

Financing of SMEs by Speculative Formula (Mudharabah): Empirical Study on Islamic Banks at the Kingdom of Saudi Arabia

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Abstract: This research studies the contribution of Islamic banks that work in The Kingdom of Saudi Arabia (KSA) in financing SMEs by speculative formula and the issues that prevent the arrival of this funding to those facilities. The most important findings of the research: Islamic banks in KSA do not provide funding for SMEs by speculative formula. Islamic banks in KSA in general tend towards short-term finance by sales formulas. Islamic banks also face difficulties limit its contribution to the financing of SMEs, the most important is the inflexibility banking system. The research finds several proposals including: adopt a national standard definition of SMEs. Accelerate in establishing the SMEs Development Commission and Islamic Loan Guarantee Foundation that contributes to the advancement of the business environment of SMEs which by consequence contributes in promoting and supporting its role in the national economy.

Key words: Finance, Islamic banks, small and medium enterprises, speculative formula (mudharabah), development, contribution

INTRODUCTION

Serious attempts started in 1963 to avoid the usurious banking transactions by the establishment of banks that provide banking services in accordance with the provisions of Islamic Sharia that's when local saving banks were held in Egypt as saving funds for small farmers. This was followed by the establishment of the first Islamic bank in Dubai in 1975 which managed an admirable success in his work in accordance with the provisions of Islamic Sharia, followed by the establishment of the Islamic Development Bank, Faisal Islamic Bank of Sudan, Kuwait Finance House, Dallah Al-Baraka Bank Islamic Capital House and in the Kingdom of Saudi Arabia (KSA) Al-Rajhi Bank, Al-Bilad Bank and Al-inmaa Bank were established. Then Islamic banks spread across the five continents and today the number of Islamic financial institutions accounts more than 700 firms operating in 60 countries around the world, 250 institutions work in the Arab Gulf States and 100 of them in the other Arab countries, according to the Global competitiveness report of Islamic banks for the year 2013-2014. The number of dealers with the Islamic banks around the world reached to 38 million traders and this sector still has great capacity to accommodate more customers regionally and internationally (Union of Arab Banks, 2016).

This research studies Islamic banks financing of SMEs by mudharabah with application on each of the Al-Rajhi Bank, Al-Bilad Bank and Al-inmaa Bank in KSA.

The problem of this study lies in knowing the extent of the contribution in financing by mudharabah of these banks to these facilities and in search of obstacles and challenges which facing that. The importance of this research is ascribed to the fact that the methods of financing the economic development, studying and developing them are considered important starting point for the advancement of the national economy. This research was chosen in order to examine the following hypothesis:

“Islamic banks in the Kingdom of Saudi Arabia are funding SMEs with mudharabah formula in high rates and these banks don't face any obstacles or challenges that limit its funding by this formula”.

Literature review: Islamic banks have been established not only because usury is forbidden but also to apply Islam with its orders and prohibitions through their business.

They depend on the Islamic fundamental issue that money belongs to God and that humans are trustee on this money in order to direct it to satisfy God's will in serving his adorers (Safar, 2004). So, the person isn't

absolutely free to spend money wherever he pleases. Hence the Islamic banks must adhere to Sharia principles which direct money primarily to serve community (Alhiti, 1998).

There are several definitions for the Islamic banks which can be concluded as banking institutions that deal with money on the fundamental of adherence of Islamic Sharia and its principles, work on investing money in legitimate ways and aim at achieve right economic and social development (Zoheily, 2007).

Islamic banks are distinct from other banks when financing SMEs in the dependence on financing methods and investment compatible with the provisions of Islamic Sharia, far from usury and its negative economic and social effects.

In the next few lines we will mention a study about mudarabah as a tool of financing small and medium enterprises and the reality of Islamic banks financing in KSA through mudarabah formula:

Mudarabah is sharing profit and loss between the capital and the labor. It takes place between investors (the capital owners) and the bank (mudarib) where profit is shared according to their agreement, the loss borne by the investor (except in cases of infringement of the (mudarib)/the bank in this example) or negligence or breach of the terms then it bears the resulting (Shabra, 1990).

We can clarify the difficulties and challenges of financing mudarabah in two ways; the first one is related to dealers with Islamic banks while the second is related to the working environment of those banks.

Difficulties related to dealers with Islamic banks: The absence of legal authority concerned with small and medium enterprises in KSA that figure out the obstacles and difficulties which limit enterprises ability to access necessary funding in order to enhance their contribution in economy. So, these facilities face difficulties in coming back to more than/50/public and private parties to finish their regulatory and legally procedures in addition to their daily transactions (Al-Riyadh EN, 2016).

Guarantee is considered the main obstacle that face applying mudarabah contract in Islamic banks because the essence of restricted mudarabah is that the agent (mudareb) is trustee and doesn't guarantee the capital unless exceeded or restricted (Abugheddah, 1993). So, the relationship that controls Islamic banks and depositors based on the principle of participating profits and losses.

Despite depositor's acceptance of this principle, practical experience of these banks proved that depositors aren't ready enough to take risk because

of the domination of usurious mental on the majority of depositors who affected by the conventional banks mental in ensuring the deposit (Rifai, 2004).

Many dealers ignore the doctrine adaption of their investment account with mudarabah formulas where it is treated like dealing with deposit in conventional banks.

Many customers refuse to pay benefits more than the amount paid to conventional banks, so Islamic banks calculate their profits depending on cost price (e.g. LIBOR) in addition to a margin profit that agreed upon. The increased amount is given up to the customer as "performance incentive" or other labels which leads to an imbalance risk borne by the Islamic bank.

Difficulties related to Islamic banking environment:

Most of Islamic banks funding sources are short-term: There is thus a discrepancy between the goals of depositors and the quality of Islamic banking which needs long-term financial resources to serve social and economic development goals (Alajlony, 2008). So, the lack of these sources limits Islamic banks from granting in mudarabah formula.

Challenges related to organizational structures and human competencies in Islamic banks where managers and employees of these banks focus on quick profit and secured revenue funding like mudarabah rather than mudarabah which need a new mechanism differs from that which just follow-up premiums maturity in time. Hence, the organizational structures for these banks lack specialized departments in each funding formula (Alshaikh, 2011) in terms of technical or marketing specialization to increase these portfolios according to specific mechanism and funding sources.

The central bank doesn't observe the special quality of Islamic banks as regulations state on subordination of Islamic banks to the common banking laws concerning with rates of cash reserve, liquidity and credit. So, that limits banks from funding with mudarabah formula.

Multiplicity of legal bodies and differing opinions of its members about many Islamic banking activities which disables some formulas and tools of providing suitable flexibility to Islamic banks like mudarabah forms. The absence of a central advisory opinion of the bodies at the national level to ensure the adoption of attitudes and standards of the Council of Islamic services and standards of Accounting and Auditing Organization for Islamic Financial Institutions.

Difficulties related to accounting and financial treatments for Al mudarabah which are still characterized by lack of clarity in the banking applications. These treatments do not only reflect the financial position of the

bank but distribution of depositor's profits depends on it also. The problem lies in how to calculate the profits and losses of partners by the speculator (the bank or investment firm), including its share because he often speculates by himself as a partner of its self-funds. The problem becomes more difficult when the freedom of entry and exit is available for speculators (as long-term mudarabah) as well as when the investments that are the subject of mudarabah are non-specific (absolute investment). Since, the speculator has several accounts and different areas, a problem may arise in the allocation of shared expenses between him and various other investments.

It should be noted that there is a possibility of finding mathematical solutions to overcome this problem in order to facilitate the application of this funding for its role in obtaining the necessary liquidity for investments. That are as follows (kantakji, 2012).

Since, profit is the differentiation between costs and sales, the profit equation can be written to the relationship:

$$F = S - T \quad (1)$$

Where:

F = The symbolizes for profit

S = For sales

T = For costs

Since, each mudarabah has its own direct costs and where they take advantage of some of the general administrative costs and publicity campaigns and so on, the total cost T is a total direct costs and indirect costs. And the relationship becomes as follows:

$$F = S - (t + v) \quad (2)$$

The case of syllogism lies in the distribution of indirect costs that will be calculated by observing relevant accounts balances for all period and calculate the share of the monetary unit/costs, since the speculator has other business besides investment (mudarabah), we will resort to the distribution of indirect costs according to the total direct costs for all mudarabah to determine the quota of each one. Bank's works will be represented by share of them like any other mudarabah.

If, we symbolize V to indirect costs, $cost_1$ to the cost of mudarabah 1, $Cost_2$ to mudarabah 2 and $cost_n$ to mudarabah n, we can calculate the share of the monetary unit/costs V_{cost} from indirect costs according to equation:

$$V_{cost} = \frac{V}{\sum_{k=1}^n Cost_k} \quad (3)$$

Where n is the number of mudarabah. Then the share of mudarabah V_{cost} are distributed from indirect costs among them by multiplication this coefficient with the cost of any investment to get its share from the indirect costs according to equation:

$$V_i = v_{cost} \times Cost_k \quad (4)$$

If, the investment were specified (bound investments) the number of partners were limited, the investment partners were known before starting the investment, no possibility to get out of the investment except to liquidate it and on the assumption that: C is the capital, C_i is the capital in the time, the unit of time is the day, P_i is the monetary payment which is paid for increase the capital in time, p_i is the monetary payment which is paid in time, therefore, we can determine the total capital that is paid at the time i by equation:

$$C_i = P_1 + P_2 + \dots + P_i \quad (5)$$

On the assumption that sales at the time i is S_i , the direct costs to calculate the investment in time i is $Cost_i$ and indirect costs which represent the percentage of the administrative costs of the economic unit is V, we can rewrite Eq. 2 on the basis F_i in time i as equation:

$$F_i = S_i - (T_i + V_{cost}) \quad (6)$$

As a result of that, the profit or loss R_i that concerning shareholder partner with a capital C_i at the time i can be determined as equation:

$$R = F_i \times \frac{C_i}{\sum_{k=1}^k C_i} \quad (7)$$

Where k is the number of the partners of mudarabah i. And we can also calculate mathematically the profit or loss in the case of non-specific investments (absolute) with non-specific partners in addition to the freedom of partners of entry and exit at any time.

Development of mathematical models for distribution of profits and losses of mudarabah with the possibility of entry and exit of partners investments, whether the investments are restricted or absolute, help to increase the exchange of mudarabah instruments as a finance tool religiously acceptable of what helps the process of use is the possibility of making the model is automated and that will allow its application to all users.

Banks can penetrate a large untapped market if they can develop an instruments for financing SMEs that does not include interest, the banks that can achieve this earliest will have positional itself advantageously (Ullah *et al.*, 2016).

That was about Islamic banks and mudarabah what about SMEs?

There are many definitions of SMEs and currently no standardize definition have been provided by international bodies (Yusoff *et al.*, 2016). The definition of SMEs is considered one of the most problems that facing analyzing this sector, due to the absence of an internationally agreed definition.

The criterion to distinguish between small and large enterprises doesn't limit to the number of workers but it also includes other criteria like value of annual sales, the invested capital or the value of assets.

It's worth to mention that about 35% of countries included in the IFC database definite SMEs as those whose number of workers doesn't exceed 250 workers (Kushnir *et al.*, 2010).

There is no specific, unified and agreed definition for SMEs in KSA where chambers of commerce definition differs from bank of credits and saving definition which also differs from industrial development fund definition which definite them as "any non-profit activity which its employees are lower than 25 workers, their annual sales don't exceed 5 million riyals (MR) and their total budget is no more than 10 MR" (Arab Advisor Group, 2016).

While Islamic bank definition is primarily based on sales/volume of annual revenue up to 100 MR (Al-Bilad Bank, 2016).

It should be mentioned that Malaysian small and medium development industry corporation adopt a distinctive definition for SMEs according to economic sector and thus USA, Mexico, South Africa and Thailand don't have a unified definition for SMEs at the national level but they adopted a joint definition for the sectorial level as well (IFC, 2009).

The importance of SMEs and the role they can do is characterized by widespread; they constitute approximately 90% of establishments around the world. They employ 50-60 % of the global work force and they contribute in about 46% of the global GDP, representing 65% of the gross national production in Europe, compared to 45% in USA and 81% of functions in Japan are provided by SMEs (Lavanya and Murthy, 2009).

Saudi official statistics revealed the rising number of SMEs in KSA which was up to 1.3 million in 2015, the number of active enterprises accounted 71% of total working enterprises. And the number of individual

enterprises is 688 thousands which is 85% of total number of enterprises. Riyadh city acquired 25% of SMEs, the percentage of establishments employing 1-4 workers was 84% of active enterprises. The 13% of which are staffed by 5-19 workers and only 3% for enterprises exceed 20 workers (Al Riyadh EN, 2016).

SMEs in KSA contribute in about 93% of total registered companies. And absorb about 27% of total employment. However, their contribution in the GDP is only 33% which considered a low contribution according to the growing Saudi economy and its concentration on economic diversification while in developed countries the SMEs at least contribute in 50% of gross domestic products (Arab Advisor Group, 2016). It is obvious that innovative cultural values exist and enforce in an SME then its performance will increase (Salman *et al.*, 2016).

MATERIALS AND METHODS

Islamic banks operating in KSA are offering credit facilities for SMEs to finance all kinds of the business activities whether by direct funding for these facilities or by guarantee program that based on adopted fiduciary standards in this concern where the program was created with the support of each of the Ministry of Commerce and Industry and banks operating in the Kingdom, the program ensures for the bank 80% of the financing granted to these existing and new facilities for all commercial activities up to a maximum amount of 1.6 million riyals to enabling these enterprises to be able to obtain financing from banks after verification of their economic viability, provided that the annual sales of these facilities does not exceed 30 million riyals (Al-Bilad Bank, 2016).

The number of Islamic banks operating in the Kingdom of Saudi Arabia is four banks which are Al-Rajhi Bank, Al-Bilad Bank, Aljazera Bank which shifted from conventional banking into Islamic one. Al-inmaa Bank which started its activities fully in 2010.

RESULTS AND DISCUSSION

This research will be limited to study data of Islamic banks that have emerged since its beginning as Islamic banks which are Al-Rajhi Bank, Al-Bilad Bank and Al-inmaa Bank.

Table 1 shows the size of the Islamic banking financing according to the funding formulas during the period (2008-2014) whereas the contained amounts of

Table 1: The amount of financing in Islamic banks (Al-Rajhi, Al Bilad and Al-inmaa) according to the formulas in Saudi Arabia during the period (2008-2014) (million riyal)

Years	Bank name	Trading		Murabaha		Leasing		Musharaka		Other		Total
		Sum	%	Sum	%	Sum	%	Sum	%	Sum	%	
2014	Al-Rajhi	38248	18.57	167230	81.20	0	0.00	0	0.00	460	0.22	205939
	Al-Bilad	16308	57.51	10115	35.67	546	1.92	1385	4.88	0	0.00	28355
	Al-inmaa	32675	60.92	0	0.00	19155	35.71	180	3.37	0	0.00	53637
2013	Al-Rajhi	36200	19.37	150150	80.37	0	0.00	0	0.00	462	0.24	186813
	Al-Bilad	11951	51.03	9461	40.40	511	2.18	1491	6.36	0	0.00	23415
	Al-inmaa	27147	60.43	0	0.00	15845	35.27	1931	4.30	0	0.00	44923
2012	Al-Rajhi	33047	19.21	138325	80.44	0	0.00	0	0.00	568	0.33	171941
	Al-Bilad	8732	47.83	7540	41.30	529	2.89	1453	7.95	0	0.00	18255
	Al-inmaa	22352	60.11	0	0.00	12211	32.83	2627	7.06	0	0.00	37186
2011	Al-Rajhi	30108	21.45	109752	78.17	0	0.00	0	0.00	535	0.38	140395
	Al-Bilad	6931	50.30	5515	40.02	353	2.56	980	7.11	0	0.00	13779
	Al-inmaa	15220	60.26	0	0.00	7498	29.69	2540	10.06	0	0.00	25258
2010	Al-Rajhi	29614	24.67	89285	74.37	0	0.00	0	0.00	1164	0.97	120063
	Al-Bilad	6318	51.41	4436	36.10	375	3.05	1160	9.44	0	0.00	12289
	Al-inmaa	9406	60.32	0	0.00	4072	26.10	2115	13.56	0	0.00	15593
2009	Al-Rajhi	32257	28.76	78429	69.94	0	0.00	0	0.00	1459	1.30	112145
	Al-Bilad	6944	63.06	2889	26.24	375	3.41	804	7.30	0	0.00	11012
2008	Al-Rajhi	36073	32.96	72089	65.86	0	0.00	0	0.00	1290	1.18	109452
	Al-Bilad	5472	66.14	1616	19.53	375	4.53	810	9.79	0	0.00	8273

Prepared by the researcher based on the (Al-ajhi, Al Bilad and Al inmaa, 2016)

funding therein reflect the net financing after provisions, other finance formulas mean the balance of the visa and istisna'a.

Contained data in the Table 1 can be studied in some detail as follows: Fig. 1 shows the percentage of financing by funding formulas of the net after provisions at Al-Rajhi Bank during the period (2008-2014).

Figure 1 shows that the percentage of debt formulas especially various commercial contracts increased in its proportion of the financing portfolio of Al-Rajhi Bank from 98.82% in 2008-99.77% in 2014 while the rest of the formulas as istisna'a despite it was small in proportion, it has been decreasing from 1.18% in 2008-0.24% in 2013 even it amounted to 0% in 2014. While the ratios of musharakah and mudarabah formulas were equal to zero during the studied period which means that the share of SMEs from bank financing by mudarabah was also equal to zero.

Figure 2 shows the percentage of financing by funding formulas of the net after provisions at Al Bilad Bank during the period (2008-2014).

Figure 2 shows that the percentage of sales formulas increased in its proportion of the financing portfolio of Al-Bilad Bank from 85.67% in 2008-93.18% in 2014. While the proportion of leasing formulas despite its scarcity it decreased from 4.53% in 2008-1.92% in 2014. Whenever also the percentage of musharakah formulas despite its scarcity, it decreased from 9.79% in 2008-4.88% in 2014. Mudarabah had not received at this bank any remarkable proportion during the studied period which means that the share of SMEs of this bank financing by mudarabah was equal to zero as well.

Figure 3 shows the percentage of financing by funding formulas of the net after provisions at Al-inmaa Bank during the period (2008-2014). It should be noted that Al-inmaa Bank began to exercise its activities and services actually in 2010.

Figure 3 shows that the percentage of sales formulas (trading) which was relatively steady around 60.30% during the period (2008-2014) in its proportion of the financing portfolio of Al-inmaa Bank. While the ratio of leasing formulas increased from 26.10% in 2008-35.71% in 2014. As the proportion of musharakah formulas decreased from 13.56% in 2008-3.37% in 2014 despite its scarcity. That was in complete absence of mudarabah funding formulas. This means, consequently, that the percentage of the financing of this bank for SMEs by mudarabah formulas was equal to zero during the studied period.

According to, the financial statements for the three banks islamic banks operating in the Kingdom of Saudi Arabia did not provide any funding by mudarabah formulas for either SMEs or other enterprises and they often still focus when awarding fund on sales and debts formulas.

In addition to that they provide the funding by leasing and musharakah formulas but their rates are very low compared to the rates of sales formulas in spite of the importance of funding by mudarabah formulas and the impact of that on overall sustainable economic and social development which relies on intermarriage between two elements labor and capital.

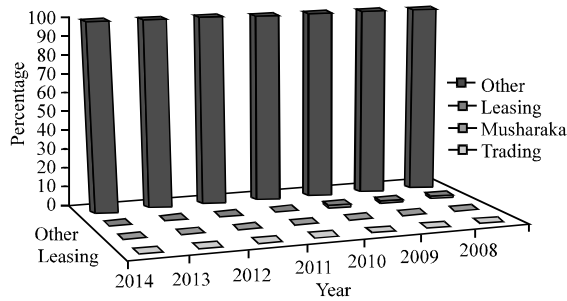


Fig. 1: Funding formulas in Al-Rajhi Bank in the period (2008-2014). Prepared by the researcher based on the contained data in "Table 1"

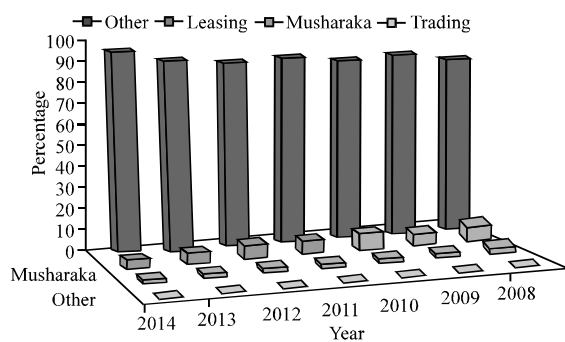


Fig. 2: Funding formulas in Al Bilad Bank in the period (2008-2014). Prepared by the researcher based on the contained data in "Table 1"

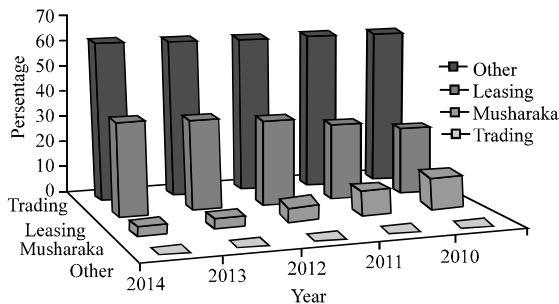


Fig. 3: Funding formulas in Al-inmaa Bank in the period (2008-2014). Prepared by the researcher based on the contained data in "Table 1"

CONCLUSION

In this research, we identify the concept of both Islamic banks and SMEs and their importance, besides studying the mechanism, reality and challenges of the Islamic banks financing to SMEs in mudarabah formula. The research concludes the following results:

Islamic banks financing in KSA demonstrates that these banks are still rely on (Mudayana) debt tools which

represent most of portfolios for these banks and avoiding mudarabah forms completely for either small, medium or other enterprises which ascribed to the challenges and obstacles that limit mudarabah funding, some of which are related to dealers with Islamic banks, others are linked to the style work of those banks.

Islamic banks financial statement in KSA shows the significant of financing their portfolios but the banking products didn't develop at the same pace where data showed the inability of development in musharaka istisna'a or lease except in a very narrow limit with absence of applying mudarabah formula completely.

Islamic banks are still faltering in terms of performing its role in economic development as outlined by the principles of Islamic economic where they expanded in a short-term funding at the expense of long-term funding which has investment nature that based on mudarabah form which based on mating between the labor and the capital.

Based on the results that this research concluded, we can reject the hypothesis of the research and accept the contrary hypothesis theory which says that "Islamic banks in KSA don't offer SMEs funding in mudarabah form" because these banks face challenges and obstacles that limit granting funding in this form.

LIMITATIONS

To include both SMEs and Islamic banks in Saudi Arabia during the period of time between (2008-2014). This research depends on the descriptive and analytical methodology that based on study and analysis various factors and variables related to the research's topic as well as the deductive methodology by putting certain assumptions and premises and then extract the results, in addition to the inductive methodology that based on an extrapolation of current reality and study its vocabulary.

To achieve the objectives of the study, it has depended on two sets of sources, the first one was books, scientific journals and international information network (Internet) to access to the previous studies related to the subject especially regarding to the methods of Islamic banking financing for SMEs, the second was some reports and annual financial statements that were issued by banks for the studied period for me to obtain the necessary information to calculate the financing ratios which were used in the study to determine the extent of contribution of Islamic banks operating in the KSA in the financing by mudarabah during the period between 2008 and 2014.

In previous studies, many researchers discussed topics related to the Islamic banks financing of SMEs and

its problems, therefrom: Bisharat (2005), Dwabh (2006), Abdul-Hakeem (2007) and Benmasuda (2008). The most important characteristic of the current study, compared with the previous ones is that it is trying to utilize from the findings of these studies concerning the subject of Islamic banking financing for SMEs, taking other turn to find out the reality of Islamic banks financing of SMEs by mudarabah in the Kingdom of Saudi Arabia and the challenges that prevent the arrival of this type of financing to those facilities, thus, this study is not a repeat but it is complementary to previous studies and an enrichment to the subject of Islamic banks financing of SMEs.

RECOMMENDATIONS

It can be made the following proposals that may contribute to the activation of mudarabah in the Islamic banks when granting finance for SMEs: adoption one definition for SMEs in KSA which considered a very important tool to apply the steps and the effective programs that support the development of these facilities as it is considered a starting point and a cornerstone for launching various initiatives and programs which aim at developing this sector. It is a framework in where the statistics related to these facilities are collected to follow the best international practices.

We should also review this definition and classify these facilities regularly at least once every three years to make sure of its consent to economic developments and social trends in KSA, along with the ongoing international developments.

Improve the mechanism of Islamic banks in KSA through developing financial instruments that allow multiple funding sources such as offering new long-term investment certificates like mudarabah and constitute restricted mudarabah funds to finance the large-scale and long-term projects as well as absolute mudarabah funds to finance multiple projects such as SMEs.

Constitute joint committees in which the relevant departments of Islamic banks, the central bank in KSA as well as accounting and auditing organization for Islamic financial institutions which aim at set accounting standards bound by Islamic banks for mudarabah formula and compatible it with the essence of their work and put a timetable to apply these standards.

Develop procedures for selecting cadres to work for the Islamic banks in KSA as well as develop practical programs according to scientific methods that ensure continuous and proper training for each administrative level in line with Islamic financing systems especially mudarabah forms that represent a special concept inspired by Islam Sharia.

The central bank should constitute a legitimacy body to form a common reference to legal aspects related to Islamic banks work which decisions are binding and so it will be part of the regulatory system in the central bank and the monetary authorities should put appropriate systems and standards for Islamic banks work nature.

Accelerate in establishing a public body for SMEs in KSA as well as encourage establishing public or private institutions concerned with ensuring risks of funding SMEs with Islamic formulas that's to stimulate banks and financial institutions to active various modes of financing especially mudarabah formula, beside studying the possibility of establishing Islamic banks that specialized in funding this type of facilities.

SUGGESTIONS

This study focused on the contribution of Islamic banks that work in the Kingdom of Saudi Arabia in financing SMEs by speculative formula, the sample of this study limited to three banks of them. It is recommended that future studies to concentrate on the other Islamic banks in KSA or in the other countries. It is also recommended that other studies focus on new other possible mathematical solutions, to overcome the issues that prevent the arrival of funding by speculative formula to SMEs in order to facilitate the application of this funding for its role in obtaining the necessary liquidity for investments.

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