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### EXPLORING THE SOURCES OF ISLAMIC AND CONVENTIONAL FINANCE FOR SMALL AND MEDIUM ENTERPRISES IN SAUDI ARABIA

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#### **ABSTRACT**

Traditionally entrepreneurs and SME owners requires funding for their ventures. SME financing is one the fast-growing sector in finance industry. The lack of fund a shortage of paid-up capitals and credits make small and medium (SMEs) enterprise vulnerable to fluctuation in the supply and demand market economy. This study aimed to compare between the Islamic and traditional financing sources for SMEs in Saudi Arabia to increase awareness in the alternatives available in both conventional and Islamic financing, their characteristics and advantage and disadvantages of using the both methods. The study was using both primary and secondary data. Primary data was collected using a survey, distributed 100 SMEs owners. The results were analyzed using the percentages, tables and SPSS software. T-test was to check the hypothesis and Cronbach's Alpha was to check the reliability of the percentage tables. The finding of the study showed that most of SMEs owners preferred Islamic sources of funds and selected Ijarah and Murabaha as their favorite products.

#### **INTRODUCTION**

The World Bank stated formal SMEs have contributed up to 60% of total employment and 40% of GDP in emerging economies [1]. SMEs play important role in the socio-economic development of both developed and developing countries toward GDP, employment and growth [2]. In Thailand,

SMEs are defined having employee numbers less than 200 or its asset value less than USD 6.04 million and contributed 41.1% of total GDP [3]. Meanwhile, SMEs comprise up to 80% of GDP and employment structure in many European countries [4]. In Malaysia, SMEs are manipulated 99.2% of all business and contributed 56.4% in total employment [5].

Financial support such as subsidies, budget investment or state and municipal guarantee for agreement of SMEs and institutions forms for necessary infrastructure for SMEs [6]. Meanwhile, financing methods employed by SMEs is vary initially from internal sources such as owner personal saving and outside sources including financial assistance from family and friends, trade credit, venture capital and angel financiers [7]. An approximately over 50% SMEs worldwide are in short of capital. In developing countries, this situation is worse due to high collateral requirement, lack of managerial skills and ineffective institutional structures, limited networking, unfavorable business environment, limited in access to right certificated land and high administration cost [8].

The development of SMEs has contributed to the development of Arab and Islamic countries economic growth, reducing the unemployment, alleviating the poverty. One of the major reasons of growth of SMEs is sources finance, especially after the growth of Islamic finance industries in these countries. The practice of Islamic banking has grown exponentially over the past four decades since the inception of first commercially successful Islamic Bank in Dubai in 1975. In 1975, Dubai Islamic Bank became the first modern commercial Islamic bank in the world. The first Islamic bank was in Dubai which competes in all aspects of commercial banking with the world's largest conventional financial institutions. The incorporation of Sharia principles into all its operations, Dubai Islamic Bank became the pioneer in offering the world an alternative based on fairness and transparency. Before emergence of Islamic commercial banking, customers had no choice but to use the conventional banks for all their financial requirements. Apart from this, the Islamic Finance House in Luxembourg was considered as the attempt to introduce the Islamic banking system in the western world which was established in 1978 [9].

Ali [10] had studied the challenges of Islamic trade finance in promoting SEMs in IDB member countries in the challenges and limitations facing the use of Islamic finance to promote SMEs in IDB member countries. The study found there was no favorable environment for Islamic finance to play important role in SMEs development in IDB member countries [10].

Mansori, et al. [11] had studied in Islamic microfinance and the fundamental roles of financial intermediaries demanded by Shariah. The Islamic thoughts and motives behind many initiatives have taken place to alleviate poverty in Muslim countries. This study had discussed the mechanisms proposed by Islam to improve the life of poor, prevent to become poor, and improve the general economic relations among members of society. The findings showed mudarabah, Musharakah, murabahah, Ijarah, and qard al-hasan were discussed

as different types of Shariah compliant contracts that can be used as the base of micro financing business model [11].

Therefore, this study aims to compare between the Islamic and traditional financing sources for SMEs in Saudi Arabia to increase awareness in the alternatives available in both conventional and Islamic financing, their characteristics and advantage and disadvantages of using the both methods.

## METHODOLOGY

The philosophical paradigm followed in this study was post positivist paradigm, also called the scientific method or empirical science. In this study, the factors that influenced to determine what source(s) would be suitable for kind of business for SMEs in Saudi Arabia focused in both conventional and Islamic mode of financing. The primary data has been collected using questionnaire and secondary data has been collected through literature review and available data.

The participants were selected using purposive sampling method. The questionnaire was distributed to 100 SMEs owners based on Jeddah, Riyadh and Dammam, Saudi Arabia. There were 45 participants had responded toward questionnaire during August and November 2016. In planning the survey exertion was made to ask as straightforward as could reasonably be expected inquiries, considering the foundation of the respondents. The survey was isolated into a few areas which incorporate demographic profiles, sources and kind of financing, and observations on the Islamic financing.

The survey was prepared to collect primary data. A Google form was used to create the online survey which provided by Google drive in term of online survey. This survey helped in forming different types of questions from multiple choices till linear scale. The result of the respondent's answer is automatically shown in chart and can be exported to excel sheet. The link of the survey was shared through E-mail and what's app to SME owners.

## RESULT AND DISCUSSION

In Table 1, the result showed most respondents rely upon their own sources of income and savings to start the business, instead of acquiring sources from any financial institutions. The results showed 36% of the respondents preferred or used their own sources, 20% of the respondents mentioned that borrowed loan the conventional banks, while other 24% acquired the fund through borrowing money from family, friends/relatives and also through equity partnership. However, 20% of the respondents borrowed loan from Islamic financial intermediaries such as Islamic Development Bank, Bank Al-Jazeera- National Commercial Bank, Al-Rajhi Bank, Babrizgjameel.

**Table 1:** Source of financing

Type of source	Percentage
Bank loan from conventional banks	20
Loan from Financial Intermediaries & Development	20

Type of source	Percentage
Initiation (e.g. Islamic Development Bank, Bank Al-Jazeera- National Commercial Bank, Al-Rajhi Bank, Babrizgameel)	
Borrow/borrowed money from Family (family loan)/ Equity partnership	24
Own personal fund (Savings and Income)	36

**Table 2** shows majority of the respondents (44.75%) agreed on the availability of SMEs Islamic financing. Meanwhile, only quarter of the population (26.5%) had no knowledge on the existence of Islamic Financing for SMEs. Awareness of available sources of finance plays an important role in deciding the mode of financing. This study revealed that majority Saudi based SMEs owners were aware of the availability of Islamic financing.

**Table 2:** Awareness on the existence of Islamic financing options for SMEs

Items	Strong Agree	Agree	Neutral	Disagree	Strongly Disagree
1- I know the existence of Islamic financing for SMEs in Saudi Arabia	4	31	42	8	4
2- I know and understand the differences between Islamic and conventional financing (Rank yourself)	9	33	16	22	20
3- I am aware about the principles and methods used by Islamic financial institution during lending loans for SMEs	13	40	20	16	11
4- I am aware about the principles and methods used by conventional financial institutions during lending loans for SMEs	11	38	27	18	7
Average	9.25	35.5	26.25	16	10.5

In Table 3, Cronbach's Alpha for the factors of awareness was 0.804 which was greater than 0.60, hence the items were the construct are reliable for measuring the awareness.

**Table 3:** Reliability statistics

Cronbach's alpha	Cronbach's alpha based on standardized items	N of items
0.804	0.801	4

In Table 4, the findings showed that 73% of the total population is willing to finance using Islamic banking products for their SME's financial requirements. Most of the SMEs owners were looking for Islamic bank financing for their projects.

**Table 4:** Selection of bank (conventional versus Islamic banks)

If you have planning to finance your business using the bank which bank would you prefer?	Percentage
Sharia compliance banks	73.33
Conventional commercial banks	26.67

Understanding the ease of obtaining loans, repayments and terms and conditions helped the Islamic banker to changing their strategies to attract more SME owners to finance their projects. In Table 5, 44% of the respondents considered that in terms of convenient both the banks were same and 49% of the respondent that the Islamic banks were more convenient than the conventional banks. 75% of the total population agreed that obtaining financing in Islamic banks were more complicated than the conventional banks. In additions, only 25% of the respondents agree that Islamic banks were less complicated in terms of obtaining the finance. For comparison of the flexibility in repayment, 15% of the respondents agreed that Islamic banks were flexible and majority of the population disagreed with this.

**Table 5:** Islamic banking and conventional banking

Items	Yes	No	Both are same
1-Do you think that getting loan from Islamic banks is more convenient than conventional bank?	49	7	44
2- Terms & conditions in obtaining the loan is more complicated than conventional banks	75	25	0
3- Do you think that Islamic banks offer more convenient schedule of repayment than the conventional bank for the loans	15	65	20

Furthermore, the results presented in Table 6 showed that nearly 60% percent of the SMEs owners would choose Islamic financing as based on Islamic principles in particular, 71% of the respondents considered sharing profit and risk sharing as important factors. Quality products and serves offered by

Islamic financial institutions is considered as important factor by 67% of the respondents. 72% of the respondents considered prohibition of involvement of non-sharia compliant investment as important factor when deciding the factors of selection. In addition, only 43% of the respondents were concerned about the avoidance of Gharar and Maysir by Islamic banks. Involvement of Riba is being considered as an important factor by respondents. 66% of the responded considered avoidance of Riba by Islamic financial institutions as important factor. An efficient service offered by Islamic banks is considered as important factory by 60% of the respondents. Only 45% of the people take recommendation of their family members as a factor when deciding their selection criteria of Islamic financing.

**Table 6:** Factors choosing Islamic financing SMEs

Items	Strong Agree	Agree	Neutral	Disagree	Strongly Disagree
1-It is based on Islamic principles	27	33	20	7	13
2-Certainty of capital and return (Sharing Profit and Risk)	20	51	18	0	11
3-Quality products and services offered by the Islamic financial institutions	27	40	16	7	11
4- Prohibition of involvement of in haram or non-permissible transaction or economic activities such as alcohol, non-halal food, pork production, gaming/number, forecasting, prostitution	36	36	13	9	7
5-Avoidance of maisir i.e. speculation or gambling and gharar i.e. Preventable uncertainty or ambiguity in transactions	7	36	7	18	33
6-Elimination of riba (literally means increase or addition) i.e. usury or rent on money in all forms and intents	33	33	22	4	7
7-Service provision is fast and efficient	20	40	29	4	7
8-Recommendation of my family and friends	7	38	13	22	20

Furthermore, 16% were for Salam, 22% were for Ijarah, 20% for Murabaha while 22% on Mudaraba and 20% were for Bay Istisna'a as shown in Table. This finding showed that financing through Ijarah and Mudaraba is the most popular modes of financing among the SMEs entrepreneurs. The respondents were asked on the question if the Islamic financial institutions should develop or innovating new products as to be competitive as the conventional banks. 60% of the respondents were strongly agreed on the issue, at least these institutions are able to increase good pictures from general society and more market share, and 29% agreed while the rest is neutral 11%.

**Table 7:** Mode of Islamic financing

Product type	Percentage
Salam	16
Ijarah	22
Murabaha	20
Mudaraba	22
Bay Istisna'a	20

In Table 8, the Cronbach's Alpha for Islamic product was 0.948 which was greater than 0.60, hence the items were the construct are reliable for measuring the awareness.

**Table 8:** Reliability statistics

Cronbach's alpha	Cronbach's alpha based on standardized items	N of items
0.948	0.948	5

Table 9, the study was accepted the zero view which stated that lack of awareness did not have any impact on entrepreneur decision while choosing mode of financing Islamic or conventional. Alternative hypothesis is rejected since the p-value (0.000) <  $\alpha$  (0.05) which was significant. This finding was concluded that lack of awareness did not have any impact on SME owner's decision while choosing mode of financing (Islamic or conventional finance) since the p-value (0.000) <  $\alpha$  (0.05) which was significant.

**Table 9:** One-sample test on impact of awareness on SMEs owners in selecting of financial (Islamic or conventional financial selection)

Item	Test value =4			
	t	df	Sig. (2-tailed)	Difference
Awareness about existence of Islamic financing options for SMEs	-41.000	44	0.000	-2.733

In Table 10, the study was rejected the alternative hypothesis and accepted the zero that the SMEs owners did not compare interest or profit rate while the owners made decision for financing from bank since the p-value (0.001) <  $\alpha$  (0.05) which was significant.

**Table 10:** One-sample test on certainty of capital and return (sharing profit and risk)

Item	Test value =4			
	t	df	Sig. (2-tailed)	Difference
Certainty of capital and return (Sharing Profit and Risk)	-3.755	44	0.001	-0.644

In Table 11, the result concluded that zero view of hypothesis is accepted and alternative is rejected which is getting loan did not have any impact on financing since the p-value ( $0.000 < \alpha (0.05)$ ) which was significant.

**Table 11:** One-sample test on obtained loan from Islamic banks was more convenient than commercial bank

Item	Test value =4			
	t	df	Sig. (2-tailed)	Difference
Do you think that getting loan from Islamic banks is more convenient than commercial bank?	-17.039	44	0.000	-1.578

Financing entrepreneurs by using Islamic Finance model still not have been taking attention as the conventional model. The despite of the recent growth of the Islamic institutions and the development of new Islamic financing products, still there was no favorable environment for Islamic finance to play vital role in the development of SMEs in the IDB member countries [10]. In this study found that based on the survey result the entrepreneurs have not a fully knowledge to apply or request from the bank or the Islamic financial institution regarding the Islamic Finance Product. In this study found that most of the entrepreneurs prefer the Islamic product but reason for patronizing an Islamic bank is due to religious factor.

## CONCLUSION

In conclusion, the result found most of SMEs owners preferred Islamic sources of funds and selected Ijarah and Murabaha as their favorite products. Islamic financial institution is recommended to focus more on Islamic financing products, product development and marketing. Hence, Islamic financial institutions need to make market strategies for other contracts.

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