

SME ACCEPTANCE ON ISLAMIC SME FINANCING, AN OVERVIEW FROM ISLAMIC BANKING ATTRIBUTES

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Abstract: *This paper aims to integrate the theory of planned behavior—focusing on the variables of attitude, subjective norm, and perceived behavioral control—with the concept of Islamic banking attributes, including access to Islamic finance and product range. By doing so, it proposes a conceptual framework to determine the preferences for Islamic SME financing. The framework formulation is based on a comprehensive review of literature related to SME financing behavior and Islamic banking acceptance. This paper addresses the critical issue of inadequate financing faced by SMEs, which significantly hampers their growth potential. By identifying the existing gap in Islamic SME financing and proposing a framework to understand these preferences, this study contributes to the literature. The findings of this research will not only assist entrepreneurs in identifying alternative and reliable sources of financing to achieve their growth objectives but will also aid policymakers and other stakeholders in enhancing the lending infrastructure and related technologies for SME financing.*

Keywords: *Islamic Finance, SMEs, Islamic Banking Attributes*

1. Introduction

Small and medium enterprises (SMEs) play a crucial role in the global economy, contributing significantly to economic growth, job creation, and innovation. Malaysia's economy has seen substantial growth in recent times, with SMEs recognized as a key driver of this progress. SMEs have contributed significantly to Malaysia's GDP, accounting for over one-third of the country's economic output (Adan et al., 2020). These enterprises play a crucial role in fostering growth, employment, and income, contributing to Malaysia's economic transformation (Tahir et al., 2018).

The Malaysian government has shown increasing interest in the role of SMEs in driving competitiveness initiatives. SMEs represent a significant portion of the business landscape, comprising 98.5% of all business establishments in the country. Furthermore, SMEs have been

integral to Malaysia's industrial development and have been considered the backbone of the country's economic growth (Tahir et al., 2018).

These SMEs, however, often face challenges especially when it came to capital management. The existing literature highlights several barriers to SME growth, including high borrowing costs, lack of consultant support, and limited access to finance (Wang, 2016). Access to financing for SMEs is a critical issue globally, hindering their growth and competitiveness (Jesus et al, 2024). SMEs face challenges in obtaining affordable financing, with capital shortage being a significant obstacle. In some regions, informal finance is becoming a preferred choice for SMEs due to difficulties in accessing formal financial services. SMEs often rely on a combination of internal and external financing sources, with a preference for more conservative financing options, such as retained earnings and personal savings (Abdulsaleh & Worthington, 2013).

On the other hand, Islamic Finance has been increasingly recognized as a viable solution to address the financing gap faced by SMEs, particularly in developing economies (Kumar & Ps, 2015; Edaich, 2019; Flaminiano & Francisco, 2021). Islamic finance has also gained prominence in Malaysia, with the country being a global leader in the development of Islamic financial products and services. The alignment of Islamic finance with the needs of the SME sector in Malaysia presents an opportunity to further support the growth and development of these enterprises. Islamic financing models, such as *Murabahah* (cost-plus financing), *Musharakah* (profit-and-loss sharing), and *Ijarah* (leasing), offer SMEs an alternative to traditional debt-based financing, aligning with the principles of risk-sharing and asset-backed transactions (Kumar & Ps, 2015; Edaich, 2019). These models can provide a more sustainable and ethical approach to financing, aligning with the principles of Islamic finance, which emphasize fairness, transparency, and the avoidance of interest-based transactions (Edaich, 2019). These products can help SMEs access the necessary financing to support their operations, mitigate the inherent liabilities associated with new entrepreneurial startups, and facilitate entrepreneurial opportunities (Ahamat, 2017).

Moreover, the principles of Islamic finance, such as ethical business practices, social responsibility, and the prohibition of interest-based transactions, are well-aligned with the values and goals of many SME entrepreneurs. The principles underlying Islamic finance, such as a focus on ethical business practices, social responsibility, and the prohibition of interest-based transactions, are well-aligned with the values and goals of many SME entrepreneurs in Malaysia. This alignment presents an opportunity to further support the growth and development of these small and medium-sized enterprises through the provision of Islamic financial products and services tailored to their specific needs. By leveraging the synergies between Islamic finance and the SME sector, Malaysia can foster a more inclusive and sustainable economic ecosystem that empowers SMEs businesses and contributes to the country's overall economic transformation.

The current trend in Islamic finance and SMEs highlights the growing importance of ethical principles and Sharia compliance in financial dealings. Islamic banking institutions play a crucial role in empowering SMEs by offering products like *murabaha*, *musyarakah*, and business financing, contributing to economic inclusiveness and justice. Overall, the trend emphasizes the significance of ethical finance practices and Sharia compliance in supporting SMEs and fostering sustainable economic growth.

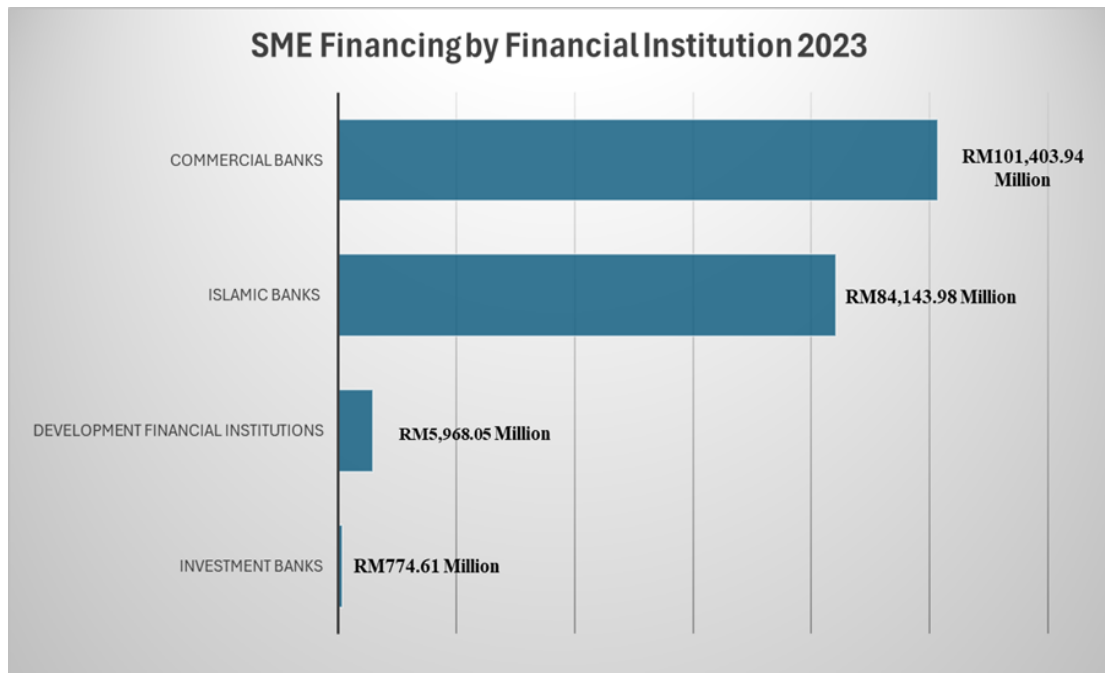


Figure 1: Financing Approved for SME by Financial Institution in Malaysia
Source: Bank Negara Malaysia Website.

There are four categories of financial institutions that offer financial support to SMEs in Malaysia. Leading the market are commercial banks, with a share of 52.94%. Following closely are Islamic banks at 43.93%, development financial institutions at 3.11%, and investment banks at 0.4%. To better compete with commercial banks, the Islamic banking sector must improve its marketing approach. This upgrade is essential for ensuring the continued presence of Islamic banks in the future. A critical aspect of developing this approach involves grasping the perspectives of SMEs regarding the use of Islamic financial services for their enterprises.

Examining the preferences of SMEs owners towards Islamic banking products is crucial within this context. Understanding the perspectives of SME owners on these financial offerings is integral to effectively addressing their needs and fostering the growth of the Islamic banking sector in relation to this important business segment. Exploring the perspectives and needs of these business owners is pivotal in shaping the development of Islamic banking products and services to better serve this integral segment of the economy.

Research has shown that while Islamic banks and conventional banks may have few significant differences in their business orientation, efficiency, asset quality, or stability, conventional banks operating in markets with a higher market share of Islamic banks tend to be more cost-effective but less stable. These insights underscore the importance of understanding SME owners' preferences and tailoring Islamic banking products to meet their specific needs. Examining SME owners' perspectives on sustainable investment criteria can provide valuable insights for Islamic banks, enabling them to better align their offerings with the preferences of this key stakeholder group. Understanding the preferences of SME owners, a crucial segment of the economy, towards Islamic banking products and services is essential in shaping the future of the industry and ensuring its alignment with the needs of this important stakeholder group.

The adoption of Islamic finance products by SMEs has been a topic of increasing interest in the financial sector, as these innovative financing solutions offer unique benefits that could

potentially address the financing needs of this vital segment of the economy. However, studies have identified a reluctance among SMEs to embrace Islamic finance, which poses a significant challenge to the growth and expansion of this industry.

One of the key factors contributing to the reluctance of SMEs to prefer Islamic finance products is the lack of awareness and understanding of the underlying principles and features of these financing options. Many SMEs are unfamiliar with the distinct characteristics of Islamic finance, such as the avoidance of interest-based transactions, the emphasis on risk-sharing, and the ethical and socially responsible investment strategies (Ahamat, 2017; Edaich, 2019). This lack of knowledge can create a perception of Islamic finance as a complex and unfamiliar system, leading SMEs to opt for more traditional financing options that they are more comfortable with.

SMEs exhibit a tendency to less prefer Islamic financing schemes due to various factors. Research indicates that while there is awareness of Islamic financial products among SME actors, the utilization rate remains low, with only 34% having or applying for Islamic microfinance. Factors influencing this decision include the perceived fundraising benefits, subjective norms, and perceived relative advantage of Islamic finance products. Additionally, the existing SME financing structure, which heavily relies on conventional methods like bank loans and cash lending, poses challenges in aligning with Islamic finance principles, suggesting a need for a shift towards transaction-based financing models to better cater to SMEs' needs. These insights highlight the complexity of SMEs' financing decisions and the importance of addressing key factors to enhance the adoption of Islamic financing schemes.

The issue of SMEs and Islamic finance revolves around challenges such as a lack of understanding of Sharia-based business management and accountability, the need for education on legal products and services in Islamic fintech to protect SMEs from fraud, and the importance of Islamic ethical principles in financial transactions to avoid being swayed by excessive profits of conventional financial institutions. Additionally, while Islamic microfinance aims to assist SMEs with capital, a significant portion of SMEs actors are not utilizing Islamic financial products despite being aware of them. However, Islamic banking plays a crucial role in empowering SMEs and cooperatives through products like *murabaha* and *musyarakah*, contributing to sustainable economic growth and national development. Addressing these challenges and promoting awareness of Islamic financial tools can enhance the support provided to SMEs in their financial endeavors.

2. Literature Review

2.1 Contribution of Islamic Banking Towards SMEs

Islamic banking plays a significant role in supporting SMEs by offering various Sharia-compliant financial products and services. Studies highlight that Islamic banking institutions provide products like *murabaha*, *musyarakah*, and people's business loans, which contribute to advancing SMEs and cooperatives, ultimately supporting sustainable economic growth. Additionally, Islamic microfinance institutions have been identified as potential solutions to the financial constraints faced by SMEs, with micro-savings significantly aiding in SME growth. Furthermore, research emphasizes the effectiveness of Islamic financing, such as *mudharabah*, in improving the financial performance of SMEs, leading to increased business income and profits. Overall, Islamic banking, with its Sharia-compliant practices and innovative financial solutions, plays a crucial role in empowering SMEs and cooperatives, thereby supporting national development goals and economic inclusiveness.

2.2 factor patronage of SMEs towards Islamic banking products

The key factors influencing the patronage of Small and Medium Enterprises (SMEs) towards Islamic banking products include Islamic financial literacy, capital requirements, nisba, convenience, adherence to Sharia principles, recognition of benefits, awareness, and educational initiatives. Islamic financial literacy, capital requirements, and convenience play a significant role in attracting SMEs to become Islamic bank financing customers (Anissa et al, 2023). Additionally, factors such as adherence to Sharia principles, recognition of benefits, improved awareness, and educational initiatives impact the decision of SMEs to utilize Islamic banking products (Muhammad et al., 2023). Furthermore, knowledge of products in Sharia banking has been found to significantly influence the interest of SME agents in choosing *musyarakah* as a financing product (Azizah & Lestari, 2022) Overall, these factors collectively contribute to shaping the patronage of SMEs towards Islamic banking products.

On the other hand, SMEs' preference for Islamic financing schemes over conventional methods is influenced by various factors. Factors such as perceived ease of use, social influence, fundraising benefits, technology readiness, customer background, understanding of Islamic financing, and the availability of sharia-compliant financial products play crucial roles in shaping SMEs' decisions (Ashari et al., 2024) (Ashari et al., 2023). Additionally, subjective norms, perceived behavioral control, product knowledge, and religiosity are significant factors affecting SMEs' funding decisions through Islamic crowdfunding platforms (Herlita 2023). These findings highlight the importance of awareness, accessibility, and alignment with Islamic principles in driving SMEs towards Islamic financing options, showcasing a shift towards more diverse and inclusive financial solutions for small businesses in various regions.

2.3 Islamic Banking Attributes

The attributes of Islamic banking have a substantial impact on consumer decision-making. According Muneer et al., (2024), Islamic banking factors such as promotion, service quality, behavior of banks staff, shariah compliance, management, convenience, fastness and charges/fees is affecting the shifting of conventional customer to Islamic banking facilities. Product and services also one of the important elements which effect the decision process of consumer to purchase and participate into a product and services (Hamzah et al., 2022). In the context of Islamic home financing, Amin (2008), find that, product range is the factor affect the decision among customer to adapt the Islamic home financing. In the other context, access to finance is affect the SMEs decision to pursue external financing products.

Access to finance has gained importance in the SME literature in which several authors have highlighted the access to finance variable (Beck & Kunt, 2006; Maiti, 2018; Mertzanis, 2017). The access to finance construct has been viewed in two ways, which are the importance of access to finance and the determinant of SMEs' access to finance. In the first approach, the importance of access to finance is to improve wealth distribution, foster economic growth, and prevent consumption and investment (Beck & Kunt, 2006; Pande et al., 2012). The empirical studies affirmed that access to finance is one of the critical obstacles that slow down SMEs' growth in emerging economies. In East Asian economies, 39% of SMEs face difficulties accessing finance (Maiti, 2018).

3.0 Proposed Framework

The principal objective of formulating a conceptual framework is to systematically incorporate all pertinent aspects of a concept to establish a procedure that provides the most effective explanation of the issue (Brown et al., 1995). As outlined in existing literature, both SMEs behavior and Islamic banking attributes are vital factors influencing the Islamic SME financing preferences. Given that the financial requirements are largely contingent on the availability of these sources and other attributes of the business and entrepreneur, it is imperative to establish a framework that steers the identification and assessment of SMEs' financing preferences for the purpose Islamic banking acceptance. This framework facilitates prospective studies on the financing of SME with a focus on the accessibility of owner behavior and Islamic banking attributes. Additionally, the study emphasizes that attitude, subjective norm, perceived behavioral control, product range and access to Islamic finance among entrepreneurs boosts their engagement in the financial realm, ultimately benefiting the growth of Islamic banking product. The conceptual framework delineating the determination of SME growth, particularly regarding financing sources, is illustrated in Figure 2.

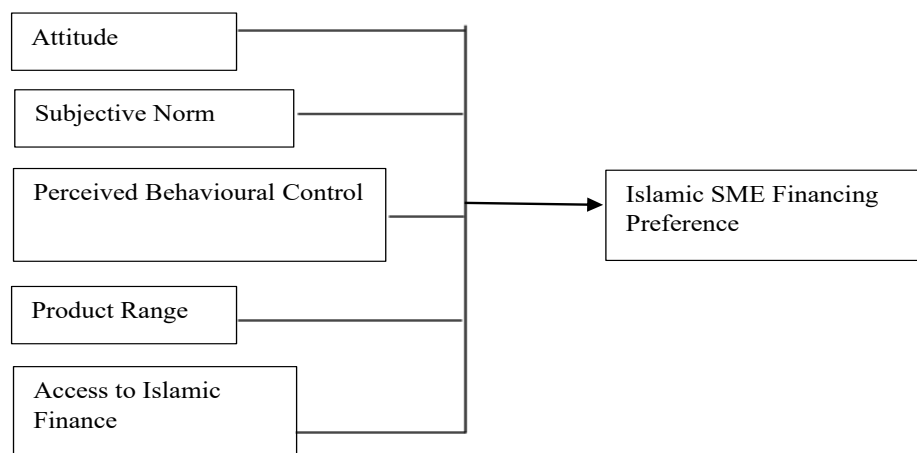


Figure 2: Islamic SME Financing conceptual framework

Based on the proposed framework, there are five hypothesis developed which:

H: Attitude is positively influencing the SME owner behavior towards Islamic SME Financing Preference

H2: Subjective norm is positively influencing the SME owner behavior towards Islamic SME Finance Preference

H3: Perceived Behavior Control Positively influence the SME owner behavior towards Islamic SME financing Preference

H4: Product Range positively influence the SME owner behavior towards Islamic SME financing preference

H5: access to Islamic Finance positively influence the SME owner behavior towards Islamic SME financing preference.

4.0 Discussion and Conclusion

This research paper investigates the financial factors that influence the adoption of Islamic financing among SME owners. Building on existing literature, five independent variables are identified: attitude, subjective norm, and perceived behavioral control (from the theory of planned behavior), as well as access to Islamic finance and product range (from Islamic banking attributes). These factors are analyzed to determine their impact on SME owners' decisions to choose Islamic financing products. The study's theoretical framework is mainly supported by empirical data from SMEs in Malaysia.

Despite finance being a critical factor for SME growth, these enterprises often face financial constraints. Therefore, it is crucial to explore and identify stable and sustainable funding sources to help SMEs achieve their growth objectives. This paper proposes a conceptual framework to evaluate the factors influencing SME owners' preferences for Islamic financing. The expected outcomes are promising, with future research based on this framework likely to improve the understanding of Islamic SME financing products.

The findings will be valuable for policymakers, entrepreneurs, and financial institutions involved in SME financing. Identifying reliable financing options for SME growth can contribute to socioeconomic progress by creating jobs and advancing local communities. The framework aims to explore unconventional sources of finance to support SMEs in reaching their growth targets, an approach not commonly seen in Malaysia.

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