Islamic finance for SMEs

While small businesses have traditionally had to rely on conventional financing, recent efforts by Islamic banks have started to make Shari'ah-compliant products viable funding options for the SME sector.

At the end of August, the Central Bank of the UAE approved its five-year strategic plan to achieve Vision 2021. The plan includes a focus on encouraging the banking sector to finance SMEs, while highlighting the legislative, regulatory, and supervisory environment for Islamic finance.

Islamic banks are looking to grow their loan books, while SMEs in the Middle East and North Africa (MENA)are still finding it hard to obtain funding, whether conventional or Islamic. Yet thousands of SMEs across the region are in limbo because there are not enough Shari'ah-compliant banking services available, according to a study, *Islamic banking opportunities across small and medium enterprises in MENA*, by the International Finance Corporation (IFC). In nine countries across the

MENA region, the IFC estimates that SMEs are in need of up to $13.2 billion in Islamic finance.

Financing to the SME sector has traditionally fallen to conventional banks more than Islamic financial institutions mostly due to the lack of available Shari'ah-compliant products available to finance small businesses, according to Ashruff Jamall, Partner and Global Islamic Financial Services Leader, PwC Middle East. This has led to a degree of innovation in the Islamic banking sector, focussing on SMEs and coming up with certain instruments that are now acceptable. A few Islamic banks are financing the sector, but there is still some time to go before they build up market share.

According to the IFC study, of the 36 per cent of banks in the MENA region that offer SME-specific products, only 17 per cent offer Islamic financing. The study also noted the potential for the conversion of an existing SME portfolio financed through conventional banking channels to Islamic finance–an opportunity worth approximately $4.1 billion.

In order to qualify for Islamic financing, the business sector needs to be Shari'ah-compliant. Certain sectors are completely forbidden, said Tarek El-Assra, Partner at the Dubai office of global law firm, Morgan Lewis. If the business is in any way related to alcohol, gambling, or the adult entertainment industry, it will not have access to Islamic financing. If, for example, the SME wanted to set up a small crowd-funding platform to lend to people on a conventional basis, that would also not be viable because there would be interest related to the repayment.

Financing obstacles

One of the challenges preventing Islamic financing from going mainstream, according to Tariq Muhammad, Partner and Head of Islamic Finance at auditing firm, KPMG Lower Gulf, is a lack of awareness of how Islamic products are structured. He added that banks would need to make an effort to educate all parties as to how these products operate within the context of SME financing.

El-Assra added that banks need to invest in people who are not only knowledgeable in Shari'ah, but who are Islamic finance professionals, with experience in both Islamic jurisprudence and banking. He added that there are many companies in the MENA region who are focussed on whether the lending option is Shari'ah-compliant or not, and refuse to borrow on a conventional basis.

"There is also a general lack of understanding when it comes to Islamic finance when compared to conventional financing; people can be quite sceptical of it. There need to be people who are able to talk about Islamic finance concepts with knowledge and authority to improve awareness," said El-Assra.

He added that it is difficult for SMEs to raise funds because banks will not finance them, owing to the risk associated with lending to them; they do not have assets for collateral so the security is not there. But if SMEs do not have access to finance, the sector cannot develop.

Previously, when borrowers have defaulted on payments, there has been no legal protection for them. The final draft of Federal Decree Law No. 9 of 2016 on Bankruptcy (the New Law) was recently passed and set to be enforced at the end of December 2016, and should allow struggling businesses to continue running and generate cash in order to repay loans.

“This law will apply to both conventional and Islamic financing, and should give Islamic banks looking to fund the SME sector some comfort, something conventional banks never had before the law was proposed. Hopefully there will be an impetus for Islamic banks to get involved in financing SMEs, knowing that if there is a default or restructuring situation, the law will enable the customer to continue running their business,” said Jamall.

El-Assra added that, in conjunction with the bankruptcy law, there needs to be standardisation of Islamic finance contracts because one bank may claim to be Shari’ah-compliant while another would have an issue with the structures in place, and that mismatch creates confusion in the market. Regulating these contracts will help develop Islamic finance in the SME sector.

Asset-based funding options:

- Murabahah

  The bank purchases an asset on the borrower’s behalf, such as a AED 50,000 vehicle. The borrower buys the asset from the bank at a certain cost, say, AED 60,000, in instalments over a set number of years. Essentially the bank makes AED 10,000 in profit. Economically it works out the same as a regular loan, but structurally the documentation is different as there are purchase and sale elements to the agreement.

- Ijarah

  The SME owner already owns assets as collateral which are sold to the bank, which is how the business owner receives capital. The SME owner leases back the assets over a fixed period, which is how they pay back the bank. The bank never takes physical possession of the assets. Under the terms of the contract, the bank will transfer ownership of the assets back to the SME owner, once the agreed amount has been paid. If a lawyer wants to open a firm, their ‘asset’ is their knowledge of the legal field, not anything tangible, so this financing option would not work for them.

  Equity-based funding options:

- Mudarabah

  This is a silent partnership where the bank, the Rab al Maal, agrees to give the capital to the SME owner, acting in the capacity of the Mudarib, who invests that sum to make a return, and pay the money back. The documents involved have a specific schedule, stipulating that the cash will only be invested within specific parameters. The SME owner will use returns generated from the loan to pay back the amount, with a small profit element attached. In Islamic finance we do not refer to interest, but it works out the same way.

- Musharakah

  This agreement is structured like a joint venture between the bank and business owner, where the bank will contribute a sum and the borrower will contribute their own cash and they agree to share in the revenues from the project.

Banks show a preference for the asset-based instruments, the Mudarabah and the Ijarah, due to their simpler documentation and the ease of their implementation.

Source: Tarek El-Assra, Partner at the Dubai office of global law firm, Morgan Lewis

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