



The Acceptance of Islamic JV among Microenterprise Operators

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ABSTRACT

Most Small Medium Enterprises (SMEs) worldwide operate as microenterprises and quite a significant number inheriting their family businesses. In Malaysia, as reported by Economic Census 2016, majority of the business establishments can be classified as microenterprises (76.5%) followed by small (21.2%) and medium (2.3%). Although their establishments are dominant in number, but their contribution to the economy is still disproportionately low, i.e. only 37.1% of gross domestic product (GDP) and 17.3% of the total export value as reported by SME Corp in 2017. The microenterprise operators primarily engage in cash transactions because they are micro or even tiny in size including what are called as 'invisible entrepreneurs' and 'nano-enterprises'. Thus, they prefer to obtain financing from non-banking channels. Although many SME financing alternatives have been provided by the banking sector, but yet microenterprise operators still prefer informal funding due to their flexibility in terms of documentation, repayment, timing, and transaction costs, which formal banking and financial institutions are very rigid about it.

The researchers conducted a pilot study on microenterprise operators running businesses in Kota Kinabalu City Centre (KKCC) in order to seek their acceptance towards the Islamic JV concept. Many scholars believe the nearer the enterprise to the bank i.e. within 5 kilometres radius, the higher the opportunity for JV to be materialized between operators and banks. Furthermore, microenterprises are said to groom big from micro to small and to medium if operators opened their door for Islamic JV which is based on actual profit generated from the venture where all parties involved as active partners. Hence, the objective of this research is to

determine the acceptance of microenterprise operators towards the Islamic JV concept. This study also identifies possible banking factors that could be considered affecting their acceptance.

Based on the result, the Islamic JV is said to be moderately accepted by the microenterprise operators located in the KKCC. However, their level of acceptance could have been higher if they had a better understanding of the terms used, the operations applied, the PLS principles and the risk factors. Five major banking factors contributed towards their understanding comprise profit-loss-sharing (PLS) principle, Islamic JV design, accept if understand (from the awareness effort made by the banking sector), reputation and image of the particular bank, and knowledgeable and trained banking personnel.

Key Words: Microenterprises, Islamic Joint Venture, *Musharakah*, banking factors.

1. INTRODUCTION

World Economic Forum reported that SMEs worldwide account for more than 60 percent of employment and 50 percent of GDP in high-income economies (World Economic Forum, 2015). They are equally important in emerging economies, where they contribute on average to more than 50% of employment and 40% of GDP. But, even though SMEs play such an important role in the global economy, they have been struggling to obtain reliable access to financing. IFC Enterprise Finance Gap Database, which using primary data from World Bank Enterprise Surveys, quoted that between 55% and 68% of SMEs in developing countries are either financially underserved or not served at all. These high numbers translate into significant lost opportunities to develop viable businesses. As small and medium enterprises (SMEs), particularly microenterprises, they have a very unique and different financial need as compared to retail customers. Islamic banks are advised to be more pro-active and innovative in offering the most suitable financing to SME operators. SMEs approach banks largely for working capital requirements or asset financing. Even though several products and structures are in place, the sector continues to be underpenetrated by Islamic banks (Alam, 2015).

The driving force behind the Islamic banking movement was the prohibition of *riba* and permissibility of *bai'* or trade and the urge of following the *Shariah* (Islamic law) principles in undertaking commercial activities. Its theory was primarily developed on the basis of the PLS (profit-loss sharing) principles i.e. participatory (Islamically acceptable) financial contract, namely *Musharakah*. However, the practices of Islamic financial institutions failed to conform to the theory and greatly relied on the mark-up principle i.e. *Murabahah*. The PLS or equity based financing is in stark contrast to the interest based financing mechanism, but the mark-up principle has not such a degree of dissimilarity from the conventional method of financing rather it seems to be similar to conventional financing mechanism (Shodhganga, 2016). The

former Malaysian Prime Minister YAB Datuk Seri Najib Tun Razak, urged Islamic banks to assist the SME industry that is huge in number. For instance, in 2014, Malaysia's total SME financing exposure in Islamic finance grew by 40.5% year-on-year to more than US\$10 billion. He emphasized on the equity-based financing, which offers a truly workable alternative to conventional banking. He added that JV under *Musharakah* embeds the participating financial institution as a provider of advice and consultancy. With the sharing of risks and its rewards, the Islamic requirement for fairness and equity is served (The Borneo Post, 2015).

2. PROBLEM STATEMENT AND AIM OF STUDY

As mentioned earlier, SMEs by number, dominate the world business stage. Although the up-to-date data are difficult to obtain, estimates suggest that more than 95% of enterprises across the world are SMEs. In Malaysia, although their establishments are also dominant in number, but their contribution to the economy is still disproportionately low, i.e. only 37.1% of gross domestic product (GDP) and 17.3% of the total export value as reported by SME Corp in 2017. In addition, majority business establishments in Malaysia can be classified as microenterprises (76.5%) followed by small (21.2%) and medium (2.3%).

Furthermore, their contributions to GDP are 36.6% and their exports are 18.6%. By exploring Islamic financing as the alternative way of doing business, it is believed that the business of SMEs could be diversified to a larger scale. This aspiration is further supported by a recent finding by the International Monetary Fund that states "*Islamic Finance's emphasis on asset-backed financing and risk-sharing feature means that it could provide support for SMEs*". Given the importance of the SME sector and its potential development in the future, it is unfortunate to notice that, all this while the financing gap does exist between SMEs and Islamic banks (Alam, 2015). Hence, this paper aims to determine the acceptance of microenterprises towards the Islamic financing concept called Islamic JV (*Musharakah*). This study also identifies the possible banking factors that could be considered affecting the acceptance of Islamic JV among microenterprise operators.

3. SCOPE OF STUDY

For the purpose of staying focused and in line with the research objectives, a few points that determined the scope of the study are highlighted here. The first one is microenterprise operators as the respondents of the study. Their enterprises must be registered and possessed a valid business license. The study focused on 350 microenterprise operators. The second one is the area covered in the study. This study selected the capital city of Sabah i.e. Kota Kinabalu City Centre (KKCC) because most of the Islamic banks' regional headquarter offices are located in this area. The city is located on the northwest coast of Borneo facing the South China Sea. It is also the capital of the West Coast Division of Sabah. It is a major tourist destination

and a popular gateway for travellers visiting Sabah and Borneo. It is also one of the major industrial and commercial centres of East Malaysia. These two factors make Kota Kinabalu one of the fastest growing cities in Malaysia. Lastly, this study focused on the equity financing instead of debt-based financing as urged by the former Malaysian Prime Minister during his opening speech at the World Islamic Economic Forum (WIEF) 2015.

4. LITERATURE REVIEW

The purpose of the literature review is to discuss on the variables to be considered in this study. The main idea is to seek the possibility of an Islamic JV to be accepted by micro operators based on the banking factors. Most SMEs in Muslim countries operate as sole proprietorships. These enterprises primarily engage in cash transactions thus, prefer to obtain funds from non-banking channels such as *Ah long*, family and government agencies. They prefer informal funding alternatives that offer more flexibility in terms of documentation, repayment, timing, and transaction costs, which formal banking and financial institutions do not provide. Moreover, a large number of microenterprises, particularly in Sabah operate outside urban areas and owners are not financially literate where the literacy rates are generally lower in Muslim countries. Shaharuddin *et al.* (2005) asserted that SMEs would become a significant market segment for Islamic banks in their effort to realize the aspirations. However, the research found that SMEs still do not consider Islamic banks as the most desirable financial institutions when seeking financing for their ventures. Thus, have limited information regarding their banking needs. This is further aggravated by lack of knowledge of Islamic products among SMEs. They are unaware of products that suit their needs given the complexity of Islamic financing models.

Hassan (2015) found that both banking systems, Islamic banks and conventional banks have failed to provide financing to SMEs, because such enterprises lack of collaterals and insufficient good track record. The situation is particularly frustrating on the part of Islamic banks, as the core principle of Islamic finance demands that the SMEs underserved by conventional banks should be included. The Islamic banks are violating this principle as they are failing to promote PLS equity-based financial instruments such as *Musharakah* to SMEs. According to Yavas *et al.* (2004), SMEs do not have the privilege that large firms have, which is a ready access to both debt-based financing and equity-based financing. In fact, SMEs have nowhere else to go to but the banks. For SMEs, banks represent an important and indispensable business partner, since they facilitate several functions necessary for their survival (Trayler *et al.*, 2000; Madill *et al.*, 2002). However, SMEs in developing and developed countries have been found to have difficulty in gaining access to credit from these institutions (Berger and Udell, 1998; Galindo and Schiantarelli, 2003).

This condition has allowed information asymmetry to circulate among SMEs and Islamic banks in the market. Thus, the situation of unequal financial information in decision-making has led to adverse selection and moral hazard. Finally, this situation will then broaden the financial gap in the SME sector (Lund and Wright, 1999; Berger and Udell, 2002; El-Hawary *et al.*, 2004; Nguyen and Ramachandran, 2006; Siddiqui, 2008; Mohammed, 2015). According to Raqaba (2017), unavailability of financing is mainly due to the reluctance of banks towards extending credit to SMEs. It is relatively easy to lend to large corporations where the economies of scale, published financial information, collaterals and credit worthiness parameters are available. Financing gap which is due to lack of availability of data on the microenterprises, banks are unable to determine whether the borrower possesses technical, managerial and/or marketing skills that will allow him to generate adequate cash flows and repay the loan on time.

According to Latip (2018) in the Malaysian context, although there exists a growing awareness and understanding of the concept of Islamic banking operations among Muslims, as well as non-Muslims, this has not been reflected in terms of sales of Islamic banking products. Even though public's knowledge on Islamic banking system has increased considerably since the establishment of the first Islamic bank (Bank Islam Malaysia Bhd.) three decades ago, customers' attitudes towards the acceptance of Islamic banking products have yet to rise at a similar pace. Thus, other banking factors such as human resource, promotional tool, reputation and logistic are seen as the next keen of factors that people will consider in accepting Islamic financing (Mohammed, 2015).

5. METHODOLOGY AND ANALYSIS OF DATA

Data of the study were comprehensively gathered from the primary source. Under the primary data collection, the researcher collected data using the survey method i.e. a combination of questionnaire and personal interview. The sampling plan was designed based on the probability sampling technique, namely Stratified Random Sampling. The same technique was applied by Nguyen and Ramachandran (2006) in their study on the attitudes of SMEs towards their capital structure preference.

For the analysis of data between the acceptance of Islamic JV (dependent variable - DV) and banking factors (independent variables - IVs), the study measures the direction of association between the variables. The possibility of measuring direction can be done since both variables used in this study are in the form of ordinal scale, using five likert scales. Hence, the study has chosen Somers'd in determining the correlation coefficient between two variables, both in the form of ordinal scales (Mohammed, 2015). Below is Table 1.0 of which showing the list of all possible banking factors contributed towards the acceptance of Islamic JV.

Numerous authors stated on the right side of the table who studied on the same independent variables before and different years were also recorded as the following:

Table 1.0: List of Studies on Banking Factors among Trade Customers

| <i>No.</i> | <i>Banking Factors</i> | <i>Authors</i> |
|------------|-------------------------|-----------------------------|
| A1 | WIDE_RANGE_PRODUCT | |
| A2 | MORE_ST_FIN | |
| A3 | COMPETITIVE_CHARGE | |
| A4 | ADEQUATE_PROMOTION | |
| A5 | HIGH_TECHNOLOGY | |
| A6 | KNOWLEDGEABLE_TRAINED | Turnbull (1983), |
| A7 | FRIENDLY_HELPFUL | Cheese et al. (1988), |
| A8 | COMPETENT_GOOD | Roach (1989), |
| A9 | STAFF_TRUSTWORTHY | Chan and Ma (1990), |
| A10 | SEARCH_NEW_MARKET | File and Prince (1991), |
| A11 | REPUTATION_IMAGE | Haron et al. (1994), |
| A12 | FAST_EFFICIENT | Edris and Almahmeed (1997), |
| A13 | SOCIAL_RELATIONSHIP | Trayler et al. (2000), |
| A14 | ENOUGH_BRANCHES | Yavas et al. (2004), |
| A15 | EASILY_ACCESSIBLE | Norudin and Syazli (2005), |
| A16 | COMFORTABLE_ENVIRONMENT | |
| A17 | FAMILIAR_TERM | Latip (2017) |
| A18 | ACCEPT_CONCEPT | |
| A19 | ACCEPT_IF_UNDERSTAND | |
| A20 | ISLAMIC_JV_DESIGN | |
| A21 | PLS_PRINCIPLE | |
| A22 | NON_RISKY_FIN | |

Notes: The dependent variable is number A18 (Accept Concept – referring to Islamic JV) and the rest is the independent variables (A1- A22 except for A18).

Below is Table 2.0 showing general guidelines for interpreting the strength of association between variables.

Table 2.0: Guidelines for Interpreting Strength of Association

| <i>No.</i> | <i>Strength of Association</i> | <i>Correlation Coefficient</i> |
|------------|--|--------------------------------|
| 1. | None | 0.00 |
| 2. | Weak/Uninteresting association | ± 0.01 to 0.09 |
| 3. | Moderate/Worth nothing | ± 0.10 to 0.29 |
| 4. | Evidence of strong association/Extremely interesting | ± 0.30 to 0.99 |
| 5. | Perfect/Strongest possible association | ± 1.00 |

Source: Babbie et al. (2003)

As a result from the bivariate analysis via SPSS version 21, the values of Somers'd were determined and they ranged from 0.524 to 0.133 (refer to Table 3.0). However, from the range, the factor of A18_ACCEPT_CONCEPT (DV) strongly depends on five IVs as shown in Table 3.0. The values are arranged in descending order i.e. from 0.524 to 0.305.

Table 3.0: Factors with a Strong Somers'd Value

| <i>No.</i> | <i>Factors</i> | <i>Value of Somers' d</i> |
|------------|---------------------------------|---------------------------|
| 1. | <i>A21_PLS_PRINCIPLE</i> | 0.524 |
| 2. | <i>A20_ISLAMIC_JV_DESIGN</i> | 0.453 |
| 3. | <i>A19_ACCEPT_IF_UNDERSTAND</i> | 0.436 |
| 4. | <i>A11_REPUTATION_IMAGE</i> | 0.380 |
| 5. | <i>A6 KNOWLEDGEABLE TRAINED</i> | 0.305 |

Nevertheless, there are 16 IVs that can be considered as to be moderately affecting the factor of A18_ACCEPT_CONCEPT as shown in Table 4.0.

Table 4.0: Factors with a Moderate Somers'd Value

| <i>No.</i> | <i>Factors</i> | <i>Value of Somers' d</i> |
|------------|------------------------------------|---------------------------|
| 1. | <i>A22_NON_RISKY_FIN</i> | 0.284 |
| 2. | <i>A16_COMFORTABLE_ENVIRONMENT</i> | 0.281 |
| 3. | <i>A12_FAST_EFFICIENT</i> | 0.266 |
| 4. | <i>A3_COMPETITIVE_CHARGE</i> | 0.257 |
| 5. | <i>A1_WIDE_RANGE_PRODUCT</i> | 0.250 |
| 6. | <i>A14_ENOUGH_BRANCHES</i> | 0.232 |
| 7. | <i>A4_ADEQUATE_PROMOTION</i> | 0.230 |
| 8. | <i>A9_STAFF_TRUSTWORTHY</i> | 0.228 |
| 9. | <i>A7_FRIENDLY_HELPFUL</i> | 0.225 |
| 10. | <i>A8_COMPETENT_GOOD</i> | 0.217 |
| 11. | <i>A5_HIGH_TECHNOLOGY</i> | 0.216 |
| 12. | <i>A13_SOCIAL_RELATIONSHIP</i> | 0.198 |
| 13. | <i>A15_EASILY_ACCESSIBLE</i> | 0.179 |
| 14. | <i>A10_SEARCH_NEW_MARKET</i> | 0.149 |
| 15. | <i>A2_MORE_ST_FIN</i> | 0.148 |
| 16. | <i>A17_FAMILIAR_TERM</i> | 0.133 |

The findings which are based on the bivariate analysis between DV and IVs show that there are five factors that can be considered as having strong effects (refer to Table 3.0) and the rest 16 factors are considered as moderate against the acceptance of Islamic JV (refer to Table 4.0). The latter does have the moderate effect, but combining them all together, they will contribute towards weak effect in the long run if not being tackled by the banking sector.

6. CONCLUSION

Here, the main idea is to determine either the microenterprises in the city area accept, do not accept, or are unsure about the Islamic JV. It is good to have views from the micro operators about this newly perceived concept of financing. Even though the concept is not actually new to the Islamic financial market, but it is relatively new to the SME sector. This situation can be proven by closely examining their financing pattern. As mentioned earlier, due to the existence of a financing gap, the microenterprise operators have been focusing on internal sources such as own savings and properties, family and friends, and non-financial institutions.

Since our government has urged enterprises to make direct investments in order to boost the economy of the country, it is considered timely if Islamic JV can be introduced and highlighted by the Islamic banks with the purpose to attract the attention of SMEs which represent one of the most available investment devices for them to remain prosperous in the competitive market. In order to conclude the study, there are a few judgements made based on the analysis done earlier. The conclusion provides an overall picture with regard to the attitude of the microenterprises in the city area towards the Islamic JV and is discussed as follows:

Diagram 1.0 shows the level of acceptance of the Islamic JV by the microenterprise operators. It can be concluded that on average, most of the respondents accept the Islamic JV. From the diagram, a total of 158 operators or 45.2 percent stated 'agree' and 'strongly agree' to the statement on the acceptance of the concept. A total number of 145 operators or 41.4 percent were unsure about the concept. This is another impact of the financing gap that needs to be reduced by the Islamic banks. It is clearly illustrated that if they have a better understanding about the concept, then the number of operators which chose 'neither agree nor disagree' scale could be reduced from 145 to 89 operators or 25.4 percent. This will in turn, increase the number of SMEs which chose 'agree' and 'strongly agree' from 158 to 234 operators or 66.9 percent.

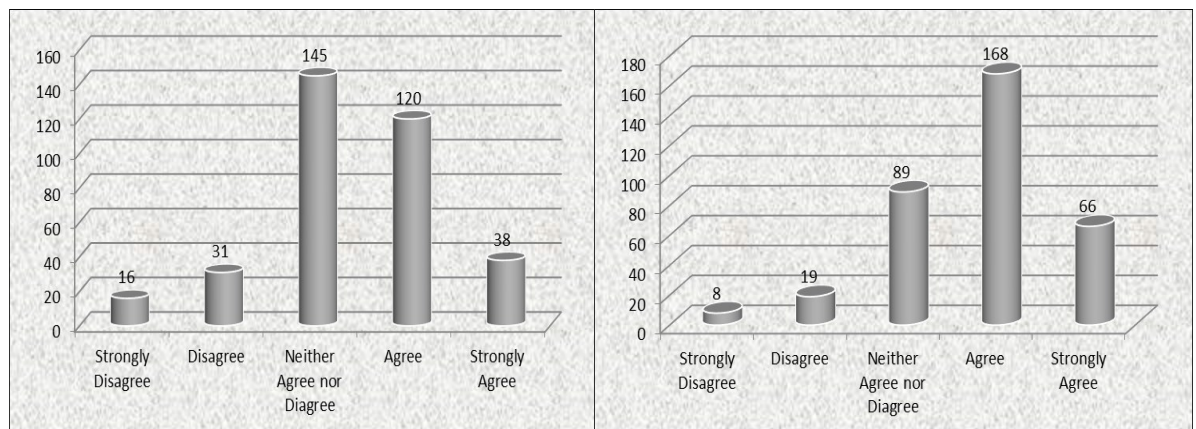


Diagram 1.0: The Acceptance of the Islamic JV Concept Before and After SMEs Understand (A19_ACCEPT_IF_UNDERSTAND)

The main motivation which prompted this study stemmed from the emergence of a relatively new concept called the Islamic JV or *Musharakah* financing that seems to have the ability to boost investments in the country and overcome weaknesses inherent in a debt-based financing. Being too focused on producing more debt-based financing has made Islamic banks, no different from the conventional ones. Islamic banks are expected to carry with them the legal maxim *al-ghonm bil al-ghorm* (risk factor) and be microenterprise-friendly and more enterprising in nature. After all, the study shows that the Islamic JV is moderately accepted by

the SMEs located in a city area. However, the level of acceptance could have been higher if they had a better understanding of the terms used, the operations applied, the PLS principles, the risk factors, and many more. Furthermore, the dual-banking system practised by the Malaysian banking industry has caused SMEs as a whole to think that there is no difference between the operations of Islamic and conventional banks. The existence of a third moderating variable generated from the low involvement of Islamic banking in the *Musharakah* financing is seen as a critical factor that needs to be tackled urgently in order to reduce the financial gap within the SME sector.

The study supports that banking staff, products, and services are very important in attracting microenterprise operators to embrace this newly perceived Islamic finance concept. The result is in accordance with the study undertaken by Dusuki and Abdullah (2007) where the customers were really concerned about the performance of the banking factors provided to them. However, the study did not discuss any specific Islamic banking products. To fill this void, this research has added to the banking factors distinct variables of the Islamic JV. The unexpected result shows that the traits of the concept have high association values. This means that other than the banking factors, a highly important consideration that micro operators should look into when opting for a specialized financial product is to examine carefully the concept offered to them together with factors such as understanding factors, the design factors, the risk factors, and the PLS factors. This result of the study interprets that most SMEs make decisions about their financing options based on their banking factors with little influence coming from the personal and business factors.

The managers of Islamic banks can benefit from the findings of this study where they can set out to establish an attractive scheme for the Islamic JV by paying great attention to the factors inherent in the unique characteristics of the concept. Lastly, from the academic point of view, this study can contribute by adding new input to the scarce knowledge of the selection criteria for specialized financing products, particularly the *Musharakah* concept. The study of specialized financing in different concepts has been explored in a limited way in previous researches. Therefore, more studies on different types of financing concepts will be conducted by the researchers. In addition, a comparative study on local SMEs in other cities such as Kuching, Sarawak and other cities in Peninsular Malaysia is also lined up. Finally, what is really important is that this study fills the research gap in the data input on specialized financing concept by providing new findings on different kinds of customer types and their preferences.

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