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EXPANDING FINANCIAL CAPABILITY OF SMALL AND MEDIUM SCALE ENTERPRISES THROUGH INTEREST-FREE BANKING

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ABSTRACT
On the 13th of August 2011 the Central Bank of Nigeria introduced the Islamic Banking system into the economic sector. Though non-interest banking has been practiced in the Islamic world for over three decades now, it is a new phenomenon in Nigeria; and while many have hailed it as a veritable source of business financing, especially SMEs, very few people understand the workings. This study reviewed the basic elements of this mode of banking and identified some similarities and differences between it and the conventional banking system. The study found that while there are many areas of similarities, there exist very major elements of differences such as the introduction of religion into economic issues and the issue of separate regulatory framework for the bank. Recommendations made included the need to bridge the gap between the NIFI framework and the BOFIA framework so that SMEs throughout the nation can benefit and improve their sources of finance using the non-interest system of banking.

Key Words: SMEs and Interest-free Banking

INTRODUCTION
The Islamic faith prohibits the charging of interest on borrowed money and receiving profit on a risk-free venture based on the command of the Quran. The moral principles espoused by the Islamic faith are reflected in the Islamic mode of banking, a practice which is at variance with the conventional banking practices that divorce religion from financial laws. According to Hanif (2011) the conflict of conventional banking with the Islamic religion gave the impetus to the educated and enlightened Islamic thinkers to jettison the conventional banking practice for one that is more at par with their faith.

The Central Bank of any nation is responsible for policing the monetary elements of that economy. As the apex bank, it acts as the government's bank as well as the banker's bank, (Afolabi, 2012; Usmani, 2002), and its major concern at all times is how to effectively unlock the potentials of the different segments of the economy to grow such sectors in other to unleash economic prosperity on the nation. Thus the addition of the non-interest banking system to the financial sector in Nigeria by the Central Bank of Nigeria (CBN) is meant to deepen and broaden banking activities in the country as well as stimulate national growth through providing more sources of finance for economic activities (CBN, 2010).

Small and Medium Scale Enterprises have been acknowledged as been very important for the economic development of any nation. According to Adelaja (2003), they account for over 95% of non-oil productive activities outside agriculture and are the greatest employer of labour, especially amongst the teaming youth. Yet, a multitude of problems militate against the SMEs in this goal to generate employment and development, chief amongst which is inadequacy of finance for capital projects, (Oyekanmi, 2003). This study therefore aims to review the mode of operation of the non-interest banking system with a view to exposing its potentials for financing the Small and Medium Scale Enterprises in Nigeria.

SME AND ITS IMPORTANCE FOR ECONOMIC GROWTH

Small and Medium Scale Enterprises (SMEs) can be found in any country in the world and in Nigeria, they are dispersed over the entire nation. A study by Fisseha (1991) estimated that SME's employ 22% of the adult population in developing countries, (Aremu and Adeyemi, 2012). They are important for any nation's development as they act to speed up national growth. They make up the sector of productive economy that use local material and ingenuity most, been especially prominent in the manufacturing, bakery, leather, furniture, textiles and construction products required for the construction industry. This sector of business operators is clearly identifiable by some characteristics which distinguish them from other forms of businesses. In defining what an SME is, the elements of employee size, amount of capital and level of technology form the basis of classification. However, Olorunshola (2003) asserted that each country decides on its definition of an SME in line with what such a nation wants to emphasize on its developmental strategy. The working definition used by Nigeria is the one given in 1991 by the National Council on Industry which is to be revised every four years. The revised definition given in 1996 states that *Small Scale Industry* are those with total cost, (including working capital but excluding cost of land) above N1 million but not exceeding N40 million, with a labour size of between 11 and 35 workers; while *Medium Scale Industry* was defined as those with total cost, including working capital but excluding cost of land, above N40 million, but not exceeding N150 million, with a labour size of between 36 and 100 workers. This definition of SMEs clearly defines them as businesses that have major issues with finance. Another trait of the SME is the lack of managerial sophistication owing to the fact that most of them owner-managed, though the owner may have little or no background of formal training in management. This usually means that SMEs tend to be an extension of the owner rather than been a separate entity of its one. This looming managerial presence tends to make for a lot of subjectivity in decision making, and prevalence of largely informal employer-employee relationship..

Like every other sector of the economy, the SME sector has a lot of challenges besetting it. Udechukwu (2003) asserted that while finance is obviously not the only problem militating against the development of the SME sector, it is certainly the most formidable. Investment in SMEs is relatively bulky because of the need for fixed assets such as land, civil works, buildings, machinery and equipment and movable assets. Moreover, empirical studies have shown that the incidence of the extra outlays required to compensate for deficiencies in the supply of the basic utilities in the Nigerian economy is relatively heavier on SMEs than large enterprises. While such extra investments have been shown to account for about 10% of the total cost of machinery and equipment of large enterprises, it represents about 20% of that of SMEs because of the absence of economies of scale. Despite the enormous advantages that this sector of the business world can bestow on any economy, it is usually refused capital funding by conventional commercial banks because it's very characteristic advantages also expose the high risks attached to its activities and since banks are profit-oriented businesses, they tend to refuse finance to this all-important sector.

Many suggestions have been made regarding sourcing finance for the SMEs, including the use of stock market, Development Finance Institutions (DFIs). NERFUND, Nigerian Social Insurance Trust Fund and part of the proceeds of privatization of the nation's publicly owned corporations. This writer believes that the funding project has to be approached from a multi-faceted angle and that the use of non-interest banking can be exploited as one of the facets for this.

CONCEPT OF NON-INTEREST BANKING

Origin of Non-Interest Banking

There are two claims regarding the origin of the non-interest banking concept. According to Abdel-Karin (2011) it emanates from Islamic principles prohibiting profiteering, speculation of currencies and sponsorship of businesses that are unlawful to the Islamic faith such as brothels and casinos. Hanif (2011) claims that in the latter half of the 20th century erudite Islamic clerics, led by Ahmad El Najfar, decided to jettison the conventional banking system for one that would be compatible with their faith and ended up with the first Islamic bank opened in the Egyptian town of Mit Ghamr in 1963. By 1970 during a meeting of all foreign ministers of Islamic countries held in Karachi, Pakistan this mode of banking was adopted by the Arabic states and it became the acceptable banking system in all Islamic nations, with banks opened in several Islamic countries under the aegis of the International Islamic Banking (IDB), (Ul-Hassan, (2007).

Eyieyien (2011) contesting the Islamic claims to the origins of non-interest banking, asserts that the practice dates back to around 1444 BC with its origin rooted in the Jewish practice of lending money to fellow Jews without charging interest (usury) in obedience to the biblical commands found in Exodus 22:25 and Deuteronomy 23: 19- 20. He claimed further that the first banks in modern times to be based on non-interest practices were operated by the JAK Members Bank of Sweden, a co-operative society (Jord Arbejde Kapital (JAK)) founded in Denmark during the Great Depression in 1931 and which later inspired a group in Swedes to develop a non-profit bank named Jord Arbete Kapital - Riksförening för Ekonomisk Frigörelse (National Association for Economic Emancipation) in 1965. Eyieyien (2011) equates modern non-interest banking with Venture Capitalism which is based on profit-sharing between the provider of capital and the user of same.

Nigerian banking laws recognize non-interest banking. Infact, Eyieyien (2011) asserts that Section 61 of the Banks and Other Financial Institutions Act of 1991 referred to a profit and loss sharing bank. Such a bank is expected to transact investment or commercial banking business and maintain profits and loss sharing accounts. The object/relevance, according to Afolabi (2012) is to give opportunity to artisans (small and medium scale entrepreneurs) to access finance without the burden of interest payment. The first bank to be licensed in Nigeria to operate in the profit and loss sharing mode is the Habib International Bank Limited (later called Bank PHB) licenced in 1992 and which started operations in 1999. Then the Jaiz International Bank Plc was granted licence in line with the NIFI provisions which, according to the immediate past governor of the CBN, Alhaji Sanusi Lamido Sanusi, was to carry on Islamic banking (Eyieyien, 2011).

Owing to the amended and reissued NIFI by the CBN on June, 2011 as "*Guidelines for the Regulation and Supervision of Institutions Offering Non-Interest Financial Services in Nigeria*" there are now two categories of these banks in the financial sector:

(a) Non-interest bank finance *based on Islamic commercial jurisprudence*. This generally recognizes profit and loss sharing and the prohibition of interest as a model for all banking transactions. In addition the specifically is against other non-permissible transactions which involve any of the following:
   - (i) Uncertainty or ambiguity to the subject matter of transactions; as well as the terms and conditions of the agreement;
   - (ii) Gambling speculation, unjust enrichment, exploitation/unfair trade practices, dealings in pork alcohol, arms and ammunition pornography and; other transactions, products, goods or services which are not compliant with the rules and principles of Islamic commercial jurisprudence

(b) Non-interest bank finance *based on any other established non-interest principle*, Afolabi (2012).

Understanding Non-Interest Banking

The intention behind the non-interest banking concept is create the platform for people with interest in conducting business (such as the SMEs) but without the right financial backing (both from their personal sources and available commercial banks) to get the requisite finance on a better term. The involvement of the provider of finance in the survival of the business, Eyieyien (2011) argued, is ensured when it can only be assured of making a gain (profit) if the business survives, hence the profit-sharing approach of the non-interest banking system. This continued interest in the performance of the business concern such as the SMEs would thus move the NIFI banks to provide services that conventional banks would not provide, such as professional financial advice, extension services and helping them comply with the laws of the land and of their particular industry. This kind of interest and support according to Afolabi (2012) will make the survival of the SMEs that much more certain. For any SME wishing to access this mode of finance, therefore, there are certain issues that it needs to understand about non-interest banking and what is expected of it and what it can expect of its bank.

El-Din (2004) claims that the basic mechanism of the Islamic bank is to accept are very similar with that of the conventional banks. They accept deposits from clients with cash in excess of their immediate needs and offer same to other clients with less finance than they need for projects and/or business they are dealing with. Any SME wishing to use this bank has to understand two main things about the banking mode: one, financing is asset-based and not cash-based. Financing under asset basis is known as *Murabaha* scheme of financing and has the capacity of inducing economic stability and creating linkages between the real sector and the financial sector; also, it creates utility through services and products and not by merely dealing in paper money.

Hanif & Iqbal, (2010) in Hanif (2011) categorized Islamic modes of financing into two broad categories of ***Sharia compliant*** and ***Sharia based***. Sharia-compliant products are those mean the modes of financing where return of financier is predetermined and fixed but within Sharia constraints. Sharia based transactions refers to the financing modes adopted by Islamic Financial Institutions on profit and loss sharing basis, including *Musharaka* (partnership in capital) and *Mudaraba* (partnership of capital and skill). Sharia-based mode of financing returns of financier is not fixed in advance rather it depends upon the outcome of the project.

El-Gamal (2000) asserts that under Sharia-based modes of financing, returns of financier are not fixed in advance; rather it depends upon the outcome of the project. However, loss is to be shared according to capital contribution. In other words, rewards for the financier are not a percentage of the sums used in the financing; instead, they depend upon the profits coming out of the business. The main financing tools used in the Islamic banking include *Murabaha* (cost plus profit sale), Ijara (a rental arrangement), Bai Salam (spot payment for future delivery), Bai Muajjal (sale on deferred payment), Istasna (order to manufacture) and Diminishing Musharaka (house financing); which are all Sharia compliant products, (Ul-Hassan, 2007).

Deposits as Financing Tool

Deposits are collected from savers who would be rewarded by a share in whatever profits are generated from the use of their deposits in accordance with the *Musharaka* and *Mudaraba* practice. This means that where reward is considerable, SMEs who partake in this stand to get a considerably higher reward than they would have in conventional banks. Where there is a loss, they would be better willing to partake in such loss.

Just as is the case with conventional banks, return on investment is higher on long-term deposits and lower for short-term deposits. In addition, the risk of loss and rewards on the investment is shared with the bank and because, not just being given a fixed percentage of the realized profits. This makes Islamic Financial Institutions (IFIs) to be more careful as only those IFIs that are rated as high financial performers are trusted with depositor's moneys. This can work in favour of the SMEs as they can have reasonable hope that their deposits are safe.

Financing and Investments

While conventional banks give loans for a fixed reward, IFIs cannot charge interest (*riba*) but can instead give interest-free loans known as *Qarz e Hasna*. The following describes the mode of financing that IFI banks can engage in:

Overdrafts/Credit Cards etc. IFIs cannot give cash facilities while financing SMEs as their laws do not allow trading in currencies/money for interest; instead the bank buys the asset for the customer. In the event of a client defaulting on payments for such asset, the remedy open to the bank is to sue such an individual/entity and ask for a fine to be awarded against it in its favour, (Usmani, 2002). With regards to credit card services, this is not allowed in the IFI banking system as an IFI bank cannot issue a credit card to its client to overspend its deposit with the bank with the understanding that he would pay back the overdrawn sums at an interest at a later date. What is operated is the debit card system, meaning the owner of the card must have money in his account to be able to use same.

SMEs usually go for ***short and medium term loans*** to meet their working capital requirements. Working capital is required by firms to invest in inventories and accounts receivables and meet the expenses. However, while conventional banks would provide cash to the SMEs, the IFIs would provide this *through participation term certificates* where by profit of a certain period on the inventories for which the short/medium term loans are required (e.g. quarter, six month, one year) is shared by IFIs on prorated, though this mode of financing is not as easy as using the short term loan method of the conventional banks. Therefore, firm seeking short-term facility from IFIs have to prove the viability of the project/business for which such loans are required to the satisfaction of investor.

SMEs usually need ***medium to long-term loans*** for purchase or building of fixed assets to engender expansion or for the replacement of obsolete or bad ones. For this, the *Murabaha, Bai Muajjal* and *Istasna* financing strategies come in very handy. These modes of financing are lease-based and they are very similar to conventional leasing except for the fact that they deal with the provision of assets and not physical cash to the client. The possible challenge to SMEs under this mode of financing would be the requirement that firms to be financed has to prove the viability/profitability of the projects/businesses to the satisfaction of IFIs in order to get the finance. Same facility is provided by IFIs under agreement of *Ijara*. *Ijara* (or leasing) is the transfer of asset or service for a consideration which may be rent (in case of hiring of assets or other things) and wage (in case of hiring of persons). This is very similar to an operating lease. Under *Ijara* asset is provided to customer for use without transfer of ownership for a specified period of time in exchange for agreed rentals. Ownership of asset can be transferred to customer through mutual agreement at the completion of lease term. All ownership risks are born by IFIs during *Ijara* tenure. Certain differences can be notices between the conventional system and the Islamic banking system. One of such is that rentals under *Ijara* are not due until the asset is delivered to the lessee for use. Also, additional rent cannot be demanded in case of default by the financed SME, although a penalty (if stipulated in original contract of lease) may be imposed. This penalty is not the income of IFI. Then during the period of a major repair to the asset which can disrupt its use by the financed firm, rent cannot be demanded by IFI. Also in cases where the asset is lost or destroyed IFI cannot claim any further installments from any SME using such products; hence all risks of ownership are born by IFI.

SMEs in the agricultural industry may do well to exploit the ***Agricultural Loans*** - which may be short-term or long-term - needed for seeds and fertilizers or to develop additional lands and purchase equipment. SME farmers who get such loans under the *Bai Slam, Bai Murabaha Musharaka and/or Mudaraba* terms would only be required to repay on the sale of the finished crops and would only be required to share profit realized on the sale and not interest on the sums used for the purchase of the items needed for agriculture. To get finance for land development and heavy equipment, however, farmers do need to convince the IFIs about profitability of the venture to warrant their taking such risks.

House financing is another area of finance that any SME looking to use this financing mode can take advantage of. Housing finance/Mortgages is the more secured form of financing for both conventional banks and IFIs. The Islamic financial system facility is provided through diminishing *Musharaka* which entails the bank purchasing the house (any other property) in a joint venture partnership with the client. The IFI then rents out its share in the property to the SME for an agreed fixed amount of bulk rent but which would be spread to cover the entire period of the repayment. As is obtainable with lease repayments on loan given by conventional banks, the client's payments to the IFI is made up of both principal and rent elements. When the final payment is made, the property is transferred to the client and ceases to be a rental. This system in effect combines elements of three types of accounting in conventional setting: joint venture, partnership and finance lease practices. The diminishing *Musharaka* financing model can create the incentive for banks to ensure that there is no property price bubble in the property market as any crisis would lead to a crash in property/rental prices which would spell doom for the SME as well as the bank, (Hijazi, & Hanif, 2010 in Hanif (2011)).

Why Nigeria should Encourage Non-Interest Banking

The forgoing shows that if properly understood and managed, the non-interest banking could prove to be a veritable source of financing SMEs for development of the economy. According to the CBN Deputy Governor, Moghaly (2011) the benefits of non-interest banking (Islamic Banking) include;

(1) deepening stabilizing the financial system and access to funds, especially for small businesses;

(2) would support the focus of the federal government in its bid to develop reliable props for the economy via development of the SME sector;

(3) encouraging artisans who usually have little collateral to meet loan terms of conventional banks so that via equity contribution, they may get all the heavy equipment they need for their work;

(4) encouraging worthy ideas to be incorporated in business practices; ideas such as fairness, transparency, accountability and consideration for the weak in the society (Abdel-Karim, 2011).

(5) provision of the infrastructure Nigeria need so badly needs by channeling redundant capital into gainful use and into energetic and young hands that are willing to contribute to the nation's growth and development but are prevented by lack of capital.

Challenges of Non- Interest Banking

The challenges before the non-interest banking relate to Nigeria being a secular state and the banking system having such a prominent tilt towards a particular religion. The CBN revised NIFI Framework is regarded with a lot of suspicion and seen as seeking to perpetuate an illegal, discriminatory and unconstitutional mode of banking on Nigeria (Eyieyien, 2011). Though non-interest banking has great potentials to develop the nation, as it is formulated now it cannot get the backing of the generality of the Nigerian population. Sanusi (2011) acknowledging this, identified some of the challenges to be:

- General public perceptions, particularly concerning the role and intendment of CBN
- Capital inadequacy
- Lack of Shariah governance institution.
- Shortage of adequate and qualified manpower and phobia on the part of other religion (Non-Muslims).

Besides these, other challenges have been identified in relation to appropriately operating the non-interest banking system to favour SMEs in Nigeria. Eyieyien (2011), Afolabi (2012) noted that these challenges include:

- Adequate preparation was not made before the banking system was introduced thus there is a dearth of knowledge, skills and technical capacity to regulate and supervise the products in the country. This relate both to what the banking is about, how it is done, who regulates it and what regulatory laws are to be abided by, etc
- Lack of robust and comprehensive legal guide and authorities to impose penalties on either the financier or the customer; and insurance to protect the banks in the event of unforeseen hazards that could impair the growth of this form of banking.
- Religious colouration attached to the non-nterest banking system makes it less attractive to those who do not belong to the particular religious sect and who see it as contravening Nigerian banking laws as contained in Section 39(1) of BOFIA.
- Establishment of a separate Advisory Council of Experts for the NIFI which are experts in Islamic law and not necessarily on Islamic Banking implies surrendering some of CBN functions to religious interests.
- Segregation of NIFI into two banks such that all interested parties cannot have access to both banks, is contrary to *Section 14(3)* of the Nigerian Constitution which insists that all Nigerians must be treated equally in everything.

CONCLUSIONS AND RECOMMENDATIONS

Non-Interest Banking is a veritable means of providing access to capital to the un-banked and those who would ordinarily not qualify for debt financing. It can provide leverage for Nigeria's economic development and must be encouraged. Even the bitterest critic of CBN concedes that non-interest banking is a good avenue to source for fund for SMEs. The concept completely removes the burden and risks of financing from the customer and places them on the financier. By not encouraging the release of cash to the customer but instead the provision of the needed capital equipment, it ensures that the SME operator would not be tempted to divert the finance to less productive activities and hence be unable to impact the economy. However, the problems facing its acceptance and use in the country are huge, the biggest of which relates to the introduction of religion into business in a country that has very many religious sects. That notwithstanding, however, the nation must take advantage of this opportunity to diversify its finance base for the SMEs. To this end, the following suggestions are made as a way of packaging the non-interest banking in a form that would be acceptable to all so that the SMEs can make good use of the opportunities it present.

- The CBN should have a uniform framework for all NIFI banks
- The bank rules should not be based on religion but on uniformly applicable banking principles of the BOFIA.
- Deliberate efforts should be made to educate the public, especially SME operators about the banking system and how they can take advantage of it.

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