

The introduction of Islamic finance in Libya: Capturing the opportunities for SMEs development

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ARTICLE INFO

Article history:

Received 22 October 2016

Received in revised form

15 January 2017

Accepted 27 January 2017

Published 30 January 2017

Keywords:

Islamic Finance

SMEs

Libya

ABSTRACT

In most countries, especially the developing ones, SMEs have a dynamic role as engines through which the growth objectives can be accomplished. This is very true in the case of Libya where the economy has been over-reliant on oil and gas as well as inefficient public sector. Unfortunately, SMEs in Libya are not playing their expected role as access to finance remains to be a formidable challenge. While banks remain the major external financier, if not the only one, many studies found that Libyans in general avoid dealing with conventional banks mainly due to religious beliefs. However, the recent introduction of Islamic banking and finance in the country could be a game changer. As such, this paper attempts to assess the opportunities for SMEs development in Libya following the recent introduction of Islamic finance. The study is exploratory; therefore the relevant literature is sourced and reviewed. The review shows that there is a strong demand for Islamic finance products from Libyan businesses including SMEs. Coupled with a strong enabling environment in which political stability and regulatory clarity are maintained Islamic finance is viable and has the ability to significantly contribute to the development of SMEs sector.

1. Introduction

Excessively reliant on the extraction of oil and gas as well as inefficient public sector, the Libyan economy is arguably one of the least diverse in the Middle East and North Africa region (MENA). Additionally, the predominance of the state and the lack of strong institutions have prevented the use of the significant financial resources (oil revenues) to address major challenges in the country such as unemployment and private sector development. However, a recent tendency has been towards encouraging and subsidising the private sector, represented mainly by small and medium enterprises, henceforth SMEs. This sector has recently attracted the interest of decision makers; as a result, in 2006 the Employment Fund was established. This was followed by the establishment of the National Programme for SMEs in 2007. In 2010, the basic legal infrastructure for developing the private sector was adopted with 22 new laws changing fundamentally commerce, customs, income tax, labour, and land registry easing the establishment of more SMEs within the economy. More recently, in 2012, the Libyan government launched the Libya Enterprise. The mission of Libya Enterprise is to create a supportive environment for SMEs throughout the country by promoting entrepreneurial culture and providing

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business support for start-ups. Consequently, many SMEs have been launched but many of them disappeared shortly mainly because of lack of funding sources.

The official definition of SMEs in Libya set by the General People's Committee in 2006, has integrated two quantitative parameters namely; the number of employees and the amount of invested capital. Consequently, small businesses have been officially defined as enterprises employ up to 25 employees with an invested capital of maximum LD 2.5 million (LD: Libyan Dinar), whilst those with a labour size between 25 to 50 workers and an invested capital up to LD 5 million are medium.

SMEs sector is perceived to have the potential to be the growth engines for Libya's private sector in order to alleviate oil and hydrocarbon dependency, kick-starts the growth and helps in re-building the national economy. However, according to previous research Libyan SMEs are facing a financing gap that causes under-capitalisation and hinders their economic growth (Elmansori and Arthur, 2014). A study by Albadri in (2006) found that Libyan SMEs depend largely on internal funding and solely a small percentage can access external sources. In addition, Alrobaie (2008) attributed the limited role of SMEs in economic and social development in Libya to a number of problems encountering them foremost of which is the lack of access to finance

One of the main reasons that Libyan SMEs demand of finance has not been met yet is the absence of Islamic finance. Elmansori and Arthur (2014) found that when seeking finance many Libyan SMEs have a cautious attitude towards the issue of interest regardless of the terms. The authors argued that the emergence of Islamic finance could make a significant difference in overcoming this hindrance. In the same vein, it was suggested that the implementation of Islamic banking and finance to meet the customers' needs, including SMEs', could play an important role in boosting the development in the Libyan society (Saleh, 2005).

Till recently the potential of Islamic banking in Libya has not been realized nor studied to be utilized as conventional interest-based banking had been the sole ingredient of the country's financial system. However, following the 2011 revolution the introducing of Islamic banking has come to the forefront of the priorities of the country's new authorities. The initial announcement about the future of Islamic banking and finance was made in late 2011. This was followed by other concrete steps; in 2012 the Central Bank of Libya obtained an approval from the National Transitional Council to promulgate a new law which formally introduced Islamic banking and finance to Libya for the first time. Another major step forward was taken in early 2013 when the General National Congress promulgated the Decree (No. 1 of 2013) banning the charging of interest on loans granted to individuals. Furthermore, it was announced that the same principles will apply to corporate loans in 2015. In addition, under this law, a special fund was established to provide interest-free loans. This fund is to be under the supervision of the Central Bank. Moreover, in practice terms, some local banks have already taken steps to meet the demand for Islamic finance in the country. For example, Gumhouria Bank (Libya's largest commercial bank) has opened a number of branches offering Islamic finance products to its clients with *Murabahah* products being the only models offered currently.

In 2013, in cooperation with the Islamic Development Bank, the Central Bank of Libya facilitated the first in a series of Islamic banking workshops to explore the financing of SMEs and establish strategic partnerships between various stakeholders including commercial banks, government agencies and non-governmental organizations. Later in the same year, The Islamic Corporation for the Development of the Private Sector and the Libyan Ministry of Economy signed an agreement to promote and facilitate access of SMEs to Islamic finance products.

In the light of the above it can be said that SMEs have been increasingly recognised as both a potential engine of growth and a means to restructure and diversify the Libyan economy. However, access to finance has been a major hinder. Yet, little academic work has been conducted in order to advance the development of this sector with regard to the access to finance especially with respect to Islamic finance. As such, this paper is an attempt to tap the potential of Islamic finance products to serve as an alternative funding source for SMEs in Libya.

The remainder of the paper is organized as follows: the next section links between Islamic finance and microfinance. An overview of the status of SMEs financing in Libya is provided in the third section. Section 4 discusses the opportunities of Islamic finance across SMEs in Libya. Finally, section 5 concludes.

2. Islamic finance and microfinance

It is argued in the Islamic financing literature that many of the elements of microfinance are in accordance with the broader objectives of Islamic finance. In this context Obidullah and Lattif (2008) believe in the possibility of a successful marriage between the two disciplines. They support their belief by clarifying some aspects these two disciplines have in common.

According to authors both Islamic finance and microfinance advocate entrepreneurship and risk sharing between the financier and the entrepreneur. Also, both disciplines, they add, prioritize developmental and social goals by encouraging the participation of the poor in the economic activities.

In the same vein, Segrado (2005, p. 5) listed a number of principles that Islamic finance shares with microfinance including:

- Prohibition of all economic activities forms that are morally or socially injurious.
- Egalitarian approach (no restriction to any category of clientele).
- Aim at social justice.
- Advocacy of entrepreneurship.
- Advocacy for financial inclusion through partnership finance.
- Participatory approach.
- Risk sharing.
- Focus on the well-being of the community as a whole, concentrating on the poor, destitute or deprived sections of the society.

In comparison with conventional methods of financing and by considering the participatory nature of Islamic financing that encourages the client loyalty Islamic financing is believed to have greater suitability and support for SMEs. This can be attributed to the ongoing dialogue between the two parties (the financier and the entrepreneur) which, in essence, improves the decision-making process. As a result, a superior outcome of the business decision-making can be expected as the two parties working together rather than working in isolation.

Islamic finance basically offers financing and attracts savings on the basis of profit and loss sharing rather than lending and interest (Abdullahi, 2016). Elasrag (2011) emphasized that unlike conventional interest-based finance which advantages the financier, Islamic finance offers unique financing techniques for SMEs that ensure justice for both parties in the contract. Similarly, Ibrahim (2003) argued that Islamic financing methods are better suited in satisfying SMEs' financial needs. The focus in Islamic financing and investment, he explained, is on the transaction itself instead of the partner's creditworthiness. As such, entrepreneurs are granted funding without an obligation on them to provide strict securities or

collateral which SMEs often lack. He adds that because profit and loss sharing is pivotal in Islamic finance, any securities or collateral demanded by the financier is not against the risk of loss, it is rather against possible fraud or repayment evasion.

A salient example of Islamic finance system that can be cited is that of Sudan where the entire financial system has been officially converted into an Islamic financial system. According to Ibrahim (2003), the Sudanese Islamic Bank opened in 1994 provided financing for up to 500 SMEs by the end of its first year in operation. These enterprises were financed through *Musharakah*, *Mudarabah* and *Murabahah* with a percentage of 17, 6 and 74 respectively. A year earlier, in 1993, Faisal Islamic Bank of Sudan was established. During the fiscal year of 1993-94, the number of SMEs financed by the bank was 1,400, of which 100% was financed by *Murabahah*. The Agricultural Bank of Sudan and Islamic Co-operative Development Bank are examples of other financial institutions offer Islamic finance to SMEs in Sudan.

3. An overview of SMEs financing in Libya

In general, SMEs can obtain finance for their operations from different sources including: personal wealth of the owner-manager/s, venture capital, business angels, trade credit, non-bank financial institutions, bank finance, and government assistance schemes (Abdulsaleh and Worthington, 2013). Unfortunately for SMEs in Libya not all these sources are available or readily accessible. Equity markets scarcely exist and debt markets are crude. Venture capital availability is almost completely absent. In this context, The Global Competitiveness Report 2008-2009 ranked Libya 133 in financial market sophistication and 131 in financing through equity market. The same survey ranked Libya 115 from 134 countries in the availability of venture capital finance (Porter & Schwab, 2008).

The vast majority of Libyan SMEs use internal funding sources in the form of personal savings and funds from family and friends to start and operate their businesses (Porter and Yergin, 2006). When it comes to external sources, however, despite some constraints, bank loans are the main source of finance (OECD, 2014). In addition, trade credit from suppliers seems to be a popular source for aiding working capital (Abdulsaleh, 2015).

Other sources of finance and guarantee mechanisms are still underdeveloped if not fully absent. There is no official active credit guarantee scheme targeting SMEs in Libya. Back in 2008 under the supervision of the Ministry of Economy a Libyan fund for credit guarantees was established. The fund draws up agreements with individual commercial banks to facilitate SMEs access to finance. For instance, the fund guaranteed up to 40% of loans provided by Gumhuriah Bank. There is no clear indication of the effectiveness of the scheme. Additionally, the scheme does not cover all banks and it is not an independent entity.

At present, five regional investment funds are to be established nationwide in Tripoli, Benghazi, Misrata, Sabha and Zawiya. These funds will be capitalised with USD 200 million each and will provide equity of up to 25% of project capital. Only start-ups will be targeted excluding existing firms. The funds are not yet operational and remain subject to the allocation of financing by the Ministry of Planning.

4. Islamic finance opportunities for SMEs in Libya

In this section the viability of Islamic finance for SMEs in Libya is discussed in the light of three factors or dimensions suggested by the International Finance Corporation (IFC, 2014). These factors are:

- Average perception towards Islamic banking and finance.
- Enabling environment.
- Supply side capabilities

4.1 Average perception towards Islamic banking and finance

The perception towards Islamic banking in a country is a factor contributing to the opportunity of Islamic funding for SMEs. This factor can be influenced by the population of the country as well as the degree of religious consciousness (IFC, 2014).

In general, the religion in any society creates special features that can be identified in its people's beliefs, behaviour and values. In the Libyan case, religion has been the most powerful influence on the society (Obeidi, 2001). Islam (the principal religion in Libya as more than 97% of Libyans are Muslim) plays a crucial role in the social, political, cultural as well as the economic aspects of Libyan people's lives. Among other factors Islam has a strong impact on the Libyan society and therefore the life of the community is formed by this impact (Aagnaia, 1997). It is estimated that 99% of the population in Libya are active in their faith (Abdussalam, 2014). Thomas and Dargusch (2011) stated that Libya is deeply a religious society with a strong commitment to the Islamic system of economics. The authors added that the influence of religion on popular participation in economic activities is evident. This situation would undoubtedly make Libyan people more familiar with the general principles and practices of Islamic banking which, in turn, could increase awareness of Islamic banking and finance within the society and, consequently, facilitates its introduction and implementation to meet the local demand for such services.

Previous studies and surveys examining the attitudes of Libyans towards Islamic banking and finance have revealed significant support. For example, a large survey by Gait and Worthington (2008) targeted retail customers, business firms and bank staff nationwide. The participants were asked their opinions on Islamic finance and its potential introduction in the country. Their findings revealed that there is a degree of awareness of Islamic banking and finance. It was also found that the majority of the respondents across the three groups represent potential users of Islamic finance methods if implemented.

Kumati (2006) examined the demand for Islamic financial services in Libya. The field study took place in the city of Benghazi one of the largest financial centres in the country. The study found popular support for Islamic banking. In addition, interviews at the Central Bank of Libya revealed an interest in Islamic finance. Another more recent study by Alhajam (2013) reported similar results. The results showed that Libyans support the implementation of Islamic banking and finance in the country believing that it will make significant contributions towards economic and social development in the society.

Stela and Baradi (n. d.) qualitatively examined the perspectives on the potential introduction of Islamic banking in Libya. The findings revealed a strong belief among the participants that the features of the Libyan society provide an appropriate mileage for Islamic banking development. The results suggested that the outlook of Islamic banking in Libya will be bright, stable, and capable of rapid development. Their results also indicated that depositors will give strong support to the introduction of Islamic banking system in Libya especially the implementation of *Qard Hasan* mechanism. Finally, focusing exclusively on SMEs a study by Abdulsaleh (2015) found that owner-managers of Libyan SMEs believe that Islamic

methods of finance would be a viable funding option for their firms. The results indicated a strong preference for Islamic finance methods with *Musharakah* being the most preferred.

Based on the above review one can conclude that there is a strong support for an Islamic banking and finance system in the country since most of Libyan people prefer to avoid interest-based banking transactions. In addition, the perceived high level of religious consciousness among Libyans can be seen as a critical element for the development of such system. As such, according to the study by IFC (2014) this high of perception towards Islamic finance in the country is an indication of more favourable chances of Islamic banking and finance to flourish to meet the high demand for Islamic finance products including that of SMEs.

4.2 Enabling environment

The supportive environment is an important factor that will have an impact on Islamic banking and finance. This factor refers to the existence of a favourable political, economic as well as regulatory environment to promote Islamic finance in a country (IFC, 2014). Accordingly, greater funding opportunity requires positive enabling environment where economic and political stability exist alongside with regulatory clarity. On the other hand, where the enabling environment is weak the funding opportunity of Islamic finance in general and particularly for SMEs would be low.

Libya is currently undergoing major transition. As part of the political reform so far three cabinets have been changed, and the first national elections in more than forty years have taken place. However, in the light of the recent events in 2011 there is still high political instability within the country. In addition, security issues continue to be a major concern. This situation, if continues, could have negative implications on the transition process. In order to ensure a rapid growth of Islamic finance there is a need to provide an enabling environment and this can only be achieved with a solid political stability.

In addition to the political stability the political willingness to promote Islamic banking is of particular importance. Both Alhajam (2013) and Baej (2013) concluded that prior to 2011 the prevailing political attitude towards Islamic banking was the main obstacle hindered providing Islamic finance products in Libya. Baej (2013) added that despite the destructive impact that the political events of 2011 had on the economy in general and on the banking system in particular the approving of the Islamic banking law by the Libyan new authorities is the most important milestone in the history of the Islamic banking in Libya.

Likewise, Islamic finance cannot play its role to promote the growth of SMEs without favourable economic environment. Riyany and Elwafi (2012) believe that despite the political and security challenges there are many opportunities for business in Libya especially for financial institutions. They add that the reform of the banking and finance sector seems to continue to be a priority for the new authorities which have already taken major steps towards pushing the Libyan banking sector to make it a positive contributor to the development of the economy. In addition, Libya's large financial reserves leave room for both public investment and fiscal incentives to provide the basis for economic diversification and a positive long-term economic outlook in which SMEs are central (African Development Bank, 2014).

In terms of regulatory framework, Baej (2013) mentioned that the absence of a clear and organized plan was of the main barriers hindering the implementation of Islamic banking in Libya. The study by Kumati in (2006) tried to answer the question of whether there is a need for separate legislation and regulation for Islamic banks in Libya. Interestingly, three different attitudes were identified. Some perceived the Libyan banking law as flexible and able to observe Islamic banks' operations, however, some non-fundamental changes could be adopted if necessary. A second view was that the law has to be

amended so that the activities of Islamic banks can be effectively supervised. A third group represented the majority argued that as Islamic banks differ from conventional ones in many aspects a new law should be issued if Islamic banking to be implemented in the country.

The position adopted by the Libyan banking regulators and policy makers appears to be in line with the third view. As such, in 2012 a new law was approved to facilitate the development of Islamic banking in Libya. The special dedicated chapter for Islamic banking in Libya published by the Central Bank states that Islamic banks are subject to the rules of the Central Bank with regard to mandatory cash reserve, liquidity ratio, capital adequacy, investment ratio, asset-risk deductions, and financial reports auditing standards. Nonetheless, according to Baej (2014) this may have a negative impact on Islamic banks as some of these rules are interest-based, while others, such as loan-to-deposit ratio, do not consider the unique nature of Islamic banks. As such, more efforts to develop an appropriate legal and regulatory framework to govern Islamic finance activities are needed.

4.3 Supply side capabilities

In addition to the above factors, the capabilities of banks to serve SMEs sector are also important. The capabilities of banks to serve the SMEs sector is reflected in a number of areas such as the availability of Islamic SMEs offerings, and the know-how of banks to deliver Islamic finance products (IFC, 2014).

According to Masoud (2014) the methods that are authorised by the new Libyan authorities to serve SMEs sector include; *Mudarabah* (the provision of capital in a partial-equity partnership), *Musharakah* (full equity partnerships), *Murabahah* (an instrument for financing the purchase of goods), *Bai muajjall* (deferred payments on products), *Bai Salam* (advance sale contracts), *Istisna* (manufacturing contracts), *Ijarah* (lease financing) and *Qard Hasan* (benevolent loans). He added that some of these applying methods could be problematic and there will be resistance to change among some quarters. However, it could be argued that this variety of financial products should ensure a successful creation and implementation of an Islamic finance system which is able to cater for SMEs' different financing needs in all economic sectors at different development stages.

Chermi and Jerbi (2015) argue that the need for highly trained personnel in the Islamic finance industry is a prerequisite to guarantee a safe introduction of the variety Islamic financial products and their success in meeting the demand side needs. In the Libyan case, the capacity of Libyan banks to be banking the Islamic way seems to be questionable. However, in fact, ahead of being licensed to trade them some Libyan banks have been working on Islamic finance products. In practice terms, some banks were already providing Islamic banking and finance products through their Islamic banking branches and windows. For example, the study by Emhmmad (2010) aimed at evaluating the practices of Gumhouria Bank in offering *Murabahah* products to its clients found that the documents and contracts for *Murabahah* operations employed by the bank are consistent with the theoretical standards. In addition, the findings showed an increase in the efficiency of the use of the *Murabahah* mode of finance.

In addition, in order to ensure the quality of the services and products to be provided cooperation agreement was signed by the Central Bank of Libya with the International Centre for Education in Islamic Finance, also known as The Global University of Islamic Finance, to provide technical support for Islamic finance in Libya. The aim of the agreement is to assist the Libyan banking sector in training staff on Islamic finance. Accordingly, the sector will be provided with a series of training programs and educational initiatives including higher education qualifications such as masters and doctorates. In addition, a technical consulting team from the Malaysian university will provide ongoing support to the Libyan banking sector. In parallel, a number of commercial banks have been sending their staff abroad for training in Islamic finance. For instance, in 2012 Gumhouria Bank sent 100 staff members to train at

the Jordanian Islamic Bank, one of the leading Islamic banking institutions in the region, as part of an eight-week training scheme.

Similarly, Abdulsaleh (2015) conducted interviews at Bank Al Tanmeya, a state-owned bank that considers SMEs its primary market, exploring its plan to implement Islamic finance operations. The findings revealed that the bank arranged for its staff a number of seminars, workshops and formal training programs on Islamic banking and finance. Initially, the staff received introductory training sessions provided at the headquarters. These training sessions are largely theoretical with the aim of building the knowledge and the skills base of the employees. For more advanced training a further stage of training took place in Jordan and it was organised cooperatively with the Jordanian Islamic Bank. These programs were more practical and vocational combining theoretical knowledge with role-playing in an inter-active environment which offers participants a strong platform in which to work. The bank staff expressed their satisfaction with what has been achieved through these training courses hoping that by 2015 the bank will be ready, though partially, to serve and meet the SMEs' demand for Islamic finance products.

5. Conclusion

SMEs are perceived as a dynamic force for sustained economic growth in emerging economies. In Libya, where the economy is mainly structured around the hydrocarbon sector, SMEs have a significant role to play in re-building and diversifying the economy. Yet, the reality on the ground is that they are unable to fulfil this role as their financial needs are underserved. A major reason for this situation is the reluctance of SMEs' owner-managers to deal with interest-based banks due to religious beliefs. However, the recent introduction of Islamic finance in the country provides an opportunity for SMEs to channel funds for their operations from an alternative source.

This paper recognizes Islamic finance as an important alternative source of finance for Libyan SMEs that can cater for their financial needs without conflicting with their owner-managers' religious values. With the official support of the country's incoming authorities Islamic finance has a lot of potential to make a significant contribution to ease SMEs' access to finance. To reinforce this potential an enabling environment for the industry to grow and develop must be provided. An adequate regulatory and institutional framework hand by hand with political stability are key to ensure the development of Islamic banking and finance in Libya. Moreover, a thorough strategic outlook should be adopted.

As Islamic finance industry in Libya is still developing one area of concern remains whether Libyan banks have the expertise or the capacity to be banking the Islamic way. Therefore, there is a need for a national centre dedicated to the function of training experts and staff in Islamic banking and finance system. In addition, the experience of other countries in the region, particularly those resource-rich countries, would be very helpful in the development process of Islamic finance in Libya.

Though it is too early to assess the Islamic finance in Libya, the introduction of a variety of financial products that derive from the Islamic finance concepts can be an indication of its viability to serve SMEs' demand. One of the limitations of this study is the lack of empirical support. As more data become available in the future, further research should provide inputs for reviewing and updating the policy agenda to regulate, supervise, and improve Islamic financial institutions and practices in Libya.

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