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# Islamic banking for small and medium enterprises (SMEs): A glance at challenges and prospects in Pakistan

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## Abstract

In Pakistan, the SME sector proved to be vital in uplifting economy and have a potential to be a game changer in the economic development of the country. Yet there are problems in the sector such as influences from big players, market conditions, corruption, inadequate infrastructure, and above all lack of proper financing guidance and facilities. Although the banking sector in general has failed to craft a policy to assist the SME segment but still the Islamic banking sector proved promising towards SMEs entrepreneurs. The data reflects that only 11% of the SMEs are well-served, 22% claimed to be underserved and 67% remains un-served. Thus, more than 89% are either deprived or totally neglected by the banking sector of Pakistan. It has been found out that spiritual belief is one of the major reasons which prevent the SMEs entrepreneurs to opt for a proper finance. More than 25% of these entrepreneurs don't opt any sort of financing and 20% restrict themselves to a necessary level. Thus, main objective is to critically examine SMEs which avoid conventional financing opportunities due to religious reasons. Tedious and extended loan obtaining procedures of conventional banking makes for SMEs remain averted from financing. This portion of the sector is yet to be targeted as there are many who would prefer to borrow if there are financing opportunities available according to the shariah principles. Using a literature review approach, this article examines the factors which inhibit the growth of SME sector in Pakistan. Finally, after the support from the State Bank of Pakistan (SBP) in drafting out the policy, it is expected that banks capacities towards the sector are expected to increase.

**Keywords:** SME; MENA; GDP; Entrepreneurs; Workforce; Economic Development

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## **1. Introduction**

Our research on the Small and Medium sized entrepreneurs was a fetching one. This is due to the being different nature of Small and Medium sized Enterprises and the shortage of academic literature. This also highlights that this sector has largely being ignored in general and there is a roam for research. Getting into the insight we came to know that this sector comprise of a variety of different businesses and it is difficult to develop a general framework which could explain all of them. The research also put forward a number of details regarding the SME sector which helps the students and fellow researchers if they want to do further research regarding the topic. This research also tries to explain the statistics in great detail, so the banks and other financial institutions who are interested in investment opportunity in the SME sector could take help from the observations presented in the article.

The SME sector is a vital component in the most of the developing nations' economy. The Governments have recognized this fact, and thus formulating policies in order to boost their SME sectors (Feeny and Riding, 1997). The SME sector of Pakistan is responsible for over 30% of the GDP, furthermore this sector contributes around 25% of its share in the exports of manufactured goods. In addition to that, this sector gives employment to over 78% of the non-agricultural workforce of Pakistan. The sector also contributes more than 30% of Gross internal product. It also gives employment to more than 75% of the non-agricultural workforce (SMEDA, 2016).

But, because of critical business situation and poor access to finance are their potential has been affecting. According to a recent study around 25 to 30 million people looking for microfinance to start their business (Rauf and Mehmood, 2009).

The Pakistani banking sector dedicated to SMEs has developed in the last decade and it is currently aiding around 4 million customers, which was around 2 million in 2010 (MicroWATCH, 2015.). They are also improvising in their product lines which results in a significant increase in the portfolio which was 25 billion in 2010 and increases to 93 billion up till December, 2016 (Raza, 2017).

But still access to proper finance is the main need for a Small and Medium sized entrepreneur, which in most of the cases is unmet. Even though these SMEs are creditworthy, they are excluded from accessing backing from Islamic banks. As a product (Sharia-complaint) which they want is either not meant for them or they are unaware of these products. The cumbersome procedures by the Islamic Banks also repel the SME entrepreneurs to avail the financing facility.

## **2. Research objectives**

Our objective is to discover those SMEs, who do not opt for financial assistance via conventional bank because of their religious reasons, a need that is unmet. Many of them (SMEs) just stick themselves to a minimum threshold to survive and definitely they would like to opt for more if there is an option which is according to Sharia regulations. This study also shed light on those SMEs who will prefer the Islamic way of

financing if available and they are using the conventional method of financing just in the absence of adequate Islamic Banking option.

## 2.1. Research methodology

The study is in a descriptive manner and mostly relies on the secondary data from other sources having similarities. Data is extracted from different journals, magazines, Reports from the State Bank and Small and Medium Enterprise Development Authority, and other related studies in this regard. Our utmost effort in this regard is to select the relevant and authentic source for the data and references which help us to infer a conclusion that is helpful for future researches.

## 3. SMEs in general

The small and medium sized entrepreneurs are the ones who are involved in originating things in order to fulfill the demand of the local market. It also turn out to be a fundamental tool in income generation and creates employment which boosts the economy Mira (2005) states that SMEs proved to be a vital tool for national income at the same time it also generates employment. On the other hand, this sector has proved its potential in the international arena, which creates a roam for the SMEs all over the globe. Lu and Beamish (2001) stressed that SMEs are the key in globalization and their fruitful relation among diverse nations. So, numerous economists, theorists and entrepreneurs have argued the significance in the economic growth.

SMEs have been defined very differently in terms of characteristics across globs which include employment, capital and income of enterprise (Cunningham and Rowley, 2008). Authorities in different countries have defined the SMEs according to the number of persons employed, assets and other related criteria. For instance, the definition of European commission states that a company which employs less than 250 persons can be called SME. There are further categorizations, for example if an organization has less than 10 workers it is called a micro organization. Similarly if the company has 10-49 workers then it is considered to be Small Company whereas the company which has 49-249 workers considered as medium sized company Loecher (2000) adds the condition of annual revenue not more than 40 million euro and 27 million euro of capital at the end of each financial period.

Here, it is quite clear that this criterion is different in developing countries than in the developed countries. This sometimes creates the confusion because of the different assessment criteria among the different nations. The definition of SMEDA for SME in Pakistan is our benchmark for our research and it describes an organization having not more than 250 employees and capital of less than 25 million Pakistani Rupees and the transaction level of 250 million Pakistani Rupees.

### 3.1. The government role in the promotion of SME

The SMEs usually face an instable environment; have poor working conditions, productivity constraints and inadequate training facilities (Tsai et al., 2007). They generally run at the practicality of job creation and

most of the entrepreneurs are self-employed individuals who definitely need government support (Rahman et al., 2015).

In the recent times, Scholars have shed light upon the impact of Government support towards the SME sector (Kwarteng et al., 2016). The SMEs impact deeply depends upon the infrastructure and suitable policies by the government (Rahman et al., 2015). The research further stresses on the necessity of policy making, in order to support the SMEs in all the three aspects of their business cycle.

The foremost aim of the SMEs sector is job creation, and their contribution could also be measured in the same sense (Tsai et al., 2007). At the same time, it is difficult to measure the direct impact of SMEs on the macroeconomic level, due to their informal and heterogeneous nature (Dar et al., 2017).

### 3.2. The demographic structure of the SME sector in Pakistan

With respect to the ownership pattern 74% of the total SMEs are sole proprietors, 13% of them are registered partnerships and 2% are societies, where the rest of them fall into other categories. The sole proprietorship is the most preferred form of ownership in Pakistan, because of the minimum regulatory requirements and convenience in forming such business. By function, the manufacturing units leads the SMEs populace with 49%, followed by the social, personal and community services sector, which accounts for almost 40%. The rest include restaurants and hotels as well as those who are in the wholesale and retail businesses (Batool and Zulfiqar, 2011).

### 3.3. The role of state bank of Pakistan in the promotion of SME

Apart from their customary tasks, the State Bank of Pakistan evolves new provisions like the credit to priority sectors and several other activities. A group specifically dedicated for the SME sector called the Development Finance Group (DFG) is established and it is operating at the SBP. This department performs as a hub which guides in matters related to the supply of financial services to the SME sector.

The State Bank of Pakistan also develops a regulatory framework under the banner of "The Prudential Regulations for Small and Medium Enterprises (SMEs)". This encourages the flow of bank credit into the SME sector. The salient features of this framework are which helps both the Islamic Banking Sector and SME sector are the following:

- Move from collateral based lending to cash flow based lending
- The Maximum limit of financing against the personal guarantees has increased to Rs three million for the SME sector.
- Easing off the bank requirements such as obtaining the copy of accounts.
- Provide guidelines to the Banks to effectively reach the SME sector.
- Encourage to develop new financing techniques and innovative products specifically for the SME sector.
- Develop the efficient and effective resource management systems.

Currently the SMEs operating in Pakistan does not have their financial information and enough data, which is required by the banks. So the SBP has advised the banks to come up with the least information requirements and regularized formats in order to facilitate such entrepreneurs. There are other SBP schemes in order to develop the Market for the SME sector such as the SME targets regime, the formation of Credit Bureaus , the Credit ratings of SMEs and a secured transaction framework helps the sector in their capacity building. The SBP also with the help of SMEDA designed a comprehensive training program, organized workshops, seminars and other related awareness programs. The SBP also facilitate the government initiatives and helps them to make policies related to the SMEs (SBP 2015).

#### **4. Problems faced by SME Sector**

Although the SME sector faces many difficulties like inadequate infra-structure, obsolete level of skill and technology, access to proper financing facility is the major constraint for all the small and medium sized entrepreneurs. The properly financed SMEs are just 11% in the whole populace, while 22% of the firms are underserved and almost 67% are un-served (IFC, 2017).

Poor company conditions and strict banking policies deprive SMEs of financial assistance. The conventional banks do not craft a necessary ease which can assist this sector, (KPMG, 2017). Furthermore, the Islamic banking sector shows extra caution to treat SMEs, resulting in a more discouraging figure of just below 5% in their total lending (Mustafa et al., 2017).

With development in their product line and their capacity, it is anticipated that the Islamic banks can hold the sector and increase their participation in the coming years (Haq et al., 2017).

The motive behind this literature review is to determine those small and medium sized entrepreneurs who do not borrow because of their religious reasons. It shows that there is a need, which has not yet been addressed. How much of these enterprises use conventional banks in order to survive, surely the people would borrow more if there is an alternative financing option available which was not contradicting to their religious principles. Surely, there is a very acute number of the enterprises who prefer Islamic banking to meet their needs, but the reason is the unavailability of adequate Islamic banking facilities, more precisely a product which can meet up to their needs and which is according to the Sharia Laws at the same time.

The religious belief is the main reason which stops an entrepreneur to opt for proper finance. Around 20% to 25% of these SMEs don't opt at all for any sort of financial assistance or their usage of a banking channel is limited to their necessities. (Mehrotra et al., 2015)

This trend tends to change in the last 4 to 5 years as the people get more aware about the Islamic mode of financing, or it is in their reach to practice a system which gives them a spiritual satisfaction as well as the material assistance they need (Raza, 2017). But again, there is no proper product line available to cater the needs of these enterprises (Mustafa et al., 2017). Even though these firms are creditworthy, they are barred from accessing the financial assistance either due to the unavailability of a Sharia compliant product line or

the customer are not properly aware of these products or these financing requires lengthy procedures to follow necessities (Al Galfy, 2012).

The State Bank of Pakistan has put its effort to develop an Islamic banking product line, particularly for the SME sector. The State bank has taken a number of measures to establish and boost a framework that is lawful, operational and according to the Sharia. These include; easing the liquidity concerns and builds up the human resources that are needed to enhance the Islamic banking,(SBP 2015). The SME sector has a positive attitude in this direction. It is a fact that the demand for Islamic banking from the Small and Medium enterprises is increasing,, (KPMG, 2017) but the lengthy process and high cost of credit discourage the customers to approach an Islamic bank (Rahman et al., 2015). So a powerful approach and dedication from the Islamic banks is needed to satisfy these issues; main of them, as per Small & Medium Enterprise Development Authority, Ministry of Industries & Production Government of Pakistan are:

- Absence of information regarding Islamic Banking
- High cost of credit and massive collaterals
- Lengthy and unnecessary procedures

#### 4.1. The general neglect of SME sector

It is commonly understood among people that industrialization means large scale industry where thousands of workers worked, irony is that the government thinks in the same manner. But despite of all the discouragement and ignorance, the small and medium sized entrepreneurs industry dominates the Pakistani economy throughout the history. As of today, more than 40% of the business takes place in the informal sector, and when we compare it to the large scale industries, this sector proved to be far more vibrant and has the potential to lift the economy if the government gives the sector its due importance (Raza, 2017). It is important to note that the SME have the breeding ground for innovation but still there is little research in this sector (Batool and Zulfiqar, 2011).

#### 4.2. Factors which inhibit the growth of SME sector

A recent survey of the top twenty banks in Pakistan, regarding the facilities banks provide to SMEs. It find out that only thirteen banks are offering their services to SMEs, out of those thirteen , only seven provide products that are Islamic in nature. Only eight of them have their separate company divisions for SMEs, out of those eight just two have a decent SME penetration and the rest are so far looking to cease any opportunity in the SME market (KPMG, 2017).

Banks and financial institutions most of the time plays a vital role in the economic development throughout the globe (Iqbal and philip, 2005). Keeping in view the considerable amount of potential present in these small and medium sized entrepreneurs arena, a policy shift would have a far-reaching effect upon economic development and on the welfare of the society (Rahman et al., 2015).

Banking rest on the accumulation of financial resources, principally they try to increase their inflow of deposits. By changing their preference in increasing the volume, which could be done by attracting peoples either by (i) increasing the substantial incentive, by (ii) stressing on safety and security, and by (iii) improving the customer service.

In order to survive and to be successful, a bank must try to attract people who need money to finance their activities according to the terms and conditions established by the bank. A commercial bank depends upon the interest rate, which is the powerful factor that stimulates all their operations. Islam is against this interest factor. So the Islamic banking dealings are based on the rules and regulations derived from Sharia (Haq et al., 2017). The Islamic principle states that the return to any service should either be in an indefinite form, like profit or in a definite form like salary.

Due to this differential advantage, the Islamic banking sector in Pakistan growing more quickly. The total deposits in Islamic banking sector observed an annual growth of around 30% (SBP, 2007).

The basic outline of Islamic banking drafts out a commercial arrangement where real transactions of goods happen, the bank buys the commodity you need and then sell it to you upon an agreed price and time of payment. By this way bank became a trader of good rather than a mere lender of money (Iqbal and Philip, 2005).

Recent commercial disaster after once more has showed the significance of SMEs in cutting unemployment and maintaining growth (Batool and Zulfiqar, 2011). SBP will provide support to Islamic investment institutions in words of enabling regulations, enable scrutiny to develop produce for this sector and stimulate the industry to make use of its marketplace expertise to discover the huge potential of this sector. There furthermore exists a circumstantial argument that entrepreneurs in SME sector are extra inclined towards Islamic investment due to their spiritual sensitivity. It is believed that the Islamic Investment Industry will allocate and finance at least 5% of the deposits or 10% of financing whichever is higher for SMEs (SBP 2015).

The SME financing in Pakistan grew and picked momentum in the last ten years because of the several initiatives started by the State bank of Pakistan and the government, such as the introduction of sensible protocols for SMEs (Rahman et al., 2015). But, the credit gap remains in financing requirements.

If we took an insight into the equation, around 50% of the borrowers belongs to these three cities (Karachi, Lahore and Faisalabad) (SMEDA, 2016). Nearly 85% of the credit financing goes in the 20 largest cities of Pakistan (Batool and Zulfiqar, 2011). In addition, most of them are medium sized entrepreneurs. The small enterprises still obtains funds from the informal medium, which has off course extraordinary comparative cost (Rahman et al., 2015). Access to finance is still the foremost issue for the small and Medium sized Enterprises of Pakistan.

Well-served SMEs are just 11% of the total populace. Whereas 22% considered to be underserved, as the formal financing meets less than 20% of their overall requirements. The remaining 67% of the total SMEs are yet to be served by the banking sector. SME entrepreneurs do not borrow at all for many reasons; these include their religious beliefs as well (IFC, 2017).

## **5. Islamic banking opportunities for SMEs in Pakistan**

Religious belief appears to be one of the main reasons hindering SME financing. This sentiment is growing sharper in the last five to six years. A huge demand for a finance that is according to their belief is already present in the SME sector; this can result in good funding opportunities. But it is also a fact that the funding to this sector has dropped significantly over the years, because the banks (both conventional and Islamic) prefer to divert their funds to a safer category in this period of uncertainty (KPMG, 2017).

Here we discuss those SMEs who do not opt for formal finance due to religious beliefs of their management. SME entrepreneurs represent a new potential market of around 3.8 billion dollars for the Islamic banking sector in the coming years, so here we present two possibilities (Al Galfy, 2012).

### **5.1. A bull-case possibility**

This possibility is based on the hypothesis that small and medium sized entrepreneurs would have better access to finance according to sharia principles, which would appeal them to avail the opportunity from a formal financing channel. This assumption also includes that there is awareness among the customers as well as bank employees regarding the Islamic finance. The banks also provide various value-added services. It is estimated that these measures likely to cater around 20% of un-served populace and around 15% of the underserved populace, who stayed away or limit their banking activities because of their religious reasons. This would likely to cater around 3.8 billion dollars to the SME sector.

### **5.2. A bear-case possibility**

It is expected that Islamic banks would likely to hit a 15% mark of those Small and medium sized entrepreneurs who avoid banking due to religious reasons. In addition, it is expected that banks likely to increase their branch penetration in the urban centers and introduce more variety in their products. The process for loan too, be made easier for these entrepreneurs. This would likely to cater around 2.6 billion dollars to the SME sector.

With respect to finance, the manufacturing sector dominates the existing share of around 70% of total Islamic SME financing. The same sector also has a significant potential because of their capital-intensive nature, this also ensures the suitable collateral to be provided. So, this could be the first target for Islamic SME financing. Additionally, manufacturing activity also has a greater economic impact. This sector contributes around 25% to the exports and their value addition into the economy is about 35%, also these enterprises have greater employment potential.

The other possible areas would be the hotels, restaurants, wholesale and retail businesses, and above all the Information Communication Technology (ICT) sector. However, these sectors are expected to have a small size, a lesser amount of capital and informal in nature. So, the funding potential is small because the demand for money from these entrepreneurs is low.



## 6. Conclusion and recommendations

The investment arrangement in the country has significantly increased in the recent times and the Islamic investment is one of the swiftest sub-segments in the financial sector. Islamic deposits have increased of over 42% and the SBP is enhancing the five year design for Islamic investment industry, stressing particularly on the SME sector.

The SME sector even with these measures still considerably underfunded as, more than 89% of SMEs are either deprived or totally neglected by the banking sector of Pakistan. This is mainly due to the extra cautionary behavior of Islamic banks towards the SMEs. The unawareness of Islamic products among the SMEs and the procedure of the Islamic banks are those factors which are responsible for the drop in Islamic SME lending.

We have found out while conducting our research that spiritual belief is one of the major reasons preventing the entrepreneurs to opt for a proper finance. There are more than 25% of these entrepreneurs who do not opt any sort of financing, and 20% restrict themselves to a necessary level. Most of the SMEs rely mainly on informal origins for funds. The tailor made versions of Islamic banks, in order to facilitate the SMEs towards the standard overdraft (which are being offered by the conventional banks) has somehow helped them.

But they have to be more innovative. The Islamic banks need to avoid their “one size fits all” approach and offer the SMEs according to their need, like most of the conventional banks are now offering. The Islamic banks need to develop the required competency, where banks secure such expertise which is essential for building and managing an effective “Islamic SME Banking” business.

In the end it is estimated that the potential worth for The Islamic Financing market for the SMEs to be over \$ 4.0 billion in the coming five years, taking into account those SMEs which are creditworthy but they do not borrow or limit themselves due to the their religious beliefs.

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