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FINANCIAL INSTITUTIONS IN ADDRESSING SMES FINANCIAL CONSTRAINTS AND POVERTY REDUCTION: A MODEL DEVELOPMENT

BY

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Abstract

The study is to investigate the situation of SMEs in terms of accessing financing through financial institutions. The poverty in Northern Nigeria became rampant, whereby financial institutions were not convinced to issue loans for SMEs due to the incapacitation of paying back the loans or the interest rate. The study used a Structural Equation Modeling based on Confirmatory Factor Analysis from the 310 data generated using SPSS and Sobel test. The predicted finding indicates that the development of SMEs with a significant number of business units and financing from Islamic financial institutions would enhance SMEs' direction and development of Islamic finance and drastically address the Poverty in Northern Nigeria. The study will also predict a general overview of the positive mediation of Islamic financial institutions in addressing SMEs Financial Constraints and poverty reduction in Northern Nigeria.

Keywords: Islamic Financial Institution, SMEs, Poverty reduction, model development

Introduction

With the inception of Islamic financial institutions in Nigeria, for the first time, many Muslims were easily convinced to agree to participate in financial institutions (Saiti et al., 2022). It developed and constitutes a window to financial inclusion and other financial transactions through masses and industries based on Shariah-compliant products and other lawful transactions (Haniffah et al., 2023). However, the products produced by such industries, the demand increased by both Muslim and non-Muslim communities (Lim et al., 2022). Moreover, there was high growth in Halal businesses in the northern part of Nigeria. Ahmed and Shuvo, (2024) indicate that the global phenomenon of the Halal business market has been estimated at USD 5.73 trillion in 2016. It is expected to grow with the growth of the Muslim population worldwide. Muhammad and Khalil (2021) indicate that the fast-growing business industries considered industries and Shariah companies are growing independently by 16-20% per annum. Muhammad et al. (2022) show Halal industries and Islamic finance have become sophisticated global brands for decades. Despite the growth, the Halal industry remains fragmented, with less structure, but it has reformed its glory in the past fifteen years (Al-Shaghdari & Ibrahim, 2024). Halal economy and Islamic finance integrated the halal products and Islamic financial system as a new economic model. The separation of Islamic finance and industries, particularly SMEs, is evident compared to Nigeria's conventional micro and macro-financial institutions (Muhammad & Khalil, 2021).

For Muslim consumers, the application of halal or haram is considered significant and primary in their day-to-day activities through their income earning (Latif, 2019). Usman et al. (2022) explained that the term Halal came originally from the Arabic word, which indicates allowability and permissibility, while haramis is the opposite of halal, which is prohibited under Islamic law (Lim et al., 2022). In addition, adhering to religious teachings led to an increase in global market demand and supply of halal goods and services (Saiti et al., 2022). Haque et al. (2019) show that it is significant for Muslim society to comply and ensure their daily consumption is dully in line with Shariah principles. Haque et al. (2019) wrote that halal industries have enormous potential as the Muslim population continues to increase globally, and the need for Shariah-compliant products also needs to increase. Such a trend generates and contributes to the demand and growth for halal products.

Gu and Fong (2022) indicate that the Asian region is considered the largest Muslim population in the world with a massive demand for halal products; among these Nations, Malaysia is regarded as the most advanced ecosystem, with significant effort from the government and private sector through funding different programs and training. The halal industry ensures the government structure and implementation that relay on the different law requirements about scope and responsibility. It is always going high to the proper and crucial in preventing integrity (Norris & Inglehart, 2012).

Moreover, seventy 70 per cent of the vulnerable people in Nigeria are in the North, an estimated 64 per cent of all live in rural and 52 per cent of the rural population was below the poverty line in 2016, and these are the Muslims-dominated areas (Muhammad & Khalil, 2021). In the Northern part of Nigeria, poverty is increasing, and this is a result of the lack of ability to start up businesses attached to the availability of finances (Saiti et al., 2022). SMEs also become vulnerable lack of access to finance based on conventional perception, which operates and relates to interest rates. In addition, the religious perception, risk perception, inadequate cost of financing and awareness of financing opportunities which is considered unlawful financing institutions in Nigeria. Both Muslims and Christians run away from conventional products and finances as a result of interest-rate gambling and speculation. Therefore, Islamic financial institutions can intervene, which will help in addressing poverty issues and SME funding as well as unemployment in the Northern part of Nigeria. The objective of the study is to search for the mediating role of Islamic institutions in addressing SMEs' financial constraints and poverty reduction in the northern part of Nigeria.

Literature Review

Islamic Financial institutions (IFIs) focus on macro and small and medium-sized enterprises (SMEs), specifically on economic development and poverty eradication (Saifurrahman & Kassim, 2023). Over the past decades, Islamic financial institutions and their activities have been well-known as potential catalysts for economic development in Nigeria (Kamaruddin & Soemitra, 2022). However, most literature has not uncovered the role of IFIs in dealing with the constraints faced by SMEs, such as lack of financial literacy among entrepreneurs, high cost of financing, and limited access to funds.

Shariah principles, such as Musharakah (joint venture) and Mudarabah (profit sharing), are financing mechanisms used by IFIs to contribute primarily. This assists in financing capital and postering partnership approach between entrepreneurs and financiers, helping in risk sharing and lowering the burdens associated with debt financing in conventional systems (Sukmana & Trianto, 2025). Islamic finance encourages adherence to ethical standards and social responsibility, making it more appealing to SMEs that prioritise sustainable growth (Muhammad & Ngah, 2023). The biggest obstacle for SMEs globally is access to finance, particularly in less developed countries (Kamaruddin & Soemitra, 2022). SMEs in certain regions face an 80% financial gap due to the stringent borrowing criteria imposed by conventional banks. In contrast, IFIs often employ more flexible assessment criteria for loan applications, which can relieve some of the constraints SMEs face (Saifurrahman & Kassim, 2023). Muhammad et al. (2024) reveal that institutions assess risk with a broader lens, considering not only financial return but also a business's socioeconomic impact. This paradigm may lead to increased entrepreneurial funding opportunities that traditional financial institutions overlook.

Furthermore, Islamic microfinance has emerged as a crucial tool for poverty alleviation. Awan et al.(2023) indicate that Islamic microfinance institutions (IMFIs) offer Shariah-compliant financial products to low-income segments, empowering them to start micro-enterprises. These financial products often come with profit-sharing arrangements. Shoaib (2024) indicated that the focus on financial inclusion aligns with Islamic Economic principles of promoting social welfare and reducing income inequality.

In addition, the study emphasises financial literacy as the key to successful entrepreneurship. The educational programs and awareness to promote financial literacy among SMEs (Tlemsani et al., 2023). While entrepreneurs are equipped with the necessary financial knowledge, their chances of securing funds and successfully managing their business operations are low. These programs help SMEs navigate the complexities of Islamic finance and cultivate a more financially savvy, entrepreneurial ecosystem, which is crucial for long-term economic stability (Qizam et al., 2025). Nonetheless, challenges remain for IFIs in maximising their impacts on SME financing and poverty reduction. Regulatory framework often lacks uniformity, leading to insufficiencies and operational hurdles. Varying interpretations of Shariah law across different jurisdictions can hinder the standardisation and scalability of Islamic financial products.

Muhammad et al. (2020) discussed that IFIs have made strides in enhancing awareness about Islamic finance, but SMEs still exhibit scepticism or lack of understanding of its principles and benefits. Through innovation, Shariah-compliant financing mechanisms, promoting financial literacy, and focusing on social responsibility, one of the crucial issues for realising the full impact of these institutions on economic development is addressing regulatory challenges and enforcing awareness.

Cost of Financing and Poverty Reduction

One of the significant attentions in Development economics is considered the relationship between the cost of finance and poverty reduction, for individuals and communities aiming to improve their economic circumstances (Tran & Le, 2021). The need to have access to affordable financial services is one of the hindrances opportunity to economic advancement for low-income populations (Dong et al., 2022). Asare and Barfi (2021) revealed that when financial costs are prohibitively high, Potential Entrepreneurs often refrain from starting small businesses, which is vital for job creation and poverty alluvion (Muhammad et al., 2021).

However, the essentiality for smooth consumption and investing in education and health is access to affordable credit. Poor household often resorts to high-cost borrowing options such as loan sharks, exacerbating their financial vulnerability to improve living standards (Zhang et al., 2023). Grubbauer and Mader (2021) argue that reducing the cost of financing through informal community living systems or microfinance institutions can lead to that. Sun and Liang (2021), in one of their studies, indicate that regions with more accessible financial services experience a more significant reduction in poverty rate. This reduction increased investment in domestic businesses, and people's spending on expenditures also went high, which is fuelled by good, affordable financing. This correlation gave an insight into the systematic nature of reduction in poverty, where financial conditions improved direct and indirect economic importance.

In addition, public policy plays a significant role in lowering financing costs. Non Governmental Organisations and Governments implemented various microfinance programs and subsidies to reduce the interest rate for communities with low income. Intervention can create a more suitable financial landscape, which is essential for harnessing marginalized populations' economic potential (Domanban, 2024) while the outcome is not impressive as low-income earners suffered financial exclusion and increase in poverty (Muhammad & Khalil, 2021).

H1 There is a positive relation between cost of financing and Poverty reduction

Risk Perception and Poverty reduction

It is important to examine the relationship between risk perception and socio-economic outcomes so as to address poverty alleviation strategies effectively (Hansen et al., 2019). Risk perception refers to how individuals and societies assess the nature and severity of risks, which can greatly impact their decision-making (Hicham et al., 2024). Hicham et al. (2024) investigate how improving risk perception can help enhance poverty alleviation through attitudinal changes in behavior, resource distribution, and policy formulation. Several studies have shown that people living in abject poverty mostly experience notable uncertainties concerning their financial futures, health, and living conditions. This unsureness can strengthen their awareness of perceived risks, thus leading to risk-averse behaviors that may unintentionally keep them trapped in hardship. Howlett and Leong (2022) emphasize that a better and clearer insight into risk can improve financial decision-making. This denotes that individuals who can successfully appraise risks are, to a greater extent, presumably to devote their finances or funds to education and entrepreneurship, potentially improving their economic situation (Cruz-Milán & Castillo-Ortiz, 2023).

Besides, researches show a connection between precise risk perception and greater society empowerment (Howlett & Leong, 2022). Matome (2023) illustrates that communities with strong risk awareness plans or policies are well-equipped to handle environmental and economic dismay. Also, promoting a custom that emphasizes the importance of understanding risks will make these communities take preventive actions such as broadening income sources and creating joint savings initiatives that assist in lessening the impact of unexpected events and ultimately lowering poverty rates (Shimada, 2022). An additional feature of risk perception towards poverty alleviation is its key role in policy-making as policymakers are gradually recognizing the importance of integrating threat analysis into developmental economic policies. Mertens (2021) reports that enabling local populations to evaluate and share their risks can lead to more informed policy choices and effectively address the unique needs of vulnerable communities. When individuals express their perceptions of risk, policymakers are able to design more targeted and meaningful interventions, thereby improving the credibility of poverty reduction plans. In addition, psychological studies revealed the importance of mental models in molding how people view threats (Hansen et al., 2019). These features can help guide the development of a focused plan to alter harmful perceptions, such as initiatives that improve financial education and risk assessment skills. These skills can equip a person to make desirable choices, helping to break the poverty line.

Closing the gap between risk perception and poverty alleviation demands a unified effort to improve both individual and collective awareness of risks. Enabling disadvantaged communities to identify and address risks can foster resilience, guide more effective policymaking, and encourage sustainable economic practices, ultimately reducing poverty. This dynamic represents an essential area for further study and action in public policy and community development efforts.

H2 There is a positive relation between risk perception and Poverty reduction

Religious Perception and Poverty Reduction

The relationship between faith doctrine and socio-economic status has captivated scholars from various fields, especially in terms of how religious beliefs have significantly contributed to alleviating poverty (Mwaura & Nzengya, 2022). Many studies emphasize that spiritual convictions or values and community participation in societal activities often promote perseverance and provide ways to reduce poverty (Nwosu, 2024). The Fundamental of this research is the idea of communal assistance, which includes the networks and connections that individuals can depend on for support. Muhammad et al. (2019) opined that religious communities often serve as key centres of social capital, rendering emotional backing, financial aid, and access to opportunities or prospects for their members. Makai et al. (2024) observed that being part of a religious sect can strengthen an individual's sense of belonging and security, which, in turn, can drive economic activities and aspirations that help reduce poverty. The study also highlighted that membership in a religious community can booster an individual's feeling of connection and safety that can motivate economic efforts and goals that contribute to poverty reduction. Abdullah et al. (2025) revealed that greater religious participation is linked to higher levels of charitable donations, indicating that religious beliefs play an active role in promoting economic assistance for disadvantaged individuals and families. Religious institutions frequently render essential social services, such as food banks and educational programs, which are particularly important in lower-income environments where government resources may be scarce (Muhammad et al., 2019). Benyah (2021) indicates a report emphasized that religious institutions are important in providing social amenities, especially in education and healthcare in less developing nations, thereby enhancing the living conditions of people experiencing poverty.

Furthermore, religion can shape personal attitudes toward work and financial management. Research has shown that religious individuals tend to have a strong work ethic, thus prioritizing diligence and integrity (Dirie, et al., 2024). This mindset can result in better employment outcomes over time, aiding in economic advancement. However, it is crucial to recognize that the connection between religion and poverty reduction is intricate and multifaceted. Critics contend that certain religious teachings can reinforce dependency or hinder women's participation in the workforce (Aduhene & Osei-Assibey, 2021). Therefore, as many aspects of religious belief can contribute to alleviating poverty, it is important to assess the potential negative consequences critically. Existing literature indicates that religious beliefs can help reduce poverty by fostering social capital, encouraging charitable actions, and offering essential services. However, further interdisciplinary research is needed to fully understand the complex effects of religious belief systems on poverty reduction strategies worldwide.

H3 There is a positive relation between religious perception and Poverty reduction

Awareness and Poverty Reduction

Poverty has continued to be a general and global issue, impacting millions of people worldwide and impeding socioeconomic progress (Yu et al., 2021). An increasing body of research emphasizes the importance of awareness as a key approach to reducing poverty (Edwards-Fapohunda, 2024). The research consolidates existing studies on how awareness encompassing financial literacy, social consciousness, and access to information drives efforts to alleviate poverty (Hariram et al., 2023).

First, financial soundness and education are key components of awareness that significantly contribute to poverty reduction. Wu (2021) suggests that individuals with greater financial literacy are more capable of making informed choices regarding savings, investments, and debt management. Initiatives designed to boost financial awareness can help low-paid individuals enhance their financial health or stability (Selenko et al., 2024). Studies indicate that financial education programs can lead to greater involvement in savings accounts and better credit scores within disadvantaged groups (Biosca et al., 2021).

This improvement in financial behaviour helps strengthen economic stability and promote social advancement. Along with financial literacy, social consciousness is crucial in understanding poverty as a collective issue that requires joint efforts to address. Outreach initiatives that spotlight the struggles of underprivileged communities can cultivate compassion and inspire greater public backing for measures focused on poverty alleviation (Srivastava et al., 2024). Zahid et al. (2024) indicate that consistent social awareness helps diminish the prejudice surrounding poverty, prompting both private and government sectors to invest in long-term development efforts, thus making community initiatives that highlight issues of social disparity and economic hardship rally resources and drive structural transformation.

In addition, the availability of digital technology acts as a channel for raising consciousness, especially within marginalized communities. Chowdhury and Chowdhury (2024) observed that digital skills and access to modern tools help close the information divide, enabling individuals to utilize assets, market data, and learning opportunities. Therefore, pertinent to note that technological advancements such as mobile payment systems and virtual education networks have transformed the way less privileged groups access knowledge and opened doors to escaping poverty. Kandpal (2022) underlines the role of awareness in enabling disadvantaged groups to champion their rights and take an active role in governance. When an individual is knowledgeable about their entitlements and the support systems available to them, they are more inclined to participate in efforts that advocate for meaningful solutions to reduce poverty (Ballentine et al., 2024). This literature revealed that awareness nurtured by financial education, social awareness, access to information, and advocacy is a key factor in driving efforts to reduce poverty. Consistent efforts to promote awareness can spark personal growth, community engagement, and the plan changes needed for sustainable socioeconomic progress.

H4 There is a positive relation between Awareness and Poverty reduction

Islamic Financial Institutions and Poverty Reduction

Islamic financial institutions (IFIs) are essential in reducing hardship across different socio-economic settings by following Sharia-based principles that encourage access to financial services, responsible investments, and social equity. The distinctive tenets of Islamic finance, including risk-sharing, profit-and-loss sharing, and the prohibition of interest (Riba), establish a policy that can play a significant role in reducing poverty (Menne, et al., 2023). A key way in which IFIs help reduce poverty is by fostering access to financial services. Conventional banking systems often leave out low-income individuals because of stringent collateral demands and strict credit history requirements (Sukmana & Trianto, 2025). On the other hand, IFIs commonly use alternative methods for credit evaluation and provide microfinance products that allow marginalised communities to access funding (Faizi, 2024). Islam (2021) has emphasised that microfinance policies within an Islamic principle promote access to financial services and empower women, leading to improved household earnings and supporting community advancement. Additionally, IFIs focus on ethical investing and social responsibility, directing funds toward projects that offer social benefits such as healthcare, education, and infrastructure. These investments help create jobs and boost economic activity in disadvantaged regions. Senghore (2023) show that Islamic banks frequently provide support to small and medium-sized enterprises (SMEs), which play a crucial role in driving economic growth in developing countries (Awan et al., 2023). By offering financing solutions that avoid imposing high-interest debt on entrepreneurs, IFIs enable sustainable business practices that can flourish in local environments (Bello, 2023).

Additionally, the zakat system, a compulsory form of charity in Islam, acts as a means of wealth redistribution that directly tackles poverty. IFIs typically assist in the collection and distribution of zakat, directing resources to those in need. Khan et al., (2021) emphasise that efficient zakat management by IFIs can greatly reduce poverty, especially when combined with community development efforts. Syahrir et al., (2023) underscores that efficient zakat management by IFIs can play a crucial role in alleviating poverty, especially when it is combined with community development programs.

Furthermore, IFIs frequently collaborate with non-governmental organisations (NGOs) and government agencies to amplify their efforts in poverty reduction. Joint initiatives efforts, such as societal development schemes and financial proficiency workshops contribute to creating a more informed group of environments capable of managing funds responsibly and promoting economic empowerment. This study shows that Islamic financial institutions have the potential to play a key role in poverty reduction by offering inclusive financial programs, making ethical investments, optimising wealth redistribution tools like zakat and collaborating with various stakeholders. Upon existing challenges, the ability of IFIs to promote sustainable economic development and poverty reduction or eradication remains an important area of research and practice within the larger field of economic development.

H5 There is a positive relation between Awareness and Poverty reduction

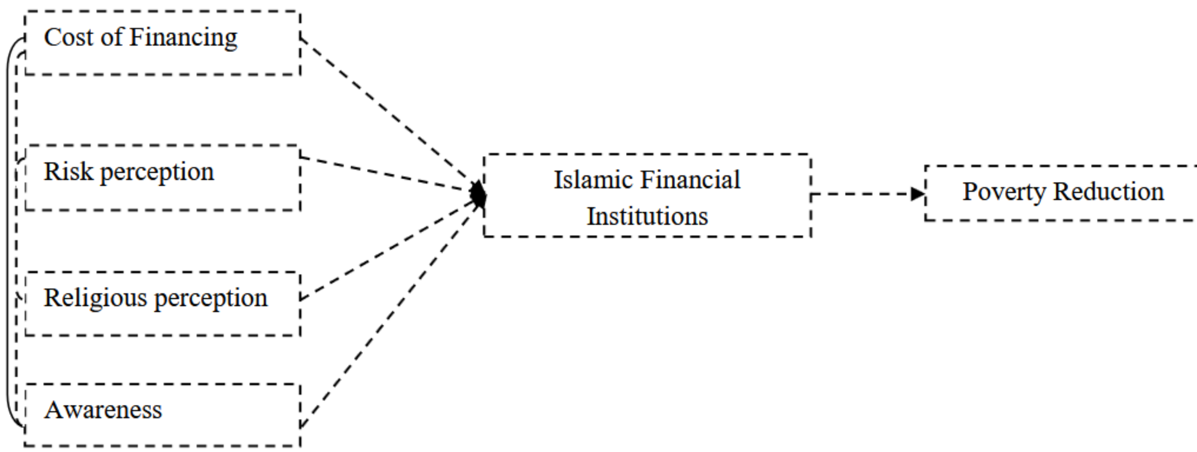

Figure 1: Development Framework

Methodology

The research examined the above literature and used a cross-sectional research design to analyse the hypotheses under study. The study population were chosen from state agencies in charge of SMEs in each state located in three regions of Nigeria, which include the North-East, North-West, and North-Central SME production, which were considered Shariah-compliant. The questionnaires were designed for the general public to analyse their perception. The data collected from 310, thus, a total representative of the population is applied to SMEs, and the scientific method was used to arrive at a sample of questionnaires as it is still considered a range of preference between minimum and maximum selection.

The research employed Structural Equation Modeling (SEM). The study applied the 5-point Likert scale for reliability and validity tests. The research passed through the pre-test by examining ambiguous questions, and those considered negatively worded and difficult were removed and deleted to suit the study. Reliability measurement of the repeatability of internal consistency of the factor using Cronbach's alpha. However, the test states that alpha coefficient for a particular factor or variable is low, the item or factor should be deleted for the improvement of the coefficient (Kalkbrenner, 2023). Malkewitz et al. (2023) show that any additional or removal of the item used in the study can improve the reliability of the variable. The Cronbach's alpha overall reliability of the sub-scale is above 0.7, which indicates a reliable model (Gebremedhin et al., 2022). Convergent and discriminant validity were assessed based on Huang et al. (2024) recommendation as confirmatory factor analysis (CFA).

Description and factor loading

Construct	Measurement	Items used	Loading Factor
CF	The cost of financing can be adjusted or reduced by using Islamic Financial Institutions and reducing poverty.	CF 1	0.895
	Reducing the Cost of financing can address poverty reduction	CF2	0.871
	The cost of financing can be addressed using Islamic Financial Institutions and restoring value and poverty mitigation.	CF3	0.833
	Islamic financial institutions can use the cost of financing to reduce the poverty level in Nigeria.	CF4	0.843
RP	Risk perception can be reduced using Islamic Financial Institutions and reduce poverty.	RP1	0.878
	Taking risks is necessary to improve my family's economic well-being.	PR2	0.803
	The impact of potential financial hardships on your family can be reduced by using Islamic Financial Institutions.	PR3	0.837
	Risk perception can bring innovative products and enhance poverty alleviation.	PR4	0.784
RG	**Developing religious products organizations in your community actively work to reduce poverty.**	RG1	0.887
	Religious faith generally encourages charitable giving and support for people with low incomes.	RG2	0.876
	Religious values play a significant role in helping individuals overcome poverty	RG3	0.876
	Religious teachings offer practical guidance for managing finances and improving economic well-being	RG4	0.818
AW	Participating in any aware of local programs or initiatives to reduce poverty in your community reduce poverty	AW 1	0.777
	Participated in any events or activities focused on poverty alleviation.	AW2	0.720
	Awareness of government policies aimed at poverty reduction, such as educational programs, addresses the level of poverty.	AW3	0.725
	Current poverty reduction strategies in your community effectively help those in need.	AW4	0.651
	Awareness levels and perceptions regarding poverty reduction efforts in a given population address poverty	AW5	0.729
IFI	**They believe that Islamic financial institutions have a significant role to play in poverty reduction within the community.**	IFI1	0.891
	Islamic microfinance is an effective tool for empowering low-income individuals	IFI2	0.831
	The family never benefited from any poverty alleviation programs offered by an Islamic financial institution.	IFI3	0.851
	the products and services offered by Islamic financial institutions accessible to people with low incomes in your region	IFI4	0.864
	Islamic financial institutions prioritize poverty reduction alongside profit-making	IFI5	0.784
PR	**Islamic Financial Institutions (IFIs) have a significant role to play in poverty reduction.**	PR 1	0.892
	The **borrowing costs hinder poverty reduction efforts in developing countries.**	PR2	0.743

Construct	Measurement	Items used	Loading Factor
	The individuals and households manage risk and build resilience in the face of poverty and uncertainty	PR3	0.681
	Participation in religious activities positively impacts individuals' ability to escape poverty	PR4	0.699
	Increasing awareness of poverty issues would lead to greater support for poverty reduction.	PR5	0.742

Source: Designed by Authors

Table 1 description of the study questionnaires and items defined the questionnaires based on the factor loading on the setting (Bryne, 2013; Hair *et al.*, 2017); the loadings indicate the six variables appear in the range of>0.5 to 0.9 (Leite *et al.*, 2022), the higher the factor loading and the more positive the construction of the study.

Table 2: Demographic analysis

Personal data		Frequency	Percentage of the respondents
Gender			
	Male	180	60
	Women	120	40
Age			
	18-35	135	45
	36-45	105	35
	45-above	60	20
Education			
	Primary	42	14
	SSCE	105	35
	Diploma/NCE	108	36
	Degree and Above	45	15
Marital Status			
	Single	195	65
	Married	105	35

Source: Designed by Authors

The research's respondents were dominated by men with 60 percent of the participants and 40 percent women. The Martial status of the respondents indicates single 65 per cent and Married 35 per cent of the participants. A significant percentage of respondents were at the age of 45 between 18 and 35, followed by 35 per cent and the remaining 20 per cent at the of 45. at the same time, the education level of the respondents indicates that the participants attended primary school 14 per cent, with an SSCE school education of 35 per cent, diplomas/NCE of 36 per cent and degrees above 15 per cent.

Table 3 Normality Assessment

Construct	Item	Skewness	CR	Kurtosis	CR
Cost of financing	CF1	-1.303	-7.385	0.647	2.823
	CF2	-0.687	-0.687	0.237	1.458
	CF3	-0.592	-7.499	0.921	3.230
	CF4	-0.786	-6.677	0.691	1.792
Risk Perception	RP1	-1.247	-8.779	1.201	3.685
	RP2	-1.271	-8.819	1.587	7.605
	RP3	-1.772	-8.400	1.620	4.630
	RP4	-1.216	-10.219	3.242	12.63
Religious Perception	RP1	-1.665	-13.516	3.815	11.603
	RP2	-1.114	-8.438	1.327	4.470
	RP3	-0.897	-7.234	0.558	2.658
Awareness	AW1	-0.809	-8.765	0.692	2.655
	AW2	-1.236	-9.492	0.706	3.349
	AW3	-0.723	-7.356	0.462	1.872
Islamic Financial Institution	IFI1	-1.454	-10.336	1.779	7.351
	IFI2	-1.357	-9.742	1.568	6.647
	IFI3	-1.207	-8.781	1.223	4.365
Poverty Reduction	PR1	-0.983	-6.336	0.332	0.757
	PR2	-1.336	-9.892	2.262	8.182
	PR3	-1.242	-8.406	1.384	4.730
	PR4	-1.104	-7.592	0.794	3.332
	PR5	-0.837	-7.456	0.956	3.347
	PR6	-1.393	-8.385	1.383	5.402

Source: Designed by Authors

The assessment of the normality indicates the skewness and Kurtosis of all defined construct with their respective variable between ±2 to ±2 and for skewness (Leite *et al.*, 2022). Kurtosis was considered ±7 to ±7, as the data set of all items constructs were normally distributed (Byrne, 2013). The skewness ranges from -0.592 to -1. 772, and the Kurtosis is ranged from 0.237 to 3.815.

Table 4 Validity and reliability

Variables	Composite reliability	Cronbach alpha
Cost of financing	0.859	0.857
Risk Perception	0.829	0.822
Religious Perception	0.817	0.819
Awareness	0.753	0.750
Islamic Financial Institution	0.844	0.839
Poverty reduction	0.873	0.869

Source: Designed by Authors

Table composite reliability (CR) has met the criterion of composite reliability, which is another way comparable with Cronbach's alpha that is considered reliable (Hair *et al.,* 2017). Similarly, the composite reliability (CR) value for all constructs exceeded the recommended value of >0.70, the same as Cronbach's alpha with a value above 0.7, which means the convergent of the constructs analyses is satisfied (Hair *et al.*, 2017).

Table 5 Discriminant validity

Variables	CF	RP	RG	AW	IFI	PR
Cost of Financing	**0.510**					
Risk perception	0.034	**0.539**				
Religious Perception	0.062	0.158	**0.610**			
Awareness	0.142	0.594	0.396	**0.540**		
Islamic Financial Institution	0.331	0.427	0.261	0.411	**0.451**	
Poverty reduction	0.241	0.372	0.435	0.362	0.323	**0.518**

Source: Designed by Authors

The discriminant validity results described in Table 5 test the latent structural variables and show the correlation between the latent based on the AVE square root, which means diagonal and off-diagonal elements. The results indicate that all items show good load in different configurations compared to mutual load. Therefore, this study validated the identification at a powerful configuration level that differentiates it from others.

Table 6. Model of fitness-based theories

Model Fit	Results	Recommended Threshold	Theories
CMIN/DF	3.934	< 5.0	(Hair *et al.*, 2017)
GFI	0.934	>0.9	(Byrne, 2013)
AGFI	0.958	>0.9	(Hair, *et al*, 2017).
IFI	0.932	>0.9	(Hair *et al.*, 2017)
CFI	0.955	>0.9	(Hair *et al.*, 2017)
TLI	0.925	>0.9	(Byrne, 2013)
RMSEA	0.042	<0.08	(Hair, *et al.*,, 2017).

Source: Designed by Authors

Table 6 describes the model's measurement and indicates each fit as indicated above. The CMIN/DF indicates 3.934, as recommended by Byrne (2013). The GFI, AGFI, IFI, CFI, and TLI have met the recommended threshold of above 0.9, while RMSEA is below 0.05, as suggested by Hair *et al. (*2017). Therefore, it indicates the suitable and accepted model of the research model.

Table 7 Hypotheses testing

Path	Unstandardized Estimate	S.E.	Critical Ratio	P-value	Hypotheses	
CF> PR	.271	.066	4.106	.000	Supported	(H1)
RP> PR	.245	.058	4.224	.000	Supported	(H2)
RG -> PR	.329	.088	3.739	.002	Supported	(H3)
AW-> PR	.227	.065	3.492	.003	Supported	(H4)
IFI -> PR	.279	049	5.693	.000	Supported	(H5)

Source: Designed by Authors

Table 7 testing hypotheses indicates the vital direct relationship between dependent and independent variables. Therefore, the direct link between the CR and PR is supported (H1). The scenario is the same with other variables which indicates a positive effect with poverty reduction and accepts the H2, H3, H4, and H5. At the same time. The above results and analyses indicate the direct link between the independent variables as a direct link with positive effects,

Table 8. Direct and indirect effect

Hypothesis	Direct effect X->Y	Indirect effect X->M->Y	Result
CF ->IFI-> PR	0.273*** (0.000)	3.21***(0.000)	Partial Mediation
RP->IFI-> PR	0.242**(0.000)	3.21**(0.000)	Partial Mediation
RG->IFI-> PR	0.303***(0.000)	0.312 (0.002)	Partial Mediation
AW->IFI-> PR	0.199**(0.003)	0.310*(0.003)	Partial Mediation

Source: Designed by Authors *<0.01

The mediation hypotheses are tested using the Sobel test to determine whether mediating variables significantly influence the independent variables to a dependent variable through the mediators. The study indicates that IFIs mediate between and PR as partial mediation for the direct effect of accelerated on both one-tailed and two-tailed probability values, and with 0.000, the same with IFIs mediates between RP and PR. At the same time, IFIs have mediated a significant between RG and PR effects. All variables have partial mediation and have met the threshold of 0.002. Islamic financial institutions have a positive relationship with independent variables and mediation and enhance poverty reduction.

Findings and Discussion

Islamic Financial Institutions (IFIs) have emerged as significant players in the financial landscape, particularly in the area of small and medium-sized enterprises (SMEs) and poverty reduction. This discussion needs to analyse the findings related to how IFIs address the financial constraints SMEs face and their broader implications for poverty reduction. This discussion synthesises existing literature and empirical data to present a nuanced view of the dynamics at play by utilising a model that incorporates the cost of financing, risk perception, religious perception, and awareness (Nwosu, 2024). One of the primary findings indicates that the cost of financing through IFIs is significantly lower than traditionally accepted financing methods, which often rely on interest-based models. Islamic finance operates on risk-sharing and profit-and-loss-sharing principles, mitigating SMEs' financial burden. Muhammad et al. (2021) indicate businesses that adopt Islamic financing mechanisms report a lower default rate than their counterparts using conventional loans, primarily because IFIs are incentivised to support the business's success rather than profit from interest payments. This feature is particularly critical in developing economies where SMEs often lack adequate collateral and credit histories.

The model developed for this discussion highlights that lower financing costs create an environment conducive for SMEs to invest in growth, thereby fostering job creation and income generation. Furthermore, as SMEs flourish, their capacity to contribute to local economies and uplift impoverished communities increases, thus establishing a clear link between affordable financing, SME growth, and poverty reduction through mediating Islamic financial institutions.

A significant challenge that SMEs face in acquiring financing is the perception of risk associated with entrepreneurial ventures. IFIs operate under a framework that emphasises risk-sharing, which can mitigate the apprehension surrounding financial risk among potential borrowers. Findings from a research study by Muhammad et al. (2024) reveal that entrepreneurs who engage with IFIs are more optimistic regarding their financial prospects than those reliant on traditional banks. This heightened internal confidence can translate to better business performance and reduce poverty. Moreover, the IFIs' risk-sharing model fosters a supportive ecosystem where the financial institution collaborates with the entrepreneur, providing capital and advisory support (Hicham et al., 2024). Such inclusivity in the financial arrangement alleviates SMEs' economic constraints, making it less risky for them to undertake expansion plans or innovative projects. This risk-taking dimension is instrumental in fostering an entrepreneurial mindset, which is vital for economic dynamism in underprivileged areas.

Religious perception plays a critical role in the acceptance and utilisation of Islamic finance among SMEs, particularly in Muslim-majority countries. Compliance with Sharia law enhances the credibility and appeal of IFIs for business owners who prioritise religious adherence in their financial dealings, as justified by Mwaura and Nzengya (2022). Hariram et al. (2023) confirmed that SMEs utilising Islamic finance reported greater satisfaction and loyalty to their funding sources than conventional banking customers. This positive Development indicates that religious perception Plays a vital role in influencing the willingness of entrepreneurs to engage with Islamic financial products. Furthermore, religious perception can foster a sense of ethical responsibility among entrepreneurs to engage in socially beneficial business practices. As SMEs align their operations with Islamic principles, they will likely contribute to community welfare and poverty alleviation efforts. IFIs can leverage this religious aspect to create awareness about the broader societal impact of ethical business practices in the fight against poverty (Biosca et al., 2021).

Awareness regarding the products and services offered by IFIs is essential for their effective integration into the SME landscape. Many potential SME clients lack adequate information about Islamic financial instruments, which may restrict their engagement with IFIs. Findings from various studies indicate that initiatives aimed at increasing awareness, such as workshops, educational programs, and online resources, significantly enhance the utilisation of Islamic finance among SMEs (Selenko et al., 2024). The developed awareness model emphasises the need for strategic communication and educational endeavours that target existing and aspiring entrepreneurs. Improved awareness facilitates better access to financing and encourages SMEs to adopt innovative practices that align with Islamic finance principles. This, in turn, can amplify their contribution to poverty reduction. IFIs are well-positioned to carry out these initiatives, making it easier for SMEs to understand the benefits of Islamic financing and the related ethical and social advantages. Furthermore, findings from the cost of financing, risk perception, religious perception, and awareness create a comprehensive model where these elements mutually support each other. The model suggests that lower financing costs reduce barriers to entry for SMEs, while Islamic financial principles mitigate risk perceptions, creating a more favourable environment for entrepreneurship. Furthermore, the interplay of religious beliefs and financial literacy contributes to the sustainability of these enterprises. The comprehensive model also implies that IFIs significantly enhance socio-economic conditions, particularly in impoverished areas.

Conclusion

In summary, Islamic Financial Institutions have an important role in addressing SMEs' financial issues towards contributing to poverty reduction. The findings underline the significance of low-cost financing, risk-sharing mechanisms, the impact of religious perceptions, and the vital of raising awareness about Islamic financial products. As IFIs evolve and adapt to local contexts, their potential to encourage economic growth and reduce poverty to the bearest maximum. It also encourages research and policy support to incorporate Islamic finance into broader economic strategies that will be essential to unlock these benefits fully.

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