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Attitudes of Australian small business firms and financial institutions towards the profit/loss sharing method of finance

Abul Jalaluddin
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ATTITUDES OF AUSTRALIAN SMALL BUSINESS FIRMS AND FINANCIAL INSTITUTIONS TOWARDS THE PROFIT/LOSS SHARING METHOD OF FINANCE

A Thesis Submitted in Fulfilment of the Requirements for the Award of the Degree

DOCTOR OF PHILOSOPHY

from

UNIVERSITY OF WOLLONGONG
New South Wales
Australia

by

Abul Jalaluddin
B.Ec. Honours (Malaysia)
M.Ec. Honours (Malaysia)

DEPARTMENT OF ECONOMICS
1999
DECLARATION

I hereby certify that this thesis has not been submitted previously as part of the requirements of another degree and that it is the result of my own independent research.

--- Abul Jalaluddin
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DEDICATION

To my mother, Mrs. Najma Begum- a living courage to my life and my wife, Tengku Rahazimah Binti Tengku Mahmud- a partner in heart and intellect.
ABSTRACT

Small business firms usually obtain finance from commercial lenders on fixed or variable rates of interest. These businesses, or any other borrower for that matter, will have to pay back the principal borrowed along with its stipulated interest at the end of the specified period. They are willing to pay the interest on the loan over and above the principal borrowed because they expect the borrowed amount of capital would make a marginal contribution in their profit at least equal to the total interest paid. They are legally liable for the payment of the interest and the principal regardless of their actual level of earnings. They must make these payments as per contract even if they suffer heavy losses in the project. This arrangement, which is common in most, if not all countries of the world, may cause a great deal of hardship on the part of the borrowers, especially at times of economic slowdown.

There is a method of finance called profit/loss sharing practiced in some South-East Asian and Middle Eastern countries. A number of financial institutions in the Western countries including UK, Denmark, Luxembourg and Switzerland has been applying this method since the early 1980s.

The main objective of this thesis is to find out the attitudes towards, motivations for and probability of using the profit/loss sharing principle of finance by the Australian small businesses and financial institutions. Two surveys were conducted to achieve this objective. Multivariate statistical analysis, especially factor analysis, discriminant analysis and logit and probit regressions, was applied to the survey results.

Factor analysis identified five factors which may explain why small businesses are motivated to borrow funds using the profit/loss sharing method of finance. These factors are business support, risk sharing, risk of default in the traditional system, cost of borrowing and suitability of the profit/loss sharing method. Another three factors were identified to provide reasons why small businesses would not borrow funds using this new principle namely, terms of borrowing, management intervention and high cost of borrowing.

Discriminant analysis indicates that risk sharing between borrowers and lenders is the most important predictor in discriminating between the two groups of small businesses—those who would and those who would not like to borrow funds using this method. The other discriminating variables include motivation for business expansion, cost of borrowing and management intervention.

The logit and probit models show that the higher the degree of risk sharing, the lesser the cost of borrowing and the greater the motivation to business expansion, the higher the probability that the small businesses would apply the profit/loss sharing method. The respondents also indicated that the lower the degree of management intervention, the higher the likelihood that the small businesses would be prepared to apply this method of finance.

A large number of variables determining the motives of financial institutions to lend funds on the basis of the profit/loss sharing method were reduced to four factors namely, business support, growth in demand for funds, risk of default under the traditional system and potential higher return to lenders. At least three underlying factors may
explain why some financial institutions would not like to lend funds on this basis namely, management complication, unfamiliarity of the profit/loss sharing method and risk sharing with borrowers.

Discriminant analysis applied to financial institutions suggests that the growth in demand for funds is the most important predictor in discriminating between the financial institutions who are prepared to lend money on the basis of the profit/loss sharing method and those who are not. The other significantly discriminating variables include the potential higher return on funds, depositors’ concern, monetary regulation, management complexity and risk sharing with borrowers.

As a majority of the responding small businesses (59.5%) are willing to borrow and a sizeable percentage of the financial institutions (41.2%) are willing to lend funds on the principle of the profit/loss sharing, the Australian monetary authority could consider offering this new method of finance as an integral part of the Australian financial system.

The financial institutions may introduce the new method on a trial basis to selected customers. The financial institutions should find some mechanisms to minimise the concerns of depositors for lending their money using this principle, perhaps through obtaining prior consent of depositors in this regard. They should also conduct serious research in the areas of simplified business performance monitoring, auditing and record keeping to minimise the cost of lending and secure a greater share of the market.
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