Sustainable Supply Chain Finance Process in Delivering Financing for SMEs: The Case of Indonesia

Imronudin[1], Javed Ghulam Hussain[2]

[1]*Universitas Muhammadiyah Surakarta, Indonesia*
[2]*Birmingham City University, United Kingdom*

[1]imronudin@ums.ac.id
[2]javed.hussain@bcu.ac.id

***Abstract*— SMEs play an important role in economic development in every country. However, the growths of SMEs are hampered because of their difficulties in accessing external capital. In this context, the application of the concept of sustainable supply chain in the operation strategy of SMEs seems to be a very important function. This supply chain also covers all three aspects of sustainable development: business, environmental, and social. This study aims at investigating the experience of supply chain management in evaluating the worthiness of SMEs to improve operation. Qualitative method is adopted in this research because this method is appropriate to investigate the experience. Data will be collected by conducting in-depth interview to SC managers in Central Java. Data obtained from interview then analyzed using Interpretative Phenomenological Analysis (IPA) to describe and explain the experience of SC managers in evaluating and delivering financing for SMEs. This research found that there are three major themes emerging from the analysis. Those themes are 1) financing evaluation process, obstacles to accessing Islamic financing faced by SMEs, and decision making.**

***Keywords*—** *Supply Chain, Financing, Assessment Process, Decision Making, SMEs*

1. Introduction

Since the first inception of an Islamic Bank in Dubai in 1975 [1], the practice of modern Islamic banking (IB) has grown significantly. The assets of Islamic banks are grown continuously. Although Islamic banking was established (formally) in the 1970s, historically the practice of financial transaction based on Islamic law has been evolving since the 1960s. For example, Mit Ghamr Local Saving Bank was established in Egypt in 1963 [2]. At the same time, in Asia region, Tabung Haji is an example of Islamic financial institution operating based on Shariah compliance in Malaysia. This institution was built in 1962 and started operating in 1963 to help muslims to save their money for pilgrimage purposes [3].

Bank Muamalat Indonesia (BMI) is the first Islamic bank in Indonesia. It was established in 1991 and started its operation in 1992. Currently, there are thirteen Islamic Commercial Banks (BUS), twenty-one Islamic Banking Units (UUS), and 166 Islamic Rural Banks (BPRS) operating across Indonesia.

Since the operation of Islamic banks focus on equity and risk sharing, their presence and the growth provide an opportunity for the development of SMEs. Under profit and loss sharing mechanism, Islamic banks have a significant role to play in servicing small and medium enterprises (SMEs), because commonly SMEs lack collateral and track record. Thus, Islamic banks can serve as an alternative source of capital besides the existing conventional bank. It has been recognized by many scholars and supported by research findings [4-6] the difficulties of accessing capital from external sources, in particular for SMEs at the growth and development stage (Beck, 2007). To avoid long term risk, bank finance is often interested in providing short term loan for the purposes of working capital. Short-term finance such as an overdraft (OD) facility makes it difficult for SMEs to plan their firm's capacity and develop new competitive products.

SMEs are considered as a risky enterprise so that banks are not willing to provide them long-term loans. This is indicated by the fact that SMEs are often unable to fulfill bank requirements at the start of the loan application as they do not have a proven track record. Due to the lack of information and track record, banks demand large collateral to protect themselves against business failure. Unfortunately, SMEs are commonly incapable to provide sufficient collateral. Insufficient collateral, then, gives rise to a finance gap for SMEs (Beck et al., 2006). In fact, bank managers tend to rely on collateral to mitigate adverse outcomes in the case of business failure. Other policy to compensate risk is imposing relatively high interest

International Journal of Supply Chain Management
IJSCM, ISSN: 2050-7399 (Online), 2051-3771 (Print)

rates to SMEs. . Thus, SMEs encounter a double barrier to grow, namely the difficulties of accessing funds and the high cost of capital. The finance constraints faced by SMEs in Indonesia are not unique, research conducted in the UK and elsewhere report similar problems for SMEs [7].

It has been observed that SMEs, have an important role to play towards economic recovery and growth either in developed and developing countries [8-11]. In the context of Indonesia, SMEs play a significant role and make major contributions towards employment and GDP. The data of the Indonesian ministry of cooperative and small and medium enterprises shows that, including micro firms, there are 56,534,592 units of SMEs in 2012 and this represents an increase of as much as 2.41% from 2011. They are spread across Indonesia both in inner cities and rural areas.

The growth of SMEs in rural areas is likely to give real economic strength towards the national economic structure of Indonesia, because the majority of Indonesian people live in rural areas. Other important role of SMEs is that they have enabled individuals and groups to engage in self-employment and encourage others to take on entrepreneurship as an alternative to seeking a government job.

By 2012, the contribution of SMEs export, excluding oil and gas, reached to 166.63 trillion rupiahs ($14.157 billion), an increase of 14.06%. This increase shows that SMEs is becoming significant not only for domestic market but also for export. In addition, SMEs proved to be resilient to the economic crisis as evidenced in Indonesia during 1997/1998. The pivotal role of SMEs for economic stability and job creation is recognized by the Indonesian government. It was evidenced by the establishment of the Ministry of Cooperative and Small and Medium Enterprises.

Other commitment of Indonesian government to support SMEs is evidenced through its policy to promote SMEs. In 2013, the Indonesian government, through the ministry of cooperative and SMEs, budgeted 2.2 billion rupiahs ($ 186.9 million) to develop SMEs throughout Indonesia. The fund was allocated for the cooperative's program of one village; one product (OVOP). Each cooperative will receive a fund as much as 100 million rupiahs which is to be used to develop distinct products in every city. There are 70 distinct products which are developed through the OVOP program in central java [12].

Although it was recognized that SMEs have important role for the Indonesian economy, access to bank finance remains a big barrier as often they are considered not bankable [13]. Therefore, the presence of an Islamic bank enable them to fill the gap left by the commercial banks as the Islamic bank have financing schema namely shares risk and participates through the injection of equity into the business. Theoretically, under profit-loss-sharing (PLS) mode of finance, Islamic banks should be willing to share loss and profit with their entrepreneurs. This mode of finance overcomes the lack of collateral experienced by SMEs. Furthermore, this mode of finance encourages entrepreneurships as viable business proposals are supported without collateral. There is a close relationship between financier and the entrepreneurs that mitigate the information and collateral gap. In theory, Islamic banks evaluate the proposal on the basis of the prospect of the project to be financed rather than the amount of collateral. Thus, the evaluation of the feasibility of financing proposal should be founded on the soundness of the projects, not the availability of collateral.

The type of products and contracts offered by Islamic banks are of great benefit to SMEs, especially when it comes to accessing external finance. Islamic financial instruments, in theory and practice, it appears to meet the needs of entrepreneurs as an alternative to conventional banks. Use and application of Islamic finance can be illustrated through the example of a Salam contract that is used in the financing of cotton farms as practiced in America [14]. In addition, Islamic banks financing will benefit SMEs, particularly PLS base loans, because SMEs are not required to pay a fixed return on loans as it is the case with interest based loans. Using profit sharing, SMEs will only be charged if the entrepreneurs make profit. There are other forms of contracts which allow alternative forms of Islamic finance for SMEs depending on the type of the business [15]. Given the diversity and population size within Indonesia, Islamic banks have an opportunity to grow if it can design and develop an effective marketing strategy to reach potential entrepreneurs; it is possible for the market share of Islamic banks to grow higher than that of Malaysia.

Although Islamic banks serve both Muslims and non-Muslim customers, the Muslim population is more concerned with whether or not financial transactions comply with Shariah (Islamic law). Given the importance of Islamic banks, this study seeks to investigate the practice of Islamic banks in Indonesia in delivering financing for SMEs. As a new entity, Islamic banks attract the interest of many researchers.

Given the growth, acceptance and use of Islamic bank finance reported within Islamic and non-Islamic countries, there is a case to investigate Islamic bank financing for SMEs in Indonesia. This study examines the experience of Islamic banks in making lending decision for SMEs; the potential obstacles that might be faced by SMEs in accessing funds from Islamic bank which may have an impact on the development and growth of Islamic banks.

The aim of this study is to investigate lending practices, policy and access to Islamic bank finance by SMEs in Indonesia from the Islamic Rural Banks point of view. The objectives of the research is to empirically investigate the experience of Islamic banks in making lending decision for SMEs and provide recommendations for policy makers and practitioners.

This paper is structured as follow. After discussing the background of this research in section 1, the paper is proceeded to review the relevant literature in section 2. The discussion of the research method adopted in this research is presented in section 3. Section 4 analyses and discuss the finding of the research. Finally, section 5 concludes the finding of the research.

2. Literature review

Supply Chain Finance and Small Medium Enterprises Businesses

Generally misjudge their capacity to extend payment terms with their suppliers. They need to focus on financing opportunities which may increase the value of the firm, and mostly SMEs don't know how working capital can be optimized. SCF enables SMEs' to optimize their working capital both from internal and external point of view. A lot of research is going on SCF being an alternative financing tool for SMEs and how SCF can assist SMEs to achieve their goals by optimization of working capital.

The concept of an Islamic bank has evolved over fourteen centuries, as the Qur'an explicitly prohibited riba (interest) [16]. However, there is no concensus about the definition of riba so that Muslim has different interpretation about it. Some Muslims consider bank's interest is riba and unlawful, while others view that bank's interest is not. In addition, in the literature of Islamic banking, it was found various interpretations of riba and there are a number of definitions about it. To harmonize the IB practices, organization of Islamic Countries (OIC) have made an effort to develop standards to bring about consensus, which appears to be at the early stage of its development. Islamic financial institutions are regulated and committed to adhere to the principle of sharia (Islamic law), the percept of which are guided by the Quran and Sunnah (the practice and saying of the prophet Muhammad), ijma (opinion collectively agreed among sharia scholars), and qiyas (analogue) [17]

The earliest practice of an Islamic bank took place in Egypt with the foundation of Mith Ghamr Local Saving Bank by Ahmad Al Najjar in 1963. This bank received savings from their customers based on profit-sharing. This bank has a great acceptance in Egypt particularly from farmers and rural communities. Due to the political issues, this bank was finally closed in 1967 [18]. However, long before Islamic banks were practiced in Egypt , the theoretical edifice of interest free banking first took shape in pre-partition India after the 1930s depression [19]. The literature gained popularity in only some Muslim society because it was mostly written in Urdu. Maulana Sayyid Abu'l-A'la Maududi was a notable person who first articulated on the subject of IB in 1941 [20]. The other major contributor at the forefront of the development of Islamic economic was Sayyid Qutb, a prominent leader of the Muslim brotherhood in Egypt, and Muhammad Baqir al-Sadr in Iraq in 1960 by writing his most celebrated book on Islamic economics, "Iqtisaduna" or "Our Economics" [21].

2.2 SME and External Financing

Themes on access to finance for SMEs have attracted a number of authors to examine both in developed and developing economies [22-24]. Those researches focus on SMEs and their relationship and issues with conventional banks. They, generally highlight the difficulties of SMEs in accessing external financing which limits their growth. [25] argue that government should make policy which be able to motivate financial institutions to facilitate financial access for SME to support their growth [26]. They argue that the importance of developing SMEs is based on two premises '(1) SME are the engine of growth, and (2) market imperfections and institutional weaknesses impede their growth'. [27] conclude that the difficulties to access external financing are a main obstacle faced by SMEs to grow. Therefore, it is imperative to reduce the barriers to access finance. It has been suggested that small businesses are better than large firms in countries which have better financial institutions.

The financial constraint for SMEs is more severe in economies with under developed and weakened financial systems [28]. These are common characteristics of many developing economies, including Indonesia. The weaknesses of financial institutions lead to a high transaction cost. This circumstance couple with asymmetric information becomes significant factors that give rise to finance gap for SMEs, particularly in developing countries. Using samples of Spanish SMEs, [29] examine the correlation between financing constraints and SME investment. They conclude that trade credit is a predictor of cash constraint for investment. . This indicates that due to constraints, firms prefer to choose trade credit as due to the limited access to bank loans in comparison to unconstrained firms. Furthermore, [30] highlights the correlation between bank competition and SMEs financing and they found that market power increases firm financing constraints.

Although some authors argue that poor access to formal credit sources impede SME growth [31, 32] the opposite finding. They found no evidence that SMEs with better access to external finance grow more rapidly than those without such access. Instead of financial access, they argue that entrepreneurial zeal is more important for firm growth than financial access. However, it cannot be denied that entrepreneurial zeal cannot be realized without adequate financing. Therefore, entrepreneurial zeal couple with adequate financing is importaningredients in realizing the expected growth of SMEs.

The market concentration of financial institutions affects availability of credit to creditworthy SMEs. . [33] argue that the greater market concentration of financial institutions can have two opposite effects to SME financing. In the first place, greater market concentration may reduce credit access using any lending technologies when the provider of funds exercises greater market power to increase profits by putting higher interest rates or fees on loan to SMEs and tightening credit arrangement to reduce risk. Alternatively, greater market concentration may give a large opportunity for SME to access credit through relationship lending. Moreover, the SME financing gap will be larger, even it becomes perennial issue in developing countries [34] where the structure of financial institution and regulatory framework is poor. Other important issue related to difficulties access of finance for SMEs is asymmetric information problem. Asymmetric information can be simply defined as the difference of information by both insiders and outsiders when they are involved in any transaction. Obviously, insiders have better information than outsiders. Asymmetric information arises when outsiders are less informed about the quality of the firms, than the insiders [35]. In this circumstance, it is possible for market participants to price firm's claim incorrectly [36]

The existence of asymmetric information makes the process of risk assessment by bank officers more difficult. Particularly for small firms, the process of risk assessment of small firm credit application has a significant effect in the relationship between the bank and the small firm client [37]. In terms of borrower lender relationship, the problem of asymmetric information in financial markets can be overcome by making long-term relationships [38]. By making a close relationship with the customer, bankers can obtain more private information about their clients to make proper decision, because this close relationship between small firms and banks may reduce information asymmetry.

When SMEs cannot make long-term relationship with banks, which in turn the asymmetric information cannot be avoided, the banks will stipulate higher interest rates to compensate for a riskier loan [39, 40].

SC for SMEs

When extending their funds to customers, IB is suggested to adopt profit and loss sharing (PLS) (Aggarwal and Yousef, 2000). Furthermore, they argue that there are some advantages of PLS concept in comparing to conventional bank (CB) based on interest principle. Firstly, PLS is considered fair and just because profit and loss are born together between financier and their clients. In contrast, under interest basis that applies in CB, borrower has a fixed burden regardless of the possibilities of profit or loss they face. Secondly, PLS may encourage the efficiency of capital allocation by putting a priority of delivering funds to productive projects rather than the creditworthiness of borrowers. Thirdly, PLS principle is viewed more capable in stabilizing the economy than an interest-based system. Therefore, IB should prioritize the use of PLS scheme in delivering their funds rather than mark-up principles or at least balance between the application of PLS and mark-up principles [41].

Under the PLS scheme, borrowers share profit and loss with the banks, which in turn share profits and losses with the depositors. The other prominence of using PLS scheme, it allows Islamic banks to extend their funds for a longer-term basis which in turn promotes economic growth [42]. In addition, the implementation of PLS principles will be more advantageous, particularly for SMEs because most of the SMEs are not creditworthy or bankable when the assessment is based on interest system. Thus, instead of the creditworthiness of the borrowers, the assessment of loan proposal will be based on the productivity and viability of the project, which leads to a more efficient allocation of capital. Thus, under PLS modes, IB should be careful to place their funds because the failure of project they finance will incur loss not only for IB but also for their depositors. Therefore, IBs should strive harder to select good customers. IBs should also monitor the activities of their clients to ensure that their business is well managed to minimize the risk.

Although theory sufficiently explained the advantage of PLS principle, [43] found that IB exercise more mark-up mode of finance, what they called as "debt-like instruments", rather than PLS scheme. They argue that this is because many IBs are operating in developing countries where the financial market is characterized by imperfect information so that the application of PLS is riskier. For instance, in Malaysia as a country where the development of IB is dominant in south Asia, the financing of IB using the PLS scheme accounts for only 0.5% which comprises of Mudarabah and musharakah contract, while the rest (Murabahah, Ijara, ba'i muajal, istisna and others) is based on mark-up principles [44]. However, this argument is not true. For example, [45] showed that at international level, Islamic Development Bank (IDB) uses PLS mode of finance in a few small projects. [46] argue that the vast majority of IBs avoid PLS in their investment activities because of information imperfections.

Other reason why IB use little PLS scheme was explain by [47]. They argue that the lack of PLS application in most IBs is caused by some reasons. Firstly, PLS contract is inherently vulnerable to the agency problem. Secondly, it requires well-defined property rights to function efficiently. Thirdly, equity financing is not feasible to finance short-term projects. Fourth, charging tax on profits of PLS is deemed unfair compared to interest charged by CB which is exempted on the grounds that it constitutes a cost item. Lastly, it is the absence of a secondary market for trading in Islamic financial instruments especially mudarabah and musharakah contracts. Even, some writers argue that the application of PLS mode, particularly Mudarabah, cannot succeed so long as the interest option exists. Surprisingly, even in a specialized Islamic financial institution, like Mudarabah Companies (MCo's) in Pakistan, which are viewed as a PLS investment base companies, have only marginal portions of their funds invested on a Mudarabah or musharakah principles [48]. Ironically, since it cannot find enough investment opportunity to absorb the bulk of funds they have, these companies are tempted to use their idle funds in speculative transactions by buying and selling shares traded on the stock market. This indicates the contradictory condition where on one side a lot of SMEs have difficulty in obtaining funds, and on the other hand Islamic banks invest their idle funds in speculative investments. This might indicate a lack of ability of the Islamic bank officers or lack of lending skills when it comes to lending to SMEs. Even in Bangladesh, though IBs have grown up and are increasingly popular, the Mudarabah concept is not yet employed in the country [49]. IB in Bangladesh is making an effort to employ Mudarabah mode of finance in the near future. Conversely, IBs appear to use more mark-up principles in extending their funds to their clients, for example, Murabahah and ba'i muajal constitute about 54.13% and 18.24% respectively. Meanwhile, the proportion of PLS, that is musharakah mode is only 3.8%. The practice of IB in Algeria is also similar to that of Bangladesh means that the Mudarabah concept has not been employed yet. Study on Banque Al Baraka d'Alge´rie found that those IBs offer four principal instruments: taadjir (leasing), musharakah (equity participation), Murabahah (profit sharing agreement), and Salam (deferred delivery payment) (Benamraoui, 2008). Again, the PLS principle is only marginally practiced in Algeria. The main product is Murabahah which accounts for more than 80% of its transactions, followed by taadjir (leasing) accounting for 10%

3. RESEARCH METHOD

Supply Chain Challenges faced by SMEs

Supply chain development in SME sector is at a moderately low level. In past, the SMEs' needs for supply chain were very basic; mostly focus on storage and cargo transportation with a basic purpose to cut down the logistics and distribution costs; overlooking the factor that optimized supply chain would help products to stream rapidly, steadily and securely amid each progression of the transportation procedure. Presently, SME s have started realizing the importance of supply chain development; as a fact that costs related to supply chain represents 55-65% of firm's gross revenue and now exploring the benefits of developed and executed supply chain excellence strategies which large corporate organizations have been doing from long time. This research adopts qualitative approach to investigate deeply the experience of Islamic banks in making financing decision for SMEs. The object of this research is Bank Pembiayaan Rakyat Shariah (BPRS) or Islamic rural banks. This object is chosen because they focus to serve small firms. Purposive sampling is adopted as a sampling method because it enables the researcher to achieve depth information on the field of the research interest. , Research sample needs to be kept on small size to achieve depth information from the interviewee. Since its aim is to generate in-depth analysis, issue of representation is less important in qualitative research than they are in quantitative research [50] .

Data is collected by interviewing SC managers located in the following cities: Surakarta, Klaten, Kendal, Magelang, Gombong, Cilacap, Purwakarta and Semarang. Qualitative data obtained from interviews was analyzed using Interpretative phenomenological analysis. The analysis illuminates the experience of

Islamic bank managers in making lending decisions for SMEs. The analysis follows some steps guided from IPA literature. The steps of doing IPA analysis were adopted from [51] as follow: Firstly, Reading and Re-reading the transcript resulted from the interview with relevant respondents.

Secondly, initial noting is made. This step was commenced by examining the semantic content and language use on a very exploratory level. Anything of interest within the transcript is noted to identify specific ways by which the participant talks about, understands, and thinks about an issue.

Thirdly, after knowing the pattern of meaning, the emergent theme was developed. Having found the emergent themes, the researcher interprets those themes which enable the result of analysis will be a product of both collaborative efforts between the participant and the researcher. Fourthly, the next step is searching for connections across emergent themes. In this step, the analysis involves mapping the themes to fit together. The themes that may not have a close relationship with the other theme may be discarded. After analyzing one case, the researcher move to the next case. This step is similar to the four earlier steps but is employed in different participants. Thus, the next step involves moving to the next participant's transcript or account, and repeating the same process. The last step is looking for pattern across cases.

Normally in supply chain relationships, buyer is more prevailing by a wide margin, suppliers are generally SMEs and new businesses that supply the goods to buyer are regularly paid late on their invoices. This presents a key liquidity risk to SMEs and new businesses that feel pressure while conducting a business with large buyers. Some of them can successfully mitigate the risks but others prefer not to go into a business deal with large buyers and due to that some SMEs and startup businesses can't hold up for a long, resulting in a bankruptcy and winding up their businesses. SCF is in developing phase and is diverse from usual kind of working capital financing approaches, such as factoring and invoice discounting. In traditional methods, there is a rivalry between buyer and seller, buyer would like to have prolonged credit where as supplier wants early payment. Here SCF works very well and it enhances the collaboration between buyers and suppliers in supply chain. In SCF the finance follows the value as it moves through the supply chain network. Asymmetric information is a crucial issue in terms of accessing finance from financial institutions [43]. It was acknowledged that SMEs have specific characteristics that differ from those of large companies. The opaqueness of information provided by SMEs is one characteristic that hinders them from accessing funds from external sources [3], including Islamic banking institutions.

1. ANALYSIS AND DISCUSSION

Table 1 Major and Subordinate Themes

Master themes	Subordinate themes
Financing evaluation process	• Information needed to assess the creditworthiness of borrower • Criteria of borrower's worthiness
Obstacles to accessing Islamic financing faced by SMEs	• Administrative requirements of financing • Collateral provision
Decision making	• Margin determination • Financing maturity

Source: Author

On the other hand, bankers' skills and experience play a pivotal role in handling problems of asymmetric information when dealing with small firms (Agyapong, 2011). This paper examines the experience of Islamic banks in providing financing for SMEs. Following the analysis guidance addressed in the methodology section, three major themes were identified. The major themes and subordinate themes are depicted in table 1.

4.1 Financing Evaluation Process

The existence of asymmetric information forces banks to carefully evaluate every loan proposal in order to avoid default risks in the future. Like conventional banks, Islamic Banks commonly use the 5C criteria (capital, capacity, condition, collateral, and character) as indicators on acceptance or rejection of a loan proposal.

4.1.1 Information Required Assessing the Creditworthiness of Borrowers

The principle of evaluation for borrowers is not different between CB and IB. Both of them commonly use the 5C criteria to accept or reject loan applications. However, IB will not extend any finance to a business that violates Shariah (Islamic law). Thus, besides the 5C criteria, Islamic banks must ensure Shariah compliance of a business before granting it a loan. This is the basic requirement for Islamic banks that differentiates them from counterparts. Shariah compliance is of utmost importance for the borrower and lender, as acknowledged by BR3.

Obviously, firstly, the business must be Shariah compliant (BR3).

Once the shariah compliance assessment is completed the next assessment is related to the type of business and the purpose of financing. Since IB offer various contracts to meet different business needs, knowing the types of business and the purpose of financing is crusial to determine the proper contract. This point is demonstrated by the following excerpts taken from an interviewee:

Firstly, we determine the borrower's needs. From this, we come to understand what type of contract is most suitable for the borrower (BR4).

Different sectors have different default risks. That is why there are sectoral differences in the SMEs financing gap [5]. For example, (Fidrmuc and Hainz, 2010) found that the default risk of the service and agricultural sectors was above average. Therefore, precise knowledge of the business sector by the bank can reduce the default risk of SMEs. Islamic banks examine each business sector or type of business to offer suitable contracts and estimate the embedded risk, a point that was commented upon by BR2.

We look at the available information in the business sector (BR2).

Financial statements can be used as a tool to predict the viability of a business of large firms. In the case of SMEs, most of them do not have standard financial statements because generally they have poor financial and administrative knowledge. "Almost all of SMEs don't know about financial statements (BR7)".This circumstance leads to informational opaqueness for banks.

The existence of financial gap for SMEs was realized by IBs, so that they make an effort to acquire information other than financial statements. This finding confirms previous studies which suggest that small banks rely more heavily on non-financial information when assessing borrowers.

Since non-financial information is not standard form, the loan officerrequires to have 'special skills' and local knowledge to overcome the informational shortcomings of SMEs. This skill can only be achieved through long-term engagement within an area and through liaising with the firm. The analysis of the responses from IB managers suggests that lending managers of Islamic banks have more discretion when approving loans for SMEs, a practice that existed until recently among the conventional banks in the UK (Deakins and Hussain, 1994). The lending managers suggested that it was not possible to assess SMEs based on the financial information available. One manager, BR1, explained:

We do not need complicated parameters. We just look at the business. Is it still running? For how long has it existed? Besides, how much assets does he/she have to back up his/her business? (BR1).

The rhetorical question "how long have you operated in this business?" implies that the firm's age is an important indicator to assess the viability of a business. This finding was confirmed by the quantitative result of this study that examined correlation analysis in table 5.18 which indicates that the age of the firm influenced the bank lending decision. Furthermore, this finding is supported by the study conducted by [6]which suggests that older firms were more likely to be successful in accessing funds from banks than newer firms. It is plausible since the capability of the older firms to run the business in any condition was tested. In contrast, newer firms did not yet prove to be sustainable in situations of economic turmoil.

4.1.2 Criteria of Borrower Worthiness

Commonly banks use 5Cs criteria when evaluating the creditworthiness of applicant. However, BPRS emphasize only on three main criteria; namely character, collateral and cash flow (BR5). This finding supports the study of (Ralston and Wright, 2003) which conclude that the worthiness of borrowers should be assessed based on their character, purpose of the loan, capacity to repay and collateral available for security. In Islamic banks, the loan purpose was considered in relation to two things; 1) whether or not the purpose of loan is Shariah compliant; and 2) the choice of suitable type of contract dependent on the loan purpose. Emphasizing on character when assessing the creditworthiness of small firm borrowers confirms that small banks favour qualitative criteria based on their loan officer's personal interaction with loan applicants (Cole et al., 2004). This was validated by the responses of BR2 and BR6.

We will grant financing for someone as long as we know his/her character. Usually, if someone has good character he will always make effort to repay, whatever the condition (BR2).

If a person is good, he will always make effort [to repay], but if his character is bad he will not remember or neglect to repay even though he has money. So, character is dominant. (BR6).

Whilst the importance of character is recognised, the most important aspect for bank officers is the ability of the borrower to repay. The capacity to repay can be estimated by analysing the cash flow and profit of a business. The importance of cash flow in evaluating the worthiness of borrowers was also suggested by [17]. This suggests that liquidity is important to ensure repayment. This supports the opinion of [8] who argued that bankruptcy occurs when firms suffer from high indebtedness, is illiquid, insolvent and of low profitability. Emphasis of capacity over character in this case is self-evident. Good character without the ability to repay becomes meaningless. A similar sentiment was expressed by BR3 and BR8 in their responses.

Islamic banks required collateral to reduce default risk and cost of lending. As reported by (Niinimäki, 2009), banks refrain from conducting costly borrower evaluations, hence lending decisions are based on collateral . In this study, IB lending managers acknowledged that, "It is quite difficult for those who don't have collateral to borrow. Loans can't be obtained without providing collateral." (BR4). Whilst BR5 said, "the first way out is cash flow and character, while the second way out is collateral. It means that collateral is secondary, but still important." These views question the assertion that IBs rely more on character than collateral or any other financial information in assessing loan applications.

4.2 Obstacles to Accessing Islamic Financing Faced by SMEs

Although it was that the growth of SMEs have significant contribution to GDP and are the best means for poverty alleviation through employment creation, financing constraints is still becoming common problem for SMEs compare to larger firms (Beck, 2007; Fumo and Jabbour, 2011). There are some obstacles that may well be coercing SMEs to access funds from external sources. This study found two important issues related to the obstacles to accessing financing for SMEs which emerged from subordinate themes, namely administrative/documents and collateral requirements.

4.2.1 The Administrative/ Document Requirements of Financing

Some documents are required to support loan applications. Banks can easily evaluate loan proposals based on financial statements and business plans provided by borrowers. Nevertheless, in the case of SMEs, this requirements are difficult to obtain This finding confirms the opinion that SMEs are an opaque firm [1]. Consequently, Islamic banks asked SMEs about the evidence of their business activity, such as notes or receipts of their business transactions. Based on these documents, Islamic banks estimate the overall capacity of the borrowers.

Actually most of the SMEs do not have a good document required by bank, including financial statement (BR8).

The lack of good documents obscures IBs ability to make an evaluation. For example, the borrower provides collateral in the form of land, but he/she could not provide the certificate of land which denotes his/her possession of the land. The application process could not be continued until the borrowers fulfill the legal requirements.

4.2.2 Collateral Provision

Theoretically, collateral is required to mitigate information gap between borrowers and lenders. The important role of collateral in loan transaction prevails both in the developing and developed countries, In the USA, where the debt market is advanced and credit scoring is a tool to screen good from bad borrowers is commonly used, credit for SMEs secured through the use of collateral is extensively used, in a approximately 80% of cases (Avery et al., 1998). Indeed, technological innovations such as small business credit scoring can lower interest rates but not collateral, even if it requires higher collateral.

Although collateral does not the most important factor in determining loan proposal decision, Islamic banks argue that the collateral is useful to protect default risk and to solve amoral hazards. This opinion is in line with the theoretical argument of using collateral in loan applications. Firstly, collateral allows loan loss reduction for the banks in the event of default because it provides the banks a prior title in specific assets. Secondly, collateral solves the problem of adverse selection. , Thirdly, collateral helps to solve the problem of moral hazard which may happen after a loan has been granted. Due to this reasons, IB managers will make loan decision faster for applicant who propose loan with collateral than those who don't. This finding support the opinion of [6] who argue that collateral makes the lending decision more efficient.

Similar opinion is articulated by [11] who claim that collateral is a powerful instrument in dealing with moral hazards. Therefore, r Islamic banks use collateral to reduce the potential morally hazardous behavior of the borrowers.

When the applicant was recognized as being of good character, then we do not need to ask for collateral. Conversely, if we are not so sure of the borrowers' character, we ask the borrower to provide collateral. Borrowers who provide collateral will have more responsibility to make repayments on time (BR6).

4.3 Decision Making

The basic principle in Islamic transactions was guided by the Qur'an (chapter 3, verse 29) which states that people could not eat others' property in vanity, except with the permission of the other. This principle cannot be achieved if one party fails to uphold their part of the agreement. Therefore, it is usual for Islamic banks to negotiate contractual terms with borrowers before approving the loan. Indeed, not all matters must be negotiated with their clients. The two most important terms are determination of margins and the financing maturity.

4.3.1 Margin Determination

Margin determination is a crucial issue in Islamic banking as it impacts on profit. Nevertheless, determining margin is influenced by a competitive environment as reported by [19] that the reduction of margin interest rate as a result of increasing competition occured in the Mauritian banking sector. Thus, the presence more and more of Islamic banks in a market may lead to lower margins for small firms. This assertion is supported by [11] who reported that the presence of alternative financial intermediaries is crucial for lowering interest spread. Since Islamic banks, more specifically Islamic rural banks, commonly lack capital, they will accept the bargaining of the "prime depositors". In this case the "prime depositors" have bargaining power rather than the ability to negotiate a profit margin.

The margin for common depositors is the same, while the margin for prime depositors is negotiable and normally higher than that for small depositors. Prime customers are those whose deposit is above the average (BR3).

The determination of lending margins could be a function of the specific loan, such as the loan size, amount of pledged collateral and cost of reviewing application. Higher asymmetric information, which is mostly experienced by SMEs, may increase the cost of loan assessment. Higher asymmetric information problem is common characteristic of small firms. This makes Islamic banks difficult to assess the true risk of small firm borrowers. To compensate that risk, Islamic rural banks charge higher margins for small firms which reflect the uncertainty of small firms. This finding is supported by [28] who claim that small firms were charged higher interest rates, particularly because they had fewer outside options for external finance. SMEs accept the policy of Islamic banks which charge higher rates than conventional banks which is shown in the following comment an IB manager.

In conventional banks the rate is 14% on average, while in Islamic rural banks, the rate is at least 1.5% flat or on average 26% a year (BR3).

The higher margin applied by Islamic rural banks for SMEs is due to several factors. Firstly, Islamic rural banks charge high margin to compensate for risk because they involve in high risk markets. Secondly, Islamic rural banks operate under diseconomies of scale conditions because they are small financial institutions which operate in local areas. Thirdly, Islamic rural banks are characterized by limited liquidity which influences the determination of margins. This is in line with the opinion of [19] who argue that banks with high levels of cash assets are able to work at lower risk premiums which in turn charge a lower spread. Charging higher rates by small banks like BPRS confirms the findings of [29] which claimed that smaller financial institutions charge interest rates that are almost 60 basis points higher than the average interest rates charged by major banks.

4.3.2 Financing Maturity

The longer financing maturity the higher the default risk because of the uncertainty in the future, particularly for risky firms. Long term debt to very risky firms will lead to adverse selection problem [11] The conformity between debt maturity and economic life of assets should be considered to ensure the continuity of firms operation without suffering financial distress. Accounting principles suggest that, current assets should be financed by short-term debt, while fixed assets should be financed by long-term debt and equity [39]. Mismatching between debt maturity and economic life of assets leads to financial problems and an operational disturbance which in turn reduces profit. In this regard, the policy of Islamic banks to negotiate financing maturity with the SME owners allows them to consider this issue. Based on the negotiation with applicant, Islamic banks decide the financing maturity by considering the common criteria and the risk of the business.

Based on the repayment capacity of borrowers, we decide how much and how long the financing will be granted (BR4).

Although the decision of financing maturity based on the repayment capacity of the borrowers, most of the financing for SMEs is in short-term period. The use of short-term debt for small firms support the study of (Al Taleb and Al-Shubiri, 2011). They found that the size of firms is positively and significantly correlated with long term debt and negatively and significantly correlated with short-term debt. This finding is also confirm the study of [27]which claimed that long-term debt increases as company size increases. This implies that large firms are able to borrow on a long-term basis because they have ability to reduce the unsystematic risk through diversification. In contrast, small firm tend to borrow in short-term basis because they do not have such ability. The prevailing use of short term loans by SMEs indicates that risky firms are screened out of the long term debt market.

4. Conclusions

SME companies that are aware of these supply chain and financing challenges—and take proactive steps to address them—will be in a much better position to capitalize on their supply chain's and financial ability to serve existing customers better, operate more efficiently, penetrate new markets and, overall, grow more profitably. This research found three major themes that emerge from the interview with SC managers about the evaluation process of loan application. Those themes are financing evaluation process, obstacles to assessing Islamic financing faced by SMEs, and decision making by Islamic banks. Since Islamic banks have the same function as conventional banks, both of them commonly used the same criteria to accept or reject loan proposal. However, Islamic bank add the other important factor in assessing whether the loan proposal is feasible or not to finance. Those requirements are the shariah compliance and the purpose of the financing. This research also found that Islamic banks required collateral from SMEs even though the contract is based on PLS scheme. This circumstance become obstacle for SMEs to access finance for Islamic bank.

Financial statement is basic information to assess the viability of the business. However, not all SMEs, particularly small firms, are able to provide financial statements. To overcome this problem, IBs rely on soft information gained from establishing close and long relationships with their borrowers. Consequently, SCM use more discretion in deciding loans for SMEs, especially for small firms. Thus, the experience and skill of the loan officer is significant determinant for SCM in making lending decisions.

5. Acknowledgements

The authors would like to thank to Universitas Muhammadiyah Surakarta for its support. This research was funded by LPPM-UMS, Doctoral Research Grant Letter No: 472.15/A.3-III/LPPM/XII/2016

References

[1] Aggarwal, R.K. and Yousef, T. (2000), “Islamic banks and investment financing”, Journal of Money, Credit and Banking, JSTOR, pp. 93–120.

[2] Beck, T. (2007), “Financing constraints of SMEs in developing countries: Evidence, determinants and solutions”, KDI 36th Anniversary International Conference, pp. 26–27.

[3] Beck, T. and Demirguc-Kunt, A. (2006), “Small and medium-size enterprises: Access to finance as a growth constraint”, Journal of Banking & Finance, Elsevier, Vol. 30 No. 11, pp. 2931–2943.

[4] Berger, A.N., Klapper, L.F. and Udell, G.F. (2001), “The ability of banks to lend to informationally opaque small businesses”, Journal of Banking & Finance, Elsevier, Vol. 25 No. 12, pp. 2127–2167.

[5] Blazy, R. and Weill, L. (2005), “Why Do Banks Ask for Collateral?”

[6] Bongini, P., Ferrando, A., Rossi, E. and Rossolini, M. (2017), “Suitable or non-suitable? An investigation of Eurozone SME access to market-based finance”.

[7] Bruns, V. and Fletcher, M. (2008), “Banks’ risk assessment of Swedish SMEs”, Venture Capital, Taylor & Francis, Vol. 10 No. 2, pp. 171–194.

[8] Bryman, A. (2015), Social Research Methods, Oxford university press.

[9] Canales, R. and Nanda, R. (2008), Bank Structure and the Terms of Lending to Small Businesses, Harvard Business School.

[10] Carbó-Valverde, S., Rodriguez-Fernandez, F. and Udell, G.F. (2009), “Bank market power and SME financing constraints”, Review of Finance, Oxford University Press, Vol. 13 No. 2, pp. 309–340.

[11] Chen, J. (2006), “Development of Chinese small and medium-sized enterprises”, Journal of Small Business and Enterprise Development, Vol. 13 No. 2, pp. 140–147.

[12] Chong, B.S. and Liu, M.-H. (2009), “Islamic banking: Interest-free or interest-based?”, Pacific-Basin Finance Journal, Vol. 17 No. 1, pp. 125–144.

[13] Cowling, M. and Westhead, P. (1996), “Bank lending decisions and small firms: does size matter?”, International Journal of Entrepreneurial Behavior & Research, MCB UP Ltd, Vol. 2 No. 2, pp. 52–68.

[14] Coy, S.P., Shipley, M.F., Omer, K. and Khan, R.N.A. (2007), “Factors contributory to success: A study of Pakistan’s small business owners”, Journal of Developmental Entrepreneurship,

World Scientific, Vol. 12 No. 02, pp. 181–198.

[15] Dar, H.A. and Presley, J.R. (2000), “Lack of profit loss sharing in Islamic banking: management and control imbalances”, International Journal of Islamic Financial Services, Banxia Holdings, Vol. 2 No. 2, pp. 3–18.

[16] Deakins, D. and Hussain, G. (1994), “Risk assessment with asymmetric information”, International Journal of Bank Marketing, MCB UP Ltd, Vol. 12 No. 1, pp. 24–31.

[17] Esiagu, L.N., Okoroji, L.I. and Anyanwu, J.O. (2016), “Assessment of the Role of Private Enterprises/Small Businesses on Economic Growth (A Study of Some Selected SME’S in Imo State, Nigeria)”, International Journal of Economics, Business and Management Studies, Pacharapa Naka, Vol. 3 No. 3, pp. 127–135.

[18] Fumo, N.D.G. and Jabbour, C.J.C. (2011), “Barriers faced by MSEs: evidence from Mozambique”, Industrial Management & Data Systems, Emerald Group Publishing Limited, Vol. 111 No. 6, pp. 849–868.

[19] Gola, K.R., Dharwal, M. and Narayanan, S. (2017), “Small and medium Sports enterprises-An Engines of Economic Growth with Special Reference to Indian Economy”, South Asia Journal of Multidisciplinary Studies, Vol. 3 No. 1.

[20] Haron, S. (1995), “The Framework and concept of Islamic interest-free banking”, Journal of Asian Business, Vol. 11 No. 1, pp. 26–39.

[21] Hasan, Z. (2005), “Islamic banking at the crossroads: theory versus practice”, International Islamic University of Malaysia.

[22] Highfield, M.J. (2008), “On the maturity of incremental corporate debt issues”, Quarterly Journal of Finance and Accounting, JSTOR, pp. 45–67.

[23] Inderst, R. and Mueller, H.M. (2007), “A lender-based theory of collateral”, Journal of Financial Economics, Elsevier, Vol. 84 No. 3, pp. 826–859.

[24] Kahf, M. (2004), “Islamic banks: the rise of a new power alliance of wealth and Shari’a scholarship”, The Politics of Islamic Finance, Edinburgh University Press Edinburgh, pp. 17–36.

[25] Khan, M.L.S. and Bhat, M.A.G. (2012), “Economic Thought of Muhammad Baqir al-Sadr: A Study of Iqtisaduna (Our Economics)”.

[26] Khawaja, M.I. and Din, M. (2007), “Determinants of interest spread in Pakistan”, The Pakistan Development Review, JSTOR, pp. 129–143.

[27] Klein, L.S., O’Brien, T.J. and Peters, S.R. (2002), “Debt vs. equity and asymmetric information: A review”, Financial Review, Wiley Online Library, Vol. 37 No. 3, pp. 317–349.

[28] Körner, P. (2007), “The determinants of corporate debt maturity structure: evidence from Czech firms”, Czech Journal of Economics and Finance, Vol. 57 No. 3–4, pp. 142–158.

[29] Lauder, D., Boocock, G. and Presley, J. (1994), “The system of support for SMEs in the UK and Germany”, European Business Review, MCB UP Ltd, Vol. 94 No. 1, pp. 9–16.

[30] Lin, J.Y. and Sun, X. (2006), “Information, Informal Finance, and SME Financing”, Frontiers of Economics in China, Springer, Vol. 1 No. 1, pp. 69–82.

[31] Mallett, T. and Sen, A. (2001), “Does local competition impact interest rates charged on small business loans? Empirical evidence from Canada”, Review of Industrial Organization, Springer, Vol. 19 No. 4, pp. 435–450.

[32] Mason, C. and Kwok, J. (2010), “Investment readiness programmes and access to finance: a critical review of design issues”, Local Economy, Taylor & Francis, Vol. 25 No. 4, pp. 269–292.

[33] McPherson, M.A. and Rous, J.J. (2010), “Access to finance and small enterprise growth: evidence from East Java”, The Journal of Developing Areas, Tennessee State University College of Business, Vol. 43 No. 2, pp. 159–172.

[34] Mudd, S. (2013), “Bank structure, relationship lending and small firm access to finance: A cross-country investigation”, Journal of Financial Services Research, Springer, Vol. 44 No. 2, pp. 149–174.

[35] Narayanan, M.P. (1988), “Debt versus Equity under Asymmetric Information”, Journal of Financial and Quantitative Analysis, Vol. 23 No. 1, pp. 39–51.

[36] Navneet, S., Boopen, S., Shalini, R. and Sawkut, R. (2009), “Determinants of Interest Rate Spread in Mauritius”, The Business Review, Vol. 14 No. 1, pp. 312–320.

[37] Niinimäki, J.-P. (2009), “Does collateral fuel moral hazard in banking?”, Journal of Banking & Finance, Elsevier, Vol. 33 No. 3, pp. 514–521.

[38] Pinto, A. and Augusto, M. (2014), “Are There Non-linear Effects of Banking Relationships and Ownership Concentration on Operational Performance? Empirical Evidence from

Portuguese SMEs Using Cross-section Analysis and Panel Data", International Journal of Financial Research, sciedu. ca, Vol. 5, pp. 67–84.

[39] Quaye, I., Abrokwah, E., Sarbah, A. and Osei, J.Y. (2014), "Bridging the SME financing Gap in Ghana: The role of microfinance institutions", Open Journal of Business and Management, Scientific Research Publishing, Vol. 2 No. 04, p. 339.

[40] Rahman, A.R.A. (2007), "Islamic banking and finance: between ideals and realities", International Journal of Economics, Management and Accounting, Vol. 15 No. 2.

[41] Rajakumar, J.D. (2014), "Corporate Financing Pattern in India: Changing Composition and Its Implications", IUP Journal of Applied Finance, IUP Publications, Vol. 20 No. 4, p. 5.

[42] Ralston, D. and Wright, A. (2003), "Lending procedures and the viability-social objectives conflict in credit unions", International Journal of Bank Marketing, MCB UP Ltd, Vol. 21 No. 6/7, pp. 304–311.

[43] Ramlee, S. and Berma, B. (2013), "Financing gap in Malaysian small-medium enterprises: A supply-side perspective", South African Journal of Economic and Management Sciences, AOSIS Publishing, Vol. 16 No. 5, pp. 115–126.

[44] Samad, A., Gardner, N.D. and Cook, B.J. (2005), "Islamic banking and finance in theory and practice: The experience of Malaysia and Bahrain", The American Journal of Islamic Social Sciences, Vol. 22 No. 2, pp. 69–86.

[45] Scherr, F.C. and Hulburt, H.M. (2001), "The debt maturity structure of small firms", Financial Management, JSTOR, pp. 85–111.

[46] Riyadi, Bambang Slamet, Basuki Rekso Wibowo, and Vinita Susanti. "Culture of Corruption Politicians' Behavior in Parliament and State Official During Reform Government Indonesia (Genealogical Study)." International Journal of Criminology and Sociology 9 (2019): 52-62.

[47] Smith, J.A., Flowers, P. and Larkin, M. (2009), Interpretative Phenomenological Analysis: Theory, Method and Research, Sage.

[48] Al Taleb, G. and Al-Shubiri, F.N. (2011), "Capital structure decisions and debt maturity structure: an empirical evidence from Jordan", The Journal of Commerce, University of the Punjab, Hailey College of Commerce, Vol. 3 No. 4, p. 49.

[49] Tambunan, T. (2011), "Development of small and medium enterprises in a developing country: The Indonesian case", Journal of Enterprising Communities: People and Places in the Global Economy, Emerald Group Publishing Limited, Vol. 5 No. 1, pp. 68–82.

[50] Visser, H. (2013), Islamic Finance Principles and Practice, Edward Elgar Publishing.

[51] Wu, J., Song, J. and Zeng, C. (2008), "An empirical evidence of small business financing in China", Management Research News, Emerald Group Publishing Limited, Vol. 31 No. 12, pp. 959–975.