DEVELOPMENT OF SME'S WITH PROVISION OF ISLAMIC FINANCE IN EMERGING ECONOMIES: A CASE OF PAKISTAN

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Abstract:
The paper seeks to investigate the characteristics and role of Islamic finance for enhancing access to finance for small and medium enterprises (SMEs) and micro and small and medium enterprises (MSMEs) in emerging economies specially with reference to Pakistan. The study explores into various SME financing options i.e. asset-based financing and equity-based financing offered by Islamic financial system and their inherent characteristics such as social equity, economic justice and financial support for entrepreneurial opportunities linked with real economy. On the practical front, the study has highlighted the current state of SME financing by Islamic banks in Pakistan and the financial needs of the SME sector thus highlighting the financing gap that exists in the market requiring policy and managerial focus by Islamic financial institutions in Pakistan. The role of Islamic finance is stressed as catalyst for enhancing financial inclusion of SMEs and MSMEs in emerging Islamic economies including Pakistan.
Keywords: Islamic Finanace, Sharia Compiance, Small and medium enterprises, Pakistan

Introduction

Micro, Small and Medium Enterprises (MSMEs), with great socio-economic significance, act as the backbone of development, specifically in emerging and developing economies. SMEs contribution to the socio-economic development is channeled through the growth of real income per capita, the improvement of economic stability and reduction of unemployment (Rasheed et al., 2016). SMEs and MSMEs play vital role in employment generation, enhancing economic opportunities, sustainability of businesses as

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well as sustainable economic growth. Due to recent developments in information technology under the umbrella of industrial revolution 4.0, SMEs have got the potential to contribute to international investment and trade. The development of SMEs is seen as a vital element of inclusive global economic activities specially in emerging and developing economies (Joint World Bank-IDB, 2015). As shown in figure 1, at global level, SMEs approximately contributed 43.5 percent to total employment and have created about 57.8 percent of total new jobs during 2015.

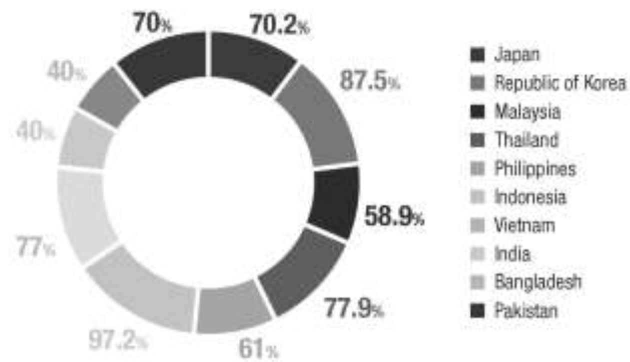

Figure 1: SMEs' Contribution to Employment in Selected Asian Economies
Source: SMEs Internationalization and Finance in Asia (Yoshino, & Wignaraja, 2015)

Asia which is home to large number of emerging and developing economies and where largest population of business enterprises operate, 98 percent of the business firms are SMEs. In Asia, SME sector has contributed about 62 percent to total employment and about 42 percent to total GDP (Borneo Post, 2015). Figure 2 summarizes the contribution of SMEs and MSMEs towards GDP in various Asian economies including Pakistan. Formal SMEs contribute up to 33 percent of national income (GDP) and almost 45 percent of total employments in emerging and developing economies. This exhibits role of SMEs and MSMEs as important catalyst for economic growth, employment and international trade. In Pakistan, SME sector is contributing around 40 percent towards national gross domestic product (GDP) and 30 percent in total exports. Approximately 3.2 million SMEs are actively working in Pakistan having a significant concentration in Punjab with 66 percent share. The population of SMEs in Baluchistan is the smallest only 2.3 percent while those of Sindh and Khyber-Pakhtunkhwa are 18 percent and 15 percent, respectively (IFC, 2014a).

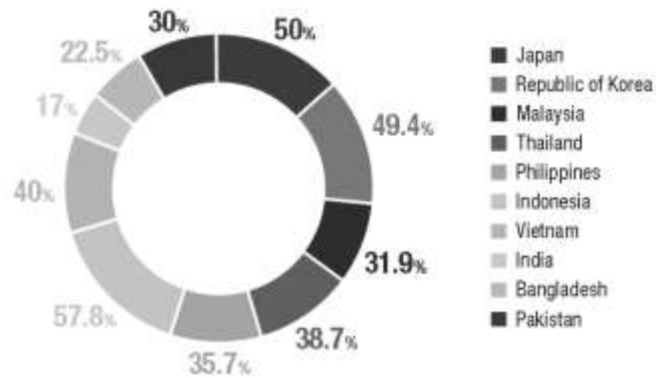

Figure 2: SMEs' Contribution to GDP in Selected Asian Economies
Source: SMEs Internationalization and Finance in Asia (Yoshino, & Wignaraja, 2015)

Apart from the economic contribution of SMEs and MSMEs, this sector is also important because of its role to engage women, youth and ethnic minorities and thus enabling them to be part of the circular economy. The sector is also well known for its inherent flexibility towards change in technology or other external environment factors contrary to corporate sector and is seen as major catalyst for innovation and commercialization (Joint World Bank-IDB, 2015).

However, despite the existing and potential contribution of SMEs and MSMEs in economic and social uplift of economy, the sector has not received a reciprocal support mechanism that would facilitate and enhance the existing and new firms operating in this vital sector of economy specially in emerging and developing economies (Joint World Bank-IDB, 2015). Among various issues and challenges faced by SMEs, poor access to formal finance is identified as the major threat to growth of existing SMEs and establishment of new ones. The other factors limiting the establishment and growth of SMEs include lack of technical and business skills and lack of awareness etc. The major issue for these enterprises, however, is poor access to finance (IFC, 2013). Among other constraints to the development of SMEs and MSMEs, access to finance remains has been the key. There are about 365-445 million micro, small and medium enterprises in emerging and developing economies. Out of it about 25-30 million SMEs and about 55-70 million micro enterprises are in the formal sector, while the rest (285-345 million) are working as the informal enterprises (Stein, Goland, & Schiff, 2010).

Same study identifies that about 45 to 55 percent of the formal SMEs operating in the emerging and developing economies do not have access to formal credit facilities despite their severe need of it (Alper & Hommes, 2013). The figure 3 has summarized the existing state of SMEs' access to formal sources of credit for purpose of either venturing into new business or meet the financial needs of their existing business. The finance gap between supply and demand is even larger when considering the micro and informal enterprises. About 65-72 percent of all SMEs and MSMEs in emerging and developing economies lack access to formal credit. Furthermore, about 55-68 percent of SMEs in these economies are either financially underserved or not served at all. This has led to high economic and social opportunity cost in terms of lost opportunity that the people have to face while struggling to realize their full potential (Joint World Bank-IDB, 2015).

Figure 3: Access to Formal Finance for SMEs in Emerging and Developing Economies

Source: Joint World Bank-Islamic Development Bank Policy Report (2015)

The size of finance gap differs varies across countries and regions. The supply factors are largely responsible for the financing gap that SMEs and MSMEs have to face i.e. it is usually easier for the large firms operating in the formal sector to obtain required financial services including loans (IFC, 2013). The same study finds that about 9 million SMEs and MSMEs do not have sufficient access to formal loans in South Asia and South East Asia. In Pakistan, SMEs, as compared to large firms, are less likely to be able to obtain financing from banks, therefore, they rely on internal or informal finance to initially run their businesses and develop further. These hurdles without any doubt have hampered SMEs' ability to realize their potential and get developed (Khan, 2015a).

Access to finance for SMEs is a global issue and a local challenge for Pakistan that needs a more thorough response by various related regulatory bodies and support agencies including financial institutions. One suggested course of action to address the issue is to have innovative and diverse financial products to meet financial needs of SMEs. Islamic finance is one such avenue of innovative and diverse financial products whose potential to meet financial needs of SMEs and MSMEs is to be investigated and analyzed. This study seeks to explore into potential role of Islamic financial system to cater to the financial needs of SMEs through its innovative and diverse product offerings and thereby enhancing SMEs' access to finance.

In Pakistan, financial market is composed of three main sources of finance, through which SMEs meet financial needs of business. Formal sources include banks and non-banking financial institution, informal sources include family members, friends, referrals, credit from suppliers and advance payments from customers, and personal savings such as retained earnings, internal funds, and equity (Khan, 2015a). As per report by International Finance Corporation (IFC, 2014b), about 67 percent of SMEs are financially unserved in Pakistan, meaning that they are not getting any formal financial facility from banks. Further 22 percent of SMEs are utilizing the formal financial services, however, out of it only less than 20 percent are satisfied with those financial services. Report further discovered that 67 percent of SME population have low intention towards formal financial products because of various reasons and the major population of SMEs is not using formal financial services because of religion factor (Rasheed et al., 2017). This evidence points to the potential need of interest-free financial and banking services which would not only meet the financial requirement of SMEs but also will satisfy the religious aspirations of the SMEs' owner-managers.

Provision of Islamic finance to SMEs is the main thrust of this study as demand of Islamic finance already exist in financial market of Pakistan. However, the sector still suffering from lack of finance which hindering the development and growth of sector as well as country's economy. Various government and private institutes are working toward achievement of inclusive finance for SME sector, though because of slow growth SMEs facing several constraints. Although, other financial institutes paying attention on the issue of access to finance, still there's need of special attention, efforts and leniency from Islamic financial institutes to empower SME sector in country.

Islamic Banking Industry

The Islamic finance industry is growing rapidly across the globe. The global Islamic finance industry grew year-on-year by of 11 percent to US$ 2.4 trillion revealed by Islamic Finance Development Report (2018). It is based on figures reported for 56 countries, mostly in the Middle East and South and Southeast Asia. Iran, Saudi Arabia and Malaysia remain the largest Islamic finance markets in terms of assets. In Pakistan, assets of Islamic banking industry were posted at Rs. 2,458 billion by end of September, 2018 as against Rs. 2,482 billion in the last quarter. The market share of Islamic banking industry's assets in overall banking industry's assets rose to 13.6 percent by end September, 2018 as against to 12.9 percent in the last quarter. The share of net financing and investments in total net assets of Islamic banking industry was posted at 55.6 percent and 21.8 percent, respectively by end September, 2018 (SBP, 2018).

The network of Islamic banking industry in Pakistan is comprised of 21 Islamic banking institutions such as; 5 full-fledged Islamic banks (IBs) and 16 conventional banks having standalone Islamic banking branches (IBBs) by end September, 2018. Moreover, the number of Islamic banking windows operated through conventional banks having standalone Islamic banking branches reached at 1,284. Despite rapid growth of Islamic finance industry SME sector not getting proper financing facilities. IFC (2014a) highlighted that 20-25 percent of SME population is interested in Islamic finance, however, whether they are not obtaining any financing facility or these SMEs are not satisfied. To offer Islamic finance products, Islamic banks are not focusing on this potential segment because of inadequate strategies to tap this opportunity.

Formal vs Informal Financing

In Pakistan main providers of formal financial products to SMEs are commercial banks, development banks, microfinance banks, specialized banks, international development agencies, leasing and insurance companies. Though, only 7 percent of SMEs population using formal credit of banks, comparatively, the percentage is higher in neighbor countries like Bangladesh and India 32 and 33 percent, respectively (Rasheed et al., 2016). Both demand and supply side constraints creating hurdles in growth of SME sector. From Supply side financial institutions consider SME sector as risker to lend money due to various reasons such as unstructured or informal business set ups. Moreover, the enterprises experience of less than 5 years considered by financial institutes young and they are not able to meet the compliance requirements. All these shortfalls keep SME sector on the level of high-risk borrower, therefore, financial institutes shows reluctant behavior towards provision of finance to SMEs. From demand side SMEs avoid formal financing because banks have very lengthy procedures in providing credit (e.g. they take 2 to 10 months in credit approvals). This delay is also because of the central bank (State Bank of Pakistan) SBP policies and regulations, as banks are not permissible to provide financing to SMEs on an unsecured basis (Dasanayaka, 2011; Sherazi et al, 2013). However, for survival and to sustain SMEs move towards informal financial market, which is an easy, affordable and quick way for them to meet their business financial needs. Figure 4 summarizes the formal Islamic financial products that can be offered by the Islamic banks to meet the financial needs of SMEs.

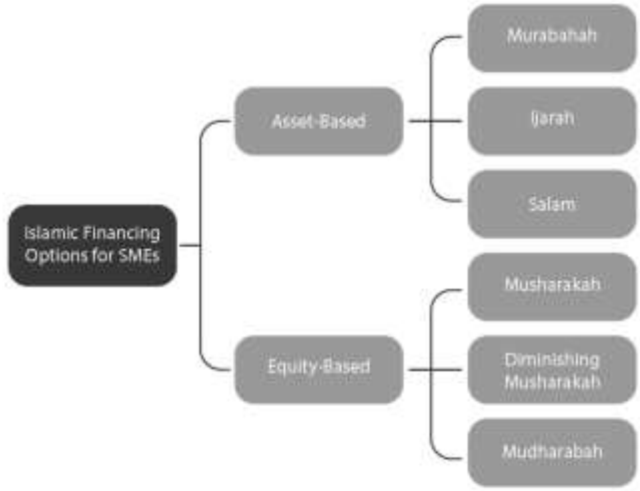

Figure 4: Formal Islamic Financing Options for SMEs and MSMEs
Source: International Shari'ah Research Academy for Islamic Finance (ISRA, 2018)

Informal financial sector, on the other hand, consists of individuals such as friends, relatives, money lenders, neighbors, traders, landlords, and group of individuals that operate mainly in rural setting (Mungiru & Njeru, 2015). Khan, (2015a) informal finance which based on friends and family members calculated around 61 percent. Moreover, the informal finance ratio from landlords recorded 30 percent, also the shopkeepers, merchants and professional money lenders ratio 2.12 percent. In informal financial sector when borrower lend any small amount credit from friends and family than no need to pay any interest rate. On the other hand, if borrowed from money lenders then they give finances on an unjust and a very high rate of interest. Studies revealed that 90 percent of SMEs in rural areas like farmers lend money from informal sources such as money lenders. The money lenders help out SMEs by offering them finance mostly to buy fertilizers, to rent machinery and other working capital requirements. In informal finance no collateral required as financial institutions asked for, however, they take share in profit at time of harvesting. Moreover, they offer interest rate 5 times higher than the interest rate offered by formal sector or financial institutions (Rasheed & Siddiqui, 2018a). Despite this injustice, SMEs prefer informal market because of opportunity cost of equity finance which is very low as compare to formal financing. SMEs with good business proposal mostly never obtain any formal finance because of strict policies and lengthy procedures to process loan proposals. Moreover, bank managers' rude and inflexible attitude and behavior also prevent them to approach formal financial institutions. Additionally, researchers agree that SMEs intention towards informal finance is higher than formal finance as well as owner-managers have lower intention towards formal finance (Kauser et al, 2012; Nkuah et al, 2013; Sherazi et al, 2012).

Current Status of SME Financing by Islamic Banks

In Pakistan, banks are the main providers of formal finance to SMEs. Table 1 shows that the lending to SMEs from banks swelled to Rs513 billion in 2018 from Rs442 billion in 2017. Furthermore, domestic private banks shows interest and provide full support in facilitating SMEs for their financial needs followed by public banks.

Banking Cluster	Dec-17	Sep-18	Dec-18
Public Sector Commercial Banks	100.31	84.54	113.03
Specialized Banks	9.48	9.41	9.41
Domestic Private Banks	299.68	282.8	343
Foreign Banks	0.16	0.15	0.15
Islamic Banks	31.79	32.64	45.68
DFIs	1.11	1.9	2.19
Total	**442.53**	**411.44**	**513.46**

Table 1: Share of Banks in SME Financing in Pakistan
Source: SME Finance Review, (2018)

A large proportion of SMEs seeking for Shariah compliant products, however, Islamic banks consider SMEs as riskier sector and therefore show more careful attitude in providing finance to SMEs. Furthermore, full-fledged Islamic banks share in financing to SMEs is very low at Rs 45 billion as compare to Rs 113 billion and Rs 343 billion by domestic public and private commercial banks, respectively. SME finance review report, (2018) exposed that in Islamic banking industry SME sector is the most neglected one as overall Islamic banks finance stands only 5.6 percent to SMEs and 69.5 percent to corporate sector.

Islamic SME Financing	Dec-17	Sep-18	Dec-18
Islamic Banking Divisions	8.86	10.37	11.1
Islamic Banks	31.79	32.64	45.68
Total	**40.65**	**43.01**	**56.78**

Table 2: Islamic Banks and Islamic Banking Divisions SME Financing
Source: SME Finance Review, (2018)

Islamic banking divisions (IBDs) share is around three percent Rs11.1 billion which is increasing gradually. Despite SMEs strong interest for Islamic financing limited products range and outreach, moreover, lacking in operational capabilities are obstructing SME sector development and growth. SMEs are taking keen interest in Islamic financial products as people because they are realizing the benefits of Islamic financing. The excellent performance growth of Islamic banks all over the world and in Pakistan because of various initiatives of central bank has further consolidated this opinion. Despite, various factors prevent SMEs to obtain formal finance from banks and other financial institutes.

Islamic Finance as Catalyst for Enhancing SMEs' Access to Finance and Financial Inclusion

The Islamic finance has taken its philosophical roots from basic values of Islamic teachings i.e. social equity, economic justice and financial support for entrepreneurial opportunities as true measure to help poor people. This has resulted in Islamic financial system which aims at inclusive economic growth and financial inclusion specially for SMEs and MSMEs as focal point of their financial services (Asutay, Mehmet & Shehab, 2012). Financial inclusion of SMEs has been addressed by Islamic finance through two major categories of its financing options i.e. asset-based and equity-based contracts, which are viable alternatives to conventional financing (figure 4). Furthermore, risk-sharing features of Islamic financing and credit to collateral strong link which is suitable for MSMEs to promote inclusive growth (Lagarde, 2015). Islamic financial system seeks to address the issue of financing gap for SME sector through a comprehensive yet diverse portfolio of asset-based and equity-based financing products for SMEs and MSMEs (Joint World Bank-IDB, 2015). The asset-based financial products ensure that financial transactions are linked to real economic activity with corresponding financial assets and thus contributing to real economic growth as a result of growth of financial assets of Islamic banks or financial institutions (Joint World Bank-IDB, 2015). The equity-based financial products ensure sharing of profit and loss between investors and SMEs owner-managers which promotes risk-sharing and thus accountability, and enhances new start-up entrepreneurship which relies mainly on equity financing (Joint World Bank-IDB, 2015).

Socio-economic justice is the hallmark of Islamic economic and financial system and is thus taken care of in the financial innovations in Islamic finance to achieve financial inclusion specially in context of SMEs. Financial inclusion is critical in overcoming issues of low investment growth, weak productivity and income inequality (IMF, 2015). Islamic banking and financial system seek to contribute towards socio-economic justice through equity-based and asset-based financing products for SMEs to meet their financial needs and ensure their financial inclusion and achieve real economic growth. (ISRA, 2018). Apart from the above mentioned financing methods, there are other financial support mechanism such as zakat, waqf and qarz-al-hassan (benevolent loan) in Islamic economic and financial system that seek to provide financial support to the poor to encourage them establish SMEs and MSMEs.

The importance of above distinct characteristics of Islamic financial system involving risk sharing, equity financing and asset-linked financial products for SMEs and MSMEs financing has been recognized by economic and financial managers specially in Islamic countries. The Organization of Islamic Cooperation (OIC) has rendered SMEs as major target of its policy endeavors to design necessary policies by member countries to close the gap between Islamic finance and SMEs sector and thus ensure an inclusive economic growth (OIC, 2012). Another nitiative has been by the Council for Islamic Banks and Financial Institutions (CIBAFI), which is the global forum of Islamic financial institutions (IFIs). The CIBAFI has conducted a meeting of top management of IFIs in 2016, which is themed as “Building Technical Capabilities to Generate Sustainable Islamic MSMEs Finance”. Further, the CIBAFI is collaborating with the Islamic Development Bank (IDB) to discuss the issues and challenges in the Islamic SMEs finance for sustainable economic growth.

Demand and Supply side Issues in Provision of Islamic Finance to SMEs

A number of issues pertaining to provision of Islamic financing solutions to SMEs have been identified in the literature. These issues are categorized into demand side and supply side issues (Figure 5). The demand side issues reflect the constraints faced by the customers i.e. SMEs in accessing formal Islamic financial services. The supply side factors, on the other hand, represent the limitations and shortcomings at the end of Islamic banks and Islamic financing institutions which limit their ability to effectively meet the financial needs of SMEs and MSMEs.

Demand Side Issues

Awareness

Awareness is an important determinant of customer intention, as it's a first step towards adoption or purchase of products and services. Researchers revealed that educated people with extensive knowledge about financial industry, financing process/procedures and financial products have high level of awareness. Thus, scholars consider knowledge a vital factor which have strong impact on consumer purchase intention, which shows that there is a strong connection between knowledge and awareness (Ringim and Yussof, 2014; Rasheed et al., 2017).

Usually the owner-managers of SMEs not educated and have no or less knowledge about appropriate financial products for their business needs. Banks, national and international organizations now undertaking initiatives to educate SMEs through various training programs and events to create awareness about different Islamic banking products and services available to fulfill their business financial needs. However, the current facts and figures revealed that still there is a need to seriously focus on this issue (Rasheed & Siddiqui, 2018b).

High Cost and Collaterals

One of the key issue SMEs never approach banks for getting finance is high interest rate and collaterals requirement. Moreover, the credit cost charged by Islamic banks 1-2 percent higher as compare to conventional banks. Additionally, SMEs are charged high collaterals ranging 130-140 percent of the total loan amount. Banks 98 percent of loans collaterized which they charged by way of cash margins and mortgage on tangible assets (IFC, 2014b).

Lengthy Process

A vast majority of SME population currently using conventional banking services or not using any financing facility, do not aspire to use Islamic finance because of the lengthy processes. The whole processes for application and approval are lengthy which take two to four months minimum. Moreover, the requirement of documentation further discourage SMEs from applying for Islamic bank financing (Khan, 2015b; IFC, 2014a).

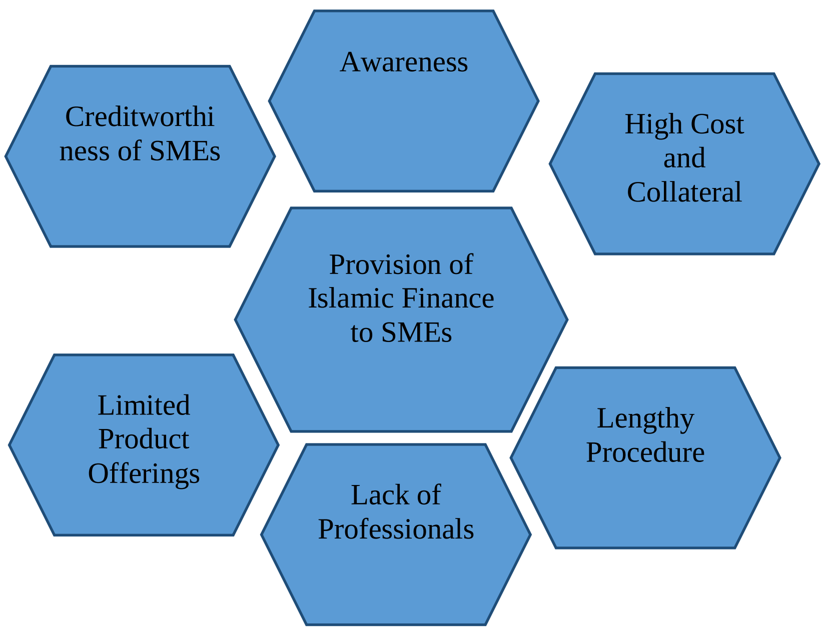

Figure 5 – Demand and Supply side Issues in Provision of Islamic Finance to SMEs

Source: Authors' compilation

Supply Side Issues

Lack of human resources

The lack of professionals in Islamic banks who have complete knowledge about Shariah-compliant product structures creates problem for both customer and bank. The problem exist across the country however, more acute in rural areas. The in-complete or no knowledge regarding Islamic products lemmatized the share of banks in financial market because banks not able to serve their customers properly. Thus, there is need to train the staff and educational institutes specifically design the courses to produce Islamic institutes' professionals (Sherazi et al., 2013).

Limited Product Offerings

The limited products and services offerings also hinder SMEs to approach Islamic banks for financing needs. Most of the Islamic banks in Pakistan do not offer few pre-requisite services e.g. mobile banking, cash management and branchless banking (Khan, 2015b).

Creditworthiness of SMEs

Islamic banks systems in Pakistan are still not efficient as they cannot analyze the worth of client properly and because of this reason they never facilitate SMEs much. Banks are not capable to analyze and manage their new and existing clients' data to identify default patterns. It can be used by banks later to analyze other loan portfolios (IFC, 2014a).

Recommendations

Despite the challenges, Islamic banking and financial products offer a financial inclusion opportunity for SMEs sector in Pakistan. The government and its financial regulatory bodies have thus an important role to play by extending financial and non-financial support mechanism for SMEs to enhance their access to Islamic financial institutions and products. Financial support may include supportive policies for provision of seed capital and collateral waivers. Non-financial support may include training programs for SMEs and business development assistance programs. For example, government in Malaysia has introduced Shariah-compliant SME Financing Scheme to enhance establishment and growth of SMEs through Shariah-compliant financial support (Borneo Post, 2013). In Pakistan, government and State Bank of Pakistan may introduce such SMEs financing schemes which are based on Islamic financial products to meet financial needs of SMEs and MSMEs.

Conclusion

In Pakistan and across the globe access to finance is one of the major issue hindering SME growth and economic development of country. A small proportion of SMEs currently using formal financing and the rest still relying on informal source of financing. Around 25 percent of SMEs interested to use Islamic financing for their business financial needs, however, they are not getting any attention from Islamic banks. Despite government and other institutes are taking initiatives to help out SME sector however, still the growth is very slow. The factor of religion creating a new funding potential of almost $2.6 to $3.8 billion for Islamic finance over the next few years. It's an opportunity for Islamic banks to expand their share in market by paying attention on the un-served population of SMEs who particularly interested in Islamic products.

Islamic banks should focus on this potential sector by providing wide range of products and services. Moreover, easy and short procedures along with basic and only important documentation can also attract many towards Islamic financing. The professional staff with complete knowledge of Sharia-Compliant products and services and improvement in existing infrastructure and capacity are essential to serve better SMEs financial needs. Government and other institutes should also take SME sector serious for sustainable growth and achievement of inclusive finance in country. Also there is need to conduct through research on supply and demand side issues of SMEs access to finance as along with the mentioned factors various other impacting both SMEs and financial institutes.

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