The Role of Small and Medium-size Enterprises (SMEs) in the Socio-economic Stability of Karachi

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ABSTRACT

Purpose: The purpose of this study is to identify the core constraints in financing of SMEs in Karachi that impede their growth and even undermine their liquidity and financial position. Literature review: The problems and constraints are faced by small and medium-size enterprises (SMEs) in Karachi with regard to access to financing. Along with Karachi, the other cities and areas in Pakistan are facing alike problems. Methods: This study is exploratory in nature and includes quantitative and qualitative data. Data was collected through well designed questionnaire from a sample group of 500 respondents of SMEs in Karachi. In addition, one-on-one formal and informal interviews were also taken from various businessmen and bankers. Conceptual Model: A conceptual model/ framework were devised to test and ascertain the statistical validity of the study. It includes dependent variable SME financing, and independent variables, financing constraints, functional/ internal barriers, government support and incentives, and SMEs growth and development. Findings: The findings revealed that most people/ SMEs feel reluctant to borrow from banks and financial institutes because of stringent collateral requirements, high mark up, lengthy and convoluted documentary process, and to some extent malpractices at banks and financial institutions. The preference of the lending institutions is to finance the large-scale corporate sector. The results of the data analysis confirmed profound relation of dependent and independent variables and accepted the hypotheses. Conclusion: A substantial portion of SMEs possesses great potential of growth. There exists unending opportunities to tap, while banking and financial system in Karachi and Pakistan enjoys enough liquidity but SMEs are unable to enjoy financial leverage because of various financial constraints, lack of support by government institutions and policy makers, and internal weaknesses and flaws of SMEs in managing their businesses. Finally recommendations were lodged.

JEL. Classification: D83; E44; G21

Keywords: Small and Medium enterprise; constraints in financing; Socio-economic Sustainability

1. INTRODUCTION

The development of small and medium-size enterprises plays a pivotal role in the growth and prosperity of nation. Although large-scale corporations, particularly industrial concerns contribute sizably/ largely in gross

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domestic products (GDP) and other economic variables of prosperity but the significance of SMEs is widely recognized around the globe. SMEs make a substantial contribution towards GDP, revenue collection in the form of taxes, fostering entrepreneurship culture, employment opportunities, income generation, skills development of human resources, poverty alleviation, and improving the standard of living and quality of life. Above all the prime economic benefits of SMEs development include encouraging perfect competition and fair distribution of wealth. If there are only large-scale corporations either, then there will be a monopoly in an industry, with a single suppliers, or oligopoly with only few suppliers, or monopolistic competition with only some suppliers, then the major portion of national income and wealth will move within the hands of big capitalists. SME sector, however, begets fair competition and equitable distribution of wealth.

SMEs assist in regional and local development as they accelerate industrialization in rural areas by linking them with the more organized urban sector and help achieve fair and equitable distribution of wealth by regional dispersion of economic activities (SME Bank 2009). According to a report by State Bank of Pakistan the small and medium enterprises have played key role in development of economies like Japan. It has also been playing key role in providing impetus to the development of some of the world’s best economies like Taiwan, Korea, Hong Kong and China. Countries in South America and India have also been focusing their efforts in developing the SME sector. Pakistan is not an exception to this as both the Government of Pakistan and the SBP has been trying to give impetus to their efforts aiming to develop SME sector in Pakistan. In this regard government has restructured the key support institutions such as SMEDA and SME Bank. However, the problems of small businesses differ than that of medium size businesses. As stated by West (2010) by quoting in the Economist newspaper, ‘small business has a big problem that is access to finance.’ Access to finance usually means access to bank finance, because small and medium size enterprises (SMEs) are usually too small to access bond and equity markets. Access to finance is one of the most significant challenges for the creation, survival, and growth of SMEs.

There appears a mushroom growth of SMEs through out Karachi including the SMEs in leading industrial estates, cottage industrial areas, industrial parks, Export Process Zones (EPZs), trade plazas, malls, and small business units scattered in the city and its surrounding villages. Historically, many SMEs thrived in Karachi and in the country because of appropriate entrepreneurial spirit and skills, managerial and labor skills, access to finance (as one of the foremost salient success factor), access to technology, marketing skills, innovative production, dedicated customer services, and the drive and capability to meet the customer expectations and opportunities better than the competitors. But unfortunately, all the SMEs and micro enterprises in Karachi and Pakistan as a whole are unable to enjoy access to finance and particularly the expected level of finance and not all of them possess appropriate level of managerial and technical skills to thrive and excel in the market place. Since the independence of Pakistan in 1947, the nation has witnessed the tremendous growth of thousands of micro, small, and medium enterprises in Karachi and all across the country.

1.2 SME Defined

Generally, SME means small and medium size enterprises but one definition lodged by State Bank of Pakistan (SBP) refers SME sector as the SME sector can itself be classified into micro, small, and medium enterprises (SBP 2010). As defined by SBP- **SME** means an entity, ideally not a public limited company, which does not employ more than 250 persons (if it is manufacturing concern) and 50 persons (if it is trading/ service concern) and also fulfills the following criteria of either ‘a’ and ‘c’ or ‘b’ and ‘c’ as relevant:
(a) A trading/ service concern with total assets at cost, excluding land and buildings, up to Rs50 million.
(b) A manufacturing concern with total assets at cost, excluding land and building, up to Rs100 million.
(c) Any concern (enterprise) with net sales not exceeding Rs300 million as per latest financial statements.

1.3 Salience of SMEs

SMEs are considered the engine of economic growth in both developed and developing countries, as they generate more employment opportunities with relatively small investment than large-scale firms do.
SME provide low cost/ investment employment because the unit cost of persons employed is lower for SMEs than for large-size units; and they are more labor intensive than large-scale enterprises, since labor uses either manual, or semi automatic, and seldom uses automatic processes of production.

SMEs assist in regional and local development because SMEs accelerate rural industrialization by linking them with the more organized urban sector. SMEs help to achieve fair and equitable distribution of wealth by regional dispersion of economic activities and contribute significantly to export revenues because of the low-cost, labor intensive nature of its products; have a positive effect on the trade balance since SMEs generally use indigenous raw materials; assist in fostering a self-help and entrepreneurial culture by bringing together skills and capital by linking various lending and skill enhancement schemes; impart the resilience to withstand economic upheavals and maintain a reasonable growth rate since being indigenous is the key to sustainability and self-sufficiency (SME Bank 2009).

The economic and social importance of the Small and Medium Enterprise (SME) sector is well recognized in academic and policy literature (UNECE 2007). It is also recognized that these actors in the economy may be underserved, especially in terms of finance (OECD-APEC 2006). There have been numerous schemes and programs in different economies to build the SME sector. However, there are a number of distinctive recurring approaches to SME finance (Berger and Udell 2005).

- Collateral based lending offered by traditional banks and finance companies is usually made up of a combination of asset-based finance, contribution based finance, and factoring based finance, using reliable debtors or contracts.
- Information based lending usually incorporates financial statement lending, credit scoring, and relationship lending.
- Viability based financing is especially associated with venture capital.

1.4 Problem Statement

As per the report of SBP (2009), the total financing to SMEs in Pakistan has been substantially declined by 20% from Rs. 437 billion to Rs. 348 billion from 2007 to 2009, due to slowing economy and loan defaults. That is why the problem has been selected for a detailed study as: *"the role of Small and Medium-size Enterprise (SME) Financing in the Socio-economic stability in Karachi.* "With statement: *Small and Medium-size Enterprise (SME) has not proper access of Finance in the Socio-economic stability in Karachi" With statement:*

1.5 Research Objectives

The research objectives are delineated below:

- To identify core constraints in access to finance by SMEs in Karachi and other pertinent obstacles in the growth and development of SMEs.
- To identify the role of government incentives and support for the growth and development of SMEs and understand their significance.

1.6 The Benefit/ Rationale of the Study

The benefit/rationale to conduct this study is to ascertain the wide gap in demand and supply of finance to SMEs in Karachi, in a bid to offer proposals to overcome their growing needs for finance.

1.7 Scope of the Study

The scope of the analytical research work of this Thesis is to explore the following key points:

- The study will be helpful in pointing out the gaps in SME financing in Karachi.
- The actions required to tackle SME financing constraints.
- The factors which create functional/ internal barriers to SME financing need to be addressed.
- The solutions to develop SME-friendly policies of the government for the growth and development of the SMEs.

1.8 Research Limitations

The key limitations of the research are portrayed hereunder:

- The time frame and financial resources to undertake exploratory activities were limited.
- In conducting interviews, many bankers, the officials of lending institutions, the senior SME leaders, and other stakeholders showed reluctance to express their opinions and considered it as leakage of secrecy.
- Due to lack of higher educational background by many of the owners and top managers of various SMEs, it took a lot of difficulties and time to get them comprehend the questionnaire and get the answers during survey.

1.9 Research Methodology

The qualitative cum quantitative research techniques were utilized to discover innovated solutions for SME financing in Karachi. The data collection methods used in this study included primary data collection techniques i.e. collecting data from unpublished and original sources including surveys. A survey was conducted and a questionnaire was framed, pretested, and filled by a sample of 500 respondents of SMEs in Karachi (males and females of varying ages and social classes, selected on the basis of convenience method) belonging to manufacturers, traders, importers, exporters, and service businesses. The measurement scale selected was Likert scale to know the amount of agreement or disagreement of respondents on a scale of five. Interviews from renowned high profile bankers were taken. One-on-one interviews from officials of SBP, SMEDA, National Bank of Pakistan (NBP), MCB, Habib Bank Limited (HBL), United Bank Limited (UBL), Allied Bank Limited (ABL), Standard Chartered Bank, Albarka Islamic Bank, micro credit banks, ORIX Leasing Pakistan Limited, and high ups of Federation of Pakistan Chambers of Commerce Industry (FPCI, the apex body of trade and industry in Pakistan) were recorded to get acquainted with the latest developments and updates on SMEs. As a businessman, the personal observations and relevant experiences of the researcher also helped in compiling data.

In the secondary data collection method, data was traced from books, magazines, journals, news papers, diaries, internet/ online sources, etc. In particular, data was extracted from the publications of SBP, SMEDA, International Monetary Fund (IMF), World Bank (WB), Asian Development Bank (ADB), United Nations (UN agencies), World Trade Organization (WTO), European Union (EU), research papers, government websites, and other various authentic data sources. The data analysis was carried separately for a quantitative and qualitative assessment to know the relationships among variables and to test the hypotheses.

1.10 Research Hypothesis

Following hypotheses are developed to conduct a thorough study:

H1[1]. High cost of financing proves detrimental for SMEs and overall socio-economic development.

H0[1]. High cost of financing does not prove detrimental for SMEs and overall socio-economic development.

H1[2]. Low cost financing increases the demand for borrowing for SMEs and profitability of banks and creditors.
H0[2]. Low cost financing does not increase the demand for borrowing for SMEs and profitability of banks and creditors.

H1[3]. SME financing heavily depends on removal of financing constraints, functional/internal barriers (of SMEs themselves), and government incentives and support.
H0[3]. SME financing does not heavily depend on removal of financing constraints, functional/internal barriers (of SMEs themselves), and government incentives and support.

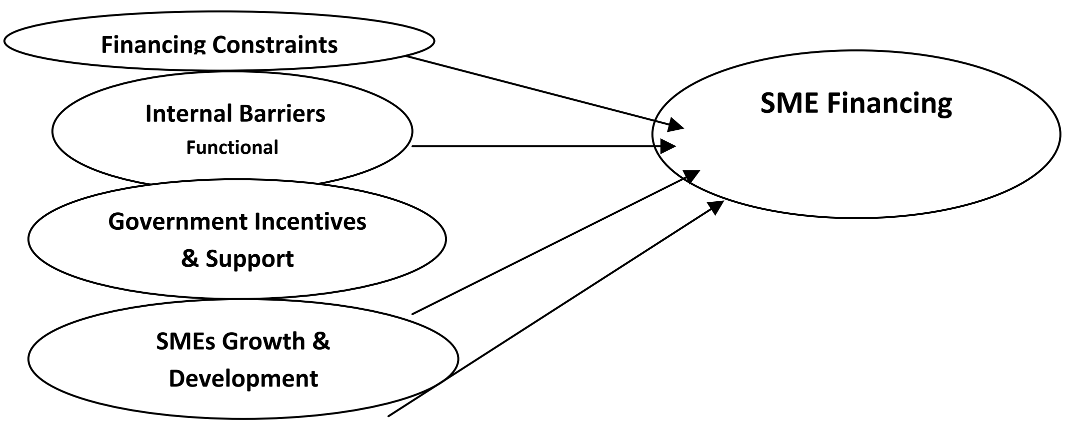
H1[4.] The growth and development of SMEs is directly linked up with capacity building of SMEs and government incentives and support.
H0[4]. The growth and development of SMEs is not directly linked up with capacity building of SMEs and government incentives and support.

1.11 Research Model

The model shows the relationship between various independent variables with dependant variables. The model will be elucidated in chapter 4.

1.11.1 Model/Conceptual Framework on SME Financing

Independent Variables: Dependent Variable



Source: The Author of this Research

1.11.2 Elaboration of the Model/ Conceptual Framework on SME Financing

There appear various kinds of constraints or issues that hamper the growth and development of SMEs in the country. The model exhibits SME financing as a dependant variable, while the independent variables include financing constraints, functional/ internal barriers i.e. internal weaknesses, government incentives and support, and SMEs growth and development. The independent variables serve as obstructions to the growth and development of SME sector and eventually, if these constraints are removed, they will lead to the superb growth and development of the SMEs. The list of such constraints is portrayed below:

Financing Constraints
- Collateral based lending
- Cumbersome and lengthy process of lending
- Preference to large-scale enterprises
- Venture capital financing
- Lack of true Islamic financing

Functional/ Internal Barriers
- Dearth of skilled labor and human resources
- Lack of management skills, marketing, accounting and finance, risk management technology and information technology, and poor work ethics
- Lack of financial information
- Lack of focus on innovation and value addition

Government Incentives & Support
- High cost of borrowing
- Ever-escalating cost of business
- High rate of taxation
- Poor infrastructure
- Lack of good governance and transparency
- Delayed judicial process (of commercial nature)
- Undermined law and order situation

SMEs Growth and Development
- Enhanced productivity
- Increased employment
- Improved income, prosperity, and quality of life
- Reduced poverty
- Investment in family health and education

2. LITERATURE REVIEW

2.1 Emergence of SMEs in Pakistan

Since inception, Pakistan's market evidence mushroom growth of small and medium enterprises. Banks and other financial institutions played pivotal role in financing those entities. The concept of SMEs emerged in Pakistan since 1972 (in the regime of former premier, Mr *Zulifquar Ali Bhutto*). ***Small Business Finance Corporation (SBFC)*** was established by the Government of Pakistan through an Act of Parliament in 1972 with the broad objective to assist small entrepreneurs for self-employment and for setting up cottage industry. SBFC facilitated the masses of small entrepreneurs with disbursing funds on easy terms with reasonable mark up/ interest charges and without collateral. The pith of the financing schemes was focus on the self-employment schemes to generate maximum employment. The loan portfolio mostly comprised unsecured loans or with inadequate collateral (Tanveer 2001).

Unfortunately, SBFC could not accomplish its milestones because of lack of transparency, corruption, and malpractices by both SBFC employees and borrowers. Most of the borrowers obtained funds on the basis of political sources. Due to failures of SBFC, eventually, it was amalgamated into SME Bank Limited effective January 1, 2002 (SME Bank 2009).

In 1998, the government of Pakistan established ***Small and Medium Enterprises Development Authority (SMEDA)*** to support and promote small and medium scale companies. A snapshot of SMEDA's business development services offered to SMEs through a nation-wide network of help desks include (SMEDA 2009):

- Project Identification and Business Plan Development
- Business Information (Library, Databases, Project Briefs, Pre-feasibility Studies)
- Sector Studies
- Assistance in Raising Finance
- Taxation – Sales Tax, Custom Duty, Excise Duty, etc.
- Capacity Building (company incorporation, legal, technical, financial, accounting, marketing, export, etc) (www.iin.com.pk).

In last two decades, both government and private sector have done appreciable work in the SME sector. ***SME bank*** was launched in Pakistan in the year 2001, as part of financial sector restructuring program of Government of Pakistan, Regional Development Finance Corporation (RDFC) and Small Business Finance Corporation (SBFC) were amalgamated into SME Bank Limited effective from January 1, 2002. SME Bank Limited was established to exclusively cater to the needs of the SME sector and to address the needs of this niche markets with tailor-made specialized financial products and services that will help stimulate SME development and pro poor growth in the country. In accordance with the report published by Economic Survey of Pakistan 2008-09 (ESP 09), up to 28th February 2009, SME Bank has financed 7,814 SMEs, disbursed loans amounting to Rs7, 936 million to 54,698 beneficiaries in the country.

Recently, commercial banks have opened SME departments in their branches to support and promote SMEs. Similarly, micro finance banks have extended their facilities to enhance financial leverage of micro enterprises. Leasing companies and other financial institutes have also launched products to strengthen the SME sector. Islamic banking also contributes in hand-holding and support to SME sector by providing financial instruments like Mudarabah, Murabaha, Ijarah, etc.

2.2 Contribution of Pakistani SMEs in the Economic Development

It has been estimated that the SME sector in Pakistan contributes 30% in the GDP, along with agriculture sector provides 90% jobs, accounts for 35% value addition in the manufacturing industry and generates 25% exports earnings [up to US$ 2.5 billion], (SBP 2009). A survey conducted by SMEDA (2008) revealed that 72% of all the SME enterprises were sole proprietors, 12% Partnership (registered), 9% Partnership (unregistered), 6% Private companies and 1% (others). According to the ESP (2009), the SME sector has emerged as a lifeline of Pakistan's economy constituting nearly 99.06 percent of all economic establishments, out of which 53 percent of the establishments belong to Wholesale and Retail Trade, and Restaurant and Hotel sectors, 20 percent are part of manufacturing sector and 22 percent fall in the Community, Social, and Personnel Services sector.

According to very latest statistics provided y SBP (2010a), 90% of the total SME loan portfolio is concentrated in Punjab and Sindh, 64.22% in Punjab and 25.93% in Sindh, while only 10% share is taken by Khyber Pakhtunkhwa, Balochistan, Gligit Baltistan, and Azad Jammu and Kashmir. The SBP report uncovers an overall decline in SME financing was observed, which fell 20% to Rs.348 billion in 2009 from Rs.437 billion in 2007, as a consequence of loan defaults and slowing economy. It was also reported that

89% of the loan disbursements by SMEs were for working capital requirements, which reflects banks' reluctance for providing long-term financing and venture capital needs. According to a recent article on the same issue, the three major cities in Pakistan, Karachi, Lahore, and Faisalabad account for more than 50% of total SME financing in the country and top 20 cities together make up 85% of total SME financing (Dawn: May 17, 2010). The share of SME financing in total lending portfolio in Pakistan is only 10% (Daily Times: May 6, 2010). In 2009, 89% of the SME financing was received for meeting working capital needs, which shows banks' reluctance to finance long-run projects (SBP 2010). According to another publication by SBP in December 2008, at the end of fourth quarter of 2008, the total outstanding credit of SME sector stood Rs383 billion. About 48% of this amount has been availed by manufacturing SMEs, followed by 36.4% by trading SMEs, and the rest i.e. 15.6% by service SMEs. The share of short-term loans (up to 1 year) constitutes about 70.9%, long-term loans (exceeding 3 years) up to 19%, and the rest was the share of medium-term loans (1 to 3 years), i.e. 10.1%. As per SBP review on, the total non-performing loans up to 31-12-2007 stood Rs41.3 billion, which constitutes 9.5% of the total financing to the SME sector in 2007.

The SME sector contributes 60% of GDP and over 70% of total employment in low-income countries (LIC); while they contribute over 95% of total employment and about 70% of GDP in middle-income countries Surprisingly, more than 90% industrial units in the country are small SMEs. 84% of the SMEs have annual revenue of less than Rs0.5 million (DFR 2008).

Table 2.1: Contribution of SMEs in Pakistan in the Economy of Pakistan

Total Numbers of Economic Establishments	3.2 million
Total Numbers of SMEs	99% of all enterprises
(Along with Agriculture) Contribution in Employment	90%
Total % of Non-Agricultural Workforce (emp. in SMEs)	78%
Average No. of Employees in 99% of SMEs	1-10 persons
Share in Export Earning	25%
Share in Gross Domestic Product (GDP)	30%
Share in Manufacturing Industry	35%

Source: Data tabulated from reports of SBP (2009); Federal Bureau of Statistics (09); & Economic Survey of Pakistan 08-09

Table 2.2: Distribution of MSMEs by Sector, As % of GDP

	Sector	**Share in GDP**
1.	Services	17%
2.	Manufacturing	30%
3.	Trade & Hotels	53%

Source: ILO/SMEDA (2002)

2.3 Problems Faced by SMEs in Pakistan

SME sector in Pakistan has amazing potential of development but the key problems include various factors as depicted below:

Till late 90s, the focus of the government, banks, and financial institutions remained mainly on the corporate sector, particularly large-scale industries and manufacturing concerns. The greater concentration of facilitating and financing corporate sector resulted high rates of failures, owing to economic slumps, institutional malpractices, political motives, and damaging activities of labor unions in that sector left the formal lending institutes with huge infected portfolios (SME Bank 2009). A substantial portion of SME sector may not have the security required for collateral. Most of the SMEs appear deficient in accounting and financial information that hinders the effectiveness of financial statement-based lending and credit scoring. This leads to “SME finance gap” particularly in emerging economies (Newberry 2006). Another obstacle is lack of business plans/ viability report that is to assess the cash flows of business and expected return on investment. Since the viability, based approach provides general business development assistance (Kamanyi 2003). Other major causes are lack of accounting and other information; and insufficiently high levels of profitability, gearing, liquidity, and other performance criteria on the part of funding applicants (ISRP 08). Some other constraints in the swift growth of SMEs in Pakistan include shortage of skills, scarcity of capital goods, poor management, lack of data on the sector, resistance to change and marketing (SBP 2009). Another report highlights that one of the problems being faced by this sector is that it does not have access to formal sources of financing (their formal credit usage is around 12%). Interestingly enough, compared to the high default rate of 65% among large concerns, SMEs default rate is only 15% (Tanveer 2001).

According to a report by World Bank Pakistan (WB 2009), there is an enormous growth potential for financial services in Pakistan, especially in rural areas. Around one third of the population borrows, but only 3% use formal services to do so. The same report further adds that an incomplete legal and regulatory framework and non-SME-friendly products and procedures hamper increased SME lending. Indirect costs, legal fees, collateral registration, and documentation make bank lending expensive for small and medium enterprises (SMEs), (WB 2009). A similar report on SME sector in Canada highlights a situation, which seems common in Pakistan as well. A research report by International Monetary Fund (IMF) reveals that financing SMEs may be a challenge. Small loans do not always justify the overhead costs of financial institutions. Many SMEs are start-ups, with little or no credit history, and with few tangible assets to secure a loan. A large portion of SMEs offer untested ideas and innovative products whose commercial success is uncertain (IMO 2007).

A similar report on SME sector in China also highlights a situation, which seems a resembling to the Pakistani situation. A study by Asian Development Bank (ADB 2002) reveals that SME investments are difficult to evaluate, take time to mature, and difficult to liquidate. In China, major institutional investors (including pension funds and insurance companies) are not allowed to invest in private SMEs. The study makes insights on international best practices on SME financing and states that to encourage investment in SMEs, most countries have the programs that either increase potential return to investors, or reduce risk of loss (ADB 2002).

2.4 SME Policy

The SME Policy 2006 is the latest available policy also called as SME Policy 2007. It is designed by the Government of Pakistan, which has taken input from various government departments and sources. This was the 1st ever policy on SMEs in Pakistan that came into being with the aim to facilitate and promote SMEs across the country. Special attention was paid to build the overall capacity of SMEs including financial, technical, entrepreneurial, managerial, human resources, marketing, and exports capability. The SME Policy was developed as a result of the deliberations of the SME Task Force and its four Working Committees. The SME Policy formulation was a participatory process through executives from ministry of production, industries, and special incentives, ministry of commerce, SBP, SMEDA, and other public sector institutions were involved, while the private sector bodies included, chambers of commerce and industries, trade associations, public sector organizations, and more than 1000 SMEs were consulted across the country (MIp. 2010)

2.5 SMEs Promotion by Private Sector

The concept of SMEs has been widely acknowledged and promoted by the private sector in Pakistan. On the front of the private sector in Pakistan, all the branches of chamber of commerce and industry and trade associations have formulated SME committees within their offices. The chairmen and members of such committees address, promote, and protect the interests of SMEs around the country. UNISAME (Union of Small and Medium Enterprises) is the specialized body of the private sector to deal with the issues of SMEs. On the academia side, business and commerce graduates are fully aware of the notion and significance of SMEs (wwwunisame). FPCCI has also set an SME standing committee to deal with the affairs of SMEs. The Committee regularly reviews and proposes the Government the policy recommendations about SMEs in a bid to promote and safeguard the interests of the SMEs (FPCCI 2010). The Committee has added input in the SME policy as well.

3. DATA ANALYSIS

Table 3.1: Descriptive Statistics

	N	Mean	Std. Deviation
SME financing	500	3.7900	.68964
Financing constraints	500	3.4988	.54813
Functional/ internal barriers	500	3.5500	1.22903
Government incentives and support	500	4.0700	.82179
SME's Growth and Development	500	4.3250	1.25699
Valid N (list wise)	500		

The ***quantitative data analysis*** has been undertaken through the software, SPSS (Statistical Package for Social Sciences) by using descriptive statistics, reliability test, and correlation techniques to test the model. The results are tabulated and elucidated hereunder:

According to respondents, opinions, the rating on independent variable SME Growth and Development was the highest with a mean of (4.32). The rating of Government Incentive and Support was second highest with a mean of (4.07), the rating of SME Financing was third highest with a mean of (3.79), the rating of Functional/ Internal Barriers was fourth highest with a mean of (3.55) and the rating of Financing Constraints was the lowest with a mean of (3.49).

The standard deviation of respondents' opinions on "Financing Constraints" was the least (0.54), as compared to the other dimensions. This indicates that there is the highest participation in SME Financing dimension. The standard deviation of respondents' opinion on SME Growth and Development was the highest (1.25), as compared to other dimensions. This indicates that there is the least involvement in SME Financing dimension.

Table 3.3: Correlations

		SME Financing	Financing Constraints	Functional /Internal Barriers	Government Incentives And Support	SMEs' Growth And Development
SME Financing	Pearson Correlation	1	.937(**)	.929(**)	.966(**)	.931(**)
	Sig. (2-Tailed)		.000	.000	.000	.000
	N	500	500	500	500	500
Financing Constraints	Pearson Correlation	.937(**)	1	.875(**)	.921(**)	.903(**)
	Sig. (2-Tailed)	.000		.000	.000	.000
	N	500	500	500	500	500
Functional Internal Barriers	Pearson Correlation	.929(**)	.875(**)	1	.884(**)	.857(**)
	Sig. (2-Tailed)	.000	.000		.000	.000
	N	500	500	500	500	500
Government Incentives & Support	Pearson Correlation	.966(**)	.921(**)	.884(**)	1	.961(**)
	Sig. (2-Tailed)	.000	.000	.000		.000
	N	500	500	500	500	500
SMEs' Growth And Development	Pearson Correlation	.931(**)	.903(**)	.857(**)	.961(**)	1
	Sig. (2-Tailed)	.000	.000	.000	.000	
	N	500	500	500	500	500

** correlation is significant at the **0.01** level (2-tailed).

The correlation values show that there is a positive correlation of SME Financing with Financing Constraints, Functional/ Internal Barriers, Government Incentives and Support and SME Growth and Development. The dependent variable "SME Financing" has the strongest correlation with Government Incentives and Support (0.966**), then with Financing Constraints (0.937**), with SMEs' Growth and Development (0.931**) and with Functional/ Internal Barriers (0.929**).

The results also accepted ***the hypothesis*** framed for the study and met its objectives, as delineated below:

$H1^1$. High cost of financing proves detrimental for SMEs and overall socio-economic development. ACCEPTED

$H1^2$. Low cost financing increases the demand for borrowing for SMEs and profitability of banks and creditors. ACCEPTED

$H1^3$. SME financing heavily depends on removal of financing constraints, functional/ internal barriers (of SMEs themselves), and government incentives and support. ACCEPTED

H1[4]. The growth and development of SMEs is directly linked up with capacity building of SMEs and government incentives and support. ACCEPTED

The research objectives were also fulfilled with quantitative results, as delineated below:

To identify core constraints in access to finance by SMEs in Karachi and other pertinent obstacles in the growth and development of SMEs. Objective FULFILLED.

To identify the role of government incentives and support for the growth and development of SMEs and understand their significance. Objective FULFILLED.

The findings of qualitative research suggest that most people/SMEs borrow but they use informal channels. They invest from their savings and retain earnings or borrow from friends and family members. Most of them feel reluctant to borrow from banks and financial institutions because of stringent collateral requirements, lengthy and convoluted documentary process, heavy mark up, and to some extent malpractices at banks and financial institutions. Most of the SMEs borrow for purchasing inventory and to meet working capital needs because the lending institutes evade sanctioning loans for venture capital or project financing for start-up businesses. The preference of the lending institutes is the corporate or large-scale sector, as they swiftly grant credit to them at discounted mark up and indirectly, they have been using credit rationing. The contribution of SME financing to total loan portfolio in 2009 stood only 10%, which decreased about 6 plus percent from last year.

4. CONCLUSION AND RECOMMENDATIONS

4.1 Conclusion

Formal financing is the biggest problem of SMEs because a substantial portion of SMEs does not have the security required for collateral. The loan processing time is very lengthy and cumbersome and the loan terms are not succinct and thoroughly understood by the borrower. The share of SME financing in total lending portfolio in Pakistan is only 10% (Daily Times 2010). In 2009, 89% of the SME financing was received for meeting working capital needs, which shows banks' reluctance to finance long-run projects (Dawn 2010). Due to insufficient funds and relatively small size of business, most SMEs even don't envisage of becoming the members of a stock exchange and issue shares of stock and bonds. There is an enormous growth potential for financial services in Pakistan, especially in rural areas. Around one third of the population borrows, but only 3% use formal services to do so. In addition, an incomplete legal and regulatory framework and non-SME-friendly products and procedures hamper increased SME lending. Indirect costs, legal fees, collateral registration, and documentation make bank lending expensive for small and medium enterprises (WB 2009). The unofficial sources report that the relations managers of various banks charge hanky panky amount, generally 3 to 5% of the loan amount against sanction of a loan, but it all depends on case to case basis. The mark up rate on financing at 12.5 % appears very high in the whole region. In addition, the banks also add a mark up spread from 2 or 3 to 6% on loans, which discourages the investment climate and the cost of doing business apparently becomes too high (SBP 2010). Islamic banking and stand-alone Islamic branches of conventional banks can make remarkable and stupendous growth provided their products offer interest free and profit and loss sharing financial solutions to enhance leverage to the SMEs.

Most of the SMEs appear deficient in accounting and financial information that hinders the effectiveness of financial statement-based lending and credit scoring. Another obstacle is lack of business plans/ viability report that is to assess the cash flows of business and expected return on investment. Other major causes are lack of accounting and other information; and insufficiently high levels of profitability, gearing, liquidity, and other performance criteria on the part of funding applicants. Some other constraints in the swift growth of SMEs in Pakistan include shortage of skills, scarcity of capital goods, poor management, lack of technology and data on the sector, resistance to change, and marketing.

4.2 Recommendations

Profit and loss sharing/ Islamic financing: It presents the best solution for promotion of SMEs in Karachi and else where because the owner does not bear the complete risks of loss and work freely to enhance the business with the financial support of a friendly bank. ***Collateral free lending:*** It should be offered for running finance (to meet working capital needs) and project finance/ venture capital in a similar way. The prudential requirements of the State Bank of Pakistan also allow collateral free lending up to Rs3 million based on cash flows lending (SBP 2010). It should be offered to established businesses and a reasonable share of such loans should be passed for newly emerging businesses. ***Using cash flows & market credibility against financing:*** Using positive cash flows and company credibility or goodwill in the market need to be considered as tantamount to traditional requirement of collateral/ mortgaged property. This will be especially suitable for SMEs with track record of success. ***Collateral free Sale-Purchase Agreement for inventory:*** As vast majority of people/ SMEs borrow to buy inventory/ stock, so such schemes should be launched on priority basis. The insurance cover for the lenders will be to get the stock of borrower insured and with consent of the borrower, some sensible person(s) can be hired on contractual terms to assist the warehouse in charge of the borrower and monitor and report the bank on the continuous progress of sale and balance status of inventory. Such products might attract very high demand. ***Collateral free lending against Trust warehouse receipt of tradable commodities:*** This practice is common in India and various parts of the world; it should also be adopted in Pakistan. The risk of the lender is minimized through receiving fresh stock of easily tradable commodities like, rice, wheat, sugar, cotton, and the like. The private warehouses under an agreement with the lender can provide such facilities. Moreover, the commodities can be covered from the risk of theft, fire, burglary, etc through an agreement with an insurance company. ***Collateral free leasing:*** There should be no collateral requirement on leased products especially for financing machinery and equipments. The risk of the leasing companies can be covered through insurance of the leased products. Moreover, the leasing company can utilize other risk minimizing instruments to safeguard its interests. ***Financing ready-made businesses:*** Schemes like 'President Rozgar Scheme' and 'Mera Apna Karobar-NBP Karobar' offered by National Bank of Pakistan (NBP) in 2007, offer tailor-made solutions for generating self-employment. The products included utility store, mobile utility store, general store, rickshaws, public call offices (PCOs), and telecaster (tele-call centre) having great demand in the country. The mark up/ interest on loans is subsidized by Government of Pakistan, as the borrower only pays 6% mark up and the rest is borne by the Government (NBP 2010). NBP attracted huge customers and involved them in income-generating projects to earn their livelihood and enjoy the spirit of self-employment. Such schemes appear need of the hour and must be initiated by numerous banks and financial institutes at concessionary mark up/ interest rates. ***Low/ subsidized mark up loans for targeted rural SMEs:*** The new SMEs, SMEs of exporters, women, and in particular of unfortunate and marginalized communities located in rural areas should be given subsidized mark up rates by State Bank of Pakistan and National Bank of Pakistan (NBP). In a similar manner, NBP's scheme, Apna Karobar is subsidized (NBP 2010). ***Establishing institutes for entrepreneurship training, capacity building, and loaning to SMEs:*** *In collaboration with SMEDA, banks and lending institutes,* specialized institutions need to be opened to train and develop entrepreneurs and SMEs. The potential entrepreneurs and SMEs should be groomed to develop business management skills, engage in business and self-employment opportunities, enabling them to identify potential projects, design new products, conduct brief viability studies (or cost/benefit analysis), and eventually, they should be offered loans to resume their own businesses. It all requires commitment, mutual trust, capacity building, and continuous coordination among all stakeholders inclusive of entrepreneurs, SMEs, SMEDA, banks and lending institutes, and ***institutes for entrepreneurship training, capacity building , and loaning.***

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