ISLAMIC FINANCING: A PANACEA TO SMALL AND MEDIUM SCALE ENTERPRISES FINANCING PROBLEMS IN NIGERIA

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Abstract

Small and Medium Scale Enterprises (SMEs) play significant role in sustainable economic growth and development, especially in developing economies. In Nigeria, SMEs are facing financing problems which hinder their survival as a result they could not play the expected roles in the economy. The objective of this paper is to explore the use of Islamic Financing in solving SMEs financing problems. The study is exploratory; hence various literatures were sourced, reviewed and discussed. It was found that the conventional sources of financing SMEs are grossly inaccessible, costly and not feasible. As a new source of financing in the country, Islamic financing is feasible, though inadequate but relatively accessible and costless. One of the recommendations is that financial institutions should be adopting Islamic mode of finaning when financing SMEs in the country as it will go a long way in solving SMEs financing problems.

Keywords: Islamic financing, panacea, micro, small, and medium enterprises,

Introduction

Nigeria like other developing and developed countries alike recognized the necessity of having a vibrant Small and Medium Scale Enterprises (SMEs) in a journey towards economic growth, development and sustainability. The recognition can be seeing vividly when one consider the government efforts in; Small and Medium Enterprises Development Agency of Nigeria (SMEDAN), Small and Medium Industries Equity InvestmentScheme (SMIEIS), National Poverty Eradication Program (NAPEP), National Directorate of Employment (NDE) etc. On their part Nigerian Entrepreneurs have been struggling to survive and ultimately to prosper in an environment that is full of uncertainties, and constraints.

It has been rightly observed by many scholars that Finance is one of the major constraints that hinder the survival, growth and development of SMEs in Nigeria as in other developing countries (Olusoji 1999, Ali 2006, Anthony 2005, Ekpenyong and Nyong 1992, Syauqi and Purnamasari, 2011). Sources of Financing SMEs in Nigeria are grossly inaccessible. Even where it is available you find out that it is not feasible to obtain. This is because of high cost of fund and stringent requirements which must be met. As a result many SMEs failed to meet the requirements hence could not get the needed fund. This seminar tries to explore the use of Islamic mode of Financing as a panacea to the financing problem faced by SMEs in Nigeria. Existing literatures on the issue and related issues will be considered and discussed for proper exploration.

Islamic financing is a mode of financing that emphasized financing as co-owners(equity holders) not financing as creditors. It recognized share of profit and loss as a return for capital not interest as the case of conventional financing. It do not believe in arriving at a predetermine amount of money as a return to capital owners rather it believed in the amount of money that is realized after executing the business which could be profit or loss.

Meaning of Micro, Small, Medium and Large Scale Enterprises

CBN (2003), defined Micro/Cottage, Small, Medium, and Large Scale Enterprises respectively as follows; Micro/Cottage industry is an industry with a labor size of not more than 10 workers, or total cost of not more than #1.5 million, including working capital but excluding cost of land. It viewed Small Scale Industry as an industry with a labor size of 11-100 workers or a total cost of not more than #50 million, including working capital but excluding cost of land. Medium Scale Industry was considered as an industry with a labor size of between 101-300 workers or a total cost of over #50 million but not more than #200 million, including working capital but excluding cost of land. And Large Scale Industry with a labor size of over 300 workers or a total cost of over #200 million, including working capital but excluding cost of land.

Countries differ in the interpretation or definition of Small and Medium Scale Enterprises (SMEs). Some based the meaning of SMEs on the annual turnover and the number of workers in SMEs e.g. Britain, Canada and USA. Japan based their own definition of SMEs on the type of industry, and consider paid up capital and number of workers. For example in Britain a business is qualified to be a Small Scale business once its annual turnover do not exceed £2million and less than 200 workers, while in Japan Small Scale Enterprise in a manufacturing sector must have ¥100million capital and 300 workers, those in wholesale requires ¥30million as capital and 100 workers, while retail business andservice trades must have ¥10million as their capital and 50 workers (Ekpenyong and Nyong, 1992 and Fatai, 2011).

In countries like India, Kenya and Uganda number of employees is considered in defining a SMEs. India consider 30-100 employees, Kenya 11-50 employees as Small Scale Enterprise, 51-100 employees as Medium Enterprise, and in Uganda 5-50 employees as Small and Medium Enterprises (Fatai, 2011).

In his definition of terms Anthony (2005), defined Small Enterprise as “an enterprise whose total cost including working capital but excluding cost of land is between ten million naira (#10,000,000) and one hundred million naira (#100,000,000) and / or a workforce between eleven (11) and seventy (70) full-time staff and / or with a turnover of not more than ten million naira (#10,000,000) in a year”. He sees medium enterprise as “a company with a total cost including working capital but excluding cost of land of more than one hundred million naira (#100,000,000) but less than three hundred million naira (#300,000,000) and / or a staff strength of between seventy one (71) and two hundred (200) full-time workers and / or with an annual turnover of not more than twenty million naira (#20,000,000) only”.While defining SMEs for the purpose of Small and Medium Enterprises Credit Guarantee Scheme (SMECGS), CBN (2010) defined it as an enterprise that has asset base (excluding land) of between #5million - #500million and labour force of between 11 and 300.

As a developing economy, the CBN definition of SMEs in 2003 is the most fair and most encompassing definition up till today. One may argue that if that is considered today uncountable number of businesses may qualify which may be difficult to cover. It is true but never forgets that these petty-petty businesses are the businesses that need real financial assistance which if provided with will grow solidly. Imagine an enterprise that worth #500million (half of a billion) but still participating as SMEs to share the meager financial assistance set aside for real SMEs. Now let consider the role of SMEs in an economy.

Role of the Small and Medium Scale Enterprises in an Economy

Despite the differences in terms of defining Small & Medium Enterprises (SMEs), scholars unanimously agreed on the stimulating role it play towards economic growth and development. According to Anthony (2005), the most important role of SMEs in developing countries is creating additional employments, which reduce poverty and enhance quality of lives. A part from employment provision Ekpenyong and Nyong (1992), and Kilby (1969), observed, SMEs provides inexpensive consumer goods with little or no import content which contribute to long-run industrial growth by moving out of SMEs to large scale industries.

Shokan (1997) as cited in Ayozie and Latinwo (2010) considered employment provision, innovation, systematic development of rural areas reducing urban migration, development of the indigenous entrepreneurship, mobilization of domestic savings and utilization of local resources, production of raw materials in the form of semi processed goods for use by bigger industries among others as the roles of SMEs in Nigerian economy.On his part Fatai (2011), viewed the role of SMEs as economic and social. He sees addressing unemployment as economic whereas solving problems of hunger, poverty and increasing standard of living as social.

From the aforementioned, it is undeniable fact that SMEs have significant role to play in Economic and Social arena most especially developing economies. In Indonesia, Micro, Small and Medium Scale Enterprises contributed 56.53% to the GDP and was having the capacity to absorb 97.30% of the total work force in 2009 (Syauqi and Purnamasari, 2011).Whether SMEs are actually playing the expected roles in Nigeria is another issue entirely. It depends on the prevailing environment within which they operate in the country. At this juncture, we consider one of the major problems facing SMEs in Nigeria.

Finance: One of the Major Constraints of Small and Medium Scale Enterprises in Nigeria.

Finance is a functional area of business without which enterprises could not survive. All business operations would stand still if finance is not adequate to handle it. SMEs in Nigeria face many problems and finance is one of the major ones. Olusoji (1999), observed that SMEs could not secure finance due to inadequate collateral to obtain loan from financial institutions, poor feasibility and lack of equity contribution which hinder the flow of financial assistance to them. Inability of SMEs to prepare a convincing business plan, resisting interest based financing due to religious beliefs and high interest rate make it difficult for the enterprises to access funds (Ali, 2006).Sometimes government policies, liberalization and deregulation of interest rates, the frequent changes, and inconsistencies in government monetary policies do hinder the financing of SMEs as observed by Ekpenyong and Nyong (1992). Syauqi and Purnamasari (2011), concurred with the other researchers that finance is one of the major problem bedeviling the SMEs. Anthony (2005), ranked financing problem as number three (3) among the plethora of problems facing SMEs in Nigeria.

On the other hand, Business Day survey (2004), viewed access to finance as number four (4) problem to SMEs after, power supply, government policies and infrastructure. As these scholars concurred there is no doubt that access to fund is a problem area as per as SMEs are concerned in Nigeria. Government is responsible for providing enabling environment (access to finance is part of it) for SMEs to play their expected roles in an economy. What are the government efforts in this direction?

Government Efforts Towards Meeting The Financing Needs Of SMEs In Nigeria

Having understood the contribution of SMEs in the provision of employment opportunities and development of an economy, various regimes in Nigeria did attempt to provide a solution to the problem of finance facing SMEs in the country. Some of the institutions and arrangements established by various regimes in the country to tackle the financing needs of SMEs for the past 30 years were: Small Scale Industries Credit Scheme (SSICS), Nigerian Bank for Commerce and Industries (NBCI), Nigerian Industrial Development Bank (NIDB), SME apex unit of Central Bank, National Economic Reconstruction Fund (NERFUND), The African Development Bank/ Export Stimulating Loan (ADB/ESL), Nigerian Export Import Bank (NEXIM), National Directorate of Employment (NDE), Industrial Development Coordinating Center (IDDC), Community Banks, People's Bank, Family Economic Advancement Programme (FEAP), State Ministry of Industry SME Schemes, Small and Medium Industries Equity Investment Scheme (SMIEIS), Bank of Industry (BOI), Small and Medium Enterprises Development Agency of Nigeria (SMEDAN), and Credit Guarantee Scheme for SMEs (Anthony, 2005 and Itodo, 2011). Despite these effort SMEs are still battling with the financing problem. This is due to lack of collateral, lack of guarantor, high interest rate, government bureaucracy, stringent documentation/ requirement, mistrust, risk avoidance among others. With exception of SMIEIS most of the institutions were established to give loan or financial assistance to SMEs not to partake as co-owner of the enterprise. There is no doubt that these efforts have not yielded the desired results. One of the alternatives for financing SMEs is Islamic financing.

The Concept of Islamic Financing

Islamic finance has become part of the financial sector world over and is getting recognition as a promising financial system that will serve as a panacea to the recurrent financial instability in general and the financing needs of SMEs in particular (Askari, Iqbal, et'al, 2011). Its origin can be traced toMuslim countries but spread over Europe, the United States, the Far East, Middle East and Africa (Shtayyeh and Piot, 2008).

As a concept Iqbal (1997), expressed himself that "the Islamic Finance is founded on the absolute prohibition of the payment or receipt of any predetermined, guaranteed rate of return. This closes the door to the concept of interest and precludes the use of debt-based instruments. The system encourages risk-sharing, promotes entrepreneurship, discourages speculative behavior, and emphasizes the sanctity of contractors."

Islamic finance based its structure on risk sharing and promotes profit and loss sharing at the same time prohibits debt financing (leveraging). This is because debt financing transfer the entire risk of the transaction to the borrower. Islamic finance championed the alternative to debt based financing by allowing both parties to share production, transportation, and marketing risks. Then, what are its principles?

Principles Of Islamic Finance

Shtayyeh and Piot (2008) viewed principles of Islamic Finance as comprising of prohibition of interest, prohibition of activities with excessive speculation (gambling, derivatives), prohibition to invest in certain sectors like; alcohol/drugs, pig related industry, interest related businesses, ammunition, pornography and prohibition on transaction that has to do with unseen. In addition, Iqbal (1997), mentioned risk sharing, money as potential capital, and sanctity of contract as part of the principles. He explained that suppliers of funds should be regarded as investors not creditors. Money becomes capital only when it is combined with other resources in productive activity, and upholding contractual obligation as a sacred duty to minimize the risk of asymmetric information and moral hazard. Sanusi (2011), concurred with the above scholars on the principles of Islamic finance where he noted, under the principles lending is not a business. Investments are to be only in morally and legally approved causes the same thing with the western concept of socially responsible or ethical investing.

In Islamic finance, interest is seen as oppression and exploitation of those who have not by those who have. Gambling, unjust enrichment or unfair exploitation and game of chance (excessive speculation) discourage investment in a productive venture and encourage opportunism. Naturally resources are limited compare to human needs it is irrational to use the meager resources in the production of harmful products like alcohol/drugs.

Even though it may be economically profitable yet principles of Islamic Finance consider it as not permissible (prohibited). Considering the above principles what are the modes of Islamic financing?

Modes Of Islamic Financing

Most of the modes of Islamic Financing are equity oriented where the profit or loss is shared in the ratio agreed upon. The rates of returns are thus replaced by ratios. Several modes of acquiring assets or financing project can be broadly categorized into three areas: Investment, Trade, and Lending (AbdulGafoor, 1995).

1. Investment Financing
   i. Mudarabah (passive partnership)
   ii. Musharakah (active partnership)
   iii. Estimated rate of return
2. Trade Financing
   i. Murabaha (mark up)
   ii. Ijarah (leasing)
   iii. Hire purchase
   iv. Sale and buy back
   v. Letter of credit
   vi. Salam (forward trade contract)
   vii. Istisna
3. Lending
   i. Loan with a service charge
   ii. No cost loan
   iii. Overdraft
4. Services

Let paraphrase these modes of Islamic Financing as enumerated above.

1. Investment Financing

i. Mudarabah (passive partnership)

This is a mode of financing where a bank agreed to finance a business proposalof a skilled entrepreneur but not having capital after which the profit resulted will be shared according to agreed ratio. If loss results the financier or the bank will take it and the entrepreneur will lose his managerial efforts. Assuming the loss was due to entrepreneur's negligence he will be forced to pay.

ii. Musharakah (active partnership)

In Musharakah both the entrepreneur and the bank contribute to the finance needed in equal or varying degrees at the same time participate in the running of the enterprises after which the profit or loss realized will be shared according to the prior agreed ratio.

iii. Estimated Rate of Return

Under this mode of financing, the bank after estimating roughly expected return agrees to finance a business proposal brought by its client (entrepreneur) with the believe that the expected return will be paid to the bank even though it is negotiable. In case the business proposal yielded higher profit than expected the excess goes to the client and if less the bank have to accept it. In case a loss is recorded the bank has to take a share in it depending on the agreement.

2. Trade Financing
   i. Murabaha (mark up)

      Entrepreneur may lack finance to acquire assets for use in his or her business. Murabaha is an agreement between the bank and entrepreneur where the bank will purchase the asset(s) as specified and sell it to the entrepreneur at an agreed profit margin. The entrepreneur may pay on the spot, installmentally, or in lump sum at a future date.

   ii. Ijara (Leasing)

      Sometimes entrepreneurs may want to use asset(s) not necessarily to own it. Ijara is a contract where a bank while retaining ownership responsibilities and liabilities undertake to procure the needed asset(s) and allow the entrepreneur to continue using the asset while (entrepreneur) shouldering the rights and liabilities relating to use. Periodic payment will be made by the entrepreneur to the bank as per the agreement. Depending on the agreement the entrepreneur may have the opportunity of owning the assets at the end of the Ijara agreement.

   iii. Hire purchase

      This is an arrangement where a bank purchases an asset base on the client's specifications, and hires the asset to the client. The price of the asset will be spread over period of time so that the client will be paying instalmenmtally. The client becomes owner of the asset after making final payment.

   iv. Sell-and-buy-back

      Sometimes an entrepreneur may find himself lacking fund to use in his business but have assets that can be sold even though he may need the assets at a future date. Sell-and-buy-back is an agreement whereby an entrepreneur sells his asset to a bank on condition that at a later date the bank will sell the asset back to the entrepreneur at an agreed price.

v. Letters of credit

This is a guarantee given by Islamic bank. The Islamic bank may agree to pay for goods ordered by his client on the agreement that the profit realized by the client after selling the goods will be shared according to agreed ratio.

vi. Salam (Forward trade contract)

A seller may undertake to supply some goods to the buyer at a future date in exchange of an advanced price fully paid at spot. This is to meet the financing need of the farmers before harvesting period and traders for import and export. (WWW.ALQALAM.ORG.UK).

vii. Istisna (partnership in manufacturing)

It is a mode of financing where the commodity involved is manufactured to the specifications of the purchaser. This is widely used in the housing finance sector, where the client seeks finance for the construction of a house. The financier may undertake to construct the house on a specified land either belonging to the client or purchased by the financier, on the basis of Istisna, with payment fixed in whatever manner the parties may wish. It is also widely used in infrastructure finance.

3. Lending
   i. Loan with a service charge where the bank lends money without interest but they cover their expenses by levying a service charge.
   ii. No cost loan where each bank is expected to set aside a part of their funds to grant no cost loans to needy persons such as small farmers, entrepreneurs, producers etc and to needy consumers.
   iii. Overdraft also is provided, subject to a certain maximum, free of charge.
4. Services

   Other banking services like money transfers, bill collections, trade in foreign currencies at spot rate etc where the banks money is not involved are provided on a commission or charge basis (AbdulGafoor, 2005).

Islamic Financing In Nigeria

The history of Islamic financing in Nigeria is not long when one look at it as financial services provided by licensed institutions. Section 23 and 61 of Banks and Other Financial Institutions Decree (BOFID) of 1991, gave birth to banking system base on profit and loss sharing basis as non interest banks and specialized banks. Some investors showed interest and applied to operate Islamic banks within 1993 to 1995. In 1996 the then Habib bank opened a non interest banking window and far later in 2004 approval in principle was granted to Jaiz international plc to establish Jaiz bank. Having NDIC, NAICOM, PENCOM, DMO, other market operators and representative of CBN as stakeholders the Islamic Finance Working Group was formed in 2008.

In January 2009, the CBN became a member of Islamic Financial Services Board and subsequently in March of the same year it issued a draft framework for the regulation and supervision of non interest banks in Nigeria. Towards ending of 2010 precisely in august the CBN issued the new banking model designated as non interest banks as part of specialized banks (Sanusi, 2011).

Discussion and Findings

The demand for funds by the Small and Medium Scale Enterprises is a derived demand. SMEs need funds to purchase plants and machineries, equipments, vehicles, raw materials, pay rent, and other bills payable. The inadequate e financial assistance provided by the government to Small and Medium Scale Enterprises is in form of money. Most of the entrepreneurs were tempted to misuse the money. Banks and other financial institutions provide the SMEs with funds at an exorbitant rate (high interest) without recourse to whether the funds were used in the best way or not. What they are after is the credit worthiness of the customer. That is once the customer is having a collateral, guarantor etc the fund will be given after filing the necessary documents. Under conventional financing system the financier is concerned only with his return not the progress of the small and medium scale enterprises. The result will be the SMEs will continue to go poorer and the financier to go richer, by getting their return no matter the outcome of the business operation.

When you look at the Islamic mode of financing you find out that the financier is a stakeholder (real stakeholder) in the business. The financier's income depends on the outcome of the business operation. If the business operation is successful then both the financier and the entrepreneur will benefit according to the predetermined ratio as agreed upon. This justifies the need for the financier to partake in the management of the business concern. The financier is part owner or is having an ownership stake in the business not creditor ship stake.

Islamic financing is viable and feasible because whatever assets you want to acquire for your business it could be provided according to your specification just at mark up and the payment could be on the spot or deferred. And if its only working capital you need it could also be provided after agreeing on the ratio to share the profit or loss. This is contrary to the conventional financing where high interest is to be paid irrespective of the business outcome. Moreover, it is efficient and effective because the financier could participate in the running of the business as part owner hence could know the exact amount needed, when and for what? After successful financing the financier can divest his interest and allow the entrepreneur to continue independently. Under conventional financing one has to be credit worthy before assessing the finance but once you are enterprising the finance can be assessed under Islamic financing. However, one must not be a Muslim before participating in Islamic financing.

Trade financing under Islamic mode of financing will solve the financing needs of all existing SMEs. The financing needs of SMEs can be met through Murabaha, Ijara, Hire purchase, Sale and buy back, forward trade contract, Letter of credit and Istisna, defending on the need.

A well conceived new SMEs as well as existing one can come on board through investment financing: Mudarabah (passive partnership), Musharaka (active partnership), and Estimated rate of return. Which means an entrepreneur who is endowed with enterprises can actualize his enterprise through an active partnership or passive partnership.

Conclusion and Recommendation

Small and Medium Scale Enterprises has roles to play in the growth and development of an economy. In Nigeria, SMEs are not playing the expected roles. Finance is one of the major problem facing SMEs in Nigeria. Government at various instances tried to provides for the finance needs of the SMEs but up to present the financing problem still remain a threat to the survival of SMEs in the country. On their part, financial institutions provide costly finance services mostly a time for short term duration after putting stringent conditions. Both Government finance and finance coming from financial institutions were grossly inadequate, ineffective and inefficient. The SMEs demand for finance is a derived demand as they require finance to pay for plants and machineries, equipments, vehicles, raw material, lands and buildings, and other bills payable. The Islamic modes of financing are suitable, viable, feasible, effective and efficient. In Nigeria, Islamic mode of financing is a new development which if patronize it will go a long way in solving financing problems of SMEs in the country.

The paper recommends that existing providers of Islamic financing (full pledged and windows) should enlighten the SMEs more about their operations and the benefits it has compared to conventional financing. Secondly, as full pledged Islamic bank in Nigeria is only one for now having only three branches it is recommended that more banks should upon a window (unit) that will be providing Islamic financing as is obtainable in HSBC, Deutsche Bank, Citigroup, and Standard Chartered. Thirdly, wealthy individuals and corporate bodies (non financial institutions) should be enlightened and encouraged on the need to identify SMEs in their neighborhood and provide needed fund for them as co-owners not as creditors. Fourthly, SMEs should be enlightened to open their doors for system that will provide solution to their predicament in as much as it is not injurious to the entity. It is a fact that some SMEs despise Islamic Financing not because it is not a solution to their financing problems but because it carries the word Islam even though sometimes it is called Interest free financing.

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