Consequently, incorporated firms appear to be in a very favoured position in receiving external funding in comparison with unincorporated firms. Other studies (Storey, 1994) concluded that limited private companies are more likely to be reliant on bank financing.

5.3 Location

The geographical area where a firm is located in the proximity of banks is also believed to have an influence on the firm's ability to gain external finance. For example, SMEs located outside major cities face greater difficulties in acquiring external finance, especially long-term debt, compared with their counterparts operating in cities (Abor, 2008). In the same regard, Fatoki and Asah (2011) added that the geographical location of SMEs close to their banks advantages them in that they can better cement relationship lending with those banks. As a result, SMEs are better able to access bank loans using no more than soft qualitative information. A study conducted by Okpara and Wynn (2007) reported poor location results in inaccessible businesses to both customers and suppliers as one of the reasons for SME failure in Nigeria. Additionally, another study by Reddy (2007) examined the challenges and obstacles encountered by SMEs in Fiji. They found that in spite of the relatively high cost of rentals, SME owners preferred to move their firms' activities to urban areas to escape the negative impact of the local environment features of rural areas on raising external finance, including poor local transportation and communications infrastructure, and consequently on the performance and growth of their firms which made their survival more difficult where such a climate exists.

5.4 Industry Sector

A number of studies evidenced that factors related to the industry sector in which a firm operates also explain capital structure and financial decisions (Mackay & Phillips, 2005; Michaelas, Chittenden & Poutziouris, 1999). Firms in the services sector, for example, can differ from those operating in manufacturing or construction in terms of financial needs and choices. Michaelas et al. (1999) empirically analysed the different capital structure determinants across time and industries utilizing a sample of 3,500 randomly selected SMEs across ten industries in the UK. They summarised that the impact of industry on short-term and long-term debt varies greatly across industries. The effect of industry classification on the capital structure of Ghanaian SMEs was examined by Abor (2007). The results of the study revealed some differences in the funding preferences of the Ghanaian SMEs across industries. SMEs in the agriculture sector and medical industries rely more on long-term and short-term debt than their counterparts in manufacturing. Abor (2007) further concluded that short-term credit is more used in wholesale and retail trade sectors compared with manufacturing SMEs, whereas construction, hotel and hospitality, and mining industries appear to depend more on long-term finance and less on short-term debt.

5.5 Assets Structure

As the provision of collateral plays an indispensable role in easing SME access to debt finance. SMEs that have more fixed assets tend to utilise higher financial leverage (Bradley, Jarrell, & Kim, 1984). The reason for this is that these firms can borrow at lower interest rates as their loans are secured with these assets serving as collateral. This explains why Coco (2000) describes collateral as the lender's second line of defence. In their investigation of the role of collateral and personal guarantees using a unique data set from Japan's SME loan market, Ono and Uesugi (2009) found that a positive relationship between the use of collateral and the strength of the borrower–lender lending relationship results in easier SME access to external sources of finance. A similar conclusion was reached by Odit and Gobardhun (2011) when examining the factors determining the use of financial leverage by SMEs in Mauritius. They concluded that access to debt finance is affected by the positive association between the debt ratio and the asset structure. Furthermore, they revealed that SMEs with a lower portion of tangible assets in their total assets are more likely to encounter difficulties in applying for outside finance because of the inability to provide the collateral required.

6. ISLAMIC FINANCE FOR SMES

As recently as the 1970s, Islamic finance has emerged as a new trend with promising potential in the field of finance. The rapid growth of Islamic finance is not confined to Islamic countries as it also has spread to non-Muslim countries with sizeable Muslim populations, including the US, the UK and Australia. It is argued in the Islamic financing literature that many of microfinance elements are in accordance with the Islamic finance's broader objectives. Obidullah and Lattif (2008) believe in the possibility of a successful marriage between the two disciplines. They

underpin their belief by clarifying some aspects which these two have in common. According to them both Islamic finance and microfinance encourage entrepreneurship as well as risk sharing between the financier and the entrepreneur. Islamic microfinance adds that both disciplines prioritize developmental and social goals by advocating the participation of the poor in the economic activities. Ibrahim (2003) argued that Islamic financing methods are better suited in satisfying the financial needs of SMEs. The focus in Islamic financing and investment, he explains, is on the transaction itself instead of the partner's creditworthiness. As such, entrepreneurs are granted funding without an obligation on them to provide strict securities or collateral which SMEs often lack. He adds that because profit and loss sharing is pivotal in Islamic finance, any securities or collateral demanded is not against the risk of loss, rather against possible fraud or repayment evasion. The most popular Islamic financing methods are:

6.1 Musharakah

Musharakah as a mode of Islamic finance can be defined as "form of partnership where two or more persons combine either their capital or labour together, to share the profits, enjoying similar rights and liabilities" (Al-Harran, 1993, p. 47). In this form, the profits are shared according to a pre-determined agreed ratio, however, in the case of loss it will be shared based on capital contribution ratio. Additionally, In Musharakah contract all partners are entitled to have a role in the management of the project. According to Lewis and Algaoud (2001) Musharakah contract can be either permanent or diminishing contract. In the former contract, which may last to limited or unlimited period depending on the original agreement, annual equal shares of the profit/loss are ensured for both parties based on pre-agreed deal. In the latter, however, capital is not permanent since the financier receives profits on a regular basis diminishing his/her equity. Consequently, this will gradually increase the total capital of the client till he/she becomes the only owner of the project. Ibrahim's (2003) findings highlighted some advantages of Musharakah contracts. First of all, compared to the rate of return of conventional finance (interest rate), rates of return for the capital provider in Musharakah are large, thus, financially, for the financing institution financing through Musharakah is profitable. Similarly, the rate of return of the partner's capital is slightly higher than his/her share in the total capital even if this share is less than the financier's. This because the inclusion of management effort in Musharakah. Another advantage for the entrepreneur is that since Musharakah does not require strict collateral guarantees so that it does not leave the entrepreneur with a heavy burden of debts or any other obligations. In addition, Musharakah is a suitable technique of financing for both fixed and working capital. Nonetheless, under Musharakah contract some ambiguity may exist regarding the title to assets in case of default or dissolution. In order to partially offset the increased risk in such situation, the procedure could be taken is to register the project's assets under the co-ownership concept provided by a partnership or corporation arrangement. Yet, capital providers especially banks may prefer to opt other Islamic financing method such as Murabahah.

6.2 Murabahah

Among all Islamic financing modes Murabahah is the most distinct and the most popular. Under Murabahah contract the financier (often Islamic bank) purchases or imports certain goods or commodities (assets or raw materials) ordered by the client and then resells them to the entrepreneur after adding a negotiated profit margin (Dhumale & Sapcanin, 1999). Under this contract the payment is due in installments. It can be inferred that Murabahah transaction entails two contracts. The first contract is that one between the financier (usually the bank) and the supplier of the goods/commodities. The second is between the financier and the client who applied for the goods/commodities. The fundamental principles that characterize Murabahah contract are summarized in (Gait & Worthington, 2007). First, the goods/commodities must be clearly classified and identified on the base of accepted standards and must be provided by the time of sale. Second, at the time of sale goods/commodities must be completely owned by the financier. Third, the entrepreneur must be informed of the cost price at the sale point. Finally, both the time of goods/commodities delivery and the due date of payment must be clearly specified. Khan and Ahmed (2001) considered the most important advantage of Murabahah is that since the financier collateralizes the debt beyond the good/commodity itself, as such, the risk of loss becomes much less than the risk of credit transaction in conventional transactions. In addition, Ibrahim (2003) asserted that Murabahah contracts will ensure that the client will have the intended goods/commodities so that avoiding using the money in a different purpose which is usually the case in the conventional loan contracts. Moreover, unlike Musharakah contract and as mentioned earlier, in Murabahah there is no ambiguity concerning title to the assets as they remain owned by the financier till the payment finalized.

6.3 Mudarabah

Gafoor (2006) described Mudarabah contract as a profit sharing and loss absorbing rather than profit and loss sharing contract. Mudarabah is a contract between two parties; a capital owner and an investment manager, under which profit is distributed in accordance to a ratio that is pre-agreed between the two parties at the time of the contract, whereas, financial loss is borne solely by the capital provider and the manager losses his/her effort and the expected profit. In other words, Mudarabah refers to two parties involve together to establish a project whereby one party (individual or

bank) provides the capital needed and plays no further role in the project while the other (entrepreneur) offers his/her skills, experience and effort. Profits are then divided between the two parties on the base of pre-determined ratio. In the case of loss, however, the financier entirely bears the financial loss and the entrepreneur bears the operating losses and receives no reward for his/her effort. One exception that the entrepreneur becomes liable for the amount of capital invested is in the case of negligence and breach of the terms of the contract (Abdulrahman, 2007). Segrado (2005) has categorized Mudarabah contracts into three categories. First category is demand deposits in which deposits are not restricted, payable on demand and do not share in any profits. Second category is that of mutual investment deposits where these deposits are combined with the bank's money with the aim to participate in mutual investment transactions conducted by the bank. Under such deposits, the percentage of profit is fixed at the end of the financial year of the bank. The third of these categories is special investment deposits under which deposits will be invested in a specific project or investment in accordance with the depositor's request. In this case the depositor will be entitled to receive profits and is liable for the losses, given that the bank is not negligent or in default. At the end of the deposit period, the bank receives its share of profit against its contribution of experience and management, while the depositor receives his/her share of profit as a capital share contributor. Due to agency issues accompanied with it, Mudarabah has been perceived as a risky product. As entrepreneurs usually do not keep track records or financial statements (Segrado, 2005; Abdulrahman, 2007) it is difficult to determine the actual profit to be shared between the two parties. Additionally, Warde (2000) concluded that Mudarabah contract was often associated with moral hazard and adverse selection. Part of the reason for this is because honesty, transparency and trustworthiness presumably characterize the entrepreneur cannot be guaranteed. As such difficulties are likely to be unavoidable in Mudarabah contracts, Segrado (2005) suggested that specific training to overcome these issues is needed; thus, he confirms that Mudaraba mode might be more suitable for businesses with a longer profit cycle.

6.4 Musawama

Musawama is a general kind of sale in which the price of the commodity to be traded is stipulated between the seller and the buyer without any reference to the price paid or cost incurred by the former. Thus, it is different from *murabaha* in respect of its pricing formula. Unlike *murabaha*, the seller in *musawama* is not obliged to reveal the cost or purchase price. All other conditions relevant to *murabaha* are valid for *musawama* as well. *Musawama* can be an ideal mode where the seller is not in a position to ascertain the precise costs of commodities that are offered for sale.

6.5 Salam

Salam is a kind of sale whereby the seller undertakes to supply specific goods to a buyer at a future date, in consideration of a price fully paid in advance. It is an exceptional mode in Islamic contractual theory for a sale transaction, whereby the existence of a subject matter and its ownership or possession by the seller is not necessary at the time of sale. Some additional considerations in *salam* are as follows:

- The buyer should pay the price, in full, to the seller at the time of effecting the sale; otherwise it will be tantamount to a sale of debt against debt, which is expressly prohibited by the Shari'a rulings (any unpaid price represents a debt to the buyer and a debt to the seller for the value of such goods not paid for in advance);
- The debt liability of the seller cannot be adjusted against the price for *salam* sale, in part or in full.
- *Salam* can be affected in only those goods that are normally available in the market and whose quality and quantity can be specified exactly;
- It is necessary that the quality of the goods intended to be purchased is fully specified, leaving no ambiguity leading to dispute among the parties involved in the transaction;
- The exact date and place of delivery must be specified in the *salam* contract. The parties may fix any date for delivery with mutual consent; and
- In order to ensure that the seller shall deliver the goods on the agreed date, the bank can also ask the seller to furnish a security, which may be in the form of a guarantee or in the form of a mortgage/hypothecation. *Salam* sales are suitable for financing agricultural operations, where the bank can transact with farmers who are expected to have the goods for delivery after harvesting, either from their own crops or from the crops of others, which they can purchase in the latter case and deliver in case their crops fail. *Salam* sales are also used to finance commercial and industrial activities, and have the advantage of elasticity to cover the needs of people working in various sectors of the economy, such as farmers, industrialists, Background to Islamic Finance contractors or traders. They can cover the financing of overheads and capital goods as well.

6.6 Istisna'a

Istisna'a is a contractual agreement to manufacture goods, allowing cash payment in advance and future delivery or a future payment and future delivery. *Istisna'a* can be used for financing in the manufacture or construction of houses and factories, and in building bridges, roads and highways.

The key features of *istisna'a* include the following:

- It is used in the manufacturing sector where the *al-saani* (manufacturer or the seller) would arrange to provide both the raw material and the labour;
- The goods and price must be known and specified to the extent of removing any *gharar* or excessive uncertainty;
- It is not necessary in *istisna'a* that the price is paid in advance. The price can be paid in instalments within a fixed time period;
- It is not necessary for the *al-saani* to manufacture the goods. The seller may enter into a contract with a manufacturer to provide the same goods, which is the subject matter of the first *istisna'a* contract;
- In an *istisna'a* contract, before a manufacturer starts the work, any one of the parties may cancel the contract by giving a notice to the other; however, once the manufacturer has started the work, the contract cannot be cancelled unilaterally;
- The *al-mustasni* (purchaser) has the right to obtain collateral from the *al-saani* for the amount paid and with regard to delivery of the goods with specifications and time; and
- The contract may also contain a penalty clause on account of breach of the contract.

Istisna'a contracts have wide fields of application for Islamic banking institutions to finance public sector needs. The *istisna'a* contract is suitable for various industries, such as the aircraft industry, locomotive and ship building industry, construction industry and food processing industry.

6.7 Diminishing musharaka

Diminishing *musharaka* is a variant of *musharaka*, and is a form of co-ownership in which two or more parties share the ownership of a tangible asset in an agreed proportion, and one of the co-owners undertakes to buy, in periodic instalments, the proportionate share of the other co-owner until the title to such tangible asset is completely transferred to the purchasing co-owner. Islamic Alternatives to Conventional Finance It is a combination of partnership and *ijara* (leasing), where the asset under co ownership is leased by one of the parties to another before the asset can be fully acquired. It is mainly used by Islamic banking institutions for house and car financing; however, it could also be used for financing in the purchase of industrial establishments, farms and other fixed assets.

The key features of the diminishing *musharaka* are given below:

- Diminishing *musharaka* is applied for the purchase of tangible assets;
- Proportionate shares of each co-owner must be known and defined in terms of investment;
- Expenses incidental to ownership may be borne jointly by the co-owners in the proportion of their co-ownership;
- Losses, if any, shall be borne by the co-owners in proportion of their respective investments;
- Each periodic payment shall constitute a separate transaction of sale; and
- Separate agreements/contracts shall be entered into at different times in such manner and in such sequence so that each agreement/contract is independent of the other, in order to ensure that each agreement is a separate transaction.

In diminishing *musharaka*, the bank (as financier) and a client participate either in joint ownership of a property or an asset that allows the client to secure the sole ownership of that asset over a period of time. The share of the bank is divided into a number of units and it is understood that the

Client will purchase such units periodically. Thus, reducing or "diminishing" the bank's share in the ownership and increasing the client's ownership until all of the bank's units are purchased, so as to make the client the sole owner of the asset. This arrangement allows the financing bank to claim rent, on a reducing basis, from the client for using the asset according to the proportion of the prevailing ownership in the property, and at the same time allows periodical return of a part of bank's investment through purchases of the units representing the bank's share of the asset.

6.8 Ijara

Ijara is equivalent to conventional leasing; however, there are some key differences, such as the requirement of the lessor to assume the risk relating to ownership of the leased asset at all times, and any sale to the lessee at the end of the lease period to not be a condition of the leasing contract. The bank's income is derived from the profit charged on the cost of a leased asset, and this profit is included with the cost in the lease repayments. Although *ijara* is strictly not

a financing mode, Islamic banking institutions are extensively using it as such to acquire fixed assets for their clients because it does not involve interest payments, is easily understood and can be used in order to obtain tax concessions in certain countries. The question as to background to Islamic Finance whether or not the transaction of leasing can be used as a mode of financing in the context of Shari'a will depend on the terms and conditions of the contract.

CONCLUSION

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.

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.

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