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Microfinance in Small and Medium-Sized Enterprises (SMEs) in Pakistan: Practices and Problems in the Prevailing System and Prospects for Islamic Finance

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1. Introduction

Almost all governments, administrative authorities, cooperative and social organizations, and NGOs support programs providing credit and finance and policies for alleviating poverty in the relatively less developed communities and societies of their respective countries. In Pakistan too, since the establishment of the banking and financial institutions, the primary emphasis of economic planning and policies has been on the provision of the basic infrastructure needed for the development of Large Scale Enterprises (LSEs) and the development of Small & Medium Sized Enterprises (SMEs).[1] Unfortunately, the initial efforts were unable to garner favorable results for SMEs, despite the fact that SMEs account for a significant part of the country's economy and provide employment for villagers, generate skilled labor for Large Scale Enterprises and retard the tendency of villagers to migrate to mega cities in search of a livelihood.

Even now, SMEs in Pakistan are facing a lack of capital funds and financial resources because conventional banking and financial institutions are located mainly in urban areas and mega cities. There is immense potential in SMEs for development as it is still an untapped segment of the country, which has been neglected by the authorities for a long time, resulting in societal disparity on a vast scale, economic imbalance and inequality, and social discrimination between urban and rural inhabitants. As the foundation stone of these development polices was not layed with an ethical and balanced economic approach, so the gap between rural areas and mega cities continues to widen at a very fast pace. A major constraint for the development of the small rural industries of Pakistan is the absence of financial linkage between those potential clients and the financial institutions.

There are approximately 2 million SMEs in Pakistan. These include 400,000 manufacturing units, 600,000 Service sector units and 1,000,000 Trade sector units (retailers). In their contribution to the GDP, they constitute well above 90% of all enterprises in the country in terms of numbers, but because they are by definition small, their share in the GDP is not quite as dominant. They are estimated to be contributing approximately 11% to the GDP. In their contribution to employment, the SMEs employ roughly 80% of the total non-agricultural labor force in the country [Gallup Cyber letter on SMEs in Pakistan 2004].

2. Prevailing Sources of Financing in Rural and Suburban Areas of Pakistan

Pakistan's economy is based on agriculture. The livelihood of more than 70% of the population is directly or indirectly associated with agriculture. The financing options for agricultural businesses are confined to the following three sources.

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1) There is no uniform definition of SMEs applicable across the whole territory of Pakistan. This paper follows the SMEDA (Small and Medium Enterprise Development Authority)'s definition approved in SME Policy 2007 (http://www.smeda.org.pk/). According to the SMEDA's definition, the employment size of SMEs is up to 250, the paid-up capital upper limit is Rs. 25 million, and annual sales are up to Rs. 250 million.

2.1 Informal Sector Financing

The major credit needs of rural and agrarian peoples are mainly met from informal credit sources, based essentially on personal contacts and local sanctions. The informal credit sector is highly heterogeneous in terms of the relationship between borrowers and lenders and can be grouped into two types. (a) Friends and relatives who provide the bulk (61%) of total credit disbursed and, (b) landlords, merchants and shopkeepers who provide a 30% share of the credit needed, while professional money lenders provide only a 2.12% share of total needs of these people. The rest comes from the formal sector i.e., banking and financial institutions. The informal sector has limited loan portfolios and operates within narrow areas of influence. This sector is typified by small credit amounts, low transaction costs and short transaction periods. The interest or reward on loans differs from case to case and situation to situation. Loans may be interest-free and sometimes they may be a usurious or an exploitative interest based loan; – if a person obtains it from his relatives or friends based on his family's trustworthiness it will be interest-free, but on the other hand if he borrows from landlords or professional money lenders, they will charge an extraordinary interest rate. According to the estimation of Government of Pakistan, more than 90% of rural businesses and smallholders obtain credit from the informal sector.

2.2 Formal Sector Financing (Banking and Financial Institutions)

According to the estimation of the Government of Pakistan, the main source of formal credit in Pakistan comes from the Agriculture Development Bank of Pakistan (35%), the Federal Bank for Cooperatives (4%), commercial banks (49%), and domestic private banks (12%). The State Bank of Pakistan is responsible for regulating these banking and financial institutions. The State Bank itself provides counter finance to the Agriculture Development Bank, the Federal Bank for Cooperatives and Agriculture Finance, and to commercial banks. Despite the handsome number of financial institutions, a survey carried out in Pakistan shows that the needy farmers and poor agricultural workers have obtained less than 6% of their credit from formal sector [Qureshi et. al 1996].

2.3 Equity Participation (Money Lender and Farmer)

This type of credit is sometimes described as a subdivision of informal credit, used by tenants and subsistence farmers. Perhaps it is the most common means for credit acquisition in rural areas. Money lenders provide credit to farmers for purchasing fertilizer, renting machinery and for daily expenses during the period of ploughing. Generally no collateral is required, but eventually the money lender will take his share of the profit at the time of harvesting the produce. The interest rate on this kind of credit is more than 5 times higher than institutional interest rates.

2.4 Past Efforts for Microfinance SMEs in Pakistan

After the nationalization of commercial banks in 1974, all the banks were consolidated and merged into six banks. This governmental measure inhibited the pace of the private sector's economic participation. The act of decentralizing state-owned commercial banks and allowing the private sector to participate in banking and financial activities started in 1992 [Daniel 2001], and this marked the beginning of the second phase of the private sector's participation in the banking and financial sector. Conventional or interest-based financial institutions for financing SMEs were setup in all four provinces of Pakistan. The names of these financial institutions are as followings:

1. The Punjab Small Industries Corporation
2. The Sindh Small Industries Corporation
3. The NWFP Small Industries Corporation
4. The Directorate of Small Industries, Baluchistan

All the commercial banks, along with the above-mentioned institutions, are responsible for sanctioning capital funds to finance SMEs in Pakistan. In addition, all commercial banks have the mandate to provide credit to SMEs and they have their own special schemes in place for this purpose. Nonetheless, SMEs are generally found to be short of institutional credit, so they have to rely on their own sources of credit for a number of activities such as upgrading their technology, increasing production, purchasing fertilizer and better quality materials. In many cases the SMEs rely on personal savings, including financial help from their families and friends. This is particularly true of small businesses which may not even approach centers of financial credit for fear of rejection.

The scope of financing in SMEs is evident from a report by the Small and Medium Enterprise Development Authority (SMEDA) which reveals that there are approximately 3.2 million business enterprises in Pakistan (*SBP Annual Performance Review* 2005). Another notable effort to aid SMEs development was the establishment of the SME Bank (Small & Medium Enterprise Bank) after the amalgamation of the Regional Development Finance Corporation (RDFC) and the Small Business Finance Corporation (SBFC) in 2002. At present, the SME Bank is the main financing bank for SMEs in Pakistan. The growth in SMEs financing is evident from the table below. Apart from the growth in loan size, the number of borrowers also increased at 134% in the period from December 2002 to June 2005. The inferred average growth in the amount of loans in this sector was 24.55%, although the average growth in the said period was 2.29 %.

Table 1: Microfinance in Pakistan

	June 2004	June 2005	June 2006	Average Growth
Amount of Loans (Billion Rupees)	231.7	313.6	356.7	**24.55%**
Percentage to Total Financing (%)	17.2	17.4	16.4	**(2.29)%**

Source: *SBP Annual Performance Review* 2005-6.

3. Need for Special Institutions for SMEs

3.1 Justification of Special Institutions for SMEs

Informal credit has limited scope and potential for financing since there is a great variation in interest-rates and check and balance systems are also absent. Furthermore, the informal sector is quite exploitative and rather brutal. The interest rate charged by the financer varies depending upon the project, the social status of the borrower and the relationship of the borrower to the lender itself. Irfan, Arif and Ali in their study [Irfan et al. 1999] found that the informal sector is monopolistic in its nature and for lenders in this sector credit worthiness is the major criteria for a loan. Mark-up in this sector also varies from product to product and also by type of borrowers as well as lenders. The average interest rate of informal credit is estimated to be 25 %. The interest lenders charge for fertilizers is as high as 29 % and for pesticides it is an ultra-exorbitant 35 %. The case study further divulges that pure money lending is on the rise with quite exploitative interest rates ranging from 48 % to 120 % per year.

The main causes of this monetary victimization are attributed to certain factors and the outcomes of this manipulation are multi-faceted. Just for reference purposes, and to show only one aspect of the potential for financial viability through providing *Shariah* compliant financing to agriculture, it's worth mentioning that the inferred average return on advances by the Islamic Banks was 9.344% in 2005 (Ministry of Finance, *Economic Survey of Pakistan* 2005-6). The informal finance market is undergoing structural change because of evolving socioeconomic developments. The role of moneylenders is declining, creating a demand for institutional mechanisms. Furthermore, the pivot of the banking system is the "collateral" that serves as an explicit guarantee for the risk associated with money transactions, i.e., lending. Unfortunately for the poor, who do not posses viable "collateral", they cannot enjoy the credit facilities of the banks. This absence of opportunity has bound them within a vicious circle. They are poor and posses no collateral, so they are unable to provide a guarantee for credit, which results in low productivity leading to low incomes, low endowments, low savings and low investments; this results in growing economic inequality and disparity. Thus the need for financial institutions operating in rural areas and investing in agriculture or rural production is also an important equity objective because poverty alleviation and equal distribution of wealth is a social responsibility and objective of the Islamic bank.

The prevailing formal sector is characterized as reluctant to lend to these people, requiring traditional collaterals such as the deeds of a property, and having lengthy and complex application procedures. Furthermore, most Pakistani nationals are illiterate and unable to fill in the application forms, hence they cannot obtain loans from these institutions. The distance to the nearest bank may be too far for rural and village peoples to travel to obtain an application form, let alone the problems of filling it out and then making regular repayments of the loan if it is actually approved. As a consequence individual entrepreneurs and small businessmen do not even bother to approach these banks and financial institutions. A major constraint for the development of SMEs in the rural areas of Pakistan is the absence of financial linkage between the clients and financial institutions [Aftab 1991].

3.2 Potential Components for Special Institutions for SMEs (1): Post Office Network in Pakistan

At present the Pakistan Post Office has a network of 12,343 field and camp offices in Pakistan. These post offices are located all over the country including urban and rural areas. These offices have brisk and well established mechanisms of communication between the rural and agrarian peoples. The staff in post offices, being located in suburban and rural areas, are more familiar with and more used to dealing with the inhabitants of these areas than the staff of banking and financial institutions in urban areas.

These post offices could be used to provide financial services by alliances between the Post Office and financial Institutions, especially Islamic banks. The premises of these post offices could be used for a franchised branch of the Islamic bank after developing arrangements to sublet premises to an Islamic bank in partnership with them to launch a wide range of financial services. The Post Office recognizes that it would have to rely on the Islamic banks for financial intermediation, although local post offices have over the years developed the trust and understanding of the local communities that they service and the banks will save a huge amount of funds because they will use the premises of the Post Office instead of building new ones. Hence the bank will save on its transaction costs, too.

3.3 Potential Components for Special Institutions for SMEs (2): Islamic Banking in Pakistan

The Islamization process of the economy and banking & financial institutions was initially started in 1979 and continued until 2002 when it proved to be a failure because of the absence of several factors. Basically, the process was initiated with a fragmented approach and half-heartedness; hence it could not meet its objectives [Khan and Bhatti 2006; Hassan and Alamgir 2007]. However, a new wave of Islamic banking has reached Pakistan since the 2000s. There are now six full fledged Islamic banks and thirteen conventional banks offering Islamic banking services through both stand-alone branches and Islamic banking windows (*SBP Islamic banking bulletin* 2007). The growth in Islamic banking in Pakistan is apparent and showing significant potential in this sector. The calculated and inferred averaged annual growth of Islamic banks is quite promising being 116%, 127%, and 121% annually in deposits, financing and total assets respectively. In my perception Islamic finance in Pakistan is the field where the most growth can be expected in the future, and the Islamic financial industry seems to have a great potential for providing financial services in SMEs and rural areas. That is why this paper especially emphasizes the role of Islamic banks among the various financial institutions.

3.4 Proposed Operational Setup of New Institutions for Microfinance

In Pakistan where poverty is rooted in socio-political inequalities, individual based lending can perpetuate and reinforce the existing socio-economic inequities and access to scarce financial resources. The current banking infrastructure is not developed enough to cater for the needs of the people in providing financial services in the rural areas of Pakistan. To overcome these circumstances there is a dire potentiality to establish a new institution for microfinance based on collaboration between the booming Islamic banks and the existing Post offices branches. Including the post offices in the operational setup will make it easier for the Islamic banks to provide microfinance services, because the existing Islamic banks do not have extensive enough branch networks in suburban and rural areas.

The proposed institutional framework for microfinance based on Islamic finance will work on the basis of the following flowchart. Funds will be disbursed from the head office to the relative town office and from there through post offices to the respective village based representatives. The monitoring will be done by the management as well as the village based representatives. The village based representative will report to the town office and the town office will report to the head office or the district office as the case may be. Figure 1 explains thoroughly the proposed financing criteria for Islamic banking and financial institutions in collaboration with the post offices.

In addition, the proposed procedure will be shown as the following four stages:

1. An Islamic bank will hire a post office employee as its agent who will act on its behalf or an Islamic bank will open its own camp office at the post office. The client or entrepreneur will approach the nearest post office of his village, where he will meet with the agent of the bank and explain his business proposal.
2. The agent will forward his proposal to the village based representative, who will, after examining the proposal, forward it to the town office.
3. The town office will, also after examining the soundness and expected incentive of the proposed project, forward it to the Islamic banking and financial institution.
4. Finally, the Islamic banking and financial institution will disburse the funds to his representative/franchised local post office, from where the borrower will collect the amount and repay the installments.

This proposal is just an idea for tapping the latent potential of the SME's based on Islamic finance framework and alleviating rural poverty and correcting social imbalances in Pakistan, so further analysis would not only clarify the technical consideration but also enhance the feasibility of such a framework.

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Figure 1: Procedure of Microfinance by Islamic Financial Institutions and Post Offices