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Islamic Banks and the Development of Halal-Manufacturing SMEs in Malaysia

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ABSTRACT

The aspiration of the government to make Malaysia as one of the world's *halal* hubs is a vision that every sector of the economy should give due attention. This is particularly important owing to the fact that more than one third of the world's consumers are muslims and indeed, as the term *halal* connotes *halal* products are not merely muslim's products but the best consumable products to everyone living on earth. One of the vital sectors that should be given prior attention in promoting the production of *halal* products is the small and medium-sized enterprises (SMEs) as these particular enterprises constitutes the majority of business establishments in Malaysia. In the course of promoting such products, not only that sufficient fund should be available but the fund itself should be of *halal*-based as well. And of course Islamic banks should play a significant role in providing such funds so as to ensure that *halal* concept is implemented wholly to conform to the spirit of Islam. Besides, such holistic approach is necessary to materialize the attainment of *maqasid-al-shariah* (the objectives of *shariah*) in economy. This paper aims to discuss the issue with a focus being given to the role of Islamic banking in promoting the production of *halal* products hence realizing the objective of turning Malaysia into a distinguished *halal* hub in the world. An overview of the existing Islamic SME-financing and recommendation for further development of such financing will be given premier attention.

JEL Code: **G21-**Islamic Banks, Islamic SME-financing, *maqasid al-shariah*

INTRODUCTION

The promotion of *halal* products has been widely propagated among muslim countries in general and Malaysia in particular upon realizing the growing awareness of *halal* products and services beyond *halal* food and the increasing demand of such products worldwide. Global muslim population alone had been around 1.6 billion and is expected to increase to 3 billion by 2010 (SME Annual Report 2006). And, growing awareness among many especially non-muslims to have healthy and functioning food would enlarge the potential of *halal* products if they were to be considered. Indeed, the urgency to increase the production of *halal* products is even alarming as many recent scientific findings indicate that a significant amount of consumable goods is not suitable for human consumption. Some are even hazardous to health as they contain carcinogenic elements that may expose consumers to cancer. Others are just junk foods that give benefit to no one (CAP 2006, PPIM 2007). As for services, many are found un-Islamic. Banking and insurance services for example, contain prohibited elements such as interest (*riba'*), *gharar* or *maysir*.

The concept of *halal* in *Qur'anic* term refers to permitted, allowed or lawful, the opposite of it is *haram* or forbidden (Che Man, Bojei, Sazili and Abdullah, 2007). And the prophet (peace be upon him) clearly mentioned that; "Indeed whatever halal is clear and whatever haram is clear, and whatever in between is syubhah.."[2]. In Islam, everything is considered *halal* (lawful or permissible) unless the opposite law (*haram*) on such thing is found in the *Qur'an* or *Sunnah* (Al-Bugha and Misto, 1998). Hence, *halal* is applicable to every single aspect of human life inclusive of food products, non-food products as well as services. With regards to food, Allah (SWT) made it clear that (in translation); "O mankind, eat of what is lawful (*halal*) and good (*thoiyyiban*) on earth"[3]. The term *thoiyyiban* refers to any food that is good and wholesome (safe, hygienic, nutritious and high in quality). Thus, consumable food in Islam is permissible and wholesome food which was produced according to the strict rules of *shariah* (Islamic law).

Being one of the renowned examples of modern developing muslim countries, Malaysia's aspiration to become International *Halal* Hub by the year 2010 is timely and highly commendable. Economically, huge potential of global market for *halal* products is an opportunity that the country should not unleash as it could give a promising monetary return to her. This is particularly so as the present annual entire value of global *halal* trade had reached USD2.1 trillion (RM7.98 trillion) in 2006 and is expected to increase with the increase of muslim population globally (SME Annual Report 2006). The size of food sector alone globally worth RM570 billion and in Malaysia, investment on food manufacturing is estimated to increase at an annual gross amount of RM1.6 billion per annum over the period 2006 to 2020[4]. Strategically, Malaysia has an advantage as her location within Asia Pacific region would allow for strategic international trade among muslim countries and non muslim countries as well. In addition, Malaysia's success in outlining *halal* certification procedures and implementing a single *halal* standard[5] (MS1500: 2004) throughout the country could be a strong basis to justify for the development of *halal* manufactured products.

In realizing the dream, the government had outlined several strategic planning laid out in the 9th Malaysia Plan and the 3rd Industrial Master Plan to expedite the development of *halal* industries in the country. Leading the way is the setting up of *Halal* Industry Development Corporation

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[2] The hadith is narrated by Imam Bukhori and Muslim. The term syubhah refers to anything that is unclear of its halal status, hence should be avoided.

[3] This is the translated verse of the Qur'an, chapter 2: 168.

[4] Refer to http://www.foodbizmalaysia.com/

[5] Recent application by neighboring countries such as Indonesia, Singapore, Thailand and Philippine to adopt Malaysia's single halal standard is a positive development in accelerating the realization of International *Halal* Hub by the year 2010 (Mingguan Malaysia, 29th June 2008).

(HDC) in 2006 to coordinate local industries as well as to promote *halal* products in international market. Efforts have been taken to promote halal products locally and internationally through MIHAS[6] and Halal Avenue[7]. Other plans underway are the set up of HalMart (*halal* retail outlet) across country and *Halal* Parks[8] in strategic locations.

One very important sector that could play a significant role in realizing the country's dream is the small and medium-sized enterprises (SMEs)[9] as these enterprises dominate food and non-food industries in the country. And of course, the essential element without which the SMEs could not commence or further their operation is the availability of finance. In this regard, Islamic banks should become a leading role in providing Islamic SME-financing so as to ensure that the holistic *halal* concept is truly applied and the objectives of *shariah* (*maqasid al-shariah*) could then be realized. This paper attempts to dwell into the matter with a focus being given to the available Islamic SME-financing and its related issue.

ISLAMIC BANKS AND SME-FINANCING

In the course of discussing the role of Islamic banks (IBs) to help promote the development of *halal*-manufacturing SMEs, there is a need to have a glance on the background of IBs as well as their philosophical foundation. The following sub-sections will look into the matter.

Background of IBs in Malaysia

The offering of Islamic financing facilities in Malaysia was earmarked by the presence of the first Islamic bank namely Bank Islam Malaysia Berhad (BIMB) in 1983. Tracing back at the history of Islamic bank will tell us that the establishment of the first Islamic bank was in fact initiated by the Bumiputera Economic Congress in 1980. The Congress passed a resolution which required the government to allow Pilgrims Management and Fund Board (now known as Tabung Haji or TH) to establish a modern Islamic bank in Malaysia. The demand was intensified when the participants of a National Seminar on the "Concept of Development in Islam" passed another resolution, urging the government to pass special legislation that would allow the setting up of a new bank based on Islamic principles. In response to that, the government had set up a committee led by the late Tan Sri Mohar Badiozaman, to conduct feasibility study. After a two-year study, the much-awaited bank i.e. Bank Islam Malaysia Berhad (BIMB) was established in 1983 under the legislated Islamic Banking Act 1983.

The setting up of BIMB marked the beginning of the government commitment to have Islamic banking system parallel to the conventional system (dual banking system). As what the then Prime Minister said in the launching of the bank; "This is the first step in the larger concept of an Islamic economy…the beginning of the effort to assimilate Islam in the system of finance and economy in the country".

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[6] MIHAS or Malaysia International *Halal* Showcase, jointly organized by MATRADE and MECD, is an annual Halal exhibition held in the country as a way to promote Malaysia to become Halal Hub. Having a holistic approach to halal offering as a niche, MIHAS five-year showcases had recorded a rising sales worth more than RM214 million through business matching.

[7] Halal Avenues, organized by the Ministry of Domestic Trade and Consumer Affairs (MTDC), is another way of promoting Malaysia as Halal Hub. Unlike MIHAS, Halal Avenue is held overseas whereby Malaysian manufacturers and suppliers have the chance to have business deals with overseas buyers or retailers through business matching sessions.

[8] A total of RM50 million has been allocated by the government to set up Halal Parks in several strategic locations such as Pulau Indah Selangor, Pasir Mas Kelantan, Chendering Trengganu nad Padang Besar Perlis (Raja Adam 2006).

[9] It is quite unfortunate to note that *halal* statistic is currently unavailable. Hence, discussion on the progress and development of *halal*-manufacturing SMEs is yet to be explored. Refer to the Opening Speech by YB Tan Sri Muhyidin Yassin, Minister of MITI at 5th MIHAS on June 12th 2008.

The aspiration of the Malaysian government to have a comprehensive Islamic banking and finance system wouldn't be realized with the presence of a single Islamic bank. A complementary system, a wide range of products and instruments plus a large number of players are required. Thus, the Interest-free Banking Scheme was then introduced in 1993 whereby conventional banking institutions were allowed to offer Islamic banking products and services. A year after, the Ministry of Finance and BNM (Central Bank) set up Islamic Inter-bank Money Market to allow an inter-banks transactions on the basis of Shariah. It was then followed by the introduction of Islamic Capital Market in 1994 and the establishment of more Islamic banks in the country.

After more than two decades of Islamic banking in Malaysia, a lot of progress and improvements had taken place. Lots of products are made available to various customers in the market, ranging from deposits facilities to financing and syndicating of bigger amount of financing. More local-based Islamic banks such as Bank Muamalat Malaysia Berhad (BMMB), AmIslamic Bank, EONCAP Islamic Bank and CIMB Islamic Bank and foreign-based banks such as Kuwait Finance House (KFH) and Al-Rajhi Bank are set up to provide wider alternatives of Islamic financing products. Their operation is even enhanced with the introduction of Islamic capital market and Islamic Offshore Financial Center (IOFC) in Labuan through which the international capital could be tapped. Today, Malaysia had aimed to become among the international centers (hubs) of Islamic financial market with the conventional commercial banks and Islamic banks go hand in hand in offering Islamic banking and financial products. Known as Islamic Banking System (IBS or popularly known as Sistem Perbankan Islam – SPI), they offers products not only to the muslim customers but to the non-muslims as well.

Philosophical Foundation

As the IBs are operating within the framework of Islamic law, it is expected that the banks should have the philosophy different from that of the existing conventional system. The philosophy should therefore, in line with the divine guidance of the *Qur'an* and the *Sunnah*. The *Qur'an* is Allah's revelations to the prophet Muhammad (p.b.u.h) that contain all basic principles, rules and regulations encompassing all human activities inclusive of business and finance. The *Sunnah* refers to the life of the prophet which reflects the way of life and behavior as required by the Almighty Allah as prescribed in the *Qur'an*. Being the second source of Islamic law, the *Sunnah* explains the actual practice of the requirements in the *Qur'an* by way of giving true examples. In other words, the *Sunnah* contains the rules deduced from the sayings (*hadith*), actions and approvals of the prophet either in specific pronouncement or action or in his approval of someone else's action or practice.

The principles of business and finance outlined in the two primary sources are mostly general in nature, and certain rulings which are sufficient to explain issues and problems then may no longer sufficient to handle the upcoming problems. In this connection, Islam recognizes individual reasoning (*ijtihad*) through devout and careful procedures to derive appropriate rulings in order to solve the problem at hand. Thus, in addition to the two sources of law, there are secondary sources namely *ijma'* (consensus) and *qiyas* (reasoning by analogy). This is where the flexibility and relevancy of Islamic law comes in and this is where business and finance find room for further enhancement and innovation within the ambit of Islamic law. The authority to such resort to the secondary sources is attributed to a *hadith* of the prophet (p.b.u.h) when he appointed Muadz ibn Jabal as governor to Yemen.

The *Qur'an* has made it very clear that trade and commercial activities (bay') are permitted and encouraged while *riba* (interest) is prohibited (Q, 2: 275-81). This revelations serve a very clear philosophical foundation of Islamic finance; that justice (*al-adalah*) and virtue must be uphold in managing business affairs whereas any form of unjustified enrichment such as *riba* (interest) must be avoided by all means. *Riba* is an Arabic word which literally means an increase, addition, expansion or growth. In *shariah* term, *riba* refers to the premium that must be paid by the borrower to the lender along with the principal loan as a condition for the loan or an extension on its maturity (Chapra, 1985).

Riba in *shariah* context is classified into *riba al-nasiah* and *riba al-fadl*. The term *nasi'ah*, which comes from the root word *nasa'a*, means postponement or delay. Therefore, *riba al-nasiah* refers to the additional time allowed to repay the loan by the borrower in return for the additional repayment on top of the loan. This addition can be in the form of fixed or variable percentage of the principal or absolute amount to be paid in advance or on maturity or any other positive return as a condition for the loan. Hence, there is no more room to argue that *riba* refers only to usury (excessive interest) and not interest (Al-Omar and Abdel Haq, 1996).

Riba al-fadl occurs when there is unjust exchange of commodity with commodity involving the six *ribawi* items as covered in the *hadith*[10] i.e. gold, silver, wheat, barley, dates and salt. Of the six commodities, gold and silver represent money while the other four represent staple foods. There are differences of opinion by muslim jurists as to whether *ribawi* items are restricted to only the six items covered in the *hadith*. The detail of this issue will not be covered here as a matter of relevancy.

The strict prohibition of *riba* in Islam is a way to establish justice in economic system and to eliminate form of exploitation and unjust practice. In a *riba*-based debt financing, the financier is assured of getting the principal loan and the positive return from the lending without sharing any risk of loosing while the entrepreneur, in spite of the hard work, is not assured of getting such return. This positive return on loan has no element of risk-sharing as the financier has the right to sell the collateral to recover the loan in the case of default payment. It is therefore a compulsion for the Islamic financial system to avoid any such element of injustice to happen in the system.

In Islam, man is a vicegerent (*khalifah*) of Allah as far as the management of wealth is concerned. The absolute ownership of wealth in the world belongs to Allah. In the *Qur'an* Allah says to the effect; "He is who created for you all that is in the earth...and when thy Lord said unto the angels; Lo! I am about to place a viceroy in the earth..." (Q, 2: 29 – 30). The wealth itself is a trust (*amanah*) for mankind. Man has been endowed with mental and physical capabilities to function as *khalifah*. Hence, as trustee of Allah, man should thereby utilize and distribute of the resources in conformity to His Prescriptions. The Islamic banks, as the trustee of wealth too, should therefore manage the financial resources according to the rules and prescriptions of Allah. The resources should not be kept idle as it is a form of wastage which is prohibited by the *Qur'an*. Therefore, any excess in financial reserve should be channeled to the entrepreneurs for productive purposes. And, the utilization should also be assured to lead to an efficient and equitable allocation and distribution of the resources.

Islam has advocated that the utilization of the financial resources should consist of a balance between individual right and the right of the community. Therefore, banks have to extend the financial resources under their care to finance projects and development for the betterment of the community. Besides, they are expected to perform social responsibility in the form of promoting social welfare programs and allocating more contributions towards the needy and the poor. Allah says to the effect; "And in their wealth and possessions the right of the (needy), him who asked and him who (for some reason) was prevented." (Q, 51: 19)

[10] The *hadith* is; "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like may be exchanged in such a manner that they are equal measure for measure, payment being made from hand to hand. If anyone gives more he had dealt in *riba*. The receiver and the giver are equally guilty."

Islamic teachings also promote the spirit of brotherhood (*ukhuwah*) among mankind (*hablumunnas*). Everyone is equal in the eyes of God and no one is having more privilege over the other, except of course those who are god-fearing (*muttaqin*). It is therefore implied that every individual has equal right and opportunity in the access, allocation and distribution of resources endowed by the Almighty. Everyone is also responsible to care and help each other. As such, one's attitude towards other human being is not to serve his own self interest (Chapra, 1992). Instead, the spirit of cooperation and mutual conducts are very much promoted and encouraged. Having this spirit of brotherhood would allow for the attainment of social equality and dignity of men as *khalifah*. Hence, within this framework of brotherhood concept, individual partner in business inclusive of bank and other financial institution, should ensure that establishing justice in all conducts is uphold, the spirit of cooperation is inculcated, healthy competition is acknowledged and material well-being of the *ummah* is developed.

On top of that, IBs are imposed to conduct all their financing activities within the framework of the law of Islamic business transaction (*fiqh ul-muamalat*). This is to ensure the establishment of justice in contracts and the avoidance of unjust exploitative elements such as *riba*, uncertainty elements (*gharar),* gambling (*maysir*) and speculation. In this regard, the Qur'an emphasized the demand to uphold justice; "O ye who believe! Stand out firmly for justice, as witness to Allah, even against yourself or your parents or your kin and whether it be (against) the rich or poor for Allah can best protect both.." (Q, 4: 135). In another verse, Allah revealed that; "Allah commands justice, the doing of good and liberality to kith and kin, and He forbids all shameful deeds and injustice and rebellion. He instructs you that ye may receive admonition." (Q, 16: 90). These verses enforce the philosophy to uphold justice irrespective of status or blood relationship among man. In the contact of business, these verses means that the Islamic financial institutions must treat their customers equally and impose banks to distribute income and wealth equitably when fixing profit-sharing ratios with their investors and business partners (Haron and Shanmugam, 1997).

Above all Islam, as a system fundamentally different from the prevailing systems, has its goals (*maqasid al-shari'ah*) to be attained through the practice and implementation of *shari'ah* so as to realize *falah* or success of men's life here in this world and the world hereafter. These *maqasid* [11]or goals are the safeguarding of our essential needs (*al-dharuriyyah al-khams*) comprising the safeguarding of faith (*hifz al-deen*), the safeguarding of life (*hifz al-nafs*), the safeguarding of intellect (*hifz al-aql*), the safeguarding of progeny (*hifz al-nasb*) and the safeguarding of wealth (*hifz al-maal*) (Chapra 1992, Al-Omar and Abdel Haq 1996, Bakar 2007, Abozaid and Dusuki 2007). The safeguarding of faith is the utmost ingredient of *shariah* as faith puts human being to behave on a proper foundation (the straight path or *sirat al-mustaqim*). It also provides moral filter (Chapra, 1992) for the utilization, allocation and distribution of resources thereby the goals of Islamic finance i.e. to have a broad-based economic well being with full employment and optimum rate of economic growth, to attain socio-economic justice and equitable distribution of income and wealth, to have stability in the value of money, to have mobilization and investment of savings for economic development in an equitable manner, and to have effective rendering of services normally expected from banking system (Chapra, 1985) can be materialized. In the context of business conduct, this manifestation of faith may become a powerful mitigating system against all sorts of misconducts or moral hazard problems in business contractual relationship.

[11] *Maqasid al-shariah* reflects the ultimate objectives of the *shariah* revealed by the Almighty Allah. The objectives of *shariah*, i.e. the safeguarding of five essentials of live (*al-dharuriyyah al-khams*) are in fact constructed by Muslim jurists such as Al-Ghazali, Al-Shatibi, Ibn 'Asyur etc through *ijtihad*. See Bakar (2007) for further elaboration.

Underlying Concepts

The Islamic financial instruments can be classified into two broad categories; debt financing instruments and equity/profit-loss sharing (PLS) instruments (BIMB, 1994). The followings are the most commonly applied concepts of Islamic financial instruments in Malaysia.

Murabahah

Murabahah a cost-plus contract in which a customer who wish to purchase equipment or goods, request the bank to purchase the required item and sell it to him at a cost plus a declared profit. This type of financing is commonly used to finance working capital on a short-term basis as well as to purchase imported goods under Letter of Credit facility (BIMB, 1994).

Bai' bithaman Ajil

The term *bai' bithaman ajil* or *bai' muajjal* literally means sale on a deferred-payment basis (BIMB, 1994). The modes of this financing is similar to *murabahah* whereby the bank finance the purchase of assets or goods required by the customer at a price inclusive of cost plus profit or mark-up to be paid at a given date in the future on installment basis. *Bai' bithaman Ajil* is commonly applied by banks to finance assets such as vehicles, houses, shop lots and shares.

Bai' Salam

Bai' Salam, known also as *bai' salaf* or *bai' mafalisa*, is a sale contract in which advance payment is made to the seller for deferred delivery of goods (Hasanuzaman, 1992). In banking practice, *bai' salam* could be used to finance farmers, traders, importers or manufacturers who are in need of capital in advance but delaying the delivery of the goods.

Bai' Istisna'

Bai' istisna' is a sale contract that allow for an order to be placed with a manufacturer to make certain products where cash payment may be made in advance or on completion of the products (Al-Zuhaily, 1996). *Bai' istisna'* opens the way to a number of opportunities in financing including some form of future contract trading of processed commodities on short term financing scheme as it permits deferral of delivery as well as payment (Al-Omar and Abdel Haq, 1996).

Ijarah

Ijarah refers to a contract that involves the transfer of usufruct (a use of property or the service of a person) for a consideration (rental or wages) at a certain determined period (Aji Haqqi, 1999). One common form of *ijarah* practically used by modern Islamic bank is *Al-Ijarah thumma al-bai'* (AITAB) or lease purchase of assets such as plants and machinery.

Bai' al-Inah

Bai' al-Inah is generally known as a twin-sale contract; one contract is done on cash basis while the other is on deferred. In this sale, the seller (prospective debtor) sells an item to the buyer (prospective creditor) for cash which is payable immediately, then the debtor immediately buy back the same item for a greater amount to be paid in the agreed future period (Kamali 2002, Rosly and Sanusi 1999). Modern practice of *bai' al-Inah* is often found in Islamic overdraft, Islamic bonds, Islamic personal loan and Islamic credit cards.

Bai' al-dayn

Bai' al-dayn is the selling of debt by the debt holder back to the debtor himself or to any third party. The *shariah* permits the selling of debt at its equivalent amount by way of *hiwalah* (Rosly and Sanusi, 1999). This mode of finance is commonly applied in trade financing and factoring.

Qard Hassan

Qard hassan refers to the loan of fungible commodities, usually currency or other standard medium of exchange, in which the borrower is required to return the equivalent or the like of what he has received (Al-Omar and Abdel Haq, 1996). In modern practice of *Qard hasan* personal loan, it is a hybrid contract whereby *al-Inah* is combined to allow for a specific return to the financier.

Mudharabah

This is one type of profit sharing contract. Technically, it is a financing in which the owner of capital provides funds to the entrepreneur for productive activity or project (Al-Harran, 1993). *Mudharabah* (known also as *Muqaradah*) application can be found in project or contract financing.

Musharakah

Musharakah is a contract by which two or more persons agree to participate in a business concern, contributing either capital or labor and distributing among themselves any resulting profit or loss (Nawawi, 1999). In the case of Islamic banking, *musharakah* will enable the customer of bank, who has insufficient capital, to get extended financing in order to run the project.

Musharakah Mutanaqisah

One form of *musharakah* application that gains popularity is *Musharakah Mutanaqisah*. Here, the equity of either partner is diminishing reciprocally through out the period of financing till finally the ownership ends up at only one partner (diminishing *musharakah*). In modern practice, *musharakah mutanaqisah* is applicable to finance the purchase of shares (equity financing) and to finance asset acquisition on shared rental basis (Abdul Razak, Meera and Haron, 2006).

SME-Financing Products

As far as the financing to SMEs is concerned, lots of Islamic SME-financing products[12] are offered to the enterprises ranging from overdraft to asset and trade financing (refer Table 1 for detail). At present, the amount of financing extended to such enterprises had shown an encouraging increase from RM1.7 billion or 2.4 percent of total SME loans outstanding of the banking system in 2000 to RM10 billion or 9.6 percent in 2006 (SME Annual Report 2006). Individually, Bank Islam Malaysia Berhad (BIMB) does provide SMEs financing apart from

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[12] The SMEs in Malaysia are indeed very fortunate as the government provide a specific matching grant for the development and promotion of *halal* products. The enterprise may get matching grant up to 50 percent (or the maximum of RM150,000) of the approved project cost to formulate, test, acquire machinery/equipment, innovate or promote a specific *halal* products or services (SMIDEC 2006). Indeed, a total of RM20 million was allocated by SME Bank to finance Halal-Manufacturing SMEs to produce halal products and services.

their consumer financing products. In fact, Bank Islam Malaysia Berhad (BIMB) targets to double its annual financing to small and medium enterprises (SMEs) to RM200 million by its financial year ending June 30, 2006 from RM100 million in 2005 (The Edge Daily, 2005).

Table 1: Islamic SME-Financing in Malaysia

Products	Concepts	Amt/Period	Rate
Contract Financing-i	Mudharabah/Shirkah Musharakah Mutanaqisah Murabahah/Istisna'/BBA/Inah Ijarah/Ijarah muntahia bi Tamlik	2-4 yrs	Profit Ratio
Trade Financing-i *Bills for Collection-i* *Letter of Credit-i* *Trust Receipt-i* *Bill of Exchange-i* *Bank Guarantee-i* *Shipping Guarantee-i* *Accepted Bill-i* *Export Credit Refinancing-i* *Murabahah Working Capital Financing-i* *Bai' al-Dayn-i* *Inward Bill-i* *Outward Bill-i*	Wakalah Murabahah/Wakalah/Wadiah Murabahah Bai' al-Dayn Kafalah Murabahah/Bai' al-Dayn Murabahah/Bai' al-Dayn Murabahah Bai' al-Dayn	n.a	n.a
Industrial Hire Purchase-i	Al-Ijarah thumma al-Bai' (AITAB)	5-9 yrs up to 90% margin	n.a
Leasing-i	Ijarah	5 yrs up tp 90% margin	
Property Financing-i	BBA/Murabahah/Istisna Ijarah/AITAB	5-10 yrs	BFR + Bank Rate
Equipment Financing-i	Ijarah/AITAB/BBA	5-10 yrs	BFR + Bank Rate
Working Capital Financing-i	Murabahah Mudharabah/Shirkah	n.a	n.a
Cash Line-i (Overdraft)	Wadiah/BBA/Bai' Inah	up to 5 yrs	BFR + Bank Rate
Personal Financing-i	Bai' Inah/Qard Hasan	6-60 mths RM3k-RM50k	2% per month
Revolving Credit-i	BBA/Mudharabah	n.a	n.a
Share Financing-i	Shirkah	up to 50% margin	n.a
Bridging Financing-i	Istisna'	up to 60%	

		of development cost	n.a
Franchise Financing-i	Bai' Inah/BBA	Min RM20k Max RM200k up to 7 yrs	n.a
Rural Development Financing-i	Qard Hasan	Min RM20k Max RM500k 5-7 yrs	5% p.a.
Business Financing-i (Belia Niaga)	Qard Hasan	Min RM5k Max RM50k 7 yrs	4% p.a.
Direct Access Guarantee Scheme-i	n.a	n.a	n.a

Sources: BIMB, BMMB, CIMB Islamic Bank, KFH, EONCAP Islamic Bank, Hong Leong Bank, AmIslamic Bank, Public Bank, OCBC, Bank Kerjasama Rakyat Malaysia.

However, knowing the fact that SMEs constitute a major portion of business establishment[13], and considering the fact that the presence of IBs in Malaysia have been more than two decades, a merely 10 percent share of Islamic SME-financing is meager. This is particularly alarming since the government is promoting the development of Malaysia as a distinguished International *Halal* Hub in less than 2 years. As was mentioned earlier, the application of *halal* concept should not only in producing *halal* products but also *halal* in every single aspect of their production including the financing sources of the enterprises. This is to ensure that *maqasid-al-shariah* could be achieved in economy. Hence, the IBs should be aggressive in promoting Islamic SME-financing among entrepreneurs to help materializing the true concept of *halal* hub in the country.

Issue

Apart from the minimal market share percentage of Islamic SME-financing, one particular issue that has been discussed for long by scholars but still persistent is the application of PLS-based modes of financing. While the financing choices provided by banking institutions are abundant, the ranges of offered products are mainly debt-based. The IBs are no less different from the conventional banks as they would rather mobilize their funds to more-secured financings i.e. *Bai' bithaman Ajil* (BBA), *Murabahah* and *Al-Ijarah thumma al-bai'* (AITAB) though there are many other modes of Islamic financing particularly Profit-loss sharing (PLS) equity financing i.e. *Mudharabah* (profit sharing), *Musharakah* (profit-loss sharing), *Musharakah Mutanaqisah* (diminishing partnership) and as such that could be utilized competitively (Hamid and Ahmad 2001, Rosly 2005). These fixed mark-up modes of financing accounted for the majority of the total Islamic financing while the profit-loss sharing (PLS) modes of financing constitute only a minimal percentage of the total usage (refer Table 2) and indeed the percentage is decreasing year after year.

[13] According to the Census conducted by the Department of Statistic (DOS) in 2005, SMEs in Malaysia constitute 98.8 percent of the total business establishments in the country.

Table 2: The Percentage of PLS Financing as Opposed to Other Modes

Year	Mudharabah & Musharakah (%)	Other Modes (%)
2001	1.4	98.6
2002	0.7	99.3
2003	0.5	99.5
2004	0.5	99.5
2005	0.3	99.7

Sources: BNM Annual Report 2001-05

The abundant availability of such facilities is justified (from the financiers' perspective) on the ground that theoretically, smaller enterprises are perceived to be highly risky. However, over abundance of debt-based financing would not help in achieving the objective of equitable income distribution as this financing mode could only secure banks' return but not the return of the enterprises. Muslim scholars believed that banks should mobilize their funds more on the basis of profit and loss sharing (PLS or *uqud al-ishtirak*) type of finance as opposed to debt finance mode. And the argument is based on the fact that PLS is theoretically superior (Ariff, 2004) to conventional debt-based banking activities. In addition, the worse part is when the dominant use of debt financing would only portray that Islamic bank to be similar to the conventional interest-based banks.

Way Forward

The preceding discussion on the current state of Islamic SME-financing may lead us to conclude that the IBs in Malaysia still have a lot to be done as far as the development of *halal*-manufacturing SMEs is concerned. One way of doing it is by the IBs offering more PLS-based modes of equity financing. Contemporary Muslim scholars argued that the application of mark-up contracts should not be out of proportion. There should be a balanced mix between mark-up and profit sharing mode of financing (Ahmed 2002 and Ahmed 2005) as they have their specific purposes and advantages. The former modes are suitable for short and medium term financing of trade and consumption. The latter on the other hands, are meant for long term investment financing. In fact M. N. Siddqui (1973), among the earliest scholars of Islamic banking and finance, considerably argued that there should be a mix in the application of the two modes of financing. This is due to the fact that partnership financing could not meet the needs of entrepreneurs to have short term financial assistance for at least the following reasons; (i) it is difficult to keep an account of profit and loss on the capital invested in such a short period, (ii) no entrepreneur would like to forego part of his profit during his entrepreneurial activity solely due to his entering into a partnership and (iii) if loss is incurred (often in short period), entrepreneur will not be able to procure capital from the capital owner on the basis of partnership. Hence, while fixed mark-up modes are necessary, the PLS-based modes of financing are important to materialize the *maqasid*. This profit-sharing method is indeed strongly justified to be applied extensively in SMEs as it "keeps entrepreneurs morale high, improves their attitudes towards authority in the work place and motivates them to work harder for increased profit" (Mukhopadhyay and Pendse, 1983, p. 35).

One very good practical example of successful equity financing application is the *Shirkah* financing schemes of the Sudanese Islamic Bank (SIB). The successful experience of SIB in extending *Shirkah* financing to small farmers in Sudan has proved the fact that financing on the basis of profit and loss sharing is advantageous. The *Shirkah* financing of SIB covers three main fields namely trade, industrial and agricultural investment. In average, the financing accounted for 52 percent of the total disbursed funds and fall second after *Murabahah*. An evaluation survey of the schemes indicated that the introduction of Shirkah financing had increased the annual income of the farmers, increases the motivation of the farmers and helped the farmers to improve their standard of living. It was concluded that "partnership financing will have an effect on morale and quality of work that is generated by a more positive perception and greater feeling of responsibility as well as material motivation to enhance earnings which are linked directly to performance" (Al-Harran 1993, p. 343).

The proponents of fixed mark-up financing argued that PLS-equity finance inherently vulnerable to severe moral hazard problem. Hence, implementing such mode of finance would only put the banks at risk of losing thus affecting stockholders. Besides, if equity financing is to be applied, the costly nature of transaction costs (i.e. screening and covenants) and monitoring costs would only cause the banks to be uncompetitive. In spite of the cost issue, a practical example shown by Agricultural Bank of Iran (ABI) is interesting to highlight. A study by Sadr and Iqbal (2002) on the choice between equity and debt contracts indicated that investment on supervision and monitoring by ABI had resulted in an increase in the share of *shirkah* financing as well as an increase in the recovery rates under different modes of financing. And, it was found that the recovery rate was the highest for *shirkah* contracts as compared to other financings. The interesting facts about the study are the enjoyment of the bank in getting the benefit of supervision and that monitoring has been found to be a profitable investment. Indeed, Sadr et. al. (2002) highlight that additional monitoring costs of sharing contracts are offset by the benefits of supervision; (i) able to overcome moral hazards and adverse selection problems, (ii) monitoring and supervision would give greater knowledge of market condition and environment and (iii) through supervision, broader knowledge of comparative advantages of industry, region or locality in which the resources are invested. The experience of the two banks (and possibly that of other banks yet to be uncovered) could set a good example in enhancing the application of equity-based financing particularly to small and medium enterprises that involve (or yet to involve) in producing *halal* products.

CONCLUSION

Malaysia's dream of becoming International *Halal* Hub by the year 2010 is not ungrounded as many advantages are sided on her. Being a modern developing muslim country which other muslim countries are looking for, Malaysia's success in applying a single *halal* standard throughout the country is a good basis for the realization of such dream. Recent interest shown by the neighboring countries to apply the same standard is infact a positive sign for further accelerating the development of the Hub. Indeed, the government financial and non-financial supports to manufacturing-SMEs via grants, MIHAS, *Halal* Avenues, HalMart, *Halal* Parks etc would give further justification for such aspiration to be materialized.

In this regard, the Islamic banks (IBs) should play a leading role in assisting the *halal*-manufacturing SMEs as providing Islamic SME-financing will not only conform to the true concept of *halal* but also enable the banks to help materializing the objectives of *shariah* (*maqasid al-shariah*). In doing so, the banks should be aggressive in promoting competitive Islamic SME-financing products and introducing more easily accessible products to smaller enterprises. Efforts should also be given to the development of new financing products that comply both to the needs of the enterprises as well as the requirements of distributive justice in Islam. This could be realized by the introduction of more equity-based financing apart from the already abundantly available fixed mark-up modes of financing.

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