Islamic Banking Opportunities Across Small and Medium Enterprises

Pakistan

In partnership with the Canadian Department of Foreign Affairs, Trade and Development, the Danish International Development Agency, Japan, Switzerland's State Secretariat for Economic Affairs and UKaid.

IFC International Finance Corporation
WORLD BANK GROUP

DISCLAIMER

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Abbreviations and Glossary

BAS	Bank Advisory Services
CAGR	Compound Annual Growth Rate
CWCD	Centre for Woman Co-operative Development
GDP	Gross Domestic Product
HBFC	House Building Finance Corporation
ICP	Investment Corporation of Pakistan
IFC	International Finance Corporation
IFSB	Islamic Financial Services Board
IMF	International Monetary Fund
KPK	Khyber Pakhtunkhwa
KYC	Know Your Customer
MENA	Middle East and North Africa
NIT	National Investment Trust
NPL	Non-performing Loans
PLS	Profit and Loss Sharing
SAB	Shariah Appellate Bench
SBP	State Bank of Pakistan (Central Bank of Pakistan)
SME	Small and Medium Enterprises
SMEDA	Small and Medium Enterprises Development Authority
WEF	World Economic Forum

01.
Preface

Small and medium enterprises (SMEs) are now widely recognized as engines of economic growth and key contributors to sustainable gross domestic product (GDP) of all countries, including those in the Middle East and North Africa (MENA) region. These businesses predominantly operate in the manufacturing and service sectors and create employment opportunities for both skilled and unskilled persons. However, market conditions and regulatory environments are not always supportive of the growth of SMEs and access to formal finance is one of the main obstacles they face.

IFC's Financial Institutions Group (FIG) in MENA provides investment and advisory services to the region's banks and other financial institutions to build their capacity in SME banking so that they can profitably and sustainably reach out to the SME sector. This is achieved through providing equity finance, lines of credit, risk sharing facilities, trade finance, disseminating best practices, improving processes and products, and streamlining delivery channels. Ultimately, IFC's goal is to increase the number of banks and financial institutions that offer financial and banking services to SMEs in a profitable and sustainable manner. IFC is recognized globally as an SME finance market leader owing to its global expertise and knowledge.

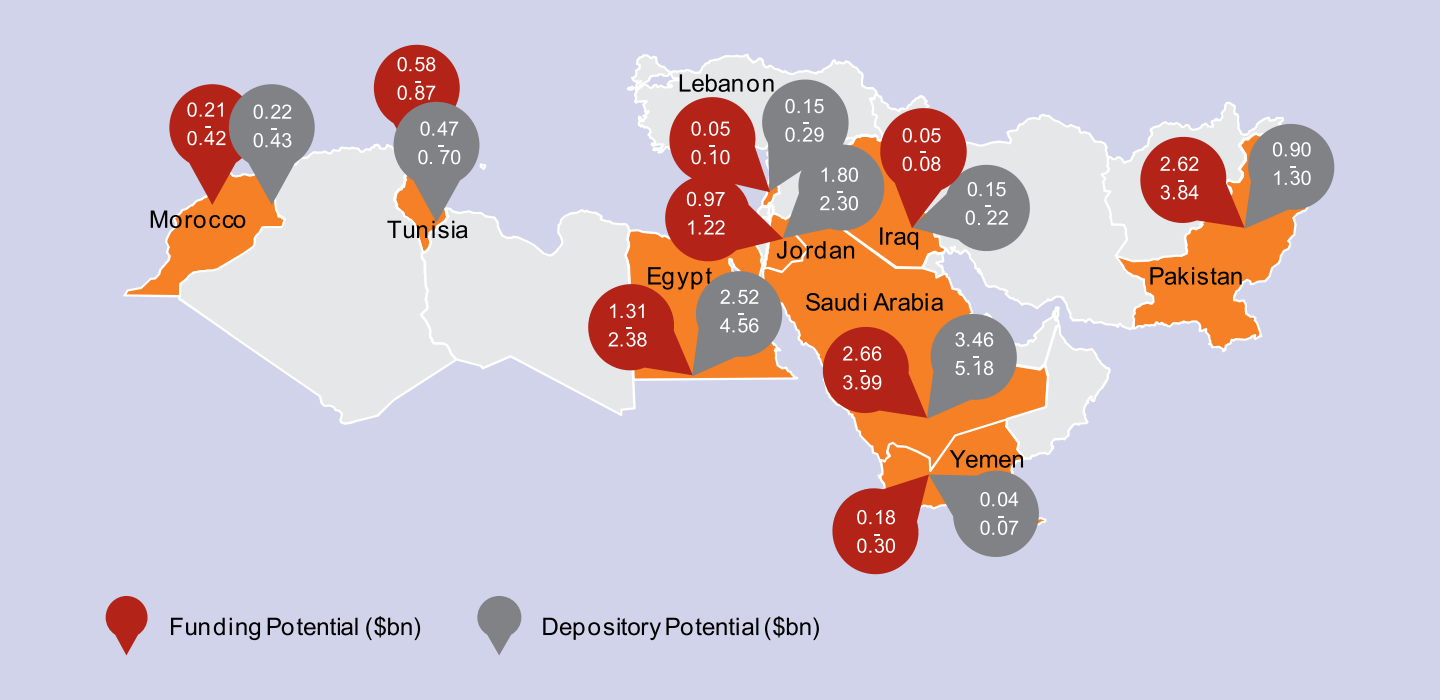
There is a huge demand for Islamic products by SMEs in the MENA region and, according to this study, approximately 32 percent of such businesses remain excluded from the formal banking sector because of a lack of Shariah-compliant products.

In order to reach out to SMEs demanding Islamic products, and as part of IFC's initiative to enhance its SME investment and advisory services offerings to Islamic financial institutions, we needed to better understand the market from both the demand and supply sides in order to identify any gaps or niches where IFC could assist and add value. With this objective, IFC commissioned a study in nine countries of the MENA region, which includes Pakistan, to better understand the demand and supply for Islamic banking products (both asset and liability products and other banking services) in the SME sector. The countries chosen for this study are: (1) Iraq, (2) Pakistan, (3) Yemen, (4) Kingdom of Saudi Arabia, (5) Egypt, (6) Lebanon, (7) Morocco, (8) Tunisia, and (9) Jordan.

The scope of the study was to: (i) identify the countries in the MENA region facing gaps in financing and banking needs of SMEs in the Islamic products space; (ii) conduct a supply side benchmarking to review current capacity of financial institutions to offer Islamic products to this sector; (iii) conduct a demand side benchmarking to identify key SME customer needs for Islamic products and see how well they are currently being served; and (iv) review the current enabling environment and readiness levels of banks in terms of the regulatory framework and Shariah compliance.

The study reiterates several of the now well researched and documented reasons for the lack of access to finance for SMEs. However, more importantly, the study reveals that, there is a potential gap of $8.63 billion to $13.20 billion for Islamic SME financing within un-served and underserved SMEs categories, with a corresponding deposit potential of $9.71 billion to $15.05 billion across these countries. This is due to the fact these un-served and underserved SMEs do not borrow from conventional banks, only owing to religious reasons. This potential is a "new to bank" funding opportunity, which is still untapped, as banks and other financial institutions lack adequate strategic focus on this segment to offer Shariah-compliant products.

Figure 1 : Islamic funding and deposit potential across MENA and Pakistan ($bn)



This Regional Executive Summary provides a comparative analysis of the SME potential across these countries and the opportunities available to Islamic institutions to tap this potential. The nine individual country reports provide a deeper insight into the SME landscape and potential opportunities for Islamic banks in each country. The reports also highlight the measures that banks may need to take to successfully target the Islamic banking potential of SMEs.

IFC acknowledges the commitment and cooperation of Israa Capital Management Consultants, Dubai, who carried out this study on our behalf. IFC thanks them for their dedicated efforts and contribution in compiling the individual country reports and the comparative analysis contained in this executive summary.

Mouayed Makhlouf
Regional Director
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Foreword

In recent years, banks in Pakistan and the Middle East and North Africa (MENA) region have become increasingly interested in targeting the small and medium enterprise (SME) sector and have realized that many small businesses demand Shariah-compliant banking. While the IFC has conducted several studies to determine the gap in financing and use of banking services for SMEs, it was still not clear how many of them were excluded due to religious reasons.

To provide clarity on the subject, IFC commissioned a study to better understand the demand and supply for Islamic banking products (both asset and liability products as well as other banking services) in the SME sector in Pakistan. The scope of the study covers (i) gaps in SMEs' banking needs in the Islamic products space; (ii) supply-side benchmarking to review the current capacity of financial institutions to offer Islamic products to SMEs; (iii) demand-side benchmarking to identify key SME needs for Islamic products and see how well they are being served; and (iv) review of the current enabling environment and readiness levels in terms of the regulatory framework and Shariah compliance.

This report on Pakistan reveals a 'new to bank' Islamic funding and depository opportunity, primarily due to un-served and underserved SMEs (approximately 20 percent to 25 percent), who do not borrow from conventional banks due to religious reasons. This potential is untapped as banks and other financial institutions lack adequate strategic focus on this segment to offer Shariah-compliant products.

Despite many SMEs exhibiting strong interest for Shariah-compliant products, narrow product offerings, limited outreach, and restricted operational capabilities are hindering this sector's growth. However, if banks and other financial institutions are able to implement the recommendations outlined in this report, they would be able to capitalize on this significant opportunity at the bottom of the pyramid.

The successful implementation of these strategies by banks could lead to the following "new to bank" potential:

Description	Funding Potential		Depository Potential	
	Min ($bn)	Max ($bn)	Min ($bn)	Max ($bn)
Un-served SME population – (a)	0.5	0.7	0.3	0.4
Underserved SME population – (b)	2.1	3.1	0.6	0.9
Total "New to Bank" (a+b)	2.6	3.8	0.9	1.3

In addition to the potential offered by un-served and underserved enterprises, the well-served conventional portfolio also offers significant 'conversion/migration' potential. Although the well-served enterprises have sufficient financing available, they are nonetheless inclined towards Islamic banking. However, they do not approach Islamic banks due to the non-availability of Islamic banking products or cumbersome transactional processes. Such segments could offer a 'conversion/migration' potential of 5 percent to 8 percent of the current SME portfolio.

02.
Executive Summary

The objective of this study is to ascertain the number of SMEs who do not borrow because of religious reasons, reflecting a need that is unmet. How many SMEs borrow the bare minimum required to survive and would have borrowed more if Islamic financing options were available. Also, how many SMEs prefer Islamic banking, but choose conventional banks for their banking needs because of the lack of adequate Islamic banking facilities?

The small and medium enterprise (SME) sector is a key component of Pakistan's economy. It accounts for 30 percent of the gross domestic product (GDP), 25 percent of exports of manufactured goods, and 35 percent of the manufacturing value added[1]. It also employs more than 78 percent[2] of the non-agricultural workforce. The SME sector can play an important role in revitalizing Pakistan's economy and ensuring inclusive growth in the long term. However, SMEs face numerous problems such as low levels of skill and training, corruption, and inadequate public infrastructure. One of the biggest problems affecting the development of SMEs in Pakistan is inadequate access to finance.

The banking system in Pakistan has been reducing exposure to SMEs over the past few years, primarily due to macroeconomic factors *and the SMEs' poor business conditions,* which make lending to them a risky proposition. In addition to this, the banks themselves have yet to build requisite capacity to serve this segment. SME lending by the banking sector as a whole declined to $2.7 billion (6.8 percent of the total lending) in 2012 from $3.8 billion (11.7 percent of total lending) in 2008[3]. Moreover, Islamic banks, which have traditionally followed an even more cautious approach when lending to SMEs, further reduced their exposure to just 4.1 percent of all loans in 2012 ($100 million) from 9.8 percent in 2008 ($145 million)[4]. However, banks are looking to reach out to the SME sector, and with improvement in business conditions and banks' capacity, Islamic lending to SMEs is expected to revive.

Access to finance is a major issue for SMEs in Pakistan; well-served SMEs account for just 11 percent of the total SME population, whereas 22 percent of the SMEs are underserved and 67 percent un-served[5]. Religious belief is a key reason hindering SMEs from opting for formal financing. Approximately 20 percent to 25 percent[6] of SMEs (accounting for more than 150,000 enterprises) do not opt at all for formal financing or borrow less than 20 percent of their requirements due to their religious beliefs[7]. This type of sentiment has been growing stronger, especially over the past five to six years. Although these SMEs are creditworthy, they are excluded from accessing funding from banks as Shariah-compliant products are either not available or not properly understood by these SMEs or involve lengthy processes, making the execution of Islamic transactions cumbersome.

1 Small and Medium Enterprises Development Authority
2 State Bank of Pakistan Revised Prudential Regulations Circular No. 08 of 2013
3 State Bank of Pakistan
4 State Bank of Pakistan
5 Calculation derived from the SME population provided by SMEDA and primary research with banking experts and professionals
6 Primary research
7 Average number of enterprises sourced from Figure 1

Islamic banking in Pakistan is well regulated with clear guidelines for Shariah-compliant practices

Islamic banking is well established in Pakistan, tracing its origin to the late 1970s. Since then, the country's Islamic banking industry has grown significantly with the establishment of five full-fledged Islamic banks. Also, 12[8] conventional banks with Islamic windows operate a wide branch network across the country. Islamic banking assets and deposits increased at a compound annual growth rate (CAGR) of 38 percent and 42 percent, respectively, over the last six years; they currently account for 8.6 percent and 9.7 percent of the country's total banking assets and deposits, respectively[9]. Asset quality of Islamic banks is better than the overall industry average. The ratio of non-performing loans (NPLs)-to-total loans is significantly lower than the banking industry's historical average.

The SBP works toward developing Islamic banking for the SME sector

The State Bank of Pakistan (SBP) has undertaken several measures to bolster Pakistan's legal, regulatory, and Shariah compliance framework; ease liquidity concerns; and build-up the human capital required to enhance Islamic finance. The bank has devised a five-year development strategy, in addition to the recent measures, incentivizing banks to extend their reach to agribusinesses and micro and small enterprises. The strategy would also focus on organizing marketing campaigns to increase awareness about Islamic banking across the country

Demand for Islamic banking from the SME sector is increasing, but high cost of credit and cumbersome processes deter customers from approaching banks

Pakistan's SME sector has a positive attitude toward Islamic banking as people are becoming more sensitized to its benefits. The strong performance of Islamic banks over the past 10 years with the help of SBP's initiatives has further consolidated this opinion. However, numerous factors deter SMEs from approaching formal institutions for finance. A few of them are:

- **Lack of awareness and knowledge regarding Islamic banking products:** Most SMEs have no knowledge of the appropriate financial products for their requirements. The SBP and a few commercial banks are now undertaking initiatives to educate SMEs about the different Islamic banking options available to them through marketing campaigns and training programs. However, there remains a significant knowledge deficit regarding Islamic banking among the SMEs in the country.

- **High cost of credit and huge collaterals:** The cost of credit charged by Islamic banks is relatively high (about 1 percent to 2 percent[10] higher than conventional banks for the same sector). In addition, SMEs are charged high collaterals ranging between 130 percent to 140 percent[11] of the total loan amount (by way of cash margins and mortgage on tangible assets)[12]. It is estimated that 98 percent[13] of all Islamic SME loans are collateralized. In 2011, the average non-secured loan amount was just $2,300 as compared to $26,450 for collateralized loans[14].

- **Cumbersome processes:** A vast majority of well-served SMEs (over 100,000 enterprises), along with around of 110,000 to 150,000 underserved SMEs, which currently avail conventional banking services, do not aspire to use Islamic finance primarily because of the tedious processes involved[15]. The processes for application and approval are lengthy, often taking two to four months. Also, the exhaustive multi-step Islamic documentation requirements further discourage SMEs from applying for Islamic bank financing.

> "....however, the key reason which deters SMEs from selecting Islamic mode of banking is the cumbersome transaction execution and documentation."
>
> — Primary Survey with three leading SMEs in Punjab, Pakistan

Banks are not well equipped to handle the requirements of the SME sector, thus creating a significant 'supply side' gap

A primary survey[16] of the top 20 banks in Pakistan revealed that just 13 banks have SME offerings, out of which only seven offer Islamic products. Only eight banks have separate business units/divisions for SMEs, whereas the others provide SME services through corporate or retail divisions. Although eight banks in Pakistan offer adequate

8 State Bank of Pakistan
9 State Bank of Pakistan
10 Primary research
11 Primary research
12 Primary research
13 Development Finance Review 2011, State Bank of Pakistan
14 Development Finance Review 2011, State Bank of Pakistan
15 Calculations based on primary research
16 Primary survey and secondary research of Commercial Banks

Islamic banking products, just two banks have fairly "good" Islamic SME penetration and the rest are still looking to break through the SME market.

Several factors deter banks from adequately tapping the potential of SME finance and these are now well documented as a result of several studies conducted by IFC. A major reason is 'non-branding' of the SME proposition by these banks. At present, of the 20 banks, just one bank is adequately branding and selling its SME proposition (refer table 6). Other reasons include:

- **Lack of human resources:** There is a shortage of skilled professionals who are well versed in Shariah-compliant product structures. Although this problem exists across the country, it is more acute in rural areas.

- **Few or incomplete product offerings:** Offerings for the SME segment are limited. Most Islamic banks do not offer non-borrowing services such as cash management, mobile banking, and branchless banking.

- **Inadequate procedural realignment:** Although a few banks offer an SME suite, their transactional procedures are quite cumbersome and not geared towards SME banking. This increases the cost of each transaction, eroding the profitability and popularity of the SME propositions.

- **Inadequate framework to evaluate creditworthiness of SMEs:** The credit information bureau's coverage is currently limited to about 2 percent of the entire adult population (World Bank 2012 data). Banks also lack capabilities to manage and analyze existing clients' data for identifying default patterns that can later be used to analyze other loan portfolios.

- **Cumbersome loan recovery process:** Despite a sound regulatory process, the loan recovery process is cumbersome and legal procedures take years to resolve a case. Another factor is the cost of litigation, which eventually makes SME transactions unfeasible for banks. In addition, increased scrutiny on the activities of loan recovery agents due to negative incidents in the past has made the loan recovery process more difficult.

Growth in demand for Islamic finance in the SME sector could result in a 'new to bank' Islamic funding opportunity of $2.6 billion to $3.8 billion

Figure 2: Islamic financing potential – 'new to bank'

and an Islamic depository potential of $0.8 billion to $1.3 billion over the next few years, primarily on account of those SMEs who do not avail of finance due to their religious beliefs

Figure 3: Depository potential

Note: This depository potential does not take into account the potential that could arise from offering non-banking activities

Note: The funding and depository potential has been derived on the basis of SME population numbers provided by SMEDA and primary research conducted with various banking industry experts and professionals. Please refer to Section 4 of the report for an overview of the calculations

In addition to the above, the existing well-served (mostly mid-sized) enterprises have sufficient conversion/migration potential from conventional to Islamic products. These well-served enterprises are inclined toward Islamic banking, but they do not approach Islamic banks due to the non-availability of suitable Islamic banking products or complicated transactional processes. This potential from well-served SME businesses could be in the range of 5 percent to 8 percent of the existing SME portfolio.

> "…. The manufacturing sector is likely to constitute a large proportion of the Islamic funding opportunity."
>
> — Senior Official, State Bank of Pakistan

This possibility largely depends on the penetration of Islamic banks and is based on the assumption that SMEs across the country would gain better understanding of Islamic banking structures and have easier access to finance as banks extend branch networks to all rural and urban areas. Furthermore, it is assumed that banks would hire skilled professionals capable of structuring Islamic SME products, start offering more Shariah-compliant products, offer several other value-added and non-borrowing services, and streamline and ease transactional procedures, thus enabling them to serve SMEs better. Initiatives by the SBP and private banks to promote Islamic banking would also help tap that segment of the SME population.

Considering the demand for Shariah-compliant products, Islamic banks could implement several measures to attract SME customers; these include introduction of new SME banking models, specialized 'branding of SME proposition', separate business units/divisions for handling SMEs, focus on advisory services, training the staff on Shariah-compliant product structures, and easing access to finance for SMEs

Since SMEs require finance more urgently than large-scale corporate enterprises, Islamic banks need to shorten the loan approval process.

- There is a shortage of skilled professionals well-versed in Shariah-compliant product structures. Better training on these structures could alleviate this concern.

- A survey reveals that most SME customers are completely unaware of the SME finance options provided by their banks, especially regarding Islamic products. excluding a few banks, such as Bank Al Habib, Habib Metro, Summit, Silk, NIB, JS, Soneri, HBL, and Bank Alfalah, people are unaware about the SME offerings of other banks. This lack of awareness creates a huge supply-side gap that Islamic banks can easily meet by properly branding and marketing the Islamic SME proposition and by also creating separate business units/divisions.

- An array of advisory services for SMEs can also facilitate the anticipated growth. However, this initiative would only yield results in the long term.

- Introduction of new SME banking models is needed to target customers. Islamic banks could consider the use of mobile banking (on the lines of United Bank's Omni facility) to enhance financial inclusion and reduce the cost of administering an account.

- Other measures include adoption of appropriate credit evaluation techniques, such as behavioral scoring, intensive statistical analysis, credit scoring, and cash flow- and program-based lending.

- Islamic banks can broaden their product and service offerings by providing non-borrowing services, such as cash management, payroll management, payments, collections, and trade finance solutions.

03.
SMEs in Pakistan

SMEs in Pakistan are an important part of the economy. They can play an important role in developing the country. However, their potential is currently affected by poor access to finance and an unfavorable business climate. The government needs to take urgent steps to address these problems and ensure sustainable sector growth.

Definition

There is no singular, comprehensive definition of small and medium enterprises (SMEs) in Pakistan, and various authorities use different criteria to define them.[17] The country's SME landscape has already been well documented by IFC in several of its earlier publications. Therefore, an exhaustive overview of the definition is not presented here. The most widely acknowledged and used definition of small and medium enterprises is that given by the State Bank of Pakistan (SME Prudential Regulations and Microfinance Prudential Regulations).

SMEs' contribution to Pakistan's economy

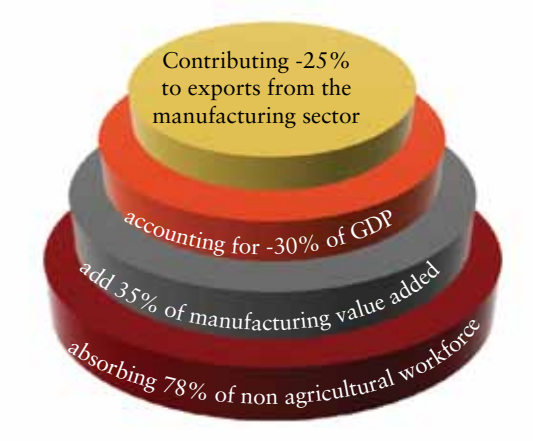
The SME sector has emerged as the backbone of the country over the last few years, generating employment and driving economic growth

SMEs form an important component of Pakistan's economy, playing a pivotal role in inclusive growth. They account for 30 percent of national gross domestic product (GDP), 25 percent of exports of manufactured goods, 35 percent of manufacturing value added[18], and employ more than 78 percent[19] of the non-agricultural workforce.

> "…. I believe that the SME sector has the potential to turn around Pakistan's economy."
>
> — Chairman of a Regional Trade Association

17 Small and Medium Enterprises Development Authority
18 State Bank of Pakistan Revised Prudential Regulations Circular No. 08 of 2013
19 State Bank of Pakistan Governor Speech 7th Pakistan SME Conference

Figure 4: SMEs' share of Pakistan's economy



Source: State Bank of Pakistan Revised Prudential Regulations 2013

SMEs in Pakistan have evolved over the years, with their contribution to the GDP increasing from -6 percent[20] in 1994–1995 to 30 percent currently. Government support and liberalization of the economy (providing opportunities for SME expansion) have been the key reasons for the increase in SMEs' GDP share.

The current SME structure is, however, less than optimal. Enterprises with fewer than 10 employees dominate Pakistan's SME sector, while enterprises with more than 10 employees account for just 1 percent[21] of the SME population.

The current structure, needs to evolve in the long term. These smaller micro enterprises tend to be less employment-intensive and economically efficient compared with large SMEs. Therefore, efforts should be concentrated toward enabling a favorable environment for microenterprises to evolve into small and medium enterprises.

SME distribution by sector, ownership, and geography

SMEs ownership patterns are highly skewed towards sole proprietorship, which accounts for 74 percent of the total, followed by registered partnerships (13 percent) and societies (about 2 percent)[22], among others. Sole proprietorship is the preferred ownership pattern in the country as minimum regulatory requirements are involved in establishing such organizations.

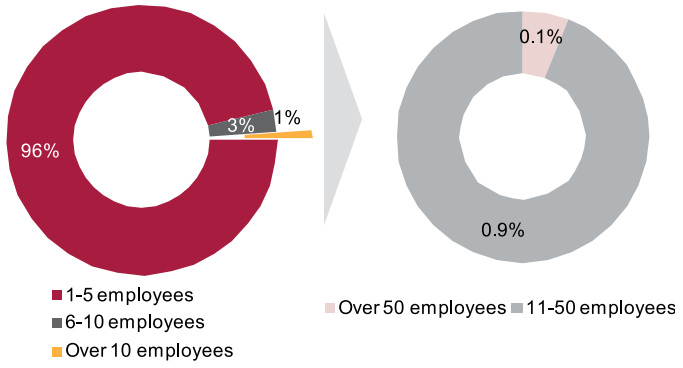
Manufacturing units dominate the SME population (49 percent), followed by community, social, and personal services (40 percent). Others include wholesale and retail trade and restaurants and hotels (7 percent) as well as other services[23].

Manufacturing enterprises have a higher impact on the economy in terms of value addition, export contribution, and employment generation. According to a 2009 survey by the Small and Medium Enterprises Development Authority (SMEDA), manufacturing SMEs held an estimated 25 percent of manufacturing exports, while their value addition to the sector was about 35 percent. Important manufacturing sub-sectors include cotton weaving, metal products, wood furniture, and jewelry making.

> "…. Most SMEs are sole proprietorships or family businesses that are managed rather informally."
>
> — CEO of a leading Pakistani bank

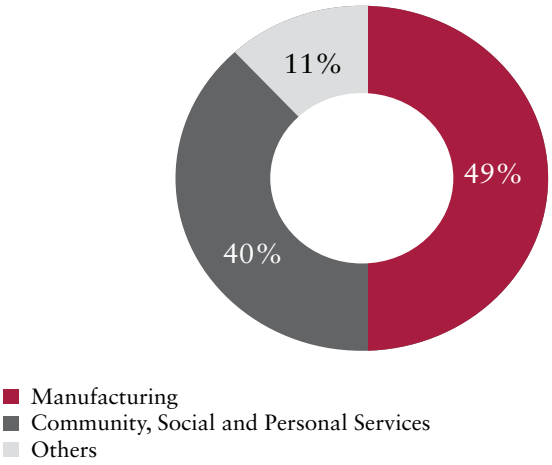
20 Economic Survey of Pakistan
21 SMEDA 2009 Survey
22 SMEDA 2009 Survey
23 SMEDA 2009 Survey

Figure 5: SME distribution by employee size



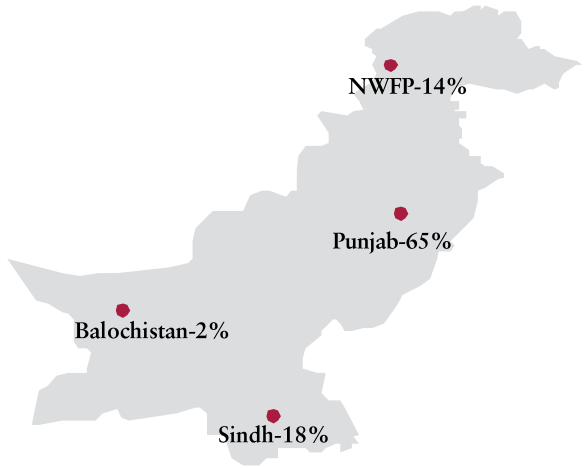
Source: SMEDA 2009 survey

Figure 6: SME distribution by activity



Source: SMEDA 2009 survey

Figure 7: Geographical distribution of SMEs



Source: SMEDA 2009 survey

The distribution of SMEs in Pakistan mirrors the country's economic geography. About 72 percent of SMEs are in the most important provinces of Punjab and Sindh, while Khyber Pakhtunkhwa (KPK) and Baluchistan account for the rest[24].

Punjab and Sindh have a dense concentration of SMEs, greater penetration of government schemes and services, a large presence of industrial clusters, and better access to finance. The combination of these factors has led to the skewed distribution of SMEs across Pakistan.

The current concentration pattern is not ideal and needs to be corrected in the long run. This is because SMEs play an important role in fostering regional development and inclusive growth across various stakeholders in the local economy by using local resources (raw material and labor).

The greater the gap in the provision of support services (government schemes and access to finance) for promoting SMEs, the larger the development gap between various regions in the country, which would affect long-term economic prospects.

SMEs "doing business" environment

Inadequate access to finance and an unfavorable business environment prevent SMEs from operating efficiently and achieving economies of scale

The concerns and challenges affecting the SME sector outweigh the factors that promote growth, thus preventing the sector from realizing its potential. According to a 2006 study, 19 percent of SMEs were less than five years old, with just 4 percent surviving beyond 25 years.[25] This is due to the large number of challenges that they face (internal and external), which affect them at various stages of development, thereby preventing them from evolving into self-sustaining enterprises.

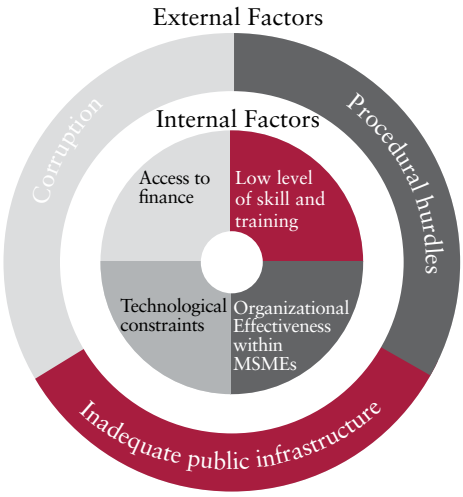
Access to finance still remains one of the biggest obstacles to the sector's growth due to mismatch in supply and demand. On the supply side, financial institutions in Pakistan have been reluctant to fund SMEs. In recent years, banks have realized the potential opportunity offered by the SME sector and are now setting up SME-focused operations. Many banks are doing this with the assistance of IFC advisory services.

24 SMEDA 2009 Survey

25 Critical Success and Failure Factors of Entrepreneurial Organization: Study of SMEs in Bahawalpur, Pakistan 2011

With regard to the demand side, SMEs have historically faced problems in accessing credit due to procedural hassles, high collaterals, and long approval processes. SME owners prefer to utilize their own savings or borrow funds from family/friends due to the lower opportunity costs involved. The range of deposit and financing products available to SMEs is also limited vis-à-vis those for emerging or large corporates. Additionally, while some banks have initiated measures to provide non-borrowing services such as branchless banking, internet banking, and mobile banking, these services are not widely available to the SME sector. Realizing this, banks are now trying to improve their processes and procedures to ensure that SMEs can access their services more easily.

Figure 8: Key challenges faced by SMEs



A large proportion of SMEs (reportedly 20 percent to 25 percent or more than 150,000 enterprises[26]) do want to approach banks due to religious reasons despite banks' efforts to reach out to the SME sector. These SMEs prefer Shariah-compliant banking products and would rather remain excluded from formal financing.

In addition to the poor access to finance, there are problems related to the business environment, such as high levels of corruption (among the 50th most corrupt countries globally[27]), weak business environment (ranked 110 of 189 countries in the 2014 Doing Business Report[28]), and poor supporting infrastructure (ranked 119th of 148 countries in WEF Infrastructure rankings[29]), which create negative externalities. Internal factors such as a shortage of skilled personnel, low managerial acumen of owners, and the application of outdated technology in business processes further hamper growth prospects.

The Pakistani government realizes the problems affecting SMEs. The Small and Medium Enterprises Development Authority (SMEDA) is the main agency that promotes SME growth by implementing policies for improving the business environment, access to finance, human resource development, and support for technology upgrade and marketing. In addition to SMEDA, numerous other national and regional agencies – SME Bank, Khushhali Bank, Punjab Small Industries Corporation, Sindh Small Industries Corporation, and KPK Small Industries Development Board – are complementing SMEDA's efforts and improving the business environment to promote SME growth. IFC's Business Edge program has played a significant role in enhancing the capabilities of SMEs.

> "…. Within the SME sector, manufacturing enterprises have greater Islamic finance potential (more than 50 percent) due to the capital intensive nature of operations and their underlying export potential (contribute 25 percent to manufacturing exports). The services sector, comprising hotels, restaurants, and retail establishments, also have Islamic banking potential, but to a lesser extent."
>
> — An SBP Islamic SME Expert

26 Primary research
27 Transparency International 2013 Corruption Perceptions Index
28 Doing Business Report 2014
29 World Economic Forum Global Competitiveness Report

04.
Current Status of Islamic Banking in Pakistan

Pakistan's banking sector has gone through a three-stage evolution process from conventional banking during 1948–1980 to profit and loss sharing (PLS) banking in the 1980s and 1990s to the current mix of PLS and Shariah-compliant banking.

An overview of Pakistan's banking system

Currently, approximately 34[30] commercial banks, including private, public sector, and foreign banks, and four specialized banks operate in Pakistan. Of these, five are Islamic banks and 12 are conventional ones with Islamic windows[31]. The industry has faced a few challenges due to the global financial crisis and the subsequent deterioration in the domestic fiscal situation, which resulted in the public sector borrowing significantly from banks. Although a rise in non-performing loans (NPLs) tested the sector's resilience, it continues to play a key, pivotal role in the country's economy.

The increasing role of private banks (which hold 81 percent[32] of commercial banking assets) in the banking sector has led to a higher level of professionalism and service orientation. Value-added services such as web banking and mobile banking have also helped revolutionize the sector.

Table 1: Banking structure in Pakistan

Type of bank	Number of institutions
Public sector commercial banks	5
Local private banks	22
Foreign banks	7
Commercial banks total	***34***
Specialized banks	4
Islamic banks	5

Source: Statistics of the Banking System, March 2012, State Bank of Pakistan

During 2006–2012, Pakistan's banking assets expanded due to a rise in the number of new banks launched and an increase in branch penetration across the country. Development and growth of Islamic banking has also contributed to asset and deposit growth during the period. The number of branches in Pakistan has significantly increased. It is estimated that the country currently has approximately 9,528[33] branches.

30 State Bank of Pakistan
31 State Bank of Pakistan
32 State Bank of Pakistan
33 State Bank of Pakistan

As of December 2011, the top six banks in Pakistan accounted for 57 percent[34] of total assets. National Bank of Pakistan is the only government-owned bank in the top six. The other five are privatized banks: Habib Bank, United Bank Limited, MCB Bank Limited, and Allied Bank Limited. Bank Alfalah is the leading local private bank in Pakistan in terms of assets. In addition, these same banks accounted for 45 percent[35] of all deposits as of December 2011.

Control over non-performing loans (NPLs) is a major challenge for Pakistan's banking sector. The ratio of NPLs to total loans increased from 6.9 percent in 2006 to 15.8 percent in March 2012[36]. NPLs have increased significantly over the past couple of years due to tight monetary policies (which led to high interest rates), deceleration of economic activity, power outages, and taxation policies. However, NPLs are expected to decrease in the near future as the State Bank of Pakistan (SBP) reduced its key policy rate by 1.5 percent in mid-2012[37].

NPLs in the small and medium enterprise (SME) sector increased rapidly during the last four years. Banks' asset quality deteriorated significantly due to a weak business climate in the SME sector and lack of the banks' ability to work in the SME sector. The ratio of NPLs to total loans for the SME sector was 36 percent in 2012[38], however, NPLs for Islamic SME have reduced significantly (from 36 percent) and vary between 15 percent to 18 percent[39].

The state of Islamic banking in Pakistan

Islamic banking in Pakistan can trace its origins back to the late 1970's when steps for the Islamisation of the banking and financial system were introduced

Pakistan was among the first three countries in the world to attempt to implement interest-free banking at a comprehensive/national level. Considering the magnitude of the task, it was undertaken in a phased manner. Islamisation measures included the elimination of interest from the operations of specialized financial institutions, including House Building Finance Corporation (HBFC), Investment Corporation of Pakistan (ICP), and National Investment Trust (NIT), in July 1979 and that of commercial banks from January 1981 to June 1985.

In June 1980, the legal framework of the country's financial and corporate system was amended to permit issuance of new interest-free instruments. An ordinance was passed to allow the establishment of Mudarbah companies and floatation of Mudarbah certificates for raising risk-based capital. Separate interest-free counters began to operate in all commercial banks and banks were also asked to provide finance under the Musharaka (profit and loss sharing) structure.

In 1985, all commercial banking in Pakistani rupees was made interest-free; no bank was allowed to accept any interest-bearing deposits and all existing deposits in banks were treated on the basis of profit and loss sharing. However, foreign currency deposits and lending continued as before. Following a Shariah Appellate Bench (SAB) judgment in 1999, it was announced that all laws involving interest would cease to have effect by June 2001. In December 2001, the SBP issued detailed criteria for establishing full-fledged Islamic commercial banks and Al Meezan became the first Islamic commercial bank.

Since then, the Islamic banking industry has grown significantly, with five full-fledged Islamic banks being established in the country. In addition, numerous conventional banks have Islamic windows, operating a wide branch network across the country.

34 Pakistan Banks› Association
35 Pakistan Banks› Association
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Figure 9: Evolution of the Islamic banking sector in Pakistan

Source: State Bank of Pakistan

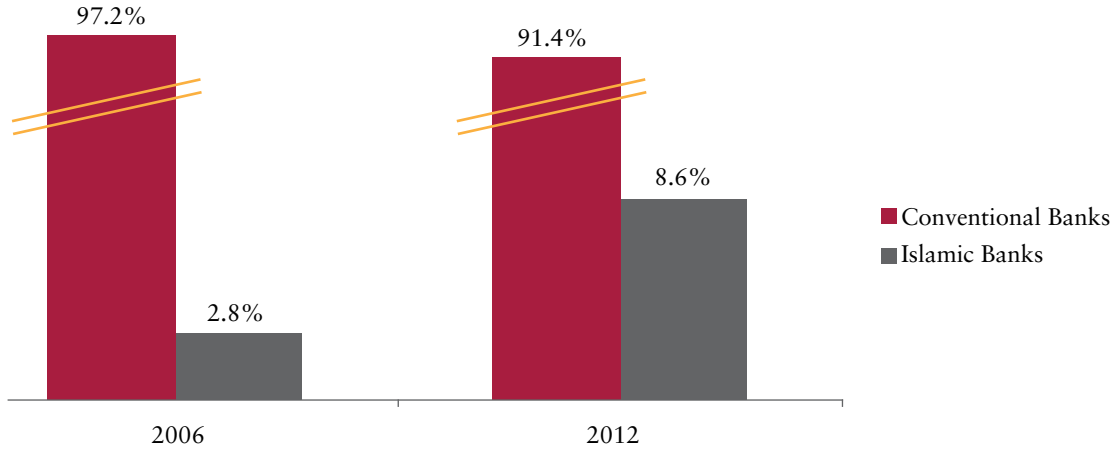
Islamic banking assets and deposits increased at a CAGR of 38 percent and 42 percent during the last six years, currently accounting for 8.6 percent and 9.7 percent of the country's total banking assets and deposits, respectively

The new initiatives launched at the turn of the century to gradually expand Islamic banking, along with the development of conventional banking, have enabled the sector to develop steadily over the past few years.

The current framework allows three kinds of Islamic banking institutions in Pakistan: 1) full-fledged Islamic banks; 2) Islamic banking subsidiaries of conventional banks; and 3) Islamic banking branches of conventional banks[40].

> "....In recent years, Islamic banking and finance in Pakistan has experienced phenomenal growth.... every 10th rupee is now being deposited in an Islamic bank account."
>
> — Leading Islamic Banking Expert

Figure 10: Breakup of Pakistan's Islamic banking assets (2006 and 2012)



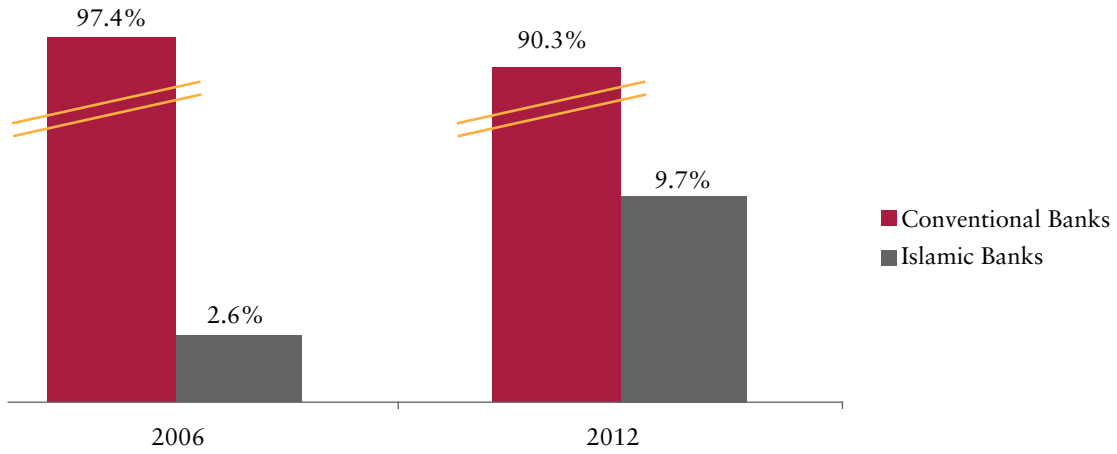
Source: State Bank of Pakistan

40 State Bank of Pakistan Islamic Bulletin, December 2012

SBP has also provided a Shariah compliant framework, including a Shariah board at the central bank level, a Shariah advisor at the individual bank level, mandatory internal Shariah audits, and periodic Shariah inspections by the central bank.

Although Islamic banking assets account for just about 8.6 percent[41] of the country's total banking assets, the segment has grown rapidly over the last few years. The rapid rise in Islamic banking assets was due to an increase in the number of Islamic banks, growth in the number of branches, measures taken by the government and the central bank, better asset quality metrics, and greater demand for Shariah-compliant products from customers.

Figure 11: Breakup of Pakistan's Islamic banking deposits (2006 and 2012)



Source: State Bank of Pakistan

With regard to deposits, Islamic banking penetration has increased rapidly over the years. Customers have had an increasing tendency to hold deposits in Islamic accounts, raising the penetration of Islamic deposits from 2.6 percent in 2006 to 9.7 percent in 2012[42].

There are currently five full-fledged Islamic banks in Pakistan and 12 conventional banks with Islamic windows. As of December 2012, the country had approximately 1,097 Islamic banking branches, up from just 150[43] in December 2006. The Punjab province accounts for the maximum number of Islamic banking branches (476), followed by the Sindh region (369), and KPK (120)[44]. The widening network of branches alludes to the rising demand for Islamic banking and the efforts taken by banks to expand their reach across the country.

41 State Bank of Pakistan
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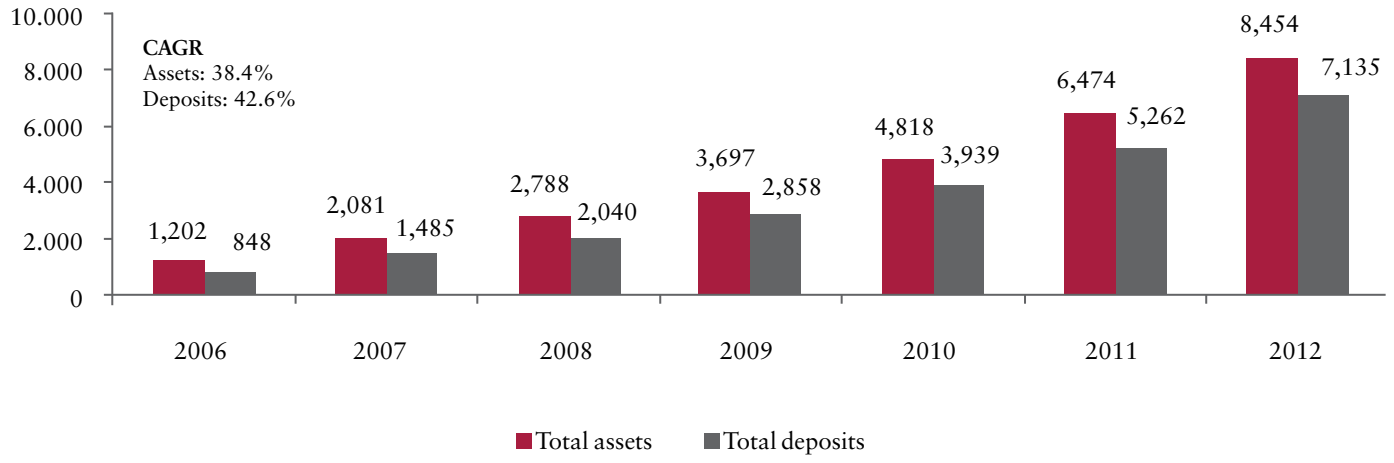
43 State Bank of Pakistan Islamic Bulletin, December 2012
44 State Bank of Pakistan

Figure 12: Total assets and deposits of Islamic banks ($mn)



Source: State Bank of Pakistan Islamic Bulletin, December 2012

Growth of deposits in the Islamic banking sector has significantly outpaced that of the overall banking system. The trend is expected to continue in the near future due to the increasing religious sentiment in the country and penetration of Islamic banks into smaller towns. Depositors also perceive Islamic banks as less risky vis-à-vis conventional ones. Moreover, Islamic banks have been investing quite heavily in Sukuk offered by the central bank during the last couple of years.

Table 2 : Break up of deposits in the Islamic banking sector

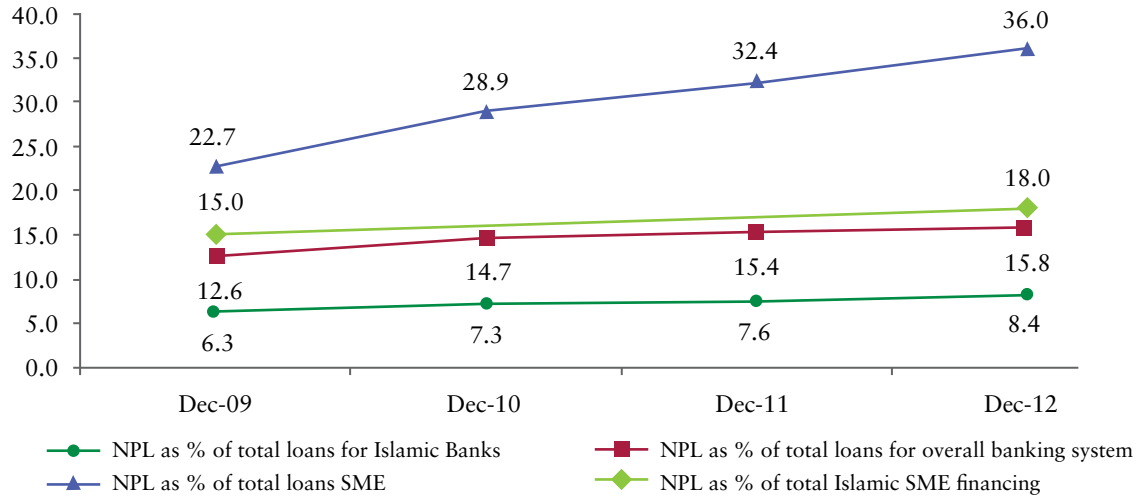
$ mn	Dec-09	Dec-10	Dec-11	Dec-12
Deposits	**2,855**	**3,939**	**5,262**	**7,135**
Customers	***2,661***	***3,668***	***4,880***	***6,676***
Fixed deposits	1,048	1,441	1,870	2,354
Savings deposits	918	1,276	1,741	2,618
Current account	675	924	1,245	1,671
Others	20	27	25	32
Financial Institutions	***194***	***272***	***382***	***460***
Remunerative deposits	186	271	378	359
Non-remunerative deposits	8	1	3	101

Source: State Bank of Pakistan Islamic Bulletins, December 2009 to December 2012

Asset quality of Islamic banks is better than the overall industry average

Islamic banks in Pakistan have traditionally followed a more cautious approach toward lending, enabling better control over asset quality vis-à-vis conventional banks. The sector's ratio of NPLs to total loans is significantly lower than the banking industry's historical average, which has helped create a positive image for Islamic banking in the country.

Figure 13: NPL as a percentage of total loans



Source: State Bank of Pakistan, December 2012

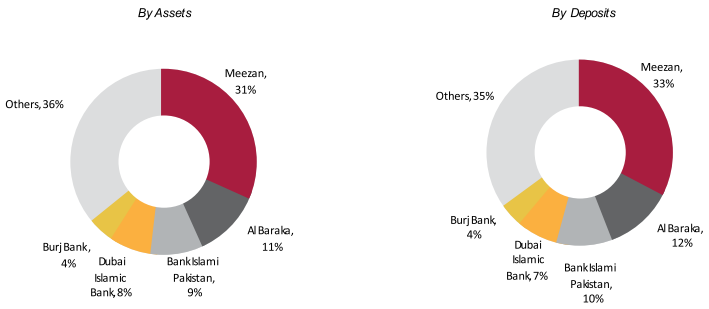
Full-fledged Islamic banks account for 63 percent of all Islamic banking assets and 65 percent of Islamic banking deposits in Pakistan

The five full-fledged Islamic banks in the country are Al Baraka Bank (Pakistan) Limited, Bank AlIslami Pakistan Limited, Burj Bank Limited, Dubai Islamic Bank Pakistan Limited, and Meezan Bank Limited. Together, they operate 657 branches in Pakistan, while the 13 conventional banks with Islamic banking windows operate the rest[45] .

Bank Alfalah Limited has the largest branch network (110 branches) among conventional banks that offer Islamic banking services, followed by Faysal Bank Limited (52 branches)[46].

Meezan, the first Islamic bank launched in Pakistan, is the largest in terms of assets and deposits, holding almost one-third of the country's total Islamic assets and deposits. Full-fledged Islamic banks account for 63 percent of total Islamic assets and 65 percent of Islamic deposits in the country[47].

Figure 14: Market share of Islamic banks (by assets and deposits, 2011)



Source: Pakistan Banks Association

Among banks with Islamic branches, Bank Alfalah and Standard Chartered are the two largest players, accounting for more than half of Islamic advances and deposits.

> "....The Islamic finance industry is likely to increase its share in the banking system to 15 percent during the next five years."
>
> — Deputy Governor, State Bank of Pakistan

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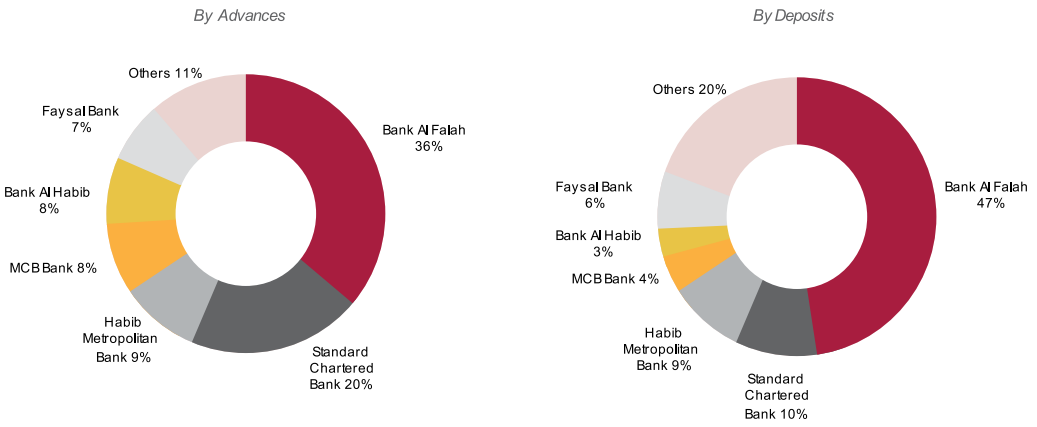
47 Pakistan Banks' Association

Figure 15: Market share of conventional banks with Islamic windows (2011)

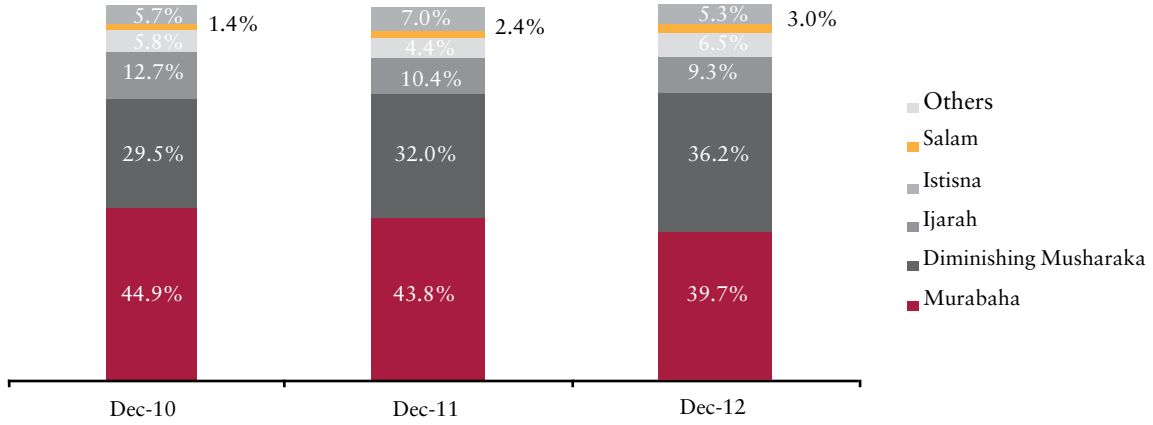


Source: Individual bank annual reports.

Murabaha and Diminishing Musharaka structures dominate the Islamic financing market

Several Islamic financing options are available in Pakistan. The Murabaha and Diminishing Musharaka structures are the most sought after and widely used. These account for approximately three-fourth of the Islamic financing market in Pakistan, with the rest contributed by Ijarah, Istisna, and Salam, among others.

Figure 16: Islamic financing mix



Source: State Bank of Pakistan Islamic Banking Bulletin

Textile and energy are the major sectors that avail of Islamic banking products in Pakistan

In terms of sector concentration, textiles and energy (production and transmission) receive almost 30 percent[48] of Islamic banking funds. The textiles sector was the largest recipient of Islamic banking funds during the past few years, in line with the trend witnessed in the overall banking industry. Despite an increase in the share of Islamic funds to the agribusiness sector, it remains underpenetrated.

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Table 3 : Islamic banking concentration by sector (% of Islamic funds allocated)

Sector	Dec-10	Dec-11	Dec-12	Overall banking industry share* (2012)
Textile	22.0%	20.1%	19.0%	16.7%
Individuals	17.0%	14.9%	14.2%	7.9%
Energy	7.0%	10.2%	10.3%	11.7%
Chemicals and pharmaceuticals	7.0%	7.4%	7.4%	3.6%
Cement	4.0%	3.0%	1.5%	1.4%
Agribusiness	3.0%	4.0%	3.7%	8.4%
Sugar	2.0%	3.3%	3.8%	2.5%
Electronics	2.0%	1.5%	1.5%	1.4%
Other	36.0%	35.6%	38.6%	46.4%

Source: State Bank of Pakistan Islamic Banking Bulletin
*Note: Overall banking industry reflects the conventional banking share.

In 2010, the IFC, in conjunction with the SBP, conducted a detailed assessment to identify the top ten priority SME sub-sectors in Pakistan and evaluate their financial needs. The sectors included manufacturing (comprising sub-sectors such as textiles and chemicals, among others), wholesale and retail trade, social and community services, and transport, storage and communication. While these sectors were found to be highly attractive, the statistics with regard to advances made to these sectors varies with the information published periodically by SBP. Currently, these sectors receive just 4.1 percent[49]of Islamic lending.

Table 4 : Cost of funds of selected Islamic banks

Bank	Cost of funds (%)		
	2009	2010	2011
Meezan Bank	5%	5%	5%
Al Baraka	8%	3%	8%
Bank Islami Pakistan	4%	5%	6%
Dubai Islamic Bank	6%	7%	6%
Burj Bank	10%	6%	7%
Bank Alfalah	5%	4%	5%
Faysal Bank	1%	4%	5%

Source: Individual banks' balance sheets and primary research

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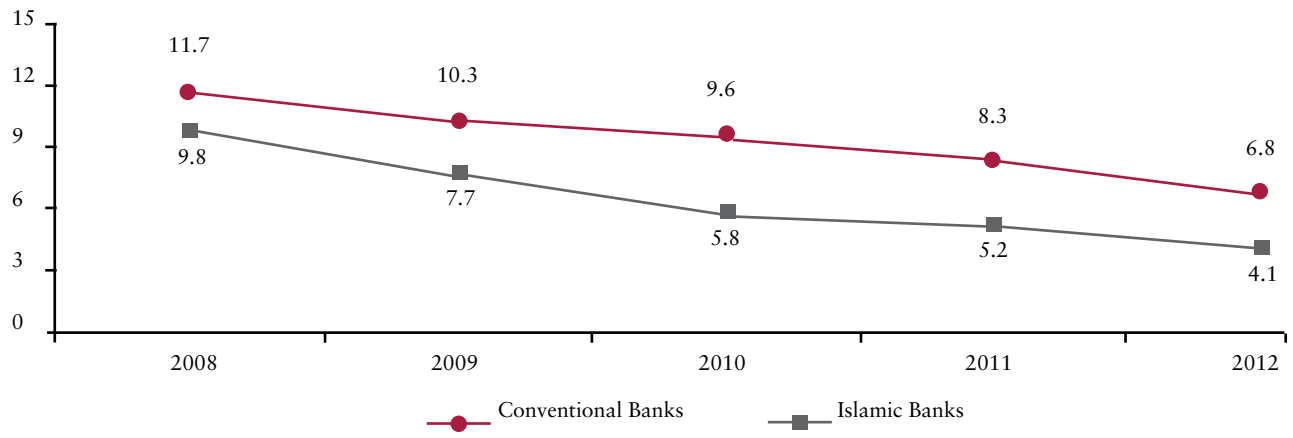
The cost of funds for Islamic loans was in the range of 5 percent to 8 percent[50] in 2011. Most banks maintained a stable rate between 2009 and 2011. The cost of funds of Faysal Bank increased during the period due to the high amounts of non-remunerative deposits, which were not deployed during the period.

Islamic and conventional banking exposure to the SME sector in Pakistan has declined during the past few years (in terms of the total lending/financing) owing to high levels of NPL rates associated with the sector

Under the current scenario wherein asset quality is deteriorating and NPLs are increasing constantly, banks, particularly Islamic banks, are taking a more cautious approach towards lending.

Figure 17: SME lending as a percent of total lending in Pakistan



Source: State Bank of Pakistan Islamic Banking Bulletins and Development Finance Report, State Bank of Pakistan

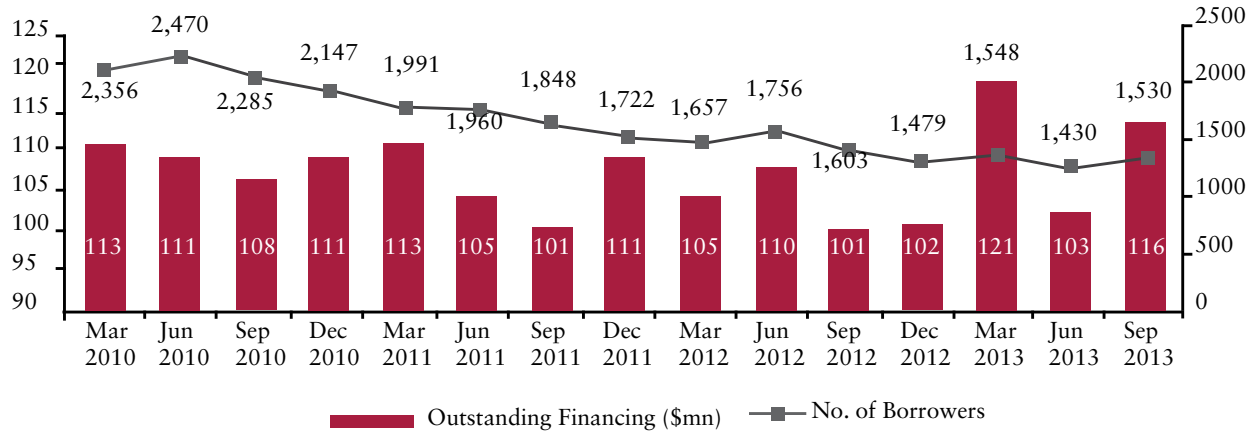
The SME sector is considered riskier and has been severely affected by this safety-first approach. Funding to the sector has decreased considerably over the years, with conventional and Islamic banks preferring to divert funds to safer asset classes. Additionally, the limited number of products on offer to SMEs and the lack of product reengineering have contributed to a decline in lending to the SME sector. Lending by conventional banks to the SME sector declined from $3.8 billion in 2008 to $2.7 billion in 2012, while Islamic banks' lending to the sector also declined from $145 million to $102 million during the same period[51]. However, as of September 13, the figure is increased to $116 million (14 percent increase in three quarters).

> "....Financing to SMEs is the natural fit for Islamic banking growth."
>
> — CEO Leading Islamic Bank in Pakistan

50 Individual banks' balance sheets and primary research

51 State Bank of Pakistan Islamic Banking Bulletins and Development Finance Report,

Figure 18: SME lending by Islamic banks



Source: State Bank of Pakistan - Islamic Banking Division

This decline in the Islamic SME portfolio could be largely attributed to the high levels of risk associated with lending to SMEs (the average NPL rate for Islamic SMEs is between 15 percent to 18 percent). As a result, the total number of Islamic SME borowers have also declined, resulting in a stagnant financing portfolio.

Regulatory environment for Islamic finance in Pakistan

The SBP has undertaken numerous measures to strengthen the legal, regulatory, and Shariah compliance framework; ease liquidity concerns faced by the industry; and develop human capital required to fuel growth of Islamic finance in the country

In 2003–2004, the SBP established an Islamic banking department, as a focal point for all matters related to the Islamic finance industry in Pakistan, with the objective to strengthen the regulatory framework to be in line with global best practice and successfully implement the strategic plan formulated for the development of the Islamic banking industry.

The current regulations and policies formulated by the SBP are geared toward creating an enabling environment for the development of Islamic banking in Pakistan. The regulations governing Islamic banking comprise:

Three-pronged strategy to promote Islamic banking:

1. To promote Islamic banking in Pakistan, the SBP has:
   - Granted licenses to full-fledged private sector Islamic banks,
   - Permitted conventional banks to set up Islamic banking subsidiaries, and
   - Allowed existing conventional banks to open full-fledged Islamic banking branches.
2. Introduced guidelines for conventional banks with Islamic branches for segregation of funds as well as systems and controls. The SBP has also implemented internal control and measures to ensure segregation of funds and protect the interest of depositors in conventional banks that have Islamic banking branches. In addition, the regulations mandated the appointment of a Shariah committee, stringent 'Know Your Customer' (KYC) rules, adherence to prescribed risk management guidelines, and implementation of appropriate internal controls and information technology systems. Banks that have weak systems and controls are debarred from starting Islamic banking operations to ensure soundness of the system.
3. Compliance to Islamic Financial Services Board (IFSB) standards and risk management guidelines. To ensure soundness and financial stability of the Islamic banking system, the SBP requires Islamic banks to adhere to the IFSB accounting standards, which

are being rolled out in a phased manner. In addition, the SBP has formulated risk management guidelines based on the 'Guiding Principles of Risk Management for Institutions offering Islamic Financial Services' issued by the IFSB.

> "…. Although the decline can partly be attributed to adverse economic conditions during the period and growth in non-performing loans, a more risk-averse posture of banks remains a major factor responsible for their low exposure to SMEs."
>
> — Deputy Governor, State Bank of Pakistan

Other guidelines: Islamic banking regulations also include guidelines on schedules of service charges of Islamic banks, an institutional risk assessment framework for monitoring and evaluating banks, and an enforcement framework to ensure compliance with Shariah standards. The SBP also formulated a comprehensive Shariah compliance framework for Islamic banking institutions, the guidelines includes;

- Shariah board at SBP and Shariah advisor at Islamic banks: The SBP established a national-level, five-member Shariah board to advise on procedures, rules, and regulations pertaining to Islamic banking and evaluate and approve Islamic products or instruments developed by the SBP. Moreover, every Islamic banking institution is required to appoint a Shariah advisor to ensure that all products and services comply with Shariah rules and principles.

- Essentials and model agreements of Islamic modes of financing: The SBP has prescribed eight modes of financing that are considered minimum requirements for Shariah compliance, including Mudarbah, Musharaka, Diminishing Musharaka, Ijarah, Murabaha, Musawamah, Salam, and Istisna. The SBP has also issued guidelines on the structure of these modes of finance and the standardization of documents required. Besides this, the SBP issued directives with regard to profit and loss distribution and pool management in Islamic banks to help improve transparency.

- Instructions and guidelines for Shariah compliance in Islamic banking institutions: The framework is meant to provide guidance to banks in areas such as Shariah compliance, internal Shariah audits, investment in shares, policy for profit distribution with PLS depositors, and financial reporting and general disclosure.

Islamic banking regulations include provisions for the establishment and operation of Islamic institutions in the country: The guidelines include licensing and capital requirements (minimum paid-up capital of $10.1 million by 2013[52]), internal controls and audit requirements, as well as statutory liquidity and cash reserve requirements. In addition, it also prescribes the minimum qualifications, experience, and integrity standards for board members and managers.

Initiatives to promote Islamic finance to SMEs in Pakistan

The SBP has undertaken numerous measures to strengthen and promote Islamic finance to SMEs. Regulations on SME financing focus on implementing effective risk management measures to facilitate easier access to finance, ease liquidity concerns faced by the sector; and develop human capital required to fuel the growth of Islamic finance for SMEs in the country.

The SBP has developed strategic five-year plans in collaboration with the Islamic finance sector

In 2007, the central bank developed a strategic plan for the Islamic banking industry in Pakistan, aimed at increasing the market share of Shariah-compliant assets to 12 percent[53], expanding outreach of Islamic banking products across commercial sectors, strengthening the regulatory and compliance framework, and developing the industry's human capital.

Furthermore, several measures were adopted to improve the governance and Shariah compliance framework of Islamic banks as well as educate consumers on Islamic banking practices. The SBP is developing a strategic plan for the next five years (2013–2017) to provide a roadmap for the growth of Pakistan's Islamic banking industry, particularly SME financing.

The SBP is addressing liquidity management through the issuance of sovereign Sukuk

The central bank, in collaboration with the central government, started regular issuance of sovereign Sukuk for the domestic market—an important liquidity management tool for the country's Islamic finance industry. During the last two years, issuance of sovereign Sukuk worth $3.7 billion[54] enabled Islamic banks to efficiently manage their liquidity problems. Furthermore, in March

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2013, the SBP issued instructions for issuance of Ijarah Sukuk.

The SBP has undertaken initiatives to improve public awareness of Islamic banking and develop qualified and trained personnel

The SBP has been undertaking several programs to create awareness regarding the industry through seminars, conferences, and workshops. The SBP has also initiated a mass media campaign to enhance public awareness and allay apprehensions about Islamic finance to SMEs.

Lawmakers have also recognized the need to develop human capital to support the growth expectations of Pakistan's Islamic finance industry. In line with this, the central bank has been running specialized training programs and encouraging Islamic finance institutions to invest in the development of human capital for SME financing.

Furthermore, in February 2013, the SBP announced it would initiate a comprehensive media campaign to promote the strengths of Islamic finance, particularly for SMEs.

Incentivizing banks to expand in tier 2 and tier 3 cities

The SBP has started providing incentives to Islamic banks to expand their network in tier 2 and 3 cities where most SMEs are located. According to the SBP, any district with less than 10 Islamic branches is defined as a rural and underserved area with regard to Islamic banking facilities. In addition, the SBP is encouraging Islamic banks to be more aggressive in their approach to these areas as more than 70 percent of Islamic branches are concentrated in just 12 cities across Pakistan[55].

Commercial banks and the IFC are actively boosting Islamic

> "....There is huge untapped potential for Islamic banks in Pakistan, particularly in the SME sector. Increasing religious sentiment among the population and limited avenues available to customers to park the existing Islamic liquidity in the market are expected to increase Islamic banking penetration significantly. The initiatives being undertaken by the SBP and other agencies are also expected to aid growth of the industry. Experts estimate that penetration of Islamic banking in the sector could reach as much as 15 percent by 2015, with SMEs Islamic financing having a substantial par."
>
> — Governor of SBP interview, 2012

Several banks in Pakistan have taken various initiatives to promote Islamic banking in the country. Some examples include:

In 2008, Meezan Bank, the largest Islamic bank in Pakistan, joined the IFC Global Trade Finance Program as an issuing bank, boosting access to trade finance services for entrepreneurs and businesses in Pakistan. In January 2013, Bank Islami also joined the program, which would further assist the SME sector in accessing cost-effective trade finance. These measures are expected to help boost the country's Islamic banking sector.

Bank Alfalah is in the process of implementing a new core banking software for its Islamic branches. This would significantly improve customer interface and enable the bank to offer facilities such as internet banking, branchless banking, and cash management services and help the bank reduce its transaction costs for SME customers.

Bank Islami Pakistan conducts regular training programs for its employees to ensure they understand the basics of Islamic banking and can easily explain Islamic products structures to SMEs. In 2012, more than 400 employees were given basic as well as specialized product training on Islamic banking. The bank further plans to initiate a 'Train the Trainer' program in 2013 to increase the frequency of training programs, particularly in rural areas, so that micro and small enterprises can be easily served.

In September 2012, Silk Bank launched its 'Emaan Islamic Banking' services by converting seven conventional branches to Islamic banking ones. It plans to launch additional branches in due course. The bank aims to offer a comprehensive list of Islamic finance products such as Islamic auto finance, personal goods finance, and investment in Sukuk to SMEs.

The SBP has issued a number of prudential regulations for SMEs, including a 'Handbook on Islamic SME Financing' [56]

Some of the regulations issued by the SBP to ensure better control of the Islamic SME sector include the following:

- Proposed products and structures for Islamic SME financing, its basic rules, transactional flows, and accounting treatment.
- Banks should identify repayment sources and assess repayment capacities of borrowers on the basis of the assets conversion cycle and expected future cash flows.

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56 By Islamic Banking Department – State Bank of Pakistan

- All facilities, except those secured against liquid assets, extended to SMEs shall be backed by owners' personal guarantees.
- In order to encourage cash flow based lending, banks will be allowed to take clean exposure, SMEs subject to prescribed thresholds.
- The maximum exposure of a bank on a single SME shall not exceed $757,500.
- Banks will be free to determine margin requirements after considering the risk profile of clients.
- Banks should look to develop and implement systems to ensure SMEs have used financing for the specified purpose.
- Specifying thresholds on the classification and provisioning of assets as well as the aggregate exposure of banks to the SME sector.

05.
Islamic Banking Opportunities across SMEs

There is a potential opportunity to tap the SMEs' demand for Islamic financing in Pakistan and address the unmet needs of the un-served and underserved SME population, owing to religious beliefs. The opportunity is currently worth an estimated $2.6 to $3.8 billion.

Access to finance for the SME sector

Penetration of formal financing channels is relatively low in Pakistan, largely restricted to medium-sized enterprises in larger cities, while access to finance is a major constraint for the SME sector

Small and medium enterprise (SME) financing in Pakistan has gained momentum in the last decade due to various initiatives undertaken by the State Bank of Pakistan (SBP) and the government, such as the introduction of prudential regulations for Islamic SMEs. However, the sector's credit gap remains wide and ranges from $2.6 billion to $3.8 billion (sourced from figure 18) of "new to bank" financing requirements.

Most of the borrowers are based in Pakistan's three largest cities (Karachi, Lahore, and Faisalabad), which together account for more than 50 percent of the country's total SME financing, while the 20 largest cities account for nearly 85 percent of financing. Moreover, these borrowers are largely medium-sized enterprises. Small enterprises generally obtain funds through informal mediums[57].

Access to finance is a major issue for SMEs in Pakistan; well-served SMEs account for just 11 percent of the total SME population, and the other two categories are:

- Underserved SMEs: These enterprises, which represent 22 percent[58] of the total SME population, avail of formal financing (Islamic or conventional) that meets less than 20 percent of their requirements.

- Un-served SMEs: These represent 67 percent[59] of the SME population who do not borrow at all for various reasons, including religious beliefs.

Religious belief is certainly one of the key reasons hindering some SMEs from opting for formal financing. Approximately 20 to 25 percent[60] of SMEs (accounting for more than 150,000 enterprises) do not opt at all for formal financing or borrow less than 20 percent of their requirements due to their religious beliefs[61]. This sentiment has been growing stronger, especially over the past five to six years. Although these SMEs are creditworthy, they are excluded from accessing funding from banks as Shariah-compliant products are either unavailable or not properly understood by these SMEs or involve lengthy processes, making the execution of Islamic transactions cumbersome.

56 Development Finance Quarterly Review, State Bank of Pakistan
58 Sourced from figure 18
59 Sourced from figure 18
60 Primary research
61 Average number of enterprises sourced from Figure 1

SMEs in Pakistan largely seek finance to meet working capital requirements

During the last few years, 80 percent of funds received by SMEs were used to meet working capital needs; capital expenditures and trade financing accounted for only 10 percent each.[62]

Table 5 : Historic data on financing split

	2007	2008	2009	2010	2011
Working Capital	71%	77%	76%	78%	80%
Long-Term Loans	14%	12%	12%	11%	10%
Trade Finance	16%	11%	13%	11%	10%
Total ($ bn)	**4.4**	**3.8**	**3.5**	**3.4**	**3.0**

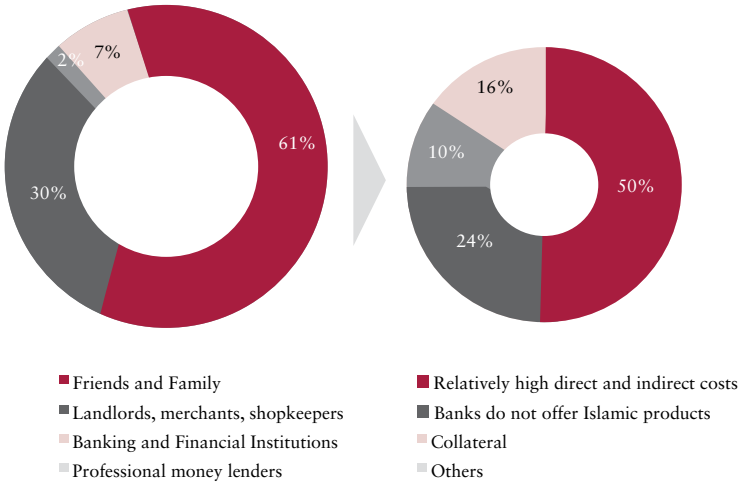
Source: Development Finance Report, 2011, State Bank of Pakistan

SMEs in Pakistan prefer short-term financing, which is in line with the characteristics exhibited by the sector in other emerging economies where small businesses adopt a short-sighted, reactive approach to business planning and management.

Informal channels fulfill major credit needs of Pakistan's SME sector

Most SMEs in Pakistan operate as sole proprietorships or family businesses. These enterprises primarily engage in cash transactions and, thus, prefer to acquire funds through informal channels. Moreover, a large number of SME owners, especially outside urban areas, are not financially literate regarding their banking needs. They prefer informal funding routes because they are based on trust and offer more flexibility in terms of documentation, repayment, timing and transactions costs, which formal financial institutions do not provide.

Figure 19: SME funding



Note: Others include convenient location of financial institutions, quality of service of financial institutions' staff and availability of other financial services from the same provider.
Source: Bringing Finance to Pakistan›s Poor: Access to Finance for Small Enterprises and the Underserved

62 Development Finance Review 2011, State Bank of Pakistan

Despite a preference for Islamic banking, many factors, including high collaterals, knowledge deficit, and cumbersome and complicated processes, restrict SMEs from approaching Islamic financial institutions

Perception and creditability of Islamic banking: People in Pakistan have a positive outlook towards Islamic banking and are becoming increasingly aware of its benefits. Islamic banking, through its emphasis on social responsibility, resonates with the beliefs of the population. The positive perception was further strengthened by the strong performance of banks over the last 10 years. A 2011 survey[63] revealed that Shariah adherence is an imperative factor for consumers when selecting a bank. Similarly, within the SME sector, too, there is a strong preference for Shariah-compliant products. This perception is expected to rise gradually over the next few years due to measures implemented by the SBP and other banks to promote Islamic banking and raise awareness among the population.

Knowledge about Islamic banking products: SMEs' preference for Islamic banking is not complemented by the knowledge of Islamic financial products and solutions. Most SMEs are unaware of financial products that suit their needs. This lack of knowledge about financial products is not limited to SMEs alone. Islamic banks are not adequately staffed with employees well versed in financial products and, consequently, they are unable to recommend and structure ideal products for clients.

Obstacles faced by Islamic financial institutions in lending to SMEs

Relatively high risk of lending and growing NPLs have discouraged financial institutions from lending to this sector

Generally, banks (both conventional and Islamic) are reluctant to extend credit to SMEs, largely due to the non-availability of documentation related to the financial position of businesses, project feasibility studies, business plans, tax records, and credit history. The NPL ratios of SMEs witnessed a significant increase, thereby prompting financial institutions to reassess their SME loan portfolio and divert funds to safer alternatives.

Economic conditions and domestic business environment have affected willingness of banks to lend to SMEs

Natural calamities in Sindh and Punjab in 2010 and 2011 and the prevailing economic environment have led to the deterioration of business conditions. Power shortages and issues related to law and order in the country have further impacted SMEs' ability to operate businesses, due to which banks have been cautious in lending to such firms.

Banks have limited specialization in SME lending

Most financial institutions in Pakistan do not have the skills or tools to evaluate SMEs. Hence, they measure SMEs with the same yardsticks applied to corporate companies or low-volume relationship models. Generally, banks do not have specialized loan officers or proper procedures for SME lending.

High operating costs and an inefficient legal environment prevent banks from expanding their SME loan portfolio

In general, SMEs have small requirements that entail high administrative costs for banks, thereby affecting their profitability. The operating costs-to-loans ratios of small businesses are high, which makes it difficult for banks to create a viable and profitable business model for the SME sector. The underdeveloped legal framework (transaction security and credit information infrastructure) also limits bank lending.

Inadequate risk assessment framework

The State Bank of Pakistan has established a credit information bureau to assess risk levels, but the bureau's coverage is limited to just 2 percent of the adult population (World Bank 2012 data). Since a large number of SMEs operate in the informal sector, it becomes difficult for banks to assess credit risks involved in lending to such parties. Efforts to spot signs of default early and directly engage with borrowers to mitigate losses are inadequate.

> "…. They lack the expertise to document their transactions properly. Besides, there is a general tendency in our society not to pay taxes. People avoid documentation also to get away from paying taxes."
>
> — CEO of a leading bank in Pakistan

63 Hamid, A., and Masood, O. (2011). Selection criteria for Islamic home financing: a case study of Pakistan. Qualitative Research in Financial Markets

Supply side analysis – penetration of Islamic banking in SMEs in Pakistan

A majority of banks are not well equipped to deal with the requirements and potential of the SME sector, thus creating a significant 'supply side' gap. In order to meet this demand, banks, including Islamic banks would have to build capacity in the areas highlighted above

A primary survey of the top 20 Pakistani banks revealed that just 13 of these banks have SME offerings and seven offer Islamic propositions to SMEs. Only eight banks have separate business units/divisions for SMEs, while others provide such services through corporate or retail divisions. Although eight banks have adequate Islamic product offerings, just two banks have 'fairly good' Islamic SME penetration, while the rest are still striving for excellence (refer to table 6). There are several reasons for this under-penetration, some of which include:

Branding is the major reason why SME finance propositions, especially Islamic offerings, lag

Most SME customers in Pakistan are unaware of the availability of SME offerings from banks, especially Islamic products. Other than a few banks such as Bank Al Habib, Habib Metro, Summit, Silk, NIB, JS, HBL, Bank Alfalah, ABL and Soneri, customers are unaware of banks that offer SME finance.

The gap in product offerings prevents Islamic banks from offering SME financing to customers

Full-fledged Islamic banks and conventional banks with Islamic windows in Pakistan largely offer similar products, Islamic structures, and service offerings to corporate clients of all sizes as well as to SMEs.

According to industry participants, the financing mix in terms of Islamic structure remained fairly constant over the past two to three years. With regard to liability, the main products offered include deposit accounts based on the Mudarbah structure.

On the asset side, the Murabaha structure accounts for 40 percent of Pakistan's SME financing market, followed by the diminishing Musharaka (35 percent), Ijarah (20 percent), and other structures (5 percent)[64].

The Salam and Istisna structures have very low penetration in the SME sector. The Istisna structure is estimated to account for less than 1 percent[65] of the overall market. SMEs in the country lack sufficient knowledge about these products. Moreover, industry experts do not anticipate any significant change in the financing mix over the next two to three years.

64 State Bank of Pakistan

65 State Bank of Pakistan

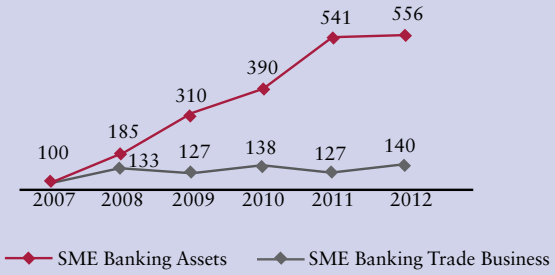
First Mover in the Islamic SME market: Meezan Bank targets the untapped SME sector in Pakistan, especially those enterprises who do not borrow 'due to religious reasons'

Pakistan's 'high growth potential' SME sector, the backbone of the country's economy', was underfunded, especially from the Islamic funding viewpoint; thus, Meezan Bank decided to be the first bank to commit itself in solving this problem

Despite the fact that SMEs are the growing force behind Pakistan's growth, they had limited access to finance. Conventional banks were limiting their exposure to this sector due to their conservative approach. In contrast, Meezan Bank believes that SMEs are more faith driven than larger corporations and access to Islamic finance would increase the SME sector's financial inclusion. Therefore, the bank put into operation its independent SME unit in 2002 with the aim of channeling Islamic finance into Pakistan's SME sector.

To effectively enter the SME sector, Meezan Bank had to reinvent the strategy followed by conventional banks. The bank established geographical 'hubs' for improved business focus and better controls. In addition, Meezan Bank designated senior officials to ensure necessary impetus and direction to the bank's SME strategy. The bank emphasized training across all levels, including basic orientation in Islamic banking, specialized functional modules, certificate programs, product-related trainings, and refresher programs. In 2012, through 109 knowledge sharing sessions, Meezan Bank extended the knowledge base training of Islamic banking to over 3,300 employees. Moreover, in 2012, the bank created awareness about Islamic banking by conducting 42 Islamic banking seminars and workshops for the corporate and SME sectors in 26 cities across Pakistan (attended by more than 5,000 participants). Due to this strategy, Meezan Bank witnessed strong growth in its business.

During 2007–2012, Meezan Bank multiplied its SME as well as commercial banking assets and trade business due to its SME strategy



Source: Meezan Bank annual report

At present, Meezan Bank is planning to further enhance its position in the SME sector by (a) deepening existing relationships, (b) geographically diversifying its client base, (c) expanding into the untapped agricultural market, and (d) offering innovative products and services.

Table 6 : Pakistani banks' supply side analysis

Bank	SME Proposition Available	Doing Islamic SME	Separate Business Division	Branding SME Proposition	Overall SME Penetration	Islamic SME Penetration	Islamic Products Availability		
							Finance	Liability	Transaction
Meezan Bank	Yes	Yes	Yes	No	Good	Good	Yes	Yes	Yes
Al Baraka Bank (Pak) Ltd.	Yes	Yes	No, Under Corporate	No	Fair	Fair	Partial	Partial	No
Dubai Islamic Bank	No	No	No, Under Corporate	No	Poor	Poor	Marginal	Marginal	No
Bank Al Islami	Yes	Yes	No, Under Corporate	No	Fair	Fair	Partial	Partial	No
Bank Al Habib - a	Yes	No	Yes	No	Good	Poor	Marginal	Marginal	No
Bank Alfalah	Yes	Yes	Yes	No	Good	Fair	Yes	Yes	Yes
Askari Bank	No	No	No, Under Corporate	No	Poor	Poor	No	No	No
Habib Metropolitan Bank -a	Yes	No	No, Under Corporate	No	Good	Fair	Partial	Partial	Partial
SAMBA	No	No	Not marketing at all	No	Poor	Poor	No	No	No
MCB	No	No	No, Under Corporate	No	Poor	Poor	Marginal	Marginal	Marginal
Summit Bank -a	Yes	No	Yes	No	Good	Poor	No	No	No
Silk Bank -a	Yes	No	Yes	Yes	Good	Poor	No	Partial	No
NIB Bank -a	Yes	No	Yes	No	Good	Poor	No	No	No
JS Bank -a	Yes	No	No, Under Corporate	No	Good	Poor	No	No	No
Allied Bank	No	No	No, Under Corporate	No	Poor	Poor	No	No	No
National Bank of Pakistan	No	No	No, Under Corporate	No	Poor	Poor	Marginal	Marginal	No
Soneri Bank -a	Yes	Yes	Yes	No	Good	Fair	Partial	Partial	No
Standard Chartered Bank	Yes	Yes	Yes	No	Good	Good	Yes	Yes	Yes
United Bank Limited	No	No	No, Under Corporate	No	Poor	Poor	Marginal	Marginal	No
Habib Bank Limited	Yes	Yes	Yes	No	Fair	Fair	Partial	Partial	Yes

Source: Primary survey with banks and analysis through websites
Note (a): Entire business proposition is on SME basis

Islamic banks can consider offering a product structure in line with the overdraft facilities offered by conventional banks

> "…. Access to formal financing channels has always been a constraint to the development and growth of SMEs in Pakistan. Banks and financial institutions have stringent policies for lending to the sector. SMEs, particularly enterprises outside major cities where financial literacy is not well-spread, feel more at ease in an informal environment due to the lack of knowledge and exposure to banking products and procedures. Moreover, religious beliefs restrict many SMEs from approaching conventional financial institutions."
>
> — Islamic Banking Expert in Pakistan

SMEs approach banks largely for working capital requirements or asset financing. While several products and structures are in place, the sector continues to be underpenetrated by Islamic banks thus rendering several thousands of SMEs unbanked. There is significant potential for Islamic banking products in the SME sector largely due to the religious orientation of many of these companies, especially those operating in rural areas. Banks should look at targeting smaller customers with retail-based offerings and larger customers with more corporate and sophisticated banking services.

While SMEs opine that most of their current requirements are met by Islamic banks, they would prefer an Islamic structure similar to overdraft facilities, known as "running finance" or "current finance" offering, by conventional banks. While some Islamic banks offer a "running Musharaka" structure that resembles an overdraft facility offered to a larger corporate, banks should consider providing SMEs with a similar structure due to the high demand and large future potential.

From a liability perspective, Islamic banks meet all the requirements of SMEs through current accounts, savings accounts, and financing against deposits. Banks should also broaden their product and service offerings to SMEs through non-borrowing services, such as cash management, payments, collections, and trade finance solutions. Other measures include appointments of dedicated SME business managers and encouraging SMEs to use mobile and Internet banking. Banks such as Meezan, Bank Alfalah, Bank Al Habib, Habib Metro, and Standard Chartered Pakistan are adept at providing such facilities to SMEs. Banks can also explore the possibility of providing SME-specific debit and credit cards with preset daily purchase limits, thereby allowing SMEs to separate personal expenses from business ones.

Potential for Islamic banking in the SME Sector

A high demand for Islamic finance in the SME sector could result in a funding opportunity of $2.6 billion to $3.8 billion over the next few years

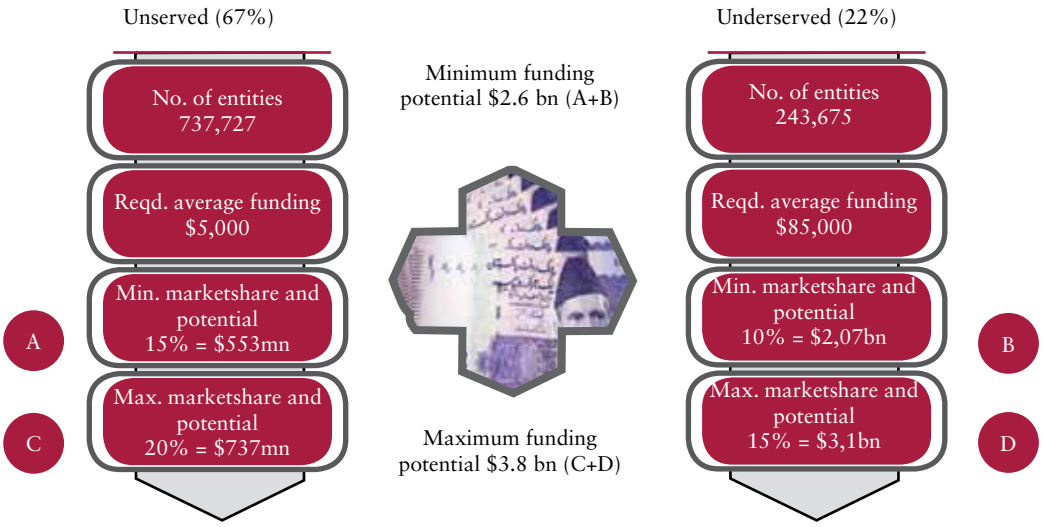
Funding to the SME sector has declined considerably over the years as conventional and Islamic banks have preferred to divert funds to safer asset classes. Islamic finance to SMEs accounts for just 4 percent of the total Islamic finance volume (7 percent in 2008). Conventional SME lending accounts for just 7 percent of the total lending volume (12 percent in 2008)[66].

Access to finance is a major issue in the SME sector. SMEs either do not avail of formal financing or avail of limited financing due to religious reasons and sentiments. It is estimated that about 20 percent to 25 percent[67] of SMEs fall under this category, and this sentiment has increased considerably, especially in the last five to six years.

SMEs that do not avail of finance due to religious reasons represent a 'new funding potential' of $2.6 billion to $3.8 billion for Islamic finance over the next few years.

66 State Bank of Pakistan
67 Primary research

Figure 20: New Islamic financing potential – 'new to bank'



Note: Well served medium scale enterprises which account for the remaining 11 percent of the SME population have been excluded from the calculations.

Possibility of a bull-case scenario: The possibility of a bullish scenario is based on the assumption that SMEs across the country would have greater access to Islamic banks with Shariah principles that would appeal to them and prompt them to avail of financing from formal channels. It is also assumed that customers and bank employees would be educated on the various Islamic finance structures. Banks would also start offering various non-borrowing and value-added services. It is estimated that 20 percent of the un-served population and 15 percent of the underserved population, which stayed away from banks due to religious reasons, would start banking with Islamic banks. This would result in an Islamic financing potential of $3.8 billion to the SME sector.

Possibility of a bear-case scenario: Under a bearish scenario, it is estimated that banks would be able to tap a maximum of 15 percent of the SME population that does not currently bank due to religious reasons. Furthermore, banks are assumed to increase their branch penetration in urban areas and introduce more diversity in Islamic structured products. Loan processing would also be made easier for SMEs. This would result in an Islamic financing potential of $2.6 billion to the SME sector.

The manufacturing sector is likely to account for a large proportion of the funding opportunity

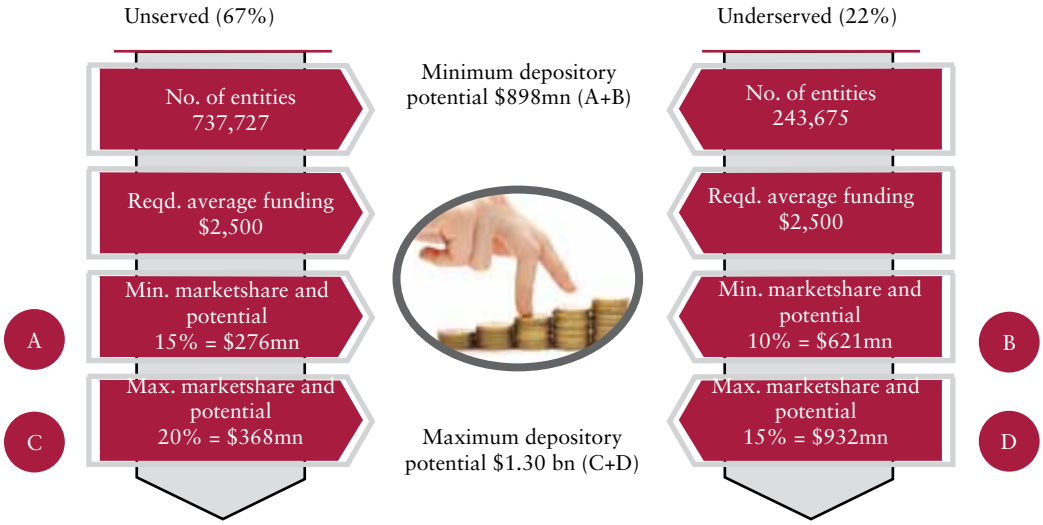
From a funding perspective, the manufacturing sector holds significant potential. This is based on the fact that, currently more than 70 percent[68] of the Islamic SME finance goes toward the manufacturing sector. Further, due to the capital-intensive nature of operations, which ensures that adequate collateral can be provided, this sector could be a first target of Islamic SME financing. Moreover, manufacturing activity has a significantly higher economic impact. SMEs in the manufacturing sector contributed 25 percent to exports and their value addition to the sector was about 35 percent[69]. Manufacturing enterprises have higher employment potential. Other viable sectors for funding are hotels and restaurants and wholesale and retail. However, most enterprises operating in these sectors are likely to be less capital-intensive, smaller in size, and informal in nature. The funding potential is small as demand for capital from these establishments is likely to be low and sporadic.

Islamic banks could also tap a new depository potential of $0.8 billion to $1.3 billion within the SME sector over the next few years

68 Primary Interview with Islamic Banking Department, State Bank of Pakistan

69 Small and Medium Enterprises Development Authority

Figure 21: Depository potential



Note: This depository potential does not take into account the potential that could arise from offering non-banking activities

Based on the assumptions that margin requirements for un-served and underserved enterprises are 50 percent and 30 percent, respectively, the deposit potential for these enterprises would be $2,500 to $25,500.

The potential also assumes that Islamic banks would offer a larger variety of diversified depository products similar to conventional banks (including confirmed rate fixed deposit). Under a bullish scenario, where Islamic banking penetration improves across Pakistan and banks offer additional deposit products to target SMEs more aggressively, the combined deposit potential is expected to be $1.3 billion. Alternatively, if branch penetration is less satisfactory and the number of products offered to SMEs remains limited, the deposit potential is expected to be $0.8 billion.

Islamic banks could attract SME customers of conventional banks (especially well-served mid-sized SMEs), increasing Islamic financing by $3.1 billion to $4.9 billion and depository base by $0.5 billion to $0.7 billion

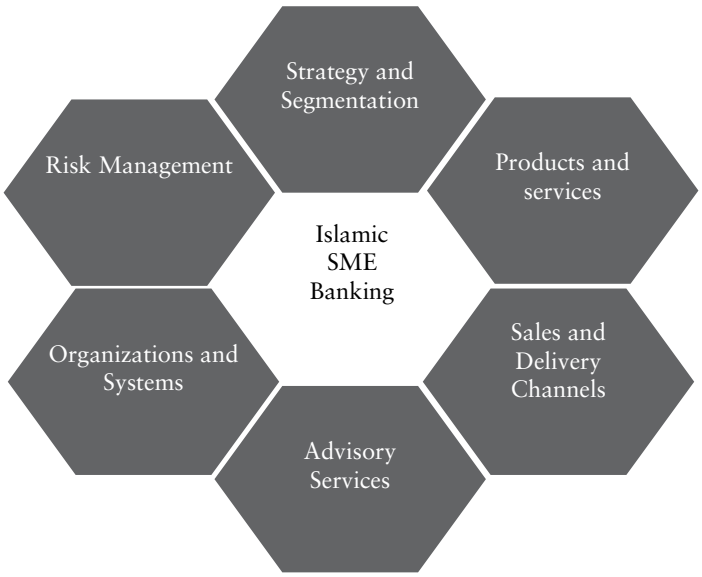
In addition to the 'new to bank' funding and depository potential, Islamic banks possess considerable potential to convert or cannibalize the existing funding/lending and deposit portfolios of conventional banks, primarily pertaining to the existing well-served SMEs (mostly middle-sized enterprises). These mid-sized SMEs deal with conventional banks due to the non-availability of appropriate Islamic banking products, complex Islamic transactional processes, and most importantly, stringent access to finance provided to SMEs by Islamic banks (currently, Islamic banks' SME sector penetration is just 4 percent vis-à-vis the conventional banks' 7 percent)[70]. However, considering the availability and feasibility of adopting Islamic banking products as an alternative to conventional banking, 5 percent to 8 percent of these mid-sized SMEs would shift to Islamic banking specifically due to religious reasons. This could provide Islamic banks a funding conversion or cannibalization opportunity of $3.1 billion to $4.9 billion and deposit conversion of $0.5 billion to $0.7 billion.

70 State Bank of Pakistan

Strategic operational adjustments can help Islamic banks target SMEs more effectively

In order to capitalize on the funding and depository potential, Islamic banks need to look beyond the conventional 'one-size-fits-all' approach and provide SMEs with customized value additions, much akin to what many conventional banks are now increasingly offering. The required competency framework is highlighted below where banks would need to acquire the required proficiencies for building and managing a successful "Islamic SME Banking" business:

Figure 21: Strategic operational adjustments to target SMEs



I. Strategy and Segmentation

A dedicated Islamic SME Banking strategy and business model is critical: Banks would need to adopt specific market segmentation approaches to be able to better understand the market dynamics, quantify the business opportunity, build appropriate propositions, and deploy the optimal operating model. Customers' lack of awareness of banks and institutions (especially Islamic ones) that offer SME finance propositions creates a huge supply-side gap. Islamic banks can fill this gap by effectively branding and marketing Islamic propositions for SMEs as well as by creating separate business units/divisions with specialized SME strategies.

II. Products and Services

Borrowing solutions: Traditional products may now allow banks to acquire the required scale for a profitable Islamic SME portfolio. Hence, it would be necessary to tailor existing corporate and retail banking products and, more importantly, build product programs and portfolio approaches.

Offering non-borrowing services: Islamic banks should broaden product and service offerings by providing non-borrowing services such as cash management, payroll management, payments, collections, and trade finance solutions. Internet banking and mobile banking services should also be considered along with provisions for SME-specific debit cards with daily limits.

III. Sales and Delivery

Introduction of new Islamic SME banking models: Islamic banks should use new SME banking models to target SMEs. The use of mobile banking (such as United Bank's Omni facility) to enhance financial inclusion and reduce the cost of administering an account could be a good initial step. Another step would be to

collaborate with Pakistan's 13,000[71] strong post office networks to cater to SMEs in Tier 2 and Tier 3 cities. The use of banking correspondents to ensure last-mile connectivity of banking services could also be a focus area. Islamic banks could establish SME-specific branches in key SME clusters. Moreover, Islamic banks need to streamline or realign their transaction execution processes to make the execution of Islamic transactions easier for SMEs.

IV. Advisory Services

Focus on advisory services: A majority of SMEs do not have sufficient knowledge about finance and management, business skills (such as financial modeling, future planning, and forecasting) and information related to government rules and regulations that impact their functioning. This knowledge deficit prevents SMEs from evolving into larger and more sustainable enterprises. Islamic banks should provide SMEs with advisory services to aid and facilitate growth.

V. Organization and Systems

Better training for SME professionals: There is a shortage of staff knowledgeable about Shariah-compliant products across financial institutions due to the inadequate amount of time and effort spent on training them. To rectify this, financial institutions need to incorporate better training procedures into their organizational frameworks. Investing in employee training would allow Islamic banks to serve SMEs more effectively and help increase market penetration.

VI. Risk Management

Adopt better and more sophisticated methodologies: Most financial institutions rely on traditional banking approaches to identify and target viable SMEs. Financial institutions need to incorporate appropriate credit evaluation techniques (such as behavioral scoring, credit scoring, and cash flow and program-based lending) and build stronger early warning systems and collections frameworks to target and manage SMEs better, price products more effectively, and reduce risk exposure.

Streamline loan application processes for SMEs: SMEs face difficulty in applying for loans due to the amount of documentation required and the long approval process (exceeding more than a month). Most SMEs lack the documentation required to apply for a loan. The financial requirements of SMEs are urgent compared with those of large-scale corporate enterprises. As a result, the approval process must be shortened. Islamic banks need to streamline processes and focus on building relationships with SMEs (existing and prospective customers), which would ensure quick delivery of credit.

In order to acquire the required competencies for sustainable, profitable, and high performing Islamic SME portfolio, banks may need to seek technical assistance. SME banking is a line of expertise hardly available in the MENA region and banks in Pakistan have not been able to champion this segment owing to lack of understanding of SME banking disciplines, best business and risk management practices.

71 Government of Pakistan

06.
Conclusion

Pakistan's Islamic financing market for SMEs is estimated to be worth $2.6 to $3.8 billion over the next few years, comprising SMEs that are creditworthy but do not borrow from conventional banking institutions due to religious beliefs.

Pakistan's banking system has evolved significantly and is a vital component of the country's economy. Islamic banking is one of the fastest-growing sub-segments in the sector, with assets expanding at a compound annual growth rate (CAGR) of 38 percent over the last six years. Shariah-compliant assets account for 8.6 percent of overall banking assets in Pakistan[72]. During the same period, Islamic deposits increased at a CAGR of 42 percent[73]. The central bank is developing a strategic five-year plan (2013–2017) for Pakistan's Islamic banking industry, especially focused on Islamic finance for the small and medium enterprise (SME) sector.

Pakistan's SME sector accounts for -30 percent of gross domestic product (GDP), 35 percent of manufacturing value added, and 25 percent of exports from the manufacturing sector[74]. SMEs continue to benefit from various government initiatives aimed at promoting the sector.

The sector remains significantly underfunded despite such measures. Bank lending to SMEs as a percent of total lending declined to 6.8 percent in 2012 from 11.7 percent in 2008[75]. Lending to the sector by Islamic banks dropped to 4.1 percent in 2012 from 9.8 percent in 2008, primarily due to the cautionary approach taken by banks to maintain their asset quality[76]. The lack of awareness about Islamic banking and the limited range of Islamic products available for SMEs are two factors responsible for the decline in Islamic SME lending. Additionally, it is estimated that about 20 percent to -25 percent[77] of SMEs do not approach banks for finance due to religious reasons.

Most SMEs seek finance to meet their working capital requirements and rely largely on informal sources for funds. Islamic banks offer deposit products as well as trade finance and cash finance products under the Murabaha and diminishing Musharaka structures. However, they should consider offering SMEs the equivalent of conventional overdraft facilities (offered by conventional banks). The most important steps that Islamic financial institutions need to take to tap the SME sector are similar to what several conventional banks are now doing, i.e. streamlining their product offerings (make them more SME-focused), investing in a well-trained workforce, improving processes, and expanding their presence in rural and urban areas alongside SME clusters. Islamic banks should also consider offering the SME sector non-borrowing services, such as cash management services and branchless banking, etc. However, banks in Pakistan would need guidance and support to successfully implement this strategy as they lack the requisite knowhow and expertise.

From a funding perspective, the manufacturing sector offers Islamic banks the highest potential (say over 50 percent, based on the fact that, currently, more than 70 percent of Islamic SME financing is towards the manufacturing sector[78]) over the next few years due to the underlying potential and the capital intensity of operations.

72 State Bank of Pakistan
73 State Bank of Pakistan
74 Small and Medium Enterprises Development Authority
75 State Bank of Pakistan
76 State Bank of Pakistan
77 Primary research
78 Primary Interview with officials of Islamic Banking Department, State Bank of Pakistan

Several initiatives are being undertaken to improve the reach of Islamic banking in Pakistan. However, it is important that SMEs and bank employees are educated on the various aspects and benefits of Islamic banking and awareness increases about products and structures. If banks were to successfully tap SMEs that do not bank due to religious reasons, the potential funding opportunity in the SME sector could be $2.6 billion to $3.8 billion. There is also a depository potential of $0.8 billion to $1.3 billion from this segment.

Islamic banking, as a practice, has immense potential in Pakistan. The strong perception about Islamic banking and the high growth exhibited by the sector would bode well for the sector over the next few years. Islamic banks should capitalize on the potential within this sector by diversifying its products and services, easing transactional procedures, reducing documentation, training staff on the various aspects of Islamic banking, and improving existing infrastructure and capacity to better serve the needs of the SME population.

Implementing these measures would enable Islamic banks in Pakistan to tap the SME sector's demand for Islamic finance more effectively and spur growth in the industry

Research Scope and Methodology

IFC, private sector arm of the World Bank Group, provides a combination of SME Advisory and Investment Services for optimal results. The services fall in the following categories:

Advisory Services:

- Build capacity of financial institutions in strategy, market segmentation, credit risk management, and product development through new approaches and systems to scale up their financing for SMEs on a sustainable basis
- Promote sub-sector focus, especially on women-owned SMEs, sustainable energy SME projects, agriculture SMEs, and leasing
- Raise awareness on best practices in the SME finance space
- Develop credit reporting infrastructure based on country needs
- Support development of secured transactions, collateral registries, and legal and regulatory framework
- Build capacity of public/private stakeholders through advice and training

Investment Services:

- Make equity investments in financial institutions/equity funds for SMEs
- Funded lines to expand investment and working capital lines, especially in illiquid markets
- Blended finance options to support the expansion of IFC's risk appetite (e.g., grace periods, performance-based pricing, subordination, higher risk/lower security or in limited cases, local currency positions) [for selected projects]
- Increase focus on underserved segments, e.g., gender, fragile/conflict, agriculture, climate
- Risk Sharing Facilities/Partial Credit Guarantees to enhance risk taking capacity and provide capital relief via low-risk weightings; avoid FX mismatches and encourage domestic resources for SME financing.

The primary objective of this report is to enable IFC to determine the market opportunity for Islamic banking products in Pakistan. The main questions the report addresses are:

- What is the overall SME population is Pakistan and how is it structured?
- Is Islamic banking in Pakistan mature enough to adequately cater to the needs of SMEs?
- What are the products and services that SMEs want from banks?
- What is the size of the SME market opportunity for Islamic banks?

Objectives and scope of the report

The study on Pakistan focuses on the following facets –

- The SME population of the country; and distribution by sector, ownership and geography
- The usage of banking services (lending and deposit) by SMEs
- Ease of SME access to credit and the potential difficulties faced by SMEs in accessing credit
- The potential for Islamic banking services in terms of financing and deposits (in dollar values)

Given the significant challenges faced during the course of research (such unavailability of more recent SME data), the main objective of the study was to provide a high level qualitative analysis to these questions. Given these challenges we are confident that the adopted approach portrays an accurate picture of the SME sector.

Defining small and medium enterprises

There is no uniform definition to classify SMEs in Pakistan with various government authorities adopting different criteria to define the sector. However, the widely acknowledged and used definition to classify SMEs is that prescribed by the State Bank of Pakistan (SME Prudential Regulations).

Table 7 : SME definition as per Prudential Regulations

Type of Enterprise	Number of Employees	Sales turnover
Small Enterprises	Up to 20 (including contract employees)	Up to $0.8mn
Medium Enterprises	21 - 250 (for manufacturing and services), and 21 - 50 (for trading companies)	Above $0.8mn and up to $4.0mn

Defining the number of SMEs

To define the number of SMEs, the study first determined the total number of MSMEs operating in Pakistan. Data published for micro-enterprises by MicroWatch (Quarterly Publication issued by Pakistan Microfinance Network) in 2007 and an establishment survey conducted by SMEDA in 2005 (published in 2009) were relied upon to determine the MSME universe. Since no other surveys/census/updates were conducted by the government or private bodies, extrapolation was relied upon to forecast MSME population numbers to the current period. Real GDP growth figures (sourced from the IMF) were used as a proxy to forecast the increase in the MSME population as this is a broad indicator of economic activity across the economy of a whole. The dominance of MSMEs in the economy would make the sector sensitive to changes in GDP growth. The extrapolated number was validated through interviews with government officials and commercial bankers to ensure consistency. Based on this method, the study determined the number of Micro and SME enterprises operating in Pakistan

- Micro enterprises: These enterprises were estimated to account for 82% of the total MSME universe or 4,988,661 enterprises
- Small and Medium enterprises: The SME universe was estimated to account for 18% of the total MSME population or 1,103,241 enterprises.

Credit usage by SMEs

Information from multiple sources was collated to provide details on the credit usage by SMEs in Pakistan. This included accessing studies published by the IFC, IMF and the World Bank on SME access to finance. More importantly, annual reports and other relevant publications (such as yearly development finance reports) from the State Bank of Pakistan were accessed to gather the necessary information.

In addition to secondary research, primary interviews were also conducted with commercial banks and SMEs to validate and expand upon secondary research insights. A combination of primary interviews, previously published studies, IFC-McKinsey MSME Database-June-2012 and financial reports of banks was used to calculate the average funding per enterprise or the average loan size. The average loan size thus derived ($5,000 for un-served SMEs and $85,000 for under-served SMEs) was a critical input for the funding potential calculations.

Primary interviews

Targeted interviews during the course of research covered both demand and supply side aspects. In-depth interviews were conducted with banks, financial institutions and SMEs to elicit different viewpoints and get a holistic picture. Key points that were covered within the discussion guide included:

- **Access to finance:** The ease of availing finance from formal institutions, banks' lending criteria, difficulties faced during the financing process, and ways of overcoming these difficulties
- **SME specific Islamic banking products:** Mapping the Islamic banking products offered by banks to the SMEs with the products and services that are demanded/required by the SMEs
- **Regulatory framework and enabling environment:** Specifying government initiatives to promote Islamic banking (and Islamic banking for SMEs), identifying sentiments towards such services amongst banks as well as SMEs that would assist the growth of the sector
- **Awareness about Islamic banking services:** Determining the level of awareness about Islamic banking services amongst SMEs. This was a key research area, as would prove to be an important indicator of the future potential of the Islamic banking market. In Pakistan, approximately 25 percent enterprises exhibited strong interest in Shariah-compliant products.

Supply side analysis

In order to understand the supply side landscape, 20 out the 34 commercial banks operating in Pakistan were interviewed to identify and classify the various SME banking services and Islamic Banking and Financing services offered.

Table 8 : List of banks contacted

Pakistan			
Meezan Bank	Al Baraka	Dubai Islamic Bank	Bank Al Islami
Bank Al Habib	Bank Alfalah	Askari Bank	Habib Metropolitan Bank
SAMBA	MCB Bank	Summit Bank	Silk Bank
NIB Bank	JS Bank	Allied Bank	National Bank of Pakistan
Soneri Bank	Standard Chartered	United Bank Limited	Habib Bank Limited

In addition, respondents were also questioned on the customers' (SME's) opinions and preferences (if any) towards Islamic banking products in the respective countries. Additionally, the survey aimed to identify

- The existing gap (if any) between the services demanded by SMEs vis-à-vis the services currently offered by banks and FIs
- Customer preference (or lack thereof) towards Islamic banking services
- Average value of lending per enterprise

Table 9 : Supply side analysis template

Sr. No.	Pakistani Domestic Banks	Doing Islamic Banking	SME Proposition Available	Doing Islamic SME	Separate Business Division	Branding	Overall Portfolio Penetration	Islamic Penetration	SME Product Availability	Islamic SME Products Availability
1	--	--	--	--	--	--	--	--	--	--

Demand side analysis

SMEs were classified into un-served, underserved and well served categories based on available financial statistics, primary interviews with SMEs, commercial bank representatives and regulators. The survey was aimed to identify

- The prevalence of banking (regular, SME or Islamic banking) within the SME sector
- Percentage of enterprises eligible for banking services (based on credit criteria, proximity to bank / financial institutions etc.)
- Challenges faced while accessing banking / financing services
- Awareness about Islamic banking services, and willingness to avail such services

The results / hypothesis was tested with existing SME and/or Islamic SME portfolios and deviations were re-forecasted after consulting the banks and regulatory authorities of the respective countries.

Funding potential calculations

The calculations to determine the funding potential ("new to bank" and cannibalization / conversion potential) for Pakistan were based on

- SME population numbers
- the classification of SMEs into well served, underserved and un-served categories based on demand side analysis
  - Well served SMEs: Large and mid-sized SMEs with access to the banking system, which were able to meet their financial needs fully. In Pakistan they comprise 11 percent of the total SME population (121,838 enterprises).
  - Underserved SMEs: Mid-sized SMEs with access to the country's banking system that were able to meet their financial needs only partially. These enterprises, which represent 22 percent of the total SME population (243,675 enterprises), avail formal financing (Islamic or conventional).
  - Un-served SMEs: Small sized businesses that are excluded from the banking system with no access to finance. Consequently they were unable to meet any of their financial needs. These enterprises represent 67 percent of the SME population (737,727 enterprises) who do not borrow at all for various reasons, including religious beliefs.
- the average funding potential based on SME credit usage trends, and
- the future penetration of Islamic banking services within the underserved and un-served sectors based on religious perceptions (sourced from previous studies)

The funding potential was calculated for each category (well served, underserved and un-served) based on the average funding size and the number of SMEs in each category. Through a combination of primary interviews, financial reports of banks as well as previously published studies and IFC-McKinsey MSME Database-June-2012 data, the average loan amount for well served enterprises was estimated at $250,000. Similarly, the average loan amount was estimated to be $85,000 for underserved SMEs and $15,000 for un-served enterprises.

To further ensure the relevance of the funding potential estimates, optimistic and pessimistic scenarios were visualized based on several ground realities (banks executing SME acquisition strategies, and SMEs displaying greater preference for Islamic products).

Table 10 : Funding Potential Calculations

Categories	No. of Enterprises	%	Max. Credit Limit Size in US$	Adaptability towards Islamic SME in percentage		Islamic Funding Potential in US$ 'mn'	
				Bull Case Scenario	Bear Case Scenario	Bull Case Scenario	Bear Case Scenario
	a		b	c	d	(axbxc)	(axbxd)
Un-Served	737,727	67	5,000	15%	20%	553	738
Under-Served	243,675	22	85,000	10%	15%	2,071	3,107
Total 'New to Bank' Potential	981,403					2,625	3,845
Well-Served	121,838	11	250,000	5%	8%	1,523	2,437
Total ' Conversion Potential	121,838					1,523	2,437
Total Potential	1,103,241					4,148	6,281

Disclaimer

The information and analysis provided in this report have been based primarily on publicly available data, and other sources deemed to be reliable. These sources have been mentioned throughout the report, wherever applicable. Efforts have been made to ensure accuracy of data through cross validation from multiple sources and inputs from industry participants. Opinions and statements contained in this report are based on current economic and market conditions and are subject to change without notice.

Table 11 : Islamic deposit products offered by major banks in Pakistan

Bank Name	Deposit Products						
	Current Account	Saving Account	Specialize Facilities Account - Individual	Specialize Facilities Account - Business	Term Deposit - Confirmed rate	Term Deposit - Non Confirmed rate	Term Deposit - Specialize
Al Barakah Bank (Pakistan) Limited	●	●	●	◐		●	
Faysal Bank	●	●	●	●		●	
Dubai Islamic Bank	●	●	●	◐		●	●
Bank Al Islami	●	●	●	◐		●	●
Bank Al Habib	●	●				●	
Bank Al Falah	●	●	●	●	●	●	●
Askari Bank	●	●				●	
Habib Metropolitan Bank	●	●				●	
MCB Bank	●	●	●			●	
Habib Bank Limited	●	●	●	◐		●	
United Bank Limited	●	●	●	◐		●	
Standard Chartered Bank	●	●	●	●	●	●	●
Soneri Bank	●	●	●			●	
National Bank of Pakistan	●	●				●	
Meezan Bank	●	●	●	●	●	●	●
Burj Bank Limited	●	●	●	●		●	
Allied Bank	◔	◔					
JS Bank	◔						
NIB Bank	◔						
Silk Bank	◔	◔					
Summit Bank	◔						
SAMBA	◔						

Source: Individual Bank websites

● Fully Servicing ◐ Partial Servicing ◔ Just Started

Table 12 : Islamic financing products offered by major banks in Pakistan

Bank	Financing Products												
	Auto Finance	House Finance	Project or Development Finance	Letter of Credit – All Types	Trust Receipt – All Types	Shipping Guarantee	BNC/ Acceptance	Avalization	Performance and Payment Guarantees	St-Business Finance	Receivable Finance	Pre-Sale Finance	EVM Finance – LT
Al Barakah Bank (Pakistan) Ltd.	●	●	●	●	●	●	●		●	●	●	●	●
Faysal Bank	●	●		●	◐								
Dubai Islamic Bank	●	●		●	◐	●	◐		◐	●	◐	●	●
Bank Al Islami	●	●	●	●	◐	●	◐		◐	●	◐		●
Bank Al Habib	●		●	◔	◐								●
Bank Al Falah	●	●	●	●	●	●	●		●	●	●	●	●
Askari Bank	●	●	●	◔	◐								●
Habib Metropolitan Bank		●	●	◔	◐					◐			●
MCB Bank	●			◐	◐				◐	◐			●
Habib Bank Limited	●		●	◔	◔				◔	◔			●
United Bank Limited	●	●			◔								
Standard Chartered Bank	●		●	●	●	●	●		●	●	●	●	●
Soneri Bank													
National Bank of Pakistan				◔	◔				◔	◔			
Meezan Bank	●	●	●			●	●		●	●	●	●	●
Burj Bank Limited	●		◔	◐	◐				●	●	●		●
Allied Bank													
JS Bank													
NIB Bank													
Silk Bank													
Summit Bank													
SAMBA													

Source: Individual Bank websites

● Fully servicing ◐ Partial Servicing ◔ Just Started

Table 13 : Other Islamic products and services offered by major banks in Pakistan

Bank	Other Islamic Products and Services		
	Trade Services Advisory	Cash Management	Online Banking
Al Barakah Bank (Pakistan) Limited			●
Faysal Bank		◐	●
Dubai Islamic Bank	◔	◔	●
Bank Al Islami	◔		●
Bank Al Habib			●
Bank Al Falah	◐	◔	●
Askari Bank			●
Habib Metropolitan Bank			●
MCB Bank			●
Habib Bank Limited			●
United Bank Limited			●
Standard Chartered Bank			●
Soneri Bank		●	●
National Bank of Pakistan			●
Meezan Bank		●	●
Burj Bank Limited			●
Allied Bank			
JS Bank			
NIB Bank			
Silk Bank			
Summit Bank			
SAMBA			

Source: Individual Bank websites

● Fully servicing ◐ Partial Servicing ◔ Just Started

Table 14 : Demand for Islamic banking products from the SME sector

Product	Product Category	Islamic Structure	SME Requirement		
			Manufacturing	Trading	Services
LIABILITY PRODUCTS					
Current Account	Current Account	Quard Al Hassan	High	High	High
SME Business Current Account		Quard Al Hassan	High	High	High
Savings Account	Savings Account	Mudarbah	Low	Low	Medium
Term Deposit – Confirmed Rate	Term Deposit	Wakala	Medium	Medium	Low
Term Deposit – Unconfirmed Rate		Mudarbah	Medium	Medium	Medium
ASSET PRODUCTS					
Letter of Credit – Sight/Usance – All Types	Standardized Trade Finance – Buying	Murabaha/ Musharaka/Wakala	High	High	Low
Acceptance Under Usance Bill		Murabaha	High	High	Low
Trust Receipt – All Types	Standardized Trade Finance – Buying	Murabaha	High	High	Low
Bills Negotiated Credit (BNC) – Confirmed Rate		Murabaha	High	High	Low
Shipping Guarantee		Murabaha	High	High	Low
Avalization		Murabaha	High	High	Low
Short-Term Finance	Standardized – Post-Sale ST Finance	Murabaha/Salam	High	High	High
Receivable Finance (Factoring PDCs/ Invoice/Export LCs)	Standardized – Post Sale ST Finance	Murabaha/Salam	High	High	High
Term Finance – Equipment Leasing	LT – Asset Base/Non-Asset Base Finance. EVM	Ijarah	High	High	Low
Term Finance – Project or Development Finance		Musharaka/Ijarah	High	High	High

Source: Israa Capital Analysis

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Notes

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