ISLAMIC BANK FINANCING FOR SMALL AND MEDIUM-SIZED ENTERPRISES IN INDONESIA

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ABSTRACT

Islamic banking and finance has gained greater recognition throughout the world since its inauguration as a contemporary finance subfield in the mid-1970s. Indonesia, the country with the largest *Muslim* population in the world, established its first Islamic bank in 1991. Presently, there are 11 Islamic commercial banks (BUS), 24 Islamic windows (UUS) and 163 Islamic rural banks (BPRS) operating within Indonesia. However, despite the upward trend in the growth of Islamic finance in Indonesia, its size and growth has been rather constrained when compared with other countries. In particular, Indonesia has much larger Muslim population than that of Malaysia yet the growth of Islamic banking of Indonesia lags behind that of Malaysia.

The growth of Islamic banks within Indonesia faces many obstacles that limit their outreach and constrains their level of market penetration. The growth of Islamic banks is influenced, on one the hand, by practices and policies employed by Islamic banks, and on the other, by customers' knowledge regarding Islamic banks. Therefore, this study examines the causes and consequences of policies adapted by Islamic banks in Indonesia and compare these with conditions in Malaysia.

Access to finance by Small and Medium Enterprises (SMEs) is recognised as a major issue for developed and emerging economies and Indonesia is no exception. However, it is suggested that Islamic banks are in a better position to meet the needs of SMEs. Theoretically, the profit and loss sharing (PLS) principles confers advantages to Islamic banks over conventional banks as IBs share risk with their borrowers, and lend money on the strength of the proposal and not on the basis of the collateral, as often is the basis for conventional bank lending. Risk sharing is preferred by SMEs which commonly do not have financial information or assets for collateral. In the context of Indonesia where the number of SMEs is large, there is a potential for Islamic banks to grow. Therefore, this research investigates lending practices, policies and access to Islamic bank financing by SMEs in Indonesia. This thesis examines the supply and demand side experiences and the obstacles that may hinder SME access to finance from Islamic banks.

To examine the experiences of borrowers and Islamic Bank lenders, the study used triangulation, a combination of quantitative and qualitative methods, to analyse the data and to test the hypotheses. Quantitative data obtained from questionnaires was used to investigate the experiences of SMEs regarding the theory and practice of Islamic banks and to examine whether there was a financing gap. To corroborate the findings, interviews with SME owners and bank managers were undertaken and analysed through the case study methodology. Furthermore, interviews with Islamic bank managers were analysed using Interpretative Phenomenological Analysis to investigate their experiences in assessing the loan applications of SMEs.

The empirical analysis undertaken in this study demonstrates: (i) the number of Islamic banks (in terms of either assets or market share in Indonesia) is small when compared to that of conventional banks, (ii) access to Islamic banks is motivated by a combination of religious and profit considerations, (iii) similar to conventional banks, collateral remained the main obstacle for SMEs in accessing funds from Islamic banks, (iv) a financing gap exists for SMEs exists in Indonesia, and (v) customer mind-set is a crucial barrier in the penetration of Islamic banks into the market.

Key words: *Islamic banking, Small and Medium Enterprises, Indonesia*

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DECLARATION

I hereby declare that no portion of the work that appears in this study has been used in support of an application for another degree or qualification of this or any other University or institution of learning.

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AAOFI	Accounting and Auditing for Islamic financial Institution
ASEAN	Association of South East Asian Nation
BPRS	Bank Pembiayaan Rakyat Syariah
BUS	Bank Umum Syariah
BIMB	Bank Islam Malaysia Berhad
BMI	Bank Muamalat Indonesia
BMT	Baitul Mal Wattamwil
BSM	Bank Syariah Mandiri
CB	Conventional Bank
CII	Council of Islamic Ideology
CPA	Comprehensive Peace Agreement
DIB	Dubai Islamic Bank
FDIC	Federal Deposit Insurance Corporation
FIBB	Faysal Islamic Bank of Bahrain EC
GB	Grameen Bank
GDP	Gross Domestic product
IB	Islamic Bank
IBBL	Islamic Bank of Bangladesh Limited
ICMI	Ikatan Cendekiawan Muslim Indonesia
IDB	Islamic Development Bank
IFSB	Islamic finance Service Board
IMF	International Monetary Fund
IPA	Interpretative Phenomenological Analysis
JBI	Jaiz Bank International
KIK	Kredit Industri Kecil
LE	Large Enterprise
MIDC	Metal Industry Development Center
MUI	Majelis Ulama Indonesia
NPF	Non Performance Financing
OECD	Organization for Economic Co-operation and Development
PBC	Pakistan Banking Council
PBUH	Peace Be Upon Him
PHB	Platinum Habib Bank
PLS	Profit and Loss Sharing
RCC	Rural Credit Cooperative
RDS	Rural Development Scheme
REPELITA	Rencana Pembangunan Lima Tahun
SEC	Securities and Exchange Commission
SIBL	Social Investment Bank Limited
SME	Small and Medium Enterprise
UAE	United Arab Emirates
UUS	Unit Usaha Syariah

CHAPTER 1
INTRODUCTION

1.1 Background

The practice of Islamic banking (IB) has grown exponentially over the past four decades since the first inaugural inception of an Islamic Bank in Dubai in 1975 (Chapra, 2007). The assets of Islamic banks are estimated to have reach $1.6 trillion by the end of 2014[1]. Although Islamic banking was established (formally) in the 1970s, historically the practice of saving and financing based on Islamic law has been evolving since the 1960s. For example, Mit Ghamr Bank established in Egypt in 1963 (Visser, 2009). Likewise, *Tabung Haji* is an Islamic financial institution operating based on *Shariahcompliance* in Malaysia. This institution was started in 1962 and started operating in 1963 by collecting funds for pilgrimage (Kahf, 2004).

In Indonesia, the presence of Islamic banks (IBs) is relatively new compared to Conventional banks (CB)andits presence in other countries such as Middle Eastern countries, as well as Malaysia and Pakistan.The first Islamic bank in Indonesia, Bank Muamalat Indonesia (BMI), was established in 1991 and started its operation in 1992. Currently, there are eleven Islamic Commercial Banks (BUS), twenty-three Islamic Banking Windows/Units (UUS), and 163 Islamic Rural Banks (BPRS) operating across Indonesia. The performance of the Islamic banking industry in Indonesia is measured by Islamic banking performance indicators such as total assets, deposits and market share(Statistic, 2014).

Although IBs have gained an overall acceptance for commercial and personal service, it has been suggested that they have a pivotal role to play in servicing Small and Medium Enterprises (SMEs), in particular, where SMEs lack collateral, financial information and track record. Therefore, the presence and the growth of Islamic banks provide an opportunity for the development of SMEs as its focus is on equity and share of risk. Thus, Islamic banks serve as an additional alternative source of

[1]http://www.kfhresearch.com/product/islamic-finance-outlook-2014

capital besides the existing conventional bank. It has been recognized by many scholars and supported by research findings(Wu *et al.*, 2008; Mason and Kwok, 2010; Klonowski, 2012; Bruns and Fletcher, 2008; Beck *et al.*, 2006)the difficulties of accessing capital from external sources, in particular for SMEs at the start-up and development stage (Beck, 2007). Bank finance is often provided for short-term purposes and there are limited financial institution products for long-term investment financing that will enable the entrepreneurs to plan their business activities and operations.Short-term finance such as an overdraft (OD) facility makes itdifficult for SMEs to plan their firm’s operations, develop capacity and competitive products.

Banks consider SMEs tobe risky propositions, a major factor considered when making lending decision for SMEs for the long-term loans. SMEs are often unable to either fulfil bank requirements at the start of the loan application as they do not have proven track record, financial information to convince banks that they are capable of servicing their loan. Due to the lack of information and track record, banks demand large collateral to protect themselves against business failure. Insufficient collateral gives rise to a finance gap for SMEs(Beck *et al.*, 2006). Deakins and Hussain (1993) argued, in the case of UK, that banks fail to evaluate the business proposal on its merit. Bank managers tend to rely on collateral to mitigate adverse outcomes in the case of business failure. In addition to seeking collateral, banks also impose relatively high interest rates to compensate them for high risk. Thus, SMEs encounter a double barrier to grow, namely the difficulties of accessing funds and the high cost of capital. The finance constraints faced by SMEs in Indonesia are not unique, research conducted in the UK, USA and elsewhere report similar problems for SMEs.

It has been observed (Chen, 2006; Lauder *et al.*, 1994; Tambunan, 2011)that SMEs, both in developed (USA, UK, Germany, France) and developing countries (China, India, and Indonesia andothers), havean important role to play towards economic recovery and growth. In the context of Indonesia, SMEs play a significant role and make major contributions towards employment and GDP. The data of the Indonesian ministry of cooperative and small and medium enterprises reported that, including micro firms, there are 56,534,592 unitsof SMEs in 2012[2] and this represents an increaseof as much as 2.41% from 2011. They are spread across Indonesia both in inner cities and rural areas. In inner cities, SMEs have a better opportunity to access loans from banking institutions because most of the headquarters of the banks exist in cities.

Whilst most of the banks are located in cities, it does not, however, mean that SMEs located in rural areas cannot access loans from banks. There is emerging evidence of the growth of SMEs in rural areas. This may be attributed towards easy access to information as telecommunication improves and in some cases improves access to finance. The growth of SMEs in rural areas islikelyto gives real economic strength tothe national economic structure of Indonesia. This is because the majority of

Indonesian government statistics for 2012[3], suggest that SMEs provide jobsto as much as 107,657,509 workers. This is an increase of 5.83% comparedto that of 2011, reported to be 101,722,458employees. Thus, SMEs have enabled individuals and groups to engage in self-employment and encourage others to take on entrepreneurship as an alternative to seeking a government job. Althoughthere is a large number of SMEs that provide employment for over 99.99% of the workforce, yet their contributiontowards the GDPwas only 59.1% in 2012. SMEs contributiontowardsthe GDP increased by 13.15% in 2012 compared with 2011. This increase suggests that the role of SMEs is important for the growthand development of Indonesia.

By 2012, the contribution of SMEs export, excluding oil and gas, reached to 166.63 trillion rupiahs ($14.157 billion), an increase of 14.06%. This increase shows SMEs are becoming significant for export. The structural changes brought about through the increasing of economic cooperation in the south East Asian region (ASEAN) and Pacific Asian region (APEC) is likely to create new opportunities for SMEs. In addition, SMEs proved to be resilient to the economic crisis as evidenced in Indonesia during 1997/1998. The important role of SMEs for economic stability and

[2]The latest data available that can be accessed

[3]http://www.depkop.go.id/

employment creation is recognized by the Indonesian government; it has established the Ministry of Cooperative and Small and Medium Enterprises. The government has created combined industrial departments to support SMEs.

The commitment of the government to support SMEs is evidenced through its policy to promote SMEs. In 2013, the Indonesian government, through the ministry of cooperative and SMEs, budgeted 2.2 billion rupiahs ($ 186.9 million) to develop SMEs throughout Indonesia. The fund was allocated for the cooperative's program of one village; one product (OVOP). Each cooperative will receive a fund as much as 100 million rupiahs which is to be used to develop distinct products in every city. There are 70 distinct products which are developed through the OVOP program in central java (Fitriana, 2013).

Despite the importance of SMEs evidenced above for the Indonesian economy, access to bank finance remains a big barrier as often SMEs are considered not bankable(Beck, 2007). Therefore, to fulfil this gap, the presence of an Islamic bank provides an opportunity for SMEs and the Islamic banks to fill the gap left by the conventional banks as the Islamic bank have financing schemes that shares risk and participate through the injection of equity into the business. Islamic banks provides profit-loss-sharing (PLS) mode of finance, at least in theory, Islamic banks are willing to share loss and profit with their entrepreneurs. This mode of finance overcomes collateral as the ethics and information transparency mitigates high risk. This mode of finance encourages entrepreneurships as viable business proposals are supported without collateral. There is a close relationship between the provider of finance and the entrepreneurs that mitigate the information and collateral gap. In theory, Islamic banks evaluate the proposal on the basis of the prospect of the project to be financed. This ensures, unlike conventional banks, that the evaluation of the feasibility of financing proposal should be founded on the soundness of the projects, not the availability of collateral.

Though the focus of this research is on SMEs, where presence of Islamic banks is important, it also offers other financial products and finance for large firms but the basis of the contract remains the same. Nevertheless, the type of products and contracts offered by Islamic banks are of great benefit to SMEs, especially when it comes to accessing external finance. Islamic financial instruments, in theory and practice, appear to meet the needs of entrepreneurs as an alternative to conventional banks. Use and application of Islamic finance can be illustrated through the example of a *salam* contract that is used in the financing of cotton farms as practiced in America (Gundogdu, 2010). In addition, Islamic banks financing will benefit SMEs, particularly PLS base loans, because SMEs are not required to pay a fixed return on loans as it is the case with interest based loans. Using profit sharing, SMEs will only be charged if the entrepreneurs make profit. There are other forms of contracts which allow alternative forms of Islamic finance for SMEs depending on the type of the business(Beck *et al.*, 2010). Given the diversity and population size within Indonesia, Islamic banks have an opportunity to grow if it can design and develop an effective marketing strategy to reach potential entrepreneurs; it is possible for the market share of Islamic banks to grow higher than that of Malaysia.

1.2 Research Problem

The thesis sets out to examine the presence of Islamic Banking in Indonesia and its lending practices towards SMEs. Furthermore, it compares the presence, practices and IBS penetration with that of Indonesia. Given the size of the Muslim population in Indonesia and the enormous growth potential it poses, one may expect a greater presence of Islamic banking products than in Malaysia. This, however, is not the case. Though Islamic banks not only serve Muslims customers, it is noteworthy that the Muslim population is more concerned with whether or not financial transactions comply with *Shariah* (Islamic law).

Information asymmetry between SMEs and IBs raises problems for banks when making lending decisions as banks necessarily evaluate the risk of lending to SMEs that fail to provide the requisite financial and managerial information. This lack of forthcoming basic information presents an obstacle for SMEs in accessing finance from both Islamic banks conventional banks. To overcome these issues, some Islamic bank officers establish close, long-term relationships with SME owners which enables banks to obtain the soft information required to overcome the problem of asymmetric information (Scott, 2006; Uchida *et al.*, 2006a). Some bank lending officers impose strict covenants to overcome asymmetric information issues (Apilado and Millington, 1992) or ask for collateral (Jimenez and Saurina, 2004) to mitigate the anticipated default risk. Evidence also suggests that banks charge higher interest rates (Cowling and Westhead, 1996) to compensate for the default risk. Review of past studies suggests that each bank has its own policy to overcome the asymmetric information but there is a general convergence of view that both IBs and conventional banks use collateral to overcome information asymmetry. Therefore, this study examines the experiences of Islamic banks in making lending decisions for SMEs and also the potential obstacles faced by SMEs in accessing funds from Islamic banks which may impact the development and growth of Islamic banks.

1.3 Research Aim and Objective

The aim of this research study is to investigate lending practices, policy and access to Islamic bank finance by Small and Medium Enterprises (SMEs) in Indonesia. The objectives of the research are:

1. To examine the current level of penetration of Islamic banks financing in Indonesia and compare to evidence from Malaysia.
2. To examine the factors influencing loan size approved by Islamic banks and the existence of the financing gap in SMEs.
3. To construct an Islamic bank lending framework for SMEs.
4. To empirically investigate the experience of Islamic banks in making lending decision for SMEs and provide recommendations for policy makers and practitioners.

1.4 Specific Research Questions

Following the research aim and objectives, this research has specific research questions to be answered.

1. What is the level of penetration of IB and CB financing for SMEs in Indonesia compared with the evidence from Malaysia.
2. What are the main factors influencing the level of SME access to Islamic bank finance in Indonesia?
3. What are the perceptions and reality of Islamic Bank lending practices?
4. What is the experience of Islamic bank managers in making lending decision for SMEs?
5. What is the policy framework of Islamic bank in delivering financing to existing and new borrowers?

1.5 Research Methodology

To realize the research aim and objectives, the research applies a mixed method and triangulation. It uses a combination of quantitative and qualitative research methods. Questionnaires are used to collect quantitative data and interviews are designed to collect qualitative data. The quantitative data from the questionnaires is then analysed using descriptive statistics to examine the trends regarding the practice of Islamic banks, while correlation analysis is employed to examine the association between the independent variables. The mean test is used to investigate the existence of the financing gap in SMEs. To corroborate the findings of the quantitative results, the interviewsare conducted both with SME owners and Islamic bank managers. Themethod chosen for this purpose enabled the researcher to collect various types of information including attitudinal, motivational, behavioural, opinionated and perceptive data.On the other hand, semi-structured interviews were used to gain a deeper insight and investigate questions emerging from the quantitative findings. In this research, also SME owners and Islamic bank managers were interviewed with the specific aim of corroborating answers to the research questions.

1.6 Outline of the Research Chapters

This chapter (as the first chapter), briefly outlines the research background, research aims and objectives, research methodology, as well as research questions. It also briefly outlines the subsequent chapters' contents.

Chapter two reviews the development of Islamic banking in the world since its inception to 2013. Thedefinition of Islamic bankingand Islamic law (*sharia*) underlying the practice of Islamic banks are considered. The provision of Islamic financial instruments is considered. This is followed by examining the factors affecting the emergence of Islamic banks, the importance of Islamic banks in Islamic and western economics, and the differences and similarities between Islamic and conventional banks.

Chapter three discusses Small and Medium Sized Enterprises (SMEs) and relevance of Islamic bank financing for SMEs. Issues associated with SMEs are examined including the importance of SMEs in theIndonesian economy, government policy to support SMEs development, the constraint on SMEs development, and SMEs access to external finance. This is followed by an examination of financing gap, asymmetric information and its potential influenceon SMEs in accessing funds from formal sources such as IB andCB.This is followed by the section thatincludes: Islamic bank financing for SMEs, model of Islamic bank financing for SMEs. Islamic bank penetration both in Indonesia and Malaysia is compared based on the data obtained from the central banks of both countries. Furthermore, the suitability of Islamic financial product for SMEs, client attitude towards Islamic banks, and the framework of SMEs financing preferences over its Lifecycle are reviewed. At the end of this chapter, several research questions are proposed.

Chapter four reviews research design and methodology used in this study. This chapter examines the alternatives reasons and provides justification of the method used for this study. This is followed by an overview of the data, its collection andthe analysis to be carried out. Finally, ethical issues and considerations are discussed for this study.

Chapter five reports the growth of Islamic banking both in Indonesia and Malaysia based on the macro data, derived from central bank websites of each country. This is followed by the analysis of the types of financial contracts preferred in the two countries. Then, the statistical data findings are discussed and empirical results are compared and contrasted with national and international trends.

Chapter six investigates the practice of Islamic banks from the supply side and reports empirical findings bank managers and it complements the findings from the demand side perspective.The interview with Islamic bank managers are analysed using Interpretative Phenomenological Analysis through steps guided in the methodology chapter. This analysis section investigates and reports the experience of Islamic bank managerswhen making lending decision for SMEs. Based on the result of both interviews with SME owners and Islamic bank managers, then the Islamic bank lending framework for SMEs are formulated.

Chapter seven, the final chapter, reports the research finding, the implication and limitation of the study. Finally, future potential research directions and developments are proposed.

CHAPTER 2
LITERATURE REVIEW

2.1. Introduction

The prohibition of *riba* was stated in the Holy Quran (chapter 2: verse 275) one thousand four hundred years ago. This is consistent with early Hindu, Judaic and Christian teachings (Lewis, 2007). However, Islamic finance, finance without interest, remained relatively dormant for a long period of time. Its resurgence is traced back to the pre-partition of India after the 1930s depression (Hasan, 2005; Visser, 2009). The currentdevelopment of Islamic banking and finance is part of what DiVanna and Sreih (2009) classify as the second generation of developmental stability and product proliferation. This era is characterized by codification and standardization of Islamic ideas relating to Islamic banking and finance. Chapter 2 provides an overview of Islamic Banking (IB) and seeks to provide a review of the *Shariah* (Islamic law) that Islamic banks have to adhere to. In order to be compliant with its fundamentals, this chapter is structured as follows: Firstly, an overview of Islamic Banking, in which its evolution and practices are both considered. Secondly, the *Shariah* (Islamic law) is examined to show its impact and influence on IB. Thirdly, it examines the factors which gave rise to the global emergence of IB. Finally, the importance of IBs within Islamic and western economies is also examined.

2.2. Islamic Banking

The concept of an Islamic bank has evolved over fourteen centuries, as the Qur'an explicitly prohibited *riba* (interest) (Qur'an 2:275). However, there are various interpretations and there are a number of definitions which appear within the literature. To harmonize the IB practices, the Organization of Islamic Countries (OIC) has attempted to develop standards to bring about consensus, which appears to be at the early stage of its development. Islamic banking institutions are regulated and committed to adhere to the principle of *Sharia* (Islamic law), the precepts of which are guided by the *Quran* and the *Sunnah* (the practice and sayings of the prophet Muhammad), *ijma* (opinions collectively agreed upon among *sharia* scholars), and *qiyas* (analogues) (Haron, 1995; Samad *et al.*, 2005).

Long before Islamic banks were practiced in Egypt in the 1960s, the theoretical edifice of interest free banking first took shape in pre-partition India after the 1930s depression (Hasan, 2005; Kuran, 2006; cited in; Visser, 2009). The literature was mostly written in *Urdu* and gained popularity only among a section of Muslim society. Maulana Sayyid Abu'l-A'la Maududi was a notable person who first spoke on the subject of IB in 1941 (Hasan, 2005). Other major contributors at the forefront of the development of Islamic economics were Sayyid Qutb, a prominent leader of the Muslim brotherhood in Egypt, and Muhammad Baqir al-Sadr in Iraq,who in 1960 write his most celebrated book on Islamic economics, "*Iqtisaduna*" or "Our Economics"(Khan, 2011; Visser, 2009). Meanwhile, the earliest practice of Islamic banking took place in Egypt with the foundation in 1963 of the *Mith Ghamr* Local Saving Bank by Ahmad Al Najjar which took the form of savings bank based on profit-sharing. This bank waswell received particularlyamong farmers and rural communities. Due to political issues, however, the bank was closed in 1967 (Visser, 2009).

In 1971in Egypt, the Nasir Social Bank was introduced as aninterest free bank and is financed and owned by the government (Kahf, 2004). Similarly, in Malaysia the interest free financial transactions were introduced through the establishment of the *Tabung Haji* or Pilgrim's Administration and Fund on the initiative of the Malaysian Government a few years after Malaysia's independence in 1956. This institution was specifically designated to help Muslimsto go to Mecca for hajj (pilgrimage) by helping them with their travel and subsistence costs. While waiting to go to Mecca, their funds were invested in real estate, the manufacturing industry and agricultural sector in *sharia*-compliant ways. For a twenty year period (in Malaysia) there was no other Islamic financial institution other than the *Tabung Haji*. The *Tabung Haji* institution was considered to be one of the most popular investment institutions because it gave competitive bonuses to depositors, and demonstrated the need and desire of Muslims to have an Islamic bank. Although *Tabung Haji* was quite successful in administering pilgrimage funds under Islamic law, this institution remained unknown to Islamic bankers and economists until it came up in discussion at IDB in 1981 (Kahf, 2004).

Some scholars consider the *Mith Ghamr* Bank in Egypt and the *Tabung Haji* in Malaysia to be experimental banks. The success of the *Mith Ghamr* Bank and *Tabung Haji*, which indicated great acceptance by Muslim clientele who at that time inspired the Muslim *ummah* (society) throughout the world, lead to the awareness that Islamic principles can be (successfully) applied in business activities.

In Malaysia, the success of the *Tabung Haji* has encouraged some experts to establish fully-fledged Islamic banks. In 1981, twenty experts in the field of economics put forward the idea and gave the recommendation to the Malaysian government to build Islamic financial institutions in Malaysia (Laldin, 2008). As a result, formally, IB made its debut in Malaysia in 1983 with the establishment of Bank Islam Malaysia Pte (BIMB) (Rosly and Bakar, 2003a). Ten years later, the introduction of Islamic windows by conventional banks started to emerge.The window system facilitated the expansion of IB practice alongside CBs as it allowed conventional banks to offer Islamic financial instruments to their clients. At the same time, the Islamic money market began to emerge and become the fastest growing segment of Islamic financial instruments. The presence of IBs in Malaysia is an advantage for the Muslim population. This is evidenced by the fast growth of IB, as the average rate of asset growth has been 19% per annum since 2000 (Kamaruddin et al., 2008).The fast growth of IB in Malaysia lead the government of Malaysia to envisage the creation of a dedicated hub for Islamic banks internationally, by opening its market to international players (Laldin, 2008; Yusof and Majid, 2008). To realize the vision of an ‘international Islamic financial market’, the government of Malaysia initiated a ten year master plan for the Islamic financial industry in order to create a presence and gain a competitive edge globally (Yusof and Majid, 2008).

In Pakistan, the evolution of IB is reported by Khan (2008). He reports that the development of IB in Pakistan is fully supported by the government. The motivation and aspiration to establish IB started in 1977 when the government, through the Council of Islamic Ideology (CII), formulated a blueprint for an interest-free economy over three years. The CII designated a panel of experts to examine technical aspects for restructuring the economy and financial sectors of Pakistan in accordance with Islamic law. CII recommended replacing the interest base system with PLS as an alternative. However, at the transition stage, the adoption of PLS encountered problems, as there was no institutional support or a fuller understanding of its impact. The government had to make regulatory infrastructure and build institutions to enable the institutions to adopt the PLS system on a large scale. The CII has a vital role in Islamic bank products in Pakistan as it provides guidance for the financial products to ensure that they are compliant with *sharia* law. The CII also gives recommendations regarding the normal rate of return which contained an interest-free provision to allow banks to charge a normal rate of return for the borrower.

In 1979 the government of Pakistan decided to convert interest based non-bank financial institutions named House Building Finance Corporation, Bankers Equity, Investment Corporation of Pakistan on an interest-free basis to serve 95% of the Muslim population (Kaleem and Wajid, 2009). In 1980, the ministry of finance of Pakistan appointed the Pakistan Banking Council (PBC) to change the 1962 Banking Companies Ordinance which enables banks to operate based on the PLS, mark-up (*murabahah*), leasing and hire purchase. Furthermore, the 1984 *mudarabah*ordinance was promulgated to allow *mudarabah* companies to operate in the corporate sector. The significant change happened in January 1981, when 7,000 domestic bank branches started to accept deposits on a PLS basis (Khan, 2008).

In Sudan, the development of Islamic banking has been documented by Mohsen (2005). He reported that the development of Islamic banking in Sudan was prompted by the implementation of Islamic law in 1998. The Faisal Islamic Bank was considered the first Islamic bank to have started operations in Sudan. Besides support from the government, this Islamic bank found significant support from the Sudanese population who preferred to deal with the interest-free based banks. The success of the Faisal Islamic bank motivated the Sudanese government to open more Islamic banks; within three years (1980 – 1983), five Islamic banks were established. They were the *Al-Tadamun* Islamic Bank established in 1980, the Sudanese Islamic Bank and Islamic Cooperative Development Bankin 1982, and theAl-Baraka Bank and the Islamic Bank of Western Sudan in 1983. The success of these banks in attracting depositors spurred the government to convert the entire financial system to comply with Islamic law.

In Nigeria, the development of IB is discussed by Obiyo (2008). The emergence of IB in Nigeria is rather peculiar since Nigeria is not a majority Muslim country. Although Nigeria is made up of people from diversified religious backgrounds, Muslims are the second largest population in this country. The establishment of IB in this country started in 2001 when the Habib Nigeria Bank, now known as Bank PHB (Platinum Habib Bank Plc) initially introduced a new "free-interest banking" product. According to the Institute of Islamic Banking and Insurance, the profit from PHB grew by as much as 60.38 percent by 1999. The success of this bank motivated others to follow, and the Jaiz Bank International Plc. (JBI), the first fully-fledged Islamic bank in Nigeria, was established in 2006 (Mohammed, 2006; cited in Obiyo, 2008).

In Bangladesh, IBs also have been operating for over two decades alongside CB. The first IB in Bangladesh started in 1983 when the Islamic Bank of Bangladesh Limited (IBBL) was founded (Khan et al., 2008). Although IBs in Bangladesh are relatively new, IBBLs performance was better compared to conventional banks, especially in terms of loan recovery and other financial measures (Ahmed et al., 2006). The great acceptance of IB in Bangladesh induces various private commercial banks to offer products which are in accordance with *sharia (Hasan, 1999)*. There are five IBs in Bangladesh namely the Islamic Bank Bangladesh Limited (IBBL), Al Baraka Bank Bangladesh Limited (Al-Baraka), Al-Arafah Islamic Bank Limited (Al-Arafah), the Social Investment Bank Limited (SIBL), and Faysal Islamic Bank of Bahrain EC (FIBB). To serve micro enterprises in rural areas, Bangladesh also has interest-free microfinance. Currently, Islamic microfinance plays a vital role in providing capital for micro enterprises and contributes greatly in creating job opportunities for poor people in Bangladesh (Alam, 2009). The presence of IB has attracted customers from conventional banks to IBs. Hamid (2000) reported that although Grameen Bank is successful in its operations, the presence of IB has attracted the clients from Grameen Bank to IBs. This demonstrates that amongst the majority Muslim population of Bangladesh there is a demand for interest free loans and other financial products.

The above review of developments of IBs in respective countries has demonstrated that there are parallel developments taking place in Muslim countries. DiVana and Sreih (2009) classify the development of IBs in four stages. The first generation occurred during the experiment of the implementation of an Islamic financial institution that lasted until 1990. The early development was triggered by some Muslims who wanted to conduct financial transactions under *Shariah* principles. The practice of Islamic finance is relatively localized (stagnant) in nature. The localized nature of Islamic finance was considered the main contributor to the variations in interpretation of *Shariah* which has led to differences in Islamic banking products in various markets. Economic growth in the Middle East, South Asia and parts of Africa coupled with a rapidly growing Muslim youth population, has created a conducive environment and market for Islamic finance. This era can be referred to as an amorphous age or pre-industry of Islamic finance.

The second phase, the period from 1990 to 2006 is called the first generation of Islamic finance or age of discovery. In this era, initial codification and the development of Islamic financial instruments took place accelerated by the growth of information and telecommunication technology. Due to the global acceptance and rapid growth of Islamic finance, it is necessary to develop standards that can be used for all Islamic financial institutions. For instance, AAOFI (Accounting and Auditing for Islamic financial Institutions) was established in 1990 in Algeria and then registered in the state of Bahrain in 1991. Most countries in the Middle East have adopted the standards developed. The early followers were the Kingdom of Bahrain, the Dubai International Financial Centre, Jordan, Lebanon, Qatar, Sudan and Syria. Other Central Banks in Australia, Indonesia, Malaysia, Pakistan, the Kingdom of Saudi Arabia, and South Africa have issued guidelines that are based on AAOIFI's standards and pronouncements.[4] Another board that encourages the standard operation of Islamic finance is IFSB (Islamic Finance Service Board). IFSB was established in 2002 in Kuala Lumpur and started its operations in 2003. The purpose of establishing the IFSB was to ensure the soundness and stability of the Islamic financial services industry, which is defined broadly to include banking, capital market and insurance.[5]

[4]http://www.aaoifi.com

[5] http://www.ifsb.org

Islamic finance is now entering the third stage or the second generation of developmental stability and product proliferationfrom 2006 to 2012. Contemporary Muslim society influences the Islamic financial industry, which led to the banks creating new products that can best serve local markets with Muslim dominated countries and countries with significant Muslim populations. DiVana and Sreih (2009) noted two different markets; a rapidly growing one, where there was demand for Islamic finance in non-served communities and another in which there was demand for more sophisticated products in currently served communities. Consequently, the banks had to re-think their product portfolios, brand identity and institutional images to serve the differentiated markets by employing modern innovative techniques and technologies.

The next period is referred to the age of expansion. This period is indicated by the expansion of Islamic bank services not only limited to Muslim societies but also to non-Muslim societies. The first customer of the Islamic Bank of Britain was a non-Muslim. Similarly, IBs now have non-Muslim clients in developed and developing countries, forexample, the Islamic banks in Malaysia and the Gulf African bank, the latter with20% of its customers from among the non-Muslim population in Kenya.

2.3. Sharia (Islamic Law) and Islamic Bank

The main feature of Islamic banks is the prohibition of *riba* (interest). However, it is not enough to argue that the difference between a Conventional Bank (CB) and an Islamic bank (IB) is (only) the issue of interest. This section reviews Islamic principles used in Islamic bank operations. There are some critics of IBs, who argue that Islamic bank operations are no different from conventional banks (Chong and Liu, 2009a; Zaman and Movassaghi, 2002), however, the approach used is clearly different. Islamic bank products are based on the PLS, products such as *mudarabah* and *musharakah*, are considered fairer and more equitable because both the lender and borrower share risk and profit according to an agreed ratio in advance (Iqbal and Mirakhor, 2007). These transactions are deemed fair and attract both Muslims and non-Muslims to use Islamic banking services.

Islamic finance is regulated in accordance with the *sharia* (Islamic law), the legal framework of Islam derived from the Qur'an and *Sunna*. The literal meaning of the

Arabic word *sharia* is 'the way to the source of life'. In a technical sense, *sharia* is used to refer to a legal system in keeping with the code of behaviour which is sourced from the Qur'an and *hadiths (teachings of Prophet Muhammad – peace unto him) (Algaoud and Lewis, 2007). Sharia* provides guidelines for Muslims to follow the principles of the holy Quran and the *hadiths* in their decision-making in all aspects of life. Islamic financial transactions operated in accordance with *sharia* ensure no exploitation of parties and a more equitable distribution of income and wealth amongst all citizens is achieved. It mitigates inequalities. To comply with *sharia*, every financial transaction should be based on the five general principles which are well documented in the literature: a) the prohibition of *riba,* b) the prohibition of *Gharar or Maysir (gambling), c)* all transaction activities should be *halal* (legal/permitted by sharia), d) paying *zakat, and d) a Sharia* board is a must to supervise and ensure that every transaction is compliant with Islamic principles (Algoud and Lewis, 2007).

The prohibition of *riba* is the distinctive feature of IBs. *Riba* means increase or addition or surplus. In the *sharia, riba* means an addition to the principle for the use of money that is specified beforehand. The prohibition of *riba* is based on a number of verses in the Qur'an (explained in detail below). Some other sources which prohibit *riba* are the *Sunna* or *hadiths*. Below are the *hadiths* regarding the prohibition of *riba* (Zuhayli, 2006, p. 26-27):

> *The saying of the Prophet (peace and blessing be upon him (PBUH), "avoid the seven grave sins" –and one of them he mentioned was devouring riba.*
>
> *Ibn Mas'ud (may Allah be pleased with him) relates, "The messenger of Allah (peace and blessing be upon him) cursed the devourer of riba, his constituent, the one who acts as witness to it, and one who acts as a notary to it".*
>
> *Hakim narrates on the authority of Ibn Mas'ud that the prophet PBUH) said, "Riba is of seventy three kinds, the lightest in seriousness of which is as bad as one's marrying his own mother; for a Muslim who practices riba goes mad.*

Generally, *riba* is classified into two types:

- *Ribaan-Nasia* (*riba* in loans). According to Iqbal(2006), *Ribaan-Nasia* which comes from Arabic word “*nasia*” means to postpone, defer or wait. This kind of *riba*includes an agreement for an increase whether it is normal or excessive on sold or loaned goods. This kind of *riba*is implied in all Qur’anic verses.
- *Riba* al-Fadl (*riba* in trade). The word *riba –al fadl* comes from Arabic word “*fadl*” meaning to increase, add or exceed. This happens when one sells things with a disparity. These things belong to the six categories of goods:gold, silver, wheat, barley, salt and dry dates (Zuhayli,2006).

Riba al fadl is based on the hadiths (such as the following):

> *Ubaida bin al-Simit (Allah be pleased with him) reported Allah’s messenger (PBUH) as saying: Gold is to be paid for by gold, silver by silver, wheat by wheat, barley by barley, paying being made hand to hand. If these classes differ, sell as you wish if payment is made hand to hand* (Muslim, book 10, number 3853, cited in Visser, 2009).

The *hadith* prohibits the exchange of what scholars referred to as *riba* ‘*al-fadl’*, but the reason behind the prohibition of *riba al-fadl* is not clear.The ban was probably designated to protect people against fraudulent traders (Talal, 2007, cited in Visser, 2009). Zahiri School confines *riba* al-*fadl* to relate to the trade of the six prohibited goods. However, the more liberal school of thought (*Madhab*) views *riba al-fadl* as not being restricted to six prohibited goods. Hanafis, for example, states that the legal reason for the prohibition of *riba* al-*fadl* is volume or weight plus the oneness of kind. Hanafis’ school of thought classifies the six commodities mentioned in *hadiths* into two groups: one measured by volume (wheat, barley, dry dates and salt) and another one measured by weight (gold and silver). If these two conditions are met, both selling with a surplus or on credit are unlawful (*haram*) (Zuhayli, 2006). Thus, the legal cause in the four commodities is the combination of volume and the like kind while the legal cause in the latter two commodities is the combination of weight and the like. Analogous to that explanation, Hanafis generalizes the ban to all goods that are measured by volume or weight (Visser, 2009), including water because it is sold in volume. In contrast, in the view of the Zahiri School the barter of water is not including *riba* even though it does not fulfil the same volume because water is outside those six commodities.

Shafi'i scholars (Zuhayli, 2006) suggest that the prohibition of *riba al-fadl*is based on the fact that those six commodities fall into two categories: currencies (gold and silver) and foodstuffs (wheat, barley, dry dates and salt), even if they are not measured or weighed. Another type of *riba* is *'riba al-jahiliyah'* which is classified as *riba al-nasia* by many Muslim scholars, but some consider it a separate category. In *riba al-jahiliyah*, there is no predetermined increase of payment at the time of delivering a loan, but if the borrower cannot pay the principle on the due date, the lender will charge more payments for an additional term (Visser, 2009). From the discussion above, it is clear that *riba* involves more than the mere phenomenon of predetermined payment over the principle. Thus, the concept of *riba* comprises not only of money loans but also the trade of goods which refers to a surplus gain. Although Islamic law strictly prohibits *riba*, there is no clear definition of it. Egypt's highest-ranking judge, Said al-Ashmawy, argues that the term of *riba* is not well-defined, as the Prophet (PBUH) passed away before he was able to give a final explanation of the Qur'anic verses on *riba* (Visser, 2009). All Muslims believe that it is not necessary to offer intellectual arguments in favour of the Qur'anic injunction against *riba.* The real question, however, is not about *riba* but about the definition of *riba.* Since there is not an explicit definition of *riba* described by the Islamic law, many Muslim scholars have different interpretations of it. Having discussed *riba* and its prohibition, the next question emerges: is the interest charged by banks to be considered as *riba*? There are various opinions regarding this issue. Iqbal (2006) categorizes this opinion in three different categories: the liberal view, the mainstream view, and the conservative view.

The liberal view considers bank interest to differ from *riba*, particularly *riba al-jahiliyah* because it is not charged on consumption loans but mostly charged on productive loans where the rate is determined by supply and demand forces. They argue that at the time of the revelation of the Quran, money was borrowed mainly to be used for consumption needs, and on such loans a high rate of interest implies the exploitation to the needy. Thus, according to them, *riba* only refers to usury which they argue is explained in the Holy Quran (chapter 3: verse 130):

> Believers! Do not swallow usury/ interest, doubled and redoubled, and be mindful of Allah so that you may attain true success *(Quran 3:130).*

In addition, interest-based financial intermediation has been instrumental in economic growth; it leads to an increase in the social wealth rather than an increase in poverty. In this view, Muhamad Rashid Rida (Visser, 2009) concluded that *riba* existing in Prophet Muhammad's (PBUH) time was in very specific forms and cannot simply be carried over to all forms of interest found today. Egypt is one country that defends the conventional form of *riba* by ruling that the interest charged and paid by commercial banks is something other than *riba* (Visser, 2009). It can be argued that a consumption loan needs to be separated from investment loans and treated differently.

Meanwhile, the mainstream view is that both interest and usury are different. Regarding the *ribaal-fadl*, the mainstream views differs(Chapra, 1984; cited in Iqbal, 2006). Since gold and silver are treated as commodities, it can be deduced that all commodities used as money are considered as *ribaal-fadl.* However, there are two different opinions concerning the other four items. The first opinion somewhat disagrees because the four commodities are sold by weight or measurement, and they are subject to *riba al-fadl*. The second opinion believes that *riba al-fadl* should involve all commodities because the four items are edible. The third opinion says that they should belong to *riba al-fadl* because the four items are necessary for subsistence and they are storable. The fourth opinion holds a belief that because the four commodities were used as money in and around Madina (the city of the Prophet) especially by Bedouins, *riba al-fadl would* be involved in trade, in which goods are exchanged against cash or commodities which are used as money.

In the **c**onservative view, *riba* refers to all kinds of additions other than the principle. Their argument is based on the hadiths in what Iqbal (2006; p.5)terms implicit *riba*:

> *The Prophet (PBUH) said: "When one of you grants a loan and the borrower offers him a dish, he should not accept it; and if the borrower offers him a ride on an animal, he should not ride, unless the two of them have been previously accustomed to exchanging such favours mutually." (Ibne Majah 2423)*

The Prophet said: "A loan from which some benefits accrue to the creditor is one of the many different forms of riba." (Al-Bayhaqi).

In Ibn Arabi's (Chapra, 1984) view, 'all excess over what is justified by the counter value' is considered as *riba*. The proponents of the conservative view argue that their definition of *riba* is considered as the most suitable for Islamic economic goals, as it can promise a just and equitable social and economic system (Iqbal, 2006). However, Iqbal (2006) refutes this view by arguing that it is opposed to three hadiths: a) the Prophet (PBUH) said: "There is no *riba* except in loaning." (Nasaee 4504); b) the Prophet said: "Verily *riba* is in loaning." (Muslim 2991); and c) the Prophet said: "There is no *riba* in hand to hand (spot) transactions" (Muslim). Another objection is that *riba* as an unjustified advantage becomes a somewhat subjective phenomenon.

The prohibition of *riba* (usury or interest) was actually not only in Islam but also in other religions such as Hinduism, Judaism and Christianity (Lewis, 2007). Although the Hebrew Bible criticises interest-taking, interpretations of the Biblical prohibition varies. Some view that the prohibition of interest in the Hebrew Bible applies only for Jews. Thus, taking interest on transactions with gentiles (non-Jews) is allowed and not categorized as sinful (Gait and Worthington, 2007a). Similarly, Christianity prohibited usury for over 1400 years, but gradually only exorbitant interest came to be considered as usurious, and in this particular form, usury law of some sort prevented excessive interest amounts (remains in force today) in many Western countries (Lewis, 2007).

Muslim scholars (Hakim, 2007) view Islam as a comprehensive set of teachings which regulate all aspects of life such as worship, *akhlaq* (morality) and *muammalah* (social activities and relationships). The statement on the comprehensiveness of Islam is in the Qur'an chapter 5; verse 3:

"…. *This day I have perfected your religion for you, completed my favour upon you, and have chosen for you Islam as your religion. ...*"

Financial transaction activity as a part of *muammalah* is also ordered by Islamic law. In this regard, Islam gives the rule that *riba* is prohibited whilst trading is allowed.

The prohibition of *riba* can be found in the Holy Qur'an, chapter 2; verse 275 as follows:

> *Those who devour usury will not stand except as one whom the Evil one by his touch hath driven to madness. That is because they say: "Trade is like usury," but Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (the offence) are companions of the Fire: They will abide therein (for ever).*

Some people who put their funds in interest-based banks argue that the marginal addition in loan does not condemn one as being sinful, as money is used for investment and returns are earned. Interest is compensation for time, value of money and, hence, acceptable. This attitude may explain why in some countries they have lower penetrations of IB practices than others.

It is suggested that Muslims should adopt Islamic teachings as a whole and not just partially. It is acknowledged that the Holy Qur'an was revealed gradually in accordance with the situations or events experienced by Muslims during the prophetic era to address the problems that they faced. Therefore, a reader has to consider all of the verses when judging whether their activities are allowed or prohibited, including when they deal with banks. Nevertheless, nowadays there is a consensus amongst (most) scholars that every addition or increase in loans that must be paid by a borrower to a lender regardless of the amount of increase, whether it is small or large, is *riba* and, hence, unlawful.

A different purpose of loans argument often leads one to argue that the prohibition of *riba* is meant for consumer loans only, as moneylenders charge interest to exploit poor people in their times of need. The reason why Islam prohibits this is that charging interest on lending for consumption is considered unjust and exploitative, yet money lending for productive purposes is deemed not to fall into the same category. Nevertheless, Iqbal and Mirakhor (2007) dispute this argument by stating that the argument is weak and based on a misunderstanding of the history of the early Islamic period, and that charging interest on such loans existed and were common at the time of prohibition.

Islam not only commands the giving up of the remains of demand for interest, but also deals with anyone who does not stop or avoid interest in his/her economic activities. It indicates that interest is prohibited unconditionally. Islam prohibits Muslims from receiving or paying interest (*riba*) regardless of the purpose for which such loans are made and regardless of the rates at which interest is charged.

Conversely, any profit or wealth other than *riba* is not opposed in *sharia* and therefore not prohibited in Islam. Gerrard and Cunningham (1997) argue that the reasoning behind profit is that there is a risk of loss engaged in any trading activities. Therefore, in order to keep from incurring *riba*, Islamic banks must create products which comply with *sharia*. According to Dusuki and Abdullah (2007b), there are at least three kinds of operational approaches used by Islamic banks. Firstly, Islamic banking strives for a just, fair and balanced society. Secondly, it is constructed on the principles of brotherhood and cooperation. And thirdly, it is characterized by ethical norms and social commitment. More importantly, Islamic banks must consider all business or customer needs. Therefore, Islamic banks should provide the kinds of products that meet the demands of customers, yet conform to the requirements of *sharia*.

Razi (1938; cited in Algaoud and Lewis, 2007, p. 45-46) gives some reasons concerningthe prohibition of *riba*. Firstly, *riba* is the exacting of another's property without any counter value, while according to the saying of the Prophet, a man's property is unlawful to the other as is his blood. Secondly, *riba* is forbidden because it prevents men from taking part in active professions. Thirdly, *riba* can lead to a strained relationship between men that may lead one to borrow at an exorbitant rate of interest. Fourthly, *riba* is a way of enabling the rich to take in excess of the principal which is unlawful in Islam and against justice and equity. As a consequence, the rich grow richer and the poor poorer. Finally, the illegality of *riba* is proved by the text of the Holy Qur'an and it is not necessary that men should know the reasons for it.

Another reason behind the prohibition of *riba* is suggested by Siddiqi (2004). He proposes five reasons behind the prohibition of *riba* based on his interpretation of some verses in Qur'an. The reasons behind the prohibition of *riba* include; it corrupts society (Qur'an 30: 37-41); implies improper appropriation of other people's property (4:161); has a negative development in social wealth (2:276);is *unjust and* demeans the human personality (2:275). Siddiqi interprets this verse to explain the rationale for not having an interest based system. He suggests that the modern financial system is complex and the relationship between the one who pays interest and the one who receives interest is not direct and visible as was the case in primitive agricultural societies. There are many agencies and institutions that mask that relationship. The same bank is charging interest for lending and paying interest for saving. Therefore, the impact of this practice is not fully understood (ibid, p.44).

The second prohibition in Islamic transactions is *gharar*. *Gharar* literally means risk or uncertainty. *Gharar* can occur when incomplete information exists in the transaction because of uncertainty to both parties. The definition of *gharar* is summarized in three headings (Al-Darir, 1977; cited in Al-Saati, 2003b). First, *gharar* is doubtfulness or uncertainty as in the case of not knowing whether something will take place or not. *Gharar* is uncertainty over the existence of the subject matter of the sale. A second view argues that *gharar* involves transactions when the subject matter is unknown. According to Ibn Hazm (cited in; Al-Saati, 2003a), *gharar* in sales occurs when the purchaser does not know what he has bought and the seller does not know what he has sold. The third view is the combination of both definitions above, which mean that *gharar* involves the transaction that covers both unknown and doubtful characteristics. This view is shared by most scholars.

An explicit statement forbidding *gharar* is not available in the *Quran*, but there are references which support the prohibition. For example, Al-Saati (2003b, p.7) has inferred the prohibition of *gharar* from the following *Qur'anic* verses:

> (Chapter 2: Verse 188)
> *"And do not eat up your property among yourselves for vanities, nor use it as bait for the judges", and further in…*
>
> *(Chapter 4: Verse 29):*
> *"Oh you who believe! Eat not up your property among yourselves in vanities; but let these be amongst you traffic and trade by mutual good will".*

There is a consensus amongst some Islamic scholars about the meaning of *Al-batil* (vanity) which is *gharar.* Furthermore, the transaction of uncertainty is due toincomplete information, that is *gharar*, which leaves one party in an adverse financial position (something not permitted in Islam), unless there is *"mutual good-will" (Qur'an 2:29).*

This mutual goodwill ensures that no one is exploited. The rejection of *gharar* has led to the condemnation of some transactions such as insurance, forward, future, and other derivative securities in a conventional system. Insurance is considered *gharar* because it involves unknown risk. The existence of *gharar* in forward and future contracts since the object of the sale may not exist at the time of the execution of both transactions, while other derivative securities involving high uncertainty (Al-Saati, 2003b; Gait and Worthington, 2007a).

The third inhibition in Islamic banking transactions is *maysir* (gambling). *Maysir* can be simply defined as a game that places one party at the risk of another party (Karim, 2007). Al-saati (2003b) views *maysir* as a desire for obtaining a return from deliberate risk-taking. *Maysir*, gambling or any game of chance is regarded as sinful by Muslims. The sinfulness of *maysir* is explicitly stated in the Holy Qur'an (2:219) and (5:90).

Although all Muslims do not question the reason behind the prohibition of *maysir*, the disadvantage of *maysir* is (still) recognized. Since *maysir* involves zero sum game (Karim, 2007), it adds nothing in an economy in terms of productivity and in fact it could lead to greater financial and societal problems. In addition, *maysir* or gambling is unnecessary for society because they cannot add any surplus to societal wealth.

The last Prohibition that must be avoided is dealing in prohibited commodities. Islam encourages any investment that is not opposed in the *sharia*. According to Islamic teachings, some commodities such as alcoholic beverages (Qur'an 5:90 and 2:219), pork (2:173) and other commodities that are not useful for societal wealth and well-being are not permitted. Therefore, trading or investment in companies dealing with commodities specified to be forbidden is not allowed. Consequently, Islamic banks are prohibited to finance businesses involved in *haram* trade or activities.

2.4. Islamic Financial Instruments

Islamic banking and finance is designed according to fundamental principles that comply with the *Sharia.* The most common Islamic finance practiced by Islamic banks can be classified into two groups: profit and loss sharing (PLS) and mark-up principles. The PLS is equity-based financial products while mark-up is fixed-income based financial products (Malde, 2013). The PLS mode of finance consists of (i) *mudarabah*, the provision of capital in a partial equity partnership and; (ii) *musharakah*, full equity partnerships. On the other hand, mark-up principles comprise; (iii) *murabahah*, an instrument used for financing the purchase of goods; (iv) *bai muajjall*, deferred payments on products; (v) *bai salam*, advance sale contracts; (vi) *istisna*, or manufacturing contracts; (vii) *ijara*, lease financing. Meanwhile, (viii) *qardh hassan*, a system of benevolent loans, is a method of finance out of those two categories above.

Mudarabah is an ancient form of financing contract practiced by the Arabs before Islam. The best evidence of the application of *mudarabah* in the early Muslim era is when Prophet Muhammad (PBUH) acted as a merchant and employed a *mudarabah* contract with Hadijah before the revelation of Qur'an (Karim, 2007). In addition, *mudarabah* was commonly practiced in the City of Medina. Indeed, the dominant practice of money lending in the pre-Islamic era was on the interest basis, and one may conclude that *mudarabah* was ranked second in terms of practical importance (Kahf and Khan, 1992).

Mudarabah was also practiced by the Prophet (PBUH), some Islamic scholars argue that *mudarabah* is needed because not everyone who owns money has trading skills and neither does everyone who is skilful in trading have money. The differences in resource ownership along with the necessity of matching financial resources with business skill might be the most crucial reason behind the need for financing (Kahf and Khan, 1992).

Mudarabah is a contract between two parties involving a capital owner (*rabbul al-mal*) or financier and an investment manager (*mudarib*). In the event of gaining profit, returns are split according to a negotiated equity percentage and cannot guarantee a return. In case of a loss, the bank earns no return (negative return) on its investment and the entrepreneur receives no compensation for their effort (Haron, 1995).

In an alternative form, the *rabb-al-mal* is a bank depositor who deposits their capital in a bank, representing the *mudarib,* to invest according to *mudarabah.* The Islamic bank acts as an intermediary agent that can be either a *mudarib* or a *rab-al-mal.* In the depositor-bank relationship represent the liabilities side of the bank, the depositors serve *as rabb-al-mal* and the bank as the *mudarib*. Conversely, on the assets side, the bank serves as *the rabb-al-mal* and the businessman as the *mudarib* (manager). *Mudarabah* deposits can be collected in a pool for investment which allows banks to mix *mudarabah* deposits with its own funds. The profit may be distributed in accordance with the ratios agreed upon between the two parties, but the loss must be borne in proportion to the capital provided by each of them (Al-Jarhi and Iqbal, 2001). Due to this risk, trust in the right people is important to make sure that the capital extended to entrepreneurs is managed correctly and accountably.

Musharakah can be translated as a “partnership or joint venture agreement”. This contract is similar to that of *mudarabah*. In the context of IB, *musharakah* means participatory financing. *Musharakah* financing is a contract where the entrepreneur and the bank jointly supply the capital and manage the project. Specifically, the contribution of joint parties can be in the form of funds, trading assets, entrepreneurship, skills, property and equipment. In case of losses, each party bears a loss in proportion to the contribution of capital, while profit proportions are negotiated freely (Haron, 1995). Although both *mudarabah* and *musharakah* contracts are the same as equity-based financial products, these two contracts have slight differences. Malde (2013) summarizes the difference between *mudarabah* and *musharaka*h contracts. With the *mudarabah* contract: 1) all loses are borne solely by the investor (IB), and 2) the entrepreneur or *mudareb*bears sole responsibility for running the business. On the other hand, with a *musharakah* contract: both financier and entrepreneur are involved in managing and running the business jointly, and 2) loses are shared proportionately between the two parties based on the amount of their monetary investment or investment-in-kind.

Lewis and Algoud (2001), classify *musharakah* contract into two forms. The first form is a permanent contract which allows both parties to receive annual profit/loss in equitable share based on an agreed ratio. The period of contract depends on the agreement. The second is a diminishing contract which enables banks to withdraw its share equity each year and receive profit/loss based on the proportion of equity balance remaining in the venture. Every year the *mudareb* would pay a greater amount to the *rab-al-mal* which consists of profit share and repayment. Eventually, the ownership of the asset is passed to the entrepreneur entirely (Malde, 2013).

A murabahah contract is commonly used by the entrepreneur as a means of trading goods or commodities. This type of contract is very popular in Islamic banking practice across the world. In *murabahah* financing, the bank buys some assets on behalf of an entrepreneur, and then re-sells to the entrepreneur at the pre-determined price (plus a profit margin). The entrepreneur can pay it within a certain period, in lump sum or instalments (Aggarwal and Yousef, 2000). Thus, this type of financing can be assumed as the transformation of traditional lending activities into sale and purchase agreements(Haron, 1995).

Although it is widely used, some observers view that *murabahah* and other types of mark-up financing are similar to thelending operationsof conventional banks and it may open a “back door” to interest (Aggarwal and Yousef, 2000). However, Mirakhor and Zaidi (2007a) pointed out the difference between mark-up in *Murabahah* and interest-based-lending by arguing that in *murabahah*, mark-up is not stipulated based on a term or period but on the price of goods. The mark-up will not increase because of the failure of the client to fulfil a deferred payment on time instead of the agreed price owing to delay. In contrast, in interest-based-lending the client will be charged because of default. It is obvious that charging because of default is the form of exploitation to the borrower, while in *murabahah,* this is not the case.

Ijara is a contract which is based on the existence of a shift of utility (the right to the use of goods) not the shift in property rights. An *ijara* contract is similar to an operating lease in conventional banking (Malde, 2013). Under *ijara* financing, the lessor (bank) purchases the assets and leases them to the entrepreneur (lessee) at a fixed charge as a rental fee for an agreed specified time with no option of ownership for the lessee. Since the ownership of assets remains with the lessor, the lessor is responsible for maintaining the assets during the contract period (Karim, 2007).

Currently, *ijara* has been adapted to provide a form of lease-purchase (*ijara wa-iqtina*), whereby an entrepreneur requests the lessor (bank) to purchase equipment with the intention of leaving it to the customer. Next, the Islamic bank leases the asset to the client who pays a certain fixed rent and promises to purchase the asset at the end of a contract to transfer ownership from the bank to the customer (Al-Jarhi and Iqbal, 2001). The *ijara* contract is similar to that of a western operating lease while *ijara* wa'iqtina is similar to a western financial lease (Zaher and Hasan, 2001).

According to a *fatwa* (decision given by a Muslim judge or *mufti* concerning a religious matter) of the MUI (Islamic Council of Indonesia), *istisna* is a contract of ordering to produce commodities or goods according to certain criteria and requirements agreed between two parties, with payment dates and price specified in the contract (Karim, 2007). This type of contract is relatively new in Islamic banking (Gait and Worthington, 2007a), but such an arrangement is widely used in real estate mortgage and manufacturing (Elfakhani et al., 2007). *Istisna* contracts are often used for long term financing such as a large construction project of property and machinery (Malde, 2013).

In the context of Islamic banking, clients request their bank to facilitate a contract of production for goods they want, and the bank makes an *istisna* contract with a third party (the manufacturer) to produce and deliver the specific item under particular requirements. This contract is not clearly explained in the Qur'an or *sunna*, but the permissibility of it is adopted by the use of analogy (*Qiyas*) among most Muslim jurists with the permissibility of *bai salam*or advance payment(El-Gamal, 2000; cited in Gait and Worthington, 2007a).

Basically, *istisna* financing is similar to that of *ba'i muajal* in terms of the payment, which is in instalments. The difference between them is that in *ba'i muajal*, the assets are delivered in early contract and the instalment is paid to the end of the contract. In *istisna* financing while paying instalments, the assets are to be delivered at the end of the contract because the production of the assets is still in progress (Karim, 2007).

Ba'i salam is a form of advance payment. Kaleem (2009, p.277) defines *ba'i salam* as"a deferred delivery contract whereby delivery of the commodity occurs at some future date in exchange of an advanced price fully paid at spot".

At the time of the *ba'i salam* contract, the commodity doesn't exist and it can lead to *gharar* (uncertainty) that is prohibited in *sharia*. In order to avoid that *gharar,*a ba'i *salam* contract should meet some legal requirements: (i) the commodities sold should not be available at the time of contracting; (ii) the quality and quantity of goods must be known; (iii) the date and place of delivery of these commodities should be defined; and (iv) the purchase cost price should be paid completely at the time of the contract (Gait and Worthington, 2007a, p.18).

The *ba'i salam* contract is widely used as an alternative form of finance for the agricultural sector to meet the needs of the small farmers who need money to grow their crops and to feed their family up to the time of harvest. Both parties take advantage of this contract as the seller receives money in advance, whereas the buyer normally pays the price at lower rates. In addition, by entering into a *ba'i salam* contract the seller can escape the risk of price fluctuation while the buyer transfers the business related risk to the seller through guaranteed quantity and quality supply of output at a pre-defined date and place (Kaleem and Wajid, 2009).

Bai'muajal refers to the sale of commodities or real estate against deferred payment and permits the immediate delivery of the product, while payment is delayed or pushed forward for an agreed-upon period without any additional penalty, that could be made as a lump sum or in instalments (Elfakhani et al., 2007, p120-121).The *ba'i muajjal* (deferred payment) contract enables firms or individuals to receive assets and their value in the future.

Gait and Worthington (2007a) claim that there is a consensus amongst Islamic jurists and scholars about the permissibility of credit sales (*bai muajjall*) as a form of finance that includes no *riba.* The increasing of price in credit sales (*ba'i muajjal*) is not considered as *riba* because it is based on trading transactions and not lending transactions.

Islam prohibits *riba* but not loans. The loan is permissible as long as it does not involve *riba*. *Qordh hassan* is one form of loan which is free-charge. It is very useful, especially to assist the needy in alleviating hardship. Qur'an (2:280) states:

> *"If the debtor is in a difficulty, grant him time till it is easy for him to repay. But if ye remit it by way of charity, that is best for you if ye only knew".*

Even though, the term "*qordh hassan",* is not found in this verse, it implies that Muslims are encouraged to help others by extending benevolent loans (*qordh hassan*) until the lendor canrepay the loan.

This loan is usually used to finance basic needs such as education and marriage rather than business. Charging interest on this loan is not ethical since these activities do not generate a profit. However, Metwally (2006) and Lewis and Algoud (2001) argue that the borrower's payment of any amount more than the principal to the lender is permissible as far as it is at the borrower's discretion. Nevertheless, *qord hasan* is commonly used by Islamic banks as a benevolent loan which reflects the social responsibility of a business firm.

2.5. The Factors which Affect the Emergence of the Islamic Bank

As discussed in section 2.2 above, the initial emergence of Islamic finance practice both in Egypt (Mit Ghamr Bank) and Malaysia (Tabung haji) inspired Muslims to develop financial institutions which operated in accordance with Islamic values. However, these individuals did not have adequate support from their governments; in the case of Egypt the Mit Ghamr Bank was closed by the government. In this section the factors affecting the emergence of the IB and its wider acceptance is discussed.

Kahf (2004) has discussed the rise of the Islamic bank andits propagation across the world. Kahf reports that though 'experiment banks', Mit Ghamr Bank and *Tabung Haji*, were widely accepted amongst the populations of each country, the institutions were not equipped to serve the normal daily financing needs of regular business, such as import, export, trading and credit because they did not have a current account or cheque facilities. The service and products provided by the two banks were too simple, the facilities were inadequate and they lacked the expertise to serve the complex needs of businesses and individuals.

The development of IB gained momentum in 1970s as a result of the oil boom. The discovery of oil deposits in the middle-eastern countries in the twentieth century was considered as one of the most important factors that induce the emergence of Islamic banks. A massive accumulation of petrodollar surplusin the middle-east led to increased wealth and created enormous opportunities for development in those countries (Vernados, 2006; Mohsen, 2005). The increases in wealth lead to an increase in business transactions and in turn the need to have financial institutions to facilitate payments. Since the populations of the middle-eastern countries are Muslim, they needed financial institutions which were not only capable of facilitating all financial transactions but which operated in accordance with *sharia*. In response to demand, two Islamic banks were establishedin 1974, namely the Islamic Development Bank (IDB) and The Dubai Islamic Bank (DIB). While DIB was founded as a commercial Islamic Bank, IDB was built as an international financial institution which aimed to assist the financing of government projects in Muslim countries. Neither the IDB nor the DIB had a *sharia*board at the beginning to ensure the products on offer complied with *sharia*.This situation persisted until 1976 when IDB made its first *murabahah* transaction with the Algerian government (Kahf, 2004). On the other hand, DIB relied on the owner's business experience and his Islamic understanding; it operated without endorsement from Islamic scholars or other formal*sharia* supervisory boards. However, both the IDB and DIB did consult experts regarding the products and transactions.

Sharia scholars *(Ulama)*, Islamic activists and religious leaders made significant contributions to the development of IB (Kahf, 2004), including the inventionof some Islamic transactions which do not involve interest (Jalil and Rahman, 2010). The*shariah*consultative committee of DIB was established in 1997, while IDB appointed its *shariah* board in 2003. The first alliance between *shariah* scholars and bankers was formed in 1976 when the Faisal Islamic Bank of Egypt was established. The alliance between Islamic banks and emerging IB institutions continued and it is evident in the formation of the Jordan Islamic Bank in 1978, the Faisal Islamic Bank of Sudan in 1978, the Kuwait Finance House in 1979 and Islamic banks in other countries. In the process of the formation and promotion of IBs, Muslim scholars and intellectuals made a significant contribution. For example, Bank Muamalat Indonesia (BMI) was the first Islamic bank to beendorsed by the Indonesian Council of Ulama (MUI = *Majelis Ulam*a Indonesia) and the Indonesian government with the support from the Association of Muslim Intellectuals (ICMI = *Ikatan Cendekiawan Muslim* Indonesia) in 1991 and started operating in 1992.[6] This trend is also observed in West Africa, Malaysia, Turkey and Bangladesh. It has been suggested that the establishment of an Islamic bank is the result of a few visionary personalities. Amongst these are Mohammad Al-Faisal and Sheikh Saleh Kamel of Saudi Arabia, Ahmed al Yasin of Kuwait, Sa'id Lutah of the UAE, Sami Hamoud of Jordan and Abd al Halim Isma'il of Malaysia (Kahf, 2004).

On the other hand, the revival of Islamic banks cannot be separated from the awakening consciousness of muslims (*ummah*) in relation to their religious tenets which require them to apply the teachings of Islam in all aspects of their lives (Chong and Liu, 2009a). Application of Islamic teachings is not only limited to worship issues but also to *muammalah* (social interaction) issues which includes activities in the economic field. On the *muammalah* issue (such as in economic transaction), Islam has explicitly provided guidelines in terms of what transactionsare allowed or prohibited. On the other hand, the phenomenal emergence of IB also implies the ability of IB in balancing profit making activities and social responsibility (Dusuki and Abdullah, 2007a). The availability of financial transactions which is not contrary to the principles of Islamic teachings encourages Muslims to divert their financial transactions to Islamic banks. This is one reason why Islamic banks are now expanding in countries which are mainly Moslem. However, the growth of Islamic banks is also taking place in western countries such as United Kingdom, USA, Canada, and Australia where the Muslim population is not the majority. The successful operation of IB in those countries has attracted western attention towards IB and finance. Consequently, nowadays there are a lot of western financial institutions that offer Islamic financial products to Muslims (Samad *et al.*, 2005).

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[6] See: http://www.muamalatbank.com

According to Kahf (Kahf, 2004), the good relationship between *Shariah* scholars and new middle-class Muslims, especially capital owners and bankers has created a new power structure in the socio-political situation in Muslim countries. This of course has benefited the development of IB in some respects. Firstly, being the major tool for convincing the religious-minded public especially potential customers to use Islamic banks for their transaction. Secondly, the new partnership serves as an important tool for reaching new clientele, people who did not do their transactions with the bank in the past because the bank relied on interest. Thirdly, the association with the*ulama*is used as a means for enhancing public understanding and perception of Islamic banks which is needed especially in asserting their new policies and getting the support of governments, the media and central banks. Finally, the alliance constitutes a kind of buffer that can function to support the main shareholders and professional managers of Islamic banks who are usually recruited from conventional banks, in their dialogue with depositors, inactive shareholders and other banking customers.

More recently, Imam and Kpodar (2010), using regression analysis, demonstrated the factors affecting the spread of Islamic banks across the world. The variables include; Islamic population, interest rate, income per capita, the incident of '9/11/2001', petroleum exporters, economic integration with the Middle-East, distance from Islamic centres, financial system development, macro-economic stability, and institutions. The result indicated that the probability that IBswill spread in certain countries rises when the countries are oil exporters, have high Muslim populations, and high income per capita. Having a close trading relationship with the middle-eastern countries and economic stability has a positive impact for IB development. Similarly, proximity to the Islamic financial centre, Bahrain and Malaysia, also has a positive effect on the growth of Islamic banking. Meanwhile, the rise of interest rates offered by conventional banks hampers the development of Islamic banking because the higher the interest rate the higher the opportunity cost for clients, especially less pious Muslims, to put their funds in Islamic bank.

According to Divana and Shreih (2009), there are several factors that may affect institutions which offer *Shariah*-compliant products in gaining a market share over conventional financial institutions. These factors are: a) advantageous shift in economic conditions in most populated Muslim countries, b) government support in improving the quality and credibility of the Islamic finance industry, and c) the withdrawal of middle-eastern and global investors from the US market as they now prefer to invest in their own country.

2.6. The Importance of the Islamic Bank in Islamic and Western Economies

The presence of Islamic banking as an alternative source of external financing for business is important, especially for consumers who prefer financial transactions which do not contradict with their beliefs. The Islamic teachings underlying Islamic financial transactionsare considered fairer and ensure the absence of exploitation of parties involved and make Islamic banks appealing (Wilson, 2009). Transactions at Islamic banks are considered to be fairer when compared with conventional banks which tend to charge higher rates to borrowers who are considered less capable. Conventional banks often charge high interest to those who are considered high risk (Beck et al., 2008) to cover the dangers. Such action clearly constitutes discrimination. By applying PLS, Islamic banks avoid this kind of discriminatory or exploitative behaviour.

The empirical findings of Hamid (2000) in Bangladesh showed that the Islamic banks attracted some Grameen Bank (GB) customers to switchto Islamic banks. The reasons to switch from GB to IBs is that GB very often gives undue pressure on weekly payments even when they are in genuine difficulty while the latter does not, and IBs do not charge interest. The IB played an important role of in developing small entrepreneursthrough two programmes: Rural Development Scheme (RDS) and the Small Business Investment Scheme (SBIS). Given the fact that the GB was successful in running its programmes, IB followed the operational procedures of the GB but within the framework of Islam to penetrate the market. Supported by the major Muslim population in Bangladesh(89.7% of the total population),[7] the newly emerging free-interest banking system gained significant acceptance.The acceptance of Islamic banks in Bangladesh is evidenced by the growth of IB. Currently, there are seven Islamic banks operating in Bangladesh.[8]

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[7]http://id.wikipedia.org/

[8]Source: www.wdibf.com

Despite the success of Islamic banks in countries that have a majority Muslim population, empirical studies show that religion is not the only determinant of success of the bank (Erol and El-Bdour, 1989). Besides the religious factor, many studies on support for Islamic banks have shown a number of factors that influence choosing Islamic banks such as speed of service, the bank's reputation, location, accessibility(Dusuki and Abdullah, 2007a). Islamic Banks are also considered more capable of fostering economic growth than conventional banks, because based on the PLS contract, the allocation of resources are more efficient and optimal than interest based banks (Rahman, 2007). It is known that higher interest is recognized as an investment barrier. For example, if the market interest rate is rising, the economic activities tend to decline. Investors will bear a higher cost of capital if the rate of interest is rising. Thus, when the cost of debt is high, investors may postpone projects. Theoretically, there is a negative correlation between interest rates and the amount of investment. The higher the interest rate, the smaller the amount of investment that takes place in an economy. This happens because every project proposal submitted to the banks is approved if the level of expected return of the project is higher than the credit interest rate charged by banks. Thus, projects that provide a lower level of return or only the same level of credit interest rate will be rejected. In Islamic banks, based on the PLS method, such obstacles can be avoided. Islamic Banks provide financing for proposed projects that have good prospects and a positive return. Particularly in PLS based contracts, the evaluation of projects should be based on the soundness of the project rather than its excess of expected return on the interest rate (Iqbal *et al.*, 1998).

Islamic banks are also perceived to contribute better economic stability because the IB does not use interest which is assumed as a source of economic instability as a result into production and consumption imbalances. Interest payment can cause economic stagnation and even depression (Karwowski, 2009). During a boom period, credit expansion takes place both for productive and speculative purposes. Increased capital demand, for both kinds of investment, causes interest rates to rise leading to a fall in profit margins. To manage demand and inflation the central bank uses the interest rates as a policy tool to regulate an economy. This results in commercial banks raising interest rates and in turn bank loans decrease. Confidence falls and consumption is postponed exacerbating the economic downturn (Ahmad

1952, cited in Karwowski, 2009). Hence, the analysis above suggests that Islamic banks (arguably) eliminate this source of volatility through PLS modes of finance.

Islamic banks operate in an ethical way so that the society is not disadvantaged. According to Dusuki and Abdullah (2007a), to encourage trade, there are at least two types of operational approaches used by Islamic banks. Firstly, Islamic banking strives to be just and fair by applying PLS principles as it does not exploit the borrower by burdening them with a fixed rate. Secondly, it is characterized by ethical norms and social commitment, something that firms in the west strive for through their corporate governance. The ethical norms and social commitment of IB are manifested in the existence of the *qordh-hasan* contract by which the IB provides charitable loans without charging interest (Iqbal and Mirakhor, 2007). Thus, the *qordh-hasan* contract is one form of social responsibility of IBs. In many countries where the majority population is Muslim, the importance of Islamic banks is indicated by support from governments. Iran, Pakistan and Sudan are three countries that have converted all banking systems from an interest-based banking system to a free-interest based system.

The importance and demand for IBs is indicated by the number of IBs operating across the world. Al-Rawashdah (2009) classifies the distribution of Islamic banks and financial institutions in the world into four different regions as follows:

- Middle East and the Arabian Gulf: 43 Islamic financial institutions.
- Asia region: 80 Islamic financial institutions.
- Africa region: 35 Islamic financial institutions.
- The continents ofEurope and America have Islamic financial institutions.

Currently, there are more than 172 Islamic Institutions operating in 62 countries in the world (Al-Rawashdah, 2009), with total assets of around $1.7 trillion in 2013.[9] In the Middle Eastern countries, Islamic Banks emphasize different roles in each country. In Jordan, the Islamic Bank clients are characterized as wealthy people who are professional and well educated. Consequently, they view the Jordan Islamic Bank as a saving institution rather than consumer credit institution. This suggests

[9]http://www.emirates247.com/

Islamic Banks need to diversify and proactively develop new products to retain their clients and attract new potential customers (Wilson, 2005). The Jordan Islamic Bank now has a focus on consumers, construction and trade finance both for retail and corporate sectors (Parker, 2010).

The importance of Islamic Banks in the Union Arab Emirates (UAE) is in its presence in retail banking that serves clients and their consumer spending. As a rich country with the highest level of income per capita in the world but with 80% of the population being expatriates, the UAE becomes a diversified-base service economy (Wilson, 2005). The presence of Islamic banks in this country is to facilitate consumer lifestyle which is indicated by a greater proportion of current account. Currently, as the biggest Islamic Bank in UAE, the total asset of the Dubai Islamic Bank is approximately 81.8 billion Dirham.[10]

Bahrain is another country in the Middle East that has experienced rapidgrowth in Islamic banking. According to Baker (2010), Bahrain is one of the pre-eminent and convenient locationsfor Islamic banks and financial institutions in the GCC region; there are 27 Islamic banks, 2 assets managers, 6 *Takaful* companies, and 100 Islamic funds. Furthermore, El-Quqa (2007)demonstrates the success of Islamic banks in Bahrain through the growth of assets of Islamic banks which grew by 43.2% in the period 2003-2006. This growth exceeds the asset growth of the entire banking system of Bahrain which amounted to only 22.9% for the same period. Although the market share of Islamic banking is still marginal compared to the entire banking system, Islamic banks experienced growth in their total assets from 4.1% in 2003 to 6.5% in 2006. By 2010, total assets of Islamic banks of Bahrain reached US$ 29.3 billion (Baker, 2010), and increased to $25.8 billion in March 2013.[11]

Within Pakistan there has been a campaign to convert all financial institutions to offer access to finance on a PLS basis and to ensure all financial transactions are in accordance with *shariah*. This is evidenced in the vision statement of the Department of Islamic Banking of State Bank of Pakistan namely to make Islamic Banking 'the

[10] http://www.reuters.com

[11] http://www.bahrain.com

banking of first choice for the providers and users of financial services'.[12] The importance of Islamic banks in Pakistan is indicated by the overwhelming response from the public who have supported the conversion from interest bearing transactions to non-interest based products. Pakistan has the second largest Muslim population in the world, about 170 -180 million people. There is a huge potential market for Islamic Banks services and products.

According to Anwar (2010), in Pakistan, Islamic banking has an important role in housing finance as it serves 12% the country's housing finance market. There is a great potential for Islamic Banks to take over greater share of the housing finance market. Anwar suggests that Islamic banks can exploit this opportunity by developing partnerships with Federal and Provincial governments to realize housing projects to meet the housing needs of the growing population.

The upsurge and importance of Islamic banks in Malaysia supported by the government, which has a vision to become an Islamic International financial hub (Yusof and Majid, 2008). As a Muslim majority country, the presence of Islamic banks is regarded as important in providing a financial transaction vehicle that supports their beliefs. Nevertheless, research suggests that Islamic banking should no longer depend on the marketing strategy of attracting pious and religious customers who might be the only concerned about Islamic financial products. IBs should be able to compete with conventional counterparts in delivering financial services to their customers (Dusuki and Abdullah, 2007a). A serious effort to develop Islamic banking in Malaysia is indicated by efforts to develop human capital in line with the growth of the Islamic financial industry to provide enough Islamic financial talent. All of this effort supports the governments vision of Malaysia having the most viable Islamic banking market in the world (Laldin, 2008).

The importance of Islamic banks in Malaysia is also indicated by the rapid growth of Islamic banks either in terms of number of institutions or assets. Recently, there were 17 banks and a number of conventional banks with Islamic windows with total assets reaching RM 381,539.8 million. At the end of November 2012, Islamic

[12]State Bank of Pakistan, Islamic Banking Bulletin, 2010, vol.5, no. 3.

banking in Malaysia served finance accounts of RM 232,798 billion in all sectors including agriculture, mining, manufacturing, electricity, trade, construction, real estate, transportation, education and household sectors.[13]

Indonesia has the largest Muslim population in the world and therefore great potential for Islamic banking products and growth. The first Islamic bank in Indonesia, Bank Muammalat Indonesia (BMI), started its operation in 1992.[14] Until 2007, there were only three Islamic banks in Indonesia namely; Bank Muammalat Indonesia (BMI), Bank Syariah Mandiri (BSM) and Bank Mega Syariah (BMS) and 26 Islamic windows. From 2008 onward, Islamic Banks have rapidly grown from three in 2007 to (presently) eleven Islamic banks, 23 Islamic windows and 148 Islamic Rural banks with 1,669 offices. During five years, total assets of Islamic Bank in Indonesia have risen sharply from Rp 21.5 trillion in 2005 to Rp more than Rp 93 trillion by the end of November 2010.[15] On the other hand, there are many Islamic micro finance providers which serve micro businesses and informal sectors. These types of financial institutions are not regulated under a banking system, but are supervised by a cooperative department.

Islamic banksin Indonesia serve all types of sectors including agriculture, mining, manufacturing, electricity, construction, trade, transportation, business services, social services and others. Business services are a priority of Islamic Bank financing followed by the trade sector and accounts for Rp 19.9 billion and Rp 7.4 billion respectively. Islamic rural banks have different priorities compared to Islamic commercial banks. Islamic rural bank financing is focused on trade which involves Rp 619.7 billion, and is followed by business services which account for Rp 282.6 billion. From the type of usage point of view, Islamic bank financing concentrates on working capital (48%) followed by consumption (32.4%), while the rest is for investment expenditure. This feature is expected to be able to encourage the growth of business and economics as a whole.

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[13]http://www.bnm.gov.my

[14]http://www.iirating.com/report/20080205_muamalat_sqr_report.pdf

[15] Total assets include full-fledge Islamic banks, Islamic windows and Islamic Rural banks, see: http://www.bi.go.id

The Indonesian banking sector is regulated by the Indonesian banking legal system. According to Indonesian banking law (Law number 10/ 1998),[16] Indonesian banking institutions are typically classified into either commercial or rural banks. Commercial banks are different from rural banks in the sense that the latter are not involved directly in the payment system and have restricted operational areas. Islamic banks in Indonesia, in terms of operational definitions are classified into non-*shariah* and *Shariah*-based commercial banks. Therefore, Islamic banks in Indonesia can be grouped into three types: (i) Islamic commercial banks, (ii) Islamic rural banks, and (iii) Islamic banking unitsin conventional banks or Islamic windows.

Sudan has adopted a purely Islamic banking system which prohibits *riba* (interest) since 1983. Nevertheless, since the signing of the Comprehensive Peace Agreement (CPA) between the Sudanese Government and the Sudanese People's Liberation Movement in 2005, it employs two different banking systems namely the Islamic Banking system in north Sudan and the conventional banking system in the southern part of Sudan.[17]

Islamic banks are not only important for countries with a Muslim majority, but also in countries where Muslims are in a minority, including the United Kingdom, the USA, Australia, Canada and others. In these countries, Islamic banks provide *sharia* compliant products for both Muslims and non-Muslims.

The United Kingdom has facilitated the establishment of Islamic Banks by amending the law to now provide personal and business finance. As one of the leading international financial centres, London wants to maintain its global status and has attempted to facilitate the development of Islamic banks to attract Islamic financial institutions and deposits. The Muslim population in the UK is about two million people,[18] who desire to bank with Islamic banks. The UK is part of Europe, where approximately 12 million Muslims are settled, and the UK attractsaround five

[16] Law no 10/1998 about Indonesian banking (see at: http://www.komisiinformasi.go.id/assets/data/arsip/uu-bank-10-1998.pdf).

[17] Welcome note; http://www.cbos.gov.sd/en/print/2

[18] See: http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/newsroom_and_speeches/speeches/econsecspeeches/speech_est_290307.cfm

hundred thousand Muslim visitors annually; this demonstrates the importance of Islamic banks for the UK, France and Germany.[19] The British Government recognized this potential and has supported the development of Islamic banking since 1990s. As a result, recently, there are five fully-fledged Islamic banks in the UK, one retail and four investment banks (Dar, 2010). In addition, according to Clive Briault,[20] there are around 25 active Islamic windows that offer a range of products and services including treasury, *sukuk* structuring, and asset management in the UK financial market. Generally, the UK is recognized as the most developed Islamic financial market in the western world.

Retail Islamic finance was first available in the UK in the 1990s on a small scale. Simple products such as home finance were offered by some Islamic banks both from the Middle East and South East Asia. Nevertheless, the growth of the Islamic retail banks was slow during the 1990s and into the early 2000s (Ainley et al., 2007). The emergence of a new Islamic financial culture among contemporary Muslim communities in the west may trigger the growth of Islamic banks on a wider scale and in a number of fields such as Islamic mortgage and pension schemes(Dar, 2010). The presence of an Islamic home mortgage is very important since the mortgage industry is a major driver of the EU economy; total residential loans outstanding at the end of 2007 were estimated at € 6.1 trillion or equal to $8.479 trillion,[21] a 7.4 % increase over 2006,[22] According to Lynda Blackwell, manager of mortgage policy, FSA, the average level of lending for house purchases was £9.5 billion or equal to $15.87 billion during 2005 to 2010. House financing is different from country to country depending on government policies in the financial sector and cultural values which in turn lead to diversity in terms of home ownership. In western countries, the mortgage industry is a mature industry. This provides opportunities for Islamic banks to be involved in this market. Regulation sometimes becomes an obstacle for Islamic banking to enter into certain types of market. For instance, the mortgage home market which is inefficient for Islamic mortgages. In Islamic

[19] Source: http://www.fsa.gov.uk/pages/About/Media/notes/bn016.shtml.
[20] Managing Director, Retail markets, FSA Industry Forum, London; see: http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/1018_cb.shtml

[21] €1=$1.39 (exchange rate in 14th April 2014)

[22] The European Mortgage Federation (EMF), see,http://www.hypo.org/Content/Default.asp?PageID=159

mortgages, stamp duty should be paid twice over; once when the financial institution purchases the property and the second when the property is transferred to the client. This was one of the reasons that until 2003, Islamic mortgage was unpopular in the UK. Since the new regulationin April 2003, which abolishedthe double duty stamp, several major players including HSBC and Lloyds TSB Bank have entered into the Islamic mortgage market. Recently, there are several Islamic institutions which offer Islamic mortgages in the UK including the Al-Ahli United Bank, ABC international Bank, Bristol and West, Lloyds TSB Bank, the Islamic Bank of Britain, HSBC, the United National Bank, and the Ansor Finance Group. They offer Islamic finance contracts in different types, involving *murabahah*, *ijarah* and diminishing *musharakah* (Almutairi, 2010).

Besides the United Kingdom, the United States of America is another country that is important for the presence of an Islamic financial institution. Although there are no estimates of the potential size of the US Islamic financial market as there is no official count of Muslims in the country, it is believed that the Islamic religion is the fastest-growing faith in the United States of America (Chiu *et al.*, 2005; Tacy, 2006). This growth is particularly due to the huge flow of immigrants mostly coming from Iran, Iraq, Somalia, Sudan, Afghanistan, and the former Yugoslavia. In addition, the numbers of Pakistani and Indian Muslims living in the U.S. have also grown significantly in the past few decades. According to various private surveys, the estimated number of Muslims living in this country is about eight million(Shayesteh, 2009).

Nevertheless, the adoption of Islamic banking practice in the USA is rather slow in comparison to the United Kingdom. Until 1997, there were no financial institutions in the United States which offered formal Islamic financing that were publicly approved by a US regulatory agency and sanctioned by *the Shariah board*(Chiu et al., 2005). The complexity of financial regulation has hampered investors to open an Islamic financial institution in the US. On the other hand, the US has the most organized, developed and sophisticated financial system in the world and it is not easy for institutions to operate within, especially where regulators often are sceptical of innovations and other systems. There are some who argue that wealthy Muslim businessmen have engaged with conventional banks for a long time without any desire to seek *sharia* compliant products, hence there may be no real demand for Islamic products. Lack of institutional willingness to support Islamic banking and lack of demand from the Muslim community for*sharia* compliant products has not promoted financial institutions within the USA(Almutairi, 2010).

Contradictory to United Kingdom where Islamic bankers from Middle-East came to establish Islamic financial institutions, the same has not happened in the case of the United States of America (Shayesteh, 2009). Post 9/11, many investors from the Gulf Corporation Council (GCC) are reluctant to make a large investment in the USA. The hesitancy of GCC investors has continued to perplex global financial markets (Zyp, 2009). Shayesteh (2009) explains the hesitation of GCC to enter the USA is due to the mistrust between Gulf-based Islamic institutions. The misperception is that US regulators are not interested in the growth of Islamic banking. There are complexities within regulatory bodies in the United Kingdom, yet the operation of financial institutions is by a single regulatory authority.In the United States, however, there are several authorities, depending on the type of product and service on offer. In the USA, the prospective bank applicant would have to deal with a variety of US regulators, including The Federal Reserve, The Office of Comptroller of the currency, The Federal Deposit Insurance Corporation (FDIC), the state banking authorities, The Internal Revenue Service and The Security Exchange Commission (Shayesteh, 2009). In fact, the development of deposit products that are simultaneously *Sharia*-compliant, eligible for FDIC protection, and do not run afoul of securities regulations is the biggest obstacle for regulators (Zyp, 2009). While no institutional framework exists for the promotion of a whole Islamic finance, there are some interest-free financial products(Tacy, 2006).

Although the growth of Islamic financial institutions is modest in the US, there are at least nineteen Islamic financial providers operating in the US including retail banks, investment banks, mortgage companies, investment advisors and community-based finance providers (Shayesteh, 2009). The products financed by Islamic institutions are structured under *murabahah, ijara*, and *musharaka* financing, which are generally used to purchase cars and homesor for small business financing. As a mature mortgage market, the size of the US mortgage is considerable. In 2005, the debt mortgage debt accounted for more than US 8 trillion dollars. Home financing is the primary source of Islamic financial services offered by a financial institution to serve Muslim who wish to adhere to their religion in the US (Tacy, 2006). Community members who refuse to participate in the conventional system under any circumstance are the prospective market for Islamic banking; however, there are no estimates to indicate the size of exclusion It is estimated that by 2025, the Muslim population will reach close to 20 million, due to high growth rates amongst Muslim families(Abdul-Rahman and Tug, 1999). The new generation with better education is likely to occupy better and affluent positions in the American society than their parents. Increases in population size and the desire to use Islamic financial products are likely to give rise to more financial institutions. It is estimated that the potential market for Islamic home mortgages could reach at least US 3 billion dollars among the Muslim community alone.

2.7 Barriers to the Growth of Islamic Banking

Although it is acknowledged that Islamic banking has grown significantly in many countries, there are still considerable barriers to the growth of Islamic banking. These barriers vary in different countries and are due to either the financial (environmental) structures of Islamic banks or the knowledge base of potential customers. The obstacles coming from Islamic banks include that they charge their borrowers higher rates than do conventional banks. Meanwhile, the barriers from potential customers include that there are groups who are of the opinion that interest is not the same as the notion of *riba* in prophet Muhammad's era, and hence interest is not unlawful (Ghafur, 2008). This group of people will not be interested in depositing or using Islamic banks as long as the interest rates charged by conventional banks remains lower. To support the growth of Islamic banking in Indonesia, the MUI issued a decree (*fatwa*) on the unlawfulness of interest. It was expected that this decree would have significant effect on the growth of Islamic banking, however, this proved not to be the case. As the study by Ghofur (2008) showed, there was no significant difference between Islamic banks and conventional banks in terms of number of assets, deposits, and financing after the decree was launched.

Other factors that hinder the development of Islamic banking include peoples' perceptions of the procedures involved in accessing funds from Islamic banks. The study by (Butt et al., 2011a) in Pakistan showed that the complex transaction procedures of Islamic banks were seen as a major barrier when considering Islamic banks. This factor became more severe for those people ignorant of Islamic teachings (Bashir and Sajid, 2011). On other hand, Butt et al., (2011b) also found that some Muslims have serious reservations about the true Islamic nature of Islamic banking and don't consider current IBs to be operating in accordance with the teachings of Islam. These two groups have similar attitudes toward the growth of Islamic banking, since even though Islamic financial principles may differ from those of conventional banks, in practice the differences tend to be negligible, and Islamic financial products appear to be similar to conventional bank mortgage, leasing, and business lending contracts (Schmith, 2005).

Butt et al., (2011a) and Bashir and Sajid (2011) conducted similar research on barriers to the growth of Islamic banks in Pakistan from the perspective of users and non-users of Islamic banks. Their results showed that the barriers to Islamic banking growth are: complex transaction procedures, inconvenient position of branch, and the perception that Islamic banks do not follow Islamic principles. Meanwhile, Bashir and Sajid (2011) examined barriers from the perspective of Islamic bank employees and found five factors that constrain the growth of Islamic banks; 1) ignorance of Islamic teachings, 2) inadequate information about Islamic banking services and products, 3) trust deficiency towards Interest free banking, 4) small network of branches, and 5) location of banks.

In contrast, it has been suggested that in secular countries such as the UK, the barriers to the development of Islamic banks are taxation, regulation, standardization, awareness, and skills, as stated by the HM Treasury report December 2008 (Trakic, 2012). Othman et al., (2012) suggest that barriers to the growth of Islamic banking are due to the economic structural environment and can be broadly summarized as follows. Firstly, the bulk of an economy is driven and manipulated by interest or usury. This circumstance has lead Islamic scholars and those concerned with Islamic banking to attempt to change this interest driven mindset within Islamic countries. This, however, has not proven to be easy, Examples of such changes are cited as changes in the law to require that all banks operate within the framework of Islamic principles, something that has not produced significant change. Secondly, since central banks act as last resort lenders to save ailing financial institutions, a parallel mechanism must be put in place to secure and support Islamic financial institutions to enable them to support and take on risky projects. There is a need to enhance the operational and management procedures of Islamic banks, which at present are incompatible with existing controls and support systems. Therefore, it is suggested that central banks may need to set up a separate control and support system. This necessitates further research and exploration by Islamic scholars to analyse Islamic business practices in order to decide upon a set of procedures and regulations which may enable Islamic banking to operate more efficiently and on a par with the conventional banks. It is suggested that government support is needed to stimulate growth of IBs (Khan and Bhatti, 2006). Indeed, governments have a role to play role in the promotion and development of Islamic banks.

CHAPTER 3
SMALL AND MEDIUM ENTERPRISES (SMEs) AND BANK FINANCING

3.1. Introduction

The capacity to access finance from various sources is a key factor for any type of business to ensure the stability of their operations. SMEs face higher obstacles in accessing funds than their larger counterparts, particularly from formal sources, because they are considered riskier than large businesses. Difficulties in accessing finance are deemed to be a hindrance to the growth of SMEs.

SMEs are important in developed and emerging economies as they make major contributions towards employment, GDP and social cohesion in a country. Recognising the important role of SMEs in economic development, the Indonesian government has implemented various policies to provide incentives for the development of SMEs. The government introduced law no 9 of 1995 that recognises and supports small and medium enterprises in all economic sectors. The government's policy of promotion and development of SMEs is practical and results oriented. The policy deals with technology, marketing, financing and so forth. Nevertheless, the difficulty of SMEs in acquiring capital at the start-up stage and to sustain the growth of their business remains a common issue. Therefore, the emergence and presence of Islamic banks is expected to be an alternative source of funds for SMEs. Islamic banks offer various financial instruments which are different to those offered by conventional banks. SMEs can select those products which promote and meet their business needs.

This chapter examines how SMEs satisfy their financial needs. In the first section, the definition, the importance of SMEs in the Indonesian economy and the government policy to support SMEs as well as the constraints of SMEs are examined. This is followed by consideration of external financing for SMEs, the financing gap, and the problem of asymmetry of information. Bank finance and the relationship between banks and SME in lending decisions are also investigated. Furthermore, Islamic Bank (IB) financing for SMEs and IB products for SMEs are considered. Client attitudes towards bank selection are explored as are SME financing preferences. Finally, a hypothesis is developed and discussed at the end of this chapter.

3.2. Small and Medium Enterprises

There are several definitions of SMEs used by various Indonesian government agencies. To address micro, small and medium enterprises (MSMEs), it is important to have a common understanding of the terminology used for SMEs. Classification of enterprises into micro, small, medium or large can be determined by the number of employees, annual sales and the value of assets. The definition may vary across countries and depends on domestic conditions (Rudjito, 2003; Kamyabi and Devi, 2011; Karubi and Khalique, 2012). According to law no. 20/2008 in Indonesia, whether an enterprise is small or medium is based on a firm’s assets, its characteristics, and number of employees.

The criteria of SMEs is as follows: enterprises with assets up to Rp. 50 million are defined as micro enterprises, and business with assets between Rp. 50 million – Rp. 500 million and between Rp. 500 million – Rp. 10 billion as small and medium enterprises respectively.[23] The other measurement of business size is the number of workers. BPS (Central Bureau of Statistics) has classified enterprises with 1 – 4 workers as micro enterprises, with 5 -19 workers as small enterprises, with 20 - 99 as medium enterprises, and with more than 100 workers as large enterprises (Wiralestari et al., 2008).

Small and medium enterprises play an important role in most countries. They promote enterprise, contribute to GDP and alleviate poverty through job creation (Rudjito, 2003). The SME is considered an engine of economic growth and innovation (Molina and Penas, 2008; Beck and Kunt, 2006). In Indonesia, there are 56,534,592 SMEs (including micro sized) which represent 99.99% of enterprises and employ 107,657,509 workers, which represented approximately 97.16% of the total workforce in 2012.[24] The function of the SME as an engine of the economy is based on three basic arguments. Firstly, SMEs enhance competition and entrepreneurship

[23] Source: www.depkop.go.id
[24] Source: http://www.depkop.go.id/

and increase economic efficiency through innovation and productivity growth. Secondly, SMEs are generally more productive than large enterprises (LEs). However, an unconducive macroeconomic environment negatively affects SME development. Thirdly, since SMEs are more labour intensive than LEs, the greater the number of SMEs the larger the employment absorption (World Bank, 2002; 2004; cited in Tambunan, 2007b, p. 98).

The importance of SMEs can be gleaned from their contribution to the economy. SMEs are the biggest source of employment, providing livelihood for over 90% of Indonesia's workforce. Secondly, they are the engine of rural economic development since they are mainly involved in agriculturally based activities which are scattered throughout rural areas. Thirdly, they produce products for the domestic market, demand for which is not dependent on the international market (Tambunan, 2008, p.15). In general, SMEs are self-employment enterprises that do not hire paid workers. SMEs are considered to have some negative characteristics in that they are often considered to be of low productivity, to produce poor quality products due to a lack of technological equipment, and to have low skilled staff as most staffs have minimal education.

The support for and establishment of SMEs in Indonesia may be motivated by the pressure of poor conditions such as high unemployment rather than by the spirit of entrepreneurship like in many developed countries. In terms of GDP, SMEs (including micro enterprises) contribute relatively higher proportions than Large Enterprises (LEs) as they account for 59.08% of the total GDP, while the LEs contribution is 40.92% of total GDP in 2012.[25] However, the greater contribution of SMEs to GDP does not mean that SMEs are more productive than larger enterprises. The size of SMEs is mainly due to the large number of SMEs. Rudjito (2003) suggests that SMEs are more resistant to economic crisis than larger corporations. The economic crisis of 1998 in the South East Asia region supported the assertion that SMEs remained stable and grew while most of the corporations collapsed during that time. This contradictive situation has motivated the government

[25] See, http://www.depkop.go.id

to focus more attention on strengthening the role of micro, small and medium enterprises (MSMEs) in the national development program.

3.3 Government Policy to Support SME Development

Considering the importance of SMEs in economic development, the Indonesian government has formulated and implemented various types of policies and measures aimed at the development of the SME sector (Tambunan, 2007a). Since 1995 serious effort has been made to develop SMEs following the introduction of law no. 9 in relation to small enterprises that covers all economic sectors. This policy is in line with the Sixth Five-year Development Plan or REPELITA (*Rencana Pembangunan Lima Tahun*) during 1994/95-1998/99 which emphasized the promotion of SMEs, aiming mainly at creating employment and improving huge imbalances of income distribution across regions and among ethnic groups. The Indonesian government has tried to implement programs to support the development of SMEs. During 1974 – 1994, the BIPIK (Small Industry Development) program was introduced in which technical assistance was extended to small enterprises through UPTs (Technical Service Units) staffed by TPLs (Extension Field Officers). To ensure the development of SMEs, the government launched a similar program called PIKM (Small-scale Enterprises Development Project). In practice, this program did not run well because of poor budget allocation (Hayashi, 2002).

SMEs have difficulties in accessing capital from formal institutions (Tambunan, 2007b). For this reason, the government introduced subsidized credit, namely the KIK (credit for small investment) and the KMKP (credit for working capital) programs in 1973 to support SMEs and continued the schemes until the 1980s. Unfortunately, these programs did not succeed as indicated by the high default rate. The programs were finally abolished in 1990 and instead the non-subsidized KUK (credit for small businesses) scheme was established. During the last five to ten years, the main credit programs available to SMEs have been: 1) the KUK (credit for small businesses) scheme, which requires banks in Indonesia to allocate 20 percent of their lending to small-scale firms; and 2) the Liquidity Credit Scheme, which re-started in 1998 and provided credits to farmers, cooperatives and SMEs. Despite these programs, only around 10 percent of SMEs use bank credit and the remaining 90 percent do not receive loans from formal financial institutions (Urata, 2000, cited in , p. 15). Although the Indonesian government has attempted to support SMEs in Indonesia, SMEs still encounter a number of problems which make it difficult for them to perform as well as their larger counterparts in terms of productivity, product quality, and exports. Despite these government policies, there has not been any systematic study of the reasons for the failure of the government schemes, and academic literature that examines the role of and obstacles for SMEs remains limited. Table 3.1 provides a summary of government programmes (1994, cited in Hayashi, 2002)

Table 3.1 Policies, Programs and Organizations for SME Development in Indonesia[26]

Technology	1969	MIDC (Metal Industry Development Centre) established.
	1974	BIPIK (Small Industries Development) Program formulated as a technical support program for SMEs.
	1979	Under BIPIK program, LIK and PIK (Small Industrial Estates) constructed and technical assistance extended to SMEs in or near LIK/PIK mainly through UPT (Technical Service Units) staffed by TPL (Extension Field Officers).
	1994	BIPIK program finished and PIKM (Small-scale Enterprises Development Project) launched.
Marketing	1979	Reservation Scheme introduced to protect markets for SMEs.
	1999	Anti-Monopoly Law enacted.
Financing	1971	PT ASKRINDO established as a state-owned credit insurance company.
	1973	KIK (Credit for Small Investment) and KMKP (Credit for Working Capital) introduced as government-subsidized credit programs for SMEs.
	1973	PT BAHANA founded as a state-owned venture capital company.
	1974	KK (Small Credit) administered by BRI (Indonesian People's Bank) launched and later (1984) changed to KUPEDES scheme (General Rural Savings Program) aimed at promoting small business.
	1989	SME Loans from state-owned enterprises (1 to 5 % benefits) introduced.
	1990	Government-subsidized credit programs for SMEs (KIK/KMKP) abolished and unsubsidized KUK (Credit for Small Businesses) scheme introduced.
	1998	The Liquidity Credit Scheme restarted.
	1999	The responsibility of directed credit programs transferred from Bank Indonesia (the central bank) to PT PNM (State-owned Corporation for SMEs) and Bank Export Indonesia.
	2000	Major government credit programs for SMEs, including KUK, abolished.
General	1973	Ministry of Light Industry and Ministry of Heavy Industry merged into Ministry of Industry.
	1976	Deletion (localization) Programs for commercial cars introduced (motorcycles in 1977 and some other products such as diesel engines and tractors later on).
	1978	Directorate General for Small-scale Industry established (in Ministry of Industry).
	1984	Foster Father (*Bapak Angkat*) Program introduced to support SMEs.
	1991	Foster Father-Business Partner Linkage extended to a national movement.
	1991	SENTRAs (Groups of Small-scale Industry) in industrial clusters organized as KOPINKRA (Small-scale Handicraft Cooperatives).
	1993	Deletion Programs for the commercial cars finished and Incentive Systems adopted.
	1993	Ministry of Cooperatives started handling small business development.
	1995	Basic Law for Promoting Small-scale Enterprises enacted.
	1997	Foster Father (*Bapak Angkat*) Program changed to Partnership Program (*Kemitraan*).
	1998	Ministry of Cooperatives and Small Business added medium business development to its responsibilities.
	1998	SME promotion emphasized in People's Economy as a national slogan.
	1999	New Automobile Policy announced and Incentive Systems finished.

[26] Thee (1994: 101-11), internal documents prepared by the Indonesian Ministry of Industry and Trade, and Hayashi's interview survey, Hayashi, M. (2002).Development of SMEs in the Indonesian Economy. In *mimeo. Canberra: School of Economics, Faculty of Economics and Commerce, Australian National University..*

Despite the range of policies formulated by the government, by definition and nature, SMEs are vulnerable in any country (specifically in developing countries). As mentioned earlier, SMEs are characterized by some fundamental disadvantages especially arising from low skilled, less educated owners and are susceptible to the fluctuating macroeconomic environment. Therefore, it may be argued that SMEs need to be continuously supported to maintain momentum.

Although the complexity of the problem varies depending on the size of enterprise or activity, there are certain problems that are common to all SMEs, which are linked to three groups of issues; infrastructure, institutional and economic issues. Hossain (1998) claims that the impact of regulatory barriers on SMEs are uneven because of their inability to cope with the regulations compared to their large-scale counterparts. He concludes that the two most significant problems faced by SMEs are power and access to finance. Furthermore, legal barriers, and poor law and order conditions, also have an adverse effect on SME development. (Beck and Kunt, 2006) argue that access to finance is an important growth constraint for SMEs. Financial and legal institutions play an important role in relaxing this constraint. These institutions are suggested to innovate financing instruments that can help facilitate SMEs access finance.

The other important problem facing all SMEs in Indonesia is marketing and the lack of capital. Most SMEs are unable to explore their own market. Instead, they depend heavily on their trading partners for marketing their products, either within the framework of local production networks and subcontracting relationships or by order from customers. In terms of fulfilling capital needs, SMEs generally rely on their own savings, funds from family or credit from informal lenders. It is not enough to only relax the constraints as suggested by Beck and Kunt (2006), due to the fact that most SMEs in Indonesia are located in rural areas that are difficult to for formal financial institutions to reach (Tambunan, 2007b).

3.4 SME and External Financing

A number of authors have examined access to finance for SMEs in developed and developing economies (see for examples: Beck and Kunt, 2006; Beck, 2007; Valverde *et al.*, 2005; Berger and Udell, 2006; McPherson and Rous, 2010; Mudd, 2013). The focus of academic research has been on SMEs and their relationship and issues with conventional banks. These authors generally highlight the difficulties of SMEs in accessing external financing, a factor which limits their growth. The government policy to motivate financial institutions to facilitate financial access for SMEs is important to support SME growth (Beck and Kunt, 2006). As Beck and Kunt argue, the importance of developing SMEs is based on two premises: (1) SMEs are the engines of growth, and; (2) market imperfections and institutional weaknesses impede their growth' (page number). In their study, Beck and Kunt suggest the main obstacle to growth faced by SMEs is difficulty in accessing external sources of funding. Therefore, the development of legal regulations and financial institutions plays an important role in reducing barriers to finance. It has been suggested that small businesses are preferable to larger firms in countries which have better financial institutions and further that the government should provide support and guidance to financial institutions to enable SMEs to prosper.

Beck (2007) argues that financial constraints for SMEs are more severe in economies with under-developed and weakened financial systems; these are common characteristics of many developing economies like Indonesia. The weaknesses of financial institutions combined with the transaction cost and asymmetric information are factors that give rise to a finance gap for SMEs in developing and developed countries. The investment opportunity for firms is highly dependent - to the extent that firms can incur capital to fund their investments. ValVerde et al., (2008) investigated financing constraints and SME investment using samples from Spanish SMEs to estimate the correlation between bank loans and investment, trade credit and investment, and accounts receivable and bank loans, as well as causal links. They reported that trade credit is a predictor of cash constraint for investment for firms. This indicates that due to constraints, firms prefer to choose trade credit due to the limited access to bank loans in comparison to unconstrained firms. Furthermore, ValVerde (2005) highlights the correlation between bank competition and SME financing in that market power increases firm financing constraints.

Coy et al., (2007) and Domeher et.al., (2014) argue that poor access to formal credit sources impedes SME growth, however, McPherson and and Rous (2010) report that poor access to finance is not an obstacle for SME growth. They found no evidence that SMEs with better access to external finance grow more rapidly than those without such access. Instead of financial access, they argue that entrepreneurial zeal is more important for firm growth. Though entrepreneur zeal is important for firm development, entrepreneurial zeal cannot be realized without adequate financing. Therefore, both entrepreneurial zeal and adequate financing are important ingredients in realizing the expected growth of SMEs.

The difficulties in accessing formal finance for SMEs are referred as the “financing gap” for SMEs. The term gap describes the inaccessibility of formal finance (sources of finance such as banks, capital markets or other suppliers of finance (OECD, 2006b) that in turn prevent SMEs from having an optimal financing structure. It is argued that the existences of asymmetric information (where banks are unable access full information on the borrower and therefore have insufficient information upon which to evaluate risk) make this gap worse. In addition, the gap is affected by certain circumstances such as ‘domestic savings investment balance, legal, institutional and regulatory framework, and structure of the financial system’ (OECD, 2006b, p.20).

According to Berger and Udell (2006), the availability of credit to creditworthy SMEs is affected by the market concentration of financial institutions. They argue that the greater market concentration of financial institutions can have two opposite effects on SME financing. In the first place, greater market concentration may reduce credit access to any lending technologies when the provider of funds exercises greater market power to increase profits by charging higher interest rates or fees on loans to SMEs and tightening credit arrangements to reduce risk. Alternatively, greater market concentration may increase the opportunity for SMEs to access credit through relationship lending. Moreover, the SME financing gap will be larger, and has become a perennial issue in developing countries (Ramlee and Berma, 2013) where the structure of financial institution and regulatory framework is poor (OECD, 2006b). It is suggested that governments develop both financial institutions and regulatory frameworks which enable SMEs to access finance from formal financial institutions easily.

Asymmetric information can be simply defined as the difference of information by both insiders and outsiders when they are involved in any transaction. Obviously, insiders have better information than outsiders. Narayanan (1988) explains that asymmetric information arises when outsiders are less informed about the quality of the firms than insiders. In this circumstance, it is possible for market participants to price a firm's claim incorrectly (Klein et al., 2002).

In a perfect capital market, investment decisions are merely dependent on the capability of firms to produce positive free cash-flow. Choice of internal or external funding is irrelevant as they are perfectly substituted (Dhawan, 1997). Unfortunately, there is no perfect capital market to be found. Conversely, asymmetric information gives rise to agency cost, as the lender and borrower have different sets of information (Dhawan, 1997; Imam, 2013). The agency cost affects the cost of borrowing in which there is an inverse relationship between the premium charged for external finance and information symmetry. Therefore, the perfect substitution assumption between internal fund and external debt does not happen.

Debt providers are challenged when evaluating a firm's assets and investment opportunity (Klein et al., 2002). To compensate for the information gap, debt providers seek collateral or charge a higher risk premium. This situation is experienced by most SMEs. As a result the financier charges higher interest rates for SMEs than larger companies. In addressing the problem of asymmetric information there have been two dimensions to the theoretical developments. For Greenwald and Stiglitz(1990), the first is that attention has been paid to the internal structure of the firm, while the second is a new view of the external aspect of the firm. These authors explain further that the internal structure of the firm is related to how rewards for individual workers should be designed, what constitutes appropriate hierarchical or reporting structures, and how the internal quality of life of the firm depends on these factors. Meanwhile, the external aspect of the firm is likely to react to external environmental and policy changes.

The existence of asymmetric information makes the process of risk assessment by bank officers more difficult. Particularly for small firms, the process of risk assessment of small firm credit applications has a significant effect on the relationship between the bank and the small firm client (Deakins and Hussain, 1994b). Sharpe (1990) and Pinto and Augusto (2014) suggest that the problem of asymmetric information in financial markets, particularly in terms of the borrower-lender relationship can be overcome by making long-term relationships. The relationship with the small business customer is important for commercial banks because borrowers and lenders rationally anticipate that the borrower will be “informationally captured” in the relationship in the future (Thadden, 2001). Furthermore, by developing a close relationship with the customer, bankers can obtain more private information about their clients to make an informed decision. In addition, the establishment of a close relationship between small firms and banks can reduce information asymmetry. A better relationship between firms and banks can lead to profitable marketing opportunities for the bank because commercial banks can raise more profit through selling other products and charging for the cost of handling the account (Deakins and Hussain, 1994b).

In a situation where the insider has better access to firm information than an outsider, the use of debt acts as an entry barrier for inferior firms. The use of debt by profitable firms leads to the situation in which it becomes increasingly difficult for inferior firms to enter the market even when the market is unable to perfectly distinguish between firms of different quality (Narayanan, 1988). The exclusion of the inferior firms from the market causes the average quality of the firms which stay in the market to increase. Consequently, the finance gap prevents wastage of scarce resources that can then be used by better performing firms. Asymmetric information is more sensitive in SMEs than in the larger enterprises because SMEs are commonly unexposed to the public. The problem of asymmetric information of SMEs might lead to credit rationing (Lehmann et al., 2004). To resolve the problem of credit rationing, banks need to gather information from the borrower to assess the possibility of default risk by internal risk classes or borrower ratings. Lehman et al., (2004) argue that these ratings depend on three factors: the characteristics of the borrower and the loan; the relationship between the bank and the borrower; and the market in which the borrower operates.

Besides the negative effect of credit rationing, in the imperfect market it is often necessary that ‘market power’ be considered (Cowling and Westhead, 1996; Huang and Kuo, 2014). These authors explain that 'market power' can be simply defined as the ability of an agent to act as price-maker in every transaction. Since SMEs commonly face considerable obstacles in accessing funds from external sources, it is possible for large banks to influence the lending terms for SMEs. For example, small firms are less capable of negotiating the terms of lending contracts with lenders.

Asymmetric information issues not only affect SMEs but also affect bank institutions. In this regard, banks face two problems, namely moral hazard and adverse selection, when dealing with small firm lending decisions (Stiglitz and Weiss, 1981). In SMEs, moral hazard will be difficult to overcome because it is very costly to monitor firms closely. When the banks face risks due to the difficulty of monitoring customers, or in other words, banks encounter a moral hazard, it can be overcome by imposing higher collateral requirements on the clients (Cowling and Westhead, 1996; Haron *et al.*, 2013). In the situation where the banks do not get adequate information from their client, it is difficult for the bank to assess and distinguish between good and bad lending risks. To overcome this adverse selection situation, banks can raise collateral requirements. Thus, the rationale for collateral (on the bank's part) is derived from the information asymmetry between the banks and their clients. In addition, Deakins and Hussein (1994b) found that although taking collateral does nothing to reduce adverse selection, collateral has an important role in raising finance (Haron *et al.*, 2013). Requiring collateral can function as a replacement for important information when dealing with the risk of lending decisions made by banks. Another strategy often used to reduce lending risk, because of asymmetric information, is through stipulating higher interest rates (Cowling and Westhead, 1996; Rajakumar, 2014).

Using a sample of small business firms that borrowed either from an existing lender or a new lender, Black (2009) investigated the impact of asymmetric information to the availability of credit by comparing "inside" lender and "outside" lender. An "inside" lender is an existing lender for firms and an "outside" lender is a potential lender for firms. The existing lender is considered to have private information about the firms that is not available to other potential lenders. Because of this condition, outside lenders encounter more asymmetric information problems. Intuitively, the higher the firm’s transparency the more increased likelihood of outside lending. However, Black’s study indicates contradictory evidence. An increase in firm transparency leads to a decrease in the likelihood of a firm receiving a competitive outside loan offer. The reason is that the transparency of firms reduces the outsider’s likelihood of winning a bad firm more than it increases the outsider’s likelihood of winning a good firm. Moreover, the study suggests that transparent firms are less likely to borrow from a new lender.

3.5. Lending Decision for SME

There are now a large number of published works that empirically examine the role of SMEs and their access to finance with a particular focus on conventional banks. Research has been carried out not only in particular countries (Apilado and Millington, 1992; Cowling and Westhead, 1996; Avery and Samolyk, 2004; Niskanen and Niskanen, 2004; Feakins, 2004; Canales and Nanda, 2008b; Shen *et al.*, 2009; Steijvers *et al.*, 2010b), but cross-country comparisons were also made (Clarke *et al.*, 2005; Beck *et al.*, 2008; Wagenvoort, 2003; Haas and Naaborg, 2005). It is argued that banks used loan covenants to mitigate the risk arising from agency problems in companies of varying sizes. Apilado and Millington (1992) investigated restrictive loan covenants and risk adjustments in SME lending compared to large firms. The results show that bank lending for SMEs is more restricted than for large firms which is indicated by the average number of covenants for SMEs is greater than that for larger companies, and the t-test suggests that the difference is statistically significant.

Using small firm data from Spain, Niskanen and Niskanen (2004) investigate the relationship between covenant and small firm lending. Contrary to the results of research by Apilado and Millington (1992), the results of the research by Niskanen and Niskanen suggest that smaller loan amounts contain less covenants and larger loans contain more covenants. Furthermore, loans with real estate collateral contain fewer covenants than the other types, indicating that this type of collateral is preferred.

Cowling and Westhead (1996) conducted a study of bank lending decisions for SMEs in the United Kingdom and found that small firms generally borrow from local branches while larger firms deal with regional branches (since 2014). The distinction between local and regional branches for small amounts does not exist as credit scoring is used to assess the loan application. They claimed that firms which obtained loans from local bank branches generally received the best all-round lending conditions due to the information and local knowledge of the bank. The result also supports the notion that localized branch banking runs on a relatively personal level and can be beneficial for small enterprises, due to gaining soft information but with a slightly higher interest rate. This finding contradicts the current literature on bank-borrower relationships which suggests that such relationships enable banks to provide lower interest loans (Petersen and Rajan, 1994a; Berger and Udell, 1995; Cole, 1998a). The benefit of a bank-borrower relationship on loan availability and loan interest rate is also highlighted by Chakravarty and Yilmazer (2009), however, these authors argue that the effect of the relationship on loan rates depends on the prevailing economic conditions. Although firms with pre-existing relationships acquire loans at a lower rate during periods of economic expansion, loan rate is not negatively correlated to pre-existing relationships during periods of economic recession.

The importance of the relationship between bank and borrower was also supported by Agrawal and Hauswald (2006), who found that borrower closeness facilitates the acquisition of soft information which helps banks overcome the problem of asymmetric information. The importance of soft information as an aid to the lending decision for small businesses is also evidenced by Scott (2006) who examined the relationship between loan officer turnover and credit availability for SMEs. The results showed that there is a negative impact on credit availability in the case of high loan officer turnover. Frequent turnover reduced the number of loan applicants significantly. This is because new lending officers have less established relationships with the bank’s existing borrowers which led to the lack of access to soft information. The study suggests that lending officers play a vital role in relationship lending by using soft information about their SME borrowers. However, this finding was disputed by the evidence reported by Uchida et al (2006b) in Japan which probably presents a unique case. The authors argue that the social environment and local culture in Japan enables soft information to be transmitted from one loan officer to another. Beyond Japan, such soft information is not transmitted from one loan officer to another due to confidentiality of information (as enshrined in law). Another explanation offered is that it could be possible that relationship lending may not be particularly important in the Japanese SME loan market. Nevertheless, generally smaller banks and banks with a rich accumulation of soft information tend to use the relationship lending technology when making a lending decision (Uchida et al., 2006a).

In the traditional set up, the authority of the bank manager has benefited SMEs in obtaining their requested loan amount. Canales and Nanda (2008a) examine the relationship between the organizational structure of banks and the terms of lending to small firms. Their study found that banks with a decentralized lending structure grant larger sized loans to small firms. This is because branch managers in decentralized banks have autonomy to determine loan terms. They have benefited more from ‘soft information’ obtained from their relationship with small firms. Conversely, with such authority, bank managers are more likely to restrict credit and charge higher interest rates when they have power, particularly in less competitive markets. The small firm will be more affected when they have fewer options to obtain loans from external sources. This condition is what Canales and Nanda called the ‘dark side’ of decentralized banks. Thus, the decentralized bank is not necessarily advantageous for SMEs, rather the relative benefits of a decentralized banking structure for small firm lending depends critically on the nature of the competitive environment in which banks operate.

The importance of relationship duration between bank and borrower was investigated by Brau and Osteryoung (2001) using 350 firms that successfully received a Small Business Administration (SBA) guaranteed loan. Their results support the study of Peterson and Rajan (1994a), Berger and Udell (1995), and Cole (1998b), which suggest that relationship lending has important value for SMEs in obtaining loans from banks. The shorter the relationship between entrepreneurs and the bank, the longer it takes to acquire credit and vise versa. In other words, there is a negative relation between the length of the relationship and the length of time required to approve a loan proposal. Nevertheless, the findings of the Brau and Osteryoung’s (2001) study give contradicting results. They found that there is no significant impact between the length of relationship and the time taken to process or approve a loan. Thus, even though the relationship is valuable in certain areas, the length of the relationship does not shorten the time of assessing loans.

In approving loan applications, bank managers rely on the financial statement. Large firms have accountability systems in place and know how to provide such information. However, small business owners neither have sophisticated systems in place to maintain financial records nor the education to make use of such information which adversely affects the loan application. This issue was investigated by Kim (2009) by using 55 loan officers from 6 small banks and 49 loan officers from 3 large banks. The results indicate that while financial statements are perceived to be important information in approving loan applications in large and small banks, credit officers in small banks have a different view towards the financial statement than those in large banks. Generally, credit officers of small banks regard financial statements as less reliable in the evaluation of loan applications than do those of large banks. This implies that the credit officer relies more on soft information when evaluating the credit proposals of small firms.

There is a close realtionship between the age of a business and the success of the loan application. Firms with an established track record may pose less of a risk and it is easier for banks to evaluate them as these businesses are able to provide banks with more financial information. Conversely, new firms are considered riskier because they did not have a track record and may be affected by new economic conditions. Thus, new firms encounter more hurdles in securing loans than established firms (Brau and Osteryoung, 2001).

The other factor that needs to be considered when assessing loan applications is loan term or loan maturity. The length of loan maturity may affect the risk of the loan. There is a positive relationship between loan maturity and default risk. Thus, loan officers seek larger collateral and take more time to assess longer maturity loan proposals. There is positive relationship between the length of credit and the number of days required to acquire the loan. However, the study of Brau and Osteryoung (2001) noted earlier contradicts this theory. As mentioned, their study showed a negative relationship between loan maturity and number of days needed to obtain a loan. Their study was not conducted in a normal setting as it is argued that one possible explanation for this anomoly may be that the Small Business Administration (SBA) guarantee program is primarily intended to promote long-term financing for small firms.

Collateral is typically used by banks to reduce risk. If the project of the borrower is considered risky, the bank will require the borrower to provide collateral. Banks will approve loan applicants who provide collateral even though the project is riskier. Consequently, banks with a more collaterized loan portfolio will have much more default probability. This is supported by the findings of Jimenez and Saurina (2003) which showed that collaterized loans have a higher probability of default than uncollaterized loans. Collateralized loans enable the bank to shorten the period of scrutiny of the loan application which in turn results in fewer days to approve it. Since banks can sell such collateral to offset the default risk, pledging collateral can reduce the risk incurred by banks. However, this argument contradicts the empirical findings of the study undertaken by Brau and Osteryoung (2001) which found that firms providing collateral must also wait longer for approval. This implies that each loan proposal must be screened even though the borrower provides collateral. Therefore, riskier firms may be required to pledge collateral and must be screened more rigorously.

Steijvers et al., (2010b) investigated the impact of relationship characteristics, family ownership and their interactive effects upon the use of collateral in SME lending in the USA by using the decision tree model. They constructed two different decision models: the collateral versus no collateral decision model, and the business collateral versus personal collateral decision model. The results indicate that relationship characteristics are significant classifying determinants in both decision models, even though they are not the primary determinants in both. The amount of loan is the most important factor in both decision models. In the collateral versus the no collateral model, the higher the amount of loan, the higher the required pledge of collateral by the family firm. Furthermore, in the business collateral versus the personal collateral model, the higher the amount of loan, firms with less collateral seem to be more likely to pledge a personal commitment while the duration of the relationship between borrower and lender is less important.

Avery and Samolyk (2004) examined bank consolidation in two different three-year periods, that is, during the 1994-1997 and 1997-2000 periods in local banking in the USA. They claimed that bank consolidation in the first period showed opposite results for different types of bank, namely that big bank consolidation is associated with lower loan growth while community bank consolidation is correlated to the rise of credit availability for small enterprises. On average, in both observation periods bank consolidation leads to the rise of loan growth in small firms' market share.

As SMEs account for a larger share of the market in terms of employment and contribution towards GDP, these too have been evaluated. Deakins and Hussain (1993) and Feakin (2004), using data from the UK and Poland respectively, examined the practices and policies of commercial banks in their decision-making processes for lending to SMEs. In the case of Poland, which has been in transition from a socialist to a market economy, the results suggest that different banks have varying policies and practices in evaluating loan applications. The banks relied heavily on local knowledge and the experience of bank loan officers. In the case of the UK, Deakins and Hussain (1993) reported similarly. However, in 2014, banks in the UK adapted more technology and a credit scoring system to approve loans of smaller sizes, where financial information plays a much more active role.

Using the panel data of the financial institutions of 79 counties in 12 provinces in China, Shen et al., (Shen *et al.*, 2009) evaluated how bank size, discretion over credit, incentive schemes, competition, and the institutional environment affect lending to SMEs. The results show that bank size, measured by total assets, is an insignificant factor in SME lending. Nevertheless, when bank size is defined by big and RCC (rural credit cooperatives) as small, the results show that smaller banks lend more to SMEs. On the other hand, local lending authorities, bank competition, incentive schemes and stronger law enforcement support commercial banks to lend to SMEs. More specifically, lending to SMEs will be higher if an institution has more self-loan approval rights, greater competition, and when the loan manager's wage is linked to loan quality. Similarly, a weak institutional environment, reflected by weak law enforcement, will lead to less SME lending.

While literature suggests using soft information when dealing with small firms, banks in the USA started to adopt credit scoring which relies on hard information to assess loan applicants. Since 1993, credit scoring is being used to assess SME loan applicants. Under credit scoring, data on an applicant are passed through an analytical model embedded in software. Next, the analysis produces a score or number that indicates the level of credit risk associated with the applicant (Asch, 2000). Asch explains that the use of such credit scoring offers the following benefits: 1) It reduces the cost and time of making a loan compared to traditional manual evaluation; 2) It makes more loans to SMEs available. Banks are able to approve and process a higher loan volume by quantifying the risk of the applicant and reducing the information needed to make a loan; 3) It controls risks more effectively; 4) It eliminates human bias from the lending decision making process, and; 5) It focusses on assessing questionable loans. It seems that this credit scoring system is effective and efficient in the evaluation of SME credit proposals. However, as suggested in many studies, it hinders the use of 'soft information' that may be useful in assisting credit officers in making lending decisions.

3.6 Islamic Bank Financing for SMEs

Theoretically, IBs are suggested to employ PLS principles when extending their funds to customers (Aggarwal and Yousef, 2000). The implementation of PLS principles was also suggested in the Islamic finance literature of the 1960s and 1970s (Rahman, 2007). According to Aggrawal and Yousef (2000), there are some advantages of the PLS concept when compared to the CB based on interest principle. Firstly, PLS is considered fair and just because profit and loss are born together between financier and their clients, whereas CBs work on an interest basis and the borrower has a fixed burden regardless of the possibilities of profit or loss they face. Secondly, PLS is different from the interest-based system which is more concerned with the creditworthiness of borrowers. PLS may encourage the efficiency of capital allocation by putting a priority on delivering funds to productive projects. Thirdly, PLS is deemed more capable of stabilizing the economy than an interest-based system. Therefore, IBs should emphasize the PLS concept in extending their funds rather than mark-up principles, or at least balance the application of PLS and the mark-up (Hasan, 2005).

Under the PLS scheme, borrowers share profit and loss with the banks, which in turn share profit and loss with depositors. The other prominent feature of Islamic banks is that based on the PLS scheme, Islamic banks can extend their funds on a long-term basis which in turn promotes economic growth (Chong and Liu, 2009a). The implementation of PLS principles will be more advantageous, particularly for SMEs, because most of the SMEs are not creditworthy or bankable when the evaluation is based on interest. Thus, the evaluation of borrowers will not be based on creditworthiness but on the productivity and viability of the project, which will lead to a more efficient allocation of capital. Nevertheless, under PLS modes, IBs should be careful in allocating funds because the failure of any project they finance will incur a loss not only for the IB but also for depositors. On the other hand, depositors are required to deposit their money in the IB which invests their funds prudently. IBs should strive harder to select good customers and monitor the activities of their clients to ensure that the businesses they fund are well managed to minimize risk.

In the discussion above it is argued that the advantages of Islamic banking may have promoted the growth of IBs around the world. However, this also raises the question; is the emergence of Islamic Banks a direct cause of PLS? And, secondly, is the PLS scheme truly applied in IBs? Although some argue that the emergence of IBs was induced by the advantages of PLS (Zaher and Hassan, 2001), Chong and Liu (2009a) claim that the rapid growth of IBs is largely driven by the resurgence of Muslims around the world rather than the advantage of PLS. This is supported by the fact that many Islamic banks operate in countries with a Muslim majority who prefer bank services that operate according to the business ethics of their faith.

In their study, Aggrawal and Yousef (2000) found that IBs employ more mark-up modes of finance, or “debt-like instruments”, rather than PLS schemes. They said that this was because many IBs are operating in developing countries where the financial market is characterized by imperfect information so that the application of PLS is riskier. For instance, in Malaysia, where the development of IBs is dominant in south Asia, the financing of IBs using the PLS scheme accounts for only 0.5% which is comprised of *mudarabah* and *musharakah* contracts, while the rest (*murabahah*, *Ijara, ba’i muajal, istisna* and others) are based on mark-up principles (Chong and Liu, 2009a). At the international level, the Islamic Development Bank

(IDB) uses the PLS mode of finance in a few small projects (Dar and Presley, 2000). Other evidence of using the PLS mode of finance is conveyed by Rahman (2007) who claimed that the vast majority of IBs avoid PLS in their investment activities to overcome information imperfections.

According to Dar and Parsley (2000), the lack of PLS applications in most IBs is caused by other reasons. The first, the PLS contract is inherently vulnerable to the agency problem. The second, it requires well-defined property rights to function efficiently. The third, equity financing is not feasible to finance projects on a short-term basis. The fourth, charging tax on profits of PLS is deemed unfair compared to interest charged by CBs which is exempted on the grounds that it constitutes a cost item. The fifth is the absence of a secondary market for trading in Islamic financial instruments especially *mudarabah* and *musharakah* contracts. Some writers argue that the application of the PLS mode, particularly *Mudarabah*, cannot succeed while the interest option exists.

Surprisingly, even in a specialized Islamic financial institution, like the *Mudarabah* Companies (MCos) in Pakistan, which are viewed as PLS investment based companies, only marginal portions of their funds are invested based on *mudarabah* or *musharakah* principles (Dar and Presley, 2000). Ironically, since they cannot find enough investment opportunities to absorb the bulk of the funds they have, these companies are tempted to use their idle funds in speculative transactions by buying and selling shares traded on the stock market (Hasan, 2005). This indicates the contradictory condition where on one hand a lot of SMEs have difficulty in obtaining funds, and on the other, Islamic banks invest their idle funds in speculative investments. This may indicate the inefficiency of the Islamic bank officers or lack of lending skills when it comes to lending to SMEs.

Even in Bangladesh, although IBs have been established and are increasingly popular, the *Mudarabah* concept is not yet employed (Ahmed; Alam, 2000). IBs in Bangladesh are endeavouring to employ the *Mudarabah* mode of finance in the near future (Hasan, 1999). Conversely, IBs appear to use more mark-up principles in extending their funds to clients, for example, *Murabahah* and *ba'i muajal* constitute about 54.13% and 18.24% respectively. Meanwhile, the proportion of PLS, that is the *musharakah* mode is only 3.8%. The practice of IBs in Algeria is also similar to that of Bangladesh – the *Mudarabah* concept has not been employed yet. A study on the Banque Al Baraka d’Alge´rie found that these IBs offer four principal instruments: *taadjir* (leasing), *musharakah* (equity participation), *Murabahah* (profit sharing agreement), and *salam* (deferred delivery payment) (Benamraoui, 2008). Again, the PLS principle is only marginally practiced in Algeria. The main product is *Murabahah* which accounts for more than 80% of transactions, followed by *taadjir* (leasing) which account for 10%.

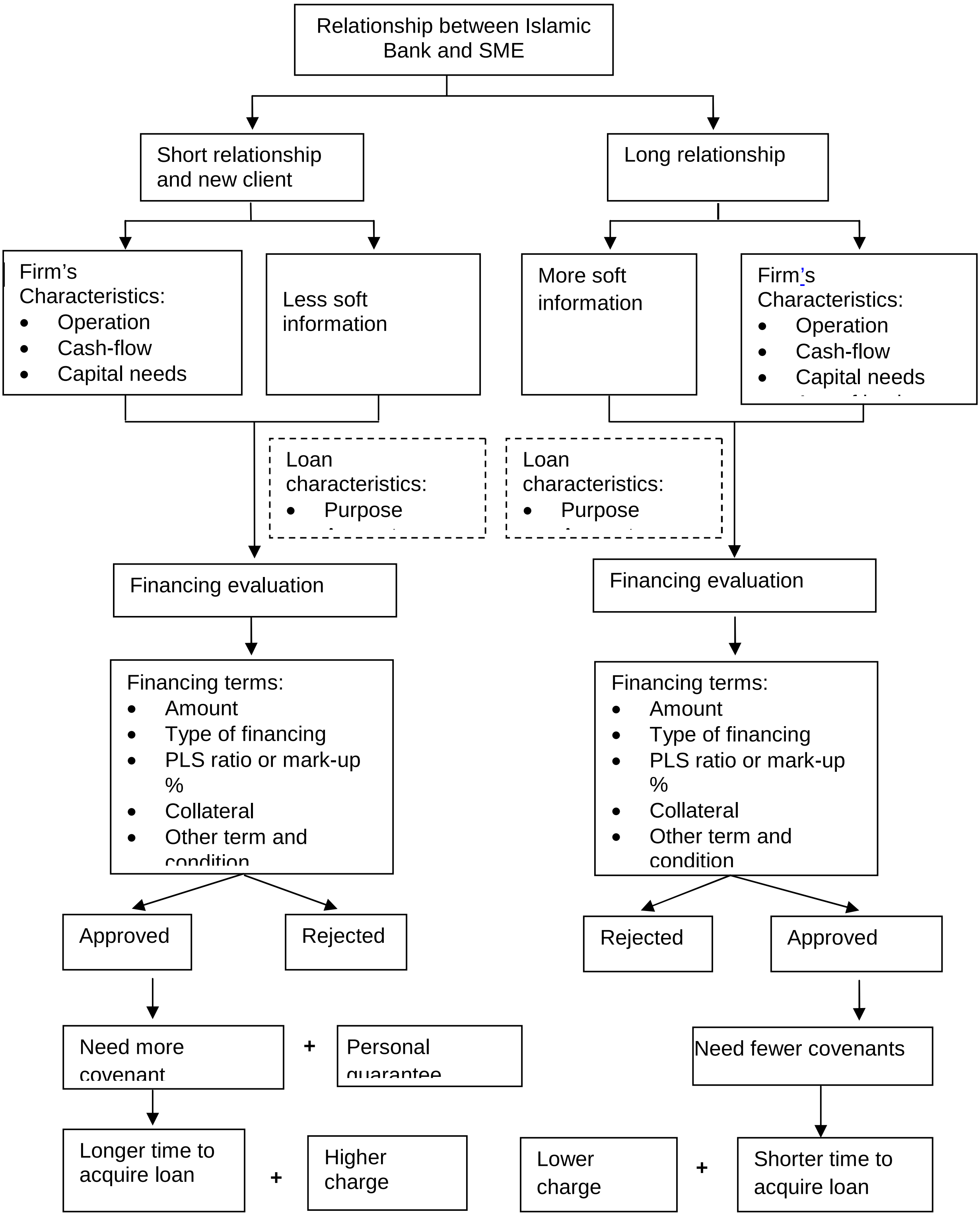
3.7 Conceptual Model of Islamic Bank Financing For SMEs

Having considered bank lending and Islamic bank financing for SMEs, the model of Islamic bank financing for SMEs is developed and depicted in figure 3.1. The relationship between Islamic banks and customers can be simply classified into two groups: short-term relationships and long-term relationships.

New and potential customers are included in the short relationship category because the bank does not have adequate soft information about them. This relationship might influence the bank in making a financing decision using soft information obtained about the firm. This kind of information is very important in evaluating financing proposals, particularly for SMEs, given the fact that banks rely on soft information when dealing with small firms to overcome asymmetric information (Agarwal and Hauswald, 2006; Scott, 2006; Ramlee and Berma, 2013; Canton *et al.*, 2013; Bouslama, 2014).

Thus, the success of the financing proposal depends on the applicant’s characteristics which involve the combination of firm characteristics, loan characteristics, soft information provided and financing terms. Nevertheless, the ability, knowledge and experience of bank officers also plays an important role in determining the result of the loan application (Feakins, 2004). In addition, seniority and authority of bank officers also bear important implications for the loan’s success or rejection (Canales and Nanda, 2008a).

Figure 3.1 Islamic bank financing for SMEs



Source: Author

If a proposal is sanctioned, the applicant who has a long-term relationship with the bank will acquire the financing immediately. It is also possible for banks to charge lower interest rates for clients with a long and good relationship. This is because via the acquisition of soft information, the bank can measure the risk of the financed project. In contrast, a bank needs more collateral and time to evaluate an applicant with a short-term relationship. It is difficult to predict the future repayment of a short relationship partner because the bank has a limited track record of them. The default of payment could come from an inability or moral hazard of the client. Therefore, the bank may require a personal guarantee to resolve that possibility.

From the above discussion, it is clear that banks may treat the entrepreneurs with whom they have had a long relationship differently than those new clients with whom they have had a short relationship. This indicates that soft information has an important value for banks in making a financing decision, particularly for SMEs. Soft information can be obtained only through the relationship between the bank and the customer. The longer the relationship, the more soft information might be obtained. This is very important for banks when dealing with SMEs, as they commonly lack adequate reliable hard information.

3.8 Suitability of Islamic financial products for SMEs

It is acknowledged by policy makers and academics in many countries that access to formal finance adversely affects SME start-up and growth. Yet SMEs make a significant contribution towards economic development, in terms of job creation, reducing poverty and stabilizing household income. SMEs access finance from informal sources in the early stages and from formal sources once established, a pattern similar to a pecking order preference. Around 75 – 90 percent of SMEs in the ASEAN region rely on internal saving, retained earnings, borrowing from family and relatives, and money lenders compared to 3 -18 percent who access formal sector finances, such as from banks, venture capital and the capital market (Leng *et al.*, 2005). Start-up businesses encounter hurdles in accessing external formal finances and the rate of take up of formal finance sources is even lower. To respond to the finance gap for SMEs in the economy, governments have adapted various policies to assist the development of SMEs (Simanjuntak, 2013). In addition to conventional policies and measures used to support SMEs, it is now suggested that Islamic bank finance is a suitable source of finance to meet the needs of SMEs. It is suggested that Islamic finance overcomes issues related with asymmetric information and collateral as the provider of finance shares profit and risk, which mitigates the need for financial information and collateral often required by traditional banks.

Islamic banks, in theory and practice, are alternative finance providers that should be able to provide financial products to enable small businesses to start and medium size enterprises to grow. Among Islamic financial products there are a wide range of financial instruments that can be used to support businesses at the start-up or growth stages. Islamic banks have the ability to be flexible and can offer financial products that are most suitable for entrepreneurs as the practice ensures that the instrument used is suitable for the economic purpose that a company seeks to achieve. Islamic finance products can be broadly classified into three groups, namely; sale-based instruments, lease-based instruments and partnership-based instruments. Sale-based instruments include *salam or advance purchases* (purchases of specified goods for forward payment) *and istisna or commissioned manufacture* (where one party buys the goods and the other party undertakes to manufacture them, according to agreed specifications), while partnership-based instruments consist of *musharakah* and *mudarabah* contracts. In addition, lease-based instruments are termed *ijara* (lease contract). The range of products offered by Islamic banks is similar to conventional banks but their conduct and operations differ and are compliant with Islamic principles which differentiate IB products from conventional bank products.

Bai salam is one of the most popular Islamic finance contracts in the agricultural sector. It is a forward sale contract whereby delivery of the commodity occurs at some future date in exchange of an advanced price fully paid on the spot. Operation of this type of contract can be traced back to the prophetic era. The prophet Muhammad (peace unto him) allowed farmers to sell their uncultivated agricultural products on a deferred delivery basis, whereby the buyer made full payment on day one and delivered the product when it was ready (Centre, 2009). The basic purpose of this contract is to satisfy the small farmers who need cash to grow their crops and feed their families until harvest time. This type of contract is beneficial for both parties. By making the *bai salam* contract, the seller receives cash in advance, while the buyer normally pays a lower price for the commodity (Kaleem and Wajid, 2009). Next, by employing the *parallel bai salam* contract, the Islamic bank sells the crop to rice mill enterprises where the selling price is equal to the cost of the goods (plus margin). In this sense, the rice mill owner gets the benefit in the form of the continuity of the raw material supply (the crops). If the farmer experiences crop failure and he or she cannot deliver the crop to an Islamic bank, the Islamic bank will bear the risk of receiving the crop. To minimize the risk, there are three solutions that can be proposed. Firstly, if the farmer can only deliver the crop at half of the agreed quantity, then the farmer must return half of the money loaned to the bank. For example, the *salam* contract involves 6 tons of rice where the price of the rice is $500 per ton. If the farmer’s crop fails and he or she can only deliver 3 tons, the farmer must pay back as much as $1,500 (3 tons x $500). Secondly, the farmer may ask the Islamic bank to delay the delivery of the remaining three tons until the next harvest. Thirdly, the farmer can buy the crop from another farmer and then deliver it to the Islamic bank.

Based on the characteristic of the *bai salam* contract that enables the seller to deliver their product in the future, it may be used by SMEs as working capital. SMEs might obtain funds from potential buyers or through an agreement with the Islamic bank. At the end of the contract the seller sends the product to the bank and the bank can sell it on the open market or to a third party. The contract is fully acceptable under modern banking. The only problem is that banks only want to deal with money rather than commodities. This issue can be resolved through a parallel *salam* contract whereby the bank enters into two separate contracts; first with the seller, and second with the buyer of a commodity. This contract is widely used in Sudan but not in any other country (Centre, 2009). Use of *bai salam* contracts for small loans can be expensive as there are costs associated with monitoring and risk of default.

The next contract that can be used by SMEs is the *musharakah* contract. *Musharakah* is one form of Islamic finance based on profit-loss sharing (PLS). In this contract two or more parties can be involved, and typically each provides knowledge and skill as well as share capital. Since SME owners are generally viewed as a business entity that have a lack of both financing and other business skills, by using a *musharakah* contract each party can share their different skills and knowledge (such as management skills, advisory services and even engage in the actual work itself). Thus, by entering into this contract, SMEs gain new skills from other parties. In this sense, Islamic banks can help SMEs by providing simple financial management training, such as in the composing financial reports and development of management skills. It is possible for one of the partners to only provide capital and he or she becomes a sleeping partner (Centre, 2009), but it will be more beneficial for SMEs if they can acquire new skills from other partners if the other partners not only provide capital but are also involved in the business. It is obvious that the flexibility feature of the contract enables any partner to become involved in the project. Different individuals possess different skills, knowledge and even capital, which in turn enhances the opportunity for SMEs to get involved in various projects. Islamic banks must promote the application of *musharakah* contracts. Firstly, this contract is based on PLS which is fairer and more just both for Islamic banks and borrowers. Secondly, *musharakah* contracts enable Islamic banks to control the financed business because Islamic bank managers are involved in the business.

Due to the inability of SMEs to provide acceptable collateral and good financial information, they fail to fulfil the stringent credit criteria of conventional banks, and rarely qualify for loans requested. Successive researchers (Jimenez and Saurina, 2004; Menkhoff *et al.*, 2006) have reported that conventional banks do not consider loan applications viable when the potential client is unable to provide collateral. Conversely, Islamic banks do not consider collateral as a main determinant in deciding financing. Particularly for SME applicants who normally do not have enough collateral, the evaluation of financing must be based on the soundness of the project rather than the availability of collateral. The requirement of collateral is basically relevant if the entrepreneur is liable for losses. Thus, the lack of collateral should not hamper Islamic banks in extending finance to SMEs on the basis of equity partnership, mainly due to the fact that the bank is involved in a portion of asset ownership. One of the Islamic financing contracts based on equity partnership is *musharakah*.

In *musharakah*, in addition to sharing the profit with the lender, the entrepreneur must return the loan principle at the end of the contract. However, delivering the loan principle in a lump sum one off payment may lead to financial distress for SMEs. Therefore, this type of *musharakah* must be modified in order to meet the SME's needs. This form of *musharakah* contract is called a diminishing *musharakah* contract (Sadique, 2008). Diminishing *musharakah*, sometimes called *musharakah mutanaqisah*, is a type of partnership contract between two parties where one partner gradually buys the whole part of the property (Osmani and Abdullah, 2010; Saad and Razak, 2013). In a diminishing *Musharakah* contract, the repurchasing agreement is part of the contract. The buyers in this contract will gradually own a larger share of the joint venture and, as a result, their share of the capital increases. By entering this contract, SMEs will benefit by possessing the entire property at the end of contract.

Diminishing *musharakah* contracts can be used for SMEs to purchase additional fixed assets, for example a new machine. The step of employing diminishing *musharakah* proposed by Maybank (cited in; Osmani and Abdullah, 2010), can be adopted by SMEs. Firstly, SMEs and the bank make an agreement between them to acquire the capital to buy the assets. The client and the bank become the joint owners of the property based on the ratio of payment in purchasing the assets. The benefit of diminishing *musharakah* is that the bank leases its share to the client and collects rent on a monthly basis for a predetermined period. The client gradually buys the bank’s share. Finally, the bank’s share comes to an end and the client gets full ownership of the assets. This type of contract is suitable for SMEs who do not have cash to buy fixed assets.

The *mudarabah* (passive partnership) contract is one of the Islamic financial instruments which are emphasized in Islamic economics since it is closer to the real sector. This financial instrument is ideal from the point of view of SMEs as they lack capital. *Mudarabah* financing provides some advantages for SMEs (Bacha, 1997). Firstly, unlike loans from conventional banks, SMEs involved in a *mudarabah* contract do not need to make payments annually. Instead, the payment made to Islamic banks comes from profits. Thus, there is no obligation for SMEs to make payments to Islamic banks if they do not get any profit during the same year. SME owners will make repayments only if they receive profits. In addition, the Islamic bank cannot foreclose or take legal action if there are no profits and therefore nothing to be shared. Therefore, using *mudarabah* financing does not increase a firm’s risk the way debt financing does through increased financial leverage.

In the *Mudarabah* model, the bank acts as *robul mall* (funds holder) while SMEs owners act as *mudarib* (agent that manages funds provided by the bank). Under this contract, a bank provides 100 percent of the funds while SMEs provide time and labour. This means that the bank has equity in the firm by providing finance to the entrepreneur. In this case, both parties agree to share the profit, based on the predetermined profit ratio in the early part of the contract. In the case of loss, the bank bears all the financial risk and the entrepreneur's loss is in time and effort. To lighten the burden of SMEs at the end of contract, the financing repayment can be structured in instalments. Initially, a bank may own 100 percent of the share, but as each instalment is repaid, the SMEs buys back the share. The bank's share decreases gradually in line with the repayments received, which in turn reduces the nominal profit shared with the bank. Conversely, under the same profit ratio, SMEs obtain more profit gradually as their share in equity increases. Since Islamic banks will fully bear the risk of the fund invested in the *mudarabah* contract, the Islamic banks will apply this contract with SME owners if they have a close and long relationship with the banks. Based on this relationship, the trust between SME owners and Islamic banks is established and will reduce the risk. Therefore, long-term relationships between banks and firms are beneficial particularly for high risk firms like SMEs (Peltoniemi, 2007).

The problem faced by Islamic banks when considering the *mudarabah* contract is an agency problem. Since Islamic banks do not get involved in the business financed under the *mudarabah* contract, the business is fully under the control of the entrepreneur. This is because *sharia* law prohibits *rab-ul mal* (financier) from interfering with the business but requires the financier to absorb all losses (Hasan, 2002; Bacha, 1997). The agency problem will emerge because both SME owners and Islamic banks have contrasting interests. Islamic banks are concerned with the repayment of loans plus their profit share, while SMEs are more concerned with high profits. As a result, SME owners may commit a moral hazard by reporting low profits to Islamic banks.

Murabahah (Deferred Payment Sale) is the most popular form of financing used by Islamic banks all over the world. *Murabahah is* preferred because of most of the financing provided by Islamic banks is directed to trade financing (Ahmed, 2008) and working capital (Akbar *et al.*, 2012). These contracts are mainly used for the purchase of goods for immediate delivery with payment to be settled at a later date either in lump sum or instalments. Various assets can be used under the *murabahah* contract, including raw materials and goods for resale. SMEs can use this type of financing for trade and working capital financing. Under this contract, SMEs might buy the raw materials and equipment they need to run their business. The advantage of using this contract for SMEs is that this contract does not require the transparency of financial reports of SMEs. Islamic banks only need to make sure that SMEs owners financed through this contract are able to meet repayments.

Ijara/leasing is considered the second best instrument after *murabahah* in Islamic banking. Like conventional leases, *ijara* is the sale to benefit (the right to use of goods) for a specific period. *Ijara* is a contract under which a bank buys and leases out an asset or equipment required by its client for a rental fee. Responsibility for maintenance/insurance rests with the lessor. Thus, *Ijara* contracts enable SMEs to use the benefits of assets from the provider without bearing maintenance risk. Buying fixed assets requires large amounts of capital which is usually hard for SMEs to obtain. The instrument of *ijara* financing enables SMEs to utilize certain fixed assets without purchasing them. Instead, they pay lease payments periodically.

The features of the *ijara* contract can be seen from its rules. According to the *Handbook on Islamic SME Financing* (Said *et al.*, n.d), there are some basic rules of the *ijara* contract. Firstly, in *ijara* financing, all liabilities of ownership are borne by the lessor, since the corpus of leased property remains in the ownership of the seller. Secondly, the period of lease must be determined in clear terms at the time of contract. Thirdly, lease for a specific purpose can only be done, if no specific purpose is identified in the agreement, then it can be used for any purpose for which it is used in the normal course. Fourthly, SMEs as lessees are liable to compensate the lessor for any harm to the leased asset caused by misuse or negligence. The leased asset shall remain the risk of the lessor throughout the lease period. Thus, by entering the *ijara* contract, SMEs owners may use the full service of fixed assets without a breakdown of the fixed assets as far as it runs in normal operation. In contrast, as a lessee, SMEs must be responsible to fix the leased property if they make some mistake which may cause damage.

Since some equipment and machinery typically involves a large amount of funds, SMEs enter into the *ijara* contract with those assets. In addition, there is free maintenance cost as well as other benefits of *ijara*. Generally, SMEs may benefit from using an *ijara* contract because it allows SMEs to own equipment and machinery without having to pay the full amount upfront. In addition, entering into an *ijara* contract facilitates management of funds for SMEs, as a repayment amount is predetermined. The other benefit of utilizing an *ijara* contract is that instalments paid for *ijara* (leasing) are eligible for full tax relief. The last advantage of *ijara* is that SMEs as lessees are free from the responsibility of maintaining the property because the maintenance risk is born by the provider.

The *ijara* mode of finance is flexible in terms of lease payment. The flexibility of payment enables SMEs to make some adjustments related to their business fluctuation. Under this contract, the lessor has the right to renegotiate the terms of the lease payment at agreed intervals. This is to ensure that the rental remains in line with market leasing rates and the residual value of the leased asset. Under this contract, the SMEs owners (lessees) are not permitted to purchase the asset during or at the end of the lease term. However, this problem can be resolved through a similar type of contract, *ijara wa iqtina* (hire-purchase) (Mirakhor and Zaidi, 2007b). In *ijara wa iqtina*, SMEs, as lessees, may sign a separate agreement to buy the asset at the end of the rental period, at an agreed price. Thus, at the end of the period of contract, the transfer of ownership flows from the lessor to the lessee. SMEs may choose the type of *ijara* contract that will benefit them. *Ijara wa iqtina* facilitates the lessor to sell the used property to the lessee. Similarly, SMEs may be able to buy the property at a low price since they have been involved in a partnership. It is obvious that both Islamic banks and SMEs benefit from an *ijara* contract and for this reason there is wide use of *ijara* contracts in Islamic banks. Table 3.2 shows some proposed products for SMEs under the Islamic mode of financing:

Table 3.2 Association between purpose and mode of financing[27]

Purpose of financing	Mode of financing
Working Capital Financing	• Murabahah • *Salam* • *Istisna*
SME Trade Finance ➢ Letter of credit ➢ Export credit financing ➢ Bank Guarantee ➢ Bill of Exchange purchased ➢ Trust Receipt	• *Murabahah* • *Salam* • *Istisna* • Other products (*kafalah, wakalah* and *hawalah*)
Asset Acquisition and Business Expansion ➢ Plant factory financing ➢ Equipment financing	

3.9. Client attitudes towards Islamic Banks

The success of a bank depends on the bank's ability to understand and satisfy customer needs. Although there is no evidence that the introduction of Islamic products through the opening of Islamic windows by conventional banks will pose a threat to fully-fledged Islamic banks, the fully-fledged Islamic bank should realize that the presence of Islamic bank windows leads to more rigid competition. Islamic banks, therefore, should gain an understanding of customer attitudes towards Islamic banking services in order to differentiate and compete with mature conventional banks. Given the competition from non-Islamic banks, Islamic banks should acknowledge that they can no longer fully rely on Muslim customers either as a source of deposits or as their fund users. Islamic banks should expand their customer base by attracting customers based on the strength of their products and services. In addition, amongst Muslims, religious motivation alone does not appear to be the primary criterion (Erol and El-Bdour, 1989) for dealing with IBs. In general, both Muslims and non-Muslims consider fast, efficient and competitive services to be the most important factors when dealing with banks (Haron et al., 1994b).

Research on customer attitudes toward Islamic banks conducted by Naser et al., (1999) considered customer satisfaction and preference towards Islamic banking in Jordan. Of the 206 respondents in their sample, the vast majority were satisfied with

[27] Adapted from the "Handbook on Islamic SME Financing".

most aspects of Islamic bank products and services. However, this research was focused within a predominantly Islamic country. Naser et al also reported that bank employees are central to the service delivery process and play a vital role in company-customer interaction, as the respondents in their study generally viewed the personal relationship with the Islamic bank as important. Personal contact with individuals serves an important role in attracting potential customers to Islamic banks (Erol and El-Bdour, 1989). The reputation of the bank is the next important factor for the customer. While Erol and Bdour (1989) argue that religious motivation is not the primary criterion in selecting an Islamic bank, in contrast Naser et al., (1999) found that the majority of customers chose Islamic banks due to religious reasons. There is a presumption that the customers of Islamic banks are ready to accept any return as long as the bank observes Islamic principles, that is, that Muslim customers deposit their money in Islamic banks to satisfy their religious priorities. The study by Naser et al, conducted in Jordan among mainly Muslim respondents, demonstrated ignorance about the specific terms and products offered by Islamic banks. These findings are similar to those reported by Gerrard and Cunningham (1997) in which Muslim customers did not understand the meaning of the terms applied to Islamic financial instruments. For potential bank clients to be in a position to engage in a meaningful way, there appears to be a need for IBs to educate their customers of their products and the terminology used in Islamic banks.

The study by Haron et al. (1994b) highlights the differences in the patronage of Islamic and conventional banks by Muslims and non-Muslims in Malaysia. Using factor analysis, the results showed that religious motivation was not the primary reason for Muslims in accessing Islamic banks. Furthermore, Muslims and non-Muslims were not different in their bank selection criteria – the provision of fast and high-quality bank services were the most significant reasons for bank selection for Muslims and non-Muslims alike. These findings were echoed by those of of Gerrard and Cunningham (1997) which suggest that while Malaysian Muslims and non-Muslims were aware of the existence of Islamic banks, commonly they did not fully understand the specificities of Islamic financial instruments. Metawa and Almossawi (1998) investigated banking behaviour in Islamic banks in Bahrain and their results suggest that the majority of Islamic bank customers are well educated. More than 50% of customers maintained their relationship with the banks which indicated the satisfaction of customers dealing with Islamic banks. The study by Naseer (2008) also suggests that Islamic bank employees play an important role in providing a high quality service delivery system.

Gait and Worthington (2009b) investigate the attitude of Libyan business firms towards the Islamic method of finance through phone interviews with 296 firms to gather information on their awareness and perception of Islamic finance. The study indicated that while commercial Islamic finance is not yet formally practiced in Libya, most firms know of the existence of Islamic banking and finance and have some knowledge about Islamic methods of finance. Two specific Islamic products, *musharakah* and *qordh*, were well known by two-thirds of the respondents. However, most of them were uninformed about most other Islamic financing methods. The study suggests that most firms in Libya are potential users of Islamic methods of finance. The study uses factor analysis to reduce the large number of explanatory variables used to determine a firm's attitudes into four determinants; religion, profitability, business support, and unique services. This study contradicts the results of Erol and El-Bdour (1989); in which the result of discriminant analysis found that religion remains the principle motivation for the potential users of Islamic finance amongst business firms in Libya. The study also suggests that the risk-sharing services offered by Islamic financial institutions appear to be a particularly attractive feature, especially for smaller firms.

Gait and Worthington (2009a) researched business firms' attitudes through investigation of the attitudes of retail customers towards Islamic methods of finance. The results are similar to that of business firm's level (Gait and Worthington, 2009b) in terms of understanding of Islamic finance vocabulary such as *musharakah* and *qordh*. This study used the same method as with the previous research, namely discriminant analysis, to determine the attitudes of retail customers towards Islamic banking products. Discriminant analysis showed that the respondents put religious motivation as the primary reason for their use of Islamic methods of finance, followed by community service and profitability. These respondents, however, were not able to provide coherent explanations as to why Islamic products are better than other finance products. The key determinant in their decision making was interest rate. Abduh and Omar (2003) investigated customer religiosity and perception toward

Islamic banks using binary logistic regression. The study showed that an individual who seeks a shariah compliant deposit account is much more likely to deposit their money in an Islamic bank compared to individuals who are not concerned with *shariah* issues. This implies that the religious factor affects the individual's decision to patronize Islamic banks. Surprisingly, bank customers tend to view Islamic banks as more secure. The number of those who believed so was almost six times greater than those who believed otherwise. The perception towards the safety of funds deposited in Islamic banks is due to the fact that Bank Muamalat Indonesia (BMI), as the only Islamic bank in Indonesia until 1999, had performed very well during the 1997/1998 Asian financial crisis which hit Indonesia severely, while many banks collapsed at that time. Nonetheless, advertisements are also an important factor in attracting potential customers to Islamic banks which implies that in the current economic context, marketing plays an important role regardless of the types of banks.

Dusuki and Abdullah (2007a) examined the main factors that motivate customers to deal with Islamic banks in the dual banking environment in Malaysia. The results suggest that the selection of Islamic banks appears to be predominantly a combination of Islamic beliefs, financial reputation and overall quality of services offered by the bank. Therefore, Dusuki and Abdullah argue that Islamic bankers can no longer rely on the marketing strategy of attracting pious and religious customers who might only be concerned about the Islamic aspects of the financial products. Conversely, actions such as treating customers with courtesy and respect, staff ability to convey trust and confidence, efficiency and effectiveness in handling any transaction, knowledge and preparedness in providing solutions and answers concerning Islamic bank products and services, good social responsibility practices and convenience must also be considered.

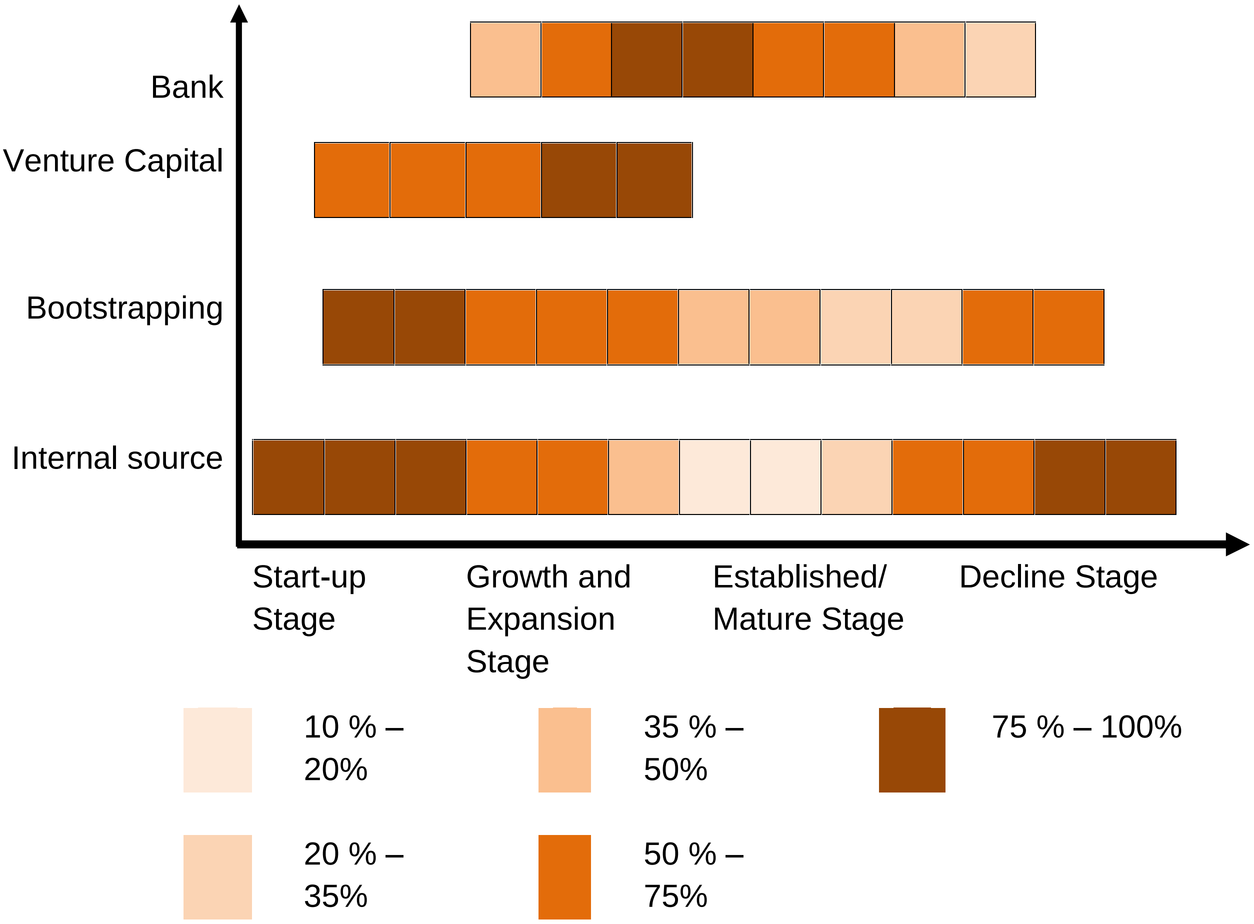
3.10 SMEs Financing Preferences over Their Life-Cycle

It is widely accepted that small firms finance their operations through various sources at different stages of their organizational lives to achieve optimal capital structure (Gregory *et al.*, 2005; Berger and Udell, 1998a). For example, Rocca et al., (2009) argue that SMEs rely on different sources of finance throughout their life-cycle. In the start-up stage, small businesses normally face barriers in accessing external finance.

This is due to information asymmetry and lack of trust that particularly affects start-up firms. Inadequate information is due to lack of an adequate track record which impedes the firm's ability to access funds from others. As the business ages, it's record of information grows as does its business reputation, which in turn enables it to raise additional capital from external sources. In this phase, the firm begins to apply different financing strategies to enhance its capital structure and use appropriate sources of finance to minimise the cost of capital. The findings of Beger and Udell (1998a) and Rocca et.al., (2009) imply that the specific financing strategy of the firm throughout its life-cycle is influenced by asymmetric information and growth opportunity considerations (Teixeira, 2006). There is a link between capital structure and firm's life-cycle (Frielinghaus *et al.*, 2005; Daskalakis and Jarvis, 2013). To understand SME financing preferences throughout the life-cycle of a business, a conceptual framework is built. A concept can be defined as a picture or symbolic representation of an abstract idea. The conceptual framework is a set of coherent ideas or concepts that can be used to explain certain reality. The conceptual framework of SMEs' financing preferences is provided in Figure 3.2.

Figure 3.2 depicts the conceptual framework which shows that SMEs use funds from different sources at different stages. From start-up until the declining stage, the financial needs of a firm change according to its ability to generate cash, its growth opportunities, and the risks they face (Rocca *et al.*, 2009). In addition, the changing degree of informational opacity faced by a firm drives its finances throughout the life-cycle (Kaplan and Stromberg, 2003). Small firms use various sources of funds at different stages of their organizational lives to achieve optimal capital structure at each stage (Berger and Udell, 1998a; Gregory *et al.*, 2005). Understanding the financial determinants of SMEs at various stages of the business life-cycle allows managers and policy makers to correctly support firm growth (Rocca *et al.*, 2009). SMEs financing preferences are illustrated by the colour gradation in Figure 3.4. The darkness of the colour gradation represents the important role of fund resources, the darker the colour the more important the source of funding becomes, which includes internal sources, bootstrapping (method of gaining funds without involving external parties), venture capital, and bank sources.

Figure 3.2 SMEs' Financing Preferences throughout the Life-Cycle



Source: Author

The first stage of the firm's growth is the start-up stage. Initially, the main source of finance used at this stage is the owner's own resources, usually in the form of personal savings (Hussain and Matlay, 2007) or family borrowing. At this stage, personal financing serves as a larger component of the firms' capital (Cassar, 2004). However, owner savings are not enough to fund all of the operations of the firm, yet it is impossible for a firm to access funds from external sources. Furthermore, at this stage of operations, the firm's cash-flow is negative as it pours cash into its investment schedule. Cash-flow is required to purchase stock, pay bills and service interest payments, all of which are expected to be met by the owners themselves, therefore, the negative cash-flow that occurs in the start-up stage inhibits small firms from pursuing external sources of finance (Weinberg, 1994).

Due to financial constraints, owners pursue additional capital through other sources. One of the sources of finance is bootstrap financing. The important role of the bootstrapping strategy is proposed by Auken and Neeley (1996) who found that 35% of start-up capital was obtained from bootstrap sources. The bootstrap financing concept (Winborg and Landstrom, 2000; Harrison *et al.*, 2004; Lahm and Harold T. Little, 2005; Ebben, 2009) was developed to explain the systematic structure that is used to raise finances at the start-up stage of businesses. Financial bootstrapping refers to the use of methods to satisfy the resources need, without relying on long-term external finance from a debt or additional equity from new owners (Winborg and Landstrom, 2000; Lam, 2010; Atherton, 2012; Fatoki, 2013). Financial bootstrapping can be used by the firm throughout its life-cycle. However, bootstrapping techniques at each stage of the life-cycle may vary (see; Neeley, 2004). The vital role of the bootstrap financing in the start-up stage is indicated by the darker colour in Figure 3.4. The start-up firm is characterized as having no business track record, lack of collateral and low number of assets. At this stage, no formal financial institutions are willing to offer funds. Although the firms which do not use external sources of finance can preserve ownership and control (Bhide, 1992), small firms use bootstrap financing as a survival tactic (Ebben, 2009). In this regard, highly-leveraged, underperforming, and cash-constrained firms are more likely to use the bootstrap strategy than others. The bootstrapping strategy can be undertaken in two forms as summarized by Harrison et al., (2004). The first form involves creative ways of acquiring finance without recourse to banks or raising equity from traditional sources. The second form includes strategies for minimising or eliminating the need for finance by securing resources at little or no cost.

Creative ways of acquiring finance without resorting to bank finance can be employed, for example, in referring to the definition of the financial bootstrapping method of Winborg and Landstrom (2000), in which funds are raised from family members. If the owner’s savings are not sufficient to satisfy the firm’s need, the owner can ask for help from family members. In this instance, the family could be considered as the second main source of capital because families provide assistance to prevent loss for the owner who avoids the use of moneylenders who commonly charge high rates of interest for loans (Dasgupta, 2004). However, it must be realized that the family can only provide a fraction of the entire capital needs of a business and hence the owner then reaches out to other family members and friends who often lend cash. External capital providers often charge interest based on an agreement but money borrowed from extended families and friends shields businesses from excessive interest charges and they do not have to repay money quickly. The funding gained from families and relatives is incredibly important for SMEs. This notion is supported by the research findings of Li and Matlay (2005) who found that nearly 41 percent of respondents in their study received non-usurious loans from family and friends. Another study conducted in China by Turvey et al., (2010) reported that the role of borrowing from friends and relatives was significant for small businesses.

Other tactics of employing bootstrap for SMEs include through obtaining advance payments from buyers, or the use of interest on overdue payments from customers. SMEs can also offer customers discounts if paying by cash. These actions can be undertaken if SMEs have established trust among their buyers or if their products are very attractive to the market. In the supply side, firms can delay payments on all purchased goods in order to balance cash-flow. In this regard, short investment is an important strategy often employed by small businesses.

The second bootstrapping strategy that can be used to minimise or eliminate the need for finance is by securing resources at little or no cost. This can be done in many ways, for example, instead of buying new equipment, the firm can use equipment to retrench expenses. In addition, it can make use of some of the firm's idle assets to secure additional capital such as hire out its idle land or other properties for cash. SME owners who have close relationships with other entrepreneurs can borrow equipment from them for a short period of time. Sometimes, the utilization of equipment provided by leasing institutions is preferred by SMEs instead of buying the equipment. The application and variability of bootstrapping financing strategies depends on the creativity of SME owners. Bootstrapping finance can be used over the life-cycle of the business and is the dominant method of finance for start-up businesses (indicated by the darker colour in the start-up stage in figure 3.4), and allows firms to meet their capital needs before they are deemed bankable.

The second stage is known as the growth and expansion stage. While insider financing is a main source of financing, firms start pursuing other external sources of funds at the growth stage and beyond. When SMEs show significant growth, they start to attract financial institutions willing to take a risk. One of the financial institutions is venture capital. Venture capital companies will be interested in the business if it needs large sums of additional capital, and are often not accessible to small (new) start-ups. Since venture capital companies are involved in equity capital, the ratio of ownership in the hands of the SMEs founder may decrease. This dilemma is encountered by SME owners who use venture capital to support business growth. Peterson and Schulman (1987) show that the ownership ratio reaches the highest proportion in new businesses, then falls for a time with age/size. The capital from the owners is not fully taken over by external parties and still plays an important role until the firm reaches the established stage (Hamilton and Fox, 1998). Therefore, the SME owners avoid joint ownership financing with other parties in fulfilling the capital needs to maintain the proportion of their ownership. In addition, approaching banks is difficult for small firms at this stage because they are relatively inexperienced in raising outside debt and equity (Cassar, 2004). Consequently, the owner seeks non-bank institutions as sources of funds to support the firm's growth. In certain types of industry, such as biotechnology, software and computers, and telecommunications, the presence of venture capitalists is essential to support the business at the growth stage (Huyghebaert *et al.*, 2007).

Retained earnings are considered an internal source of funds that assist businesses to undertake new investments or reduce debts without having recourse to external sources. Research by Hamilton and Fox (1998) indicates that new firms retained more earnings than other groups, however the firm needs much more capital than retained earnings to invest and expand. Normally, a new firm has inadequate internal financial sources to sustain growth and cannot access external equity finance. So, the firms begin to seek capital from banking institutions. The first step is to approach small or rural banking institutions. Business owners prefer to approach the rural banks because they normally apply simple procedures and are less bureaucratic and cumbersome than large banks. In addition, SMEs are commonly the main target market of rural banks. Realizing that SMEs are a promising market, nowadays there are a lot of Islamic rural banks (*Bank Pembiayaan Syariah*/ BPRS) in Indonesia.

Access to funds from banks increases significantly when SMEs began to expand their businesses. Firms in this stage have an adequate track record from which the banks can evaluate their loan application. The firms also have enough tangible assets which can be pledged as collateral. Therefore, the use of bank debt increases over time and becomes increasingly important from this stage on (Berger and Udell, 1998a). Consequently, SMEs commonly rely heavily on bank credit as an external source of funds (Berger and Udell, 1994; Berger and Udell, 1998b; Berger and Black, 2010; Kundid and Ercegovac, 2011; Voordeckers and Steijvers, 2008). In addition, SMEs cannot access additional funds from the capital market, such as stock or bonds, because SMEs are typically not publicly held, and therefore not subject to the public disclosure regulations of the Securities and Exchange Commission’s (SEC). Additionally, small firms often do not have audited financial statements as one of requirement of issuing share in the capital market (Gregory *et al.*, 2005).

Although obtaining additional capital from banks is easy for SMEs at this stage, bootstrapping financing is still important. One of the bootstrap measures is gaining credit from suppliers as a short term source of finance. When an SME has a good reputation and relationship among suppliers, they can secure loans in the form of buying inventory and raw material on credit. The willingness of the supplier is based on the belief that the firm has good prospects in the future and the likelihood of default is minimal. Trade credit is useful both for buyer and supplier. The buyers can attain the goods they need without paying cash. This means that the buyer obtains finance from the supplier. On the other hand, by providing trade credit, the supplier can maintain the buyer so that they do not look for other suppliers.

The third stage is the Established/mature Stage. This level is characterized by stabilized sales, no more innovation, and an established organizational bureaucracy (Miller and Friesen, 1984). A firm’s existence is acknowledged by the banks and the firms have an adequate track record upon which banks can easily evaluate their overall feasibility to finance. More importantly, the firms have more tangible assets that can be used as collateral. A bank loan is typically more readily available after a firm has achieved a significant number of tangible assets. Therefore, the SME owners’ begin to enjoy the profit resulting from the firms and retain a small part of the profit within the firms. SME owners do not worry about funding source shortages anymore because they can access funds from banks more easily. However, the capital structure is rebalanced at this stage by gradually increasing internal sources (retained earnings) as suggested by the pecking order theory (Rocca *et al.*, 2011). Petersen and Rajan (1994a) argue that leverage decreases with the age of the firm, as young firms are externally financed especially in the growth and expansion stages, while mature ones mainly used retained earnings and equity. This is because a devoted entrepreneur will remain inclined to re-inject self-generated financial resources into the firm to maintain his or her control. These funds provide further capital and, consequently, the fraction of borrowing from banks declines as the firm matures (Rocca *et al.*, 2011).

The final stage is the declined stage. In this stage, firm's sales drop because the firm cannot compete with external challenges and because of lack of innovation (Miller and Friesen, 1984). The decreasing of a firm's sales reduces the profitability of the firm. Consequently, the firm will experience a lack of cash inflow which causes the firm to fall into an illiquid condition. This condition leads to difficulties in maintaining the operation of the firm without additional fresh capital. Unfortunately, banks will view firms in this condition as a high risk firms and would not be willing to lend. The role of banks will reduce and be replaced by internal sources of funds. The role of bootstrapping increases in this stage as an alternative source of finance. However, only a limited type of bootstrap strategies can be used in this stage, for example, deliberately delaying payment to suppliers may not be permitted because the suppliers face default risk.

From the above discussion, it is clear that firms emphasize the use of different sources of finance to meet resource needs. While informal and formal financial institutions may be used at specific phases of the business, bootstrap financing may be utilized over the life-cycle of the business. However, different bootstrap techniques are employed at different stages of the business. Thus, the bootstrap financing method uses a much wider spectrum of means of meeting the need for resources. It appears that the bootstrapping method is dominant in the early stage of the business, as the firm is yet be trusted by any other source of finance. As time passes and the existence of the business is recognized, external sources of funds, particularly informal financial institutions and small banks, begin to be interested in helping finance firms. In the established stage, banks take a dominant role in fulfilling the capital needs of smaller firms. Figure 4.4 depicts the whole picture of the SME financing life-cycle in which the conceptual framework meets the pecking order theory proposed by Myers (1984).

3.11 Hypothesis Development

3.11.1 Firm Age and Loan Size

Firm age can provide important information for banks in their evaluation of the capability of a firm in managing their operations. Established firms have more experience in different economic circumstances as economic conditions do not remain stable and fluctuate over time. This is referred to as economic conjuncture. Firms which have withstood changing conditions over time have good endurance, and are creative in securing finance to meet their capital needs. Firms which survive over time tend to be more successful in securing finance from lenders as they become more acceptable to the lenders which enables them to increase debt in their capital structure (Peterson and Schulman, 1987; Hamilton and Fox, 1998)). On the other hand, as a firm becomes older and less informationally opaque, it becomes more attractive to lenders (Berger and Udell, 1998b). That is why the leverage of a firm increases over the life-cycle of the firm. Start-up firms on the other hand may have more difficulty in obtaining external financing (Teixeira, 2006). Furthermore, banks can obtain more information from the track record of an older firm.

Empirical results show that firm age has a positive impact on bank loans. For example, Arslan and Umutlu (2009) conducted research in Turkey and found that the age of a firm has a positive and significant impact on access to bank loans. Similarly, Vos et., al (2007) found a positive relationship between firm age and access to external capital. This means that as SMEs grow in size and age, they have better access to external sources of capital because older SMEs have better track records which in turn reduces informational opacity. In addition, older firms have much more experience than newer ones. The study by Okurut et al., (2011) suggests that the longevity of SMEs reduces their likelihood of being credit rationed by banks. The same analysis can be applied to Islamic banks, as age information asymmetry is minimized and small firms are able to secure higher loan amounts from Islamic banks. Based on the discussion above, I propose hypothesis 1 as follows:

H1: Firm age has a positive impact on loan size.

3.11.2 Number of Workers and Loan Size

It is suggested that the number of workers in a firm can be used to classify firm size (Rudjito, 2003). The larger the number of workers the bigger the firm, but this classification does not work in all cases. In western economies, firms may have small numbers of employees but their turnover and profit may be much larger than a firm in a developing country. The total output of the firm is the result of the total productivity of every worker in the firm. From this it may be inferred that the larger the number of workers in the firm the higher the total output which leads to an increase in cash-flow, though this proposition may not hold in all cases. The higher the cash-flow generated, the greater the capacity of the firm to repay loans. According to Berger and Udell (1998b), the larger the firm the more attractive the firm is to outsiders who may extend loans.

This is demonstrated by the empirical study by Kutsuna and Cowling (2003) in Japan which shows that there is positive relationship between loan approval and the workforce size of small businesses. Similarly, research by Leung et al., (2008) suggests that firms with more employees tend to have a higher incidence of debt. Thus, it is expected that the Islamic bank will extend financing to firms which possess more employees. Therefore, hypothesis 2 is proposed below:

H2: The number of workers in a firm has a positive impact on loan size.

3.11.3 The Value of a Firm’s Assets and Loan Size

The second measurement of firm size frequently used is the value of total assets. Hence, the value of assets indicates how large the firm is. Generally, assets can be classified into two forms; tangible assets and intangible assets. Assets considered in this case are tangible assets, which include current assets and fixed assets. These types of assets are used to produce output in the firm. Since value of assets indicates the size of a firm, then the firm with larger assets will attract outsider investors, including banks (Berger and Udell, 1998b). Besides that, assets can serve as collateral in debt and mitigate adverse selection and moral hazard behaviour

(Teixeira, 2006). Thus, the higher the assets of a firm the safer it is for the bank in terms of confiscating assets when credit is in default.

Empirical evidence shows that the size of a business, which may be measured by a firm's assets, influences loan approval. Agyapong (2011) found that the size of a loan relative to the size of a business ranked highest in the criteria of accepting SME loan applications. Similarly, Fatoki and Odeyemi (2010) conclude that business size is a significant determinant in credit approval. Hence, it is expected that the higher the assets of a firm, the higher the loan size obtained from an Islamic bank. Thus, I propose hypothesis 3 as follows:

H3: The value of the assets of a firm has a positive impact on loan size.

3.11.4 Sales Growth and Loan Size

The prospect of a firm is important for lenders when deciding to provide loans. A firm with good prospects will have better cash-flow which enables it to make higher repayments. This prospect can be viewed from sales growth. If the sales growth of the firm has a positive trend, this suggests that the firm has good prospects and vice versa. The sales of the firm are a real cash-flow, particularly if the sales are in cash. The sales growth means the firm is growing and needs more capital to increase production. It is acknowledged that capital requirements are different at different stages of a firm's growth as observed by Timmons (2006). For example, small and young firms may draw capital from internal sources, such as family and friends. As the successful firm grows, the firm needs more capital to finance growth, and typically needs at some point to turn to external sources such as banks and the public debt and equity markets (Coleman and Cohn, 1999).

The growing sale of the firm presents a good opportunity for IBs to be involved in financing. The higher a firm's sales, the higher the income and profit of the firm, which in turn improves the capacity of the firm to make repayments. Agbozo and Yeboah (2012) found that the availability of external financing depends on a firm's sales. Ung and Hay (2011) found that firms with high sales are highly likely to obtain external finance. Therefore, it is expected that Islamic banks will deliver more financing to firm's with higher sales growth. Thus, I propose hypothesis 4 below:

H4: Sales growth has a positive impact on loan size.

3.11.5 Profitability of a Firm and Loan Size

Profitability is the real power of firm in generating 'free cash-flow'. Free cash-flow can be used to increase the working capital of the firm. From the banks point of view, firms with high profitability have a high capacity to repay their loan. As indicated by the results of the study by Oladeebo and Oladeebo (2008), profitability has a positive relationship to loan repayment. These authors also found interdependence between profitability and bank loans. Furthermore, they explain that bank loans are positively related to a firm's profitability and that the profit of an SME tends to increase with increasing loans amounts. This is because borrowers who are able to make substantial profit are expected to have a higher capacity to repay (Wongnaa and Awunyo-Vitor, 2013).

Furthermore, more profitable firms are able to borrow on better terms (Strahan and Function, 1999). This relationship is in line with simple economic theory which suggests that access to credit should lead to higher profits (Olutunla and Obamuyi, 2008). This is further confirmed by the work of McMahon et al. (1993) which suggests that the financing decision impacts upon the profitability of an enterprise, and that of Keasey and Watson (1991) which argues that the use of bank financing by SMEs is associated with higher business performance. Thus, banks are willing to lend money to the high profitability firm because banks can be sure that those firms have a high capacity to repay their loan. Consequently, high profitability firms have high leverage (Coleman and Cohn, 1999).

In contrast, according to pecking order theory, the firm, especially SMEs with higher profitability, will avoid obtaining loans from the bank. Firms will primarily use internal sources of funding, followed by debt and finally equity to meet their capital needs (Myers and Majluf, 1984). This implies that profitable firms will retain earnings and use less leverage than less profitable firms. Therefore, it is proposed that the higher the profitability of the firm will reduce the loan size which leads to the following hypothesis:

H5: Profitability influences loan size.

3.11.6 Credit Maturity and Loan Size

The maturity of a loan can also affect the likelihood of default (Jimenez and Saurina, 2002). The longer the maturity, *ceteris paribus*, the greater the risk of the borrower encountering problems (Jackson and Perraudin, 1999). Therefore, the maturity of financing can be important for banks when evaluating loans for borrowers because the longer the term of the loan, the higher the uncertainty faced by banks. However, banks may suggest that prospective borrowers extend the maturity to reduce the burden of instalments which in turn brings down the probability of default. Firms can even refinance and extend the maturity of loans during normal times to reduce the burden before these loans become due (Mian and Santos, 2011). Glennon and Nigro (2005) investigate the performance and default history of a sample of Small Business Administration (SBA) guaranteed loans with varying times to maturity. They found that long-term loans to firms in the agriculture, fishery, and forestry industries are much less likely to default.

Lengthening the loan maturity is more suitable for SMEs normally characterized by lack of capital. In this regard, SMEs are viewed as a weak firm in finance. In contrast, only firms with greater flexibility and strong financial strength can use proportionately shorter term loans (Jun and Jen, 2003). From the SMEs perspective, the shorter the term of financing the higher the burden of repayment which places greater financial distress on the firm in the short run. SMEs prefer loans for longer periods as this reduces the financial burden and default risk. Hence, it is expected that the longer the maturity of financing the higher the loan size.

H6: The maturity of financing has a positive impact on loan size.

3.11.7 The Duration of the Bank-Client Relationship

Asymmetric information is a major problem in many SMEs as reported in studies for the UK and other countries. Information asymmetry is more severe amongst SMEs which is the major reason for the reluctance of banks in providing loans for SMEs. There is considerable literature on this that suggests overcoming information asymmetry improves the chances of SMEs securing loans and improves relationships between small firms and banks over the long-term (Berger and Udell, 1994; Berger and Udell, 2002; Petersen and Rajan, 1994b; Repetto et al., 2002). A large numbers of SMEs do not have the skills or knowledge to provide financial statements or information in the format expected by banks and with which banks evaluate loan applications. As a result, banks cannot rely on this ‘hard information’ to evaluate the viability of the firm.

Instead, Islamic banks should rely on soft information by forming close and long relationships with SME owners. Obtaining soft information from SMEs through engaging over the long period with them, enables Islamic banks to evaluate the viability of the firm. On the other hand, SMEs should endeavour to develop good relationships with banks in order to get credit from banks easily. As Haron et.al., (2013) found, a good relationship with the bank has a significant effect on the likelihood of loan approval. In addition, the longer the relationship the easier it is for Islamic banks to determine the characteristics of the SME client. Therefore, Islamic banks can obtain the proper information related to the soundness of the project of an SME which leads to providing a better service for SMEs. Thus, I propose hypothesis 7 as follows:

H7: The duration of the bank and client relationship has a positive impact on bank services.

3.11.8 The Financing Gap in Indonesia

A financing gap for SMEs exists when there is a significant number of SMEs that could use additional funds productively if the funds were available, but they are unable to obtain adequate finances from the formal financial system to meet their financial needs (OECD, 2006c). The financing gap occurs in all countries. In an emerging market, the finance gap is more severe because of poor financial infrastructure. In the developed market, although there is a better financial infrastructure, the finance gap still exists, particularly for SMEs in the high technology sector, known as Innovative-SMEs (ISME) (OECD, 2006d). Berger and Udell (2006) argue that differences in the financial institutional structure and lending infrastructure that exist in each country may influence the availability of funds to SMEs. The financial infrastructure includes the information environment, the legal, judicial, and bankruptcy environments, the social environment, and the tax and regulatory environments in which financial institutions operate. The lending infrastructure covers the rules and conditions set up mostly by governments that affect financial institutions and their abilities to lend to different potential borrowers. The elements of the lending infrastructure may influence the credit available for SMEs by affecting the extent to which different lending technologies are employed. Weak financial institutional structures and lending infrastructures in many emerging markets may diminish the availability of funds for SMEs, Indonesia is no exception. This leads to the condition called the financing gap, particularly for SMEs. Therefore, I propose hypothesis 8 below:

H8: There is a SME financing gap in Indonesia.

All the above hypotheses will be tested and analysed based on the quantitative data collected through questionnaires. Furthermore, this finding will be corroborated with qualitative analysis based on interviews with relevant respondents.

3.12 Conclusion

A number of observations can be made from the literature review discussed in Chapters Two and Three. While there are many studies which have examined Islamic banks, these studies mostly describe the advantages of Islamic banks from a theoretical point of view and tend to be descriptive. There are several studies (see for examples: Alam *et al.*, 2011; Salman and Zeitun, 2005; Mouawad, 2009; Al-Tamimi *et al.*, 2009) which have explored the growth of IBs, both in Muslim and non-Muslim countries. Although Indonesia has the largest Muslim population in the world, it is not an Islamic country as Indonesia is not governed according to *shariah* law. Despite being the country with the largest Muslim popular, the growth of IBs in Indonesia lags behind that of Malaysia, even though the two countries have similar cultures and demographies. Therefore, there is a need to investigate why there is varying level of penetration of Islamic banks in Indonesia compared to Malaysia.

Secondly, there are a number of studies that have examined access to finance for SMEs in developed and developing economies (see for examples: Beck and Kunt, 2006; Beck, 2007; Valverde *et al.*, 2005; Berger and Udell, 2006; McPherson and Rous, 2010; Deakins and Hussain, 1993). Most of the academic research has been focused on SMEs and their relationships with conventional banks, yet their interactions with IBs and the roles of or participation in IBs has not been examined. There appears, therefore, to be a gap in the literature that examines IBs and their relationships with SMEs. As such, there is a need to investigate the access to finance for SMEs from Islamic banks. This study examines whether there exists a financing gap for SMEs which wish to use IBs rather than conventional banks.

Thirdly, asymmetric information between SMEs and IBs raises problems for banks when making lending decisions for SMEs. Existing studies in the West report that some bank officers establish close and long relationships with SME owners which enable them to obtain soft information to overcome the problem of asymmetric information (Scott, 2006; Uchida *et al.*, 2006a). Other bank officers impose strict covenants to overcome asymmetric information (Apilado and Millington, 1992) or ask for collateral (Jimenez and Saurina, 2004) to mitigate the anticipated default risk. Evidence also suggests that banks charge higher interest rates (Cowling and Westhead, 1996) to compensate for the default risk. Review of past studies suggests that each bank has its own policy to overcome the problem of asymmetric information but there is general convergence of view that both IBs and conventional banks use collateral to overcome information asymmetry. Review of the literature suggests that there is a gap in research examining the experience of Islamic banks in making lending decisions for SMEs and on how issues of information asymmetry and relationship lending are managed, a gap this study attempts to fulfil.

CHAPTER 4
RESEARCH METHODOLOGY

4.1 Introduction

Chapter 4 provides an overview of the research methodology discusses the philosophy and rationale behind the methods chosen and considers the approaches adapted for this study. Here, the relevance of the case studies, the survey, and the rationale of the phenomenological analysis, the research instruments, the sample selection, and the data collection methods are examined in depth. Issues related to ethics and confidentiality is also deliberated.

4.2 Research Philosophy

This study was undertaken with the determination to establish a methodology that brings the researcher closer to the truth. Therefore, in social science, the research philosophy as well as methods adopted is critical in investigating the complex and multi-dimensional perspectives. It is essential, therefore, to look at the philosophical foundation which will guide the research process before choosing the appropriate research method or research design. The philosophical foundation about the nature of reality is a very important element in developing an understanding of the overall perspective from which a study is designed and carried out (Krauss, 2005). The philosophical foundations associated with ontology, epistemology, and methodology must be considered when carrying out research. Ontology refers to the theory of existence or the philosophy of reality (Krauss, 2005). Epistemology is the general set of assumptions about the best way of inquiring into the nature of the world (Easterby-Smith *et al.*, 2002). Examination of fundamental philosophical issues helps a researcher to clarify philosophical values in finding “reality” in the research design stage. Specifically, a philosophical review will assist a researcher to comprehend the interrelationships which exist between ontological, epistemological and methodological levels in the financial study of SMEs.

The philosophy of research methodology follows two paradigms; positivist and interpretive approaches. A positivist approach examines reality through the study of an object that is context free (Collins and Hussy, 2009). In this context, positivists discover and verify knowledge through direct observation and measurement of phenomenon (Ryan, 2006). The opposite is an interpretive paradigm which assumes that the observer is a part of what is being observed (Easterby-Smith *et al.*, 2002). In this context, knowledge is determined by the past experiences of researchers and its meaning is articulated to what they are studying. Since the interaction between financing provider and SME owners may have an effect on their respective behaviours and attitudes, this relationship must be investigated and interpreted to describe the experience of both the monetary provider and SME owners.

4.2.1 Positivism

Positivism is an ontological position which affirms that social phenomena and their meanings have an existence that is independent of social researchers (Bryman and Bell, 2003). This implies that social phenomena and the categories we use in everyday discourse have an existence that is independent or separate from researchers. According to a positivist paradigm, an investigation about reality acknowledges that only measurable and quantifiable results can inform the truth about reality. Therefore, knowledge should be derived from human observation of reality through the use of the human senses to collect measurable and objective data (Crossan, 2003). In the context of this study, the researcher examines the relationship between Islamic banks and SMEs (and does not directly interact with them). The researcher observes the financing experiences of SMEs to reveal a relationship between Islamic banks and SME owners. This is because researchers should be relinquished from the subject studied to avoid their subjective views when collecting the data (Easterby-Smith *et al.*, 2002). Furthermore, they may apply software to help them analyse the complicated structural equation model. However, the influence of the environment on reality is highly undesirable due to the positivist view that reality exists in its purest format. Therefore, positivism is difficult to apply in the study of Islamic banks and SME financing since it involves human relationships that may have significant influence on the outcome.

In the ontology paradigm of positivism reality is single and objective, (wholly) independent from the researchers (Lincoln and Guba, 1985). Epistemologically, the positivism paradigm views that knowledge about the social phenomenon is derived from observation and experiment like in natural science. The researcher is independent of the phenomenon being investigated (Denscombe, 2010). In this paradigm, the methodology to comprehend social phenomena adopts a deductive approach. The deductive research method starts with the development of a conceptual and theoretical structure, then the hypothesis is tested based on the empirical observation using quantitative approach (Pathirage *et al.*, 2008; Gill and Johnson, 2002). The deductive approach helps to find causal relationships (Saunders *et al.*, 2007).

4.2.2 Interpretivism

In the view of interpretivism reality is not objective and exterior, but is socially constructed and given meaning by people (Easterby-Smith *et al.*, 2002). In more concrete terms, reality is formed by the role of an actor as the agent of knowledge creation (Mingers, 2001). This implies that knowledge of the world is derived from a person's actual life experience. Thus, person or researcher and reality are inseparable (Weber, 2004). In this case, it can be inferred that the relationship that emerges when an actor comes into contact with the world is constructed in an effective way rather than given by nature (Andrade, 2009). Silverman (2005) explains that using an interpretative approach in research may help in the quest to explore (effectively) the complex relationship of those (people) who participated in the research. However, it must be acknowledged that the research result of the interpretive approach cannot be generalized.

Ontologically, the form and nature of the interpretivism paradigm is that realities are multiple and holistic (Lincoln and Guba, 1985). Whereas, epistemologically, this paradigm argues that knowledge about social phenomenon can be acquired through a number of methods to explore realities (Collins and Hussey, 2009). In this case, the researcher and the research are inseparable (Lincoln and Guba, 1985). The methodology to comprehend phenomena uses an inductive approach where the qualitative data is collected to gain an in-depth knowledge with a small sample. The end product of this induction is theory formulation (Saunders *et al.*, 2007).

4.2.3 Pragmatism

The philosophical paradigm of pragmatism has many forms, but pragmatism emerges from existing actions, situations, and consequences rather than previous conditions (Creswell, 2012). Instead of focusing on methods, pragmatism researchers emphasize problem solving and use all existing approaches to comprehend the problem (Rossman and S.F., 1985). Researchers should be ‘free’ to mix methods from different paradigms, adopting them on the basis of usefulness to answer the research questions. Pragmatism suggests that the weaknesses of one paradigm can be offset with the strengths of another, and therefore the philosophical debate about reality and the nature of knowledge should be ignored (Collins and Hussey, 2009). Therefore, pragmatism can be used as a mixed method research approach in which researchers may freely employ the assumptions of both quantitative and qualitative methods. By combining different research methods, preferably from different (existing) paradigms, the research results will be richer and more reliable (Mingers, 2001).

4.2.4 Research Philosophy of This Study and The Rational of Using Mixed Method

The ontology of this research is that the social phenomena dealing with Islamic banks and SMEs’ access to external funds is a single fact. However, the social and cultural context allows people to have their own beliefs; a single fact has many realities. The researcher opines that society is objective and tangible however the people playing various roles in the society are subjective. Therefore, this study recognizes the importance of the subjective reality of the individual within the real and objective social world (Gill and Johnson, 2002; Saunders *et al.*, 2007).

The issue of Islamic banks and the role they play in delivering loans to SMEs can be explored through (not only) measuring the hard facts, but also through understanding the role of the actors, their subjective interpretations, and the cultural beliefs that shape the meanings of these hard realities. Therefore, it is imperative to not only focus on the system and institutions of Islamic banks but also on the effect of socio-cultural factors on Islamic banks and the relationship between IBs and SMEs. To fully comprehend the complexity of reality, the researcher is positioned in the middle of the two paradigms of positivism and interpretivism. In other words, this study applies a pragmatism paradigm to explore the complex reality of the process of Islamic bank financing for SMEs. Therefore, it is necessary to employ a triangulation method or mixed method to explore the process and the factors which affect the relationship between Islamic banks and SME owners. The choice of mixed method in this research is based on several reasons. Firstly, to investigate the issues of the development of Islamic banking in Indonesia compared to that of Malaysia requires quantitative data from Islamic banks from both countries which in turn will require a quantitative method of analysis. Secondly, the low penetration of Islamic banks in Indonesia cannot be separated from Indonesian government policy, the experience of Islamic bank in making decision for financing, and the understanding of customers of Islamic banks. In this case, a qualitative approach is appropriate. Thirdly, the weaknesses of a quantitative approach will be corroborated with the strengths of the qualitative approach and vice versa.

This study employs both quantitative and qualitative approaches to ascertain specific data. The quantitative approach will be used to find facts on issues related to the relationship between Islamic banks and SME owners. Whereas a qualitative approach is used to further investigate the hidden realities. Triangulation or the combination of quantitative and qualitative approaches will be used to corroborate the information obtained.

4.3 Research Design

Creswell (2009) and Kumar (1999) suggest that research methods enable researchers to have a strategy for data collection and analysis, and assist them to adapt a systematic approach to address the emerging challenges related to the study. Furthermore, Yin (1994, p. 18) suggests research design serves as a blueprint that outlines the overall research program and provides guidance for collecting, analysing, and interpreting observations.

The appropriateness of research design and its implementation is important to gaining an accurate and objective view of the key issues of any research. There are a number of research designs for varied fields of research that can be used by researchers in accordance with the research aims and objectives. Bryman (2004) proposed five types of research design; experimental design, cross-sectional design, longitudinal design, case-study design, and comparative design.

Experimental design allows the researcher to examine the impact of one independent variable on another dependent variable provided that all other variables that might affect the relationship between two variables are kept neutral. This is done by separating the experimental subject to one of two or more experimental groups, each of which represents different types or levels of the independent variable. However, in the social sciences there are many complications where direct observation or data is not accessible, and proxy variables are often used. This approach requires a manipulation of data to infer meaningful results. However, the vast majority of independent variables with which a social researcher is concerned cannot be manipulated.

In contrast, using a cross-sectional design it is not possible to manipulate the object of research by intervening in the situation. Cross-sectional research considers static data by using observation that is taken one snapshot at a time. Cross-sectional research is characterized by a number of elements such as more than one case, at a single point of time. It is either used with quantitative or qualitative data or it can be used to observe and draw out the pattern of association. Cross-sectional study is widely used in social research especially with research which involves a large number of samples and observation of variation within a sample. The approach is useful in dealing with the real world, where variation exists between people, families, organizations or events. Such an approach is often employed in case studies where variations are observed.

To observe changes over a longer time, longitudinal research design is often considered the most useful approach. Longitudinal design is often expensive and time consuming as the sample is surveyed repeatedly on more than one occasion. It requires repeated surveys and research using a self-completion questionnaire, or fully-structured interviews, within a cross-section. Longitudinal research represents cross-sectional survey, which is conducted over time. Hence, in terms of validity and reliability, the longitudinal study is costly and time consuming. This method is often used in sociology, social policy, and human geography research.

A case study approach is adapted here to gain in-depth understanding of the issues not captured through the interviews or questionnaire. Case study design involves investigation of in-depth issues which only emerge in a specific context and which require the provision of an overview of the organisation or persons experiences.

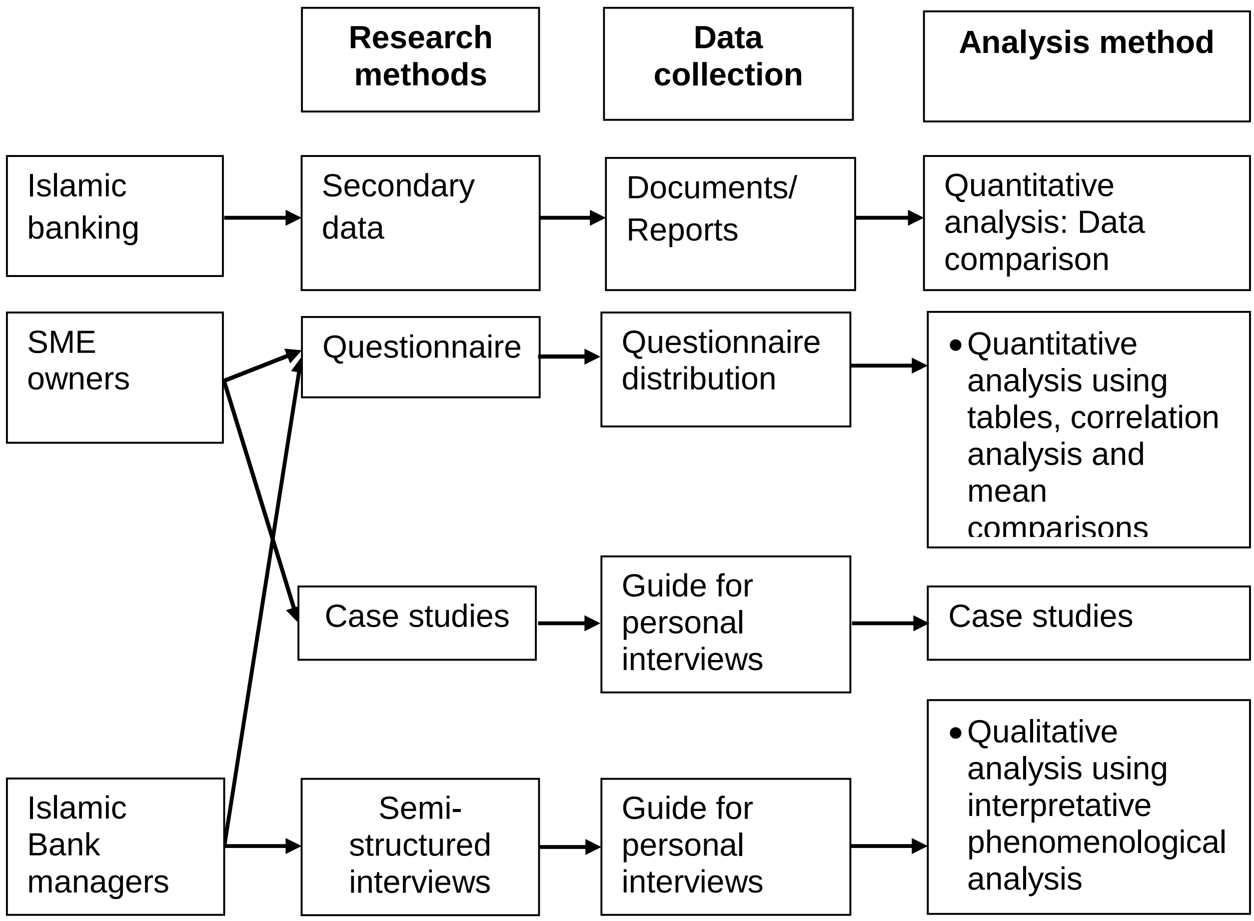
Moreover, to cope with complex research questions, one particular research design may not be appropriate. Thus, considering the dynamics of a changing environment or situation, a mixture of approaches is considered. In this kind of environment, comparative research design enables researchers to observe changes. The other perspective, identical methods, might be used in different contrasting cases. This enables researchers to comprehend social phenomena when they are comparing two or more different meaningful situations. The comparative research design can be used in quantitative or qualitative research. However, akin to cross-sectional design, the limitations of this approach are the issues of validity, reliability and generalizability.

Among those choices of design, cross-sectional is considered the most appropriate approach to this research for a number of reasons. The aim of this study is to investigate lending practices, policies and access to bank (Islamic and conventional) financing for SMEs. The feature of SME financing is that it usually involves a short term lending period, as the finance is commonly used for working capital purposes. Hence, cross-sectional design can be suitably applied this type of financing scheme. It enables the researcher to examine the prevalence of a phenomena, situation, or problem to obtain the overall ‘picture’ of a particular time of study (Kumar, 1999).

In regard to the robustness of the methods for this research, a previous study conducted by (Deakins and Hussain, 1994a) pointed out that the questionnaire and case study approach are considered appropriate to examine access to finance for SMEs. The central feature of this study is to gather detailed data (not available from a database) related to SMEs and banks. Hence, in the sense that it is primary data, it requires in-depth interviews through which to examine the experiences of SME owners in accessing finance from Islamic banks. Furthermore, in order to arrive at the objective of this research, the framework for the overall research process and design will be discussed further later and is illustrated in figure 4.2.

The adopted framework covers the design, strategy and methodology to observe both data from the demand and supply side of information. Hitherto, the detailed method of analysis of this research will be discussed in further sections.

Figure 4. 2 Research Design Strategy and Methodology



The method of research is those techniques adopted by researcher in the study. In choosing the appropriate method many factors should be considered, such as the nature of the research objective, the required information and the data population being observed. Puch (2005) suggests that the researcher should choose the appropriate method corresponding to the research type, field and issue being examined. Therefore, the choice of research method is a consequence of the research objective.

There are two types of method that can be adopted in undertaking empirical research, namely qualitative and quantitative methods. Each has its distinctive advantages and disadvantages. No method of research, qualitative or quantitative, is intrinsically superior. Thus, in choosing a method, everything is dependent on the research objective (Silverman, 2005). In the quantitative approach, the researcher is required to utilize standardized instruments. Thus, the different experiences and varying perspectives of respondents fit into a limited number of pre-determined response categories. Hence, the result of the research does not give specific and detailed information, but general features of issues. In contrast, the qualitative method enables the researcher to obtain more detailed information on the selected issues, yet lacks generalization. The possibility to measure the reaction of many respondents in a limited set of questions is one of the advantages of the quantitative method which in turn facilitates comparison. Conversely, the qualitative method provides detailed information about a lesser number of people.

This research combines both qualitative and quantitative methods to cope with the disadvantages of each method and to strengthen the validity of the results. The combination of these methods is termed mixed method or triangulation. Creswell (2009) proposes several types of mixed methods in terms of collecting data; sequential explanatory, sequential transformative, concurrent triangulation, concurrent embedded, and concurrent transformative strategy. Meanwhile, Bryman (1988; 2004) has described three ways to combine quantitative and qualitative methods, namely; a) qualitative research facilitates quantitative research, b) quantitative research facilitates qualitative research, and c) both approaches given equal emphasis in order to produce a general picture.

Drawing on Creswell's (2009) classification, this research uses a concurrent triangulation strategy in which the data is collected. In other words, this study adopts Bryman's notion in which 'both approaches given equal emphasis' in order to produce a general picture (Bryman, 2004). Furthermore, this study uses separate qualitative and quantitative methods as a means of off-setting the inherent weaknesses of each method and to strengthen one and another. The purpose of the quantitative method is to depict the pattern and trend of the perception of SME owners about the practices of Islamic banks. Meanwhile, qualitative methods are used to corroborate the findings of the quantitative method. The mixing of the research methods will be reflected in the interpretation section which compares the results of both methods (Creswell, 2009).

The quantitative data is analysed using tables, correlation analysis and by comparing means. With regard to qualitative data from the case study, it is presented to analyse the experience of SMEs owners in accessing funds from Islamic banks. On the other hand, Interpretative Phenomenological Analysis (IPA) is employed to analyse the interviews with managers of Islamic banks regarding their experiences in making lending decisions for SMEs. In the first place, the quantitative data will be analyzed and will be then followed by the interpretation of the qualitative data which may support or refute the quantitative results.

4.3.1 Justification of the Triangulation Approach

Methodological triangulation approaches are also called multi-method or mixed-method, and combine the use of both qualitative and quantitative methods to investigate phenomena (Bryman and Bell, 2003). The reason for using a triangulation method is to increase the researcher's capacity to interpret and examine the validity of the findings. This is because the triangulation method may reduce the bias, enhance the trustworthiness of the analysis, and overcome the weaknesses of one method through the strength of another (Gorard and Taylor, 2004; Thurmond, 2001). Furthermore, triangulation is not only used to validate the results, but also to deepen and broaden one's understanding (Olsen, 2004).

Many studies have used quantitative methods (Danost *et al.*, 1989; Rosly and Bakar, 2003b; Hudayati and Auzair, 2009; Dusuki, 2008b; Dusuki and Abdullah, 2007a) or qualitative methods (Dusuki, 2008a) in examining finance to SMEs. Most researches, however, used only one method rather than combining methods. The consideration of using a research method depends on the scope of research issues and the objectives. In some research the quantitative method may be more suitable whilst in other research the qualitative method may be more appropriate. In some cases, both may be applied in combination.

The limitations of the quantitative approach has always been taken as a starting point from which to support the use of a qualitative research approach (Flick, 2006).

This does not mean that the qualitative method is better than its counterpart. A qualitative approach may sometimes be more appropriate to certain research problems. Similarly, the quantitative method may be more suitable to others. Therefore, a research method should be chosen according to what is most appropriate to what the actual research will expose (Silverman, 2005).

The use of the triangulation method in financial institution research has been employed in the previous studies (Hamid, 2000; Sandhu, 2007; Abdul-Karim, 2010; Ismail, 2010). Hamid (2000) investigated the role of an Islamic bank in the development of small businesses in Bangladesh. He used a field survey to investigate the experience of small business owners in accessing Islamic Bank Bangladesh Limited (IBBL) through two kinds of scheme provided, namely the *Rural Development Scheme* (RDS) and *Small Business Investment Scheme* (SBIS).

In his study, quantitative data was used to examine the preferences of clients in terms of whether or not they want to shift from Grameen Bank (GB, a commercial bank) to Islamic banks. It also investigated the possibility of the shift from 'other' (clients other than IBBL and GB) to either IBBL or GB. Furthermore, qualitative inquiry, through interviews, was conducted and used to highlight the reasons why they did or did not want to move to another type of bank.

Sandhu (2007) uses the triangulation method to investigate the lending policies of financial institutions towards agribusiness in the Punjab, India. The data were gathered using a combination of instruments such as semi-structured interviews, questionnaires, focus groups, and case studies of one hundred farmers and fifty bank managers. Case study was used to investigate four different types of farmers which were classified into marginal, small, medium and large farmers. The case study was used to illuminate each of those classifications in terms of background in terms of economic condition, land holdings, the development of the business and his or her experience. Semi-structured interviews and questionnaires were used to examine the lending practices of banks for farmers, the bank perceptions of farmers, farmers' perceptions of bank managers and factors affecting lending decisions.

Karim (2010) employed the triangulation method to address four main areas concerning Islamic funds, namely; analysing the return and risk characteristics;

examining performance trends, investigating the impact of *Shariah*-compliance requirements, and exploring the actual Islamic fund operation of fund management companies through the perceptions of those involved. The quantitative method was used to determine the salient features between return and risk characteristics of Islamic funds and conventional funds and examine the performance of the former relative to the latter. In addition, the qualitative method was undertaken to gain in-depth insight into the handling of Islamic funds by fund management companies and valuation of the performance of Islamic funding. The qualitative analysis employed semi-structured, face-to-face interviews with Islamic fund/investment managers.

Ismail (2010) used the triangulation method to investigate the management of liquidity risk in Islamic banks. The quantitative method was used to analyse two different types of data; financial data and questionnaire data. The financial data was analysed using time series, while the primary data from the questionnaire was analysed using descriptive statistics and correlations to examine the liquidity risk and its management for Islamic banking. The perceptions of Islamic banking depositors and Islamic bankers were investigated using a qualitative method based on the primary data to shed further light on liquidity risk issues, which were not captured in the time-series analysis.

The research using triangulation discussed above suggests that this method may produce results that are more comprehensive. Indeed, the combining of two different methods (quantitative vs qualitative) leads to debate because both have a different underlying ontology and epistemology. In the *epistemological* perspective, their paradigm argument sees quantitative and qualitative research as grounded in incompatible epistemological principles, which leads to different ontological arguments and methods. According to this perspective on their nature, multi-strategies research is not possible (Bryman, 2004).

Conversely, many authors (e.g. Creswell, 2009; Gorard and Taylor, 2004; Olsen, 2004; Thurmond, 2001) encourage the application of the triangulation method because of its benefits. Furthermore, from the *technical* point of view, both quantitative and qualitative methods are able to be used in combination. In the *technical* perspective, which is the position taken by most researchers, it gives greater prominence to the strength of the data-collection and data-analysis techniques with which quantitative and qualitative research are each associated, and sees these as capable of being fused. There is a recognition that quantitative and qualitative research are each connected with distinctive epistemology and through ontological assumptions but that the connections are not viewed as fixed and ineluctable (Bryman, 2004).

Based on the justification of the triangulation discussed above, this study uses a mixed method in which qualitative and quantitative data provides the base which enables us to examine the pattern and choice of finance preferred and explores the lending policy of Islamic banks. Data collected based on the mixed method approach is used to investigate the finance gap for SMEs in Indonesia, particularly in Central Java, to review financial provisions, investigate lending policy, and evaluate the criteria used by IBs in making financial decisions. A similar survey of SME owners is employed to complement the analysis which considers educational qualification, number of employed, type of business, total assets, and annual sales of SMEs. The relationship between SME owners and Islamic banks will be explored to further understand their perceptions. In addition, interviews with small business owners are undertaken to confirm the findings of the quantitative analysis. Finally, semi-structured interviews with IB managers enable useful comparison with the findings from small business owners, so that the result may be corroborated from a different point of view.

The choice of triangulation in this study is based on several considerations. Firstly, research on Islamic banking practice is still limited, so that the use of only one method will only produce a limited feature or issues. Secondly, the system and operation of Islamic banks is very different from that of conventional banks, so after we know the pattern obtained from the quantitative data, we can gain a more comprehensive understanding of the perceptions of Islamic bank customers related to their access to Islamic banks. Finally, it enables us to compare the findings both from the quantitative and qualitative sets of data.

The questionnaire distributed to SME owners will result in quantitative data in numeric form. This type of data cannot reveal the variety of or details on information about issues. Therefore, interviews are employed to discover the detailed and varied responses of the interviewees concerning the policies and processes of Islamic bank lending. The use of a combination of research methods is expected to produce more valid results.

4.3.2 The Constraints of Triangulation

Some arguments support the use of combining both quantitative and qualitative as addressed above; it is by no means that triangulation is unproblematic in practice. Some constraints may emerge when performing triangulation because it is akin to carrying out two sets of research. The principle constraint of conducting triangulation is basically dependent on the funding context, the adequacy of financial resources and the skills of the researchers. In addition, time is also considered a constraint, as the study is limited by the length of the scholarship period. Insufficient funding is a vital constraint in this study since the scholarship does not cover the costs of the research. The researcher did not find beneficiaries willing to fund this research. Nevertheless, the researcher regards that the triangulation approach is the best methodological approach to be employed for this type of research.

4.3.3 Relevance of Case Study

A case study is an empirical inquiry that investigates a contemporary phenomenon within its real-life context, especially when the boundaries between phenomena and context are not clearly evident (Yin, 1994, p.13). The basic idea of the case study is that one case will be studied in detail which may help to develop a deep understanding of certain cases (Punch, 2005). This approach has been used to investigate behaviour, and choice of individual or organization.

Despite being widely used, criticisms may emerge when using case studies in research. A common criticism of the case study approach is the matter of generalization. How can the result of the case study be generalized from a single case? Yin (1994) argues that case studies are generalizable to theoretical propositions rather than populations.

The case study method enables researchers to retain the holistic and meaningful characteristics of real life events – such as relations between individuals, and between individuals and institutions. The use of a case study approach is regarded as an appropriate method to gain a deeper understanding of the relationship between SMEs and Islamic banks. It allows the researcher to obtain information on soft issues related to the varied experiences of SME owners in accessing funds from Islamic banks, including on Islamic bank policy, procedure, and constraints that may hamper them in getting funds.

4.3.4 Relevance of Survey

The survey is a widely used research technique for collecting data. Bryman (1989) defines survey research as 'the collection of data on a number of units and usually at a single juncture in time, with a view to collecting systematically a body of quantifiable data in respect of a number of variables which are then examined to discern patterns of association' (p.104). Most surveys involve the use of a questionnaire that can be administered through self-completion and face-to-face interview.

The investigation and analysis of Islamic bank financing policies requires data, which involves financial information, such as denied/granted financing requests, terms such as the amount, profit ratio, collateral, among others. It also deals with the type of financing (*mudarabah*, *musharakah, murabahah, ijara, istisna* and others), borrower characteristics (size of the project, types of business), and financial data (ownership, number of assets, source of funds and others). Such information could not be obtained from the existing sources, but could be achieved directly from the financiers and their clients. In order to extract this information, the method adopted was to question SME owners and Islamic bank managers about their financial policies, which would involve lenders revealing the criteria used in their decision making process.

4.3.5 Rational of Interpretative Phenomenological Analysis (IPA)

Smith et al., (2009) loosely define Interpretative phenomenological analysis (IPA) as 'a qualitative approach committed to the examination of how people make sense of their major life experience' (p.1). IPA is a recently developed and rapidly growing analytic approaches used in qualitative research.

IPA is influenced by phenomenology, hermeneutics and ideography (Smith et al., 2009). As a method of analysis, it is concerned with describing a personal experience of a particular phenomenon. In addition, it seeks to explore in detail how participants make sense of their personal and social worlds. In other words, it aims to explore individual perceptions or accounts of an event rather than attempting to produce an objective record of the events (Smith and Osborn, 2007a).

Smith and Osborn (2007a) further explain that making sense of participant perspectives is dependent on the researcher's own conception through a process of interpretative activity. They called this a two-stage interpretation process. The participants try to make sense of their world while the researcher tries to make sense of the participant trying to make sense of their world.

IPA research is gaining popularity in social, health and clinical psychology research (e.g.: Smith and Osborn, 2007b; Fade, 2004; Westland and Shinebourne, 2009; Cope, 2010). Fitzgerald and Howe-Walsh (2008) employed IPA to examine the experiences of a self-initiated professional female expatriates. The study was conducted on Cayman Island, an overseas territory of the United Kingdom and attempted to better understand what influences self-initiated female expatriates to take on international work experiences, how their experiences affect their career concept and the extent of any issues of discrimination they faced. The study interviews 10 self-initiated expatriate female managers currently living and working in the Cayman Islands and uses an exploratory approach due to a shortage of literature on this subject.

Smith and Osborn (2007b) adopt IPA to examine the psychological impact of chronic benign lower back pain in 6 patients. The study uses semi-structured interview to collect data required by asking the participants to talk as widely as possible about the different ways their pain had affected or influenced their feelings, attitudes or beliefs about themselves.

Using IPA, Westland and Shinebourne (2009) analyse the experiences and understandings of therapists working with clients they describe as self-deceptive. The study explored how participants experience working with clients they describe as self-deceptive, as well as the participants' reflections on the experience and their understandings of self-deception. Data collection was conducted in two stages. First, four participants were asked to provide a written description of a specific incident or of a set of sessions in which it seemed to the therapist that the client was deceiving him/herself. Then, semi-structure interviews were undertaken to follow up the written description in detail.

The application of IPA in business research was undertaken by Cope (2010). His research aims at developing a detailed "phenomenological hermeneutical" conceptualization of the lived experience of failure. The research seeks to provide "theoretical insight" into the impact and outcomes of failure from the entrepreneur's perspective. Eight entrepreneurs were interviewed, made up of four entrepreneurs that were geographically spread throughout the UK, and four US participants based in Silicon Valley, California. The sampling technique adopted in the study is snowball or chain sampling in which the UK participants were identified through personal networks, whilst the US participants were recommended by a contact in a venture capital firm that had been involved with the failed ventures. Semi-structured interviews were used to extract information regarding the participants' experiences.

Some of the researches above suggest that the IPA approach is successful in developing an understanding of personal experience. Indeed, the use of IPA in banking and financial research is rare. Nevertheless, IPA, which has roots in phenomenology, is considered useful for the current study because of the way SME owners talk about their experiences, and it carries important information about the practices of Islamic banks. Moreover, it not only about the participants but also recognizes reflection and interpretation of the researcher in the construction of the story (Smith et al., 2009).

Furthermore, IPA is considered a suitable approach when the researcher is trying to find out how an individual perceives the particular situation they are facing, such as accessing Islamic banks. It is particularly useful when researchers deal with complexity, a process, or a novelty that is explorative in nature. Hence, Smith and Osborn (2007a) argue that there is no attempt to test a pre-determined hypothesis, rather the aim is to explore, in detail, an area of concern.

In line with the purpose of detailed analysis of the perceptions and understandings of a particular group, IPA requires a small number of samples. In addition, achieving representative samples is not the aim of most qualitative research. Instead of generalizability, the aim of IPA research is to produce an in-depth analysis of a small number of participants. There is no strict determination of sample size. It partly depends on several factors: the degree of commitment to the case study level of analysis and reporting and the richness of the individual cases. A distinctive feature of IPA is its commitment to a detailed interpretative account of the cases included and many researchers recognize that this can only realistically be done on a very small sample – thus, in simple terms one is sacrificing breadth for depth (Smith and Osborn, 2007a).

Since the purpose of research using IPA is to analyse in detail how participants perceive and make sense of things happening to them, a flexible data collection instrument is required. Semi-structured interviews are suggested to be suitable instruments in fulfilling that purpose (Smith et al., 2009).

4.3.6 Research Instruments

4.3.6.1 Questionnaires

In research on bank lending, a number of researchers have used questionnaire surveys Black (2006) and Hudayati and Auzair (2009). The questionnaire is arranged to collect quantitative data. The research questionnaire design is dependent on the concept and operationalization of theoretical constructs. Determining the measurement, in which respondents will be asked to respond, is the major issue in designing questionnaires. Both theoretical thinking and an understanding of data analysis should be reflected in the questionnaires (Vaus, 2002). An effective questionnaire should convey useful and accurate data or information from the respondents to the researcher (Wilkinson and Birmingham, 2003). The questionnaire has some advantages and disadvantages (Gillham, 2008). The merit of a questionnaire is the ease in getting information from many people very quickly. In addition, respondents can complete the questionnaire when it suits them. Since the questions are in a standardized form, interview bias can be avoided. More importantly, it can provide suggestive data for testing a hypothesis (p.6).

On the other hand, a questionnaire has disadvantages. These involve the problem of data quality, misunderstandings cannot be avoided, and it is impossible to check the honesty or the seriousness of a response (Gillham, 2008, p.8).

In addition, Hague (1993, p. 12) argues that there are four purposes of the questionnaire. Firstly, it draws accurate information from the respondent, obtained by asking the right question of the right person. Secondly, the questionnaire provides a structure to the interview so that it flows smoothly and orderly. Thirdly, it provides a standard format on which facts, comments and attitudes can be recorded. Lastly, it facilitates data processing.

The value of research does not depend on the quantity of information, but most importantly the quality of information. One of research instruments is the questionnaire. The questionnaire is a useful method with which to acquire views, opinions, attitudes, and knowledge of behaviours and perceptions from key respondents. It should also be considered carefully since the quality data of obtained from questionnaires will affect the quality of the research. Hence, consideration should be given when designing a questionnaire to ensure it elicits good quality information. Sudman and Bradburn (1982) suggest that to build a good questionnaire, the researcher should prioritize the respondents' needs above the interviewer's, while data processing staff are of the lowest priority. Nevertheless, the logical starting point for developing a questionnaire is to ask the extent of its broad aims, and what the researcher is trying to find out. Then, it is important to consider other various issues, for example a) types of questions, b) clarity, c) sequence of questions, d) administration, and e) length of the questionnaire, when formulating questionnaires (Gillham, 2008; oppenheim, 1992).

This study employs two different questionnaires for the two different respondent groups – SME owners and Islamic bank managers. Each questionnaire has both structured (closed) and open questions. The structured questions include yes/no questions, categorical questions, multiple choice questions, and Likert scale type questions. As suggested by Cameron and Price (2009), this study uses Likert scale type questions which provide respondents with a range of responses from which they can choose. Meanwhile, open questions are used to enable participants to give their own views on the topic in question. Moreover, open questions are useful for exploring new issues or ones on which the researcher has limited knowledge (Bryman and Bell, 2003; Bryman, 2004).

The sequence of questions is important as sequential questions make it easier for the participant to complete the questionnaire and it facilitates coding by the researcher (Czaja and Blair, 1996; Sapsford, 1999). The questionnaire used in this study was built sequentially to avoid bias by structuring the order in which questions were asked and answered. The sequence of the questionnaire comprised its division into various sections, as each section was designed to extract particular information from respondents.

The length of the questionnaire was another issue to consider (oppenheim, 1992; Sudman and Bradburn, 1982; Vaus, 2002). There is a widespread view that a long questionnaire or interview should be avoided because it will increase the burden on respondents and lead to lower response rates (Vaus, 2002). The thickness of the question booklet, number of pages, and time required to complete it have been investigated many times, but the results do not suggest how long the questionnaire should be (oppenheim, 1992). Nevertheless, Wilkinson and Birmingham (2003) proposed that a questionnaire should take no more than around twenty minutes to complete to ensure that respondents do not abandon a part of the questionnaire. The optimal length of the questionnaire will depend on the nature of the sample and the topic under investigation: the more specialized the population and the more relevant the topic, the longer the questionnaire can be (Vaus, 2002, p.129). Moreover, although an envelope, front sheet and cover letter are not essential in determining the quality of information of the questionnaire, they need to be considered because the first thing the respondent will see is either the envelope or the cover letter. The cover letter is vital because it is the point at which the respondents will make the decision whether or not to complete the questionnaire (Cameron and Price, 2009).

Another important factor in generating valid and relevant information is the clarity of the questionnaire (Gillham, 2000; Flowler, 2002). To ensure the clarity of the questionnaire, pilot projects will be conducted to test the instruments. The questionnaire will be piloted among students who have taken subjects in Islamic economics and banking at the Muhammadiyah University in Surakarta, Indonesia. Their responses and comments are useful for revising the questionnaires.

In this research, most of the research literature on Islamic banking was reviewed in English, so the questionnaire was first written in English. However, the data will be collected in Indonesia. The English version was translated into Bahasa Indonesia and in the process some problems were encountered as some English terms have no exact Bahasa Indonesia translation. To resolve the problem, the questionnaire was checked by an expert in translating either from English to Bahasa Indonesia or vice versa.

The objectives of the questionnaire were briefly stated in the questionnaire cover letter to prepare respondents' understanding. Respondents were informed that all information put forwarded would remain confidential. In addition, they were informed that their information was to be used for research purposes only and respondents' names were not documented to guarantee the anonymity of individuals or organizations in order to encourage target groups to participate and respond to the questionnaire.

4.3.6.2 Interviews

To gather qualitative data, interviews with respondents are employed to capture their opinions, perceptions, attitudes and behaviours in relation to a particular subject. The aim of the interview is to cover topics that are not easy to investigate through closed questions, which were mainly used in the questionnaire. It is also useful to clarify and interpret some of the questions in the questionnaire. To meet the research goal, the researcher should determine the target of the interview, namely to comprehend the respondent's point of view rather than mere generalization.

In general, there are three types of interviews; structured, semi-structured and unstructured.

a). Structured interview: closed-ended questions where all respondents receive the same set of questions asked in order or sequence. The interviewer fully controls the pace of the interview using a script that should be followed in a standardized and straightforward manner. A structured interview is basically a questionnaire administered face-to-face rather than being self-administered.

b). Semi-structured interview: lies somewhere between unstructured and fully structured, and is a widely practiced business research method (Cameron and Price, 2009; Gillham, 2008).

c). Unstructured interview: open-ended questions where interviewer advises on the width of the topic and lets the interviewee answer as they wish.

The differences in using structured and unstructured interviews are explained by Fontana and Frey (2003). They argue that the former aims at capturing precise data, in order to explain the behaviour within pre-established categories, whereas the latter attempts to understand the complex behaviour of a society member without imposing *a priori* categorizations that may limit the field of inquiry.

Sometimes, unstructured, semi-structured and structured interviews are treated as if they were discrete categories, but 'semi-structured' covers a wide range of structures, and corresponds to an extended part of a continuum rather than a discrete category (Cameron and Price, 2009; Gillham, 2008).

In this study, face-to-face interviews will be carried out to empirically investigate perceptions, attitudes and opinions concerning the practice of Islamic bank financing for SMEs. The interviews will explore both the demand side and supply side of funds. On the demand side, the interview will be delivered to SME owners to investigate their perceptions related to Islamic bank practices which involve lending policies, procedures, administration, experience, and the relationship between the Islamic bank and their clients in obtaining funds from Islamic banks. The in-depth face-to-face interviews will be carried out to corroborate the findings of the questionnaires and to investigate the soft issues that may not yet have been revealed.

On the supply side, the interviews with the managers of Islamic Rural Banks (IRBs) were designed to investigate their relationships with clients using semi-structured interviews. Semi-structured interviews are used to examine the process of Islamic financing to SMEs from the bank managers' point of view, which enables the researcher to compare these with the perceptions of the SME clients. These interviews investigate the experiences of Islamic bank managers in dealing with SMEs and include discussions of the evaluation of the loan proposal, procedures, and the requirements imposed on SME borrowers. In addition, the Islamic bank's policy in anticipating the unavailability of important and relevant information is also examined.

To ensure clarity, the interview schedules both for SMEs and Islamic bank managers were piloted among several lecturers of the Economics Faculty of Universitas Muhammadiyah Surakarta. After being interviewed, the respondents were asked to give a review, and offer comments and feedback. The interview schedule was then revised accordingly.

4.3.7 Population and Sampling

Schofield (2006) defines population as 'the whole element collection that is actually available for sampling'. The population in this research includes SMEs and IBs in Central Java, Indonesia. Central Java is chosen as it is one of the provinces which has a large number of Islamic financial institutions servicing SMEs (Statistics, 2009). There are 19 Islamic Rural Banks (IRBs) operating in Central Java, while there are 83,205 SMEs distributed unevenly in Central Java, ranging from 21.44% to 0.02 % in 34 cities (Appendix 1).

4.3.7.1 Quantitative Sampling

King and Harrock (2010) argue that the sample determination in quantitative research, more specifically surveys, which is statistically representative of the population to be studied, is very important to ensure the generalizability of study. In the survey, there are two main methods of sampling. The first is *non-probabilistic sampling (*quota sampling). The second is *probabilistic sampling* which includes simple random sampling, stratified random sampling and cluster sampling (Schofield, 2006). Researchers should consider the balance between cost and feasibility when selecting the sample.

Since the SME population is dispersed, quota sampling was used (Vaus, 2002). When the sample frame is unavailable, quota sampling is most suitable. The samples include the cities which have Islamic banks, either fully-fledged Islamic banks or Islamic rural banks.

Table 4. 1 Cities which have an Islamic Bank and SME Distribution in Central Java, Indonesia

Cities	Number of population	Number of SMEs	Number of Fully Fledged Islamic Bank Branches	Number of Islamic Rural Banks
Banyumas	1,510,102	1,379	2	4
Cilacap	1,629,908	1,340		2
Grobogan	1,345,879	426		1
Kebumen	1,222,542	929		1
Kendal	965,808	464		1
Klaten	1,136,829	17,843	1	2
Kudus	797,617	299	1	
Magelang	1,317,272	808	1	1
Pati	1,175,232	1,077		1
Pekalongan	1,136,032	1,705	4	
Purbalingga	834,164	10,601		1
Semarang	1,533,686	336	4	3
Sragen	862,910	1,630	1	1
Surakarta	528,202	6,098*	7	3
Tegal	1,661,602	3,751	4	

*data from local government.

Through banks and other networks, 150 SMEs were identified which enabled the researcher to identify and quantify the trends. A sample size of 150 is considered to be enough as a representative of the population. The sample will attempt to have a proportionate number of small and medium size businesses, though it is recognized that there may be a higher representation of small businesses in certain regions.

4.3.7.2 Qualitative Sampling

Unlike quantitative research samples, the samples of qualitative research tend to be purposive instead of random. Purposive sampling is based on the chosen research condition that enables the researcher to achieve depth of information on the field of the research. Easy access to representative participants is the rational sample consideration. There is no requirement of sample size in qualitative research because this approach does not focus on statistical significance. However, to achieve depth of information from the interviewees, the research sample needs to be kept small. Since its aim is to generate in-depth analysis, issues of representation are less important in qualitative research than they are in quantitative research (Bryman, 2001). Within the context of the present study, the sample is determined by the participants who were contacted through the distribution of questionnaires in the previous stage. This study draws on five SME owners as a sample to be interviewed for the case studies.

On the supply side, 8 bank managers from different IRBs were interviewed. This will enable the researcher to compare experiences of SMEs, and identify any variance that may be of significance. Ideally, the interviews should be done with 8 Islamic rural bank managers in 8 cities based on the percentage of the number of SMEs in each city. Unfortunately, not all of those cities have an Islamic Rural Bank. Consequently, the sample was not determined by the distribution of SMEs in every city, but rather based on the availability of Islamic rural banks. There are 20 Islamic rural banks in central Java, but they are not distributed in 20 cities (see table 5.1). Cities such as Surakarta (Solo), Semarang, Cilacap and Klaten have more than one Islamic Rural Bank. Thus, the sample was prioritized based on the cities having the most Islamic rural banks to those with the least.

4.3.8 Data Collection and Analysis

Firstly, using the literature and empirical studies, the provision of finance by CBs and IBs for SMEs in Indonesia and Malaysia is evaluated. Malaysia is selected for comparison as it has similar characteristics to Indonesia, specifically in terms of majority Muslim population and presence of Islamic banks. The penetration of IBs amongst SMEs will be measured through the use of quantitative data.

To collect quantitative data, the questionnaires were distributed to respondents. Due to the time constraints and uneasy access to SMEs, the researcher cooperated with PPMB (Centre of Management and Business Development) to distribute the questionnaires. Before distributing the questionnaires, field workers were given a brief explanation of the questionnaires. This was done to anticipate any problems that may arise and make sure that the field workers could provide adequate information to respondents where needed because the questionnaire involved both open and closed questions.

Since PPMB has limited data on those SME owners with funding from Islamic banks, the questionnaires were also distributed through the account officers of Islamic banks. The account officers also helped deliver questionnaires to their clients.

Considering the time limitations, the questionnaires were delivered to the respondents through by direct visits which are more likely to guarantee a positive response rate than is the drop-off technique. Yet, there were some respondents who were reluctant to complete the questionnaires while the field workers waited and asked that the questionnaire be left with them and an appointment be made for collection at a later date.

Of the 150 questionnaires, 124 questionnaires were returned. Three questionnaires were not used because only the first page was filled in (the questionnaires were printed on two sides). Therefore, a total of 121 questionnaires could be used for further analysis.

While distributing the questionnaires to respondents, potential interviewees were identified. Next, five SMEs owners were chosen to undertake interviews. This sample consists of the firm owners from businesses involved in metal casting, furniture, convection, printing, and trading. In-depth face-to-face interviews were carried out to corroborate the findings and investigate the soft issues.

On the supply side, one Islamic rural bank in each city was visited and asked to participate in an interview. Some Islamic banks were suitable for interview and some were not. Of the 21 Islamic rural bank managers asked, 10 responded to the interview request. Of those 10, two Islamic rural bank managers were excluded because the banks they managed, BPRS Central *Syariah Utama* (Surakarta) and BPRS *Suriyah* (Cilacap), are located in the same cities as two other bank managers recruited for interview.

Therefore, the sample included Islamic bank managers from banks in Surakarta, Klaten, Kendal, Magelang, Gombong, Cilacap, Purwakarta and Semarang. Of the Islamic Rural Bank managers, 8 were interviewed using a semi-structured questionnaire to gain insight into their experiences when making lending decisions.

This will enable the researcher to compare the experiences of SME owners and identify any variance that may be of significance.

Data collected through questioner was analysed using a quantitative approach. This analysis was undertaken using descriptive statistics, which produces a description of the SMEs that access funds from Islamic banks. The description covers the characteristics and capital structure of SMEs. The analysis also describes how the entrepreneurs view the ways in which Islamic banks serve their clients and make lending decisions. In addition, the repayment schedule and the significant factors influencing bank financing decisions are also analysed.

4.3.8.1 Correlation (Statistical Test)

Some questions in the questionnaires were analysed using correlation analysis to examine the relationship between financing size approved by banks and other variables such as firm age, number of workers, number of assets, sales growth, profitability, financing maturity and debt to total assets. There are three types of correlation which can be used to examine the relationship between two variables: Pearson correlation, Spearman correlation and Kendall correlation (Field, 2009). The Pearson correlation is used to test the relationship of two variables where the data are ratio or interval. In addition, the Pearson correlation requires that the data has to be normally distributed.

Since the data is categorical rather than ratio or interval, Spearman correlation is used in this study. In addition, Spearman correlation does not require a normal distribution of data. Another type of correlation that may be used in the study is Kendall correlation. However, it is only appropriate if the data is small with a large tied rank (Field, 2009). Based on the above consideration, the study uses Spearman rank correlation to examine the relationship between financing size and one other variable. The Spearman correlation coefficient was calculated as follows:

$$r_s = 1 - \frac{6\sum D^2}{n(n^2-1)}$$

Where r_s is the coefficient of Spearman correlation and D is the difference between two ranks of tested variables, while n is the number of observations. In practice, the coefficient of Spearman correlation is not calculated manually, but rather using SPSS software.

4.3.8.2 Mean Comparisons

To investigate the presence of a financial gap, compare means t-test was used in the study. This test is used to examine the difference between the amount of proposed and approved financing. The financing gap exists if there is a significant difference between the amounts of proposed and approved financing, and does not exist otherwise.

With regard to qualitative inquiry, the data was obtained through interviews with SME owners and Islamic bank managers. Qualitative data obtained from interviews with SME owners was presented as a case study. The case study illustrates five SMEs which accessed finance from Islamic rural banks. It addresses several issues, including the background of the firms, reasons for seeking funds, experience in accessing Islamic banks, obstacles in accessing funds from Islamic banks, and how these could be overcome.

4.3.8.3 Interpretative Phenomenological Analysis (IPA)

Qualitative data obtained from interviews was analysed using Interpretative Phenomenological Analysis. IPA is considered most suited to the investigation of experience because it has been informed by concepts from three key areas of the philosophy of knowledge: phenomenology (study of experience), hermeneutics (study of interpretation), and ideography (concern with the particular). The analysis will illuminate the experience of Islamic bank managers in making lending decisions for SMEs. The analysis follows several steps outlined in IPA literature. The steps of the IPA analysis used here are adopted from Smith et al., (2009) and described as follows:

Step 1: Reading and Re-reading

The first step of IPA analysis is reading the transcript. If the transcript of the interview is based on an audio recording, it is useful to listen to the full audio recording (carefully) and imagine the participant's feelings. This is useful to ensure that the analysis will focus on the participant. Having finished listening to the interview of one participant, the researcher writes down the important points of the interview. Repeated readings may help the researcher to develop an overall interview structure and enables the analyst to obtain a general understanding of how a narrative can link certain sections of an interview together.

Step 2: Initial Noting

This step proceeds by examining semantic content and language use on a very exploratory level. Anything of interest within the transcript is noted to identify specific ways in which the participant talks about, understands, and thinks about an issue. While undertaking this step, the researcher should maintain an open mind to ensure that he or she maintains focus on the participant. The aim is to produce a comprehensive and detailed set of notes and comments on the data.

These notes are then used to develop analyses, which stay close to the participant's explicit meaning. The interpretative notes help the researcher to understand how and why the participant has these concerns by looking at the language they use, while considering the context of their concerns. It is likely for the analyst to comment on similarities and differences, amplifications and contradictions in the participant's expression. Hence, the researcher might identify more abstract concepts to make sense of the pattern of meaning.

Step 3: Developing an Emergent Theme

In this step, the work shifts from the transcript to the initial notes. It involves reducing the volume of detail, but maintaining the complexity in terms of mapping the relationships, connections, and patterns in the exploratory notes. Then, analysis is made of the exploratory comments to identify emergent themes which involve a focus on a discrete chunk of transcript. Having found the emergent themes, the researcher interprets those themes which ensure the results of the analysis will be a product of the collaboration between participant and researcher.

Step 4: Searching for Connections across Emergent Themes

In this step, the analysis involves mapping the themes together. The process of connecting across the emergent themes is guided by the overall research question and its scope. Therefore, not all emergent themes must be incorporated into this stage of analysis. The themes that may not have a close relationship with the other themes may be discarded. If necessary, the researcher can come back to the earlier transcript to re-evaluate the importance of some themes.

Step 5: Moving to the Next Case

This step is similar to the four earlier steps but is employed differently for each participant. Thus, the next step involves moving to the next participant's transcript or account, and repeating the same process. During this process, it is possible that the analyst will be influenced by what was already found. Therefore, it is important to bracket the ideas emerging from the analysis of the first case whilst working on the second.

Step 6: Looking for Patterns across Cases

This stage involves looking for patterns across cases for the purpose of answering questions such as: What are the connections across cases? How does a theme in one case illuminate a different case? Which themes are the most potent? The final result of this process shows the connections for the group as a whole.

4.4 Ethical Considerations

Since the objects of inquiry through interview are human subjects, researchers must take extreme care to avoid harm. Fontana Andrey (2003; p.88-89) argue that traditionally, ethical concerns have oscillated around three issues. Firstly, *informed consent* (receiving consent by the subject after having carefully and truthfully informed him or her about the research). Secondly, the *right to privacy* (protecting the subject's identity). Lastly, *protection from harm* (emotional, physical, etc). To respect the respondents' privacy, questions that overstep the limits of individual privacy should be avoided. In addition, before starting the study, informed consent was sought from the respondents. Furthermore, potential respondents were notified about the purpose of the study and their permission was sought prior. In addition, stopping the interview at any stage is respondents' own right. Next, it was guaranteed that the contributions of respondents would remain confidential.

Another ethical problem that should be considered is the veracity of the reports made by the researcher. Thus, the researcher must avoid deception and concealment. Respondents are informed on all aspects of the research and the researcher engages in the research processes honestly and openly. Permission is also required from the relevant governing authorities prior to commencement.

CHAPTER 5

EMPIRICAL ANALYSIS OF THE GROWTH OF ISLAMIC BANKING IN INDONESIA

5.1. Introduction

The overall objective of this research is to examine the presence, utilization and effectiveness of Islamic Banking (IB) finance for SMEs in Central Java, Indonesia. Therefore, the analysis derived from both the primary and secondary data is divided and presented in chapters five and six. Chapter five examines the acceptance and penetration of Islamic banks in Indonesia and Malaysia. The acceptance and penetration of IBs has been measured and examined using secondary data obtained from reports published by central banks in both countries to address research question number one.

Next, the data collected from questionnaires is analyzed to answer research question number two. In this case, the analysis is relying on quantitative data (which was analyzed using a table). The findings from quantitative data are corroborated with qualitative data derived from interviews. Quantitative data is specifically used to answer the hypothesis generated in chapter three by applying the correlation analysis. The final section of this chapter seeks to investigate the obstacles faced by SMEs in accessing finance from Islamic banks. Finally, the analysis employs a case study approach to explore the obstacles from the SME owners' points of view.

5.2 Penetration of Islamic banking in Indonesia

Indonesia has the largest Muslim population in the world; it has the potential to become the centre for IB products and services and to revitalise its economy through enterprise. Indonesia has a cultural and religious environment conducive to promoting and adapting to Islamic banking practise for enterprise (Alamsyah, 2012). Islamic banking was introduced into Indonesia in 1992.[28] Studies suggest that

[28] See: http://www.muamalatbank.com

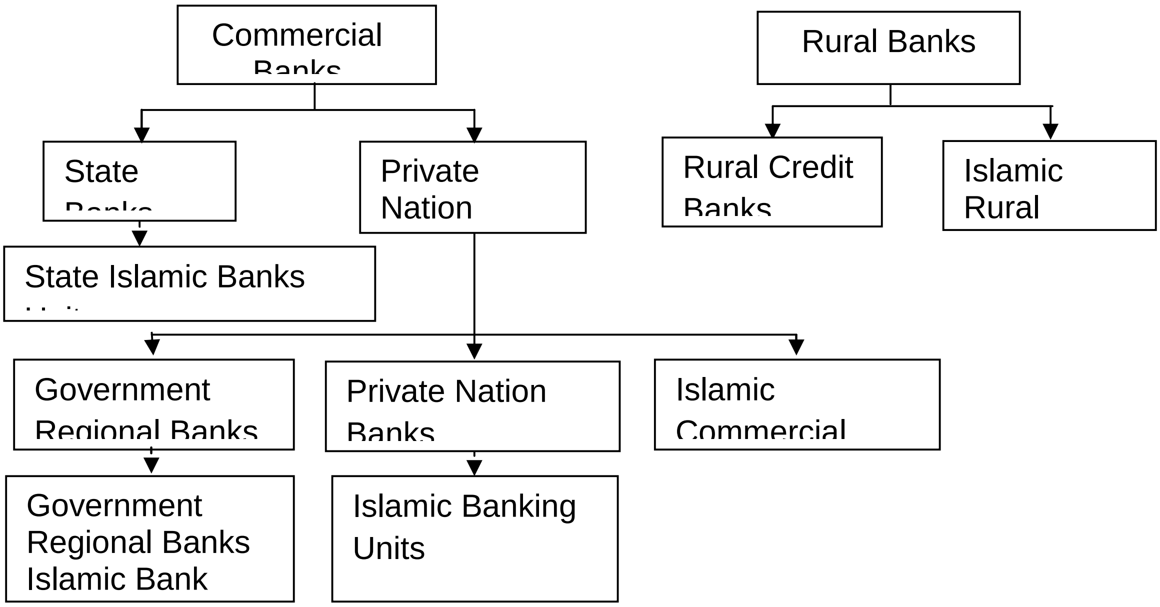
Islamic banking services and practices were positively received by the government and customers alike who has gradually led to IB growth and penetration. By 2012, the percentage of assets of IBs grew to 4.61% of the Indonesian banking system (see table 5.2). In attempt to raise awareness among Indonesian Muslims about illegitimate interest charges, the Ulama Council of Indonesia (MUI) announced *a fatwa (*decree*)* at the end of 2003 which emphasized that bank interest is *haram* (against the teachings of the Quran). Prior to the announcement of this *fatwa,* some Indonesian Muslims viewed interest as *haram*, but others considered it acceptable. It was expected that after the announcement of this *fatwa* there would be a significant flow of funds from Conventional Banks (CBs) to IBs, which in turn would increase the assets of IBs.

Although the MUI is a formal Islamic institution with authority to declare *fatwas,* the aforementioned *fatwa* did not achieve a significant response from Indonesian Muslims. Some Muslim bank customers moved their accounts to IBs, however, the number of customers and the amount of money moved was not significant. There are many reasons why customers choose IBs yet it appears religious considerations are not primary. Customers who support IBs are driven by many other reasons such as safety, the role of bank marketing, and advertising (Abduh and Omar, 2010).

To gain appreciation of IB and of how it is perceived and practised within the context of Indonesia, it is important to consider the structure of the Indonesian banking industry and the position and role of Islamic banks in Indonesia. According to the law of Indonesian banking, Indonesian banking institutions are typically classified into commercial and rural banks. Commercial banks differ from rural banks in the sense that the latter are not involved directly in the payment system and have restricted operational capacity and regional operations. In terms of operational definitions, the banks are classified into non-*shariah* and *shariah*-based principles. The detailed structure of Indonesian banking is depicted in figure 5.1.[29]

[29] Source: www.bi.go.id

Figure 5.1 Banking Institutions in Indonesia



According to figure 5.1, it can be concluded that Islamic banks based on the *sharia*-based principle include Islamic commercial banks (BUS), Islamic banking units or Islamic windows (UUS), and Islamic rural banks (BPRS). Allowing conventional banks to provide Islamic windows led to faster growth of Islamic banks as non-Islamic banks had more branches and reached out to more customers. Although not all customers moved their accounts to *sharia*-based accounts, they had the opportunity to use some of the *sharia* approved products.

5.3 The Growth of IBs

The growth of Islamic banks is evidenced in table 5.2 which shows the number of Islamic banks and their offices. Currently, there are eleven Islamic commercial banks (BUS) whereas in 2008 there were only five. Meanwhile, the total number of Islamic bank branches increased significantly from 1,024 in 2008 to 2,990 in 2013. The list of Islamic commercial banks is as follows:

Table 5. 1 Islamic Commercial Banks in Indonesia

Name of banks	Head office
Bank *Shariah* Mandiri	Jakarta
Bank *Shariah* Mega Indonesia	Jakarta
BUKOPIN *Shariah*	Jakarta
Victoria *Shariah*	Jakarta
Jabar and Banten *shariah*	Jakarta
Maybank Indonesia *shariah*	Jakarta
Bank Muamalat Indonesia	Jakarta
BRI *Shariah*	Jakarta
PANIN *Shariah*	Jakarta
BCA *Shariah*	Jakarta
BNI *shariah*	Jakarta

Source: Author

Table 5. 2 Islamic Banking Network in Indonesia

Types of Banks	**Year**					
	2008	2009	2010	2011	2012	2013
Islamic Banks						
• Number of Banks	5	6	11	11	11	11
• Number of Offices	581	711	1,215	1,401	1,745	1,998
Islamic Business Units/ windows						
• Number of Islamic windows	27	25	23	24	24	23
• Number of Offices	241	287	262	336	517	590
Islamic Rural Banks						
• Number of Banks	131	138	150	155	158	163
• Number of Offices	202	225	286	364	401	402
Total Number of Offices	1,024	1,223	1,763	2,101	2,663	2,990

Source: Author

The number of Islamic windows has decreased slightly from 27 in 2008 to 24 in 2012. On the other hand, the number of Islamic rural banks (BPRS) has increased significantly from 131 in 2008 to 158 in 2012 with over 401 branch offices. In total there are 2,663 Islamic bank branches spread across Indonesia to meet the needs of Islamic financial transactions (particularly for Muslims). The significant increase in Islamic rural banks suggests that Islamic banks have developed the capacity to compete with the non-*sharia* credit rural banks (BPR).

Table 5.3 shows that IBs increased significantly in terms of total asset accumulation of around 51,248 billion rupiah (US?$4.2billion) in 2008 to 248,109 billion rupiah ($20.35 billion) at the end of 2013. The percentage of IBs to total assets of the Indonesian banking system grew from 2.19% in 2008 to 4.66% in 2013. Although IB assets in Indonesia have increased, they still lag behind Malaysia, which had a total asset base of 22.92% at the end of 2013 (see table 5.8).

Table 5. 3 The Growth of Islamic Bank Assets in Indonesia (in billion rupiah)

	2008	2009	2010	2011	2012	2013
Total assets of Indonesian Banking System	2,343,090	2,571,660	3,054,595	3,708,631	4,392,984	5,196,743
Total Assets of Islamic Banks	51,248	68,216	100,258	148,987	199,717	248,109
% of IB assets to total assets of Indonesian banking System	2.19%	2.65%	3.28%	4.02%	4.61%	4.66%

Source: Author

Table 5.4 Market Share of Islamic Bank in Indonesia (in billion rupiah)

	2008	2009	2010	2011	2012	2013
Total credit of Indonesian Banking System	1,334,417	1,467,518	1,801,749	2,243,870	2,761,234	3,384,562
Total of Islamic Bank financing	39,452	48,473	70,241	105,331	151,059	238,889
% of IB financing to Total credit of Indonesian banking System	2.96%	3.30%	3.90%	4.69%	5.47%	7.06%

Source: Author

In terms of financing, Indonesian Islamic banks have shown a positive upward trend from 2008 to 2013 in which market share rose from 2.96% in 2008 to 7.06% in 2013 (see table 5.4). The growth in market share suggests that there is less awareness and acceptance of Islamic banking amongst the Indonesian people as the average of Indonesian IBs financing for five years is only 4.56%, while the average of Malaysian IBs financing reached 17.98% for the same period (see tables 5.4 and 5.8).

The Muslim population of Indonesia is greater than that of Malaysia; hence it represents a huge untapped potential market. This raises the question as to why there is a low penetration of IBs in Indonesia. One explanation may be that IBs do not yet have appropriate strategies to reach the potential market. Therefore, Abduh and Omar (2003) suggest that IBs should aim to develop strategies to identify potential customers and target them using the appropriate tools.

In terms of the products and contracts types offered, Indonesia also lags behind Malaysia. There are different types of contracts used for the purposes of lending to individuals and businesses but the range and types of contracts or products are less in Indonesia than they are in Malaysia. The contracts range and types varies but the key products or contracts available in the market are *mudarabah, musharakah, Murabahah, istisna, Ijara and qordh*. Table 5.5 and 5.6 illustrate the trend in terms of different contracts or products used in Indonesia over the period 2008 to 2013.

Table 5.5 Financing Composition of Islamic Commercial Banks (BUS) and Islamic Windows (UUS) (in billion rupiah)

Contracts	2008	%	2009	%	2010	%	2011	%	2012	%	2013	%	Average
Mudarabah	6,205	16%	6,597	14%	8,631	13%	10,023	10%	12,023	8%	13,625	7%	11%
Musharakah	7,411	19%	10,412	22%	14,624	21%	18,960	19%	27,667	19%	39,874	22%	20%
Murabaha	22,486	59%	26,321	56%	37,508	55%	56,365	55%	88,004	60%	110,565	60%	58%
Salam	0	0%	0	0%	0	0%	0	0%	0	0%	0	0	0%
Istishna	369	1%	423	1%	347	1%	326	0%	366	0%	582	0	1%
Ijara	765	2%	1,305	3%	2,341	3%	3,839	4%	7,345	5%	10,481	6%	4%
Qardh	959	3%	1,829	4%	4,731	7%	12,937	13%	12,090	8%	8,995	5%	7%
Total	**38,195**		**46,887**		**68,182**		**102,656**		**147,495**		**184,122**		

Source: Author

Table 5.5 shows that the *murabahah* contract is the most popular financing product, and accounts for approximately 58% of the total market share. The high percentage of *murabahah* contracts is not only found in Indonesia but also in many other countries (Chong and Liu, 2009a). The second most commonly used products are *musharakah* and *mudarabah* which account for 20% and 11% respectively, whereas *qord hasan* is (6 %), *Ijara (3%) and istisna less than (*1%). *Istisna* is the rarest contract used in Indonesia because it is usually only suitable for real estate mortgages and manufacturers (Elfakhani et al., 2007). In *istisna* contracts, clients request their bank to provide a contract of the production for goods that they want, and the bank makes an *istisna* contract with a third party (the manufacturer) to produce and deliver the specific items under particular requirements. In Indonesia there are not many sectors suitable for *istisna* contracts. For example, housing financing that is suitable for *istisna* contracts commonly use *murabahah* because the customer buys products which are designed and provided by developers instead of asking a developer to build under particular requirements. While there are developers who build specific houses according to customer requirements, particularly in the case of larger homes, but this segment is very small.

Table 5.6 Financing Composition of Islamic Rural Banks (billion rupiah)

Contracts	2008	%	2009	%	2010	%	2011	%	2012	%	2013	%	Average
Mudharabah	43	3%	53	3%	66	3%	76	3%	99	3%	107	2%	3%
Musharakah	113	9%	145	9%	218	11%	247	9%	321	9%	435	10%	9%
Murabahah	1,012	81%	1,262	80%	1,622	79%	2,155	81%	2,855	80%	3,516	80%	80%
Salam	0.04		0.11		0.05		0.02		4.95		0.030	0	0%
Istishna	25	2%	33	2%	28	1%	24	1%	21	1%	18	0	1%
Ijara	6	0%	8	1%	14	1%	14	1%	14	0%	8	0	1%
Qardh	40	3%	50	3%	63	3%	72	3%	80	2%	93	2%	3%
Others	18	1%	29	2%	51	3%	89	3%	162	5%	237	5%	3%
Total	**1,257**		**1,580**		**2,062**		**2,062**		**3,557**		**4,414**		

Source: Author

Islamic rural banks also make use of other instruments such as *salam (*purchase of specified goods for forward payment*)* but these account for a very small proportion of total transactions. The *salam* contract accounts for less than 1% of the total products categorises ‘others accounts for 3%. Like Islamic banks in general, BPRS also rely on *murabahah* contracts. However, the use of *murabahah* contract in Islamic rural banks is larger (80%) than in Islamic commercial banks (57%). The reason for the popularity of *murabahah* is its simplicity and suitability for SMEs.

Table 5.7 Percentage of PLS Compared to Mark-Up Contracts in Indonesia

Types of Contracts	BUS and UUS (%)	BPRS (%)	Average Mode of Finance
Mudarabah	11%	3%	PLS comprises 21.5%
Musharakah	20%	9%	
Murabaha	58%	80%	Mark-up comprises 78.5%
Salam	0%	0%	
Istishna	1%	1%	
Ijara	4%	1%	
Qardh	7%	3%	
Others)	0%	3%	

Source: Author

Table 5.7 summarizes the use of Islamic financial contracts based on PLS and mark-up principles. Although Islamic law promotes the use of PLS based contracts, namely *mudaraba* or *musharaka (Masood et al., 2011)*, particularly when dealing with small business, the use of contracts based on PLS is much less than that of mark-up principles. Evidence gleaned from the field work and presented in table 5.7 suggests that Islamic banks prefer mark-up based principles which account for 78.5% whereas PLS only account for 21.5% of the total market share. The high preference of Islamic banks to use mark-up schemes is because this scheme is considered simpler than the PLS scheme. In addition, mark-up based financing does not require transparency and honesty of borrowers in providing profit reports. Thus, the lower use of PLS-based financing confirms the opinion that SME's are opaque firms.

As observed earlier, although IBs in Indonesia have grown significantly, the percentage of assets and market share is still low compared to the total banking system. Empirical research over the last two decades has identified the demand factors that have influenced the growth in Islamic banks in many countries, but the focus of this research has been customers' point of view (see for example; Gerrard and Cunningham, 1997; Dusuki and Abdullah, 2007a; Abduh and Omar, 2010; Haron *et al.*, 1994a; Rammal and Zurbruegg, 2007; Gait and Worthington, 2007b; Al-

Ajmi *et al.*, 2009; Ahasanul Haque *et al.*, 2009; Erol and El-Bdour, 1989). There are, however, limited studies that examine the obstacles faced by Islamic banks from the supply side. The study of IBs from the supply side in Pakistan conducted by Bashir and Sajid (2011) reported that the lack of growth of IBs was due to the small network of branches, inadequate information about Islamic banking services, ignorance of financial teachings of Islam, trust deficiency towards Interest free banking, location of banks and shortage of experienced and qualified staff (Butt et al., (2011b). In terms of the development of Islamic banking in Indonesia, the factors identified by Bashir and Sajid (2011) and Butt et al., (2011) also apply. Ignorance of the type of Islamic financial contracts leads customers to assume that access to Islamic banks is more complicated than to conventional banks. For example, when borrowers visit conventional banks to acquire loans, the banks offer interest as a price of the loan regardless of the borrowers' needs. In contrast, Islamic banks ask details of the borrowers' requisites in order to provide a specific product for their requirements, as BR6 reported:

> *Obviously people do not yet fully understand Islamic banks and when introduced to IBs, peoples' response was that "it is too complicated, not as simple as a conventional bank". People lack familiarity with Islamic banking.*

Another major factor that influences and constrains the growth of IBs is consumer mindset or views in relation to IBs. Due to inadequate knowledge of Islamic teachings, borrowers cannot distinguish between conventional and Islamic banks and argue that both of them charge "interest".

> *We face much difficulty because of the old mindset. They said "what is the difference between conventional and Islamic banks?" (BR4).*

> *The most difficult aspect of marketing IBs is to change people's mindset; they assume that the Islamic bank is no different to the conventional bank (BR7).*

If the assumption about the similarity of IBs and CBs does not change, borrowers will prefer conventional banks to Islamic banks, in particular those customers who are engaged with banks in the pursuit of profit. In contrast, customers of Islamic banks are motivated by their religion and tend to conform to bank requirements. This group of people are often referred to as emotionally motivated, and the Islamic banks target this group in particular.

> *Changing mindsets is not so easy, because they are formed over a long period. Therefore, we are prioritizing emotional motives, those who are eager to engage*

in shariah. Hopefully, in the future, our customers will move from an emotional motive to a rational motive (BR5).

We classify people into three groups. The first category is emotional. This group is easy [to invite], the importance for them is only shariah. The other is the rational [group]. We have to have different approaches towards [each group]. At the start, it was the emotional group that was much more interested (BR8).

The challenge for the proponents of IBs is how to promote IBs amongst rational groups. It has been suggested that to promote IBs, Islamic scholars need to promote Islamic finance education to inform the Muslim population. Although *fatwas* that prohibit interest do exist, it has been suggested that the declaration of a *fatwa*, and the publicity surrounding the *fatwa*, can damage the image and equity of a brand (Hashim and Mizerski, 2010; p.38). Again, although a *fatwa* was declared by the MUI it did not have a significant impact on the growth of Islamic banks despite the fact that 83.1% of Indonesian Muslims are aware of the *fatwa* (Abduh and Omar, (2010).

A fatwa on riba is like a fatwa on smoking. Although the MUI launched a fatwa stating that smoking is haram (forbidden), most Indonesian Muslims ignore it. Similarly, the MUI launched a fatwa that interest (riba) is unlawful, and the fact remains that many people ignore that fatwa. People deem that conventional and shariah banks are one and the same (BR3).

Though Islamic financial education may promote effectiveness in IBs, it must be underpinned by appropriate legislation. In the case of Indonesia, the government lacks the initiative and the pace to legislate to promote IBs. To regulate Islamic banks, the Indonesian government launched law no. 21 in 2008. This law specifically addresses issues relating to the operational aspects of Islamic banks. It may be argued that it is too little, too late - especially for an Islamic country. The law to regulate IBs in the UK came into effect decades earlier, which lead to the establishment of IBs in the UK, though their size compared to other financial services in the UK also remains small.

5.4 Islamic Bank Penetration in Malaysia

Malaysia, Indonesia’s northern neighbour, has aimed to develop Islamic Banks to complement conventional banks and help boost its economy. In Malaysia, there is a greater awareness and acceptance of IBs than in Indonesia. This is indicated by the comparatively larger growth in IB financing as a proportion of the total banking system in Malaysia. The high percentage of IBs financing in Malaysia is triggered by the fact that awareness among Malay Muslims of the need to avoid *riba* started well before the existence of modern Islamic banks. *Tabung haji*, the first institution practicing Islamic financial transactions, was established in 1962 (Kahf, 2004). In 2012, the assets of IBs in Malaysia accounted for nearly 19.98% of the total assets of the Malaysian banking system, and show nearly 6% growth since 2008, as depicted in table 5.8 below.

Table 5.8 Growth of Malaysian Islamic Bank Assets (in RM miliion)

	2008	2009	2010	2011	2012	2013
Total assets of banking system	1,337,978.2	1,426,206.4	1,549,779.3	1,781,863.1	1,909,829.4	2,058,265.9
Total assets of Islamic banks	192,682.3	233,656.3	267,602.9	334,982.6	381,539.8	433,523.3
% assets of IB to total assets of banking system	14.40%	16.38%	17.27%	18.80%	19.98%	21.06%
% of IB financing to total credit of banking system	14.40%	17.04%	18.02%	19.63%	21.01%	22.92%

Source: Author

The market share data, presented in table 5.8 is used to gauge the penetration of Islamic banks.The data shows that in terms of market share, Islamic banks in Malaysia experienced significant growth in the period 2008 to 2013, from 14.4% to 22.92%. This high increase in IB market share indicates that Muslims in Malaysia are increasingly aware of the reasons for avoiding *riba.* In addition, this increase also implies that Malaysian IBs have good strategies for marketing their products to their target market. This is in line with the goal of Malaysia to be a hub of Islamic banks internationally (Laldin, 2008; Yusof and Majid, 2008).

Malaysian Islamic banking gained greater momentum through governmental efforts and a greater desire on the part of the population to seek a banking alternative that complies with their Islamic beliefs. Furthermore, banks proactively offered a greater range of products and services compliant with Islamic principles. It can also be inferred from Tables 5.5 and 5.9 that in terms of types of contracts, Malaysian Islamic banks have more variety and types than those in Indonesia. On the financing side, there are 8 types of financing contracts employed by Islamic Banks in Malaysia, including *Bai Bithaman Ajil, Ijara, Ijara Thumma Al-Bai, Murabahah, Musyarakah,* *Mudharabah, Istisna',* among others. The uses and trends for each of these is shown in table 5.9.

Table 5.9 Financing Contracts in Islamic Banking in Malaysia (in RM million)

Type of contract	2008		2009		2010		2011		2012		2013		average
	amount	%	amount	%	amount	%	amount	%	amount	%	amount	%	%
BaiBithamanAjil	34,534	33%	42,914	32%	53,688	34%	63,210	32%	74,281	32%	83,139.5	38%	34%
Ijara	2,774	3%	4,033	3%	3,940	3%	4,122	2%	4,636	2%	6,373.2	3%	3%
*Ijara*ThummaAlBai	31,847	30%	38,953	29%	43,497	27%	50,982	26%	54,575	23%	62,370..3	22%	26%
Murabahah	15,855	15%	23,020	17%	23,295	15%	30,385	15%	40,018	17%	57,026.9	20%	17%
Musyarakah	1,137	1%	2,349	1%	3,958	3%	7,398	4%	11,832	5%	16,354.2	6%	3%
Mudharabah	314	0%	376	0%	276	0%	252	%	142	0%	146	0	0
Istisna'	1,384	1%	1,487	1%	1,615	1%	1,465	1%	989	0%	696.2	0	1%
Others	16,802	16%	20,351	15%	28,971	18%	39,181	20%	46,325	20%	54,799.9	20%	18%

Source: Author

In general, Malaysian Islamic banks are no different from Indonesian Islamic banks. The data in tables 5.7 and 5.10 suggest that customers both countries prefer to use mark-up principles rather than PLS. This is because mark-up contracts are simpler than PLS contracts. In mark-up contracts, Islamic banks simply determine how much margin should be charged to the firms. In this case, Islamic banks do not need to monitor how much profit will be obtained by the borrower which in turn will determine the share received by Islamic banks based on the advance agreement. In contrast, PLS contracts require transparency in the financial reporting of firms and honesty of owners.

Table 5.10 below shows that the implementation of the PLS concept, consisting of *mudarabah* and *musharakah* were only 3%, while the mark-up account was 97% on average. The types of contract are dominated by *bai bithaman ajil, Ijara thumma al-bai, and murabahah.* All of these contracts are mark-up based. While using different modes of financing, the features of IB financing in Indonesia and Malaysia are similar. This means that the use of the mark-up concept in both countries is higher than the PLS concept. This finding is contradictory to the theory of Islamic banks which suggests that IBs should emphasise their financing on the basis of PLS. The benefit of IBs over conventional banks is that IBs share their profits and losses with entrepreneurs, particularly in the case that the IB employs PLS in their financing contracts. The rationale behind employing PLS in the financial contracts of IBs is that it is considered to be fairer since it does not exploit the borrowers by burdening them with a fixed rate (Iqbal and Mirakhor, 2007).

Table 5.10 Percentage of PLS Compared to Mark-Up Contracts in Malaysia

Contract Type	%	Mode of Finance
Mudarabah	0.19%	PLS comprises 3%
Musharakah	2.83%	
Bai Bithaman Ajil	33%	Mark-up comprises 97%
Ijara	2%	
Ijara Thumma Al Bai	27%	
Murabahah	16%	
Istisna'	1%	
Others	18%	

Source: Author

5.5 Islamic Bank Financing Decisions for Small and Medium Sized Enterprises

This section examines Islamic bank financing for SMEs from the demand and supply side by mainly using primary data. Firstly, it examines the distribution of population, small firms, Islamic commercial banks (BUS), and Islamic rural banks (BPRS) in the cities in which the study was undertaken. Secondly, it reports on the analysis of the questionnaire from the demand perspective. It represents descriptive data and outlines the characteristics of the respondents, such as their age, sex, education, and family size. Thirdly, it investigates the capital structure of SMEs by examining the age of firms, the business sectors they engage in, the purpose they borrow from both formal, especially Islamic banks, and informal sources, such as family and friends, and empirically tests whether there exists a finance gap for SMEs. Finally, this analysis concludes by investigating the lending criteria of Islamic banks for SMEs and the various factors influencing lending decisions, from the perspectives of SME owner managers and bank managers.

5.5.1 The Distribution of SMEs and Islamic Banks in the Sample Cities

Islamic commercial banks serve all clients and are predominantly located in inner cities. Islamic rural banks, on the other hand, focus on small firms and retail customers and mainly serve customers in rural areas. As shown in Table 5.11, Islamic rural banks are concentrated in certain areas

Table 5.11 Population and Islamic Bank Distribution in the Sample Cities

Cities	Population	Number of SMEs	Branches of Islamic Commercial Banks (BUS)	Number of Islamic Rural Banks (BPRS)	Number of Commercial Rural Banks (BPR)
Banyumas	1,510,102	1,379	2	4	8
Cilacap	1,629,908	1,340	-	2	8
Kebumen	1,222,542	929	-	1	6
Kendal	965,808	464	-	1	16
Klaten	1,136,829	17,843	1	2	20
Magelang	1,317,272	808	1	1	13
Semarang	1,533,686	336	4	3	18
Surakarta	528,202	6,098	7	3	11

Source: author

Table 5.11 shows the total population distributed in the cities varies, ranging from 528,202 to 1,629,908. Although the presence of Islamic rural banks was intended to serve SMEs, the distribution of Islamic rural banks depicted in table 5.11 is not in proportion to the number of SMEs in each city. For example, Klaten, the city with the largest number of SMEs in the sample has only two Islamic rural banks, while Semarang which has the least number of SMEs has three Islamic rural banks. Similarly, the number of Islamic rural banks in Purwakarta is twice that of Cilacap though both cities have the same number of SMEs. The representation of Islamic banks and their presence in each city does not follow the distribution of SMEs. A possible explanation could be that the presence of Islamic banks is dictated by the demand for its products and not necessarily by the population of SMEs. This suggests that there is a need for Islamic banks to those cities with a high concentration of SMEs.

Investigation of the disproportionate distribution of Islamic rural banks and SMEs in each city showed that this variance can be explained by the fact that the BPRS share the same market as Rural Credit Banks (BPRs) and appear to complement one another rather than compete. However, they operate a different scheme. BPR operate based on the conventional business model with interest while BPRS is based on *shariah* saw. Even though the number of BPRS is less than BPR, the number of BPRS is growing. The growth in BPRS suggests that there is a demand for *shariah* compliant products by SMEs.

Nevertheless, the number of Islamic rural banks in each city is less than that of Rural Credit Banks. This makes sense because BPRS are newcomers in the financing business compared to BPR. Therefore, it can be inferred that the penetration of Islamic banks, particularly Islamic rural banks is difficult since they must compete with established institutions like BPR and the commercial banks. Furthermore, customer knowledge of Islamic banks is limited, in particular amongst SME owners. There has been only a gradual increase in demand for and awareness of Islamic banking services. This could be due to lack of appreciation of the marked differences in products and services offered by Islamic and conventional banks. This is evidenced by those customers who argued that there is no difference between Islamic and conventional banks (BR3).

Islamic commercial banks are not available in every city. For instance, Cilacap, Kebumen and Kendall do not have Islamic commercial banks, but they do have Islamic rural banks. The absence of Islamic commercial banks in these cities is primarily because they provide services to medium and large businesses. Therefore, the presence of BPRS appears to be much more strategic in terms of their location; they tend to favour cities where they have more chance of securing greater market share. In contrast, Islamic commercial banks are concentrated in Surakarta, while Semarang and Purwakarta have four and two Islamic commercial banks respectively. The main reason Islamic commercial banks have opened branches in these areas is because these are major regional cities. Meanwhile, the head offices of all Islamic commercial banks are based in Jakarta, the capital city of Indonesia. The presence of Islamic rural banks is as a complement to Islamic commercial banks, but their services focuses on the micro, small and medium-sized firms, particularly for the customers who avoid *riba*. In this case, there is an intersection of market segments, between BPRS and commercial banks. Although Islamic commercial banks focus on large companies and BPRS on small firms, but also serve medium-sized companies. While medium-sized firms can get finance access both from commercial banks and BPR/ BPRS, small firms have only limited access of finance from BPR/ BPRS. Thus, the presence of Islamic rural banks in each city indicates the financial inclusion of small firms not served by large banks (Bhanot *et al.*, 2012).

5.5.2 The Demographic Breakdown of Respondents

The characteristics of the total 121 SME respondents who participated in the research are described in table 5.12. Most of the businesses are dominated by young entrepreneurs of which nearly 46.3 per cent were 31-40 years, and 32.2 per cent between the ages of 41-50 years. There were only 18.2 per cent SMEs owner/ managers aged under 30 years and 3.3 per cent aged 50 or more. The findings of this study are consistent those of Rudjito (2003), which suggested that involvement of young people in small business indicates that SMEs create new jobs in the economy. Alhtough they have less experience, young people are characterized as being highly motivated, creative and innovative – characteristics that can be helpful in triggering the growth of SMEs.

Based on the selected sample, most of the SME owners/managers (71.1 per cent) were male while the remaining (29.9 per cent) were female. These findings support the social norm that males are mainly the bread-winners of the family, especially in developing nations, including Indonesia (Adesua-Lincoln, 2011) and Malaysia (Ghani, 2003). This could be influenced by the prevailing culture where males have a major role in family. In addition, less involvement of females in businesses could lead to more financial constraints for them, particularly at the start-up stage of a business, than for their male counterparts (Roper and Scott, 2007).

Table 5.12 Characteristics of Respondents

Variables	Percentage (%)
Age (years old)	
< 30	18.2
31 – 40	46.3
41 – 50	32.2
51 – 6	2.5
> 60	0.8
Total	100.0
Sex	
Male	71.1
Female	28.9
Total	100.0
Education	
Elementary school	4.1
Junior high school	18.2
Senior high school	47.9
Undergraduate degree	21.5
Post graduate degree	8.3
Total	100.0
Number of family members	
2-3 people	19.0
4-5 people	68.6
6-7 people	10.7
8-9 people	0.8
> 9 people	0.8
Total	100.0

Source: author

As shown in table 5.12 concerning respondents' education, 4.1 per cent of the entrepreneurs received elementary school level education, 18.2 per cent were educated to the junior high school level, 47.9 per cent completed senior high school, 21.5 per cent had undergraduate degrees and 8.3 per cent held postgraduate qualifications. The result indicates that education is an important factor for banks to consider when aiming for SME growth. There is a positive correlation between education and the success of entrepreneurs in securing finance. These findings are consistent with earlier empirical research findings that the educational achievements of entrepreneurs have a positive impact on the entrepreneurs ability to access finance from external sources (Bhanot *et al.*, 2012). The majority of SME owners in the sample had senior high school level education. SME owners with undergraduate certificates were lower represented less than 21.5 per cent of respondents. The findings suggest that there are less people with undergraduate qualifications involved in running SMEs and that limited education is linked to the need to seek finance to develop a business. Undergraduate degree holders generally prefer to and have greater access to work in large companies or institutions as professionals. The findings also suggest that those owner/managers who have post graduate degrees generally hold a formal job and consider their business a secondary source of income.

When the family structure of SME owner/managers is examined, the results show that 68.6 per cent of the participants had 4-5 family members, 19 per cent had 2-3 family members, 10.7 per cent had from six to seven family members and 8 per cent with 8-9 and more than 9 family members. In Indonesia, it is common for a family to have many children. This condition cannot be seperated from the belief that the more children one has the more fortunate one is. Although it cannot be inferred that there is a certain relationship between family size and rejection or acceptance rate when SMEs sought external finance, SMEs borrowers with many children may be more inclined to misuse of loans due to financial constraints. Therefore, lenders should strictly monitor the SMEs borrowers who have many children because they may use the loan from the bank to meet family needs rather than the intended business purpose, which may effect their business performance and hence the loan repayment.

5.5.3 Capital Structure of SMEs

Firm age is an important criterion for banks to consider when evaluating credit scoring of the borrower. In general, the firm track record is available if the firm has operated for a reasonably long time. In contrast, banks will be reluctant to disburse loans to the firm at the start-up stage with insufficient past financial information.

Concerning the age of the firm table 5.13 shows that as much as 30.6 percent of SMEs in the sample were between 1-3 years old. These firms can be considered as being in the start-up stage, whereas the remaining 69.1 per cent of SMEs had longer track records. Indeed, IBs prefer to serve well established businesses, however, they are also clearly willing to provide finance for start-up business. SMEs age profile supports the findings of Iqbal et al., (1998) that Islamic banks are more concerned about the soundness of a project rather than the age profile at the start-up.

Table 5.13 indicates that the businesses/SMEs in Indonesia are divided into 7 sectors. In the selected sample, trading is the most common type of SME business which covers 57 per cent and which is followed by ‘others’ (unspecified business ventures). The highest number of SMEs involved in the trading sector is confirmed in the study by Scherr and Hulburt (2001) which found that SMEs are mostly involved in short term assets maturity. The explanation of this could be that SMEs which are involved in trading business do not require a high number of fixed assets like those of the manufacturer sector.

Approximately 19.8 per cent of the participants were not able to define their business sector, hence they chose the category of ‘others’ to describe their business, while there were only 14.9 per cent of respondents in the manufacturing sector and 4.1 per cent in the agriculture sector. Due to the risk nature of agriculture, there are less SMEs involved in this sector. These findings are supported by Fidrmuc and Hainz (2010), who also found that agriculture is a high risk sector, hence only a few banks are interested in financing agricultural businesses that are susceptible to drought, flood and pestilence, all factors beyond the control of business owners. A further 0.8 per cent of SMEs fell under the construction category. This low level indicates that construction firms are usually big companies requiring huge and long term investment. Therefore, Islamic rural banks, as small IBs, are not able to serve construction companies since the maximum loan maturity of BPRS is four years. As explained by an IB manager (BR3) “Long term projects are usually financed by Islamic commercial banks”.

The findings of the analysis suggest that the businesses at the start up stage obtain funds from internal sources such as from family or relatives or from personal savings. The banks are reluctant to lend to the businesses at the start-up stage due to the lack of past credit history which is an important requirement for banks. These findings are similar to Deakins and Hussain (1994a) . This data indicates that firms follow a pecking order; when the business grows they cannot fulfil their capital needs from internal sources they look for external funds from banks.

Currently, there are two types of banks which lend to all types of businesses, namely conventional and Islamic banks. A firm can choose the type of bank according to their own preference and convenience. Funds which obtained from banks can be used for investment, working capital, consumption and for other purposes. Table 5.13 shows that 90 per cent of SMEs used their financing from Islamic banks for working capital, whereas finance for investment and other purposes covered 8.3% and 0.8% respectively. This is plausible since most SMEs need little capital to invest. More importantly, loans were taken out in the initial stage of the establishment of the business, though some firms needed capital spending for new investment.

SMEs that cannot secure sufficient funds from external sources approach relatives to meet their capital needs. This supports the pecking order hypothesis which suggests that firms meet their capital needs from internal funds, with family members being the main source (Myers, 1984; Myers and Majluf, 1984). The respondents mentioned in interview that families may be able to provide a fraction of funds required, therefore, they did not want to borrow from banks which commonly charge high rates of interest (Dasgupta, 2004). This research found that almost 20% of SMEs sought additional capital from family. In contrast, 85% of SMEs did not borrow any capital from family. These results indicate that most of the SMEs used banks to finance their businesses and supplemented the loans with personal savings and funds from relatives.

Most of the SMEs in the sample had been in business for four years. This finding is supported by research conducted by Hussein et al. (2006) which found that as many as 56% of SMEs in the UK obtained capital from financial institutions after they had been established for two years and the percentage of funds from financial institutions rose sharply to 78.6% for those SMEs which were in business for over five years. Paradoxically, the share of immediate family financing decreased considerably from 57.7% in the initial funding to only 7.1% after five years.

Once a business is established, it cannot continue to rely on family funds and therefore replaces informal funding sources with formal financial institutions. SME owners who want to avoid *riba* can approach BPRS for additional capital. Research findings suggest people selecting IBs are motivated by their awareness and desire to avoid *riba.* In addition, to avoid interest there are many reasons for SMEs to deal with Islamic banks. Generally, people who access financing from Islamic banks can be classified into three broad categories. The first group (Muslims) is persuaded by religious beliefs and emotions rather than considerations of profit. They believe that the interest (*riba)* charges of conventional banks are strictly prohibited according to Islam (Quran: Chapter 2 verses 275-276 and 278-279) and must be avoided. This group covers only 15.7 percent of the research sample. The second category, the borrowers, is motivated solely by profit. Borrowers derive funds from Islamic banks, only if the cost of capital from Islamic banks is lower than that of conventional banks. This group consists of 18.2 percent of the total sample taken. The third category includes borrowers who are motivated by both religious and rational motives and covers 35.5 percent of the sample.

Thus, it can be inferred from the above results that borrowers from Islamic banks were motivated by both religious and profit motives. These findings are consistent with the study by Haron et al., (1994a) who found that the selection of Islamic banks in Malaysia appears to be based on a combination of religious and non-religious motives. This represents a challenge for Islamic banks which compete with conventional banks in terms of cost charged to the client. IBs must be aware that most of firms act rationally in selecting banks. The cost of capital is a crucial aspect for every business. Therefore, IBs should find strategies to reduce their cost so that they can charge their clients less.

Another important factor in attracting SMEs to Islamic banks is the simple loan sanctioning criteria. According to 16.5 per cent of the owner/managers, the lending procedures of Islamic banks were simple and easy compared to those of conventional banks. Further, their concern over the lengthy and complex procedures adopted by the conventional banks had a negative impact on business activity. These findings confirm the research conducted in Malaysia which found that good quality service is one of the factors influencing the customers to select Islamic banks (Haron et al., 1994a).

Table 5.13 Characteristics of Sample SMEs

Variables	Percentage (%)
Age of firms	
1-3 years	30.6
4-6 years	36.4
7-9 years	11.6
10-12 years	12.4
>12 years	9.1
Total	100.0
Business sectors	
Agriculture	4.1
Mining	-
Manufacture	14.9
Construction	57.0
Trading	3.3
Transport/communication	19.8
Others	100.0
Total	
Purpose of financing	
Investment	8.3
Working capital	90.0
Others	0.8
Total	100.0
Capital from family	
Yes	19.5
No	80.5
Total	100.0
The reasons of accessing finance from Islamic bank	
Religious	15.7
Profit consideration	18.2
Mix between religious and profit	35.5
The procedure easier than conventional bank	16.5
IBs are more skilful than CB in engaging with SMEs	5.0
IBs have more financial instruments than CBs	9.1
Total	100.0

Source: author

The financing gap is an important issue, particularly for SMEs in the emerging market (OECD, 2006b) and the financing gap for SMEs in Indonesia is no exception. The existence of the financing gap for SMEs was examined by using a compare mean t-test. The results are plotted in table 5.14.

Table 5.14 Gap between Proposed and Approved Financing

	Mean amount proposed	Mean amount approved	t-value	Significance
Applicant	2.96	2.88	2.56	0.012

Source: author

Not all SMEs are able to obtain the amount of capital they proposed from external sources. It was acknowledged by some authors that the ‘financial gap’ is much more for SMEs (Thompson *et al.*, 2006; Rouse and Jayawarna, 2006). The existence of financial gaps in SMEs was examined by using the comparative mean t-test between proposed and approved financing as indicated in table 5.14. The result shows that there is a significant difference between the average amounts of proposed finance and the average amount of approved finance. The mean of the loan amount approved is less than the amount proposed. It could be concluded that a financial gap for SMEs exists in Indonesia, meaning that IBs tended not to fund the entire amount of loan proposed by SMEs. The reason for this is that the decision of the financing amount is based on evaluation and assessment of the financed project and the capacity of SMEs to repay. It was acknowledged that most of the entrepreneurs will convince the bank that they have the ability to repay the financing by exaggerating the soundness of the project (Blumberg and Letterie, 2008).

The financial gap reflects the rationing behaviour of the bank (Atieno, (2001). The financial gap would be higher if the ‘discouraged borrower’ is included (Kon and Storey, 2003). Yet, the sample only includes the SMEs which were successful in securing funds from Islamic Rural Banks.

5.5.4 Lending Criteria of Islamic Banks

The duration of customer-bank relationship may influence the IB manager’s attitude. Intuitively, the clients who have a longer relationship with Islamic banks were expected to get bank funding more easily.

Table 5.15 shows that most of the respondents, 50.4 per cent, who engaged with the Islamic bank indicated that they had an account with the Islamic bank for between one to three years. While 20.7% were involved with the Islamic bank for four to six years, and three per cent had been dealing with Islamic banks for nine or more years. This indicates that the SME involvement with IBs is a relatively new and emerging phenomenon. This implies that IBs should adopt innovative measures to increase their financial outreach.

Despite the findings above, most IBs argue that collateral is not the most important factor when lending to SMEs. Nevertheless, the result provides contradictory evidence. As shown in the table, 97.5 per cent of SMEs provided collateral in order to obtain funds from Islamic banks. Hence, the importance of collateral was acknowledged by Islamic bank managers, as is supported by the following interview comment that, If the collateral is not adequate, the application will be rejected (BR3).

Most respondents in the sample were current customers (who obtained finance) from IBs, with only 17.4 percent of loan applications rejected. Based on an interview with an Islamic bank manager, the lack of collateral is the prime reasons behind the loan rejection.

Their main problem is collateral, their collateral is minimum (not adequate to cover the proposed financing) (BR2).

The cost of loans from Islamic banks is commonly equal to that of conventional banks. This is consistent with the reasons SMEs seek funds from Islamic banks – most are motivated by religious and profit considerations (see table 5.13). Important to Islamic borrowers are that Islamic banks do not charge higher financing rates than conventional banks. Nevertheless, Islamic banks will charge slightly higher rates for clients who represent a higher risk.

Table 5.15 shows that as much as 43.8% of SME owners consider that the cost of capital of IBs is equal to that of CBs, whereas 38% regard the cost of capital of IBs as higher than that of CBs. Variations in charges of the costs of capital depend on the circumstances of the project financed and the ability of the SMEs to bargain.

> *For lending, profit ratio is negotiated. ....every client is charged a different profit ratio because the characteristics of different businesses have different margins. Some have lower and some have higher margins (BR3).*

Table 5.15 Lending Characteristics/Criteria of Islamic Banks

Variables	Percentage (%)
Account duration in Islamic bank	
< 1 year	17.4
1-3 years	50.4
4-6 years	20.7
7-9 years	9.7
>9 years	2.5
Total	100.0
Provide collateral	
Yes	97.5
No	2.5
Total	100.0
Ever been rejected	
Yes	17.4
No	82.6
Total	100.0
Cost of capital of IB compared to CB	
Lower	18.2
Equal	43.8
Higher	38.0
Total	100.0
Provide financial statements	
Yes	51.2
No	48.8
Total	100.0
Type of contract	
Mudaraba	41.7
Musharaka	7.5
Murabahah	38.3
Ijara	4.2
Istisna	0.8
Lainnya	7.5
Total	100.0
The frequency of visiting IB to acquire financing	
Once	25.6
Twice	49.6
Three times	19.8
Four times	2.5
Five times	0.8
>five times	1.7
Total	100.0
Bribe	
Yes	-
No	100.0
Total	100.0

Source: author

The major use of Islamic financial contracts is *murabahah*. Both SME and IB managers prefer to use this form of contract because it is easier to calculate.

"So far, we have much more murabahah lending, because it is safer" (BR4).

Explanation of why the majority of SME owner-managers use *murabahah* contracts was provided by one of the Islamic Rural bank managers as follows:

> *The contract which is actually proper for mudarabah is then converted into murabahah. This is because the key of mudarabah and musharakah is the honesty of the borrower to provide factual reports to IBs. (BR3)*

As a result, it is difficult for Islamic banks to offer the PLS scheme (*mudarabah* and *musharakah* contracts) which demand transparency. Transparency can only be realized if the borrower can provide a valid report. External parties, including IBs, deem that a financial statement is valid if it is audited by public accounting officer. The reality is that most of the financial statements of SMEs are not audited by public accountants and are therefore not valid documents. Unavailability of valid documents forces Islamic banks and borrowers to use the simpler form of contract, mark-up schemes.

In addition, most of the respondents chose *mudarabah* contracts which imply they did not fully understand the financing terms used by Islamic banks. Thus, they chose the answer blindly when they were asked to "check sign" in the questionnaire. This was confirmed in a face-to-face interview with an entrepreneur who acknowledged that he did not understand any Islamic finance terms. For him, it was only important that he could obtain funds from Islamic banks (with the lowest charges), without considering the name of the instrument.

> *I just went to the Islamic bank and bargained the cost. I asked the lowest cost and agreed on it (OR1).*

Another respondent revealed that he did not understand the terms used in Islamic banks at all. To understand such terms was not important for him. He only needed the capital from Islamic banks whatever the name was.

> *Actually I don't really understand those terms. Although I am religious enough, I am confused concerning those terms. Obviously, I need working capital to purchase goods for production needs (OR3).*

Most SME owners were of the view that the attractiveness of Islamic rural banks is the flexibility and swiftness of the loan evaluation/application screening process, which depends on the documentation provided by the customers/ entrepreneurs. The time required by the Islamic rural bank to sanction loans to SMEs varies from one to 30 days. Nevertheless, many SMEs received the financing decision in 7 days. There were exceptions however, particularly in the case that the SME is implicated in a legal issue of collateral binding through a notary institution at the time and in such cases financing applications may take two and three months.

Success in applying for finance from Islamic banks varies for every prospective client and depends on the initial assessment of the Islamic bank officer. For instance, Islamic bank officers need less time to decide on financing for existing customers with a track record or past credit history. A track record is a vital indicator for banks to assess whether a customer is a good or bad borrower. The characteristics and performance of such clients can be seen from previous bank records. Conversely, it is more difficult for Islamic bank officers to evaluate the feasibility of new customers, which can take longer. In fact, Islamic bank officers should ask some ‘informants’ to inquire about the character of prospective customers. Although frequency of approaching Islamic rural banks for loans varies with each customer, 95 per cent of entrepreneurs mentioned that they visited Islamic banks one to three times before they received financing. In accordance, there were 25.6 per cent who visited only once, 49.6 visited twice and 19.8 visited three times in attempt to get a loan approved. Customers who approached IBs only once and succeeded to get loans approved were those who fulfilled all the IBs requirements and were promptly considered creditworthy. Conversely, customers who applied to IBs more than once usually had difficulties in meeting some of the requirements determined by IBs (which is normally experienced by new customers). Thus, the high percentages of customers who tried more than once to get a loan approved implies that most IB clients are new customers.

Table 5.16 Repayment

Variables	Percentage (%)
Repayment schedule	
Monthly	97.5
Quarterly	1.7
Half yearly	-
Annually	-
Others	0.8
Total	100.0
Repayment determination	
Imposed on you	10.7
With your agreement	89.3
Total	100.0
Routines of repayment	
Yes	92.6
No	7.4
Total	100.0

Source: author

Theoretically, the repayment of Islamic bank financing will depend on the type of instrument employed. Financing based on PLS should be paid at the end of term or at least in the end of the accounting year, because the partner (bank's client) must calculate the loss or profit they get as a basis of sharing. Both entrepreneurs and IBs receive profit or loss based on the ratio agreed in advance. Meanwhile, the repayment of mark-up based financing is conducted according to a periodic schedule in the form of instalments.

The findings outlined in Table 5.16 suggest that 97.5% of SMEs repay Islamic banks in monthly schedule(s). This is in line with the common use of mark-up based financing. This implies that most of the financing is based on mark-up rather than PLS financing.

Although it is acknowledged that Islamic banks may collect the margin of mark-up based financing in periodical schedules, Islamic banks did not impose repayment schedules on entrepreneurs but made agreements with them instead. These agreements were made to accommodate those customers whose income fluctuated and who knew their business best. According to the data, as much as 89.3% of repayments were made through joint agreement. The remaining 10% of repayments were imposed by IBs implying that the customer did not object and was able to meet the repayment schedule imposed by IBs.

Most of the SMEs repaid their financing routinely (92.6%), while 7.4% experienced financial distress that affected their ability to repay as scheduled. This indicates that most of the small firms running businesses in their niche market were viable.

5.5.5 Factors Influencing the Lending Decision

According to Islamic bank managers, SMEs did not have significant problems in obtaining finance from Islamic banks to the extent that they could not fulfil the requirements. Nevertheless, 71.3% of SMEs indicated that they experienced difficulties when making a loan application. IB managers and SME owners may have different opinions in judging the factors that influence lending decisions. IB managers and SME owners were asked their opinion of the factors influencing lending decisions as depicted in table 5.17.

Table 5.17 Factors Influencing Lending Decision

Factors Considered	**IB's opinion**		**SME owner's opinion**		**Category**
	%	**Rank**	**%**	**Rank**	
Credit track record	75.0	1	-	-	
Debt to total assets	62.5	2	-	-	Very important
Average of sales	50.0	3	-	-	
Age of firm	75.0	1	60.3	2	
Type of business	75.0	1	63.6	1	
Number of assets	62.5	2	53.3	4	
Average of sales	50.0	3	56.2	3	Important
Collateral	50.0	3	51.2	6	
Bank account duration	50.0	3	-	-	
Age of owner	-	-	52.1	5	

Source: Author

Table 5.17 shows the comparison between the opinions of SME owners and Islamic banks concerning factors influencing the financing decision. The table is established based on a 50% cut-off, which means that only factors identified by at least 50% of the respondents are included in the table and considered a significant factor.

In the table both Islamic banks and SMEs share similar opinions regarding important factors that affect loan decision making. Nevertheless, there are slight differences between them. Firstly, Islamic banks view that the factors fall into two categories; “important” and “very important”. On the other hand, SMEs consider that all factors influencing financing decisions fall in to one category namely the “important” category. Secondly, SME owners view that the age of the owner is important in determining the success of obtaining a loan, whilst Islamic bank managers do not judge it as an important factor. Conversely, Islamic banks consider that bank account duration is a more important factor than the age of the owner. This indicates that both parties have different points of view in considering important factors influencing loan decisions. For instance, bank account duration is more important for IBs because it can provide information on the average amount of deposit and the activities of business payment through banks. In contrast, SMEs think that the age of the business enterprise is more important than the bank account duration because the longevity of a firm is evidence that the SME is sound in different economic conditions.

Three of the following items: credit track records, debt to total assets and the average total of sales are not important factors to SMEs. Conversely, Islamic bank managers view these factors as being very important factors, which undoubtedly influence the loan decision making process. This difference is due to both parties having different interests which lead to differing viewpoints – SMEs are more interested in attaining loans successfully, whilst IBs are more interested in the continuity of repayments.

The credit track record provides a record of the continuity or deferment of repayments in the past. The previous loan repayment history reflects the credibility of the customer; consequently IBs assume that this condition will continue in the future. Generally, for all types of Islamic bank lenders, the ratio of debt to the total assets is very important in determining the viability of the customer. High debt to the total asset ratio indicates high liability. The insignificance of debt to the total asset ratio for SMEs implies that most SMEs cannot estimate their real burden to the external party compared to their ability. This happens since most SMEs do not have any record of their cash flow. They assume that their businesses are in good condition as long as they are running.

The average of sales was considered a very important factor for Islamic banks in making decisions on financing SMEs. Since sales records are difficult to obtain from small firm clients, IB officers make estimations by observing the SME site and through discussion with prospective customers. The average of sales affects the IBs decision to finance SMEs. It indicates the cash flow of the SME and its ability to repay the bank. The higher the average of sales, the higher the cash flow it might obtain. Consequently, this increases the ability of SMEs to repay Islamic banks. On the other hand, Islamic banks will be suspicious if the SMEs report on average of sales is too high. It indicates that such smaller and faster growing firms with insufficient financial strength and lack of collateral suffer from credit rationing (Steijvers *et al.*, 2010b). This is supported by the correlation analysis in table 5.19 which shows that there was no significant impact of sales growth on loan size.

5.5.6 The Relationship between the Borrower's Criteria and Loan Size: Correlation Analysis

This section examines the relationship between the loan size and each of the following variables: age of firm, the number of workers, the number of assets, sales growth, profitability, and maturity. These are analyzed using the Spearman correlation conducted to corroborate the above findings through evidence from statistical examination. The correlation test shows that Islamic banks consider some important factors in deciding their lending to SMEs. These include age of the firm, size of the firm (measured according to the number of assets and number of workers), firm growth, profitability, loan maturity and duration of relationship between SMEs and banks.

Table 5.18 Summary of Correlation Analysis

Model	Correlated Variables	Correlation coefficient (Spearman's rho)	t-sig
Correlation 1	Loan size and firm age	0.407	0.000
Correlation 2	Loan size and number of worker	0.472	0.000
Correlation 3	Loan size and value of assets	0.536	0.000
Correlation 4	Loan size and sales growth	0.121	0.184
Correlation 5	Loan size and profitability	0.170	0.063
Correlation 6	Loan size and maturity	0.360	0.000
Correlation 7	Bank services and relationship duration	0.361	0.000

Source: author

The result of the correlation analysis shows that the age of the firm has a positive and significant relationship to loan size. This is indicated by the positive sign of correlation coefficient and the significance of statistics which shows less than 1%. Thus, hypothesis 1 which states that the firm age has a positive impact on the loan size is evidenced, meaning that the more established the firm the larger the loan amount approved by an Islamic bank. This makes sense because the older the firm, the easier it is for banks to glean information about them, such as track record, growth and experience.

In contrast, the bank may offer smaller loans to young firms. Young firms have less experience in handling business and therefore potentially carry a higher risk. These results are consistent with the empirical evidence that older and younger enterprises have significant differences in their financial structures and consider different factors when choosing finance (Teixeira, 2006). Deakins and North (2008) reported that in the UK younger firms were twice as likely to experience problems in accessing loans and less likely to obtain either the full amount, or at least part of the funding that they required. The main reason for younger firms encountering problems in accessing finance is related to the lack of credit history and high risk. This implies that firm age is an important factor that banks consider in extending finance. The result reported in this thesis supports the financial growth model proposed by Berger and Udell (1998b). In addition, an empirical study by (Messah and Wangai, 2011) suggests that established firms can access funds from formal sources more easily than younger firms because they have accumulated assets which are used as collateral, such that the firm is perceived as creditworthy.

The correlation analysis reported considers the relationship with the number of workers and loan sizes where the number of workers is used as a proxy for the firm size. The number of workers can be used to classify the level of firm, as small, medium or large size enterprises (Rudjito, 2003). The larger the number of workers, the larger the firm size and the greater potential for higher profit. Furthermore, the higher the profit of the firm the higher the capacity of the firm to raise loans and to make repayments. Capacity is another important criteria or banks in evaluating applicants; however, one IB manager commented that no-one neglects the importance of this factor though capacity is not a major aspect for most SMEs.

The results of the correlation show that the number of workers, as a scale with which to measure firm size has a positive and significant relationship with financing amount, where the t-test value is less than 1%. Therefore, the hypothesis 2 which states that the number of workers in the firm has a positive relationship with the loan size could not be rejected. The result is consistent with the growth of financing models of Berger and Udell (1998a). Thus, the larger the size of the firm the easier it is to access loans from formal financial institutions. An OECD (2006a) study found that manufacturing firms with fewer than 20 employees were five times more likely to fail in their loan applications than larger firms.

The value of assets is the another important factor that may influence loan size. The number of assets and loan size has a positive effect. Empirical findings show that the coefficient of correlation is 0.536 which means that the higher the value of assets the larger the loan size. This result confirms hypothesis 3 and supports the 'financial growth model' of Berger and Udell (1998b). Nevertheless, Berger and Udell (2004) emphasize that small firms use different lending technologies. Most banks use relationship lending rather than transaction lending when dealing with SMEs. Furthermore, the result is consistent with empirical literature which concludes that larger and smaller firms choose different financial strategies for their capital structures (Teixeira, 2006). The results reported above are similar for Islamic banks; a larger asset base enables the firm to obtain more financing from Islamic banks since the assets are used as collateral. The availability of tangible assets which can be used as collateral can facilitate the SMEs to access funds from external sources, including Islamic banks (Ayadi *et al.*, 2009; Messah and Wangai, 2011).

The reason for requiring collateral is so that banks can manage the funds belonging to the third party. Banks are responsible for all the funds extended to the client, which means that if the client is going to be bankrupt, the bank can sell the collateral to repay the financing. Thus, selling the collateral is the last resort. Moreover, the regulation allows Islamic banks to take the collateral. These circumstances have been criticized by many authors (Agrawal and Yousef, 2000; Chong and Liu, 2009b) who argue that the practice of Islamic banks is no different to that of conventional banks. If IBs are to be consistent with the concept of PLS, pledging collateral should not be obligatory for every loan application.

The highest correlation between financing size and number of assets implies that there is no difference between Islamic banks and conventional banks in evaluating the viability of SMEs. Both banking types emphasize the safety of financing by ensuring the adequacy of assets as collateral instead of the soundness of the project. Although the safety of financing is important, IBs should prioritize the soundness of project rather than the number of assets of firms. The number of assets is nothing if the project is not feasible. In contrast, if the project is favourable, the applicant not only has the capability to make repayments but also to increase their assets in the future. Therefore, the emphasis of loan assessments must be on the soundness of the project rather than the number of assets.

Theoretically, Islamic financing which is based on PLS, namely *mudarabah* and *musharakah,* means that the bank is ready to not only share the profit but also bear the risk which may be encountered by the client. It implies that Islamic banks should not require collateral, particularly when the mode of financing is on the basis of PLS.

Concerning the relationship between sales growth and loan size (0.184), there is a positive relationship but not significant at 5%.This finding contradicts the unpublished research on Scottish enterprises undertaken by Glencey and Greig (cited in Deakins and North, 2008) which suggests that fast growing firms find it easier to obtain finance in the central belt. The result also contradicts Sanders' (2001) model which indicates that the size of term loans increases with increases in business sales. Therefore, hypothesis 4 is rejected.

In contrast, it has been reported that there are some banks which are reluctant to extend funds to fast growing firms, particularly in rural areas as bank managers lack expertise on how best to evaluate the potential of such firms (Atieno, 2001). Similarly, fast growing manufacturing firms in Scotland commonly move to the metropolitan areas to access larger loans. Voordecker and Steijvers (2008) report that more than 50% of SMEs experienced credit rations in Belgium over the period 1993-2001, particularly smaller and faster growing firms with insufficient financial strength and lack of collateral.

Overall, sales growth does not have a significant relationship to the financing size which implies that IBs did not emphasize the soundness of the business prospect when they were evaluating the applicant. The result suggests that the practices of IB financing are not so different to those of conventional banks (Chong and Liu, 2009b).

The relationship between loan size and profitability is not significant, although the relationship is positive as shown by the positive sign of the correlation. The result implies that SMEs might not use all profits to acquire greater capital but rather use it for other needs. If all profit was retained and used for the acquisition of additional capital, then the relationship between financing size and profitability is negative as predicted in hypothesis 5. Using the partial profit for other needs beyond business needs appears to be sensible as SME owners commonly do not distinguish between business needs and personal spending.

This is contradictory to the findings reported by Bhaird and Lucey (2011) which suggest that the retained earnings become a more important source of funding for all firms. Thus, higher profit firms use more retained earnings and less leverage (Teixeira, 2006). In this circumstance, the firm with higher profitability should propose less financing to Islamic banks.

Significantly, market equity for small business is not developed well enough to raise equity from capital markets. Furthermore, they are costly and inefficient for smaller finance amounts (Blumberg and Letterie, 2008). The relationship of Islamic banks with SMEs is costly and time consuming and the IBs do not have the same quality of information or the skills of conventional banks. Therefore, IBs charge higher margins or profit ratios to compensate for the risk caused by the lack of information. While high numbers of assets facilitate firms to access funds from banks, the existence of high leverage hinders firms from get financing from banks (Ayadi *et al.*, 2009).The results here suggest that IBs profit and loss (P&L) basis, does not approves the access to SMEs as the theory implies.

The results of this study suggest that financing maturity has a positive and significant relationship to loan size. There was a positive value of the correlation coefficient and at 5% represents a significant level. Thus, hypothesis 6 stating that the loan maturity has a positive impact on the loan size is upheld.

The results reported for this study are similar with the model established by Sanders (2001) which suggests that the size of a term loan increases with the increase of loan maturity. This is understandable since the shorter the maturity the higher the burden of SMEs to repay bank loans. By lengthening the maturity, the burden of the borrower was less because the repayment was distributed over a longer span of time. Therefore, some Islamic bank managers suggest prolonging the maturity of financing to reduce the burden of repayment.

Conventional banks loans are of longer duration, for a fixed period and rate, the longer the maturity of loan benefit bank. As also shown in a study by Gottesman and Roberts (2002), loans of longer duration had a higher spread. Banks will charge higher rates for longer term loans to compensate them for the higher risk that may be caused by the asymmetric information. Similarly, Islamic banks commonly use market interest rates as a benchmark in determining margin and profit ratio to their clients (Chong and Liu, 2009b).

In terms of bank service and bank-client relationship, duration has a positive and significant relationship. The correlation coefficient is 0.361 and significance at 1%. The positive and significant relationship of both variables suggests that SMEs will have long relationships with Islamic banks, thus improving their chances of securing loans. The result confirms hypothesis 7 and is supported by empirical studies on relationship lending (Berger and Udell, 1994; Berger and Udell, 2002; Petersen and Rajan, 1994b; Repetto *et al.*, 2002).

Relationship lending could play an important role in solving problems of asymmetric information in bank-client relationships (Steijvers *et al.*, 2010a). The problem of asymmetric information can be reduced effectively by engaging in close relationship with the customer over a long period of time. This long relationship allows the bank to gather soft information which cannot be revealed publically or through accounts. Berger and udell (1994) found that borrowers with longer banking relationships pay a lower interest rate and are less likely to require collateral.

The analysis suggests that Islamic rural banks in Indonesia are considered to be favourable in rural areas since they use relationship lending since managers have local knowledge. The success of rural banks is attributable to a number of factors: firstly, the size of the Islamic rural bank is typically small with few managerial layers; secondly, they have a limited number of branches; and thirdly, they usually operate in local areas. These factors allow Islamic banks to process applications more expediently. More importantly, the focus of Islamic banks tends to be on the provision of services for SMEs that are typically considered as informational opaque business entities (Berger and Udell, 2002). It is a challenge for Islamic rural banks to obtain complete financial information to adequately evaluate SME clients, and within this relationship context banking gains significance. In contrast, large enterprises have standard financial statements that can be used to assess the strength of the business; SMEs neither have resources or knowledge to provide such reports.

Therefore, the only way to serve the small business is to not rely on hard information such as financial reports (Uchida *et al.*, 2008). This suggests that Islamic rural banks should shift from the use of ‘hard information’ to ‘soft information’. Soft information such as character and reliability of firm owners is hard to encode, quantify, verify and communicate through the normal channels of the bank organization (Berger and Udell, 2002). Soft information can only be gathered through maintaining long-term relationships, engaging in two-way communication, and exchanging information with SMEs. This ‘special relationship’ can be of benefit to support or sustain the business interest. Through relationship banking the bank can acquire important information which cannot be obtained from financial statements, collateral or credit ratings, such as; character, environment of firm, staff quality, organizational systems, firm suppliers and customers (Hua, 2009). Information on the number of family members and the family’s financial commitments is non-business information but this information influences the SMEs capability to repay. It is recognized that small or family firms tend not to separate family spending from business needs; hence some lenders use family related information to assess loan applications from SMEs.

Although large and small banks do not differ in producing soft information, small banks rely more on soft information (Uchida *et al.*, 2008). Large banks concentrate their resources on transactional lending, while Islamic rural banks emphasize relationship lending as a tool when evaluating customers. The loan officers, as repositories of soft information, have critical roles in commercial banks since soft information deteriorates as it is transmitted to others within the hierarchy of the bank (Uchida *et al.*, 2008). As a small bank, BPRS can keep hold of such soft information because they have fewer layers of management than larger banks.

5.6 The Experiences of SMEs Owners in Accessing Financing from Islamic Banks: A Case Study in Central Java

The experiences of SME owners in accessing funds from Islamic banks vary, as no two SMEs are similar. This is influenced by many factors such as the risk of the business, the age of the business, the owners' character, and the collateral they possess. Furthermore, the relationship between SME owners and the bank also has significant value in terms of the borrowing evaluation. Therefore, this section investigates the experience of SME owners in accessing funds from Islamic banks. Five cases are explored regarding firm profile, the reason to access funds from Islamic banks, the experience of accessing Islamic banks, and the constraints that they may encounter when accessing funds from Islamic banks. In the following, the issues emerging from the case studies are summarized.

5.6.1 Analysis of Case Study One

The firm was established eight years ago as a small furniture business producing rattan furniture and mainly operated within the region serving the domestic market. When the firm started to grow, it needed more space to increase production. Due to the limitations in accommodation facilities the owner sought another location to facilitate growth. Consequently, the firm now has multiple locations for its production and currently has 100 employees.

With the growth and development of the business, more capital was required to support business growth both for investment in fixed assets and for working capital. The business has gained the confidence of its raw material supplier which enables them to procure materials for production and make payments upon sale of the product. However, this is not sufficient and the firm requires additional funds to support increasing demand. The firm does not require just the raw materials but additional space for production, warehousing, to pay salaries for additional employees, and other operating costs. The firm, therefore, sought more capital from external sources as funds from internal sources were not adequate to support such growth. The firm's track record and relationship with the conventional bank assisted banks to support the firm with additional loans.

However, for the subsequent developments, the firm approached Islamic banks for loans. The introduction to IBs was through an acquaintance of the business owner who worked in an IB. In interview it appeared that the firm owner did not have knowledge of IBs nor did the bank explain the terms or benefits of using IB services. It was acknowledged by the owner that he did not have enough insight about Islamic banks and did not know the types of financial instruments offered by Islamic banks. For him, the terms of the financial instrument used by Islamic banks were very difficult to understand. HIs only concern was how to obtain funds cheaply, quickly and with minimum complications irrespective of the name of the product provider. The owner's main concern was the cost of the financing. The owner neither understood the IBs philosophy nor its terms. This behaviour raised fundamental questions for the motivation of the end users of IBs. This also raised the question of how IBs are able to offer loans at a lower rate. Possible explanations are that IBs in this case were able to offer cheaper loans because the owner has had a good relationship with Islamic bank and there was no asymmetric information provided by the SME.

The owner explained that without the relationship with the employee of the IB it would have been very difficult to obtain loans. This case study suggests that for the firm owner the religious motivation was not significant but more important were the ease with which he could access an IB loan and the cost of the capital. However, the owner acknowledged that the IBs requirements were more complicated than those of the conventional banks. When questioned about the Islamic bank's customer service, he explained that the Islamic bank served him well in the early stages but the service deteriorated over time and he attributed this to a change in lending management, which can also happen with the conventional banks. This analysis suggests that IBs are not necessarily any different to conventional banks in the way they conduct business with customers.

The firm's owner suggested that providing collateral for the conventional bank loans is most difficult. However, in the case of IBs, the requirement for collateral was less emphasized enabling him to obtain more loans from Islamic banks; this raised questions as to why IBs are able to offer more loans with less collateral? In this case, the owner met IBs which emphasized that the important aspect of assessing the creditworthiness of applicants is their capacity rather than their collateral.

5.6.2 Analysis of Case Study Two

Case two is a garment company, founded in 1999. The business was an extension of the owner's wife's tailoring service. The business produced uniforms for schools. As an extension, the firm produced not only uniforms for schools but entered the commercial market through producing clothes for sale in the traditional market. The firm also marketed its products in other provinces. However, growth lead to issues related to collection of goods sold on credit and the business has since limited its operations to local areas including Solo and Boyolali. The firm has only 5 permanent employees and demand for its products is cyclical, with peak demands met by sub-contracting the work externally.

The business was started with personal funds and external finance which was first obtained from the supplier in the form of purchases of raw material on credit with payment made once the goods were sold. To support the growth of the firm, the owner secured financing from Bank Mega *Sharia,* an Islamic bank. He reported that accessing funds from Islamic banks was easier than from conventional banks as it involved less collateral and filling in of complicated forms. However, he reported that the loan price of the Islamic bank was higher than that of conventional banks, a direct contradiction to case study one above. It is acknowledged by some Islamic banking experts in Indonesia that commonly, the loan price of Islamic banks is slightly higher than that of conventional banks because the sales of IBs is still low and do not yet reach economies of scale. In case one above, the applicant paid a lower price merely because he had a close relationship with an IB manager and had a good business reputation. Indeed, there is some circumstances in which IBs charge lower prices to certain customers.

However, the processing time for the application was relatively quick, about 1–2 weeks. The whole process was easy as the requirements were not as complicated as those of conventional banks. Islamic banks emphasize the character of the owner in considering the worthiness of the business as a lender by making enquiries in his neighbourhood. The bank ascertained his character through references from community members to fill the information gap. In interview, he too reported to have not known the Islamic financial terms, because Islamic banks offered him the loan but at no stage was the Islamic financial terms explained; the only explanation that was given was that the loan would be charged based on the profit and loss basis without explaining what the terms imply.

The analysis appears to suggest that Islamic bank requirements are simpler, especially with this case. Most importantly, IBs want to know if the applicant had a business idea and could be trusted, while the guarantee of repayment was not so important. However, the Islamic bank did require a tax identification number as proof. The tax number is also a requirement for conventional banks. On questioning the business owner on the differences he perceives between the services of IBs and conventional banks, he suggested that the service of Islamic banks was different from that of conventional banks. Islamic banks are more active in visiting entrepreneurs to offer their products and once the loan is made they continue to engage with the business through regular visits to sustain the relationship, and that is not the case with conventional banks. The entrepreneur reported that he did not experience significant barriers or obstacles in accessing funds from Islamic banks. However, he did acknowledge that he could not obtain funds if he did not provide collateral.

5.6.3 Analysis of Case Study Three

Case three is a printing and publishing firm which publishes books for elementary and high schools. The firm was founded 25 years ago and currently employs 50 permanent and 50 casual employees.

With the development of the business, the firm began to gain trust from suppliers who provided machinery and raw materials. Before obtaining bank funding the business acquired working capital from business colleagues through mutual agreement on the amount of interest. During the second phase, the firm started to secure loans from conventional banks. However, after an Islamic bank was established locally, the owner began to access additional capital from Islamic banks. The only reason for accessing funds from Islamic banks was his faith that forbids *riba*. In this case, it was religious belief rather than economic logic that moved the business away from conventional banks.

In comparing his experiences accessing funds from both conventional banks and IBs, in this case, the firm had a lot of assets which could be used as collateral. For the owner, the process of loan approval from Islamic banks was faster than conventional banks because the owners have close relationships with Islamic bank officers through Islamic teaching forums. This is evidence of where BPRS as small banks rely on lending relationships when dealing with their customers. However, their close relationship does not mean that loans are administered without collateral. He was also required to provide collateral when proposing financing to the Islamic banks.

His motivation to avoid *riba* is very strong as is evidenced in his desire to seek additional capital only from an Islamic financial institution. For example, when he reached the maximal ceiling of financing from an Islamic commercial bank and BPRS, he approached an Islamic micro financial institution (BMT = *Baitul Mal Wa Tamwil*) for additional financing. He argued that finance from BMT is only used for small and emergency needs because the process is very fast.

Through his good reputation and closeness with Islamic bankers, built through numerous and varied interactions, the owner of this firm had no obstacles in accessing funds from Islamic lending institutions. More importantly, he argues that getting financing from Islamic banks helps his life to be filled with more *barakah* (Arab. his heart feels more tranquil). As a result the owner no longer sought loans from conventional banks. Thus, his religious motivation is reflected very clearly in his desire to avoid *riba* transactions. However, he still has a savings account in a conventional bank to facilitate his business transactions because the conventional banks generally have a wider network than Islamic banks.

5.6.4 Analysis of Case Study Four

Case four is a manufacturing firm involved in metal casting established in 1997. The owner learned the business from his parents. The initial capital was obtained from the owner's savings and family finances. The company currently has 60 employees.
In line with the growth of business, the firm began to expand by establishing new plants. In 2003, the firm secured capital from conventional banks, borrowing 450 million rupiah from Bank Negara Indonesia (BNI) with land as collateral. The loan was used to build a new plant. Next, the firm borrowed 1.2 billion rupiah from venture capital *Permodalan Nasional Madani* / PNM to purchase machines and equipment. At the same time, the Islamic bank officer of Bank Syariah Mandiri, which had just opened a branch locally, approached her and offered financing to support the firm. Observing the factory and the huge value of its assets, the bank offered a loan of 1 billion rupiah.

The firm has benefited from the presence of the new branch of the Islamic bank. As a new branch, the bank needs larger borrowers to immediately achieve sales targets determined by the bank headquarters and the owner of this firm was one of its targets. Therefore, she did not face significant obstacles in accessing funds from the Islamic bank. However, she thought that the process of loan application was longer than that of conventional banks because she had no previous dealings with IBs.

She is attracted to get loans from IBs because they offer loans based on the PLS scheme where the IB is willing to share the potential loss of the project. She said that she did not receive the same service from conventional banks in terms of sharing the loss. In addition, she receives other advantages since her firm's assets, which are purchased from loans, can be used for collateral because her loan was used to buy fixed assets. In addition, the owner considered the Islamic bank more tolerant in terms of repayments than conventional banks.

5.6.5 Analysis of Case Study Five

Case five is a trading firm established in 2002. The company has 16 store branches located in different places. This firm diversifies its business to include mobile phones, books, laptops and traditional herbal medicine. It employs 70 people.

Like other small firms, this firm meets its capital needs mainly through owner and extended funds. Capital loans obtained from relatives were on the basis of profit sharing. To support growth, the owner borrowed funds from an Islamic financial institution. The owner never accessed funds from conventional banks because he believes that it was not compatible with the prohibition against *riba* in his faith. Therefore, he only accesses funds from Islamic financial institutions such as Islamic microfinance (BMT) providers, Islamic rural banks and fully-fledged Islamic banks.

Initially, the owners borrowed money from an Islamic microfinance provider (BMT; *Baitul Mall Wattamwil*). The growth of firm required the owner to obtain more capital, while funds from BMT were not adequate. Therefore, he began to approach Islamic banks, applying for 25 million rupiah to BRI *syariah*. The next loan, acquired from Bank Syariah Mandiri (BSM) was 130 million rupiah. A more recent loan of 1.5 billion rupiah was gained from Bank Muamalat Indonesia (BMI). Unlike other entrepreneurs, he fully understood the terms of Islamic financial instruments and he could explain the types of Islamic contracts eloquently.

He suggested that the evaluation process undertaken by the Islamic bank was more detailed than conventional banks. He thought that while conventional banks emphasized on the value of collateral, the investigation conducted by the Islamic bank emphasized the capability of the borrowers more.

The owner of this business perceived Islamic banks to be more accommodating towards SMEs as the IBs portfolio of loans for SMEs was higher than conventional banks. Furthermore, IBs were more connected with entrepreneurs as Islamic banks, particularly Islamic rural banks, provided training for SMEs, such as in preparing a simple financial report commonly required from SMEs. However, he acknowledged that it is difficult for start-up firms to obtain funds from Islamic banks because they have no track record and inadequate collateral. In the case of start-up firms there is no difference between IBs and conventional banks.

Consistent with the pecking order theory, this entrepreneur also relied on capital from family and relatives. The owner acknowledged that banks need collateral to provide loans; therefore he did not try to obtain funds from banks before he had enough assets for collateral. After the initial start-up stage, he began to access funds from external sources starting with Islamic microfinance and moving on to fully-fledged Islamic banks. The perception that IBs do not require collateral, according to this entrepreneur does not strictly accurate in his experience as IBs also require collateral. This again puts into question the purpose and foundation of the IBs. However, the entrepreneur acknowledges that acquiring capital from Islamic banks is not particularly difficult. To promote IBs amongst other SMEs, the Islamic banks encouraged him to share his experience with other SMEs to encourage them to approach Islamic banks.

5.7 Issues Emerging from the Case Studies

Common themes emerged from the five case studies. Firstly, all participants mainly used their own savings at the start-up phase of their business. This finding is consistent with the result reported in the UK (Paul *et al.*, 2007) and the pecking order theory (Myers and Majluf, 1984). Secondly, these initial funds were acquired from family and relatives. In two cases here, besides obtaining funds from relatives, funds were also gained from suppliers in the form of provision of raw materials on credit. The owners only paid part of the total value of goods as down payment, while the rest was paid after all goods were sold. One firm owner met his capital needs by approaching colleagues or relatives to share profits with them. This owner avoided using interest because he did not want to be involved in *riba* transactions strictly because he believed that *riba* is strongly banned in Islam. Thirdly, firm owners began to access funds from formal sources if the funds gained from informal sources were no longer adequate to support growth. These cases support the pecking order hypotheses proposed by Myers (1984) and Myers and Majluf (1984). In addition, having the capacity to access funds from banks, the firms began to rely heavily on bank institutions (Park et al., (2008).

Generally, business owners engaged with conventional banks the first time when they needed funds from formal institutions. This commonly occurs because the Islamic bank was not available in their area at that time. However, one owner was never involved in conventional banking, even though he needed additional capital to support his business. He strictly avoided the use of interest (*riba)* in financing the business accessing funds from external sources that were *shariah* compliant (this owner is a relatively new to business and when he commenced IBs were present in his locality).

The SME owners began to get involved in Islamic banks after Islamic banks began to heavily promote their products to them. However, in one case study the owner would not have approached Islamic banks if he did not have colleagues working in the Islamic bank. He argued that it would have been impossible for him to obtain funds from Islamic banks if he had not known anyone working in the Islamic banks. This does not mean that an Islamic bank has more complicated lending requirements, but that the owner did not have any prior experience in accessing funds from an Islamic bank. The owner is what Kon and Storey (2003) term a discouraged borrower. Interestingly, SMEs are not loyal to one Islamic bank but make relationships with any Islamic bank. This is true particularly for medium sized firms that need more capital and different schemes, for example, the firm that accesses funds from BMT (Islamic microfinance), Islamic rural banks and fully-fledged Islamic banks. Of the five cases, only one case utilized funds from venture capital.

In Indonesia, it is normal for Islamic banks to promote their products using Arabic terms such as *mudarabah, musharakah, murabahah, injure, istisna* and so on in many promotional media. Unfortunately, most of the borrowers did not understand those terms, although he/she was Muslim. Of the owners in the five case studies, four not only did not understand the terms of IBs but did not care about the details of those terms. What they needed was to obtain funds to finance their businesses regardless of the specific meaning and details of the terms. Although Arabic terms were used in various promotional media, Islamic bank officers are aware that borrowers do not generally understanding them. Therefore, Islamic bank officers described the contracts as simply as possible by explaining the basic scheme used in Islamic banks, namely profit loss sharing or mark-up schemes as equivalent to a certain percentage of interest. The borrowers would understand if the cost charged to the loan was converted to interest rates. In addition, both Islamic banks and the borrowers normally use market interest rates as a benchmark. As a result, the loan charge determined by the Islamic bank was not different from that of conventional banks. This circumstance lead to the opinion that the practice of Islamic banks was not so different to that of conventional banks (Chong and Liu, 2009a).

In the case studies, there are no significant obstacles faced by participants in accessing funds from Islamic banks. This is because all of them have good business reputations. This does not mean that all SMEs can access funds from Islamic banks easily, because the case studies involve those who succeeded in obtaining capital from Islamic banks. In addition, several had close relationships with Islamic bank officers. The case studies imply that lending relationship technologies prevailed in these cases (Berger and Udell, 1995).

One important thing that must be considered in obtaining funds from Islamic banks is collateral. Most of the borrowers here were required to provide collateral to obtain funds from Islamic banks. It was also acknowledged by Islamic bank officers that loans would not be delivered if borrowers could not provide collateral. This issue is normally perceived as an obstacle for SMEs in accessing funds from banks. In addition, one case showed that similar collateral could only be used to secure fewer loans indicating that Islamic banks emphasize the value of collateral rather than the viability of businesses. This is in contrast to Islamic banking theory suggesting that Islamic banks should emphasize the soundness of business rather than collateral in extending financing for entrepreneurs (Iqbal *et al.*, 1998; Zaher and Hassan, 2001).

Although all participants succeeded in accessing funds from Islamic banks, they had differing opinions regarding on the application process. Some viewed the assessment process undertaken by the Islamic bank was easy and fast while others deemed that the Islamic bank needed more time to process the application than conventional banks. However, all were of the opinion that Islamic banks offers better services than conventional banks.

In sum, the participants expect that Islamic banks will emphasize the soundness of the business rather than the value of collateral. Since Islamic banks have profit and loss sharing schemes, Islamic banks should be willing to share losses with the entrepreneur, by not accentuating the availability of collateral. In addition, Islamic banks should provide training for SMEs, in particular in building their skills by providing simple but useful financial statements so that it is easier for Islamic banks to assess the viability of small firms.

CHAPTER 6
THE EXPERIENCE OF ISLAMIC BANK IN DELIVERING FINANCING FOR SME

6.1 Introduction

Asymmetric information is a crucial issue in terms of accessing finance from financial institutions (Deakins and Hussain, 1994a). It was acknowledged that SMEs have specific characteristics that differ from those of large companies. The opaqueness of information provided by SMEs is one characteristic that hinders them from accessing funds from external sources (Yifu and Xifang, 2006), including Islamic banking institutions. On the other hand, bankers' skills and experience play a pivotal role in handling problems of asymmetric information when dealing with small firms (Agyapong, 2011). This chapter examines the experience of Islamic banks in providing financing for SMEs to answer research question number four as stated in chapter one. The experience of Islamic bank managers is analysed using Interpretative Phenomenological Analysis (IPA) based on interview. Following the analysis guidance addressed in the methodology chapter, four major themes were identified.

Table 6.1 Major and Subordinate Themes

Master themes	Subordinate themes
Financing evaluation process	• Information needed to assess the creditworthiness of borrower • Factors influencing the sanctioning process • Criteria of borrower's worthiness
Obstacles to accessing Islamic financing faced by SMEs	• Administrative requirements of financing • Collateral provision
Decision making	• Margin determination • Financing maturity
Monitoring	• Borrower monitoring • Repayment performance

Source: Author

The major themes and subordinate themes are depicted in table 6.1. Furthermore, based on the analysis of the result, the lending framework for the two different types of borrowers, that is new and existing borrowers, is established to answer question number 5.

6.2 Financing Evaluation Process

The existence of asymmetric information forces banks to carefully evaluate every loan proposal in order to avoid default risks in the future. Banks commonly use the 5C criteria (capital, capacity, condition, collateral, and character) as indicators on acceptance or rejection of a loan proposal.

Chapter six examines the financial evaluation process, starting with the information required by banks to assess the creditworthiness of borrowers since Islamic banks are slightly different in their operation and philosophy from conventional banks. Thus, IBs might need different sources of information before approving loan applications. The next step is the investigating factors which influence the sanctioning process of the borrower application. At the end of this section, the criteria of borrowers' worthiness are examined.

6.2.1 Information Required to Assess the Creditworthiness of Borrowers

Like conventional banks, Islamic banks commonly use the 5C criteria to accept or reject loan applications. However, a business cannot be financed by an Islamic bank if it is not trading according to *Sharia* principles, and if it violates *Shariah* (Islamic law). Thus, besides the 5C criteria, Islamic banks should consider the *Shariah* compliance of a business before granting it a loan. This is the basic requirement for that differentiates Islamic banks from conventional banks. *Shariah* compliance is of utmost importance for the borrower and lender, as acknowledged by BR3.

> *This is the most important aspect that must be considered by an Islamic bank. Obviously, firstly, the business must be Shariah compliant (BR3).*

Once the *shariah* compliance assessment is completed the evaluation of the loan application can continue on the same basis as conventional banks. The next important criteria are the type of business and the purpose of financing. Both are crucial for Islamic banks because they determine what type of contract is suitable for each business. Islamic banks offer various contracts to meet different business needs. Every business has different characteristics which lead them to utilize different types of contracts. So, by understanding the characteristics of a project to be financed, banks can determine the type of financing appropriate to meet the business financing needs. This point is demonstrated by the following excerpts taken from an interviewee:

> *Firstly, we investigate the type of business. We are very flexible when helping them because an Islamic bank offers more financial instruments than a conventional bank does (BR5).*
>
> *Firstly, we determine the borrower's needs. From this, we come to understand what type of contract is most suitable for the borrower (BR4).*

The information about the business sector is important because different sectors have different default risks as found by Fidrmuc and Hainz (2010). For example, they found that the default risk of the service and agricultural sectors was above average. The agricultural sector in particular faces natural risks outside of farmers' control. Islamic banks examine each business sector or type of business to offer suitable contracts and estimate the embedded risk, a point that was commented upon by BR2.

> *Q: What information do you need before you grant finance for SMEs?*
> *A: First of all, we look at the available information in the business sector (BR2).*

Therefore, investigating the business sector of a prospective SME allows Islamic banks to predict their repayment continuity in the future. According to McKillop and Barton (1995), precise knowledge of the business sector by the bank can reduce the default risk of SMEs and it seems Islamic banks use this methodology to minimise default risk. Risk can also be reduced by having precise knowledge of the borrower through the proximity of the bank to the SME, either through its location or through informal relationships that enable bank officers to have familiarity with borrowers. Thus, the presence of Islamic rural banks in rural areas is favourable for SMEs because they will normally be run by one bank that avoids information asymmetry. This point is supported by BR3.

> *Actually, our good borrowers are those who live within a radius of five kms from the [bank] office, because we, generally recognize people in this area (BR3)*

Another source of information useful in reducing potential default risk is the Debtor Information System (DIS); used to detect whether or not new borrowers have a good track record according to national banking data. This information system contains all debtors in the national banking system and it is shared. This implies that if banks do not find the name of new applicants in the DIS this suggests that they have never borrowed funds from any bank. The database will also show if a borrower has a bad track record with a certain bank as his/her name will appear in the DIS records. This was confirmed by BR3.

> *From a financial aspect, we can check the DIS (Debtor Information System). From this, we can see whether someone has had debt. So, if someone has a bad track record, he will emerge [in DIS] (BR3).*

For a large firm the viability of a business can be predicted from financial ratios derived from the financial statements. In contrast, it is not applicable in SMEs because not all of them have financial statements. Most SMEs cannot prepare financial statements because generally they have poor financial and administrative knowledge. This circumstance leads to informational opaqueness (Yifu and Xifang, 2006) for banks. The absence of financial information for SMEs is supported by the response of BR7.

> *Almost all of SMEs don't know about financial statements (BR7).*

Islamic banks are aware of the finance gap and they make an effort to acquire information other than financial statements to enable them to extend the loan facility. This finding confirms previous studies which suggest that small banks rely more heavily on non-financial information when evaluating borrowers than the large banks (Berger *et al.*, 2004; Kim, 2009). Due to the unavailability of a financial statement, Islamic banks help SME owners to estimate their capacity to repay. The transcription notes for BR1 suggest that Islamic banks were able to gain a (business) specific piece of information about the SMEs cash flow.

> *No financial statement in a standard form is available. The sales report is the only information about cash in and cash out (BR1).*

It was acknowledged that the major shortcoming of small businesses is that they do not have the capacity nor the systems to maintain their financial information record nor records of their transactions. It was reported by bank managers that small businesses do not know the importance of preparing a financial statement, such as balance sheets and income statements, which are normally prepared by large firms.

Lack of administrative and financial skills are a major concern for small enterprises and this limits the banks' ability to assess the worthiness of the business and this point was made by BR3 during the interview. Hence, in absence of financial information Islamic banks rely on other indicators to assess the SMEs' worthiness. To do this the loan officer requires 'special skills' and local knowledge to overcome the informational shortcomings of SMEs. This skill can only be achieved through long-term engagement within an area and through liaising with the firm. The analysis of the responses from IB managers suggests that lending managers of Islamic banks have more discretion when approving loans for SMEs, a practice that existed until recently among the conventional banks in the UK (Deakins and Hussain, 1993). The lending managers suggested that it was not possible to assess SMEs based on the financial information available. One manager, BR1, explained:

> *We do not need complicated parameters. We just look at the business. Is it still running? For how long has it existed? Besides, how much assets does he/she have to back up his/her business? (BR1).*

The rhetorical question "how long have you operated in this business?" implies that the firm's age is an important indicator to assess the viability of a business. This finding was confirmed by the quantitative result of this study that examined correlation analysis in table 5.18 which indicates that the age of the firm influenced the bank lending decision. Furthermore, this finding is supported by the study conducted by Fatoki and Asah (2011) which suggests that older firms were more likely to be successful in accessing funds from banks than newer firms. It is plausible since the capability of the older firms to run the business in any condition was tested. In contrast, newer firms did not yet prove to be sustainable in situations of economic turmoil.

Other information that may reflect the viability of SMEs is the existence of tangible assets, either the business's assets or private owner assets. Since the family needs were not separated from business needs, the profit from business was normally used to buy assets that (directly) do not support the business. Profit gained from business was used to buy a new motorcycle, car, and land or renovate the house. Thus, viable small businesses could be determined from physical or aesthetic changes (such as the owner's home, vehicle or land ownership).

SME assets and owners are considered together. Therefore, we usually see whether he/she has physical assets, such as land, a vehicle. If such evidence exists, it means that his/her business is running well and produces adequate profit (BR3).

The quote from BR3 suggests that Islamic rural banks do not only consider the firm's assets but also the personal assets of the owner. That is why a small business is frequently required to provide a Personal Financial Statements (PFS) when proposing bank loans (Thompson *et al.*, 1993). In their study, Thomson et al., (Thompson *et al.*, 1993) found that 85.8 per cent of banks used PSFs when evaluating commercial (business) loans.

6.2.2 Factors Influencing the Sanctioning Process

The comprehensiveness of loan requirements is a decisive factor for the success of applicants because it gives required information. Information such as a business plan reflects information related to business activity, especially what will be done in the future. This information will be required when entrepreneurs apply for a loan from the bank. A business plan states the current business condition and depicts the future goal(s) and the development of strategy to achieve the goals of the business. Thus, a business plan is an effective tool used by firms to organize goals and objectives into a coherent format, particularly for SMEs (Hormozi *et al.*, 2002). On the other hand, the business plan indicates the amount of funds needed by the firm to run the plan. For an Islamic bank, a business plan is an effective and efficient tool to evaluate the feasibility of a business. More importantly, based on the information gleaned from a business plan, an Islamic bank can decide what type of contract is most suitable for such a proposal. In addition, it estimates the cash flow of the project in the future. Thus, a business plan provides some sort of guidance to help achieve that goal. It was empirically evidenced that firms' utilizing business plans are more successful than others (Orser *et al.*, 2000). Furthermore, Fatoki and Asah (2011) found a positive relationship between a business plan and the SMEs' access to debt finance. It implies the important role of providing a business plan for SMEs when accessing funds from a bank. According to respondents in this research, almost all of the small businesses applying for finance from Islamic banks did not provide a business plan. According to BR7, most of them do not understand what a business plan is.

So far, we have rarely asked for the business plan [from them], because they don't know how to prepare a business plan. Small firms have a very simple mindset. They cannot articulate their idea in the form of a business plan (BR2).

I think we are not so rigid. Even they do not know their actual business size. We act as technical assistants for them, by providing them with some forms to fill in. For example; how much did you purchase your business for? How much would you sell the business for? How much is your inventory/ stock etc?. By doing this, we not only help them but also know the viability of their business (BR5).

The responses above from bank mangers suggest that information is elicited by using financial tools to assist in making a lending decision. Here, the long experience of the bank manager plays an important role in engaging with SMEs. It seems as though Islamic bank managers do not ask SMEs to provide them with a business plan, instead they construct one for themselves and this allows them to complete the financial jigsaw. Another view expressed by BR6 (below) is that there is no need to ask for the business plan, given their size:

Islamic rural banks are involved in small financing. So we need not require a business plan (BR6).

This finding supports earlier studies which suggest that most SMEs do not engage in strategic planning or prepare business plans (Wang and Redmond, 2006; Richard B Robinso and II, 1984; Sexton and Auken, 1986; Berman *et al.*, 1997; Orser *et al.*, 2000).

The other factors that might influence Islamic banks to make decisions is the amount of financing required by the business as it will influence the default risk. This means that the higher the amount of debt, the higher the risk for banks. Therefore, Islamic banks investigate a business' existing loan to estimate the potential default risk in the future; hence the bank may also require additional security for a larger loan than that for a smaller loan. The bank managers in this study reported that some Islamic banks have standard procedures to be followed for different sizes of loans. There is much more of a rigorous evaluation procedure for loans of a larger size than for smaller loans.

"For financing of less than 50 million, the assessment took place in a week, for financing of more than 50 million it needs two weeks for an assessment, because we have to check this and that (BR7)."

Nevertheless, in general, the time required to make a lending decision depends on the completeness of information provided by a SME rather than the size of the loan. The faster the information requirement was fulfilled, the quicker the decision is made. Therefore, the experience of SMEs in dealing with banks and being able to provide information will influence the processing time of the loan application. SME owners who frequently engage with banks were expected to be better in preparing requirements required by banks than those who have less frequent engagements.

6.2.3 Criteria of Borrower Worthiness

BPRS have their own criteria when evaluating the creditworthiness of SME applicants. This criterion is expressed by an IB manager below:

> *In financing, we have the 5C criteria, but we only emphasize two points of it, namely character and collateral. However, we consider cash flow another important criterion. Thus, to make an assessment of borrowers' worthiness we emphasize character, collateral and cash flow (BR5).*

It was established through interview that an Islamic rural bank manager will consider every financial proposal based on the 5C criteria. Nevertheless, if the financing proposal does not meet all of the 5C criteria, Islamic banks emphasize at least the three criteria mentioned above. Combined with a loan purpose (as addressed in subsection 6.2.1), there are four important criteria determining the assessment of a financial proposal. This finding supports the study conducted by Ralston and Wright (2003) which suggests that borrowers should be assessed based on their character, purpose of the loan, capacity to repay and collateral available for security. In Islamic banks, the loan purpose was considered in relation to two things; 1) whether or not the purpose of loan is *Shariah* compliant; and 2) the choice of suitable type of contract dependent on the loan purpose. Thus, all Islamic banks take these criteria into account. The consideration of these three (assessment) criteria varies among institutions. Islamic banks emphasize character in assessing the creditworthiness of small firm borrowers; this confirms that small banks favour qualitative criteria based on their loan officer's personal interaction with loan applicants (Cole *et al.*, 2004). The long relationship with loan applicants allows loan officers to know their character better. This was validated by the responses of BR4 and BR7.

> *We will grant financing for someone as long as we know his/her character. Usually, if someone has good character he will always make effort to repay, whatever the condition. If necessary, he will sell his own bicycle to repay (BR2).*

> *If a person is good, he will always make effort [to repay], but if his character is bad he will not remember or neglect to repay even though he has money. So, character is dominant. (BR6).*

This finding confirms the opinion that a small firm has an advantage in relationship lending (Berger and Udell, 2002). The understanding of a customers' character would be better if the bank has had a close relationship with them over a longer period. Acquiring a good character profile from small borrowers will offset the weaknesses of SMEs in relation to providing good financial statements.

Whilst the importance of character is recognised, the most important aspect for bank officers is the ability of the borrower to repay. The capacity to repay can be estimated by analysing the cash flow and profit of a business. This suggests that liquidity is important to ensure repayment. This supports the opinion of Altman (1968) who argued that bankruptcy occurs when firms suffer from high indebtedness, is illiquid, insolvent and of low profitability. Emphasis of capacity over character in this case is self-evident. Good character without the ability to repay becomes meaningless. A similar sentiment was expressed by BR3 and BR8 in their responses.

A firm's capacity will be reflected in the adequacy of cash flow and profit. The importance of cash flow in evaluating the worthiness of borrowers was also suggested by Barrickman (1997). Indeed, loans can be paid by any cash generated from any source such as through collateralized assets, other fixed assets or from other loans. The lender in this case wishes to establish that the loan can be serviced without disrupting business activity. Therefore, it was suggested that when a bank evaluates applicants, it should consider two things related to cash flow; the adequacy and the volatility of cash flow. High cash flow does not guarantee that instalments will always be good if it goes hand in hand with high volatility. Loan risk default would be more severe for firms with high cash volatility. To take account of the above, Islamic banks stipulate that the repayment terms should not be such that it affects the firm's operational abilities, particularly for new borrowers. Therefore, loan duration for Islamic borrowers tends to be longer and continuity of the business is considered to be important, this view was supported by *BR7*.

It is debatable which criteria, character or capacity, is most important. Those who consider character to be more important than capacity, rationalize that the borrower will make a sincere effort to honour repayments, whatever the conditions. If necessary they will sell their own assets to repay. In contrast, those who believe that capacity is more important than character argue that the borrowers with good character but less capacity will have repayment difficulties if they face financial problems. In fact, selling assets to repay their loans is not desirable. These two differing opinions arise as a result of the different experiences of bank managers. Banks view that both character and capacity are the same. In their responses, BR3 and BR5 considered capacity and character to be of equal importance to collateral.

Interestingly, all Islamic bank lending managers ranked collateral in third place. It seems that Islamic banks rely on collateral. Besides observing the rule of central banks, collateral can be used to mitigate the potential loss caused by default risk. Requiring collateral is allowed in *Shariah* (Islamic law). To mitigate the risk of failure, IBs ask the applicants to provide full information. Every borrower is expected to make a concerted effort to demonstrate good character and high capacity when dealing with banks to secure funds. Hoque (2003) reports that asymmetric financial information, non-transparent financial transactions, and an imperfect financial market act as incentives for borrowers to provide false information about their character and capacity by overstating the true value of the firm’s assets to secure loans (p.15). This is supported by respondent BR3:

> *The borrowers always say good things when they borrow, without ever stating the negative side (BR3).*

Therefore, to overcome imperfections in information, just like conventional banks, Islamic banks require collateral to mitigate the possibility of default. Bank mangers refer to collateral as “the last way out” *(BR3, BR4, BR7, and BR8)*, particularly in the case that collateral can be used to resolve the problem of loan default. Islamic banks are reluctant to use collateral in the case of default as it has negative connotations and an image problem, especially where the Islamic bank is relatively new compared to its conventional counterpart. If IBs use collateral frequently, people would argue that an Islamic Bank is no different to a conventional Bank.

Similar to conventional banks, Islamic banks use collateral to reduce default risk and cost of lending. As reported by Niinimaki (2009), banks refrain from conducting costly borrower evaluations, hence lending decisions are based on collateral . In this study, IB lending managers acknowledged that, “It is quite difficult for those who don’t have collateral to borrow. Loans can’t be obtained without providing collateral.” (BR4). Whilst BR5 said, “the first way out is cash flow and character, while the second way out is collateral. It means that collateral is secondary, but still important.” These views question the assertion that IBs rely more on character than collateral or any other financial information in assessing loan applications.

IBs evaluate similar sector related risks and other financial information to estimate potential risk and return. It was acknowledged that different types of business and sectors give different rates of return and risk. Islamic banks utilize this information to predict whether SMEs have the strength to yield sufficient returns to make repayments and hence mitigate the default risk (Agyapong, 2011). BR1 reported that the cost of a loan was determined on the level of risk of the business.

This suggests that criteria used by Islamic banks are no different than those of conventional banks. However, it is necessary to emphasize that although IBs mimic the conventional banks’ approach, they tend to place higher weighting on the three factors character, cash flow (which reflect capacity), and collateral. Islamic banks also require borrowers to not be involved in businesses that violate *Shariah* law.

6.3 Obstacles to Accessing Islamic Financing Faced by SMEs

Small and medium sized enterprises are considered crucial toeconomic development, both in developed and developing countries (Karadeniz and Gocer, 2007; Beck *et al.*, 2005; Fumo and Jabbour, 2011). SMEs make contributions to GDP and are the best means for poverty alleviation through employment creation. Unfortunately, most SMEs across the word have financing constraints in comparison to larger firms (Beck, 2007; Fumo and Jabbour, 2011). There are some obstacles that may well be coercing SMEs to access funds from external sources. This study discusses two issues related to the obstacles to accessing financing for SMEs which emerged from subordinate themes, namely administrative/documents and collateral requirements.

6.3.1 The Administrative/ Document Requirements of Financing

Islamic banks required some documents to support loan applications. Banks can evaluate loan proposals based on financial statements and business plans. Nevertheless, most SMEs cannot provide both the financial statement and business plan. The difficulties faced by SMEs in providing such documents are acknowledged by Islamic bank officers. This finding confirms the opinion that SMEs are an opaque firm (Berger *et al.*, 2001). Consequently, Islamic banks asked SMEs about the evidence of their business activity, such as notes or receipts of their business transactions. Based on these documents, Islamic banks estimate the overall capacity of the borrowers.

> *Actually most of the SMEs do not have a good financial statement. We help them provide simple calculations (BR8).*
>
> *They cannot provide good calculations of their business which enables them to illustrate future cash flows (BR2).*

The lack of good documents obscures IBs ability to make an evaluation. For example, the borrower provides collateral in the form of land, but he/she could not provide the certificate of land which denotes his/her possession of the land. The application process could not be continued until the borrowers fulfil the legal requirements.

> *Actually, the process is fast, the process was going excellently for three days, but the obstacle is the legal issue. The binding of collateral, the legality must be clear. For example, collateral in the form of land whose certificate is still in the parent's name(BR3).*

6.3.2 Collateral Provision

Theoretically, collateral arises as a consequence of an information gap between borrowers and lenders. The important role of collateral when accessing funds from banks prevails not only in the developing countries but also in developed countries. In the USA, where the debt market is developed and credit scoring is a tool to screen good from bad borrowers is commonly used (Berger *et al.*, 2011), credit for SMEs secured through the use of collateral is extensively used, in a aprroximately 80% of cases (Averya *et al.*, 1998). Indeed, technological innovations such as small business credit scoring can lower interest rates but not collateral, even if it requires higher collateral (Indersta and Mueller, 2007).

Islamic banks argue that even though collateral is not the most important factor in deciding a loan proposal, the collateral is useful to protect default risk and to solve amoral hazards. This is in line with the theoretical argument of using collateral in loan applications which was summarized by Blazy and Weill (2006). Firstly, collateral allows loan loss reduction for the banks in the event of default because it provides the banks a prior title in specific assets. Secondly, collateral solves the problem of adverse selection emerging, when banks assess the borrowers. Thirdly, collateral helps to solve the problem of moral hazard which may happen after a loan has been granted.

SME owners who propose loans accompanied by collateral will accelerate IB manager's decision making. Because IB managers believe that the applicant will make a keen effort to repay on time. This is correspondent to the argument of Indersta and Mueller (2007) who claim that collateral makes the lending decision more efficient. The explanation is that the cost of borrowing is lower when collateral is used and that gives high NPV for the cash flow, hence it increases the viability of the project. Hence, collateral improves the lender's incentives to accept marginally positive projects, making the credit decision more efficient (p. 828).

In the case of Islamic rural banks in Indonesia, since all of them did not use any tools for reducing the asymmetric information problem, the collateral requirement becomes an obligation to mitigate default risk. Collateral is one tool used by Islamic banks to mitigate the potential default risk in the future. This is in line with the opinion of Ortiz-Molina and Penas (2008) who argue that lenders can mitigate risks and the asymmetric information problem by demanding collateral. Psychologically, the borrowers who provide collateral will behave prudently in managing their business and meeting their instalment repayments on time. Thus, collateral forces the borrowers to act responsibly towards their liability. This is supported by the opinion of Boot et al., (1991) who argue that collateral is a powerful instrument in dealing with moral hazards, though it imposes a (deadweight) repossession on the bank (p. 458). The importance of collateral for Islamic banks was to reduce the potential morally hazardous behaviour of the borrowers.

> *When the applicant was recognized as being of good character, then we do not need to ask for collateral. Conversely, if we are not so sure of the*

borrowers' character, we ask the borrower to provide collateral. Borrowers who provide collateral will have more responsibility to make repayments on time (BR6).
We hold a prudential principle (BR1).

The obligation of any small firm to provide collateral reflects that the Islamic bank doubts the continuity of loan repayments which could lead to loss for the bank regardless of what funds are borrowed to the SMEs. Another reason for requesting collateral is that IBs have a responsibility to protect funds from a third party because most of the IB capital comes from a third party.

Collateral is important because we are responsible for third parties' funds (BR4, BR7)

The obligation to provide collateral for SMEs confirms the wide use of collateral found in the study undertaken by Davydenko and Franks (2008). They found that more than 80% of SME applicants provide collateral both in Germany and the United Kingdom. Even in the United States where Small Business Credit Scoring (SBCS) is available for banks to reduce asymmetric information (Berger *et al.*, 2011), the use of collateral remains at 73% (Gonas *et al.*, 2004). The lack of collateral is also acknowledged by Islamic rural bank managers, as reflected below:

Most of their problem is collateral; most of them have less collateral (BR2).
It was quite difficult [to acquire funds from Islamic banks] for those who don't have collateral (BR4).

Other problems regarding collateral provision are legal issues. This circumstance is more severe for SMEs because the fact that most of them did not have any concern about the legality of any of the fixed assets they possess. For example, the borrower who provides land as collateral finds it difficult to be granted a loan because of the unavailability of certificates/documents in his/her possession. This is a frequent occurrence when inheritance assets have not yet been legally transferred to the new owner.

Regarding collateral binding, the legal issue must be clear. For example; a borrower who provides land as collateral where the certificate of the land is still in his parent's name, must provide other documents to prove that the land is his asset (BR3). The unavailability of documents causes a bank to take time in processing loan applications (BR7).

The lack of good document complicates the process of evaluation by IBs. For example, the borrower provides collateral in the form of land, but he/she could not provide the certificate of land which denotes his/her possession of the land. In such cases, the application process cannot be continued until the borrowers fulfil the legal requirements. This finding implies that legal issue is another problem that is faced by SMEs in providing collateral. The difficulties of providing collateral confirms the results of the study undertaken by Beck et al., (2006) in 80 countries which reported that collateral requirement was rated as the first, and most important financing obstacle, particularly for small and medium firms, amongst twelve other financing obstacles.

6.4 Decision Making

The basic principle in Islamic transactions was guided by the Q*ur'an* (chapter 3, verse 29) which states that people could not eat others' property in vanity, except with the permission of the other. This principle cannot be achieved if one party fails to uphold their part of the agreement. Therefore, it is usual for Islamic banks to negotiate contractual terms with borrowers before approving the loan. Indeed, not all matters must be negotiated with their clients. The two most important terms are determination of margins and the loan duration.

6.4.1 Margin Determination

Margin determination is a crucial issue in Islamic banking as it impacts on profit. Profit in Islamic banking is determined by the spread between deposit and lending margin minus operation cost. Nevertheless, Islamic banks cannot stipulate the margin as it is influenced by a competitive environment that influences the margins. Navneet et al., (2009) reported that the reduction of margin interest rate as a result of increasing competition occured in the Mauritian banking sector. Thus, the higher the numbers of Islamic banks in a market may lead to competitive margins for small firms. This assertion is supported by Khawaja and Din (2007) who reported that the presence of alternative financial intermediaries is crucial for lowering interest spread.

Islamic banks do not operate in isolation and the rates they offer have to be competitive yet they have to maintain their profit. Therefore, BPRS must maintain the optimum spread between the loan and deposit margin. Margins shared for common depositors are determined solely by the BPRS. Conversely, large depositors, known as "prime depositors", normally negotiate with BPRS managers in seeking a higher profit share than common depositors. This leads to a decrease in the spread received by BPRS. If BPRS is reluctant to accept the demands, the depositors will move their funds to another Islamic bank. Since Islamic banks, more specifically Islamic rural banks, commonly lack capital, they will accept the bargaining of the “prime depositors”. In this case the “prime depositors” have bargaining power rather than the ability to negotiate a profit margin.

> *The margin for common depositors is the same, while the margin for prime depositors is negotiable and normally higher than that for small depositors. Prime customers are those whose deposit is above the average (BR3).*

The determination of lending margins could be a function of the specific loan, such as the loan size, amount of pledged collateral and cost of reviewing application (Mallett and Sen, 2001). The cost of evaluating applications may increase as a result of higher asymmetric information that is mostly experienced by SMEs. The higher asymmetric information problem characteristic of small firms makes it difficult for Islamic banks to assess the true risk of small firm borrowers. Consequently, Islamic rural banks charge higher margins for small firms which reflect the uncertainty of small firms. This finding is in line with the finding of Canales and Nanda (2008a) who conclude that small firms were charged higher interest rates, particularly because they had fewer outside options for external finance. SMEs accept the policy of Islamic banks which charge higher rates than conventional banks which is shown in the following comment an IB manager.

> *In conventional banks the rate is 14% on average, while in Islamic rural banks, the rate is at least 1.5% flat or on average 26% a year (BR3).*

The higher margin applied by Islamic rural banks for SMEs is due to several factors. Firstly, Islamic rural banks are involved in high risk markets, so that the high charges are intended to compensate for the risk. Secondly, since Islamic rural banks are small financial institutions and operate in local areas, they operate under diseconomies of scale conditions. Thirdly, Islamic rural banks have a lack of liquidity which influences the determination of margins. This is in line with the opinion of Navneet et al., (2009) that banks with high levels of cash assets are able to work at lower risk premiums which in turn charge a lower spread. Thus, the charging of higher rates by BPRS confirms the findings of Mallett and Sen (2001) in which found smaller financial institutions charge interest rates that are almost 60 basis points higher than the average interest rates charged by major banks.

In term of charging the borrowers, Islamic banks allow the borrowers to negotiate. The margin imposed by Islamic banks is a result of negotiation. In this case, Islamic banks have had minimum margins that must be maintained.

> *Principally, we offer the margin, because in Shariah everyone can negotiate. We have standards, but the magnitude of the margin depends on the result of negotiation particularly with "prime customers" (BR2).*

Although Islamic banks do not use interest in their transactions, they use market interest as a benchmark. This is the easy way for Islamic banks to determine their return. In addition, this benchmark is useful for Islamic banks when offering financing to borrowers who have experience engaging with conventional banks because the borrowers will compare the Islamic bank loan price with that of a conventional bank. Consequently, the loan price of Islamic banks is equal to the price of conventional banks. This circumstance is criticized by some authors who argue that the practice of Islamic banks is not different with conventional banks in terms of charging loans (Chong and Liu, 2009a; Agrawal and Yousef, 2000).

> *We cannot charge the same margin, but it depends on the borrower. If the borrowers have ever come to conventional banks, they knew the interest rate in the conventional banks, so we offer a margin equal to that interest rate. For new borrowers we offer a margin [regardless of the market interest rate] and then negotiate (BR6).*

Generally, Islamic banks determine and negotiate the financing margin based on the potential risk that they may face in the future. It was acknowledged that different types and sectors of business have different risks. Therefore, Islamic banks consider each business sector where SMEs operate. Thus, Islamic banks determine margins for financing based on the potential risk of the borrowers.

> *For financing, the margin was determined based on the risk [of the business]. We make an offer and then borrowers negotiate (BR1).*
>
> *For lending, a margin was negotiated, but a bank has a standard to offer. Every business has a different ratio because they have different characteristics [associated to risk]. Higher risk businesses are charged with higher rates, whilst lower risk businesses are charged with lower rates (BR3).*

6.4.2 Financing Maturity or the Duration of the Loan

The longer the duration of the loan period the higher the default risk because of the uncertainty in the future, particularly for risky firms. According to Scherr and Hulburt

(2001), no one will lend long term debt to very risky firms because of the resulting adverse selection problem. Nevertheless, Islamic banks will encounter some borrowers moving to another bank to secure longer term loans, which in turn decrease the number of borrowers, if they avoid giving long term loans. Consequently, the return will decrease in the long run.

Similarly, Islamic rural banks cannot grant financing for a long duration to serve the borrowers who need a maturity period longer than 4 years because the capital of Islamic rural banks is limited and needs to be recovered to make further loans. Therefore, an Islamic bank is required to balance between providing short term and long term financing properly to avoid an illiquid condition.

> *The maximum maturity is 4 years. If the maturity more than 4 years our liquidity will be a problem (BR3).*

From the firm borrower's point of view, deciding the financing appropriately is crucial to ensure the continuity of firms operation without suffering financial distress. Therefore, conformity between debt maturity and economic life of assets should be considered. According to the accounting approach, current assets should be financed with short-term debt and fixed assets with long-term debt and equity (Gapenski, 1999). If a firm cannot manage the financial needs by matching debt maturity and economic life of assets, financial problems might arise and lead to an operational disturbance which in turn reduces profit. For instance, if debt has a longer maturity than the economic life of assets, cash flow generated from the assets will stop before the rest of the debt is repaid, whilst if debt is less than the economic life of assets, there may not be enough cash to repay the principle (Yi, 2005). In this regard, the policy of Islamic banks to negotiate financing maturity with the SME owners allows them to consider this issue. Islamic banks decide the financing maturity based on the result of evaluation which considers the common criteria and the risk of the business.

> *Based on the repayment capacity of borrowers, we decide how much and how long the financing will be granted (BR4).*

Some Islamic banks have standards of financing maturity based on the loan ceiling. The quotation of financing maturity is determined by considering the capacity of the borrowers. This means that if the borrowers have a higher burden to repay higher loans, Islamic banks will reduce the burden by extending the maturity. This policy is reflected as follows:

> *Financing maturity depends on the financing ceiling. Financing up to Rp5 million, of its maturity is a year. For Rp5-20 million, maturity is 2-3 years. For more than 10 million, maturity could be 4 years maximum (BR3).*

The explanations from the IB managers above imply that Islamic rural banks are involved in short term financing. This circumstance is supported by the quantitative data results from the questionnaires which reported that 90% of SME financing is used as working capital (see table 5.12), where normally it is short term in nature. This finding confirms the result study of Scherr and Hulburt (2001) which found that small firms engage in retailing or other sectors whose assets are short term. A greater proportion of large firms involved in the manufacturing sector and other lines of business require investments in long term assets. The use of short-term debt for small firms also confirms the study of Taleb and Shubiri (2011) which indicates that the size of firms is positively and significantly correlated with long term debt and negatively and significantly correlated with short-term debt. Korner (2007) also shows that long-term debt increases as company size increases. These results imply that large companies borrow on a long term basis while smaller ones prefer short term borrowing. This is plausible, as larger firms have the ability to reduce the unsystematic risk via diversification, while smaller firms do not have such ability. The prevailing use of short term loans by SMEs indicates that risky firms are screened out of the long term debt market (Highfield, 2008).

The use of short term debt for small firms is also in line with the findings of Chen *et al*, (1999), Majumdar (2010) and Elyasani et al., (2002) who reported that consistent with the contracting-cost hypothesis, firms with high growth options use more short-term loans where, on average, growth options were more likely in smaller firms rather than large firms (Denis, 1994). More importantly, collateralized assets and leverage are to the determinant of debt maturity choice (Majumdar, 2010).

To ensure the continuity of the repayment, besides considering the assessment result, some Islamic banks also negotiate with the borrowers in deciding the financing maturity. Nevertheless, the important consideration for Islamic banks is the capability of the borrowers to repay.

> *When offering, we have to consider the [capability to repay of] borrowers (BR8).*

Thus, though Islamic banks offer the option for borrowers to negotiate, the result of negotiation will not be detached from the assessment. This implies that negotiation is used to ensure that the borrowers are not excessively burdened to repay on time, while the final decision regarding financing maturity remains the authority of the Islamic bank.

Given the fact that Islamic rural banks are small banks, their capability to finance is limited either in terms of the amount or the duration. That is why; Islamic rural banks are mostly involved in small and short term financing. For firms that require a much larger amount and a longer term finance (than Islamic rural banks can offer), they will secure finance from larger, either Islamic or conventional, banks.

6.5 Monitoring

In imperfect markets which are characterized by asymmetric information, it is hard to identify good borrowers. In these circumstances, adverse selections may be made. Therefore, it is important for banks to screen borrowers to ensure that the selected borrowers are those who are more likely to repay. Nevertheless, the potential risk may emerge following a moral impropriety by the borrower after the loan was granted. In anticipation of this , banks need to make an effort to monitor clients to ensure that loans granted are used properly and to avoid undue risk (Agostino *et al.*, 2008). Concerning financing monitoring, there are two sub-ordinate themes that emerge. These themes include borrower monitoring and repayment performance.

6.5.1 Borrowers Monitoring

Islamic rural banks, as small banking institutions are less capable of screening borrowers than large banks. Large banks have screening tools with which to select good from bad borrowers through credit scoring through the use of financial data from the financial report but this information is not readily available for new start-ups and small businesses. In assessing borrowers, large banks rely more heavily on hard information such as financial reports and credit ratings. The screened-based lending is likely to reduce the time it takes to seek an approval of a loan, and through scoring banks can make the same consistent decisions, as it serves to be a more transparent system (Agostino *et al.*, 2008). Credit scoring assists the loan officer to follow standard procedures stipulated by the bank in deciding credit. To reduce human bias credit scoring was proposed by Deakins and Hussain (1993) and this was also a recommendation made by Cole et.al., (2004) as a “cookie-cutter” for lending decisions. However, it is suggested that one system for all is not suitable. Small banks have competitive advantages in gaining soft information through personally contacting the person (Berger and Udell, 2006) that offers them a competitive advantage. Such information gained through credit scoring can enable banks to set-up systems that monitor the performance of the business and identify potential risks at an advanced stage. Similarly, soft information gained from personal sources or through closer interaction with business can alert the bank of a potential risk. Both monitoring systems have potential monitoring costs involved. Financial and personal monitoring is of equal importance for Islamic and conventional banks (Stiglitz and weiss, 1988).

The question is how can Islamic banks monitor their borrowers? Also there is the question of whether there are alternative monitoring methods? One monitoring method also used by the conventional banks involves looking at the repayment record. If it is found that a borrower delays repayment, the bank can contact the borrower to investigate the problem he may be encountering and this is particularly easy for small banks. If necessary, bank officers can visit the borrower to resolve the problem. Moorman and Garasky (2008) suggested that a single call could be made to assess the current situation and determine what solution could be implemented, especially if there is a good working relationship between the entrepreneur and the lending manager. It is suggested in the literature, that intervention helps reduce financial problems and that potential bankruptcy should be undertaken. This approach was outlined in the responses by BR1 and BR2:

> *To monitor, we sometimes call them or send short messages (BR1). But, before that, we look at the monthly repayment and sometimes we support clients by asking our marketing officer to visit the client to support the business. To build the relationship, managers are encouraged to share special events with clients and exchange gifts on their birthdays (BR2).*

From the responses of lending managers it appears that IBs use relationship and emotional ties with clients to minimise monitoring costs and continue maintaining the trust to share the success or risk of the business. Responses from lending managers suggest that monitoring was usually applied to medium sized enterprises and frequent visits to the borrower allowed the bank to monitor the condition of the business over time.

The proximity of borrowers to the location of Islamic bank offices might affect the quality of the loan. Living in close proximity to an IB enhances the firm's prospect of securing a loan. Borrowers who live in the vicinity of the head office of banks enables the loan officer to evaluate their worthiness more effectively. This makes sense because loan officers still recognize most people in the local area. In addition, if any repayment problem emerges the next day, Islamic banks can detect it quickly and collaborate to resolve it.

> *Actually, the good borrowers are those who live in a radius of 5 km from an Islamic bank office, because we mostly recognize people in this area. We can investigate the applicant appropriately by asking in their neighbourhood (BR3).*

This finding confirms the result study of DeYoung *et al*., (2008) who found strong evidence that the probability of loan default increases with borrower-lender distance. An understanding of local social life and its characteristics is a good method assists the banks in selecting the best borrowers. Therefore, Islamic banks tend to be have a stronger relationship with borrower, as evidenced through the questionnaires and case studies.. The analysis of responses suggests that IBs collects soft information for SMEs over time, which provides them with an informational advantage compared to conventional banks who often have a distant relationship with clients and may not enjoy the same degree of access to local information (Agarwal and Hauswald, 2006). Thus, the local IBs have privileged access to soft private information which allows them to estimate the risk default (Indersta and Mueller, 2007). This is also confirmed in the study of Gibilaro and Mattarocci (2009) who found that the longer a bank is established in the local area, the greater its debt recovery efficiency. This may be the reason for the success of and justification for the presence of Islamic rural banks in Indonesia.

Concerning monitoring and distance, the result of the investigations with the Islamic rural bank managers in Indonesia found that a close relationship is a means for monitoring. Frequent monitoring of borrowers by IBs is in line with the study conducted by Blackwell and Winters (1997) who found that banks frequently monitor firms with greater credit risk.

We visit them routinely [at a certain time] (BR6).

Visiting borrowers routinely allows IBs to monitor the condition of the borrowers' business over time. This finding supports the findings of Papias and Ganesan (2009) which found that there is a positive and significant relationship between the frequency of visits and repayment performance of borrowers. Visiting the borrowers frequently provides greater understanding of the borrowers' business and allows IBs to offer technical advice if the borrowers encounter any type of financial problem.

Frequent monitoring through visits is possible for businesses which are located near banks but it is a problem for those a long distance away. Monitoring through visits has cost implications that in turn impacts on bank profit. On a small scale, Islamic rural banks are able to employ such monitoring methods, but it is questionable if such a method is tenable as the bank grows, although small banks have an advantage in serving customers in local areas.

Some Islamic banks also use the first repayment as an indicator of a repayment problem. If the borrowers have problems since the very first repayment, it can be inferred that the rest of the repayments may also be problematic.In such instances, banks will pay extra attention in monitoring the borrower and their business activity. As Moorman and Garasky (2008) argue, Repayment behaviour can provide an early warning of pending bankruptcy.

The first repayment is an important indicator. If a borrower delays his/her first repayment, this borrower must have problems (BR4).

For the borrowers who have a close relationship with Islamic bank officers, monitoring could be neglected because the trust between them has been established. This trust was reflected by not conducting visits to these borrowers before granting financing.

We do not visit those whom we have not recognized well.

Thus, close relationships bring advantages for both borrowers and banks. As Blackwell and Winters (1997) conclude, firms with longer relationships are monitored less frequently, and these less frequently monitored firms pay lower interest rates on average. This finding implies that instead of being involved in multiple bank lending, a small firm can lower its cost of capital by concentrating most of its borrowing with a single bank. Close relationship with a single bank allows the bank to develop an information advantage over other lenders. Due to a competitive environment, the bank's cost saving will be passed on to the firm in the form of lower interest rates. Thus, the borrowers gain advantage in the form of low rate charges and the bank benefits by not monitoring. In contrast, multiple banking relationships and banking market size affect the probability of SMEs being credit-rationed (Agostino *et al.*, 2008).

6.5.2 Repayment Performance

Recovery rate, which is the inverse of a loan default rate (Hoque, 2003), is a crucial issue for a bank as an indicator of credit performance. Although banks have made an effort to select the good from the bad (borrowers), this does not mean that instalments would be expeditious in the future. High default can happen in unexpected conditions. Default occurs when borrowers are not able to or are unwilling to repay their loans. This could be caused by the existence of moral hazards or other factors. Moral hazard prevails if borrowers who are able to repay but unwilling to repay (Hoque, 2003). Unwillingness to repay implies that the borrowers do not repay their loan though they have enough money. The misuse of the loan outside the proposed agreement is a starting point of moral hazard which will potentially cause repayment problems in the future.

The misuse of loans may occur in both conventional and Islamic banks. Almanun (2011) found that there is a relationship between what the credit was used for and repayment performance. Repayment problems commonly emerge among borrowers who use credit in non-income generating activities. Thus, it is clear that the proper use of loans for income generating activities reduces the probability of a repayment problem. Where monitoring is not rigorous, misuse of loans may occur and this can happen with both IBs and conventional banks. It is observed that conventional banks focus more on loan recovery. It means that as long as the borrower can repay the loan on its due date, then some misuse of the loan can still be tolerated. Islamic banks, however, are more vigilant about the use of proposed financing. Despite this the borrower may still use the loan inappropriately as no system is fool-proof. BR4 reported:

> *We have never had any misuse of financing (BR4).*

This finding confirms the research of Khan (1971) cited in Hoque (2003) in Bangladesh reporting that improper utilization of loan is a cause for loan default. To overcome this issue, Islamic banks instead of loaning money directly will pay for raw materials through the use of a *murabahah* contract that ensures money is used to purchase raw material and pilferage does not take place. This method ensures misuse of financing in Islamic banks is less than that of conventional banks as money is loaned for the purpose of the transaction. Thus, this mechanism avoids the borrower using the loan for purposes other than that written in the contract. In contrast, conventional banks credit money into a borrower's account and have no control over the use of the loan. Tight control over the use of the loan is often considered to be complicated as BR4 reported:

> *Customers assume that the requirements employed in Islamic banks are complicated. In conventional banks, if the marketable collateral is available then the loan will be granted without considering the use of the loan. In Islamic banks, we will monitor [the use of the loan] so that there is no opportunity for misuse [of the loan] (BR4).*

The result of the interview above reflects that borrowers recognise that the loan process in Islamic banks is more complicated than that of conventional banks. Borrowers do not feel free to use the money obtained from Islamic banks beyond the contract. Nevertheless, this is a good point to avoid the possibility of default caused by the misuse of the loan. As Almanun (2011) found, there is a relationship between the use of credit and the recipient's repayment performance.

In the case of Islamic rural banks in Indonesia, the problem of repayment was mostly caused by less liquidity arising from lack of business performance and pilferage due to diversion of funds for family expenditure such as paying tuition fees for their children in a new academic year, expenditure on social needs and family health. BR1 suggests that where "*MEs do not have personal and family problems, their repayments will be good (BR1)." BR6 reported that where "…a borrower's family member is sick [repayments will be hampered] (BR6)."*

The finding that family expenditure influences repayment confirms the study of Canner and Luckett (1990) which found that the larger the family, the greater the probability of late repayment. For small firms, this problem was more severe since they commonly have less liquidity. Although small firms could take a high margin, low level of sales causes total profits to remain low.

Another observation noted in this study is that repayment schedules are affected by family expenditure during times of annual Islamic religious celebrations, a pattern also observed during Christian celebrations where individuals are burdened with debt. To counter special expenditure for school fees and Islamic holiday celebrations, some Islamic banks have anticipated such cyclical patterns and adjusted their repayment plans.

BR5 reported that:

> *The problem is old fashioned. For example, their children may be sick, and may have to enrol their children in school. So, we extend their repayments by two months to support them when they have to enrol their child in school and for the Islamic feast day (BR5).*

The response of bank managers suggest that the bank is not acting purely as a commercial entity but is much more involved within the society. Such behaviour gives rise to the problem of moral hazards in Islamic rural banks as monitoring systems cannot be developed to detect the client's real inability to repay and unwillingness to repay. Indeed, moral hazards are not only caused by borrowers but also come from lender behaviour. Hoque (2003) argues that loan defaults can be caused by moral hazards unleashed by both lenders and borrowers. He explained that moral hazard of the lenders could be in the form of lender's morally indefensible behaviour. Thus, the debt burden of the borrowers doubles, because loan amounts not duly paid capitalized on which interest was charged at the same rate. This case will not occur in Islamic banks, since they charged an extra fee, and agreed that advance charging is forbidden in Islamic teaching.

Business failure due to external factors such as lack of demand gives rise to default. This condition cannot be avoided other than by developing strategies to minimise the impact by diversifying the business. Failure to control adverse business conditions leads to cash flow problems which in turn impact repayments. This adverse condition is encountered by all lending institutions and not just the IBs (Derban *et al.*, 2005). This is acknowledged by BR6 where he reported that, "*If the business condition is bad, the repayment will be late (BR6).*"

Therefore, it is important for Islamic banks to consider the volatility of cash flow of the borrower firm. The volatility of cash flow of the firm reflects the risk of the loan provided to it. Barrickman (1997) argues that the volatility of the cash flow is influenced by the conditions of the competitive economic and environment. He further explained that volatility of sales, gross margin and operating leverage are the determinant of vulnerability to external environmental change. Operating leverage involves using a large proportion of fixed costs to variable costs in the operations of the firm. Primary components of fixed assets are large investment in fixed asset and overhead cost. The higher the degree of operating leverage, the more volatile the EBIT figure will be relative to a given change in sales, all other things remain the same. Therefore, SMEs which are involved in business sectors with volatility income streams resulting from a changing economic environment, changing consumer tastes, or natural factors such as the weather, must carefully control fixed costs to avoid excessive volatility in cash flows.

It emerges from the analysis that the problem of repayment comes from the lack of management skill. Most of the SMEs did not have adequate management skill in organizing the firm's finance properly. Inadequate management skills of SMEs affect the firm's liquidity level, especially when they cannot plan effectively for future activities and make effective financing provisions for the anticipated shortfall. To plan and manage cash calls for strategic planning (Wang *et al.*, 2007). BR7 supported this analysis and reported that:

> *Generally, SMEs do not have good planning. Sometimes, surplus of funds are often used to purchase excessive inventory that may lead to cash flow problems in the future (BR7).*

The analysis above suggests there are two issues, financial training for owners that enables them to provide effective control over cash flow and allows them to plan their business and personal expenditure. Better financial management will allow SMEs to schedule cash expenditure appropriately and the problems identified above will not occur.

The lack of financial management skill, the volatility of business and inadequacy of cash are characteristics of SMEs. Therefore, it was acknowledged by Islamic bank managers that the problem of low repayment loan normally exists not only in Islamic rural banks but also in credit rural banks because they are involved in the high risk market. The acknowledgment of Islamic banks about the high rate of non performing financing (NPF) of small firm borrowers confirms the literature suggesting that SMEs are riskier than their larger counterparts (Berger and Udell, 2002; Jacobson *et al.*, 2005). Although, Islamic rural banks are involved in risky segments, most of them satisfy the repayment rate.

> *NPF (non performing finance) for Islamic rural banks is high, because it involves high risk [segment] (BR1).*

This research found the low repayment problem to be inevitable in Magelang city. Most of the borrowers cannot repay their debt for some time because their business was disrupted by a natural disaster, most recently eruption of Mt. Merapi in nearby Yogyakarta. The Islamic bank manager reported that as many as 38% of his borrowers we affected by this disaster.

> *We just faced a natural disaster, Merapi Mountain. Almost 40% of business performances of our borrower were affected by that disaster (BR8).*

From the discussion of SME repayment performance above, there are several reasons for problems with repayments. The findings of this research confirm the reasons for repayment problemscas summarized by Derban et al., (2005, p.329) to include: business idea does not work out; health—physical/ psychological condition of the borrower, cash flow problems—trading results not in accordance with the projections contained in the initial business plan, difficulty or failure in the business, lack of liquidity, and inadequate sales.

6.6 Lending Policy for SMEs

6.6.1 Lending for New Borrowers

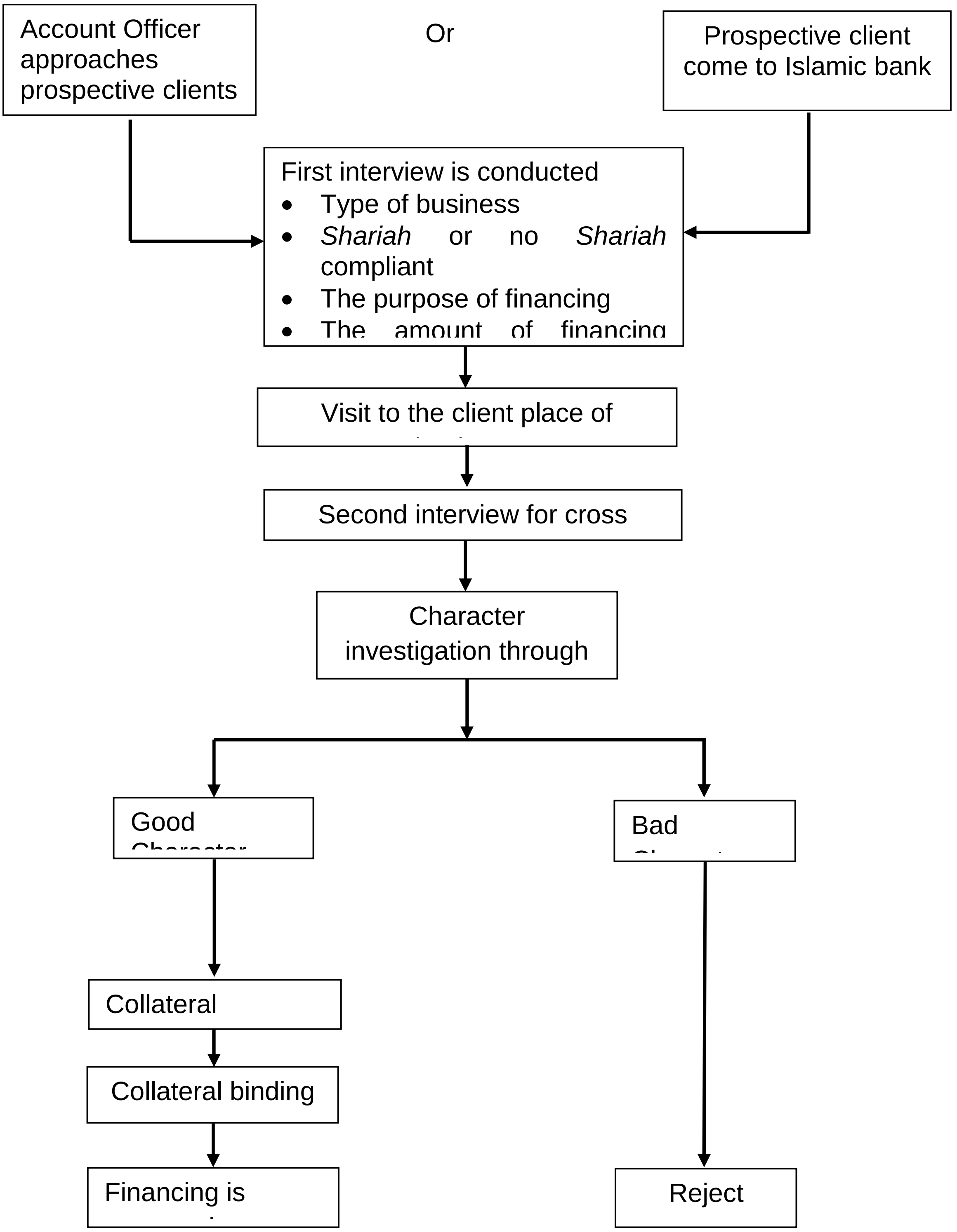
Figures 6.1 and 6.2 illustrate that a loan extended to new borrowers be forthcoming within two ways. Firstly, the Islamic bank visits prospective borrowers to offer its products. This is particularly vital for those customers with a limited track record or no previous interaction with banks. Secondly, lending managers also visit those borrowers who wish to move their business from conventional banks to Islamic banks. In both cases these borrowers are likely to have some awareness of Islamic bank products, either through advertisement or through their informal networks. Figure 6.1 provides the evaluation process used by banks for new borrowers and information required from them.

Since Islamic banks do not have any information about the new borrowers, they (like any bank) will investigate the new borrowers in depth. For existing borrowers, Islamic banks did not need to examine the type of business, whether or not the business was *Shariah* compliant as these two prerequisites had been established previously. In the checking process, establishing whether the product is *Shariah* compliant is rigorously tested. A key difference between IBs and conventional banks is that even the good applicants will be rejected if the business activity violates the *Shariah*. For example, firms involved in business activities such as those which would be considered obscene, involve the production and / or sale of liquor, the selling of pork meat, prostitution and adultery are considered unlawful and therefore not appropriate to be financed (Haron, 1996).

Once a *Shariah* test was carried out the the bank will examine business related information and the purpose of the loan will be rigorously tested as IBs offer distinct types of financing for different purposes. For example, the borrowers who need to buy trading goods should utilize a *murabahah* contract. Similarly, a *mudarabah* and *musharakah* contract is suitable for investment purposes. Therefore, the investigation of loan purposes is intended for selecting the most suitable type of financing. A comprehensive discussion of Islamic financial instruments has been addressed in chapter two.

The assessment of cash flow along with the amount of the proposed loan will determine the continuity of instalments in the future. In this regard, the bank and the borrower will look for the best way to stipulate the amount of instalments that does not overburden the borrower. It could be done by reducing the amount of the loan or increasing the duration of the loan. If IBs decide to reduce the amount of loan, the borrower will receive an amount of funds that is less than their needs. This circumstance will force SMEs to pursue other loans from other banks. In contrast, if the borrowers still want to obtain the amount of funds proposed, the bank will suggest extending the maturity of the loan. Thus, the important determinant of the amount of loan and loan maturity is eventually the cash flow.

Figure 6.1 Lending for New Borrowers



Source: Author

The next step is visiting the client to directly observe the reality of their business. This is done to cross check the previous information gleaned from interviews with SMEs. By visiting applying firms, Islamic bank officers can observe the business activity, the number of assets, the total inventory and other important information. While observing the condition of the business, Islamic bank officers explore further information by asking relevant questions. In this phase, the Islamic bank officer can also make judgements about the character of the borrower. A borrower's good character would be reflected in the suitability between the initial data which is conveyed to the bank and the reality observed through the visit. Conversely, if the initial data is significantly different with the reality, it implies that the borrower has a bad character. Thus, the visit to the applicant is useful to cross check the validity of the initial data gained from initial interviews compared to the reality.

The extent of decision variability is affected by the interpretation and accountability in interpreting the rules (Fletcher, 1995). For large banks with many more layers of management, the decision is strictly based on the rules. In contrast, for small banks, the loan decision is commonly made based on the discretion of loan officers. Of course, individual variation of credit criteria varies due to different experiences and tendencies though loan officers receiving comprehensive and standardized training (Kumar and Motwani, 1999).

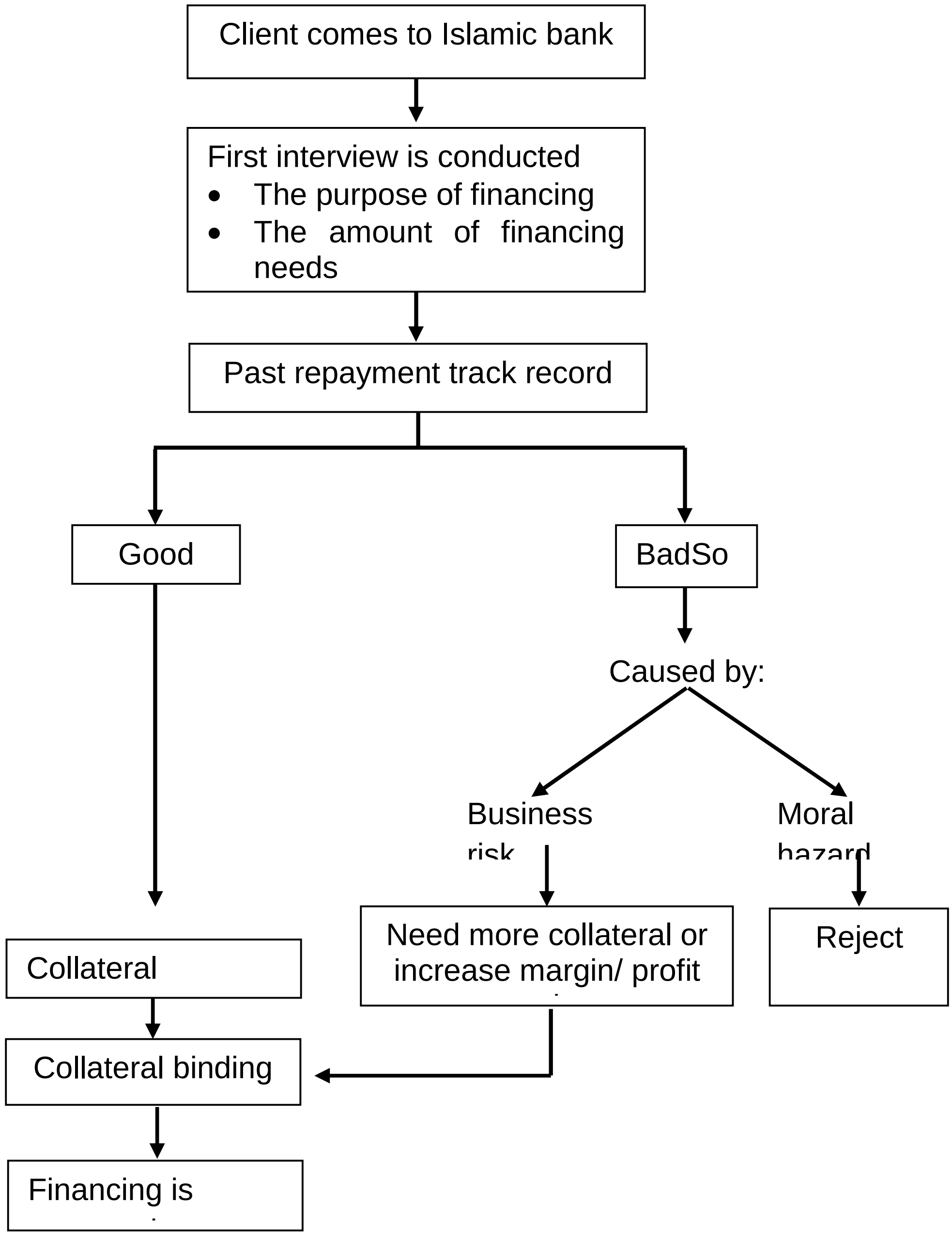
If bank officers still doubt about an applicant's character, they will ask in the applicant's neighbourhood to get detailed information of the applicant's character. If the borrower has bad character, the application will be rejected. It is acknowledged by Islamic bank officers that borrower's character is the most important criteria in the approval or rejection of a loan application. The emphasis on character for small loans is common in small lending. The next step is the assessment of collateral. Although it is acknowledged that collateral are not the most important criteria, the loan will not be approved without the firm pledging collateral. Indeed, the use of collateral could be used to anticipate default risk by seizing the collateral when the borrowers go bankrupt. Further, Islamic banks use collateral to push the borrowers to make a concerted effort to repay on time since pledging collateral can be seen as a sign of commitment of the firm's owners (Fletcher, 1995). Furthermore, collateral can be used to obtain more favourable loan terms (Boot *et al.*, 1991). Generally, the borrower should provide collateral of a higher value than the proposed loans. In addition, personal collateral is sometimes requested in addition to business collateral (McKillop and Barton, 1995). Since SMEs have a lack of collateral, the loan approved is usually less than what is proposed which in turn causes a financing gap to exist in SMEs (OECD, 2006b). Therefore, the role of government is needed to resolve this issue. Mckillop and Barton (1995) suggested that while the financial institutions provide loan finance, the government underwrite personal collateral requirements.

6.6.2 Lending for Existing Borrowers

The evaluation of the worthiness of the existing borrowers is commonly faster than that of new borrowers. The bank has had some information about existing borrowers gained from previous investigations. However, an interview is primarily intended to find out the most relevant information. Firstly, the purpose of financing. This information is important in examining whether or not the loan would be utilized in supporting the borrower's business or for consumption purposes. If the loan would be used to promote their business, then what kind of loan would they need? For example, the additional loan could be used to invest or to increase working capital. This information is important because the different purposes of loans incur different consequences in terms of cash produced from the invested loan. As a result, this can influence cash flow in the future. In addition, since Islamic banks have various types of contracts, knowing the purpose of a loan enables Islamic banks to determine the contract properly.

The amount of financing needed is important information that needs to be examined. The existing burden of the borrower will reduce the capacity of small firms to make another loan repayment. Therefore, banks should consider the balance between the amount of financing needed and the capacity of the firm to repay. While the worthiness of a new borrower was explored through some steps of the investigation, past repayment track record is a significant and useful tool for Islamic banks to determine whether or not the existing borrower is feasible for a new loan. Past track record offers relevant information related to the viability of the business and the capability of owning in handling the business. Past track record is a tool which can be used to screen good from bad borrowers.

Figure 6.2 Lending for Existing Borrower



Source: Author

Next, the bad borrowers are evaluated further to examine what has caused it. If the bad past repayment track record is caused by moral hazard the applicant will be rejected. Conversely, if the past repayment tracks record is bad and caused by business risk, IBs will ask the borrowers to provide more collateral. Although the loan would not be delivered without pledging collateral, the value of collateral could be less than the amount of the loan for existing borrowers. This implies the character is the most important consideration for small loans. The comparison of investigation between new and existing borrowers is summarized in table 6.2.

Table 6.2 Comparison of Investigation between New and Existing Borrowers

Required Information	New Borrower	Existing borrower
Shariah compliant	Need to be investigated	Has been known previously
Type of business	Need to be investigated	Has been known previously
Collateral	More important	Less important
Amount of loan	More than the value of collateral	Less than the value of collateral
Maturity	Less	Longer
Character	Investigated through neighbourhood	Known through past track record

Source: Author

Table 6.2 shows that the investigation of new borrowers was different to that of existing borrowers. It appears that what is important for new borrowers is not important for existing borrowers. The required information for both new and existing borrowers is the same, but IBs' treatment for both is different. It can be interpreted from the table 6.2 that the process of making lending decision for new borrowers is longer than for existing borrowers.

6.7 Conclusion

The results and analysis of the interviews shows that IBs have similar criteria to conventional banks which rely on the 5C criteria. However, BPRS as a small bank emphasizes the three most important criteria namely, character, capacity, and collateral. In addition, IBs must ensure firstly that the borrowers do not involve unlawful (*haram*) business. Since not all SMEs, particularly small firms, provide financial statements, IBs rely on soft information gained from establishing close and long relationships with their borrowers. Consequently, BPRS use more discretion in deciding loans for SMEs, especially for small firms. Thus, the experience and skill of the loan officer is an important determinant in making lending decisions. Finance maturity is negotiated between IBs and borrowers to make sure that the borrowers do not have an excess burden to repay and to anticipate default risk in the future. Although monitoring is undertaken frequently, the level of non-performing finance (NPF) is high, reflecting the high risk of SMEs. IBs assess new and existing borrowers differently. The ending framework shows that the evaluation process for new borrowers is more complicated than the existing one because IBs do not have a track record of the new borrowers.

CHAPTER 7
CONCLUSION

7.1. Introduction

Chapter seven abridges the research conclusions, elicited from the primary and secondary data. The research conclusions are presented in two parts of the thesis: the literature review and the empirical research chapters. The secondary data is for the purpose of the literature review, and to conduct comparative-analysis of Islamic bank financing in Malaysia and Indonesia. The primary data was collected through a survey conducted using a questionnaire distributed both to SME owners and Islamic bank (IB) managers to investigate experiences, perceptions and the practices of Islamic banks. To gain a deeper insight, a semi-structured interview technique was used to investigate the experience of SME owners in accessing funds from Islamic banks, and compare the experiences of Islamic bank managers. This was followed by the research summary and summarised of the contribution of the study. The study examines the actions of Islamic banks in anticipating the issue of asymmetric information when dealing with SMEs. Furthermore, the research finding presents the implications for policy makers and stakeholders of the Islamic banking industry, and suggests how IBs may respond to the findings in order to promote the development of IBs amongst SMEs. Next, the limitations of the research are acknowledged. Finally, potential areas for future research are identified and suggestions made.

7.2. Summary of the Research

The aim of the research is to investigate lending practices, policy and access to Islamic bank finance by Small and Medium sized Enterprises (SMEs) in Indonesia. Using quantitative and qualitative analysis, this study produced valuable and significant findings. The most important of these findings are summarized below.

The literature review section has demonstrated that IBs have evolved over the last several decades. There is now a well developed theoretical and practical presence of IBs in the Islamic and non-Islamic world. The institution of IBs has been enshrined in the laws of western countries, for example in the UK, and in Eastern Islamic countries including Malaysia, the Middle East and Pakistan where the whole banking system has been reformed in accordance with Islamic principles.

The results derived from the secondary data and supported by in-depth interviews with Islamic bank managers shows that the penetration of Islamic banks in Indonesia remains relatively small compared to total credit finance in the Indonesian banking system. The difficulty for Islamic banks to infiltrate the banking system was caused by the limited understandings of the vast majority of customers who think that there is no difference between Islamic and conventional banks. In addition, the understanding of people related to Islamic teachings is an important factor affecting the penetration of Islamic banks. Islamic banks have 4.61% of total assets of the banking system in Indonesia, with a market share of 5.47%. In comparison, the asset of Malaysian Islamic banks is 19.98% of the total Malaysian banking system and the market share is 21.01%. The comparative figures suggest that the penetration of Islamic banks in Indonesia is relatively small compared to Malaysia. However, the growth of IBs in Indonesia is significant as demonstrated by the increasing number of Islamic bank offices from 1,024 offices in 2008 to 1,745 in 2012.

This study found that collateral is an important requirement when accessing funds from Islamic banks which in turn affects the level of SMEs access to Islamic bank finance in Indonesia. The result from interviews with SME owners shows that they must provide collateral when acquiring finance from all banks including Islamic banks. This result was corroborated with Islamic bank managers who explain that loans would not be approved without providing collateral. Furthermore, data from questionnaires confirms that as much as 97.5% of respondents provided collateral to gain capital from Islamic banks. This is a consequence of higher use of mark-up principle than PLS based contracts. This is supported by the result gained from interviews with IB managers which found that IBs prefer to use financing contracts based on mark-up rather than PLS, though theoretically PLS based contracts have many more advantages than mark-up based contracts. BPRS (Islamic rural banks), with a business focus on servicing SMEs, use PLS contracts less often than fully-fledged Islamic banks. On average, as many as 12% of Islamic rural banks (BPRS) financing is in the form of PLS contracts, while for fully-fledged Islamic banks PLS contracts account for 32% of financing contracts. The study also found that most of the SMEs receiving IB loans are involved in trade businesses which are mostly involved in short-term investment. The other factors that affect the level of SME access to finance from Islamic banks is the lack of good administration services within banks and the inability of SMEs to retain and record their financial information accurately.

The study found that the common perception amongst the population is that Islamic banks operate on a profit and loss sharing basis. However, this practice is not evinced. The vast majority of financing provided by IBs is based on a mark-up principle both in Indonesia and Malaysia. Analysis of the respondents' comments suggests the reason people access funds from Islamic banks is not merely to avoid interest (*riba)* but because they are motivated by rational economic considerations, costs and ease of access. As much as 18.2% of SMEs reported that they are engaged with Islamic banks because of profit considerations, while 15.7% of the respondents were motivated by their religious affiliation only. However, most of the SMEs (35.5%) acknowledged that the consideration to access funds from Islamic banks was motivated by both religious and profit considerations. In terms of considering the most important factors affecting loan decisions, the perceptions of SME owners and Islamic bank managers differ. In this regard, SME owners do not consider track record and the debt to total assets ratio important. Conversely, bank managers viewed that these factors are very important when making lending decisions to SMEs.

The research found that the experience of IBs in making lending decisions is relatively similar to that of conventional banks. However, respondents were firm in the belief that Islamic banks must ensure that the borrower does not get involved in a business that is forbidden by Islamic law.

IB managers like conventional banks found it difficult to make lending decisions because most SME applicants could not provide the required documents to evaluate a business and approve the loan application. Responses from BPRS managers emphasized three important criteria when evaluating SME borrowers; character, capacity to repay and collateral. Although, the value of collateral affected the loan size, there are several other factors that influence the loan size. The result of correlation analysis shows that the factors such as firm age, number of workers, number of assets, profitability, maturity, and debt to total assets, significantly influences loan size. In addition, the correlation analysis shows that there is a positive relationship between bank service and the duration of relationship. Comparison of the mean t-test shows that there is a significant difference between the average amount of proposed finance and the average amount of approved finance. The mean amount loan approved is lesser than the amount proposed. This result implies that a financing gap exists for SMEs in Indonesia. BPRS employ a unique monitoring system upon their customers. For borrowers located in the area close to the main bank office, the Islamic banks collect from borrower savings on a weekly basis. At the end of the month a percentage of the savings would be debited to repay their loan. This approach is normally used for small firms which have not yet acquired good financial management skills.

This research developed the lending framework for both for the new and the existing SME borrowers to provide analysis of the practices. The lending framework demonstrated that the assessment process for new borrowers is longer than for the existing borrowers, and provided an explanation for the time difference. Where Individuals or established businesses had proven track records, bank managers were able to shorten the evaluation process and hasten the lending decision.

The summary of the research outlined above is arranged according to the aims and objectives of the research as stated in chapter 1. The objective of the research to examine and compare the level of penetration of Islamic banks in Indonesia and Malaysia is achieved through analysis of data published by the central banks of both countries. Next, the research objective of examining factors influencing loan size approved by Islamic banks is achieved by showing that collateral is the ultimate factor influencing success in attaining funds from Islamic banks. Meanwhile, examining the existence of the finance gap is achieved by the result which indicates a significant difference in that the mean amount of loan approved is less than the amount proposed. Thus, the research aims and objectives: to examine the current level of penetration of Islamic banks financing, to examine the factors influencing loan size, to construct an Islamic bank lending framework for SMEs, and to empirically investigate the experience of Islamic banks in making lending decisions for SMEs, are all achieved in this research.

7.3. Contribution of the Study

The findings of this study are useful to augment the existing literature on the preference of using Islamic financial instruments, either under PLS or mark-up principles. Although theoretically, the PLS principle is superior to the mark-up mode of finance, in reality, financing under mark-up principle more prevalent than PLS. The findings of this study answer the question of why Islamic banks and their customers prefer to provide and receive financing under mark-up rather than PLS principles. This research is also useful as it provides new insight and understanding of the obstacles faced by SMEs in accessing finance from Islamic banks. This study explains that customer mindset is a major obstacle encountered by SMEs in accessing funding from Islamic banks. In addition, the study shows that collateral is other obstacle which hinders SME access to finance from Islamic banks. The other contribution of this thesis is in the form of extending understanding of the operations of Islamic banks and examining whether they are in a better position to mitigate the finance constraints experienced by SMEs under the conventional banking system. In certain circumstances, SMEs benefit from Islamic banks, particularly when financing utilizes PLS principles because the risk is born by both Islamic banks and their customers. In addition, Islamic banks can mitigate asymmetric information better than conventional banks because they place more emphasis on relationship banking. Finally, this thesis captures the intimate relationships, theories, practices and functioning of Islamic banks in meeting financing needs for SMEs.

7.4. Implications of the Study

This study provides a rich picture of Islamic bank operations and examines their limitations. As a consequence, it draws together implications for government, academics and policy makers.

7.4.1 Implications for Government

The Islamic banking system is aspired by the Muslim population around the world and Indonesia is no exception. The Islamic banking system focuses on ethical banking that bridges the information asymmetry between the lender and borrower through relationship banking. Hence, government has both the responsibility and the authority to regulate the banking industry; it too has a responsibility to develop an understanding of the Islamic banking system and to legislate and monitor its operations. Therefore, the implications for the government are as follow:

1. Government policies should enable Islamic banks to facilitate efficient delivery of finance for small enterprises.
2. Effective regulation should be established to enable Islamic banks to improve access to finance for SMEs.
3. Government should develop legislation for supervision of Islamic banks whereby it may encourage wider utilization of PLS contracts, especially for SMEs.

7.4.2 Implication for Academics and Practitioners

The role of academics and policy makers is essential in improving all aspects of human life including facilitating access to finance for SMEs. Islamic banks as a new business entity in Indonesia are still not competitive with conventional banks. Therefore, research exploring the practices of Islamic banks is important to identify problems associated with Islamic banks to improve their efficiency and outreach. The research implies that:

1. For practitioners, it is important to understand the technical and legal knowledge required for product development and contractual fulfilment and their impact on SME development and growth.
2. For academics, it is essential to provide well informed research findings to support governments, banks and support agencies to examine the role Islamic banks can play to enhance access to finance for SMEs and thereby impact on the GDP and employment of the country.

7.4.3 Implications for Financial Institutions

Financial institutions and Islamic banks are at the forefront of providing financial support for SMEs. Therefore, this study recommends that:

1. Islamic banks provide training for Islamic bank officers to gain an in-depth understanding of the motivations and practicalities of Islamic banking operations and be able to relate to the needs of SMEs.

2. The Islamic banking system lacks a credit scoring system when evaluating SME loan applications such that greater discretion is given to the lending manager and by implication this may give rise to inconsistent evaluation of loan applications. Therefore, to create a uniform credit approval system, IBs may consider a credit scoring system similar to that used in the western banking system.

7.4.4 Implications for SMEs

The findings suggest that SMEs lack adequate knowledge and understanding of the benefits IBs offer. Therefore, it proposes that SMEs acquire greater understanding of IB products, operations and Islamic justification of the products on offer.

1. Research findings suggest there is a need for education amongst SMEs about Islamic financial systems and operations when compared with the conventional bank operations.
2. The research findings suggest that SMEs lack financial knowledge to compare the cost incurred when sourcing finance from Islamic or conventional banks. Furthermore, SMEs lack knowledge on how best to maintain financial information to negotiate a better deal with banks.

7.5. Limitations of this Research and Recommendations for Future Research

One limiting factors in this research was the large geographical area of Indonesia which has 33 provinces. It is impossible for a researcher to include all provinces in the research sample because of the limitations of time and funding. Another limitation is that the sample of this research is limited to SMEs that succeeded in accessing funds from Islamic banks. It is very difficult to find applicants who failed to get financing from Islamic banks, because there is no channel which can be accessed to acquire this data. Consequently, this research does not capture the experiences of those applicants who were rejected. In fact, it would be useful to comprehend why they failed to gain finance from Islamic banks. The final limitation of this research is that the Islamic banks interviewed only included small Islamic banks (BPRS) rather than fully-fledged Islamic banks (Islamic commercial banks) because requests to interview Islamic commercial bank managers were rejected. Due to the absence of fully-fledge Islamic banks in this research, the results do not fully describe the practices of Islamic banks in Indonesia.

Therefore, the recommendations for future research are: Using an identical business plan and financial information set, examine the approaches and decisions arrived at by IBs and conventional banks to see if there are any fundamental differences in the approaches employed by two banks.

Further, to investigate the impediments to using PLS contracts both from the supply side and demand side; and to examine the scope and effectiveness of the credit scoring system for Islamic banks when approving loans for SMEs aspiring to use Islamic finance.

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APPENDICES

Appendix 1

T-Test

Notes

Output Created		09-Jan-2015 17:50:40
Comments		
Input	Data	D:\Digabung (studi)\Appendix\Data kuesioner\Data menyeluruh dari kuesioner.sav
	Active Dataset	DataSet1
	Filter	<none>
	Weight	<none>
	Split File	<none>
	N of Rows in Working Data File	121
Missing Value Handling	Definition of Missing	User defined missing values are treated as missing.
	Cases Used	Statistics for each analysis are based on the cases with no missing or out-of-range data for any variable in the analysis.
Syntax		T-TEST PAIRS=AFP WITH AFA (PAIRED) /CRITERIA=CI(.9500) /MISSING=ANALYSIS.
Resources	Processor Time	00:00:00.000
	Elapsed Time	00:00:00.000

```
[DataSet1] D:\Digabung (studi)\Appendix\Data kuesioner\Data menyeluruh dari
kuesioner.sav
```

Paired Samples Statistics

		Mean	N	Std. Deviation	Std. Error Mean
Pair 1	amount of financing proposed	2.96	121	1.551	.141
	amount of financing approved	2.88	121	1.531	.139

Paired Samples Correlations

		N	Correlation	Sig.
Pair 1	amount of financing proposed & amount of financing approved	121	.973	.000

Paired Samples Test

		Paired Differences					t	df	Sig. (2-tailed)
		Mean	Std. Deviation	Std. Error Mean	95% Confidence Interval of the Difference				
					Lower	Upper			
Pair 1	amount of financing proposed - amount of financing approved	.083	.356	.032	.019	.147	2.557	120	.012

Appendix 2

Correlation

Notes

Output Created		09-Jan-2015 18:33:02
Comments		
Input	Data	D:\Digabung (studi)\Appendix\Data kuesioner\Data menyeluruh dari kuesioner.sav
	Active Dataset	DataSet1
	Filter	<none>
	Weight	<none>
	Split File	<none>
	N of Rows in Working Data File	121
Missing Value Handling	Definition of Missing	User-defined missing values are treated as missing.
	Cases Used	Statistics for each pair of variables are based on all the cases with valid data for that pair.
Syntax		NONPAR CORR /VARIABLES=AFA AGE NOW NOA Growth Profit DTA FM /PRINT=SPEARMAN TWOTAIL NOSIG /MISSING=PAIRWISE.
Resources	Processor Time	00:00:00.016
	Elapsed Time	00:00:00.015
	Number of Cases Allowed	74898 cases[a]

a. Based on availability of workspace memory

Correlation									
			amount of financing approved	age of firm	number of worker	number of assets	sales growth	profitability	financing maturity
Spearman's rho	amount of financing approved	Correlation Coefficient	1.000	.407**	.472**	.536**	.121	.170	.360**
		Sig. (2-tailed)	.	.000	.000	.000	.184	.063	.000
		N	121	121	121	121	121	121	120
	age of firm	Correlation Coefficient	.407**	1.000	.368**	.368**	.231*	.015	.070
		Sig. (2-tailed)	.000	.	.000	.000	.011	.873	.446
		N	121	121	121	121	121	121	120
	number of worker	Correlation Coefficient	.472**	.368**	1.000	.574**	-.038	.165	.015
		Sig. (2-tailed)	.000	.000	.	.000	.679	.071	.872
		N	121	121	121	121	121	121	120
	sales growth	Correlation Coefficient	.121	.231*	-.038	.061	1.000	-.073	.064
		Sig. (2-tailed)	.184	.011	.679	.504	.	.426	.491
		N	121	121	121	121	121	121	120
	profitability	Correlation Coefficient	.170	.015	.165	.138	-.073	1.000	.038
		Sig. (2-tailed)	.063	.873	.071	.132	.426	.	.678
		N	121	121	121	121	121	121	120
	financing maturity	Correlation Coefficient	.360**	.070	.015	.036	.064	.038	1.000
		Sig. (2-tailed)	.000	.446	.872	.694	.491	.678	.
		N	120	120	120	120	120	120	120

Correlations

			Relationship Duration with Islamic Bank	Bank service
Spearman's rho	Relationship Duration with Islamic Bank	Correlation Coefficient	1.000	.361**
		Sig. (2-tailed)	.	.000
		N	121	121
	Bank service	Correlation Coefficient	.361**	1.000
		Sig. (2-tailed)	.000	.
		N	121	121

**. Correlation is significant at the 0.01 level (2-tailed).

Appendix 3

QUOTAION

Tabel of Analysis (BR1)	
Emergent themes	**Original transcripts**
Business worthiness is an ultimate factor Islamic rural bank have specific target market	Q: what information do you need before granting financing for SMEs? A: Principally the worthiness of business, adequate business worthiness. Not all small business can access [financing]. Indeed, we select specific customers whose their existence is obvious.
The viability of business is an indicator of business worthiness Character is the second important factor	Q: what is the indicator of business worthiness? A: We do not need complicated parameters. We just look at the business. Is it still running? For how long has it existed? Besides, how much assets does he/she have to back up his/her business? That's all. That is the general picture and...Plus character, we know well about their character.
Character can be explored through interview	Q: how do you know character of new borrowers A: we interview with him/her. It is obvious from speaking style. Although the client does not have enough education level, but if he has experience he can tell his business experience.
SMEs cannot provide business plan. the important thing for bank is information of positive cash flow	Q: Does prospective borrowers proposing financing was also required to provide business plan? A: The important thing for SMEs is how they can survive. They did not need something grandiose. What we need is positive cash flow.
Financial analysis through interview and visit	Q: So SMEs do not have financial statement? A: No financial statement in a standard form is available. Sales report is only the information about cash in and cash out. Transaction information are available and we can use it to help decision making.
Visit to almost all prospective borrowers The close relationship with bank is an added value for SMEs Borrower's character is also acquired from other people	Q: do you visit SMEs before granting financing? A: yes, more than 95% were visited. We do not visit for those whom we have recognized well, but this case is rare. Sometimes, information should not obtain directly. Sometimes we use reference. For example, he was the borrower of other bank and has good repayment tract record.

Visit provide 5C information and aspect of *shariah* compliant of a business	Q: what kind of information do you get from visit? A: principally 5C, but the different in shariah is shariah compliant
Islamic bank do not serve loan but financing	Q: could you explain what the difficulty might be face by SME when proposing financing? A: firstly, the education. How to understand that we don't serve loan but financing. That is different concept.
The assessment for new borrower is more detail The requirements for repeated borrower can be relaxed	Q: could you explain the difference between evaluating new and repeated borrowers? A: for new borrower should be examined in detail, because we don't know yet. For those whom we known, the requirement could be relaxed. For example, we can grant financing more than the value of collateral.
5C as a base for approval and refusal of financing application	Q: could you explain what criteria to accept and reject financing proposal? A: obviously from 5C
The duration of assessment does not depend on the size of financing	Q: do you need more time to assess the bigger financing? A: based on my experience, we have no certain time standard. The important is the *shariah* principle was met, 5C was fulfilled, regardless the amount, either big or small .
The requirements for each borrower is different	Q: Do you need the same requirement for all borrowers? A: obviously, it is different. For consumption [financing], we have to examine where he work, how much his salary. For production[financing] besides legality issue, we have to visit the business place
Margin for saving account is equal Margin for deposit account is negotiable Margin for financing is determined based on the risk Margin for financing is negotiable Higher margin as a consequence of fast process	Q: do you charge the same margin for all borrowers? A: For saving, the margin is equal, while the margin for time deposit is negotiable. For financing, the margin was determined based on the risk [of business]. We offer and then borrowers negotiate We offer and then borrowers negotiate. Generally, they accept the margin we offer. They accept if we offer higher price than conventional bank because they aware that it is as a consequence of faster process.
Collateral as anticipation	Q: what does collateral means to you? A: we hold a prudential principle

Bank rarely/ does not use personal guarantee	Q: what does personal guarantee means to you? A: we rarely use personal guarantee
mostly *murabahah* and *ijaroh*	Q: what type of financing do you prefer? A: mostly *murabahah* and *ijaroh*
Direct monitoring done by officer by phone and send short message	Q: how do you monitor your borrowers? A: direct monitoring done by officers. To monitor, sometimes we call them or send short message
Financing is decided by bank based on the assessment result	Q: how do you decide financing maturity? A: it depends on the borrowers. Mostly we ourselves determine [the maturity]. Although the borrower asked 5 year for maturity, *but if according to my assessment it should be 2 years,* we will decide it for two years
Personal and family issues influence repayment	Q: what the difficulty might face by SMEs in repaying? A: generally, if SMEs do not have personal and family problem, the repayment would be good.
Satisfy with recovery rate High NPF because BPRS involve in high risk segment	Q: do you satisfy with current recovery rate? A: NPF for Islamic rural bank was usually high, because it involves in high risk [segment].
	Q: how do you advertise your product? A: all low cost media we can use. Through media by distributing brochures.
Business with *shariah* value is more difficult	Q: what difficulty of Islamic bank to penetrate market? A: the most difficult is business with *shariah value*
Tabel analysis (BR2)	
The important information required from borrower are business sector, DIS, character and collateral The most important is information of business condition and character	Q: what information do you need before you granting finance for SMEs? A: First of all, we look at the available information in the business sector Nevertheless, the important is the business is running and then character.
SMEs do not understand of	Q: Does every prospective borrower was required to provide business plan? A: So far, we have rarely asked for the business plan

business plan SMEs do cannot make business plan	[from them], because they don't know how to prepare a business plan. Small firms have a very simple mind-set. They cannot articulate their idea in the form of a business plan. Small firms commonly have so simple mindset. They cannot articulate their idea in the form of business plan. After all, they don't have good transaction documents
SMEs do not have financial statement Teach SMEs in making calculation	Q: When proposing financing, does Islamic bank require financial statement? A: For those whom sales turnover more than 50 million, we can calculate from his activities directly. Although he did not have [financial statement], we can drive him so he can provide calculation like accounting report.
Visit to cross check Investigate their character through neighborhood	Q: Do you visit SMEs before granting financing? A: yes, visit to ensure that the business is really exist and not fictive. From visit we know neighbourhood. Basically, we ask neighbourhood about the character of the person, is he good or not.
Providing collateral is difficult for SMEs	Q: Could you tell me the difficulties may be encountered by SMEs when proposing financing to Islamic bank? A: Most of their problem is collateral; most of them have less collateral. Secondly, we have difficulty in understanding of their management. For example; they cannot provide good calculation of their business which enables them to illustrate future cash flows.
The assessment for new borrower by asking to neighborhood Character is the most important for new borrower Character play important role The assessment of repeated borrowers from their tract record	Q: Could you explain the different of evaluating new and repeated borrower? A: For new borrower, the most important is their character. Usually, if someone has good character he will always make effort to repay in whatever condition. If necessary, he will sell the only his own bicycle to repay. For repeated borrower, we can see their repayment tract record. For new borrower we check directly to their place and also ask the neighbourhood. In fact, the character has an important role, actually.
Investigate their character through neighborhood Check through Debtor Information System (DIS)	Q: You mentioned that you can assess repeated borrower, for new borrower you don't have any profile? A: The emphasizing, we ask their neighbourhood, we ask till three people. From financial aspect, we can check DIS (Debtor Information system). From that we can see in where place someone has had debt. So, if someone has bad tract record, he will emerge [in DIS].

Business trend influence worthiness evaluation	Q: Could you tell me what criteria you used to approved or refuse financing application? A: usually we see the business trend in this time. For example, for this moment agriculture is more risk because of pest/bug. So we look at the business sector first when someone propose financing application, and then the tendency of the business. Is it stagnant, decrease or increase.
The duration of assessment depends on the requirement completeness not the amount	Q: Do you need more time to evaluate the bigger financing? A: Actually, it is not always. So, in term of time, it depends on the completeness of documents we obtained. The fast we collect the document we need the fast we make decision
Cash flow if important factor when analyzing worthiness of borrowers	Q: Do you need the same requirement for all borrowers? A: usually we us cash flow analysis. How much of their earning and routine expenditure. Does he have liability in other place [financial institution]. From this, we can see his surplus. This surplus must be adequate to make repayment.
Character is very important Character is the most important Collateral is important	Q: what consideration to approved and refuse application? A: firstly is character. Secondly, business sector. If the business sector has high risk, we reject this application though he has good character. Thirdly, collateral. Is it adequate or nor to cover the value of financing.
Character is important	Q: You talk character very often, is the character so important? A: Yes, character is important. Actually, it is suggested that when doing business we share risk and profit. Could the borrower says loss when he loss and says profit when he get profit? In fact, the entrepreneur shouting loss loudly when he loss and he silent if he get more profit.
Margin is negotiated	Q: Do you charge the equal margin for all clients? A: The treatment is equal. Principally, we offer the margin, because in *shariah* everyone can negotiate.
Margin is negotiated	Q: In *murabahah* contract is also negotiated? A: yes, We have standards, but the magnitude of the margin depends on the result of negotiation particularly with “prime customers
Collateral is the most important	Q: What is collateral means to you? A: may be...collateral is the most important.
	Q: could you tell me, the order of important between

Character more important than collateral	character and collateral? A: In fact, character is number one. We will grant financing for someone as long as we know his/her character. Usually, if someone has good character he will always make effort to repay, whatever the condition. If necessary, he will sell his own bicycle to repay
Central bank prohibit personal guarantee	Q: what is personal guarantee means to you? A: we actually, don't have personal guarantee. In fact, central bank prohibit of such opersonal guarantee. Personal guarantee is actually, how far we recognize someone's character so we believe in him/her.
Financing contract depends on the type of business need In fact, Islamic bank prefer to *mudarabah* and *murabahah* contract	Q: what type of financing that Islamic bank like most? A: Actually, it depends on the type of business that will be financed. If the business is project, actually, Islamic bank prefer to *mudarabah* and *musharakah* contract, profit and loss sharing, the projection is obvious. Nevertheless, if the borrower is only buying consumption goods, we prefer to *murabahah* contract. So it depends on the type of business we will finance.
Monitoring was conducted by looking at the repayment and visit by marketing officer	Q: How do you monitor your client? A: firstly we look at the monthly repayment. Sometimes we look at the monthly repayment and sometimes we support clients by asking our marketing officer to come over to the client to support the business. To build a relationship, managers are encouraged to share special events with the clients and exchange gifts on their birthdays
Financing maturity decision was based on borrower' repayment capability	Q: how do you decide the financing maturity? A: firstly, we see the cash flow. So the capability of borrower will determine the financing maturity. Ideally, the borrower should repay no more than 30% of their earning. If the repayment more than 50% of their earning, it will cause problem in the end because he has another expenditure.
Character and wrong analysis cause repayment problem	Q: What is the difficulty may encountered by SMEs in making repayment. A: from my experience, it commonly character and the second is wrong analysis.
Satisfy with recovery rate	Q: do you satisfy with recovery rate? A: Actually, we are around two years, not so long. So, non performing financing is still relatively few. We can control because my borrower are not more than 600 borrowers. The agreed application that have more than 50 million is around 50 borrowers.
Advertise by giving voucher in	Q: How do you promote your product to your prospective client? A: we made brochures and then distribute to people in the

Islamic teaching (*pengajian*) event	event such as hajj preparation activities (manasik haji). In that event, we also give voucher which cannot be converted to cash instead of opening account in my Islamic bank.
Islamic bank compete with Islamic microfinance /BMT (*Baitul Mal wattamwil*)	Q: what the obstacle of Islamic bank to make market penetration? A: Here [in Klaten] compete with BMT (baitul mal wattamwil). There huge number of BMT here.
Mindset of borrower is still conventional	Q: compared with Solo? A: May be, the BMT much is more here than solo. Besides, people's mindset cannot distinguish between BMT and bank. The other competitor is conventional bank. Fortunately, our requirement is not so complicated and more flexible. In term of financing, Islamic bank is not so difficult, but in term of funds collection, we acknowledged that it is rather hard.
Tabel analysis (BR3)	
The business must be *shariah* compliant	Q: What information do you need before granting financing for SMEs? A: This is the most important aspect that must be considered by an Islamic bank. Obviously, firstly, the business must be Shariah compliant
Business viability is more important than business plan The second important is market segment Physical amendment is an indicator for the viability of business	Q: Does every borrower proposing financing should provide business plan? A: Not so. In SMEs, the important is where he get raw material or where he buy goods and resell? It was about the continuity of distribution. The second is whether or not he has market segment. SMEs, assets and owners are considered together. Therefore, we usually see whether he/she has physical assets, such as land, vehicle. If such evidence exists, it means that his/her business is running well and produces adequate profit. If so, means that his/her business is running and produce adequate profit
SMEs that have already be able to arrange financial statement would not come to Islamic rural bank Cost of capital of Islamic bank is more expensive than conventional banks	Q: Do you ask financial statement for borrower? A: From a financial aspect, we can check DIS (Debtor Information system). From this, we can see in what place someone has had debt. So, if someone has a bad track record, he will emerge [in DIS] Q: Why? You should check financial statement to know financial condition, shouldn't you? A: Because if a person have capable to provide that [financial statement], means he has experience about banking, why he/she come to Islamic rural bank whose margin is more expensive. In conventional banks the rate is 14% on average, while in Islamic rural banks, the rate is at least 1.5% flat or on average 26% a year
Visit to borrower is obligatory	Q: do you visit client before granting financing for SMEs? A: oh... it is obligatory. If the client comes to my office by

Islamic rural banks do not yet have bargaining power Islamic rural bank is the last choice for borrowers	himself, around 80%-90% the client was problematic. Our concept is to choose, not be chosen. It means that we choose the client [by visiting them and offer product to them], not otherwise. We don't have any bargaining position yet. So, if the clients come to me, means that they may have already rejected in everywhere [in any financial institution], but before deciding financing we ensure to visit.
Direct visit and visit to neighbourhood Direct visit associated with business issue Direct visit to assess the value of collateral Borrower's character was acquired from neighbourhood Visit for cross check	Q: what kind of information do you acquire from visit? A: Visit can be direct visit or indirect visit. Direct visit associated to business. For example, from where he get merchandising goods, how the process, it was sold cash or credit. Direct visit to assess the value of collateral. Information of the character can be acquired from neighbourhood. Visit to ensure that the result of interview and riel fact is match. The borrowers always talk good things when they borrow, without ever stating the negative side.
Collateral binding complication	Q: could you tell me what difficulty may faced by SMEs when proposing financing g to Islamic rural bank? A: Actually, the process is fast, the process was going excellently for three days, but the obstacle is the legal issue. Regarding collateral binding, the legal issue must be clear. For example; a borrower who provides land as collateral where the certificate of the land is still on behalf of his parent's name, must provide other documents to prove that the land is his asset
The borrower evaluation of repeated borrower was undertaken through tract record The evaluation of new borrower is more detail	Q: could you explain, the difference between assessing new and repeated borrower? A: for repeated borrower, we just look at the repayment tract record. That is easier. For new borrower, we asked someone lived in the same area [with new borrower] before visiting the client to cross check whether he/she have business like what he told.
The criteria of approval and refusal of financing is based on 5C analysis	Q: could you tell me what criteria you used to approved and refuse application? A: based on the 5C factors.
The order of borrower evaluation is: capacity, character and collateral	Q: From 3C, how the order? A: capacity, character and collateral. Capacity and character is equal and then collateral.
The duration of assessment do	Q: Do you need longer time to evaluate the bigger amount of financing? A: it is equal. Because assessing of feasible or not have

not depends on the amount of financing Ideally, Islamic rural bank involve the financing under 50 million rupiahs The human resources capability of Islamic rural banks is still in simple level The finance under 50 million is not vulnerable to takeover	the same procedure. Ideally we involve under 50 million, though theoretically we can involve in 324 [million]. If we serve in 50 million and bellow, firstly, that is our segment. Secondly, our human resources still have simple skill to do analysis. Furthermore, if we involve in 50 million, it is not vulnerable to takeover.
Administrative requirement is the same for all borrowers The industrial license is required for production firms	Q: do you ask the same requirement for all borrowers? A: generally, it is same, but it is different for special business. For example, if the borrower is home industry, he must have licence from industrial department or DEPERINKOP.
The criteria of approval and refusal of financing is based on 5C analysis	Q: what consideration to approved and refuse application? A: the consideration is based on those 5C.
Deposit margin is equal except for prime customers Margin is negotiable for lending client Bank has had standard minimum margin Equivalent rate is not so different, though profit ratio is different	Q: do you charge equal margin for all borrowers? A: Margin for common depositor is the same, while the margin for prime depositors is negotiable and normally higher than small depositors. Prime customer are those whose deposit above the average. For lending, a margin was negotiated, but a bank has astandard to offer. Every business has a different ratio because they have different characteristics [associated to risk]. Higher risk businesses are charged with higher rates, whilst lower risk businesses are charged with lower rates
Collateral is the last way out	Q: what does collateral means to you? A: Collateral is the last way out.
Personal guarantee is only some sort of reference	Q: what does personal guarantee means to you? A: till now no one tied that the guarantor would repay if the borrower is default by debiting guarantor account. So personal guarantee is only moral guarantee. So it is only some sort of reference.
Murabahah is 80-90% People do not fully understand about Islamic financial contract Generally, contracts were driven to *murabahah* contract	Q: what type of financing contract do you prefer? A: In Indonesia *murabahah* contract covers 80-90 percent. It is because most actors do not fully understand about Islamic financial contract. So, the contract deserved to *mudarabah* or *musharakah* were converted to *murabahah* contract.

Project can also use *murabahah* contract Transaction notes is a key of *mudarabah* and *musharakah* Proyek juga bisa dimurabahahkan Islamic banks is better prepared to undertake *mudarabah* and *musharakah* contract than SMEs Authentic data is an ultimate prerequisite for *mudarabah* and *musharakah*	Q: why? A: indeed, theoretically it could be. For example, the most proper financing scheme for project is mudarabah or musharakah, but in the project there is purchasing activities. So, such purchasing activities can use murabahah contract. In mudarabah and musharakah, the key is transaction notes. We involve in micro, who had such notes? . From my opinion, in order to grow, we should increase mudarabah and musharakah contract. If we use *murabahah* contract, we get profit 1.75% - 2% flat, but if we use mudarabah or musharakah contract we will get the profit 5% -6% per month. Yet, are the borrowers ready? We are ready [to employ PLS method] as long as borrower can provide authentic data.
Good borrower is those lived in radius 5 km around the bank office Monitoring was conducted through daily pick-up of borrower's saving Borrower saving living in radius more than 5 km were pick up in every week	Q: how do you monitor your clients? A: Actually, the good borrowers are those who live in a radius of 5 km from an Islamic bank office, because we mostly recognize people in this area. We can investigate the applicant appropriately by asking about their neighbourhood
The *mudarabah* repayment was done monthly, at least part of the profit, while the overall calculation was conducted in the end of financing Banks have maturity standard for each credit ceiling	Q: How does repayment for *mudarabah* contract? A: according to central bank rule, bank should receive repayment every month. So, since the central bank assume that bank should receive repayment every month, the borrower should repay every month and the complete calculation will be conducted in the end of financing term. Financing maturity depends on the financing ceiling. Financing up to 5 million, of its maturity is a year. For 5-20 million financing, its maturity is 2-3 years. For more than 10 million, its maturity could be 4 years maximum. The maximum maturity is 4 years. If the maturity more than 4 years, our liquidity will get in problem.
SMEs do not distinguish between business needs and family expenditure	Q: What is the obstacle of SMEs in repayment? A: They never distinguish between profit and live expenditure. They never consider which part of profit can be used for business and which part can be used for life needs, so that in certain month such as Mei,

Repayment was clogged up because of family or social needs (*kondangan*)	June and July where children going to school. In addition, repayment is also clogged up because of social needs.
Far from satisfaction The criteria of NPL is different between BPR and commercial bank	Q: do you satisfy with current recovery rate? A: I do not satisfy very much. There is different point of view in seeing NPL. In commercial bank, the repayment should be paid not more than the end of month, because if the repayment was late it falls in "call 2". In Islamic rural bank, the repayment "call 2" if the client do not repay three times.
Personal selling by visiting to Islamic teaching groups activities	Q: how do you advertise your product? A: The most effective way is from person to person by visiting group of Islamic teaching activity and distributes our brochures.
The regulation is still refers to that of conventional bank regulation The influence of fatwa *riba* is just like fatwa for smoking The assumption that Islamic bank is equal to conventional banks	Q: what the obstacle of market penetration of Islamic bank? A: A Fatwa on riba is like a fatwa on smoking. Although MUI (Indonesian Ulema Council) launched a fatwa stating that smoking is haram, but most Indonesian Muslims ignore it. Similarly, MUI launched a fatwa that interest (riba) is unlawful, and the fact remains that many people ignore that fatwa. People deem that conventional and shariah banks is one of the same
Tabel analysis (BR4)	
Customer's needs determined type of contract Collateral is important for backing-up for third party funds *Shariah* aspects must be fulfilled Repayment capability of borrower was considered by examine their cash flow	Q: what information do you need before granting financing for SMEs? A: Firstly, we determine the borrower's needs. From this, we come to understand what type of contract is most suitable for the borrower. Collateral is important because we responsible for third parties' funds. Secondly, since we are Islamic bank, *shariah* compliant must be fulfilled. We have prudent principle, so we have to analyse the repayment capability of borrower by considering their cash flow.
SMEs does not provide business plan Banks require borrower cash flow information Comparing between interview and the result of visit	Q: does every borrower were asked to provide business plan? A: we analyze by our self, and from that we know their cash flow. We are comparing between interview and survey result (visit), and sometimes asking cash flow if they can provide it. Is there any flirt or not.

Monthly profit is important Repayment capability determined the financing maturity	Q: what information do you acquired from financial statement? A: beside cash flow, monthly profit is also important. When he proposes financing, his repayment capability will determine the financing maturity.
Visit to prospective borrower is obligatory	Q: Do you visit borrower before granting financing? A: it must be. It is obligatory.
Character is the most important	Q: what kind of information do you get from the visit A: Character of the person, and then what liabilities and cash flow. The most important is character. Secondly, we asked expenditure documents.
SMEs have difficulty to provide collateral Financing could not be granted without providing collateral Collateral is the last way out Assumption that Islamic bank requirements is so complicated No opportunity of misusing the loan	Q: could you tell me what difficulties may encountered by SMEs when proposing financing? A: It was quite difficult [to acquire funds from Islamic banks] for those who don't have collateral. Loans could not be obtained without providing collateral. Indeed, so far, financing could not be realized without providing collateral. The collateral is the last way out. Besides, customers assume that the requirement employed in Islamic banks was so complicated. In conventional banks, if the marketable collateral is available then the loan will be granted without considering the use of the loan. In Islamic banks, we will monitor [the use of the loan] so that there is no opportunity for misuse [of the loan] (
The evaluation of new borrower is more detail The evaluation of repeated borrower can be seen from tract record	Q: could you explain the different of assessing new and repeated borrower? A: obviously, the treatment for new and repeated client is different. For new borrowers, we asked full requirements. For repeated borrower, we check them through repayment tract record while visit.
The criteria of refusal and approval of financing based on the repayment capability The financing maturity was determined based on the financial analysis Bank has the level of authority to make financing decision making	Q: could you explain how to refuse and approved proposed financing? A: it depends on the analysis, and repayment capability. We examine the business growth, financial analysis. From that we can determine how much financing can be approved and for how long. We have some level of authority to approved financing, such as head of marketing, director and commissioner. Financing decision will be taken in committee meeting.

The determination of financing maturity is based on the assessment of borrower	
Administrative requirement is equal for all borrowers Huge financing need to detail information exploration	Q: do you employ the same requirement for all borrowers? A: for administrative requirements are the same for all borrowers, while visit is different. The bigger the amount of financing the more details the assessment. The information not only be explored from borrower but also from other people.
Margin negotiable	Q: do you charge the same margin for all borrowers? A: Negotiable. So before deciding the contract, we negotiate first.
Collateral is the last way out	Q: what is collateral means to you? A: as the last way out, because we must responsible to third party funds.
Personal guarantee was provided for borrower in the one holding with islamic rural bank	Q: what does personal guarantee means to you? A: [firm] in the same holding [with this Islamic bank], we asked personal guarantee from their director.
Murabahah is the major contract *Murabahah* contract is safer *Mudarabah* has not launched yet Aversion risk to *mudarabah* financing *Murabahah* contract is around 90%	Q: what type of financing do you prefer? A: actually we prefer all type of Islamic financing, but currently we mostly use *murabahah* contract because it is safer. We do not yet launch *mudarabah* contract. Since we afraid of risk and must be responsible to third party, finally we mostly use *murabahah* contract which cover 90% of financing.
The first repayment as an indicator Misuse of financing was occurred	Q: how do you monitor your clients? A: usually, the first repayment is an important indicator. If a borrower delays his/her first repayment, this borrower must have problems. We never had any misuse of financing.
The determination of financing maturity is based on the assessment of borrower	Q: how do you decide financing maturity? A: Based on the repayment capacity of borrowers, we decide how much and how long the financing must be granted.
Economic condition of borrower affects repayment	Q: what obstacle may face by SMEs when repaying? A: The difficulty was related to economic condition. Secondly, if their family was sick

Family issues affect repayment	
Not yet satisfy with recovery rate	Q: do you satisfy with current recovery rate? A: we will improve [recovery rate] more and be more careful
Advertise by distributing brochures Personal selling to borrower	Q: how do you advertise your product? A: so far we promote by distributing some brochures, and we visit people and invite them to save.
People mindset is still conventional People assumption that Islamic bank is not different with conventional bank	Q: what the obstacle of penetrating for Islamic bank? A: We face much difficulty because of the old mindset. They said "what is the difference between conventional and Islamic banks?"
Tabel Analysis (BR5)	
Type of business is important information Islamic financial instruments is much more than conventional bank	Q: what information do you require before granting financing for SMEs? A: Firstly, we investigate the type of business. We are very flexible when helping them because an Islamic bank offers more financial instruments than a conventional bank does
SMES do not provide business plan SMEs do not yet understand their business scale Islamic bank acts as technical assistance for SMEs	Q: Do you asked everi borrower to provide business plan? A: I think we are not so rigid. Even they do not know their actual business size. We act as technical assistants for them, by providing them some form to fill. For example; how much did you purchase your business for? How much would you sell the business for? How much is your inventory/ stock?Etc. By doing this, we not only help them but also know the viability of their business
Visit to compare interview with real fact Information was explored through interview The most important criteria are: character, cash flow and collateral The most important criteria are:	Q: Do you visit SMEs before granting financaing for them? A: exactly. When proposal came, we firstly dialogue [with borrower] to collect data. Secondly we visit them to compare between his story and the real fact. In financing, we have had the 5C criteria, but we only emphasize on two points of it, namely the character and collateral. However, we consider cash flow as another important criterion. Thus, to make an assessment of borrowers' worthiness we emphasize on character, collateral and cash flow

character, cash flow and collateral Collateral is number two but important	
Borrower mindset is still conventional in nature	Q: could you explain what difficulties may face by SMEs when proposing financing? A: firstly their conventional mindset was formed since 1945 till now. They came here and asking; "how much you interest?" we said "we don't recognmize interest, but margin".
The evaluation for new borrower is more detail	Q: could you explain the different of assessing new and repeated borrower? A: actually, no bank would finance for new one, because no tract record available, but the investigation is more detail than the old borrower. Firstly we try with small scale [financing].
We adopts evaluation form from simplified form of conventional bank	Q: could yoy explain what criteria to refuse and approved financing? . A: I try to provide analysis form in one or two pieces of form which was adpted from bank BNI. We just take the most important in analyzing borrower worthiness.
The decision taken by director based on information provided by account officers	Q: what criteria to express that this application is good and this is bad? A: We have financing committee consisting of head of and director. After analysing using 6C criteria and their opinion based on the visit fact, the financing was decided. Our decision will be wrong if you [account officer] give me wrong data. So we decide the financign in committee meeting.
The duration of evaluation process does not depends on the amount of financing	Q: do you need longer time to evaluate bigger financing? A: not necesseraly. Explore the information as complete as possible but not too long. You must consider the life expenditure. Do they have liability if leasing company? Do they have liability in other bank?
The borrower liability in other bank was indicated in Debtor Information System (DIS) If the analysis process is too long, Islamic rural bank would not marketable	Q: how do you know that information? A: we have debtor information system (DIS) linked to central bank. When clients have bad credit card, it can be seen in the DIS. So in term of small or big financing, the analysis is fixed. We have standard (of analysis]. If the process is long, we are not marketable.
Bank provides analysis format differently for each business characteristic	Q: do you need require the same requirement for all borrowers? A: different characteristic of business, then the analysis format is also different.

Approved and refusal consideration was based on interview and visit	Q: what criteria to refuse or approved financing? A: For refusal, we hear what he told us and said "when we looked at your business place, there is no match between real fact and your story".
Margin was negotiated	Q: do you charge the same margin for all borrowers? A: essentially, in shariah is negotiable.
Collateral is important It is difficult to distinguish between business risk and human error Borrower would not be transparent *Mudarabah* contract require transparence	Q: what does collateral means to you? A: why collateral was needed by bank, because we cannot distinguish between business risk and human error. Secondly, does borrower will be transparent? In fact, mudarabah is transparence demanded. Finnaly, to avoid dishonesty we translate collateral is number two but important. We should save the fund of third party. So, the first way out is cash flow and character, while the second way out is collateral. It means that collateral is number two, but still important.
We disappointed with personal guarantee	Q: what does personal guarantee means to you? A: we have ever received personal guarantee but finally we disappointed. So we still receive personal guarantee but with consideration.
Murabaha is the highest proportion of contract Bank did not yet provide *musharakah* contract Borrower assume that *mudarabah* and *musharakah* contract are more expensive	Q: what type of financing do you prefer? A: obviously, murabahab contract is the most favorite. Mudarabah contract is only few. We have no musharakah contract yet. PLS is not familiar because they deemed that PLS scheme is more expensive.
Monitoring through repayment profile Central bank tolerate repayment for rural bank/ Islamic rural bank up to three times of arrears as a good	Q: how do you monitor your clients? A: we monitor through repayment record. Central bank tolerate for all financing facility will be considered good until three times of arrears. When borrowers do not repay twice, we visit them and asked what their problem.
Islamic bank open to negotiate	Q: how do you decide for financing maturity? A: shariah open to negotiate, because by negotiating it will be justice. So everything must be negotiated.

Family problems influence repayment	Q: what does the difficulties may encountered by SMEs when repaying? A: The problem is old fashioned. For example, their children may be sick, and may have to enrol their children to school. So, we extend their repayment by two months to support them when they have to enrol their child to school and for an Islamic feast day
Satisfy with recovery rate	Q: do you satisfy with current recovery rate? A: we satisfy, but we do not work solely. We have employee who did our instruction and produce this result [while showing the graph of recovery rate.
People paradigm is still conventional banking	Q: what obstacle to penetrate market for Islamic bank? A: Changing mindset is not so easy, because it was formed over a long period. Therefore, we are prioritizing emotional motives, those who are eager to engage in shariah. Hopefully, in the future, our customers will move from an emotional motive to a rational motive.

Tabel of analysis (BR6)

Worthiness is based on 5C analysis	Q: what type of information do you need before granting financing? A1: principally, financing analysis is actually the same between conventional and Islamic bank namely 5C, but the difference is only the type of contract.
Character is the most important	Q: from 5C, what is the important for you? A1: character.
Character is the dominant	Q: could you explain further? A1: If a person is good, he will always make effort [to repay], but if his character is bad he will not remember or neglect to repay even though he has money. So, character is the dominant. Secondly is the business [condition].
Islamic rural bank did not require business plan	Q: does every borrower were asked to provide business plan? A1: I mean that Islamic rural bank is involved in small financing. So we need not require such business plan.
Islamic bank help SMEs to arrange financial statement	Q: Does isalmic bank require financial statement from SMEs? A1: We help them
SMEs do not provide financial statement	Q: It measn that SMEs do not provide financial statement? A1: No. Our people rarely have well administrative/ documentation.
	Q: do you visit borrower before granting financing? A1: so far we look at the amount of [financing] . If the

Visit to borrower is a must The officer visiting the borrower will depens on the aomount of financing	financing is only 5 million, Acoount officer visited, for 10 million vice director visit the borrower, for 50 million and more, director visit the borrower.
Information obtained from visit is 6C Visit to cross check	Q: what kind of inoramtion dou you get from visit? A1: obviously 6C is a must plus business situation. Usually he came here and we received and hear whatever he told, and then we visit to compare to ensure whether what he told is the smae with the real fact.
Collateral provision issue is difficult for SMEs Collateral is useful for backing up third party funds	Q: could you explain what obstacle may face by SMEs when proposing financing? A: collateral, because if we do not require collateral we will be warned by central bank. Besides, since we lend funds of other people, we have to responsible of it.
Evaluation of repeated borrower from tract record Evaluation of new borrower is more detail, moreover for big financing	Q: could explain the different bteweenn evaluating new and repeated borrower? A2: from repayment tract record, repeated borrower can be seen. For new borrower, we analyze more detail, moreover for big [financing] we have to [analyze] as detail as possible. For investigating the character, we asked till four people; neighborhood, his business partner etc.
Approval and refusal of application was based on 5C analysis	Q: could you explain what criteria to approved and reject the application? A: it's based on 5C. If the business is good but character is not, the application is rejected. For example from business side he is good and grows, but from character side, the borrower is gambler. It is obvious that the borrower have high risk in the future.
Serving is the same for either big or small financing	Q: do you need more time to asses the bigger financing? A: we have prime service. For both big and small, the service is equal. The important is [that the borrower can provide] complete requirements. The borrower causes long process because he cannot provide complete requirements. As long as the requirement is complete and met 5c, financing process can go on.
The requirement is equal for all clients Financing might be granted 100% of collateral value.	Q: do you need the same reuirements for all clients? A: generally, the requirement sit eh same for all. We do not differentiate between them. Yet, the analysis may be different. We can grant financing 100% of collateral value for repeated borrower.
Margin was negotiated and depends on the type of business or risk Conventional interest rate as a benchmark Margin is negotiable	Q: do you charge the same margin for all borrowers? A: we negotiate. We cannot charge the same margin, but it depends on the borrower. If the borrowers have ever come to conventional banks, they knew the interest rate in the conventional bank, so we offer a margin equal to the interest rate. For new borrowers we offer a margin [regardless of the market interest rate] and then negotiate

Collateral is to anticipate	Q: What does collateral means to you? A: the important of collateral depends on the borrower. When the applicant was recognized as being of good character, then we do not need to ask collateral. Conversely, if we are not so sure with the borrowers' character, we ask the borrower to provide collateral. Borrowers who provide collateral will have more responsibility to make repayments on time
Personal guarantee is only for reference Although borrower provide personal guarantee, 5C analysis was still undertaken	Q: what does personal guarantee menas to you? A2: Personal guarantee is only; "here I have good borrower, my family of friend will borrow". We still use 6C for analysis.
Murabahah contract is the favorite contract because the simplicity	Q: what type of financing do you prefer? A: so far the favourite is murabahah
Borrowers were not ready to adopt *mudarabah* and musharakah contracts *Mudarabah* and *musharakah* contract are difficult to be applied because of transparence obstacle	Q: why murabahah, not the others? A: because of simplicity. They think that mudarabah and musharakah are so complicvated because they should make financial statement and so on, except for CV we push to utilize mudarabah or musharakah contract. They asked the simple one. Actually we prefer to mudarabah adn musharakah contract, but they are not ready yet.
Monitoring was done by picking up daily saving of the borrower In the end of month, the daily collected saving was debited	Q: how do you monitor your borrowers? A: we visit [them]. Fortunately our borrowers are mostly depositor. So we pick up their saving every day. We have three officers to collect their saving by visiting them everyday. In the end of month, the saving will be debited for repayment. Secondly, for big borrowers, we visit them routinely [in certain time].
The determination of financing maturity was based on analysis and it was decided in the financing committee meeting	Q: how do you decide financing maturity? A: so when the application is coming, it was analysed by account officer, and then vice director visit [the borrower]. The result was discussed in the committee meeting.
	Q: what kind of obstacle faced by SMEs when repaying? A: it is related to real situation. If the business condition is bad, the repayment will be late.
There is no misuse of financing	Q; it means that it is impossible to use the financing for other need other than business? A: so far, based on my experience, there is no misuse [of financing]. Secondly, if a borrower's family member is sick [the repayment would be hampered]

Sick family member can affect repayment	
Satisfied enough	Q: do you satisfy with current recovery rate? A: Alhamdulilah, satisfied enough
Advertise the product through brochures distributed working with foundation and radio Advertise product by placing billboard in RIA supermarket	Q: how do you advertise your product? A: firstly, we use pamphlet. Secondly, we advertise though radio and jumat bulletin. We cooperate with foundation that have bulletin and we put my logo on it. We place some brochures in the borrower's shop. We also place billboard in RIA supermarket
People does not fully understand of Islamic bank The assumption that Islamic bank is complicated	Q: what difiiculty to do market penetration for Islamic bank? A: Obviously people do not yet fully understand Islamic banks and when introduced to IBs, peoples' response was that "it is too complicated, not as simple as a conventional bank". People lack familiarity with Islamic banking
Tabel analysis (BR7)	
Assess the worthiness of borrower based on 5C criteria Character is the most important	Q: what information do you need from SMEs before granting financing? A: the business condition. Firstly we assess generally based on 5C. The first is character, which is the most important. Indeed we must searching information about many things. If needed we check the DIS (debtor information system)
Borrower's character was discovered from neighborhood	Q: you said that character is important, how do you know it? In fact, you do not recognize him? A: we have information from neigborhood. Usually we have informan in some place. Principally, in every place where we doing marketing, we have some sort of informant there.
Repayment capability is the second most important factor	Q: you said that character is ultimate factor, so what the second order? A: the capability for repayment, the capability of business
SMEs do not provide business plan The general purpose of finance is for investment and	Q: does every borrower were asked to provide business plan? A: for small business, the financing proposal is usually for investment or for inventory. At least we help them, if they cannot provide it, through interview. Collateral is the last, because our approach is not only collateral approach. We emphasize to cash flow approach.

working capital Collateral is last consideration, but it must be available	
Bank estimate borrower financial condition based on interview	Q: do you ask financial statement from SMEs? A: No. Almost not available. We make [some sort of financial statement] based on the interview.
Purchase receipt was required	Q: so the account officer who calculate? A: yes, we calculate, the borrower will not do it. For example, how much of this inventory? Do you have bank account? Could I see it? Could you copy it for me as evidence? And so on. So we also ask the receipt of purchasing.
For SMEs running business is more important than financial statement SMEs feel get profit as long as their business is running	Q: So generally, they don't have any financial statement? A: Almost all of SMEs don't know about financial statements. What they know is their business still running. As long as their business is running, they feel that they get profit. So we make it [financial statement like].
Account officer visit the borrower	Q: do you visit SMEs before granting financing? A: yes, account officers do it. Everything was investigated
Informasi from visit is worthiness Aseeesment process in a working week	Q: what kind of information do you get from the visit? A: the first is worthiness. If we are doubt, we searching other information to examine his character, but we must do fast. For example you apply on Monday, on Friday the assessment must be finished, in term of approved or rejected.
Document provision issue is something difficult for SMEs Unavailability of documents complicate bank to make assessment Collateral binding complicate borrower Cost of collateral binding is expensive	Q: Could you explain what difficulty might be faced by SMEs when proposing financing? A: administrative requirements. Sometimes, I have obligation to educate them. The unavailability of documents causes a bank to take time in processing loan applications. From external side we have difficulty with collateral binding, the cost is expensive. There is rule of central bank that all collateral must be legalized in order to be acknowledged as reserve [in financial statement].
Evaluation of repeated borrower was seen from tract record	Q: could you explain what the difference between assessing new and repeated borrowers? A: I only check from repayment tract record. How many times he received financing. So every boorower have his/her own file, we just need to open the file. For new

New borrower was explored from the beginning Assessment for huge amount can be took place for 2 weeks	borrower, we should check the business condition; we should investigate from the beginning. Indeed it take more time, but it be finished in aweek. If the amount is big, it might take 2 weeks.
Approval and refusal of application was based on financial analysis result	Q: could tell mewhat the criteria to accept and reject financing application? A: from financial analysis
Bank need more time to assess the bigger amount of financing	Q: do you need more time to evaluate the bigger financing? A: for financing under 50 million, the assessment is a week, for more than 50 million financing need 2 weeks for assessment because we have to check this and that.
Generally, the requirements is equal for all borrower, but there is slight different of completeness	Q: do you need the same requirements for all borrowers? A: generally, it is the same. Administratively is the same, but the completness [of requirements] is different
Margin is negotiable	Q: do you charge equal margin for all borrowers? A: Oh no. It's different, depends on the negotiation. Bank has considered why this [financing] is high [ratio] because it may have hihg risk.
Collateral is important to obey the central bank's rule Collateral is last way out besides cash flow Collateral is important to back up third party funds	Q: what does collateral means to you? A: Collateral is important because we have to obey central bank's rule. As I said to my marketing officers that when you send me a financial proposal you should have two ways out. The first is cahs flow and the second is collateral. Collateral is important because we have to save the third party funds.
Bank rarely utilize personal guarantee. Personal guarantee means that guarantoe must be responsible	Q: what deas personal guarantee means to you? A: we rarely use personal guarantee. Personal guranatee does not mean that if the borrower does not repay and then must insist him/her to pay, but also have to responsible.
Murabahah contract is demanded very much Islamic bank prefer to PLS contract	Q: what type of financing do you prefer? A: Murabahah, because it does not demand to make complicated calculation. It is simple. For Islamic bank, actually prefer to utilize mudarabah adn musharakah, but borrower feel that they have to share much more profit (when using mudarabah and musharakah contract]. It is because the profit ratio cannot be

Assumption that *mudarabah* and *musharakah* contract is more expensive	changed, so for exaplme currently [the business] produce 1 million profit and on the other occasion get profit 3 million, the nominal [that should be shared] is increased.
Monitoring was done routinely by collector department	Q: how do you monitor your borrowers? A: it si monitored routinely by colletion department. If he found a proble, the collactor will tell the account officer and then the account officer will follow up.
Maximum financing maturity is 5 years long The determination was based on the capability of repayment	Q: how do tou decide financing maturity? A: we have rule, maximum of financing maturity is 5 years. Principally, the repayment is as light as possible, contiuity is the important.
SMEs do not distinguish between business needs and family spending Social needs is also affect repayment	Q: what the difficulty migh be faced bny SMEs in repaying? A: Generally, SMEs do not have good planning. Sometimes, surplus of funds are often used to purchase excessive inventory that may lead to cash flow problems in the future Secondly, it is related to daily family needs, for school, for social needs (kondangan). The other factor is bad character.
Do not yet satisfy with recovery rate	Q: do you satisfy with current recovery rate? A: not yet.
Advertise product through brochures distribution Door to door marketing	Q: how do you advertise your product? A: we use much more pamphlet, an then marketing door to door
There is assumption that Islamic bank is not different with that of conventional	Q: what the difficult of market penetration for Islamic bank? A: The most difficult aspect of marketing IBs is to change people's mindset; they assume that the Islamic bank is no different to the conventional bank.
Tabel analysis (BR8)	
The required information is 5C	Q: what kind of information do you need before granting financing for SMEs? A: what we need firstly is 5C
Of 5C, the most important is capacity and character, the others are not so important	Q; of 5C, could you explain what criteria is the most important? A: for micro business have specific thing that different from other banks. So we emphasize to capacity. The second is character. the other factors is not so important
	Q: Does every prospective borrower were asked to provide business plan?

Most of the SMEs do not provide business plan	A: SMEs has it, but most of them do not have [business plan]
Business plan provide development plan	Q: what kind of information do you get from business plan? A: generally what we need is development plan.
Bank helps them to flirt/confabulate financial statement	Q: when SMEs proposed financing, does Islamic bank asked financial statement? A: Actually most of the SMEs do not have a good financial statement. We help them provide simple calculations. It is very few SMEs that have it.
Account officer visit to prospective borrower	Q: do you visit SMEs before granting financing? A: definitely yes. Not me but my Account officers. It must be.
Information acquired from visit is particularly character, capacity and type of business	Q: what kind of information do you get from visit? A: ultimately the 2C, particularly character, including type of business.
People do not yet recognized Islamic bank well Borrowers are not ready to utilize *mudarabah* contract	Q: could you tell me, what is the difficulty of SMEs when proposing financing to Islamic bank? A: nothing. They just do not yet recognize Islamic rural bank well. So we have difficulty in explaining our product. For example, Islamic bank should utilize [more] *mudarabah* product, but in reality they are not ready [to use PLS scheme]
Mudarabah contract was deemed more expensive when SMEs obtain bigger profit	Q: why? A: That the reality. I don' know why. They are afraid with mudarabah contract. Actually, mudarabah contract is fairer. I have an experience with the borrower who afraid with *mudarabah* contract. Entrepreneur sometimes got more profit, he afraid to cheat, sin, but if he report [his profit] honestly he was shocked [because he must share too much profit for bank]. He don't remember that if he loss, bank is also loss. He doesn't consider it.
There is no much difference between new and repeated borrower	Q: could you explain the different assessment of new and repeated borrowers? A: actually it is not so much different, because the repeated borrower must have many changing. So for us, it is almost the same. We do not differentiate between new and repeated borrower.
The duration of assessment process does not depend on the amount of financing	Q: do you need more time to assess the bigger financing? A: oh no. It depends on the [acquired] information. If the information have already complete, why should it be so long?
The approval and refusal of financing application based on 5C analysis and the shariah	Q: what is the consideration to accept and eject financing proposal? A: generally, 5C. For Islamic bank, forbidden business is excluded.

compliant	
Margin is negotiable	Q: do you charge the same margin for all borrowers? A: Negotiable, sure.
Collateral is the last way out	Q: what does collateral means to you? A: actually.... [Thinking quite long] as the last way out. But it is not must. So bank may use collateral, but the bank translate world “may” as an obligatory.
	Q: what does personal guarantee means to you? A: we ever use personal guarantee but not much.
Islamic bank is more prepared to apply profit and loss sharing than borrowers	Q: what type of financing do you prefer? A: actually we prefer to PLS scheme, but the problem is that borrowers do not yet ready [to use it]. So we forcedly use much more *murabahah* [contract].
Routine saving as a medium for monitoring	Q: how do you monitor your borrowers? A: we have two ways. When the borrowers received financing, we asked them to save routinely, weekly or even daily. The saving also taken by our Account officer. That is the medium for monitoring. If, for example, he usually save daily and then he don’t save for a week, he must have a problem
Financing maturity is negotiated	Q: how do you decide financing maturity? A: bank must do negotiation. But when offering, we have to consider the [capability to repay of] borrowers
Do not yet satisfy with recovery rate Most of the client was imposed to natural disaster /merapi mountain disaster	Q: do you satisfy with current recovery rate? A: hm... not yet Q: Why? A: as it were, We just faced a natural disaster, Merapi Mountain [explosion]. Almost 40% of business performances of our borrower are affected by that disaster. The exact percentage is 38% of our borrowers.
Through radio and distributed brochures	Q: how do you advertise your product? A: ehm... we use various ways. We advertise through radio, and then brochures. Actually the most effective is by visiting Islamic teaching group activity.
People understanding about Islamic bank need to be improved Emotional group response faster to the presence of Islamic bank	Q: what the obstacle of Islamic bank to penetrate market? A: We classify people in three groups. The first category is emotional. This group is easy [to invite], the importance for them is only shariah. The other is the rational [group]. We have to have different approaches towards [each group]. At the start, it was the emotional group that was much more interested in. Q: for emotional group, are they easier? A: definitely, yes. But currently those groups are rare. When Islamic bank open in the first time in new area, the emotional group is much more interested in.

Appendix 4

Questionnaire for Small and Medium Sized Enterprises (SMEs)

Please tick the boxes adjacent to the appropriate responses, but should you feel to qualify your point, write any comments in the space below the question.

Section I
Personal Bio-data

City ………………..

Your age: ☐ <30 years ☐ 31-40 years ☐ 41-50 years ☐ 51-60 years ☐ >60 years

Please state your gender:

☐ Male ☐ Female

Your business sector: ☐ Agriculture ☐ Mining ☐ Manufacturing ☐ Construction ☐ Trade ☐ Transport/ communication ☐ others

Your qualification: ☐ Elementary school ☐ Junior High school Senior high school ☐ Graduate ☐ Post Graduate

Number of your family ☐ 2 -3 people ☐ 4-5 people ☐ 6-7 people ☐ 8-9 people ☐ More than 9 people

Section II
The reasons of seeking fund

1. How long your business has been established?
   - ☐ Less than 5 years
   - ☐ 5 – 10 years
   - ☐ 11 – 15 years
   - ☐ 16 – 20 years
   - ☐ More than 20 years

2. How many employees do you have?
   - ☐ 1-5 people
   - ☐ 6 -20 people
   - ☐ 21-30 people
   - ☐ 31-50 people
   - ☐ 50-100 people

3. How much is your firm's assets?
   - ☐ Less than Rp. 50 million
   - ☐ Rp. 51 million – Rp. 100 million
   - ☐ Rp. 101 million – Rp. 200 million
   - ☐ Rp. 201 million – Rp. 300 million
   - ☐ More than Rp. 300 million

4. How do you think of your sale for the last three years
   - ☐ Little increase
   - ☐ Much increase
   - ☐ Stagnant
   - ☐ Little decrease
   - ☐ Much decrease

5. How much of your business profitability?
   - ☐ Less than 10 %
   - ☐ 10% – 20%
   - ☐ 21% – 30%
   - ☐ 31% – 40%
   - ☐ More than 40%

6. Do you have saving?
   - ☐ Yes
   - ☐ No

7. If you borrow from Islamic bank, what the purpose of the loan?
   - ☐ Investment
   - ☐ Working capital
   - ☐ Consumption
   - ☐ Others, specify............................

8. What the amount of loan do you request?
   - ☐ Less than Rp. 10 million
   - ☐ Rp. 10 – 25 million
   - ☐ Rp. 26 – 40 million
   - ☐ Rp. 41 – 55 million
   - ☐ More than Rp. 55 million

9. What the amount of loan was approved?

- [ ] Less than Rp. 10 million
- [ ] Rp. 10 – 25 million
- [ ] Rp. 26 – 40 million
- [ ] Rp. 41 – 55 million
- [ ] More than Rp. 55 million

10. What is the percentage of debt to total assets?
- [ ] Less than dari 10%
- [ ] 10 % - 20%
- [ ] 21% - 30%
- [ ] 31% -40%
- [ ] More than 40%

11. How long the duration of loan do you required?
- [ ] 0-1 tahun
- [ ] 2 – 3 tahun
- [ ] 4 -5 tahun
- [ ] 6 - 7 tahun
- [ ] Lebih dari 7 tahun

12. Do you borrow money from conventional banks?
- [ ] Yes
- [ ] No

13. If the answer to ‘question 12’ is ‘no’ because:
- [ ] did not need money
- [ ] unfamiliar with banks lending provisions
- [ ] borrow money from relatives
- [ ] Borrow money from money lenders/ any other; Specify…………………………

14. If you borrow from conventional banks, why do you want to borrow from Islamic banks?
- [ ] The amount of loan gained from conventional bank less than required
- [ ] To reduce cost of capital
- [ ] To share loss with Islamic bank
- [ ] Others, specify...............................

15. Do you borrow money from family?
- [ ] Yes
- [ ] No

16. If you borrow money from your family, what is the reason?

- ☐ Unfamiliar with banks lending provisions
- ☐ Cannot provide required collateral for bank
- ☐ Money getting from bank less than required
- ☐ Money getting from bank less than required

17. What is your reason to use an Islamic bank for your enterprise:
    - ☐ Religious reasons
    - ☐ Profit/cost reduction reasons, solely
    - ☐ Profit/cost reduction and religious reasons combined
    - ☐ The lending process is easier to deal with than a conventional bank
    - ☐ Islamic banks are more competent than conventional banks
    - ☐ Islamic banks have a wider range of facilities to offer than conventional banks

Section III
Islamic bank services

18. For how long have you had a bank account with Islamic Bank?
    - ☐ Less than 1 year
    - ☐ 1 – 3 years
    - ☐ 4 – 6 years
    - ☐ 7 – 9 years
    - ☐ More than 9 years

19. The length of bank relationship helps you to acquire funds from them?
    ☐ Strongly agree ☐ Agree ☐ Neutral ☐ Disagree ☐ Strongly disagree

20. Do you agree that Islamic banks offer service to SMEs better than conventional bank?
    ☐ Strongly agree ☐ Agree ☐ Neutral ☐ Disagree ☐ Strongly disagree

21. Procedure to obtain funds from Islamic bank is easier than that from conventional bank
    ☐ Strongly agree ☐ Agree ☐ Neutral ☐ Disagree ☐ Strongly disagree

22. Lending policy of Islamic bank support better to SMEs than conventional bank
    ☐ Strongly agree ☐ Agree ☐ Neutral ☐ Disagree ☐ Strongly disagree

23. Have you approached an Islamic Bank for obtaining funds and your application was rejected?
    - ☐ Yes
    - ☐ No

    If yes please state the reason/reasons:---

24. Are you required to provide collateral when borrowing from Islamic bank?
   - ☐ Yes
   - ☐ No
25. What do you think the cost of funds getting from Islamic bank comparing to that of conventional bank
   ☐ lesser ☐ the same ☐ higher

26. Are you required to provide financial report of your business when you propose financing from Islamic bank?
   - ☐ Yes
   - ☐ No

27. If you have borrowed Islamic funds, the type of contract you used was:
   - ☐ Mudaraba
   - ☐ Musharaka
   - ☐ Murabaha
   - ☐ Ijara
   - ☐ Istisna
   - ☐ Other Please mention………………………………………………

28. What is your problem when dealing with Islamic bank?
   ………………………………………………………………………………………………
   ………………………………………………………………………………………………

Section IV
Sanctioning and delivering of financing

29. How long was taken to:
   - Sanction the loan……..days/moths.
   - Received the loan…….days/months.

30. How many times you had to visit the concerned officials to get the sanction of your proposal?

☐ Once	☐ Three times	☐ Five times
☐ Twice	☐ Four times	☐ More than five times

31. Did you give bribe to bank officer in order to approve your financing application?
   - ☐ Yes
   - ☐ No

32. What factors do you think influencing the delay of the sanctioning and / or delivering of financing?
   - ☐ Insufficient bank staff

- ☐ Unnecessary queries
- ☐ Unfriendly attitude of staff
- ☐ Any other (specify)……………

Section V
Repayment schedule

33. If you use PLS mode of finance (*mudaraba* or *musharaka*) and you get a profit from the project financed by Islamic bank, how do you repay to the bank?
    - ☐ monthly
    - ☐ quarterly
    - ☐ half yearly
    - ☐ annual
    - ☐ Others specify.....................

34. Was the repayment schedule?
    - ☐ Impose upon you
    - ☐ finalized with your consent

35. Are you paying regularly on schedule?
    - ☐ Yes
    - ☐ No

    If not, state what the reason..

Section V
Additional information

36. State the problem you encountered while dealing with Islamic bank:
    - ☐ loan application
    - ☐ Getting approval from the bank

37. Significant factors effecting bank's lending decision:

	Very important	Important	Neutral	Not very important	Not important at all
Personal Age					
Gender					
Personal education					
Age of business					
Type of business					
Number of assets					
Percentage of liability to total assets					
Average of sales					
Collateral					
Duration of account with the bank					

Past tract record of loans					
Personal relationship with the bank manager					
Business plan					

38. Please feel free to make any additional comments, which you think are relevant
....
....
....

Appendix 5

The List of Interview Questions for SMEs

A. General question about your company

1. How long your company was established?
2. How many employees work in your company?
3. What type of business is your company?

B. Questions related to the Reason of seeking funds

1. How do you fulfil the funding needs of your business?
2. Why do you choose Islamic bank?
3. What type of Islamic finance instrument do you need the most? (*Mudarabah, Musharakah, Murabahah, Ijara, Istisna, Others).*
   Why?

C. Questions related to SMEs' experience in accessing Islamic bank

1. How was your experience of accessing Islamic banks?
2. What do you think about the policy employed by Islamic bank to their client?
3. What are the most difficult requirements you have to meet? Why?
4. Whether are you satisfied or not with the service of Islamic bank? Why?
5. In your opinion, how the service of conventional bank compare with Islamic bank?

D. Questions related to SMEs' obstacles in seeking funds from Islamic bank and how they overcome their financial needs.

1. What is the main obstacle of accessing Islamic bank? Why?
2. How do you overcome the difficulties of accessing Islamic bank?
3. Do you borrow money from conventional bank in addition to Islamic bank? Why?
4. Do you seek funds from informal sources? Why?
5. What are you suggestion to Islamic banks in order to facilitate the relationship between entrepreneurs and Islamic bank?

Appendix 6

Interview Schedule for Islamic Rural Bank managers

The list of questions

Section I
Personal Bio-data
City ………………..

1. What is your designated position?
2. How long have you worked for this bank?
3. What is the minimum qualification required for financing officer?
   - ☐ Senior high school
   - ☐ Diploma
   - ☐ Bachelor
   - ☐ Post graduate
4. What type of skill is needed for financing officer?
5. Does the bank provide training to financing officer?
   ☐ Yes ☐ No
6. What type of training is provided?
7. How often is such training updated?
   - ☐ Monthly
   - ☐ Quarterly
   - ☐ Half yearly
   - ☐ Yearly

Section II

Please choose the significant factor effecting banks' lending decision:

	Very important	Important	Neutral	Not very important	Not important at all
Personal age					
Gender					
Personal education					
Age of business					
Type of business					
Number of assets					
Percentage of liability to total assets					
Average of sales					
Collateral					
Duration of account with the bank					
Past tract record of loans					
Personal relationship with the bank manager					
Business plan					

Section III

1. What kind of information do you require from SMEs owners?
2. What information do you obtain from the business plan?
3. What information do you obtain from accounting information?
4. Do you visit the borrower before lending? What information do you extract from the visit?
5. What are the difficulties that is faced by SMEs when propose financing to your bank?
6. Could you explain the difference of assessing between new client and old client?
7. Tell me what criteria does the bank use to determine the suitability of proposal financing application?
8. Do you need longer time to approve larger amount of financing?
9. How do you perceive the business risk of SMEs?
10. Do you require the same covenant for every client? If not tell me why?
11. Could you tell me the consideration of approved and rejection of the proposal?
12. Do you impose the same charge for every client?
13. What is the important collateral means to you?
14. What is personal guarantee means to you?
15. There are many type of Islamic financing instrument, could tell me what type of financing do you prefer to provide for SMEs? Why?
16. How do you monitor you clients?
17. How do you decide about the length of loan repayment?
18. What are the difficulties, if any, that SMEs usually encounter in the case of repayment?
19. Do you satisfy with the existing recovery rate?
20. How do you inform the SMEs about the various financing provision offered by your bank?
21. In your opinion, what is the main obstacle for your bank to penetrate the market?

Appendix 7

Questionnaire Untuk Usaha Kecil dan Menengah (UKM)

Silahkan centang kotak yang tersedia untuk masing-masing pertanyaan, tulis komentar apapun pada titik-titik yang tersedia.

Section I

Bio-data

Kota/kabupaten ………………..

Usia anda: ☐ <30 tahun ☐ 31-40 tahun ☐ 41-50 tahun ☐ 51-60 tahun ☐ >60 tahun

Jenis kelamin : ☐ Laki-laki ☐ Perempuan

Sector bisnis usaha anda: ☐ pertanian ☐ pertambangan ☐ Manufaktur ☐ konstruksi ☐ perdagangan ☐ Transport/ komunikasi ☐ lainnya

Pendidikan anda: ☐ SD ☐ SMP ☐ SMU ☐ Sarjana ☐ Pasca Sarjana

Jumlah anggota keluarga ☐ 2 -3 orang ☐ 4-5 orang ☐ 6-7 orang ☐ 8-9 orang ☐ Lebih dari 9 orang

Section II
Alasan mencari modal

1. Berapa lama umur perusahaan anda berdiri?
   - ☐ 1 – 3 tahun
   - ☐ 4 – 6 tahun
   - ☐ 7 – 9 tahun
   - ☐ 10 – 12 tahun
   - ☐ Lebih dari 12 tahun

2. Berapa jumlah karyawan yang anda miliki?
   - ☐ 1-5 orang
   - ☐ 6 -20 orang
   - ☐ 21-30 orang
   - ☐ 31-50 orang
   - ☐ 50-100 orang

3. Berapa jumlah asset perusahaan anda?
   - ☐ Kurang dari Rp. 50 juta
   - ☐ Rp. 51 juta – Rp. 100 juta
   - ☐ Rp. 101 juta – Rp. 200 juta
   - ☐ Rp. 201 juta – Rp. 300 juta
   - ☐ Lebih dari Rp. 300 juta

4. Bagaimana menurut anda penjualan perusahaan anda selama tiga tahun terakhir?
   - ☐ Sedikit meningkat
   - ☐ Meningkat banyak
   - ☐ Tetap
   - ☐ Sedikit menurun
   - ☐ Menurun banyak

5. Berpa tingkat profitabilitas/ keuntungan perusahaan anda?
   - ☐ Kurang dari 10 %
   - ☐ 10% – 20%
   - ☐ 21% – 30%
   - ☐ 31% – 40%
   - ☐ Lebih dari 40%

6. Apakah anda punya tabungan?
   - ☐ Ya
   - ☐ Tidak

7. Jika anda meminjam uang dari bank syariah, untuk apa pinjaman tersebut?
   - ☐ Investasi
   - ☐ Modal kerja
   - ☐ konsumsi
   - ☐ lainnya,............................

8. Berapa jumlah pinjaman yang anda butuhkan?
   - ☐ Kurang dari Rp. 10 juta
   - ☐ Rp.10 – 25 juta
   - ☐ Rp. 26 – 40 juta
   - ☐ Rp. 41 – 55 juta
   - ☐ Lebiha dari Rp. 55 juta

9. Berapa jumlah pinjaman yang disetujui?
- ☐ Kurang dari Rp. 10 juta
- ☐ Rp.10 – 25 juta
- ☐ Rp. 26 – 40 juta
- ☐ Rp. 41 – 55 juta
- ☐ Lebiha dari Rp. 55 juta

10. Berapa besarnya prosentase utang terhadap asset perusahaan anda?
- ☐ Kurang dari 10%
- ☐ 10 % - 20%
- ☐ 21% - 30%
- ☐ 31% -40%
- ☐ Lebih dari 40%

11. Berapa lama jangka waktu pinjaman yang anda butuhkan?
- ☐ 0-1 tahun
- ☐ 2 – 3 tahun
- ☐ 4 -5 tahun
- ☐ 6 - 7 tahun
- ☐ Lebih dari 7 tahun

12. Apakah anda meminjam dari bank konvensional?
- ☐ Ya
- ☐ Tidak

13. Jika jawaban “pertanyaan 12” adalah “tidak” karena:
- ☐ Tidak membutuhkan uang
- ☐ Tidak paham dengan pengajuan pinajam ke bank
- ☐ Pinjam uang dari kerabat
- ☐ lainnya; sebutkan…………………………

14. Jika anda pinjam dari bank konvensional, mengapa anda masih ingin meminjam dari bank syariah?
- ☐ Jumlah yang diperoleh dari bank konvensional kurang dari yang dibutuhkan
- ☐ Karena imbalannya /biayanya lenbih murah
- ☐ Untuk berbagi risiko dengan bank syariah
- ☐ lainnya, sebutkan...............................

15. Apakah anda meminjam uang dari keluarga?
- ☐ Ya
- ☐ Tidak

16. Jika anda meminjam uang dari keluarga, apa alasannya?

- [ ] Tidak paham dengan pengajuan pinjaman ke bank
- [ ] Tidak dapat menyediakan jaminan yang disyaratkan bank
- [ ] Uang yang diperoleh dari bank lebih kecil dari yang kebutuhan
- [ ] Lainnya, sebutkan……………………………..

17. Apa alasan anda untuk menggunakan pembiayaan bank syariah?
    - [ ] Karena agama
    - [ ] Hanya pertimbangan keuntungan atau pengurangan biaya modal
    - [ ] Kombinasi antara alasan agama dan keuntungan/ pengurangan biaya modal
    - [ ] Prosesnya lebih mudah dibandingkan dengan bank konvensional
    - [ ] Bank syariah lebih terampil menangani UKM dibandingkan dengan bank konvensional
    - [ ] Bank syariah memiliki lebih banyak jenis fasilitas kredit/pembiayaan dibandingkan dengan bank konvensional

Section III
Pelayanan bank syariah

18. Berapa lama anda memiliki rekening di bank syariah?
    - [ ] Kurang dari 1 tahun
    - [ ] 1 – 3 tahun
    - [ ] 4 – 6 tahun
    - [ ] 7 – 9 tahun
    - [ ] Lebih dari 9 tahun

19. Lamanya hubungan dengan bank membantu anda untuk memperoleh dana dari bank?
    ☐ Sangat setuju   setuju   Netral   Tidak setuju   Sangat setuju

20. Apakah anda setuju bahwa bank syariah menawarkan jasa kepada UKM lebih baik dibandingkan dengan bank konvensional?
    ☐ Sangat setuju   ☐ setuju   ☐ Netral   ☐ Tidak setuju   ☐ Sangat setuju

21. Prosedur untuk memperoleh dana dari bank syariah lebih mudah dibandingkan dengan bank konvensional.
    ☐ Sangat setuju   ☐ setuju   ☐ Netral   ☐ Tidak setuju   ☐ Sangat setuju

22. Kebijakan pembiayaan bank syariah kepadaa UKM lebih baik dibandingkan dengan konvensional
    ☐ Sangat setuju   ☐ setuju   ☐ Netral   ☐ Tidak setuju   ☐ Sangat setuju

23. Apakah anda sudah pernah ke bank syariah untuk memperoleh modal dan aplikasi anda ditolak?
   - ☐ Ya
   - ☐ tidak

   Jika ya, silahkan beri alasan:……………………………………………………………………………………
   ……………………………………………………………………………………………………...

24. Apakah anda diminta menyediakan jaminan ketika meminjam dari bank syariah?
   - ☐ Ya
   - ☐ Tidak

25. Bagaimana menurut anda biaya modal (imbalan yang harus diberikan) untuk dana yang diperoleh dari bank syariah dibandingkan dengan bunga yang harus dibayarkan kepada bank konvensional?

   ☐ Lebih rendah ☐ sama ☐ Lebih tinggi

26. Apakah anda perlu menyediakan laporan keuangan bisnis anda ketika mengajukan pembiayaan ke bank syariah?
   - ☐ Ya
   - ☐ Tidak

27. Jika anda pernah pinjam dana dari bank syariah, fasilitas yang anda gunakan adalah:
   - ☐ Mudaraba
   - ☐ Musharaka
   - ☐ Murabaha
   - ☐ Ijara
   - ☐ Istisna
   - ☐ lainnya Sebutkan …………………………………………………

28. Apa masalah yang anda hadapi ketika berhubungan dengan bank syariah?
   ....
   ....
   ....

Section IV

Persetujuahn dan pencairan pembiayaan

29. Berapa lama untuk:
   - Persetujuan pembiayaan ……..hari/bulan.
   - Pencairan pembiayaan …….hari/bulan.

30. Berapa kali anda harus mengunjungi bank untuk mendapatkan persetujuan proposal anda?

☐ sekali	☐ Tiga kali	☐ Lima kali
☐ Dua kali	☐ Empat kali times	☐ Lebih dari lima kali

31. Apakah anda memberikan suap kepada pegawai bank untuk menyetujui aplikasi pembiayaan anda?
    - ☐ Ya
    - ☐ Tidak

32. Faktor apa yang mempengaruhi penundaan persetujuan dan atau pencarian dana?
    - ☐ Jumlah Staff bank yang tidak cukup
    - ☐ Penyelidikan yang tidak perlu
    - ☐ Staff yang tidak terampil
    - ☐ Sikap staff bank yang tidak bersahabat
    - ☐ Lainnya, sebutkan

Section V
Skedul angsuran

33. Bagaimana anda membayar angsuran?
    - ☐ Bulanan
    - ☐ kwartalan
    - ☐ Semesteran
    - ☐ Tahunan
    - ☐ Lainnya, sebutkan......................

34. Bagaimana penentuan jadwal angsuran?
    - ☐ Dipaksakan kepada anda
    - ☐ Diselesaikan dengan persetujuan anda

35. Apakah anda membayar angsuran secara teratur?
    - ☐ Yas
    - ☐ tidak

    Jika tidak, mengapa?
    ....
    ....
    ....

Section V

Additional information

36. Sebutkan masalah yang anda hadapi ketika berhubungan dengan bank syariah:
    - ☐ Aplikasi pembiayaan
    - ☐ Persetujuan dari bank
37. Factor yang mempengaruhi keputusan bank:

	Sangat penting	Penting	Netral	Tidak begitu penting	Tidak penting sama sekali
Usia					
Jenis kelamin					
Pendidikan					
Usia perusahaan					
Jenis usaha					
Jumlah asset					
Prosentase utang terhadap total aset					
Rata-rata penjualan					
Jaminan					
Lamanya rekening bank yang dimiliki					
Catatan pinjaman masa lalu					
Hubungan Personal dengan manajer bank					
Rencana bisnis					

38. Silahkan isiskan komentar tambahan yang menurut anda relevan:

....
....
....

Appendix 8

Daftar Pertanyaan Untuk Wawancara dengan UKM

A. Pertanyaan umum tentang perusahaan anda

1. Berapa lama perusahaan anda berdiri?
2. Berapa orang yang bekerja di perusahaan anda?
3. Apa jenis usaha anda?

B. Pertanyaan tentang alasan mencari dana

1. Bagaimana anda memenuhi kebutuhan dana untuk membiayai usha anda?
2. Mengapa anda memilih bank syariah?
3. Jenis keuangan syariah apa yang paling anda butuhkan? (Mudarabah, Musharakah, Murabahah, Ijara, Istisna, atau yang lain). Mengapa?

C. Pertantanyaan tentang pengalaman SMEs dalam mengakses bank syariah

1. Menurut pendapat anda bagaimana mengakses dana dari bank syariah?
2. Menurut anda bagaimana kebijakan yang diterapkan bank syariah terhadap nasabah?
3. Persyaratan apa yang paling sulit anda penuhi? Mengapa?
4. Apakah anda merasa puas atau tidak puas terhadap pelayanan bank syariah? Mengapa?
5. Menurut anda bagaimana pelayanan bank syariah dibandingkan dengan bank konvensional?

C. pertanyaan tentang Kendala SMEs dalam mengakses dana dari bank syariah dan cara mengatasi kekurangan dana

1. Apa yang menjadi kendala utama dalam mengakses bank syariah? Mengapa?
2. Bagaimana anda mengatasi kesulitan dalam mengakses bank syariah?
3. Selain mencari dana dari bank syariah apakah anda juga meminjam dana daria bank konvensional? Mengapa?
4. Apakah anda mencari sumber dana dari sumber informal diluar perbankan? Mengapa?
5. Apa saran anda bagi bank syariah untuk mempermudah hubungan antara pengusaha UMKM dengan bank syariah?

Appendix 9

Daftar Pertanyaan Untuk Interview Dengan Manajer Bank Pembiayaan Syariah

Section I

Personal Bio-data

Kota/Kabupaten ………………..

1. Apa jabatan anda saat ini?
2. Berapa lama anda bekerja di bank ini?
3. Apa syarat minimum yang dibutuhkan untuk orang yang mengevaluasi pengajuan pembiayaan?
   - ☐ SMA
   - ☐ Diploma
   - ☐ Sarjana
   - ☐ Pasca Sarjana/ Master

4. Ketrampilan apa yang dibutuhkan seseorang yang menilai pengajuan pembiayaan?

5. Apakaah bank memberikan training kepada petugas penilai pembiayaan?
   ☐ Ya ☐ Tidak

6. Jenis pelatihan apa yang diberikan?

7. Seberapa sering pelatihan tersebut diberikan?
   - ☐ Bulanan
   - ☐ kwartalan
   - ☐ semesteran
   - ☐ Tahunan
   - ☐ Sekali ketika masuk

Section II

Silahkan pilih factor yang mempengaruhi keputusan pemberian pembiayaan:

	Sangat penting	Penting	Netral	Tidak begitu penting	Tidak penting sama sekali
Usia					
Jenis kelamin					
Pendidikan					
Usia perusahaan					
Jenis perusahaan					
Jumlah asset					
Prosentase utang terhadap asset					
Rata-rata penjualan					
Jaminan					
Lamanya rekening di bank					
Rekam jejak pinjaman masa lalu					
Hubungan pribadi dengan manajer bank					
Rencana bisnis					

Section III

1. Informasi apa yang anda butuhkan dari pemilik UKM?
2. Informasi apa yang anda perolah dari rencana bisnis UKM?
3. Informasi apa yang anda peroleh dari laporan akuntansi?
4. Apakah anda mengujungi peminjam sebelum memberikan pembiayaan?
5. Informasi apa yang anda peroleh dari kunjungan ke pemilik UKM tersebut?
6. Apa kesulitan yang dihadapi UKM ketika mengajukan pembiayaan ke bank anda?
7. Bisa anda jelaskan perbedaan penilaian antara klien baru dengan klien lama?
8. Ceritakan criteria apa yang digunakan bank untuk menentukan kelayakan aplikasi proposal pembiayaan?
9. Apakah anda memerlukan waktu lebih lama untuk menyetujui usulan pembiayaan dalam jumlah yang lebih besar?
10. Apakah anda memerlukan persyaratan yang sama untuk semua klien? Jika tidak coba ceritakan mengapa?
11. Bisa diceritakan pertimbangan mengenai persetujuan dan penolakan pengajuan pembiayaan?
12. Apakah anda mengenakan bagi hasil atau beban yang sama untuk setiap klien?
13. Apa pentingnya jaminan menurut anda?
14. Apa arti jaminan personal menurut anda?
15. Ada banyak jenis instrument pembiayaan syariah. Jenis pemniayaan apa yang paling anda sukai untuk diberikan kepada UKM? Mengapa?

16. Bagaimana anda memonitor klien anda?
17. Bagaimana anda memutuskan mengenai lamanya pembayaran kembali kontrak pembiayaan?
18. Kesuliatan apa, jika ada, yang biasanya dialami oleh UKM dalam hal pembayaran kembali/ mengangsur?
19. Apakah anda puas dengan tingkat recovery yang ada?
20. Bagaimana anda menginformasikan tentnag berbagai macam pembiayaan yang ditawarkan bank anda?
21. Menurut pendapat anda, kesulitan apa bank anda untuk melakukan penetrasi pasar?