

WAR 26 THE CHALLENGES OF ISLAMIC TRADE FINANCE IN PROMOTING SMEs FOR HALAL INDUSTRY IN MALAYSIA

Dr. Latifa Bibi Musafar Hameed, Marliana Abdullah

Kolej Universiti Islam Antarabangsa Selangor (KUIS),
Bandar Seri Putra, 43000 Kajang, Selangor, Malaysia

latifabibi@kuis.edu.my, marliana@kuis.edu.my

ABSTRACT

Small Medium Enterprises is the backbone of Malaysia in term of employment and economic growth. SME's GDP growth continuously outpaces the overall economic growth of the country. However, the major challenge faced by the SMEs is access to finance. The financing issue becomes severe since financial institutions such as banks widely consider SMEs as being too risky due to factors such as lack of collaterals and non-sufficient credit history. This creates difficulty for the SMEs to expand their business, especially expanding in halal market. Islamic financial institutions are presented with an opportunity to target companies in the halal sector and provide them financial solutions which can further expand the asset base and outreach of the global Islamic finance industry. The halal industry is a cross border business sector, as such; halal firms are heavily involved in International trade. In this process, halal firms are in critical need of trade financing to support international trading activities. Among the product offered by Islamic banks for trade financing are trade working capital financing-I, bills of exchange purchased-I, accepted bills-I and bank guarantee-i. The study identified among the challenges faced by the Islamic trade financing to promote SMEs globally are laws and regulations and various rules of trade in other countries, awareness among the SMEs and strict requirement of banks.

Keywords: SMEs, Islamic Financial Institutions, Halal industry, Trade Finance, International trade, Islamic Banks.

1.0 Introduction

Innumerable studies have been conducted across different countries and regions confirming that the Small Medium Enterprises (SME) sector is the key economic driver of the national economies. Malaysia's SME growth performance is impressive but still a long way to achieve a high income nation. Halal industry is considered one of the fastest growing business segments in the world including Malaysia. Research by World Halal Forum Secretariat (2011) reveals that the global trade of halal food and non-food products is estimated US\$2.3 trillion. In the Third Industrial Master Plan, the government has stressed on the potential for Halal products globally. Table 1 shows the potential of Halal product globally.

Table 1: The Potential of Halal Product Globally

USD 580 billion	Annual global market value for Halal food trade
USD 2.1 trillion	Annual global market value for entire Halal trade
USD 900 million	Annual retail sales of Halal meat in the United Kingdom
1.6 billion	Present global Muslim population
1 billion	Muslim population in Asia
3 billion	Estimated global Muslim population in 2010

Source: Third Industrial Master Plan (2006-2020).

Halal industry grows very fast due to high demand from Muslim consumers, affected by courage of religious concern. Malaysia targets to become the worldwide hub for the Halal industry. Participation of SMEs on halal product will strengthen the growth of Malaysian economy. Halal product industry in Malaysia is considered a new growth area, has shown significant development.

Realising the potential for the SMEs to venture on halal industry, financing is one of the most important factor that need to be looked into. Most of the literatures show that the common challenges facing the SME's are relating to the funding. The increasing cost of business, addition with the GST and minimum wage implementation affected the operation cost of the businesses. The lack of financing prevents SMEs from contributing effectively to the economic prosperities because of the lower capital, higher risk and less competitiveness. The demand and supply for Islamic SME financing specifically has to be analysed from various perspectives to put it into context with the factors related to innovative financial solution, benefitting from potential investment opportunities as well as serving a growing Muslim population and their Shariah preferences.

This study is conducted to examine the challenges of Islamic Finance to promote SMEs for the Halal industry in Malaysia.

2.0 Literature Review

According to the Bank Negara report (2005), a well-developed financial infrastructure that is able to meet the diverse financing needs of SMEs is essential to support the competitiveness and continuous growth of SMEs. The results of the Census of Establishment and Enterprise 2005 (Census) showed that most SMEs used their own internally generated funds and funds sourced from friends and family members to finance their operations. Only 16 per cent of SME respondents indicated a reliance on financing from financial institutions (banking). In contrast, 50 per cent of large companies indicated that financial institutions were their main source of funding. Looking at the source of financing of SMEs by size, revealed that financial institutions were the main source of financing for medium-sized enterprises. However, micro and small enterprises depended mainly on their own internally generated funds. Indeed only 10 per cent of micro enterprises indicated that they relied on financial institutions for financing.

Hasnah et. Aal (2013) in their study on the factors influencing SMEs to obtain loan claim that many SMEs are facing difficulties to access financing. One of the main reasons for the inability to sustain their business is finance issue. Most of the financial institutions are reluctant to disburse funds to the SMEs is due to lack of collateral and good track record of the company. Financing is necessary to help them set up and expand their operations, develop new products, and invest in new staff or production facilities.

Norasikin Salikin et. al (2013) revealed that capital insufficiency is the crucial problems among SMEs in Malaysia which might due to the difficulties to obtain external fund. The study indicates that only 7 per cent of the SMEs had their initial capital from commercial banks and government grants. 26 per cent of the SMEs in the study were running the business using their own capital as their main financial strength. In this study most of the SMEs responded that it is difficult for them to get loan from the banks due to the financial performances and incomplete financial record.

The similar findings can be found in Nurbani et.al (2011). A large number of SMEs have yet to tap into funds provided by the banks. According to this study, only 13 percent of SMEs have successfully received this funding. Many micro firms lack collateral and insufficient documents to support their loan application. Banks require collateral as a safe guard for their loan. The financing problem faced by the SMEs still persist due to the problems such as the facilities packaged by the banks. The SMEs have the perception that being a small company they are not able to get financing from the banks due to various reasons and this has prevented them from approaching the banks and they tend to secure loans from other sources.

Interestingly Ali S. Saleh et.al (2008) in his study, financial issues was not the main barriers for the SMEs. Government policy and availability of infrastructure scored the highest indicating that these factors are perceived as a major barrier for the SMEs.

Zairani and Zaimah (2013) evaluated the difficulties in securing funding from bank. The result shows that the banks appear to be reluctant to approve loans, especially to micro businesses. This resulted in some SMEs turning to illegal money lenders/loan sharks since it is the fastest and easiest way of obtaining finance. Collateral is the vital factor considered by banks when deciding whether to approve a loan. The findings also revealed that the SMEs are lack of accurate information on the types of loans available. They reported the SMEs depend on informal information sources regarding available loans, rather than on official information from banks.

Shamsubaridah & Berma (2013) evaluated the financing gap in Malaysian SMEs. The analysis indicates that, the majority of SMEs, only 13.4 per cent rely on banks and 2.7 per cent on development financial institutions to fund their business. Loan approval and disbursements take more than 3 months for SMEs and time taken become longer for smaller-sized loans. Banks are seen to be not “user friendly” as tedious processes is involved when applying for loans and disbursements. In some cases loans are not even disbursed as borrowers are unable to fulfil the pre-disbursement conditions stipulated by the lenders. Efforts to make funds more accessible among SMEs are often interrupted by the very opaque nature of the borrowers.

Results from most of the literatures above showed that there are common challenges facing the SMEs in Malaysia relating to the funding. SMEs are the backbone of Malaysian’s economic growth. It is very important for the SME’s to get funds from the banks to expand their business. There is a serious need to look into the issues addressed above in order to generate an elucidating set of findings that can help check the problem.

3.0 Performance of SME in Malaysia

Latest statistic from SME Annual Report (2014) indicated that the long term growth trend of SMEs in Malaysia since 2004 has remained, with SME GDP growth continuously outpacing that of the overall economic growth of the country. Table 2 below shows the SME GDP share by key economic activity.

SME contribution to GDP increased from 32.2 per cent in 2010 to 35.9 per cent in 2014. In terms of performance by economic sectors, the increase in share of SMEs to GDP in the period 2010-2014 was contributed by all economic sectors, particularly in services sectors.

Table 2: SME GDP Share by Key Economic Activity (Constant 2010 prices)

	SME Contribution to GDP			SME GDP Growth
	2010 (% share)	2014 (% share)	Increase/decrease in Share	CAGR 2011-2014
Overall	32.2	35.9	+3.7	8.3
Construction	0.9	2.0	+1.1	28.9
Services	19.6	21.1	+1.5	7.3
Mining & Quarrying	0.0	0.1	+0.1	39.3
Agriculture	4.3	4.5	+0.2	6.7
Manufacturing	7.2	7.8	+0.6	7.5

¹CAGR refers to compounded annual growth rate

²Total value-added after taking into account import duties

Source: SME Annual Report 2014/15

According to the survey on SMEs in 2013 and 2014 by SME Corporation Malaysia, most of the businesses claimed that among the critical factors hindering SMEs from expanding were high cost of raw materials (47.8%), high cost of labour (44.7%) and shortage of skilled labour (33.7%). About 40 per cent of the businesses had requested for financing for business purposes in the last six months.

Regarding the Minimum Wage, 79 per cent of the businesses believed that implementation of the policy led to higher labour cost. On the Goods and Services Tax (GST) implementation, about 35 per cent of the SMEs stated that it gives negative impact to their businesses.

With the current high cost of doing business, SMEs highlighted that they required higher credit lines to operate their business operation. 42 per cent of the businesses indicate that they were seeking new and additional external financing for business purposes.

For the applicants whom have been rejected by the banks, the key reasons cited were not able to qualify the conditions set by the banks such as failure in providing sufficient documentation and having too high leverage or outstanding loans. 58 SMEs did not request for new additional external financing and the reason behind it were that they did not require any financing or do not like to be in debt.

Assess to finance therefore a major challenge to SMEs and this issue need to be addresses more thoroughly.

4.0 Halal Industry in Malaysia

Malaysia has aspirations to become a global hub for the production and trade of Halal products and services as outlined in the 2006 Third Industrial Master Plan. As per latest statistics available Malaysia's exports of halal products totalled RM 35.4 billion (2014), representing nearly 5.1 per cent of the country's total exports.

Islamic financial institutions have a promising opportunity to encourage companies, whose core businesses are halal, to utilise Islamic financing facilities and achieve a wholly Shariah-compliant status. Companies in the halal industry, like any other business, have various financial needs including trade finance. Islamic finance is an obvious conduit for channelling

surplus funds into productive investments found throughout the value chain within halal economy. The relationship between Islamic finance and halal industries is mutually beneficial.

Islamic financial institutions are presented with an opportunity to target companies in the halal sector and provide them financial solutions which can further expand the asset base and outreach of the global Islamic finance industry. In recent years, firms in the halal industry have also tapped the Islamic financial markets to meet those various financial needs. The halal industry is a cross border business sector, as such; halal firms are heavily involved in International trade. In this process, halal firms are in critical need of trade financing to support international trading activities. Islamic banks should help the halal SMEs to cater financial needs. Integration between the world halal industry and the global Islamic Finance system is a huge developmental potential for the growth and expansion of Islamic economics in the world markets.

5.0 Islamic Trade Financing

Islamic trade finance has benefitted from the shifting preferences towards Shariah-compliant banking and could serve as one of the key growth drivers to help the SMEs in halal industry. Islamic trade finance can provide new opportunities and become the preferred choice for emerging market such as Malaysia. Trade finance helps to facilitate exports and imports and ultimately economic growth.

Product offered for SMEs from Islamic banks are:

i. Trade Working Capital Financing-i

To finance domestic purchases or international trade documents against Letter of Credit or Inward Bills for Collection.

Islamic concept: Murabahah

A contract entered between buyer and seller where the bank will sell on deferred term goods to the buyer at an agreed selling price that comprises the Bank's purchase price and profit margin.

Features:

- customers to take delivery of the goods immediately on arrival and settle the payment on deferred basis.
- convenient cash flow management for customers.
- financing or up to 100 % of invoice value.
- fixed rate financing
- flexible financing tenor, 30 to 180 days.

ii. Bills of Exchanged Purchased-i

Financing of the customer's receivable occurring from the creation of the outward bills for collection under open account or drawn against export letter of credit.

Islamic Concept : Bai' Dayn

Sale of debt (receivables) arising from trade transaction.

Features:

- improve customer's cash flow
- convenient cash flow management
- financing up to 100 % of invoice value
- fixed rate financing
- flexible financing tenor, 30 to 180 days.

iii. *Bank Guarantee-i*

Irrevocable written obligation issued by the Bank to a beneficiary of an agreed sum, in case of the customer defaults in fulfilling its obligation.

Islamic Concept: Kafalah

Guarantee or surety given by one party to discharge the liability of a third party in the case of default.

Features:

- widely accepted thus giving the beneficiary more confidence
- competitive commission charge for BG-I issuance
- flexible tenor depending on customer's requirement and as per credit approval.
- no other hidden costs.

6.0 Challenges facing Islamic Finance to Promote SMEs

Based from the literature, most of the SMEs have difficulties to get fund from the Islamic banks due of the requirement of the bank such as collateral. Smaller firms could not expand their business into trade.

According to Abd Elrahman (2013) reported that the regulations and the effective implementation of trade rules are also challenges for the SMEs. Fliess and Busquests (2006) found that the procedural barriers to trade such as arbitrary customs valuation, subjective interpretations and arbitrary decisions of clearance goods through customs, technical barriers, laws and regulations regarding the various rules of trade represent one of the most obstacles of SMEs in IDB countries. It also can be one of the challenges for Malaysia.

Awareness relating to the Islamic trade financing among the SMEs also considered as a challenge for Malaysia. Most of the SMEs are still not aware on the product offered by the Islamic banks. There is a lack of coordination between SMEs and Islamic banks.

The requirement of banks to approve SMEs loan on Islamic trade financing is one of the biggest challenge faced in Malaysia, especially for smaller SMEs. The government should provide a suitable policy to help the small SMEs where they could not provide collateral to the bank to get fund.

7.0 Conclusions

SMEs are the important drivers of the economic growth of Malaysia. The Halal industry provides opportunities for SMEs to expand their market locally and globally. Malaysia is a leading exporter of various halal goods. In recent years Islamic finance has been utilised to meet the various financing needs of the SMEs in the halal industry.

Trade financing will help the SMEs to expand their market. However, there are several challenges such as laws and regulations and various rules of trade in other countries, awareness among the SMEs and strict requirement of banks made the Islamic trade finance face difficulties in promoting the SMEs in other countries.

Islamic finance should provide flexible financial solutions for the SMEs. Islamic finance currently offers a comprehensive range of products and services that are capable of supporting the financing needs of halal industry SMEs, regardless of size and maturity. In this regard we hope that the challenges faced by Islamic trade finance in promoting the SMEs could be reduced.

References

- Abd Elrahman, E.,S.,A (2013). The Challenges of Islamic Trade Finance in Promoting SMEs in IDB Member Countries. *RTI Working Paper Series WP#1435-06 IRTI-IDB*.
- Ali., S.,S. (2008). Perceptions of business challenges facing Malaysian SMEs: some preliminary results. *Faculty of Commerce Paper (Archive)*.
- Azlan, A., S. (2012). Islamic Financing: A Viable Alternative for SMEs. Bank Islam, Kuala Lumpur.
- Bank Negara (2005). Annual Report. Kuala Lumpur.
- Hasnah Haron, Saniza Said, Jayaraman, K. & Ishak Ismail (2013). Factors influencing small medium enterprises (SMES) in obtaining loan. *International Journal of Business and Social Science*. Vol 4 No (15) Special Issue.
- Irfan, IS., Daud Awang,M.& Suhaimi, A.,R. (2013). The concept of Halal economy: An initiative to integrate the halal products industry and Islamic Banking and Finance. *Paper proceedings of the 5th Islamic Economics System Conference*.
- Malaysia (2006). Third Industrial Master Plan (2006-2020). Kuala Lumpur.
- Norasikin,S., Norailis, Ab., W. & Izlawanie, M. (2013). Strengths and weakness among Malaysian SMEs: financial management perspectives. *International Conference on Innovation, Management and Technology Research, Malaysia, 22-23 September 2013*.
- Nurbani, H. & Susan, T.,S.,C. (2011). Financial constraint and opportunities of Micro enterprise entrepreneurs: A theoretical Framework. *International Conference on Business and Economic Research*. Vol 1.
- Nurul Aini, M., Nathasa, M.,R., Sumaiyyah, A.A., and Nor Asiah, Y. (2014). Integrating Islamic financing and Halal industry: A survey on current practices of the selected Malaysian Authority Bodies. *Asian Social Sciences*. Vol 10 (17).
- Shamshubaridah, R. & Berma, M. (2013). Financing gap in Malaysian small-medium enterprises : A supply-side perspective. *South African Journal of Economics and Management Sciences*. Vol 16. No (5)
- SME Corporations (2014). SME Annual Report 2013/14. Kuala Lumpur.
- State of the Global Islamic Economy (2014). *The Halal Economy. Huge Potential for Islamic Finance*. Bank Negara Malaysia.
- State of the Global Islamic Economy (2015). *Halal Ecosystem Prospects for Global Growth*. Bank Negara Malaysia.
- Suzanna, E.,M. (2015). Islamic economy option: SWOT case study analysis. *Advances in Management and Applied Economics*, Vol 5 (3). PP 63-84.
- World Bank (2014). *Leveraging Islamic Finance for SMEs*. Islamic Development Bank-G20 Policy Paper.
- Zairani, Z. & Zaimah, Z.,A. (2013). Difficulties in securing funding from banks: success factors for small and medium enterprises (SMEs). *Journal of Advanced management Science*. Vol 1. No (4).