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Formal versus Informal Financing of SMEs in the Libyan Context: The Case of Gharian City

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Abstract: Many economists recognize that the development of small and medium enterprises (SMEs) is one of the most important contributors to economic and social development, particularly in developing countries. Therefore, the governments of many countries are interested in these companies and support them in different ways, according to their capabilities and the resources available. Promoting the establishment and growth of SMEs is among the most successful means that governments of developing countries such as Libya can use to tackle the problems of unemployment and poverty in society, and to accommodate the large numbers of laborers and job-seekers. The constraints facing such projects, especially economic ones, can be addressed by assessing these constraints and then finding the best solutions for them, in addition to improving these projects. The most important problems are lack of funding and poor liquidity. Although there are many specialized banks and commercial financial institutions, such problems persist. This research explores the methods for funding SMEs, based on a field study in Libya of a sample of SMEs and the Trade and Development Bank, conducted between 2007 and 2012.

Key words: small and medium enterprises; formal finance; informal finance; Islamic finance
JEL codes: G30

1. Introduction

Financial institutions in Libya face difficulties that obstruct the country's economic development, partly because of their role in supporting small and medium enterprises (SMEs). As financial institutions have not operated freely during recent decades, there is a need to take care of these firms so that they can contribute to the national economy of Libya. Given that the gross domestic product of a country is the range of goods and services provided during a specified period of time, usually a year, it cannot be calculated in the absence of data for the private sector, which involves financial institutions. At the same time, it is not possible for the public sector in any country to accommodate all of the economic forces operating in that country.

For the above reasons, this research was conducted to identify the financial problems faced by SMEs and to discover what kind of finance is preferred by business owners in Libya.

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2. Objectives

In order to address the problems facing SMEs it is necessary to have a clear understanding of them. This research therefore has the following objectives:

(1) To investigate the financing problems faced by SMEs in a Libyan city.

(2) To identify the methods most often used to finance these businesses from both formal and informal sources.

2.1 The Concept of SMEs

The definition and the concept of SMEs vary from one country to another, according to the country's capabilities and economic conditions (Zarook et al., 2013). Thus, the Georgia Institute of Technology found not less than 60 different definitions of small firms in different 75 countries (Auciello K. et al., 1975). Similarly, a report by the Small Business Administration in the USA notes that there is no steady and fixed definition of SMEs, because of variations in technological development and the development plans of each country (Jamie, 2002). More broadly, SMEs in developed countries differ from those in developing countries (Wahab & Abdesamed, 2012; Abu Al-Nor, 1993). The Arab Center for Human Resources Development (2007) specifies that small and medium businesses are any productive or service activities which are owned by one person or more, are managed independently, have no more than 99 workers, use simple techniques, and the property rights belong to the owner and his/her partners. SMEs can also be classified in terms of numbers of staff and capitalization (Abu Alnor, 1993). Omar (2010) states that an SME is a company or individual facility that engages in an economic, productive, or service activity and has a specified capital. Modern economic theory defines an SME as an initial unit that organizes production resources to achieve wealth, and controls the different factors of production by a unified management represented by one person (Al-Ali & Al-Najjar, 2010). The International Labor Organization lists a set of standards to identify SMEs: workers and staff, equity capital, sales and revenue, productivity, and technique used (Abo Al-Nor, 1993). In Libya, the General People's Committee for Manpower, Training and Employment (2006) has adopted the following classification of SMEs: Small firms have at least ten and no more than 25 workers, and an equity capital of less than 2.5 million Libyan dinar (LD), whereas medium firms have no more than 50 workers and an equity capital of less than 5 million LD.

2.2 The Importance of SMEs

The importance of SMEs is related to the fact that they are considered the prime movers of economic development in any nation around the globe. Wahab and Abdesamed (2012) state that the importance of the SME sector varies between countries and that in many, its economic contribution could be enhanced. Abor and Quartey (2010) add that SMEs can make a great contribution to a country's national product. In an interview with the French newspaper *Le Monde*, J. Marseille is cited as asserting that the most profitable businesses, in the long term, are not the large firms but the small ones, managed by families depending on their own experience (Qouaiaa, 1997). SMEs are also a source of employment (Zarook et al., 2013) and a tool to combat poverty in society (Onugu, 2005; Cook & Nixson, 2000). In Japan, 99% of the industrial sector consists of SMEs, while in the USA, small projects account for 80% to 90% of businesses overall (Shamiah, 2006).

3. Literature Review

Although SMEs have been considered very important in any country and are seen to play a vital role in enhancing the development of any national economy (Wahab & Abdesamed, 2012), decision makers in Libya have not paid close attention to this sector. SMEs in Libya suffer from many obstacles which impede the growth of the sector (Zarook et al., 2013), including lack of finance (Wahab & Abdesamed, 2012). Several studies have demonstrated that small businesses have more credit constraints than large firms (Beck, 2007; Pandula, 2011b). Other studies have found substantial evidence that SMEs have funding constraints and have less access to formal credit (Beck & Demirguc-Kunt, 2006; Deakins et al., 2008; Riding et al., 2010).

In Libya, Wahab and Abdesamed (2012) examined the issue of financing SMEs in the startup phase and when they were established as businesses. They found that 80.9% of startup firms used informal sources of finance and among these, 60.5% preferred personal savings, whereas only 17% preferred formal sources of finance. Moreover, 72.4% of the mature businesses were still using informal financing such as personal savings (25%), family subsidies (25%), trade credit (15.8%) and their own profit (5.3%), whereas 27% were relying on bank loans. The author concludes that owners refrained from taking bank loans for religious reasons, because such loans require the payment of interest.

In another study carried out in Libya, Zarook et al. (2013a) investigated the impact of the financial performance of SMEs on their access to finance and found no evidence of such effect. They attributed this surprising finding to socio-demographic and political issues which tend to affect the access to financing of SMEs in Libya. The same researchers also reported, however, that management experience (Zarook et al., 2013b) and level of education (Zarook et al., 2013c) did affect SMEs' access to finance in Libya. They state that the higher the level of education of a firm's owner, the better was that firm's access to loans. They also found that there was no significant impact on the firm's access to other forms of finance.

Elsewhere, Gudov (2013) analyzed the requirements of Russian SMEs as to financial sources and the constraints facing such firms. The study revealed that during the startup phase, businesses depended heavily on informal sources, specifically "love money", as personal and family savings were the dominant sources. The same study found that formal sources accounted for a low percentage of finance compared to innovation-driven countries. Gudov (2013) also indentifies other economic factors that might influence informal investors, including personal relations with business owners, which is reportedly a factor that affects the financing of SMEs in Russia.

From the above literature review it is apparent that a number of researchers have studied various aspects of the financing of SMEs (Gudov, 2013; Beck, 2007; Pandula, 2011b; Beck & Demirguc-Kunt, 2006; Deakins et al., 2008; Riding, 2010). However, it is also evident that these studies have tended to investigate the issue of finance from the demand side (business owners, borrowers, entrepreneurs). For instance, in Libya, Zarook et al. (2013a, b, c) studied the effect on SMEs' access to finance of their financial performance (2013a), of demographic factors (2013b) and of the management skills of their managers/owners (2013c). Similarly, when Wahab and Abdesamed (2012) examined the financing of SMEs during the startup and mature phases, they also concentrated on the demand side.

These studies and others have not considered the supply side (banks, financial bodies, special funds, etc). In other words, no study of SME financing, at least none conducted in Libya, appears to have considered the perspectives of both the potential lender and the prospective borrower. Therefore, this article breaks new ground by addressing the issue of SME financing from both the demand side (business owners) and the supply side (lenders). The research reported here investigates whether formal or informal sources of finance were seen as preferable, according to data collected in Libya from 70 SMEs and from the Trade and Development Bank.

4. Alternative Methods of Funding SMEs

Funding is among the most important problems facing businesses around the world in general and particularly in Libya. It could be said that access to funds by SMEs is a global issue (Ayyagari et al., 2006; Beck, 2007; Beck et al., 2006; Rocha et al., 2011). The reason for these problems in Libya can be explained by the small number of specialized banks that provide small enterprises with sufficient funding. Zarook (2013) states that social, economic, demographic and political factors also hinder the access of SMEs to finance. The main financial decision for a firm is to choose the best funding resource from among those available; many factors will influence this decision and should be taken into consideration. Furthermore, it is very important to have a resource suitable for the assets of the enterprise (Al-Ali & Al-Najjar, 2010). The most common funding sources can be categorized as either informal or formal, as detailed in the following two subsections.

- Informal (internal) sources

Kaplan and Stromberg (2000) categorize informal finance as follows: funds provided by the owners themselves, their family and friends (love money), and funds provided by business angels who are investing for sound business reasons, not because of family relations or acquaintanceships; such investors are considered to be potential entrepreneurs. As a first step in funding a project, self-financing is the approach most commonly taken by small enterprises (Li et al., 2008). Falah (2006) classifies this as ‘informal finance’ and states that 73% of Libyan SMEs rely on such informal sources for their funding. However, this type of funding faces certain problems, such as the lack of private property, which is in the form of shared land and estates, and the difficulty of converting it into money, which can take a long time. Moll (2014) states that self-finance is a good source of funds but agrees that it takes time. Taking a slightly different approach, Macan Bhaird and Lucey (2010) suggest that if the SME lacks assets to be used as a guarantee, personal savings could be used as collateral. In Indonesia, Indarti and Langenberg (2004) found that businesses which relied on family and third party funding enjoyed greater success.

It has been generally accepted that SMEs can borrow money from formal financial institutions such as banks, as well as informal sources such as the immediate family, other relatives and friends (Wahab & Abdesamed, 2012), but Falah (2006) reports that only 4% of Libyan SMEs borrow money from banks. Equity finance, which take it as a return a proportional share of the value of the business, may be obtained through personal funds or from family members, friends and partners (Kuehi et al.; 1990; Omar, 2006; Lerner, 1995). Under this kind of financial arrangement, each equity owner takes a share in the firm, buying this with his/her capital, which is needed by the business at the time of purchase. On one hand, the advantage is that the new shareholders will be participants in the decision-making process, to avoid any potential conflict between the original owner and the newcomers. On the other hand, the disadvantage is that the founders may fear losing control of the business and will usually dislike such share splitting. Therefore, the owners of SMEs which are established as corporations usually sell shares to friends and family in order to avoid share splitting, thus keeping the business in the informal financing category.

Wahab and Abdesamed (2012) state that the owner’s savings constitute the most often used source of finance, particularly for newly established businesses, as confirmed by Hasan (1990); and Rozali (2006) also found that 68% of Malaysian SMEs depended on self-finance during startup. Yet, even if most SME funding, especially of new businesses, is informal, firms still tend to need external (formal) finance if they are to grow.

- Formal (external) sources

Banks are still considered the main source of formal financing of SMEs all over the globe. Cosh and Hughes (2003) state that banks are the most used external source of business finance and that bank loans are the dominant source of such funding in the UK. Firms' owners will usually try to avoid long-term debt finance because of financial constraints such as high interest rates and shortage of liquidity, which might lead to business failure (Kotey, 1999). This has pushed business owners to adopt a pattern of preference, whereby they will use personal fundings first and then look for loans or other kinds of finance provided by banks (Howorth, 2001). Many scholars have attributed such avoidance to liquidity issues, which usually impede business owners from establishing new ventures (Blanchflower & Oswald, 1998; Evans & Jovanovic, 1989; Holtz-Eakin et al., 1994). Another issue for potential borrowers in the arena of SME finance is the fear of rejection by banks. Kon and Story (2003) found that, in spite of having constructed robust business proposals, owners of SMEs did not apply for bank loans because they thought they were likely to be refused.

The most common types of formal, external sources of investment finance are equity (common and preferred stock, venture capital) and debt (bonds, bank overdraft, lease), according to Gudov (2013). He states that equity finance is highly dependent on the investors having ownership in the business, whereas debt funding needs to be guaranteed by the firm's current financial status. Gudov (2013) categorizes formal types of finance as either institutional venture capital financing, bank loans, or initial public offerings. These provide greater amounts of funding, but the disclosure of accounting data is very strict.

Another type of formal financing is borrowing from specialized banks. Nowadays, banks are more attentive in making such loans, especially to SMEs. Japan is considered a role model in establishing SMEs; thus, Saleh (2010) suggests that countries seeking to boost economic development and to reduce unemployment should adopt the Japanese model. Since SMEs play an important role in supporting and meeting the needs of large firms in Singapore, the Singaporean Development Bank supports SMEs with funding and fixed interest rates (Saleh, 2010). Singapore is thus also considered a successful model of economic development to which SMEs are the main contributor.

Foreign investment is also considered an important source of funding for economic projects in developing countries. To attract foreign investment, Malaysia retraced on all decisions of claiming the foreign investor on the shares in the local investment firms (Abdul Alzim, 2009). Ghareeb (2010) recommends that the Libyan government should work on this resource to support the Libyan economy, to eradicate unemployment, to enhance the country's economic status, and to ensure optimal utilization of the available local resources.

The next subsection considers an alternative approach to funding: Islamic finance.

- Islamic Finance

Islamic finance is described by Qahef (1991) as providing wealth to another person who uses it to produce a yield for the lender, in permissible ways under religious rulings. Similarly, the Accounting and Auditing Organization for Islamic Finance Institutions (AAOIFI, 2006) states that Islamic finance is the provision of financial services in accordance with Islamic jurisprudence (Shariah), where interest is banned (Al-Hashel, 2013). Islamic funding has two main features which are useful to SMEs: asset-backed financing and risk-sharing (Kammer et al., 2015). The characteristics of Islamic finance include ruling out the use of usury and directing the money towards real investment. Islamic banks often use the following terminology to denote forms of finance that are suitable for Islamic enterprises (Hussain, Shahmoradi & Turk, 2015):

- Murabaha, where the seller authorizes the buyer to cost his/her good, then they negotiated the profit that the seller wants over the cost. In other words, Murabaha includes sales with markup, deferred payments or purchases with deferred delivery of products, and leasing with different options to buy.

- Musharakah, when the lender finances the project alone or with partners, and as a result has the right to participate in the management or supervision of the project. The financer and the business owner have equity-like financing of the project, so they share both profits and losses.
- Mudarabah, which implies profit and loss sharing, as the lender provides funds and the business owner provides labor and skills.
- Wadi'ah refers to services, like safe-keeping contracts (Wadi'ah) as for current deposits, or agency contracts (Wakalah), which are also increasingly used for money market transactions.

5. Methodology and Approach

This research adopts the case study method and takes Gharian city as its case. This methodology is supported by many researchers (e.g., Yin, 1989; Bouchikhi, 1993; Ram, 1994; Stockport & Kakabadse, 1992; Holliday, 1995) who have stated that case studies are widely used in SMEs studies, and have stressed the value of this technique in eliciting in-depth opinions within smaller organizations.

The study population comprises a sample of 70 owners and managers of SMEs, plus ten employees of the Credit Department of the Gharian branch of the Trade and Development Bank. Two questionnaire tools were used to collect data: one set was distributed to the SME participants and the other to the bank employees. The questionnaire items were in the form of both closed and open questions, with space to write notes.

General questions addressed to the SMEs were on the type of business, level of education, number of employees, gender of the owners, whether they had support from any party including the government, and the age of the SMEs. The second part of the SME questionnaire asked about the initial capital invested in the startup phase, sources of finance (formal, informal), conventional versus Islamic financing, type of bank (specialized/ commercial), and whether or not they had applied for loans.

The second questionnaire asked employees of the bank about the number of loans granted, type of businesses, consultation and technical assistance to SMEs and Islamic finance loans. In addition to these main questions, some of the questionnaire items used for SMEs were also included, taking into account the relevant issues shared between the bank and the borrower. The descriptive statistical method was used to study and analyze the data collected.

6. Findings and Discussion

The Trade and Development Bank was established in 1981 to fund economically feasible investments in the fields of agriculture, industry, tourism, and service projects, with an equity capital of 100 million LD. The bank provides loans guaranteed by estates, machinery and equipment, demand bills, and any other type of guarantee accepted by the administration. It supports and funds industrial firms working in minerals, food, wood, plastic and chemicals, and textiles, as well as general contractors and service companies (Al-Basha, 2008).

Responses to the general questions revealed that about 70% of the businesses surveyed were commercial projects ranging from grocery stores, home hardware, building and construction materials to pharmaceuticals. This is consistent with the observations of Shamia (2009) that the vast majority of SMEs in Libya were in trade, wholesale and retail. A further 20% of the SMEs surveyed in the present study were service providers such as barber shops, cafés, restaurants, medical clinics (generalist surgeries) and travel agencies. The remaining 10%

were productive businesses such as olive oil pressers (Gharian is famous for its olive trees), recycling firms and bakeries.

As to the level of education of the owners/managers, we found that 55% of respondents held a university degree, 30% had intermediate qualifications, 10% were below secondary education and 5% had a master's degree. Thus, 40% of respondents had relatively poor qualifications, which might hinder them from generating good business plans to convince lenders. This is a similar finding to that of Garcia (2005), who found that owners with a college degree were better at management and had better knowledge and skills that those with lower qualifications. Similarly, De Kok et al. (2006) reported that there were significant differences in management approaching among entrepreneurs depending on their educational level. Zarook et al. (2013) confirmed this by stating that in Libya, the higher the level of education, the better the chance of access to formal finance.

Regarding numbers of employees, the current study found that 54% of the businesses had fewer than five workers, 38% had five to ten and 8% had more than 25. Thus, around nine-tenths of the firms surveyed had fewer than 10 employees, meaning that they fell outside the classification of the General People's Committee for Manpower, Training and Employment (2006) cited above, being too small to count as small firms, while only 8% counted as medium firms. This suggests that the Libyan government should reconsider its classification, which appears to count the vast majority of smaller enterprises in the country as micro-businesses rather than SMEs.

The questionnaire responses revealed that the entire sample was male, there being no female respondents at all. This is expected in an Arab country and specifically in a rural town such as that where the data were collected. This is supported by many researchers such as Nilufer (2001), who found that socio-cultural factors in developing countries impede women from becoming entrepreneurs, and Salehi-Isfahani (2000), who notes that married women in developing countries are less likely to join the labor force.

As for the age of the businesses investigated, we found the average to be 10 years; however, around 80% of the SMEs were less than 10 years old. This is a factor which might hinder their access to formal finance, since Zarook et al. (2013) found that in Libya, older firms are more likely to gain access to formal finance than younger ones.

Nine-tenths of SME respondents claimed not have any sort of technical or administrative support from any governmental or nongovernmental bodies, while only 10% of the sample stated that they did get some sort of support. This is unlike many developed countries, where governments usually support SMEs by providing them with managerial and technical advice, according to Zarook et al. (2013).

Regarding capital invested during the startup phase, the questionnaire revealed that the average was between 15,000 and 50,000 LD. However, five respondents did not answer this question. The answers of the ten respondents at the Trade and Development Bank were consistent with those of the SMEs, stating that the majority of loans granted ranged from 15,000 to 50,000 LD.

When asked about sources of finance, 75% of respondents said that they had started their businesses by using informal finance, which is consistent with the 73% of Libya SMEs that were found to rely on informal sources of funding in a study by Falah (2006). Most had used their personal and family savings at startup. This was to be expected, since informal finance is a common source of funding in many parts of the world, as reported by Kuehi et al. (1990), Omar (2006), and Lerner (1995). Furthermore, Wahab and Abdesamed (2012) found personal and family savings to be the most often used sources of funding for SMEs in Libya.

Regarding formal sources of finance, only 10% had access to such funding, via commercial bank loans or the only specialized bank in the city, the Trade and Development Bank. This finding was confirmed by respondents from the Bank itself, who stated that number of credit applications was very low. A clear explanation came when SME respondents were asked about Islamic finance, as 90% of them stated that they were reluctant to borrow money with interest, as they believed it to be prohibited for Muslims. This is confirmed by Zarook (2013) and by Wahab and Abdesamed (2012), who found that the majority of business owners in Libya were unwilling to borrow money with interest. Indeed, this finding is shared by many scholars of Islamic finance, such as the AAOIFI (2006), who defines Islamic finance as being free of interest, which is banned by Shariah (Al-Hashel, 2013). The Libyan government has been working on the issue of Islamic banking since 2010, when a memorandum of understanding was signed between the Trade and Development Bank and the Small and Medium Enterprises, emphasizing the need for Islamic finance and stating that this specialized bank should implement Islamic finance to help SMEs in the country.

7. Conclusion

The percentage of SMEs in most economies makes them one of the most important contributors to economic and social development in both developed and developing countries. In the case of developing countries, SMEs contribute to solving the problems of unemployment and poverty, providing work for large numbers of laborers and job seekers.

Acquiring finance is one of the main issues facing SMEs, along with business ideas, patents and so on. Commercial banks still constitute the main source of formal finance for SMEs in all parts of the world, although the interest rates that they charge can be considered high, and can to some extent be an obstacle to success for many SMEs.

In the case of Libya, as in other developing countries, financing is one of the main problems for SMEs, most of which depend on informal sources of finance at startup; they lack trust in commercial banks, and the high interest rates create an uncomfortable relationship between the parties. Islamic banking may offer a good solution and the Libyan government has been working on this. Establishing micro-finance departments in Islamic banks would encourage SMEs to take further steps in borrowing money from them. It might also encourage females in the private sector to take this step. Using such sources of finance will help to minimize risk and will create a sound platform for SMEs to expand the scope of their businesses, compared with other less formal sources.

Recommendations

Further research should be done on solutions to financing for SME projects, especially the formal ones. Islamic banking might be one of the main players, especially in the case of Libya. Micro-finance departments in those banks will be a good start, encouraging SMEs to approach Islamic banks to finance their projects. There is also a need to study the role of females in Libyan SMEs.

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