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The Impact of Islamic Financing on the Small Medium Enterprises (SME's) Performance in Lasanod Somalia

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Abstract

The objective of this paper is to examine the influence of Islamic financing on the performance of small-medium enterprises in Lasanod Somalia. Many businesses obtain financings such as Murabaha, Microfinance, and Qard Al Hassana from Islamic banks operating in Somalia to raise funds and capital required to expand and run their businesses smoothly. This study employs a quantitative research approach. A total of 148 questionnaires were distributed and collected from Small Medium Enterprises owners and workers in Lasanod Somalia who obtained Islamic financing from local Islamic banks in Somalia. The responses were analyzed using SPSS 21. Descriptive statistics, correlation analysis, and bivariate regression analysis were conducted to investigate the impact of Islamic financing on the performances of businesses operating in Somalia. Small Medium Enterprises owners and workers believe that Islamic financing has helped their businesses to obtain the funds needed for their businesses to grow and expand beyond existing markets. Furthermore, this study suggests there is a positive relationship between Islamic financing and business performance. The finding of this paper is statistically significant.

Keywords: Islamic financing, Islamic Banks, Murabaha, MicroFinance, Qard Alhassan, Small Medium Enterprises (SME's), Growth, Lasanod Somalia.

Introduction

Formal financial institutions and the commercial banking sector have been missing in Somalia since the fall down of Somalia's central government in 1991. Before beginning the civil war, the financial sector of Somalia was formal and strong, including four financial institutions, namely, the Central Bank of Somalia, State Insurance Company, Somali Development Bank, and Commercial and Saving Bank (Mohamed, 2019).

After the fall of the central government, privately-owned financial institutions began operating and providing basic financial services. They started with money transferring (earlier) and moved to the financial intermediary (Islamic banking) offering deposit and financing products. Although many challenges are facing the financial sector of Somalia, which includes the absence of effective formal banking industry, lack of skilled staff, the insecurity issue due to the civil war and fragile regulatory framework and security exchange, the Central Bank of Somalia is taking significant producers to develop national financial systems (Mohamed, 2019).

Islamic banking refers to a banking system that is based on the principles of Shariah (Islamic rulings) and its practical application. Islamic banking is also known as an interest-free banking system as the Shariah prohibits the practice of *riba* or interest rate. The concept of Islamic Banking appeared more than half-century.

The Islamic financial structure led to the abandonment of the interest-bearing system and adopting the principle of sharing in profit and loss, which has been adhered to and applied by the Islamic banks to various operations and bank services. (Hassan, 2019; Farah, 2020).

Currently, several Islamic Banks are operating in Somalia, and a few others are going to be established soon. Somalia Islamic banks currently finance many private sector activities, including SMEs financing, Personal financing and home financing, by using modes of finance such as *Murabaha*, *Musharaka*, *Mudaraba*, *Salam* and *Qarad Hassan* (Adan, 2014).

Small and medium enterprises (SMEs) play a crucial part in economic development, poverty reduction through the creation of job opportunities and stands a key interest for government and policymakers in both developed and developing countries (Storey, 1994; Chen, 2006; Hassan, 2008; Inyang, 2013; Ali, 2013; Bazza, Maiwada & Daneji 2014; Armeanu, Istudor & Laches, 2015; Tambunan, 2005).

The SME's effectiveness is influenced by market access, infrastructure facilities, procurement services, and financial services, also known as business development services (Musara & Fatoki, 2010).

As financial services such as financing facilities play a vital role in the improvement of SMEs performance, studies found that SMEs are realized to have development in financing their capital (OECD, 2018). However, SMEs face an obstacle to obtaining financing to expand their operations and encounter large credit restrictions compared to big firms (Beck & de la Torre, 2007).

The motive for this study is to reveal the impact of Somalia's Islamic banks on the business performance of SMEs.

Problem Statement

Over the past two decades, many Local Islamic Banks emerged in Somalia. They began operating and monopolizing Somalia's banking sector due to the absence of a strong and functional central bank. It is illegal for conventional banks to operate in the country due to religious beliefs which paved the way for only Islamic banks to provide services to individual customers and businesses. Islamic banks provide loans to businesses in Somalia however there is no research done on the influence of those loans on business performance. *Murabaha* is the most common financing type which Somali Islamic banks provide to the customer with a high-profit rate and short repayment time. Thus it is not known whether business owners benefit from those loans.

The Objective of the Study

The aim of this paper is to investigate the impact of Islamic financing on the performance of SMEs in Somalia specifically Lasanod City.

Hypothesis

H₁: there is a significant impact on Islamic financing on SME's performance

Literature Review

The Organization of Islamic Conference (OIC) defines an Islamic bank as a financial institution whose statutes, rules, and procedures expressly state its commitment to the Shariah Principles and to the prohibiting of the receipt and payment of interest on any of its operations. Tayyebi (2008) describes Islamic Finance as any Finance that is compliant with the principles of Islamic Law (Thomi, 2014).

Islamic banking can be defined as a banking operation that adheres to sharia (Islamic law), under which a key point is the banning of interest or riba. Generally, Islamic banking is understood to mean interest-free banking (Centre, 2009).

The first Islamic financial institution came into the picture in 1963 in Egypt. The institution was based on the principle of profit and loss sharing (Archer and Karim, 2002). In 1974, the Organization of Islamic Countries (OIC) had established the Islamic Development Bank or IDB to become the first Islamic bank operating as a formal bank. The basic business model of this bank was to provide financial assistance and support on profit sharing. By the end of 1970, several Islamic banking systems have been founded throughout the Muslim world, including the first private commercial bank in Dubai (1975), the Bahrain Islamic bank (1979), and the Faisal Islamic Bank of Sudan (1977) (Hassan, 2019; Farah, 2020)

There is more than one type of financing proposed by Islamic banks. It can be categorized into two financing mechanisms: those based on profit and loss sharing financing such as Mudharaba and Musharaka) and those based on an asset including, Murabaha and Salam. In Somalia, Mudharaba, Musharakah (Profit and loss sharing), Murabaha, and Salam are used by the Islamic bank's financing products.

Murabaha

Murabaha is the most used contract in Islamic banking based on the products offered by Islamic banks. Islam disallows charging fixed interest on money but allows charging fixed profits on the sale of goods. Islamic banks, therefore, use a sale based, transaction-Murabaha, to avoid interest (riba). Murabaha is a sales contract where the profit is made by buying a commodity and selling it to the customer cost plus the fixed profit. It is an agreement whereby the bank purchases a requested item by the customer, and onwards the bank adds a pre-agreed profit to it and sells the item to the customer on a price including the cost of the item and the bank's profit. The majority of Islamic banks and financial institutions use Murabaha as an Islamic financing product, and the majority of its financing transactions are based on Murabaha (Usmani, 1998).

Profit and Loss Sharing (Mudharaba and Musharakah)

The profit-and-loss sharing (PLS) approach is the distinct characteristic of Islamic finance. This feature fundamentally differentiates the Islamic financial system from the debt-based conventional system (Mallinckrodt et al., 2016).

Mudharaba is a form of partnership in profit whereby one party provides capital (rab-al-maal) and another, management skill or labor (mudarib). Whereby, Musharaka is a partnership between two or more parties whereby each partner contributes a specific amount of money in a manner that gives each one a right to deal in the assets of the partnership, on condition that profit is to be distributed among the partners according to the partnership agreement and losses are to be borne by the partners in accordance with the contribution of each partner to the Musharaka capital.

In the mudarabah contract, the Islamic bank as the rabb almal (capital provider) contributes capital to start a commercial venture and the client, who is the mudarib (manager), takes sole responsibility to manage the business (ElGindi et al., 2009).

According to Shariah (Islamic law), the rabbu al-mal receive an agreed share of the profit at the end of the business operation; but if the business experience any loss, the capital provider must carry the full amount of the loss (Iqbal and Mirakhor, 2011). However, there is a provision that if the financial loss happens because of the entrepreneur misconduct or negligence, the capital provider is allowed to impose the loss on the Mudarib (Khan, 2008). On the other hand, in the Musharakah contract, both parties are entitled to be business partners by contributing capital and managerial efforts. They mutually share the business' output, whether it is profit or loss (Iqbal and Mirakhor, 2011).

Similar to other financing contracts, the primary concern in the Musharakah and Mudharabah agreement is to identify proper clients. Mudarabah is a trust-based agreement, and Musharakah needs capital contribution. It is significant to consider certain features that clients should have in this regard. It is also essential to make sure the amount of capital for the proposed business and define the PLS ratio. These provisions depend on the mutual agreement between the parties involved (Jais et al., 2020).

Salam

Salam is the Islamic version of the conventional forward contract (Amine, 2008). However, the method of working of Salam is different from the conventional forward contract. Salam can be defined as is the purchaser of a commodity for deferred delivery but for immediate payment. It is a type of sale in which the price, is paid at the time of contract while the delivery of the item to be sold, is deferred. (Amine, 2008). It carries many distinguishing features like the non-existent subject matter, spot payment, and deferred delivery Anwer (2020).

SMEs

Defining SMEs

The lack of a specific internationally accepted and agreed definition of SMEs creates a scenario where the definitions differ from one country to another or particular legislations. However, most definitions, as argued by Kasekende and Opondo (2003), MTIC (2015), Tumwine et al. (2015), Turyahikayo (2015) and UBOS (2011), look at SMEs in terms of employee size, asset size and annual turnover. For instance, European Commission (2015) and OECD (2005) define SMEs as those enterprises that employ less than 250 persons, with an annual turnover not exceeding EUR 50 m, and an annual balance sheet total not exceeding EUR 43 m. In countries such as the United Kingdom, an SME is considered to be an enterprise with an annual turnover of less than £2 m and employs less than 200 persons whereas, in Japan, an enterprise is regarded as SME if the capital is less than 100m yen and having less than 300 employees depending on the sector (Isah et al., 2014).

Despite the differences in definition of SMEs, researchers collectively acknowledged the active part do SMEs play toward economic growth and development. According to Abdulaziz (2016), SMEs play a key role in generating job opportunities among people especially in rural areas thereby reducing inequalities in income, promoting growth and prosperity of economies of low developing countries Hassan (2020) aimed at shedding a light on the Islamic methods used for financing small enterprises. He targeted to explore the impact of such finances on supporting the owners of small enterprises and developing such enterprises. He aimed to shed a light on several concepts that are related to Islamic finance and small enterprises. He found that there are several administrative and marketing barriers hindering the owners of small enterprises from being funded by Islamic financial institutions. He found that the Islamic finance formulas of Islamic banks are very significant and positively affects SMEs and in turn the national economy.

Abu Shanab (2015) investigates the role of Islamic finance forms in funding small and medium-sized enterprises in the Hashemite Kingdom of Jordan. He investigated the role of the Islamic finance formulas in supporting small and medium-sized enterprises in Jordan. He added that such enterprises face many funding-related problems. He found that Islamic finance modes are appropriate for the owners of small and medium-sized enterprises (SMEs) in Jordan. He found that Islamic finance modes contribute to fighting against poverty and unemployment in Jordan.

Methodology

As this paper seeks to examine the impact of Islamic financing on the performance of SME's in Lasanod Somalia, quantitative research design is adopted. The data were collected in a form of questionnaire from 148 SME's owners, managers and staff in Lasanod Somalia whom received investments from Islamic banks operating in Somalia. The respondent's responds were analysed using SPSS 21.

In order to meet the objective of this paper different statistical analysis were done such as descriptive statistics, correlation analysis and bivariate regression analysis in order to investigate the relationship between Islamic financing and SME's performance.

Analysis and Results

Demography Analysis

Table 1: respondent's age

Age of The Respondents					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Male	89	60.1	60.1	60.1
	Female	59	39.9	39.9	100.0
	Total	148	100.0	100.0	

Table 1 shows that 89 of the respondents which is equivalent of 60.1 percent were male whereas females were 59 which is equivalent to 39.9%.

Table 2: respondent's educational level

Level of Education					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	High School	64	43.2	43.2	43.2
	Diploma	30	20.3	20.3	63.5
	Bachelor Degree	48	32.4	32.4	95.9
	Master Degree	6	4.1	4.1	100.0
	Total	148	100.0	100.0	

The above table shows that 43.2% of the respondents were high school graduates followed by university graduates with diploma, bachelor degree and master degree whom were 30, 48 and 6% respectively. The vast majority of the respondents were university graduates 56.8 percent.

Table 3: Financing type

Type of Financing					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Murabaha	74	50.0	50.0	50.0
	Micro Finance	30	20.3	20.3	70.3
	Qard Al Hassana	44	29.7	29.7	100.0
	Total	148	100.0	100.0	

Table 3 shows that the most common type of Islamic financing which businesses receive from Islamic banks is Murabaha with 50% followed by Qard Al Hassana and Micro Finance with 29.7 and 20.3% respectively.

Table 4: the effects of Islamic financing on small medium enterprises

Effects of Islamic Financing on SME					
	N	Minimum	Maximum	Mean	Std. Deviation
Islamic banking has provided the required capital for my business	148	2.00	5.00	4.0541	.69775
Islamic banking has shared profits with me at the end of the loan repayment	148	1.00	4.00	1.8243	.83067
Islamic banking has improved my financial management skills	148	3.00	5.00	4.1351	.56723
Islamic banking has enhanced my accessibility to capital	148	2.00	5.00	4.0810	.64970
Islamic banking has improved my level of competitiveness on the market	148	2.00	5.00	4.0067	.65207
Islamic banking has facilitated the growth of my business market share	148	2.00	5.00	4.0278	.65310
Islamic banking has improved the sales growth rate of my business	148	2.00	5.00	4.0477	.65509
Islamic banking has facilitated better use of my resources	148	2.00	5.00	4.0678	.65710
Islamic banking has led to growth of my SME financially	148	2.00	5.00	4.0878	.65910
The management team is able to improve the financial profitability	148	1.00	5.00	2.6554	1.40317
Adopting Islamic banking interest free loans enables businesses to gain competitive advantage	148	3.00	5.00	4.1351	.56723
SMEs have gained market share due to interest free loans	148	3.00	5.00	4.1351	.56723
Valid N (listwise)	148				

The above table surveys the SME's stakeholder's perspective towards the effect of Islamic financing on the business performance. Table 4 indicate the SME's stakeholders believe that Islamic financing has positive impact of their businesses.

Vast majority of business owners and workers consider that Islamic financing has helped their businesses to gain a better market share and grow financially due to their access to Islamic free loans such as Qard Al Hassana.

Table 5: the influence of Islamic financing on business growth

The Influence of Islamic financing on Business Growth					
	N	Minimum	Maximum	Mean	Std. Deviation
Islamic banking has facilitated my accessibility to greater market	148	2.00	5.00	4.0541	.62447
Islamic banking has improved my compliance with regulatory provisions	148	2.00	5.00	1.8243	.63888
Islamic banking has provided me with the required capital for my business expansion	148	2.00	5.00	4.1351	.67508
Islamic banking has connected me with other businesses to share business experiences	148	2.00	5.00	4.0810	.62296
Islamic banking has offered me inventory loans to expand my business	148	2.00	5.00	4.0067	.67508
Islamic banking has ensured equitable access to credit for my business growth	148	2.00	5.00	4.0278	.63830
Islamic banking has offered me a different banking product from the formal banking products	148	2.00	5.00	4.0477	.74893
Inadequacy of funds affects growth of SMEs	148	1.00	5.00	4.0678	.72843
Islamic banking is a stimulant for financial inclusion for small business	148	2.00	5.00	4.0878	.62755
Islamic banking has enabled me to make higher incomes due to low interest rates	148	2.00	5.00	2.6554	.73659
Islamic banking has shown me good profitable investment to venture in.	148	3.00	5.00	4.1351	.56929
Valid N (listwise)	148				

Table 5 shows that Small and Medium business owners and workers believe that Islamic financing such as Murabaha, Micro Finance and Qard al Hassan play a key role in their business growth. It is believed that Islamic financing has led to SME's to become more

profitable by securing a higher income. Islamic financing has played a key role for businesses to expand to a new markets by providing capital and investments needed by the businesses.

Correlation Analysis

Hypothesis	Regression weights	Beta coefficient	R ²	F	P value	Hypotheses supported
H1	Islamic Finance - SME performance	.408	.238	45.650	.000	YES

Table 6: correlationCorrelations

		Financing	SME Performance
Financing	Pearson Correlation	1	.488**
	Sig. (2-tailed)		.000
	N	148	148
SME Performace	Pearson Correlation	.488**	1
	Sig. (2-tailed)	.000	
	N	148	148

** . Correlation is significant at the 0.01 level (2-tailed).

The above correlation table shows there is a positive correlation between Islamic financing and Small Medium Enterprises performance with 0.488 and the significance level is 0.00 which is way below 0.01. This demonstrates that the correlation is statistically significant and the correlation observed does exist in the population.

Bivariate Regression Analysis

Table 7: hypothesis

The hypothesis tests if Islamic financing carries significant impact on the performance of SME's in Lasanod Somalia. The dependent variable of SME's performance was regressed on predicting variable, the Islamic financing to test the hypothesis H₁. The above table shows that Islamic financing significantly predicted SME's performance, F (1, 146) = 45.650, p < .001, which indicates that Islamic financing can play significant role in shaping SME's performance (b=.408, p<.001). This finding indicates the positive affect of Islamic finance on SME's performance. Furthermore the R² =.239 shows that the model explains 23.8% of the variance in SME's performance

Conclusion and Recommendation

The aim of this study was to explore the impact of Islamic financing on the performance of SMEs in Lasanod Somalia.

The study sought to investigate the effects of Islamic financing has on business performances and found that Islamic finance helps the business improve their financial management skills through training, gain competitive advantage and market share due to interest-free loans, provide required capital, enhance the accessibility of capital, and help the level of competitiveness in the market with mean of 4.135-4.002. SME owners and workers believe that Islamic financing improves their business performance and helps firms grow with

an average mean of 3.77 and 3.73 respectively. The study found out that Islamic banks play a key role in improving the performances and growth of SMEs in Lasanod Somalia.

The findings showed that Islamic financing helps businesses to grow. To examine the relationship between Islamic financing and SME growth correlation analysis was conducted. The Correlation analysis showed that there is a positive relationship between Islamic financing and business growth with 0.488 and a significance of 0.000. This validates that the correlation is statistically significant and the correlation observed does exist in the population. This means that Islamic financing improves the performance of SMEs in Lasanod Somalia. In addition, to test hypothesis H_1 , the dependent variable of SME performance was regressed on the predictive variable, Islamic financing. The findings suggest that Islamic financing significantly predicted SME performance ($F(1, 146) = 45.650, p.001$), implying that Islamic financing can have a considerable impact on SME performance ($b=.408, p.001$). This research demonstrates that Islamic finance has a positive influence on SME performance. Furthermore, the model's $R^2 = .239$ indicates that it explains 23.8 percent of the variance in SME performance.

SME owners obtain Islamic financing from banks to enhance their business capabilities. Islamic financing significantly predicted SME's performance, $F(1, 146) = 45.650, p < .001$, which indicates that Islamic financing can play a significant role in shaping SME's performance ($b=.408, p < .001$). Businesses that obtained financing from Islamic banks experience higher income and expand their market share.

As emphasized in many financial studies, SMEs operate with insufficient capital. In other words, working capital is the main problem of SMEs, thus proper capital management is vital for SME's to grow and expand their business. In this respect, it is very important for them to support their business financially by making use of Islamic Finance tools. As Islam forbids interest it is vital for SMEs to avoid taking loans with interest when seeking external capital. Besides SMEs should plan ways to increase their market share according to their financial strength.

This study focused on SME's in Lasanod Somalia and cannot be generalized by the whole country.

For further research it is recommended to compare the performance of companies operating in the same sector, using Islamic finance instruments, with the performance of companies that receive interest-bearing loans from conventional banks.

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