



Analysis on Islamic Banking Financing Difficulties for SMEs Using Musharakah and Mudaraba Financing Instruments

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Abstract :

The aim of this study is to identify and analyze the role of Musharakah and Mudaraba instruments using by Islamic banking in the limitation of SMEs finance gap, and what are the main difficulties face using these instruments, in this study we used the analytical and descriptive approach, on the form that enabled us to identify the reality and size of the obstacles that prevent the activation of Musharaka and Mudaraba instruments in SMEs financing by Islamic Banks.

As a result, we find that asymmetric information problem which distinguish the relationship between the Islamic bank and SMEs, is the main obstacle that limit the use of these instruments

Key Words: Islamic banks, SMEs, Musharakah, Mudaraba, asymmetric information.

JEL Classification : G32, G21.

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Introduction:

Small and medium enterprises (SMEs) play a major role in most economies around the world for what offer job opportunities, local development and value added to the national economy, for example, SMEs represent more than 99% of all European non-financial corporates and employ over 90 million people, and they also generate close to 60% of total gross value added (Ana Baata, 2019, p. 4) according to the world bank, SMEs represent about 90% of business and more than 50% of employment worldwide, formal SMEs up to 40% of national income (GDP) in emerging economies, world bank estimates 600 million jobs will be needed by 2030 to absorb the growing global work force and , most formal jobs are generated by SMEs which create 7 out 10 jobs (www.worldbank.org). For these and other reasons, SMEs are extremely important in developed and developing countries, but at the same time, despite of the great importance of SMEs, they suffer from many difficulties in access to funding resources, especially long term financing needed for starting, growth and expansion, because it is considered opaque and too risky enterprise.

Islamic banking can play a major role in helping SMEs overcome their financial problems the Islamic financial market, especially Islamic banks, knows a very



remarkable development. Today, almost 400 Islamic financial institutions in more than 70 countries are contributing to the Islamic banking and finance industry (Hssan, 2015, p. 20), because these banks offer various financing tools that suit the characteristics of SMEs, especially the problem of not having collaterals. Musharakah and Mudaraba financing mods or as known PLS (profit and loss sharing), are considered most important and suitable mode financing for SMEs, but the reality shows that these two instruments are not widely used by Islamic banks, and sometimes there is no use of theme, Islamic banks heavily used Murabaha and Ijarah mode, because it's easy and simple to apply and risk free.

So, what are the methods that can be adopted to mitigate the problem of using Musharakah and mudaraba in financing SMEs by Islamic banks?

I. SMEs and access to finance:

Many studies suggest that financing problem is the biggest challenge facing SMEs, due to their specific characteristics that make it difficult to obtain the necessary financing from banks or financial institution.

1. SMEs characteristics:

SMEs have the following characteristics that make it different from large companies:

- SMEs lack managerial capabilities to manage business effectively, this leads to an inefficient operations structure, weak financial reporting;
- SMEs operate in informal sector significantly;
- Banks are reluctant to lend to SMEs and perceive them as risky investments;
- Lack of information on SMEs, the lack of a credit bureau with adequate information on SMEs is a significant hurdle preventing banks from lending to them (Elasrag, Islamic Finance for SMEs,, 2016, p. 448)
- SMEs are regarded by creditors and investors as high-risk borrowers due to insufficient assets and low capitalization vulnerability to market fluctuations and high mortality rates (United Nations& Geneva , 2001, p. 3)

SMEs have more difficulties in accessing finance partly because their small size and lack of credit worthiness, due to the inefficiency of credit markets resulting from problems of asymmetric information, especially in developing economies where capital markets is not developed, in addition to regulatory frameworks undeveloped (Razali Haron, 2016, p. 393)

The financing problem is the most important obstacle faced by SMEs, SMEs face several challenges include the following (Hassan, entrepreneurship, Islamic finance and SME financing, IFSB 7th public lecture on financial policy and stability, 2015, p. 14) :increased transaction costs; lack of skilled human resources; Adverse legal and regulatory environments; insufficient access to technology; lack of market accessibility; lack of product standardization; insufficient bank policies that utilise movables collaterals; lack of information sharing between financial institutions; lack of financial literacy; insufficient branding strategies for banking products and services.



2. SMEs finance gap:

Finance gap is a term used to describe the financial situation of SMEs. The financing gap can be defined as the situation in which SMEs have reached their development stage, where all short-term funding sources were used, but they did not reach the level that allowed them to obtain long-term financing, either by financial institutions or by accessing the financial market (Bouharb, 2014, p. 117). OCDE considered that the SMEs financing gap is that SMEs find it more difficult to obtain financing from banks financial markets or other lenders than large institutions, the finance gap can be in innovative SMEs because they are considered new in the market looking for financing an innovative new product or service and their cash flows are usually negative, therefore, they pose a high risk to banks so that they cannot be evaluated in the same way for traditional SMEs or large enterprises (OCDE, 2006, pp. 2 - 3).

Fig. 1 : « SMEs finance gap volume» USD Trillion



Source: MSME finance gap, assessment of the shortfalls and opportunities in financing micro small and medium enterprises in emerging markets, international finance corporation, World Bank, OCDE, 2017, p 27.

According to the study carried out by OCDE, the volume of SMEs finance gap estimated at 5, 2 trillion USD, SMEs finance gap, is the difference between current volume and potential demand of funding. According to the following equation (IFC, 2019, p. 20)

$$\text{MSMEs finance gap} = \text{potential demand} - \text{existing supply}$$

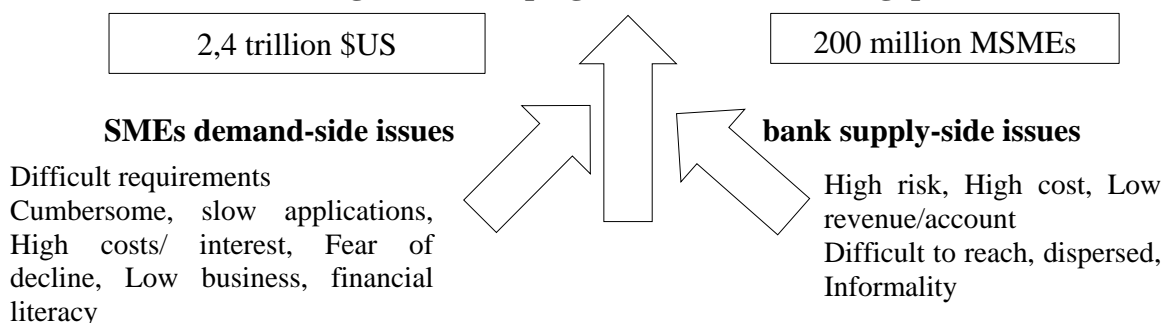
This study determined the volume of the finance gap through a study covering 128 countries, and considered that providing data is the big constraint to providing more estimates about the volume of the financing gap (International Finance Corporation, World Bank, OCDE, , 2017, p. 21) SMEs are less likely to be able to obtain bank loans than large firms; instead, they rely on internal funds, or cash from friends and family, to launch and initially run their enterprises. The International Finance Corporation (IFC) estimates that 65 million firms, or 40% of formal micro, small and medium enterprises (MSMEs) in developing countries have an unmet financing need of \$5.2 trillion every year (World Bank). SMEs finance gap in Africa was estimated at 140 Billion USD (World Economic Forum , 2019), access to a sources finance is a very important in creating an economic environment that allows institutions to grow and prosperity, according to a study about the obstacles to the growth of SMEs, the financial challenges they face came



in second place, while they ranked fourth among large enterprises, and these challenges are more in low-income countries, they showed that on average 43% OF SMEs see that rate of financing and access to financing or the cost of financing is the main obstacle they face, while in high-income countries only 11% of SMEs consider that access to finance as an obstacle for them, so the international finance corporation estimated that the size of finance gap for SMEs operating in the official framework outside the high-income organization for economic corporation and development (OCED) countries was estimated at 700 to 8550 Billion USD (Dalberg Global Development Advisors, 2011, p. 10). Most SMEs are informal, use their own money or money from family and friends due to weak formal credit culture, difficult to meet collateral security requirements, lack of knowledge about how to prepare business plans and keep accounting records, moreover, banks prefer to deal with government and large enterprises, according to OCDE, average of 28% of business have loan from a financial institution, and average 35% of business leaders identify financing as a major constraint to doing business (51% in Algeria, 44% in Mauritania, 25% in Jourdan and Oman) (Stevenson, Tackling Financing Obstacles in the MENA Region, MENA - OECD Working Group on SME Policy, Entrepreneurship and Human Capital Development, 2011, p. 10).

There are several reasons why banks are reluctant to grant loans to SMEs, as we see in the below figure:

Fig. 2: «Developing market SMEs credit gap»



Source: Alternative Data Transforming SME Finance, SME Finance Forum, GPFI, G20 Germany 2017, World Bank Group, May, 2017, p. 4. (data 2011)

There are two main reasons for SMEs finance gap (Grietjie, 2018, pp. 5 - 6):

- Information asymmetric, which would be ex-ante or ex-post transaction, ex-ante occur before funding, that make funding very difficult for SMEs, while ex-post occur after funding, that make funding more expensive through high transaction cost in loan and credit facilities;
- Inability of SMEs to access financial markets when they need external financing, and as a result, SMEs are more vulnerable to the consequence of the financing gap.



II. Islamic Banking Financing for SMEs:

Islamic banking product can play a major role to close the SMEs finance gap especially through the use of equity-based financing, Musharakah and Mudaraba by sharing profits and losses between SMEs financed and Islamic bank

1. Islamic banking concept:

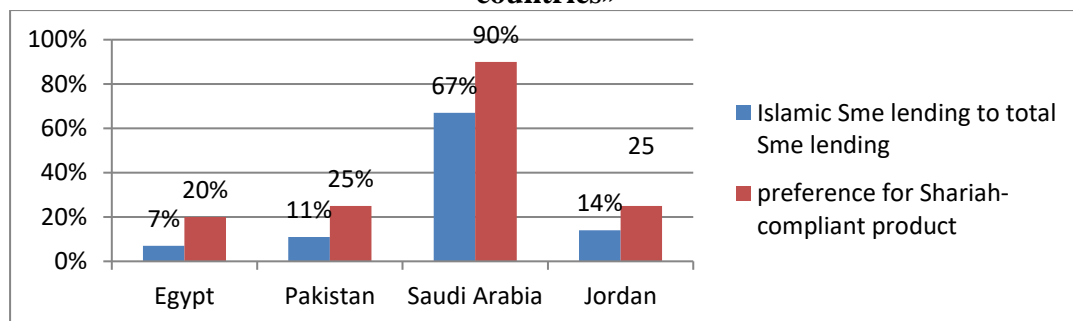
Islamic banking is a system of banking which abides by Islamic sharia Law, and its activities are bounded by the principals of Islam, one of the fundamental differences between Islamic banking and conventional banking is the prohibition of Riba, which refers to interest (Cham, 2018, p. 22), and other distinguishing feature of Islamic finance is risk sharing where the Islamic finance institution operate using profit and loss provision schemes (Abdelmuttaleb M.A, 2020, p. 138).

Islamic banks are financial institution that provides financing but in accordance with Sharia principles, which include the prohibition of interests and all transactions that do not conform to the principles of Islam, and finance only Halal sectors and activities.

These are the most important principals of Islamic banks (Sajjad Hussain Zafar, 2019 , p. 3): Prohibition of interest on transactions; Financing must be linked to real assets; Engagement in immoral or ethically problematic businesses not allowed, e. g: arms, manufacturing or alcohol production; Returns must be linked to risks.

2. Islamic SMEs finance gap:

Fig. 3: « Demand and supply side of Islamic SME financing in simple countries»



Source: leveraging Islamic finance for SEMs, Joint WB-ISDB G20 Islamic finance policy paper, Word bank finance and markets global practice, Islamic development bank Islamic research and training institute, 2015,p 8.

As we can see in this figure, the percentage of SMEs preference for Shariah compliant product estimated at 7% and the Islamic SMEs lending to total SMEs lending, estimated at 20% in Egypt and it is the lowest percentage, In Saudi Arabia the preference for Shariah compliant product is estimated at 67% and the Islamic SMEs lending to total SEMs lending is estimated at 90%, it is considered the highest percentage among other cases. It is estimate that about 32% of SMEs in the Middle East and North Africa (MENA) region in addition to Pakistan completely excluded from access to finance, due to the lack of products compatible with Islamic Sharia, many SMEs are looking for Islamic banking products to funding



their financial needs and don't want to resort to conventional banks because of their inconsistency with Islamic Sharia (World Bank Finance and global practice, Islamic development bank research and training institute, 2015, p. 15)

3. Musharakah and Mudaraba mods for SMEs

The main principal financing mod in Islamic Banking is profit and loss sharing (PLS) which is represented in Musharakah (profit and loss sharing) and Mudaraba (loss sharing) mods, these two types of Islamic financing considered as the best and suitable mod to finance SMEs, because it fits well with the SMEs characteristics.

3.1 Mudaraba:

Mudaraba is special type of partnership between two parties, where one partner the "Rabb- al – Mal", provides the capital and other having the skill to manage, the mudarib, runs the business on agreed terms and conditions (Minhas, 2014, p. 19). Mudaraba is a contract between two parties where one party has capital (Islamic Bank) and the another party (entrepreneur) has skills or an idea or a project that needs funding, these two parties meet through a Mudaraba contract that combines between capital and work, and profits are shared between the two parties according to the pre-agreed ratio and the loss is borne by Rabo –al-mal (Islamic Bank), and Mudarib (entrepreneur) loses his effort and his work only if he is not the cause of the loss , because it is one of the principals of Islamic Sharia, that each party loses only what it offered. For SMEs Mudarib is the most suitable Islamic mod financing, especially in the seed stage, where don't have the needed funding to start.

3.2 Musharakah:

Musharakah is a relationship between two parties or more, of whom contribute capital to a business, and divide the net profit and loss pro rata (Sekreter, Sharing of Risks in Islamic Finance, , 2011, p. 15). Musharakah is another method of co-financing, where Islamic banks contribute to a capital of project; profits and loss are shared between the parties according to the participation rate of each party, a contrary of mudaraba mod; both parties to the contract contribute to the conduct of the business. For SMEs financing by Musharakah is another suitable and preferred mode, in all stages, from seed stage to growth and expansion stage where SMEs needs mush funds.



Table 1: « Musharakah and Mudaraba SMEs financing »

Islamic financial product	Musharaka	Mudaraba
Definition	Is a partnership agreement established by two or more parties in which all partners provide capital to a joint venture to share its profits and losses, profits are distributed among partners based on pre-agreed ratios, while losses must be borne by the partners proportionate to their capital contribution.	Is a partnership between a capital provider (Rabu-ul-Mal) and an entrepreneur who is acting as fund manager (Mudarib), profits may be distributed at any pre-agreed ratio, whereas losses are borne by the capital provider.
Benefits for SMEs	<ul style="list-style-type: none"> - profit and loss sharing; - ability to receive a percentage of profits higher than entrepreneurs capital contribution; - useful for long-term financing. 	<ul style="list-style-type: none"> - profit-sharing only; - no need to contribute capital to the venture, in contrast to Musharaka; - ability to negotiate percentage of profits; - useful for long-term financing.
Opportunities	<ul style="list-style-type: none"> - serve Islamic-oriented SMEs and start-ups; - attract capital and excess liquidity for Islamic or conventional venture capital and private equity funds with parallel Shari'ah structures, increasing access to finance to SMEs and start-ups; - catalyze the entrepreneurial ecosystem 	<ul style="list-style-type: none"> - serve Islamic-oriented SMEs and start-ups; - attract capital and excess liquidity for Islamic or conventional venture capital and private equity funds with parallel Shari'ah structures, increasing access to finance to SMEs and start-ups; - catalyze the entrepreneurial ecosystem
Main challenges	<ul style="list-style-type: none"> - high equity risk, especially for Islamic banks, to deal with SMEs and start-ups; - exit scenarios through secondary markets and other channels; 	<ul style="list-style-type: none"> - high equity risk, since other counterparts have any capital contribution; - exit scenarios through secondary markets and other channels;

source: Authors 'own based on: leveraging Islamic finance for SEMs, Joint WB-ISDB G20 Islamic finance policy paper, World bank finance and markets global practice, Islamic development bank Islamic research and training institute, 2015, pp, 16 – 19.



III. Asymmetric information problem in Musharakah and Mudaraba contract

Asymmetric information problem considered as the main reason for avoiding the use of Mudaraba and Musharakah contracts in Islamic banks especially with SMEs, because of the high percentage of risk, for both, the nature of these contract and the SMEs specifics itself

1. Agency theory:

Before talking about asymmetric information, it is necessary to point out an essential point which is “agency theory”.

Agency problem exists whenever there are more parties than a single self-financed owner-manager in a business arrangement; the managers are the agents of the owners (obiya Athulla, 1995, p. 37) . Agency theory is related to the problem that occurs when cooperating parties have different goals and division of labor, specifically the agency theory focuses on the relationship in which one or more persons (the principals) engage another person (the agent) to perform some work on their behalf, therefore, the separation of ownership and control will result in decisions by the agent which are not always in the principal’s best interest and there will arise costs (agency cost) of bringing the agent’s behavior into line, especially, there are two problems that the agency theory tries to solve, the first is the problems that arises when the goals of the principal to verify what the agent is actually doing, the second is the problem that arises when the principal and agent have different attitudes toward risk, which can lead to different preferred actions (Landstrom, 1993, p. 205).

In the case of Musharakah and Mudaraba contracts, the problem of agency occur significantly in Mudaraba more than Musharaka, because in Mudaraba contact the principal (rabo- el – male) don’t involve in work and project management, so, there is a big separation between the principal (rabo – el – male) and the agent (Mudarib).

2. Definition of asymmetric information:

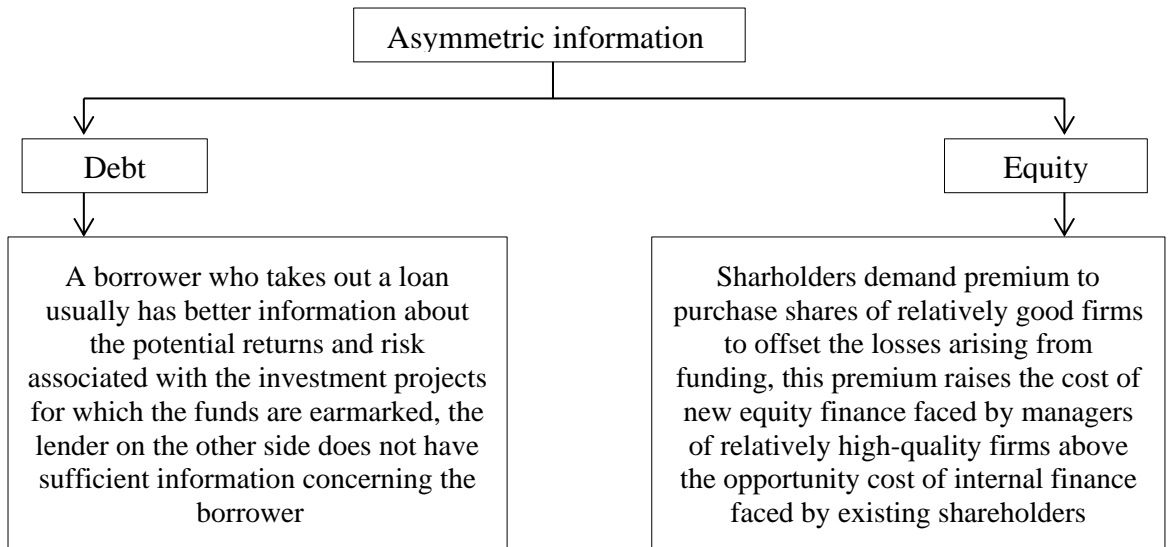
Asymmetric information is information that differs between parties to transaction situation in which consumers, suppliers and producers do not have the same information on which to base their decisions (Sekreter, Sharing of risks in Islamic finance, 2011, p. 18). Asymmetric information can be defined as information that is known to one party in a transaction but not to other (Kettel, 2011, p. 36)

By their position, agent (i. e. corporate managers) may know more about the present and future expected conditions of the firm than the principals or other outside investors (Norton, 1991, p. 163). We can define asymmetric information problem, as the case where all parties of a transaction don’t have the same information, or don’t share the right information for reason of interest conflicts, as a result of owner separation of project (agency).

We can find two cases of asymmetric information; the first one is for debt markets and the second one for equity finance, as shown in following figure:



Fig.4: « information asymmetric types »



Source: Brian Kettel, introduction to Islamic banking and finance, a John Wiley and Sons Ltd publication, United Kingdom, 2011, p, 36.

As we can see in this figure, we have two types of asymmetric information, the first one concerns debt markets, in this type a borrower always have the right information and the reality of the situation more than the lender, especially what concerns risks and return of the project financed, the second type of asymmetric information, concerns equity finance, in this type sharholders demand premium to purchase shares to offset the loss from funding, this concerning new equity which arise the cost of financing more the internal finance faced by existing shareholders, why, because there is hidden information meaning asymmetric information concerning new equity, holders of these shares don't know and don't have more and all information about the firm that issued the shares.

Asymmetric information creates problems before and after transaction, before transaction is known Adverse Selection, after transaction, is known Moral Hazard.

2.1 Adverse selection: adverse selection occurs before a contract, where the customer (borrower) willingly provides data and information that are false to get his application for financing acceptable by the bank, adverse selection occurs because banks don't have enough information about the reputation and the real financial condition of customers, this limitation is due to the lack of transparency among banks (Ahmed Rodoni, 2018, pp. 409 - 410);

2.2 Moral Hazard: unlike the adverse selection problem that can occur prior to a transaction, the problem of Moral Hazard appears only after the contract, so that the problem uses the finance obtained in unproductive or high risk activities which increases the likelihood of default, this is usually associated to the problem of agency this problem can be assumed up as a problem of behavior of the borrower, which the lender cannot predict, and it is more likely present in financing of SMEs compared to financing big enterprises because of their lack of financial



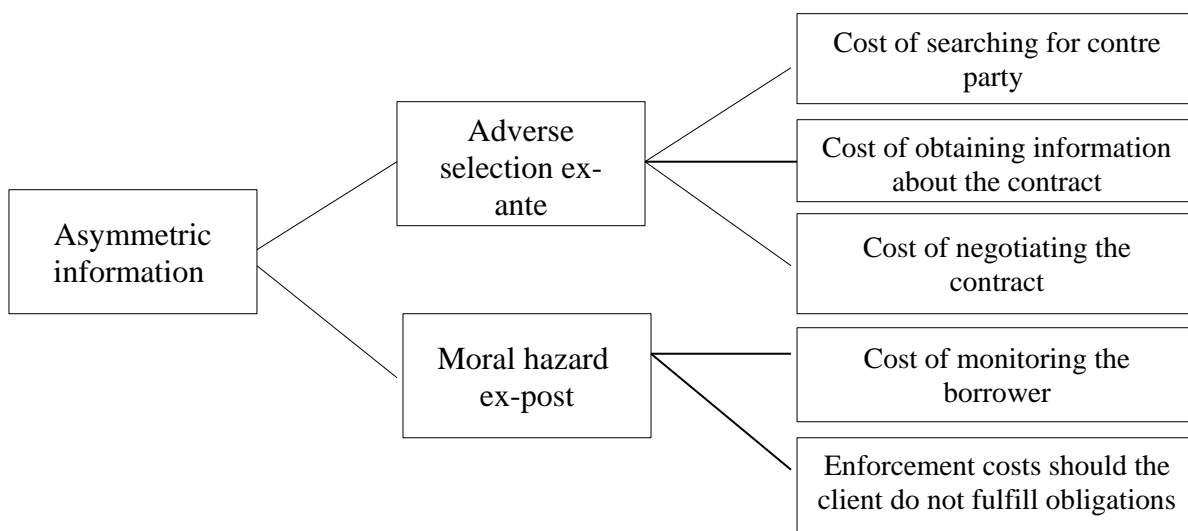
transparency, ownership structure and their owners concealment to the real purpose of the project (Mazeri Abdelhafid, 2019 , p. 18)

So adverse selection concerns the false information or uncompleted information provides by the agent before transaction, Moral Hazard, concerns the behavior of agent after transaction, where acts against principal interest.

3. Asymmetric information costs:

The problem of asymmetric information leads to many costs, costs concerning before transaction (adverse selection), other costs concerning after transaction (moral hazard), we can resume these costs in the following figure:

Fig.5: « information asymmetric costs »



Source: Abdelhafid Benamraoui, Yousef Alwardat, Asymmetric Information and Islamic Financial Contracts, International Journal of Economics and Finance, vol 11, N°1, 2019, published by Canadian center of science and education, p, 103.

In Islamic banking, especially in using “Musharakah” and “mudaraba” financing modes, the main problem that limits their application is asymmetric information, because there is a big separation between owners and managers, especially in “Mudaraba” mode.

In Islamic finance context, the main concept related to asymmetric information is “gharar” (Abdelhafid Benamraoui, Asymmetric Information and Islamic Financial Contracts, 2019, p. 99), Gharar in Arabic language means deceit, risk, fraud, uncertainty or hazard that might lead to destruction or loss (Uddin, 2015, p. 4), Gharar refers to a sale or a contract, which is considered either risky or unsafe, also, in Arabic language means deception as a result of lacking knowledge of the item being exchange between the parties (Abdelhafid Benamraoui, Asymmetric Information and Islamic Finance, 2019, p. 99)

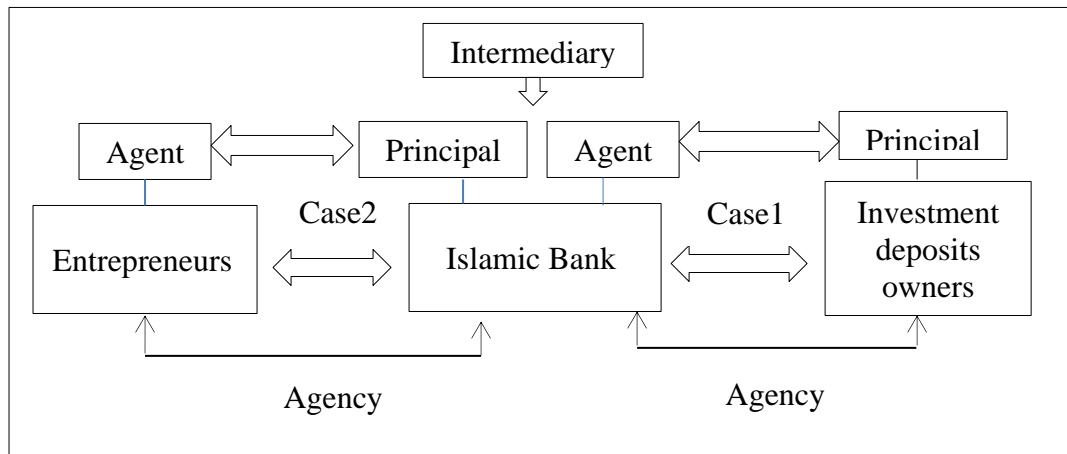
The most common factors that lead to Moral Hazard in Islamic banks are (Siddiqui, 2019, p. 15): the borrower using the funds for different purposes than



agreed with the bank, and not reporting the profit correctly and truthfully, and holding inside information used against the interest of the bank.

Islamic bank is an intermediary between depositors and entrepreneurs, so we have three parties have an agency relationship, the below figure illustrates this relation:

Fig.6: « agency relationship parties in Islamic banks »



Source: Author's own

We have two cases of agency problem, the first one is between investment deposits owners and Islamic banks, the second one is between Islamic banks and entrepreneurs, in the first case, investments deposits owners are the principal and Islamic banks are the agent, in the second case, the Islamic bank becomes the principal and the entrepreneurs are the agent, so there is a significant problem of asymmetric information in those two cases.

4. Reasons for Islamic banks avoid Musharaka and Mudaraba mods with SMEs:

The main reason for avoiding Musharakah and Mudaraba mods in Islamic banking especially with SMEs, is asymmetric information problem, because SMEs in general are not listed companies, this makes it characterized by a lack of disclosure and transparency, which leads to higher contract costs resulting from the search for information concerning SMEs. Moreover, these mods of contract are more risky than others, such as Murabaha and Ijarah; this risk can be transmitted to depositors, risk of loss, especially in case of early stage where the probability of project failure is very high.

(Irawan, 2007) consider that Islamic banks avoid PLS instruments, because there are very few credible institutional infrastructures to conduct common monitoring and to share information of credit rating on borrowers and entrepreneurs (information asymmetry) (Febianto, 2007, p. 8). Mudaraba and Musharakah, require thorough vetting of potential entrepreneur in the form of feasibility studies and exhaustive due diligence, both of which carry high transaction costs, an emphasis on standardization would result in increased information sharing, which would reduce redundancies and lower transaction costs (Hassan, Entrepreneurship,



Islamic Finance and SMEs Financing IFSB 7th Public Lecture on Financial Policy and Stability, , 2015, p. 31). Another reason is that the major funds in Islamic banks are obtained from the short-term deals (Sekreter, Sharing of Risks in Islamic Finance, 2011, p. 18), and at the same time, Musharakah and Mudaraba require long term deposits, this is a big problem facing Islamic banks in the application of PLS instruments.

We can resume these reasons in the bellow table:

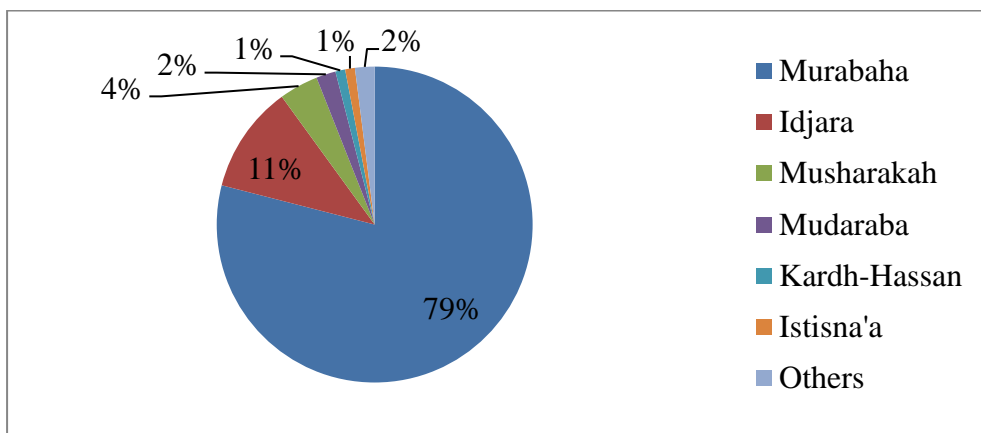
Table 2: « Reasons banks avoid pls»

Demand – side considerations	Supply – side considerations
PLS require keeping and revealing detailed records most businessmen do not like this	Due to moral hazard and adverse selection programs in all agent-principle contracts, there is a need for closer monitoring of the project this requires project monitoring staff and mechanisms, which increases the costs of these contracts.
It is difficult to expand a business financed through Mudharaba because of limited opportunities to re-invest retained earnings and/ or raising additional funds.	On the liabilities side, the structure of deposits in Islamic banks is not sufficiently long term. Therefore, they do not want to get involved in long term projects.
The entrepreneur cannot become the sole owner of the project except through diminishing Musharakah, which may take a long time.	PLS contracts require a lot of information about the entrepreneurial abilities of the customer. This may not be readily available to the bank.

Source: Irawan Febianto, Risk management in Mudharabah and Musharakah financing of Islamic banks, 2nd Islamic Economics Conference, Kuala Lumpur, Faculty of Economics and Muamalat, Islamic Science University of Malaysia, 2007, p, 9.

Statistics also indicate that the percentage of Mudaraba and Musharakah to total transactions is very small.

Fig.7: « Musharakah and Mudaraba within portfolio of Islamic banking »



Source : Valdislav V.Antropov& Irina A.Strelkova, Islamic banks in the global economy with special reference to in CIS countries, Journal of reviews on global economics, the word economy and global finance department, financial university under the government of the Russian Federatio, vol, 9, 2020, p, 96.



As can be seen in figure n°6, Murabaha represents 79% of the total transactions of Islamic banks, then, Ijarah which represent 11%, but for Musharaka represent only 4%, and Mudaraba only 2% of the total transactions, because Murabaha is very simple and easy transaction and almost risk-free, and doesn't require significant costs as Musharakah and Mudaraba. For example, the percentage of Murabaha instrument to total others instrument was estimated at 55%, Mudaraba at 5,3% and Musharakah at 6,4% (Central Bank of Sudan , 2018, p. 67) , while in Pakistan percentage of Musharakah was estimated at 20% plus diminishing Musharakah 33,6% and Murabaha was estimated at 13,5% (Islamic Banking Department State Bank of Pakistan, 2019, p. 4). Musharaka instrument considered as the most risky and complex in terms of making financing decisions, assessing returns and risks, for these reasons we find that most of Islamic Banks avoid these instruments, the table below shows the percentage of Musharaka Instruments comparing to Murabaha instruments in some Islamic Banks:

Table 3: « The importance of Musharaka compared to Murabaha in Islamic Banking examples from some Arab countries (2011-2016) »

	Murabaha	Musharaka
Abu Dhabi Islamic Bank	95%	4%
Kuwait Finance House	85%	0
Al Rayan Bank	85%	3.5%
Jordan Dubai Islamic Bank	85%	0
Jordan Islamic Bank	50%	0
Sharjah Islamic Bank	85%	1%

Source: Author's own, based on: Mahmoud Jamal Naji Mohamed Zagzoog, Participation Financing in Islamic Banks Between Reality and Expectations, The International Scientific Conference "The Role of Islamic Economics and Finance in Development", Alexandria University, 25-27 April 2018, p, 183.

The previous table shows the modest importance of participation (including Mudaraba) as a percentage of Islamic banking activity, which was estimated at 0% in some of these banks, given that the share of SMEs in the total financing granted by Islamic banks is minimal, most transactions are directed towards the less risky methods represented mainly in Murabaha, the following table shows the percentage of SMEs financing out of the total financing granted at some Saudi Arabian Islamic Banks:

Table 4: « The percentage of SMEs Financing in Some Saudi-Arabian Islamic Banks »

	2016	2017	2018	2019
Alinma Bank	1,86%	2,92%	3,22%	4,28%
Bank Aljazira	5,2%	4,9%	3,6%	2,3%
Bank Albilad	10%	13%	17,46%	16,55%

Source: Author's own, based on: the annual reports of Alinma Bank, Bank Aljazira, Bank Albilad 2016, 2017, 2019.



5. tools to improve using PLS instruments

The tools that can be adopted in decreasing the asymmetric information in Islamic banking when using Musharakah and Mudaraba instruments can be divided into three categories, the first one concerning Islamic banks, the second one SMEs and the third one concerning the role of government.

5. 1. tools concerning Islamic banks:

There are many tools or mechanisms can be used by Islamic banks to overcome the problems concerning using Musharakah and Mudaraba especially the problem of asymmetric information:

- Collateral may help to mitigate the bank's asymmetric information these collateral can ensure repayment to compensate for adverse selection risks (Sajjad Hussain Zafar& Danish Ahmed Siddiqui, Impact of Asymmetric Information in Islamic Financial Contract: En Empirical Analysis, 2019, p. 4) ;

- Use of incentive can overcome the problem of asymmetric information it will encourage the borrowers to provide the data of company, this incentive can save the Islamic financial institution from Moral hazard (Sajjad Hussain Zafar& Danish Ahmed Siddiqui, Impact of Asymmetric Information in Islamic Financial Contract: en Empirical Analysis, 2019, p. 15) because moral hazard is a problem incurs after contracting by providing false or shaded or incomplete information about the real situation of the company, so this incentive provided by Islamic banks can reduce this problem by creating trust and confidence between Islamic banks and SMEs;

- Screening and monitoring process, screening and monitoring are very important in reducing information asymmetric in Musharakah and Mudaraba instruments these process can alleviate the adverse selection problem, because the wrong selection of entrepreneur may cause the project to fail, the first one, Before contracting, concerning adverse selection to acquire more information about the entrepreneurs and the investment project, these information concerning conditions of the market, environment, the region where the resources are invested (Roly, Problem of Agency in Murabaha Contract,, 2019, p. 61) another element can be added, which is related to collecting personal information about the entrepreneur, for example information about the honesty and sincerity of the entrepreneur is very important in PLS instrument. The second one, Screening and monitoring process after contracting, concerning Moral hazard, Islamic banks should evaluate and monitor the entrepreneur's visions, objectives, market strategy, financial strategy and production process throughout the execution of the contract (Roly, Problem of Agency in Mudarabah Contract,, 2019, p. 61), moreover, Islamic bank in PLS instrument should monitor the entrepreneur's compliance with the terms of the contract and the validity of the results by the project, whether profit or loss;

- The owners of investment deposits must accept the idea of a possible loss (but in reality almost no loss occurs, if the loss occurs, there are reserves set aside by the bank to cover this loss), because one of the most important principal of sharia'ah is that the reward sharing is related risk sharing between transaction parties;



- Islamic banks must provide incentives and encouragement to attract long-term deposits, which are used in Musharakah and Mudaraba instruments, because most Islamic bank's deposits are short-term deposits.

5. 2. tools concerning SMEs:

- SMEs should improve and enhance internal governance, by improving the standardization of financial system of the enterprises and information transparency, SMEs should offer effective financial reports with high quality and professionally (Liu, Analysis on Financing Difficulties for SMEs Due to Asymmetric Information, , 2014, p. 30) ;

- SMEs should give good business plan of the project financed from Islamic bank, business plan is very important because it represents the project, and on the basis of it, the quality of the business is judged;

- SMEs manager must be honest and trustworthy, especially what concerning the disclosure of the profits

5. 3. tools concerning the role of government:

- Act as strategic partner for Islamic bank to identify the potential SMEs, as SMEs are widely dispersed, the government can help the banks to identify the location of SMEs and the viability of the business, the government should have data base of SMEs in their region, if government can provide reliable data on SMEs, it will help the banks to lower its operational costs;

- The government can work together with academia to create innovative credit scoring for SMEs valuation; this gives Islamic banks the ability to assess the risks of the business (Huda, 2012, pp. 185 - 186);

- Developing the multi-level financial market (Liu, Analysis on Financing Difficulties for SMEs Due to Asymmetric Information,, 2014, p. 31), by sitting conditions that takes into consideration SMEs characteristics, such as, the minimum required capital and realized profits this gives an opportunity to SMEs to be a listed company, and as a result, SMEs becomes more transparency and more professional;

- Establish centers for training SMEs, for example training on record-keeping, how to prepare financing requests, and training on how to deal with banks (Stevenson, Tackling Financing Obstacles in the MENA region, MENA-OECD Working Group on SME Policy, Entrepreneurship and Human Capital Development,, 2011, p. 13) this can improve SMEs management and be more professional and increase the ability to disclose.

- Creating an enabling environment, by adapting financial regulations that take into consideration the features of Islamic finance and don't disadvantage Islamic banks, for example, capital requirements for banks should be adapted to account for Islamic finance's risk-and-profit sharing model- which allows for some loss-bearing by investors and reduces risk weights applied to equity-like financing (Elasrag, Islamic Finance for SMEs, 2016, p. 449);

- The government should provide advisory services for SMEs, because a majority of them don't have sufficient knowledge about finance and management, business skills such as financial modeling, future planning and forecasting (Hussein Elasrag,



2016, p. 451), this advisory service can improve financial management and therefore will can provide financial reports according to required standards and quality;

- Fundamental role of the government is to provide efficient regulation and supervision of the financial sector by creating efficient regulatory framework, for example risk-sharing arrangements can increase lending by lowering the amount of collateral that SMEs needs to pledge to receive a loan because the guarantor provides part of the collateral, than a credit guarantee can allow higher risk borrowers to receive a loan (International Finance Corporation & World Bank & OCDE, 2017, p. 43);
- fostering the availability of credit information by improving corporate accounting and supporting information sharing between parties including lenders and utility companies (International Finance Corporation & World Bank & OCDE, 2017, p. 44)
- The government should provide tools that can help Islamic banks to proof infringement and default of Mudarib (SMEs), in order to bear the resulting losses, by setting strict laws for this.

Conclusion:

We have covered in this paper the importance of Musharakah and Mudaraba instruments offering by Islamic banks for SMEs, and the main difficulties they face in using these instrument, and how to mitigate these difficulties. Musharakah and Mudaraba are very important Islamic instrument that can be used to mitigate SMEs finance gap, but the reality shows that these instruments are not used at the required size, because are too risky and SMEs don't meet the required conditions. Through this research, we came to the following results:

- SMEs suffer from many difficulties that make it very risky enterprises;
- There is a significant SMEs finance gap for both, conventional and Islamic Finance;
- Musharakah and Mudaraba instruments represent only 4% and 2% of the total instruments offered by Islamic banks, and Murabaha represent 79% which is the most instrument used because it is easy and simple to use and risk free;
- We can consider that government is the most important factor that can play a significant role to improve and accelerate the Islamic banking finance for SMEs in general, and PLS instruments in particular, with the laws and legislations can provide the necessary protection to all parties, whether, Islamic banks, depositors owners and SMEs;
- Asymmetric information is the main problem that limits the use of Musharakah and Mudaraba instruments;
- Islamic banks avoid PLS instruments with SMEs to protect depositors' funds.

To improve and accelerate the use of PLS instruments in Islamic banking with SMEs, we can propose these suggestions:

- Create Islamic capital market for SMEs with special listing requirement commensurate with SMEs characteristics;



- Training and Formation of SMEs owners and managers on how to carry out the disclosure process and keeping accounting records and how to deal with Islamic banks, the role of training and formation is a function of government;
- Create Islamic investments institutions specialized on Musharakah and Mudaraba deals only with SMEs, which gives her the necessary experience, especially with regard to requirement and conditions of the market and feasibility study of the project, and the ease of accessing the necessary information;
- To try to avoid the risk of default , Islamic banks should vary investment and the kind of SMEs financed , and offering sukuk of Mudaraba and Musharakah compatible for young savers directed to small business financing;
- Carry out promotional campaigns to attract depositors who accept entering into the field of Mudaraba and Musharakah;
- Islamic banks, depositor's owners and SMEs should realize that they deal with Islamic instruments require honesty and truthfulness, because are principals of Islamic laws, not only because PLS instruments or Islamic banks are efficient and effective.

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