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Small and Medium Enterprises (SMEs) Financing Practice and Accessing Bank Loan Issues -The Case of Libya

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Abstract**—**The purpose of this paper is to examine the financing practices of SMEs in Libya in two different phases of business life cycle: start-up and matured stages. Moreover, SMEs' accessing bank loan issues is also identified. The study was conducted by taking into account the aspect of demand. The findings are based on a sample of 76 SMEs in Libya through the adoption of questionnaires. The results have pinpointed several things- evidently, SMEs use informal financing sources which prefer personal savings; SME owners are willing to apply for bank loan, that the most pressing problem has been identified, not to apply bank loan is loan with interest (religion factor).

Keywords**—**SMEs, Formal Finance (loan from bank), Informal Finance, Loan with interest (religion factor), Libya.

I. Introduction

THE relative importance of the SME sector varies greatly across countries, whereby SMEs have been known to make important economic contributions, whether in developed or developing countries. A number of large enterprises develop from SMEs and some of them even rely on SMEs. For instance, SMEs are very active in some fields, engaging in multiple product lines, small-series productions and the service industries. Even though the definitions of 'SMEs' come in variation, the importance of SMEs in the contemporary global economy has demonstrated the shift of emphasis towards SMEs in all countries. This is justified by both the quantitative and qualitative contributions of SME sections to the well –being of a nation's economy. Their effects can be seen in a number of areas, including providing job opportunities for the workers, distributing income, alleviating poverty, providing a training ground for the development and upgrading entrepreneurship skills, and serving as important vehicles for promoting forward and backward linkages in geographically diverse sectors of the economy in many countries.

Despite the importance of (SMEs) in the national economy in general, they face many obstacles that hinder their development; one of which is evident in the aspect of financial access. Several empirical studies have documented the existence of a strong positive link between the functioning of the financial system and economic growth across countries, and that stage of financing increases the probability of performance measures such as investment and employment [1]–[2]–[3]–[4]–[5]–[6]. It is generally acknowledged that small businesses can borrow money from formal financial avenues such as banks or informal avenues like family and friends to increase their capital. However, there is substantial evidence that SMEs face increasingly large number of constraints and have less access to formal sources of external finance, potentially explaining the lack of SME contributions to growth [7]–[8]–[9]. Falah [10] states that 73% of SMEs' owners- managers in Libya have relied on informal financial measure for financially supporting their firms, and only 11% have resorted to use bank loans. However, the government has proactively created various financing programs and support measures to promote a vibrant SME sector, one of which is the establishment of national programs for SMEs in 2008.

Therefore, the purpose of this paper is to bring to light one of the major prerequisites, namely SMEs' financing practice and bank loan access, which serve as the foundation towards accelerating economic growth. Therefore, the main objectives of the paper are firstly, to identify the financing practices of SMEs in Libya. Secondly, it seeks to identify the factors influencing the extent of accessing bank loan among the SMEs. Thus, the study was conducted by taking into account the aspect of demand.

SMEs' inability to have access to the bank loan can be explained through some well-known reasons such as the collateral required by the banks, high interest rates, and lack of relationships with bankers or simply the fact that the enterprises may not be needing any loan yet. Moreover, there is also one factor, whereby the owner-managers do not apply for any bank loan, for the loan is known to have interests (related to the aspect of religion whereby interests in loans are forbidden in Islam). This is something which is yet to be investigated in other similar or related studies.

II. SME's Financing Sources

Financing sources which are available for SMEs are internal and external sources, and both of them have two types of financing; one is formal, and the other is informal type of

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financing. In each of the two, there are aspects worth considering like debt and equity.

A. Equity Finance

Equity finance is obtained in return for a proportional share of a firms' value, where it may be obtained through personal funds, or private investors which include family members, friends, and partners [11]. In fact, it gives the equity investors a share in the business through their buying part of the firm with their own capital which the business requires at the time. As a result, they will then be interested in the success and profitability of the business, and will give them a degree of control about how the business is run [12]. In addition, it also necessitates the involvement of those members in the decision-making process, as share owner which may in turn be conflicting with the goals and intention of the initiator [13]. Therefore, the owner does not usually prefer the share-splitting due to his or her fear and concern that they will lose control over their firms. Thus, for a small business structured as a corporation, it is very common for shares of the company stock to be sold to friends and family; something which constitutes informal financing [14].

Personal savings of the owner – managers have been shown in most researches to be the most important source of equity finance. Especially for new establishments of SMEs, Hasan [15] found that short-term finance as start-up is obtained mainly from non-institutional sources. Rozali [16] further learn that in Malaysia, 68% of owner-managers settle for self-financing during their start-up. However, personal savings are often insufficient because of the low saving rates, especially in developing countries. Therefore, entrepreneurs often borrow from family, relatives, and friends. Studies have shown that the high percentage of the SME financing comes from informal financing avenues, such as from family and friends. For instance, in Malaysia, 34% of SME financing comes from individual savings and 23.6% from family and friends [17].

In spite of SMEs relying on personal savings when they first need to establish themselves, most of them, in fact still need the external finance to grow and develop.

B. Debt Finance

Debt financing, a notion which indicates that the money borrowed must be repaid, can be obtained from two sources, formal and informal financing. Informal sources refer to family, friends and others, whereas formal sources are normally regarded as institutional sources particularly with regards to banks**.**

Most small firms receive their financing from external sources, and debt financing plays a major role in their financing decisions. Janne, [18]–[19], mention that firms prefer debt financing because it is the lowest source of capital and because the interest on debt is tax-deductible. Moreover, Saridakis, [20] have found the positive link between bank finance and firm survival. Hence, many SMEs, which require external finance, prefer to use debt as a source of finance, particularly banks finance which has remained the dominant source of capital for SMEs in most countries [21]–[22]

However, the banks provide debt financing for firms particularly successful ones and those which continue to grow, and this automatically points to the fact that equity financing has its own limitations. Those limitations are due to the possible loss of control to the external investors. Concerning this, many studies have shown that the most important external finance source for SMEs is the bank loans. For example, in 2005 banks in Malaysia had played a major role in financing SMEs after informal finance (personal savings, family and friends) [23]. Also, Irwin & Scott [24], in their study validate that personal savings is the main source and this is popular among 70% of SMEs' owner-managers. The second source is the bank loan where 13% of owner-managers have used it at startup.

III. SME and Issues Accessing Bank Loan

Firms typically need different types of financing measures for different purposes and at different points in their life cycle. Many studies have demonstrated the heavy reliance of SMEs on internally generated funds but, once established, they tend to operate gearing ratios similar to, or higher than, large firms and a proportion of short-term debt that is higher than large firms .

On the other hand, the loan from commercial banks must come with interest and in Islam, however, interests (Riba) are prohibited in all affairs, including in the business transactions. The verses of the Qur'an state: (Surah al-Rum,verse 39) " *that which you give as interest to increase the people wealth increase not with God; but that which you give in charity, seeking the Goodwill of God, multiplies manifold.*" (30:39) and in (Surah al- Imran, verses 130-2) "*O believers, take not doubled and redoubled interest, and fear God so that you may prosper. Fear the fire which has been prepared for those who reject faith, and obey God and the prophet so that you may receive mercy*." Following this a study by World Bank in [25] suggests religious factor as one of the internal reasons for the owners to not seeking external formal type of financing. In addition, Fig. 1 illustrates both the access and no access to financial services.

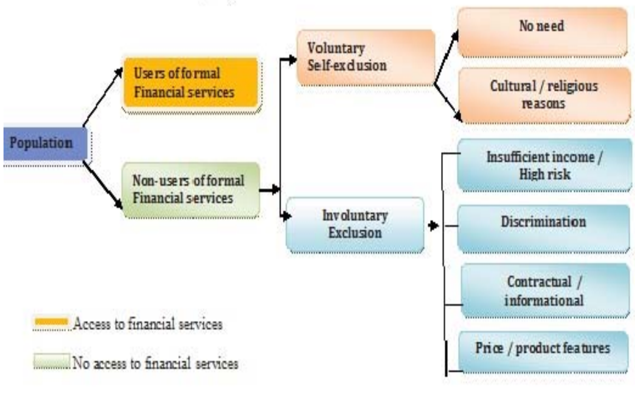

Fig. 1 Access and no access to financial services

From the figure there are two groups of population: the first group has no problem in accessing financial services, and the second group faces problems in its access. The second group is further divided into two kinds of populations, the first

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are those capable to get financial services easily, but chooses not to; they are called the self-excluded population, and the second are those who find difficulties in getting access to financial services; they are called the involuntarily excluded group. Either group has its own reasons. The involuntary exclusion group finds themselves excluded due to the following reasons; insufficient income factors, high risk in investing, discrimination, or informational framework and price of product. The self-excluded group chooses not to get financial services due to aspects which are religious, cultural and functional (or the lack of it). Following the religious reason, according to the annual report of the national program for small and medium enterprises in Libya 2010 *"lack of Islamic finance causes the reluctance of some entrepreneurs to complete the procedures after the approval of the bank"* [26]. Also Almhrog, [27] has found that, most SME owners do not want to obtain loan from the commercial banks, knowing that those loans from commercial banks come with interest which is prohibited in Islam. Similarly, Hasan [28] points out that the owner-managers of these SMEs do not employ bank credit to exercise their piousness. This factor may be the underlying reasons behind the reluctance of owners of SMEs in Libya to seek external formal financing. However, Libya is one of the countries that has yet to practice Islamic banking and finance, even though all Libyans are Muslims.

Furthermore, for those accessing bank loan, as we know money borrowed from commercial banks must be repaid with interest, and the interest rates for business loans are generally determined by the prime rate. A benchmark rate has been volatile, depending on the economic conditions in the country. Therefore, SMEs which have access to bank loans are often charged with higher rates with one to three points higher than the prime rates because smaller firms find it relatively more costly to resolve informational asymmetries with lenders and financiers [29].

Thus, the issue of the unavailability of information affects the willingness of banks to supply debt finance to small firms, on the grounds of greater uncertainty. Such a problem can lead to the existence of 'debt gap' where commercially viable projects do not obtain funding [30]

The constraint on external financing is a particularly serious one and the SMEs use internal finance as a fallback option [31]. In addition, Ca´novas & Solano [32] mention that house banks often serve as a prime example of relationship lending, and they are considered to be the firm's main lender, with the capacity to generate more and better information than other financial intermediaries.

Therefore, this will lead to smaller firms being offered less capital or offered capital at higher rates comparatively to that of larger firms. As a result, the cost of evaluating and administering loans to SMEs would make such loans unprofitable for banks. Even though SMEs with longer bank relationships have enhanced access to loans, at the same time they incur higher costs for their debt [33]. Due to SMEs having a higher risk than large enterprises, and therefore, if prime is 8 per cent, the loan to SMEs may have a rate as low as 9 per cent or as high as 11 per cent. However, they can only obtain these rates from very limited bank credit, which is via the formal banking institution. Besides that, SMEs' ability and desire to borrow from the formal financing is often restricted, so they may have to borrow from the informal finance (non-bank) since no collateral would be involved, and no much information is needed. Bhaird & Lucey [34] confirm that the personal funds of the firm owner and funds from friends and family are the most important in firms with low turnover.

IV. Research Questions

The research questions of the study were (1) from where do SME owners seek to finance their firms?, and (2) what are the reasons behind SMEs not applying for such loans?

V. Research Objectives

The main objectives of present study were (1) to identify the financing sources of SMEs in Libya and (2) to find out why some SMEs do not apply for bank loan.

VI. Conceptual Framework

The conceptual framework for the study was illustrated in Figs. 2 and 3.

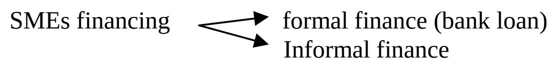

Fig. 2 Conceptual framework for objective 1

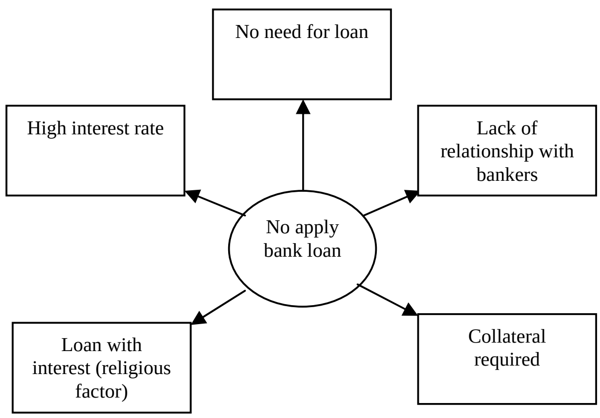

Fig. 3 Conceptual framework for objective 2

VII. Methodology

A research method can be either qualitative or quantitative. To address the research questions we have used both qualitative and quantitative methods to generate data. Primary data were used for the research. The primary data were collected from the owner-managers of the SMEs in Libya. For the research models, we have identified, the sources of financing that have been used by SMEs by questionnaires. Then, we identify the reasons for the non-application of bank loan for 76 SMEs in Libya. To achieve the objectives of the study, questions are in the direction of the most popular sources of finance that these businesses have been using at start up and after startup. This is addressed through a question posed to the SME managers that indicate what type of financing instruments that the firms have been using. To achieve the second objective, the questionnaire contains 5 items that could inform us about the reasons for not applying bank loan such as collateral required by the banks, high interest rate, and lack of relationships with bankers, not in need of loan at the moment and loan with interest (religions factor) which represent five stages of concern and are measured on the scale from 1 (strong disagree) to 5 (strong agree). The questionnaire was translated into the local language, *Arabic.* Then it was tested for validity and reliability. The analysis of the pilot study shows that the cronbach's alpha for the 5 items was 0.9. The results show that the questionnaire has high validity and reliability. Questionnaires were distributed to SMEs' owner managers operating in two cities - Tripoli as the capital city and Sabha as the fourth largest city. The researchers had distributed questionnaires to selected 100 respondents, and 76 were safely returned to the researcher.

Data collection procedures and analysis used in the study are shown in Table I. The Descriptive statistics such as the frequency, mean, and standard deviation were used for determining factors explaining why some SMEs do not apply for bank loan.

TABLE I
RESEARCH QUESTIONS AND DATA ANALYSIS

Research questions	Instruments and Sample	Data Analysis
From where do SME owners finance their firms?	Questionnaire76 owner- manager	Frequency, Descriptive
What are the reasons for SMEs not applying for bank loan?	Questionnaire76 owner- manager	Frequency, Mean, Standard Deviation

VIII. RESULTS

A. Sources of Finance

At the startup stage, SMEs can be financed by both formal avenues like the bank loan or informal financial sources. The SMEs tend to rely more on loans and investment from informal financing such as personal saving and or close family members, as well as loans from other family members and friends.

TABLE II
BANK LOAN AT STARTUP

Valid	Frequency	Percentage
No	63	82.9
Yes	13	17.1
Total	76	100

Looking at Table II, almost 82.9% of the respondents make use of informal finance as self-financing, family, friends during their start-up period and only 17.1 % obtain loans from banks. This finding confirms the results of other studies [35] –[36]–[37]–[38].However, savings as a financing source is natural for SMEs at their early stage of business.

Furthermore, the ability of SMEs to acquire debt is limited at the early stage. Thus, it is common for entrepreneurs to rely on personal savings, friends, and relatives as primary sources of capital at the beginning of the business. As Storey [39] (205) notes, "The small business owner is likely to be significantly better informed about the business than an outsider such as, a bank"

B. Main Sources of Start-Up Capital

This question was developed under six broad categories namely; personal savings only, family, friends, family and friends in return for a share in the profits or losses of the business only (inactive partner) and as an active partner who shares profits and losses as well as the management of the SMEs and bank loan. The idea was to identify the main sources of start-up capital for SMEs.

Respondents were asked to indicate which of these sources of finance they have to depend on to help provide their start-up capital. Table III presents a summary of the results.

TABLE III
SOURCES OF FINANCE AT THE STARTUP STAGE

Source	Frequency	Percentage
Personal	46	60.5
Family Loan	3	3.9
Friends Loan	7	9.2
Active Partner	2	2.6
Inactive Partner	4	5.3
Bank Loan	13	17.1
Total	75	98.7
Missing System	1	1.3
Overall Total	76	100.0

An inspection of the data presented in Table III clearly shows that 60.5% respondents rely on their personal resources; while (3.9 percent) are reliant on their families and 9.2% on friends. Only 2.6 percent admitted to have obtained funding from family and / or friends in return for a share in the profit of the business, and similarly only 5.3% obtained funding from inactive partners. However, Inactive and active partners both show very low percentages (see Table III above for precise figures). This may suggest that, in seeking for financing, owner-managers prefer to rely upon sources that do not affect the decision-making processes of their firms. Bank loans could be considered as the second most important source of finance in terms of the start-up capital since (17.1%) of the respondents have financed their start-up phase through these channels.

C. Main Sources of Financing after Startup

SMEs, after the startup stage, are perceived to have built a good rapport with their banks. Through continuous contact, their banks can gather information with the firms and entrepreneurs in the provision of financial services. The information produced, emerging from these relationships may be collected over time together with the extension of credit. This relationship could lead to a number of benefits to SMEs, including lower cost, or greater availability of credit due to efficient gathering of information, protection against credit crunches, or the provision of implicit interest rate or credit risk insurance.

TABLE IV
APPLIED BANK LOAN AFTER STARTUP

Valid	Frequency	Percentage
No	55	72.4
Yes	21	27.6
Total	76	100.0

However, 27.6% have applied bank loan and 72.4% have used informal financing (Table IV shows SMEs which apply and which do not apply for bank loan) such as personal savings (25%), family (25%) and 2% of the respondents use the firm's profit as shown in table V below

TABLE V
FINANCING EXPANSION AFTER STARTUP

Source	Frequency	Percentage
Family	19	25.0
Trade Credit	12	15.8
Personal Saving	19	25.0
Firm Profit	4	5.3
Bank loan	21	27.6
Total	75	98.7
System	1	1.3
Overall Total	76	100.0

Therefore, to understand and find out why SMEs do not apply any bank loan (to respond to the second objective of the study), respondents were asked to indicate which of these reasons contribute to them not applying for bank loan- because of the collateral required by the banks, high interest, the fact that they do not need any loan, loan has interest and this demotivates them, and the poor relationship with bankers. Table VI summarizes the analysis of factors for the non-applicants of bank loan. The results of the total highest values of mean show that the high mean scores of respondents indicating the loan with interest (religions factor) was 3.5132 (M=3.5 .SD = 2.2) Collateral required was (M = 2.5, SD = 1.8), high interest rate was (M = 2, SD = 1.7), loan no needed (M = 1.8, SD = 1.5) and lack of relationship with bankers (M = 1.5, SD = 1.1).

TABLE VI
MEAN AND STANDARD DEVIATION

Type	Mean	Standard Deviation
Collateral required	2.55	1.85
High interest rate	2.15	1.70
No need loan	1.78	1.49
Loan with interest	3.51	2.20
Lack relationship bankers	1.49	1.17

However, based on the results, the highest mean value for 'loan has interest' was 3.5(M = 3.5, SD = 2.2) which indicates that the most important reason as to why SMEs do not apply for any loan from the bank is due to the presence of interest. This finding confirms the results of other studies such as [40]- [41]- [42] and also with the reported 2010 national program for SMEs in Libya [43]. The results indicate that the total lowest values remain at the 'lack of relationship with bankers', no loan needed, high interest rates and collateral required as well as the fact that they do not influence SMEs' owner-managers in applying for bank loan.

IX. CONCLUSION

The paper examines the financing practices of SMEs in Libya and identifies SMEs' sources and uses of funds at two different phases of business life cycle: start-up and matured stages. The findings are based on a sample of 76 SMEs. It is evident that SMEs which use informal financing sources at startup (82.9%) and which prefer personal savings (60.5%) are favored as the means of securing financing for SMEs in Libya during the start-up stage. Respondents who use the formal financing during startup were only 17%. Additionally, 72.4 % SME financing after start up still use informal financing, such as personal savings 25%, also family (25%), trade credit 15.8% and SME profits 5.3%. However, 27% use the bank loan. Therefore, the main reasons for their not applying for the bank loan is that the loan comes with interest (religion factor) while others are regarded as insignificant such as collateral required, high interest rate, no need for loan and the lack of relationship with the bankers.

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