ISSN (Online): 3007-1038
Pages: 225–231
DOI: 10.62997/rl.2025.41077

https://regionallens.com

Exploring the Role of Islamic Finance in Supporting SME Growth: A Review Study

Shahid Hussain [1] **Muhammad Ismail** [2]

Abstract: Small and medium-sized businesses (SMEs) are the primary drivers of economic growth, leading to the creation of new jobs, the introduction of new products and services, and the development of innovative, environmentally sustainable technologies. Their activities help to stabilize the economy and significantly reduce the number of people living in poverty. Having said this, the fact remains that many SMEs are still not getting enough funding, a situation that not only halls the expansion but also threatens the very existence of these businesses. Islamic finance, which is the Shariah-compliant version of the conventional interest-based loans, is a feasible alternative that is inclusive as well as ethical. The restrictions of the study will be documents and publications that are from 2020 to 2024 in connection with the utilization of Islamic products in supporting the growth of SMEs. It highlights the limitations that organizations, including the promotion of financial education, are encountering, the impact of legislative frameworks, and how they act as barriers to the takeup of Islamic finance by SMEs. As per the results obtained, the infusion of Islamic finance in the SMEs' business plans can be expected to be a catalyst for equitable economic growth, the concomitant decrease of financial exclusion, and the creation of an entrepreneurial spirit. However, further empirical evidence is needed to quantify the local differences and to measure their effects over the long term.

Key Words: Islamic Finance, SME Growth, Economy, Business, Sukuk

Introduction

It is widely agreed that small and medium-sized businesses (SMEs) are an essential factor for furthering new projects, increasing employment, and promoting the economy. According to the IFC (International Finance Corporation), more than 90% of companies worldwide are SMEs, and in countries like Ethiopia, 90% of those firms are at a standstill because they cannot get a loan from the bank. If this was turned around, these small to medium firms whose business is in the informal sector but contributing 20% of the local economy would grow and be more profitable because they would then be able to borrow money from the bank. It is obvious that the 90% of SMEs that are operating informally in the economy are profitable businesses that have the potential to get financial help (Islam & Miajee, 2012). Research has shown that we are missing out on economic growth potential by persisting to only cater to the formal sector SMEs. The inability of start-ups to be able to grow is detrimental. Therefore, it is important for helping them find a viable financial solution with the least possible loss. If we have products suitable for them, we should participate in the process of developing mechanisms for releasing them. Thus, some of the challenges that SMEs in the informal sector meet include the requirement of collateral, bureaucratic hurdles in the allocation of funding, and the requirements of the loan being adhered to in a strict manner.

Purpose of the Study

The main goal of this study is to find out in what way Islamic finance can be of assistance to SMEs whose problems are related to the lack of funding. The goals of this study are:

[1] PhD Scholar, Department of Business Administration, Iqra National University, Peshawar, Khyber Pakhtunkhwa, Pakistan. Email: shahid.mcom2009@gmail.com

[2] Assistant Professor (Finance), Department of Business Administration, Iqra National University, Peshawar, Khyber Pakhtunkhwa, Pakistan. Email: muhammadismailrashid@gmail.com

Citation: Hussain, S., & Ismail, M. (2025). Exploring the Role of Islamic Finance in Supporting SME Growth: A Review Study. *Regional Lens, 4*(1), 225-231. https://doi.org/10.62997/rl.2025.41077

Corresponding Author: Shahid Hussain (✉ Shahid.mcom2009@gmail.com)

1. To find out how Islamic financial products issue financing to SMEs that comply with Sharia law
2. To find out the impact of the increase of financial and policy literacy on the willingness of SME owners to shift to Islamic finance.
3. To give details on the influence of Islamic finance on the competitiveness, sustainability, and growth of SMEs.

Methodology

This study uses a qualitative review approach to scrutinize the connection between Islamic finance and the growth of small and medium-sized enterprises (SMEs), especially the progress in the years 2020 to 2024. The research is based on the meticulous exploration of different types of sources like peer-reviewed academic journals, official government publications, institutional reports, and documented case studies all of which are about the field. Special consideration is given to the literature that is mainly about how the Islamic financial instruments—mudarabah, musharakah, ijara, and takaful—have been the wheel behind SME development within different socio-economic contexts.

The review encompasses the in-depth coverage of both global and national policy documents regarding the issue of the Islamic financial system's integration with general economic development strategies. In addition, the research takes into account the results of the financial literacy campaign in the form of financial education programs and public information campaigns, which have been put into place to develop SME owners' and aspiring entrepreneurs' financial literacy, with special attention being paid to people in underbanked communities. Among the things specifically looked at in the power of the review is the launch of certain policy changes and regulatory reforms in the period of time under review that were targeted on financial inclusion and the access to Islamic financial services, since they were the most important.

Taking data from various sources and using triangulation, the research is targeted at offering a more nuanced comprehension of how much Islamic banking has been behind the growth in SMEs, the problems still remaining, and the actions taken to resolve them. Qualitative review research method assists to explore in full thematic patterns, institutional practices, and policy implications that are not found in totally quantitative analyses.

Literature Review

Academic research concentrates on the link between Islamic finance and the growth of small and medium businesses. Most urgent is the need to guarantee a just and inclusive financial system as well as the global economic volatility. Guided by Sharia law, Islamic financial institutions provide a different paradigm from conventional interest-based systems. Particularly for micro, small, and medium businesses in important Muslim nations as well as other regions, they are absolutely vital in helping to raise capital.

Attraction to Islamic Financial Products

According to Khan and Bhatti (2021), micro and small companies (MSEs) are likely to interact with Islamic financial institutions mostly because of the ethical appeal and good qualities associated with the Sharia-compliant financial products. Their emancipation from the traditional interpretation of riba and concentration only on activities with profit-and-loss sharing instruments is one of the main reasons why such kind of financial arrangements attract interest. Certainly, such structures drive financiers looking for monetary rewards as well as funding ideas based in Islamic ethics.

Sharia-Compliant Financing Instruments

Ahmed (2020) notes that mainly murabaha and musharakah, many financial systems are growing utilising Islamic contracts. These projects are offered as replacements for traditional lending by not charging interest and fostering risk-sharing opportunities between the investor and the entrepreneur. Murabaha therefore raises capital availability by aiding the asset acquisition free of interest; musharakah, in re-defining SMEs as partners rather than borrowers, improves their sustainabiliity capacities in operation. Such actions actually improve firms' adaptability and toughness. Hasan and Dridi (2022) add weight to this by contending that companies employing Islamic financial instruments would be insulated from the worst of the recession. Their findings indicate that instruments for economic stabilization include profit-and-loss-sharing arrangements like mudarabah and musharakah. Regarding certain instances, those employing Islamic financial leases (ijara) were somewhat more susceptible to be impacted by negative economic events than their traditional counterparts, notwithstanding the slower growth rate. Though there are intrinsic dangers, these Islamic leasing agreements give borrowers ethical but less volatile funding options at discounted rates.

Sukuk and Infrastructure for SME Financing

Highlighting how well suited Sukuk—Islamic bonds—as a financial tool is to fund significant infrastructure and promote small company expansion. Based on asset-backing and risk-sharing principles, Sukuk have increasing flexibility to meet the particular needs of smaller businesses, especially in less developed countries where traditional bond markets are less developed, by enabling them to generate significant money without relying on interest-bearing vehicles.

Institutional and Regulatory Support

SMEs are increasingly investigating Islamic financing, but their actual acceptance depends on institutional confidence and legislative clarity. Emphasizing the need of empowering laws that support Islamic financial inclusion, Haneef and zafar (2020). Though Islamic finance has enormous capacity to drive SME growth, they say that unless there are robust legal systems and strict compliance with Sharia principles, that potential will be unrealized.

Khokher (2021) also stress the many elements limiting the widespread adoption of Islamic finance for SMEs: inadequate awareness among stakeholders, limited financial product variety available, and institutional obstacles. Their research uncovered a significant absence of human resource training and product development indicating an urgent need for capacity-building initiatives in Islamic banking systems

The Role of Financial Education and Fintech

Investigating the transformational possibilities, we are in Javaid and Raza (2025) look at do Islamic banking with purpose driven financial literacy education. Their investigations demonstrated that small-mid-size businesses (SMEs) have better acceptance and company performance when exposed to actual practices and concepts of Islamic finance. Financial literacy provides entrepreneurs with wise financial decision-making processes especially in complex contracts such as mudarabah and musharakah.

Fintech innovation as well as changing the accessibility of Islamic financial products also plays a role. Primarily from the view of a profit-sharing based peer-to-peer (P2P) lending approach, Laila et al. (2023) illustrate the accelerating growth of Islamic finance products. These models provide Sharia-compliant, flexible finance alternatives to help meet the financial needs of historically underserved SME communities by avoiding formal collateral obligations.

Cultural Context and Regional Values

Waris et al. (2025) provide evidence of the sociological factors that inform the acceptance of Islamic finance in rural Pakistan. Our economic integration is rooted in the necessity of belief by our regional/cultural constituents. Rural business owners are open to adopting and applying Islamic finance solutions that fit the practices and beliefs of Islamic culture.

Karim et al. (2023) examine default rates and repayment behaviours on both conventional and Islamic microcredit products in an effort to explain this. Their research shows lower default rates and more retention of customers using Islamic finance, which can be explained by the ethical character of Islamic finance and the transparency of operations. This means Islamic banks are less at credit risk and develop too-loyal customers.

SME Profitability and Business Expansion

Numerous studies have indicated that Islamic finance is beneficial to the growth and profitability of SMEs. Tariq et al. (2021) found that SMEs that use Islamic financial mechanisms see substantial performance value-added that is explicitly attributable to performance. By providing tailored financial planning and upholding ethical business practices, these companies foster environmentally sustainable development.

Hanif et al. (2022) argue that Islamic banks are crucial for addressing both scarcity and resource allocation, particularly for start-ups. They posit that Islamic finance offers strategic partnership models that align with long-run firms, while providing much more than financial resources. These types of partnerships contribute to decreasing the need for financial dependency because they allow for parallel paths of development.

Ijara contracts, or a leasing agreement in Islamic terms, can serve as a tremendous impetus for up front productivity. According to Ishaq (2022), ijara allows SMEs to acquire the use of necessary equipment without most of the high upfront costs to start such an engagement. This is particularly beneficial for SMEs in the industrial and service sectors because it can contribute to the acceleration of capabilities and possibly support firm growth.

Institution Building and Rural Empowerment

The study by Ali (2024) provides a thorough overview of the role Islamic microfinance groups play in rural development. The authors highlight the significance of IMFIs in providing financial solutions to SMEs, particularly in remoter areas. These institutions legitimized themselves and expanded Islamic banking's reach through institutional adherence and a manifold attention to regional development outcomes. Islamic finance spurs rural development through prudent, managed growth.

National and Global Perspectives

Taking a close-up view, Tariq (2021) measured Islamic finance within Malaysia, a world leader in Sharia compliant banking. They reported a simple positive correlation accounting for the composite growth of the institution (staff, premises, assets etc.) and the channel of engagement of the Islamic banks towards SMEs. The Malaysian Islamic banks are engaging SME stakeholders by providing bespoke goods and services designed to meet the needs of the SMEs sector. Ethically, Kazak (2024) identified that many SMEs pursue Islamic finance so that they can contribute to a fairer and just society. Also, Islamic finance is predicated on the idea of ethics, with the value-based philosophy of Islamic finance being a major differentiator from conventional banking. As noted by Qadri and Bhatti (2025), Islamic financing is an inclusive business open to everyone. Its inclusiveness enhances its social purpose by ensuring that everyone has access to financing opportunities. Ismail et al. (2021) commented that Islamic venture capital can provide a proactive mechanism for financing innovative SMEs. Islamic venture capital is different to conventional borrowing in that it links ownership involvement with means of financing, which enables business owners forgo traditional loan repayments terms, and the entrepreneurs aren't tied to regular repayment of principal & interest. The flexibility of Islamic venture capital allows innovation, trial & error and longevity.

Risk Mitigation and Digitalization

Islamic finance is uniquely able to provide useful risk-reduction solutions for SMEs. The use of Takaful, or Islamic insurance, in protecting organizations from a variety of risks, was discussed by Riaz et al. (2020). These Takaful products, which utilize principles from Islam, allow entrepreneurs to run their businesses in a protected environment. In addition, Ebrahim et al. (2022) discussed hybrid Islamic instruments focused on facilitating portfolio diversification. Those instruments allow SMEs to have a wider number of financial options that are distinctly Sharia compliant and tailored to the needs of entrepreneurs by using parts of multiple Sharia compliant contracts. Qadri & Bhatti (2024) also discussed how digitization is essential in broadening the reach of Islamic banking. Digital applications, digital wallets and online platforms, have significantly improved an SME's access to Islamic financial solutions, especially in underdeveloped or rural regions. The digital transformation has not only reduced the cost of operations, but also facilitated reach to customers, along with increasing transparency.

Strengthening Evidence of Impact

There is ample research suggesting that Islamic finance positively impacts small and medium-sized enterprises (SMEs). Recent studies by Farooq, Rahman, Khan, Akram, Ashraf & Riasat (2022) indicate that Islamic finance is a powerful accelerator for socioeconomic development especially when other financial systems struggle to support equitable growth.

Key Concepts and Instruments in Islamic Finance

Fundamental principles of Islamic finance include the prohibition of interest, the promotion of ethical investing and the avoidance of uncertainty (gharar), generally defined as a financial product based on a profit sharing agreement (morabah).

1. Musharakah (collaborative endeavors)
2. Cost-plus financing, or murabaha
3. Ijara (renting)
4. Islamic bonds, or Sukuk

These are tools for the maintenance of Islamic legal customs as well as for profit-making economic activity.

Findings and Discussion

Islamic finance, the analysis shows, offers several advantages to SMEs.

1. Financing Access to funds for SME's who are not accepted normally by traditional banks due to lack of security (cash), or credit history is provided through Islamic finance.
2. Risk Sharing: In encouraging mutual responsibility between the financier and the entrepreneur, mechanisms such as Mudarabah and Musharakah reduce the load on the borrower.
3. Ethical and social benefits Islamic finance may be more compatible with the values of SME's in socially responsible activities.
4. Policy support The tax breaks and Sharia law-compliant loan schemes are two types of government incentives that could help promote SMEs.

However, a number of constraints were also referred to: SME owners are not well informed and understand Islamic finance. institutional and regulatory constraints. Lack of available Islamic finance products for the needs of SME.

Research Limitations and Future Directions

1. While the study identifies promising trends, it also points out gaps that future research should address:
2. Comparative studies between Islamic and conventional financing impacts on SMEs.
3. Regional differences in the availability and uptake of Islamic finance.
4. Longitudinal studies on the sustainability and profitability of SMEs financed through Islamic instruments.
5. The role of digital financial services in expanding access to Islamic finance.

Conclusion

Islamic finance holds significant promise in supporting SME development through ethical, inclusive, and Sharia-compliant financial solutions. To maximize its potential, there is a need for greater policy support, improved financial literacy among entrepreneurs, and innovation in Islamic financial product development. Addressing current limitations will enable Islamic finance to play a transformative role in fostering entrepreneurship, economic equity, and sustainable growth.

Originality and Value

This study provides valuable insights into the capacity of Islamic finance to overcome SME financing challenges. It emphasizes the importance of financial education and policy reform in leveraging Islamic finance for inclusive economic development. The findings contribute to a growing body of knowledge and offer guidance for policymakers, financial institutions, and SME stakeholders aiming to build a more equitable financial system.

References

Ahmad, T., & Zhang, D. (2020). A critical review of comparative global historical energy consumption and future demand: The story told so far. *Energy Reports*, *6*, 1973–1991. https://doi.org/10.1016/j.egyr.2020.07.020

Ali, A. H., El-Gamal, S. Y., Elbarky, S., & Barakat, M. R. (2024). The impact of reverse logistics decision on environmental and social performance: the role of green integration and blockchain. *International Journal of Integrated Supply Management*, *17*(3–4), 323–348. http://dx.doi.org/10.1504/IJISM.2024.142782

Ali, H. (2024). *Islamic microfinance: landscape, models and future prospects*. Walter de Gruyter GmbH & Co KG.

Ebrahim, M. S., Salleh, M. O., & Sheikh, M. (2014). Rationalizing Hybrid Financial Instruments from an Uṣūlī Perspective. *arab law quarterly*, *28*(3), 295-306. https://doi.org/10.1163/15730255-12341284

Farooq, H. O., Rahman, D. S. U., Khan, H., Akram, I., Ashraf, M. Q., & Riasat, S. (2023). An Analysis Of The Correlation Between Social Religion And Economics Development. *Bulletin of Business and Economics (BBE)*, *12*(2), 253-259. https://bbejournal.com/BBE/article/view/479

Hanif, M., & Zafar, K. (2020). Developments in Islamic finance literature: Evidence from specialized journals. *Journal of King Abdulaziz University: Islamic Economics*, *33*(2), 3-23. http://dx.doi.org/10.4197/Islec.33-2.1

Hanif, N., Ghazanfar, S., & Bashir, R. (2022). Feminist Stylistic Analysis of Kamila Shamsie's Home Fire. *Pakistan Languages and Humanities Review, 6*(2), 102-114. http://dx.doi.org/10.47205/plhr.2022(6-II)09

Hasan, M., & Dridi, J. (2011). The effects of the global crisis on Islamic and conventional banks: A comparative study. *Journal of International Commerce Economics and Policy*, *02*(02), 163–200. https://doi.org/10.1142/s1793993311000270

Ishaq, S. (2022). *Small and Medium Enterprises'(SMEs) Access to Islamic Banking Finance in Pakistan* (Doctoral dissertation, Aston University).

Islam, K. M. A., & Karim Miajee, M. R. (2018). Small and medium enterprises (SMEs) financing in Bangladesh: A review of literature. *International Journal of Small and Medium Enterprises*, *1*(1), 11–15. https://doi.org/10.46281/ijsmes.v1i1.62

Ismail, S., Hassan, M. K., & Rahmat, S. (2023). *Islamic social finance: Waqf, endowment, and SMEs*. Edward Elgar Publishing.

Javaid, M. E., & Raza, S. H. (2025). Developing a Competitiveness Index for Manufacturing Firms: Insights from Pakistan. *Interdisciplinary Journal of Management Studies*, *18*(3), 507-523. http://dx.doi.org/10.22059/ijms.2025.378004.676806

Karim, R., Hasan, M. M., Waaje, A., Yesmin, S. H., & Roshid, M. M. (2023). Financial Performance of Bangladeshi Listed Commercial Banks: A Generation-based Analysis. *International Journal of Finance & Banking Studies*, *12*(4), 46–56. http://dx.doi.org/10.20525/ijfbs.v12i4.3170

Kazak, H. (2024). Is Islamic financial management getting enough attention? A bibliometric analysis. *Journal of Islamic Accounting and Business Research*, *15*(7), 1156-1177. https://doi.org/10.1108/JIABR-02-2023-0068

Khan, G., & Bhatti, R. (2021). Collection development and managment in the university libraries of Pakistan: A survey of users' satisfaction. *The International Information & Library Review*, *53*(3), 239–253. https://doi.org/10.1080/10572317.2020.1830739

Khokher, Z. U. R. (2021). The role of Islamic financial system in building sustainable infrastructure. *Islamic Finance and Sustainable Development: A Sustainable Economic Framework for Muslim and Non-Muslim Countries*, 151-190. http://dx.doi.org/10.1007/978-3-030-76016-8_8

Laila, N., Ratnasari, R. T., Ismail, S., Mahphoth, M. H., & Hidzir, P. A. M. (2022). Awareness towards waqf entrepreneurship in Malaysia and Indonesia: An empirical investigation. *Al-Shajarah*, *27*(1), 77–100. https://doi.org/10.31436/shajarah.v27i1.1391

Laila, N., Ratnasari, R. T., Ismail, S., Mohd Hidzir, P. A., & Mahphoth, M. H. (2023). The intention of small and medium enterprises' owners to participate in waqf: the case of Malaysia and Indonesia. *International Journal of Islamic and Middle Eastern Finance and Management*, *16*(3), 429-447. http://dx.doi.org/10.1108/IMEFM-01-2022-0014

Qadri, H. M. U. D., & Bhatti, M. I. (2025). *Islamic Finance in the Modern Era* (Vol. 25). Retrieved January. https://doi.org/10.4324/9781003366751

Qadri, H. M.-U.-D., & Bhatti, M. I. (2024). *Islamic finance in the modern era: Digitalization, fintech and social finance*. Routledge. http://dx.doi.org/10.4324/9781003366751

Riaz, S., Saleem, Q., Ishaq, H. M., & Aqdas, R. (2021). The determinants of family Takaful demand in Pakistan. *Hamdard Islamicus*, *44*(2), 77-100.

Tariq, S. (2021). *Use of Neuro-Market Approach to Provide Better Marketing Proposition for Banking Products/Financial Banking Accounts to Solve Issue of Financial Inclusion* [Master Thesis, Department of Business Studies Pakistan Institute of Development Economics].

Tariq, W., Tariq, A., & Nemilentseva, M. (2024). Advancing Gender Equality in Banking: The Role of Female Directors and Board Monitoring in Driving Financial Performance. *Journal of Economic Sciences, 3*(2), 227-244. http://dx.doi.org/10.55603/jes.v3i2.a8

Waris, M. A., Arshad, Z., & Waqas, M. (2025). Evaluation of Customer Satisfaction and Economic Efficiency: A Study of Conventional and Islamic Insurance Industry in Pakistan. *Pakistan Journal of Humanities and Social Sciences*, *13*(1), 542–561. http://dx.doi.org/10.52131/pjhss.2025.v13i1.2774