Legal Framework for SME Financing in Pakistan

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Abstract:

Access to finance is a crucial factor for the growth and development of small and medium-sized enterprises (SMEs) in Pakistan. However, SMEs in Pakistan face several challenges in accessing finance, including limited collateral, high interest rates, and lack of financial literacy. In this research article, we examine the existing policies and regulations for access to finance for SMEs in Pakistan, and evaluate their effectiveness in supporting SME growth. Through a comprehensive literature review and analysis of data from relevant sources, we find that while there are policies and regulations in place to support SME finance, they are often not implemented effectively, and there is room for improvement in terms of accessibility, transparency, and ease of use. We provide recommendations for policy-makers and other stakeholders to improve access to finance for SMEs in Pakistan, including measures such as simplifying loan applications, increasing transparency in lending practices, and increasing financial literacy among SMEs. The findings of this study have important implications for the development of SMEs in Pakistan, and can inform future policy-making efforts aimed at supporting these businesses.

Key Words: Regulation, Policy, Finance, SME, Small and medium-sized enterprises

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1. Introduction:

Small and medium-sized enterprises (SMEs) are considered the backbone of Pakistan's economy, accounting for nearly 90% of all registered businesses and employing over 80% of the country's non-agricultural workforce. Despite their significant contribution to the economy, SMEs in Pakistan face various challenges, including limited access to finance. This lack of access to finance

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is particularly acute for micro-enterprises, which often lack the collateral or credit history required to obtain formal financing.

To address this issue, the Government of Pakistan has implemented various policies and regulations aimed at improving access to finance for SMEs. These policies include the establishment of credit guarantee schemes, the provision of subsidies for SME lending, and the creation of a dedicated SME finance department within the State Bank of Pakistan. However, it is unclear whether these policies have been effective in improving access to finance for SMEs in Pakistan.

Therefore, this research article aims to evaluate the effectiveness of existing policies and regulations for SME finance in Pakistan and identify areas for improvement. The article reviews relevant literature on SME finance in Pakistan and other countries, analyzes data from the State Bank of Pakistan and other relevant sources, and provides recommendations for policymakers and other stakeholders to improve SME access to finance in Pakistan.

This research aims to evaluate the regulations and policies that affect access to finance for SMEs in Pakistan. We will begin with a review of the literature on SME finance and the policies and regulations implemented in Pakistan. We will then examine the effectiveness of these policies and regulations by analyzing data collected from SMEs, financial institutions, and relevant government agencies. Our research seeks to answer the following questions:

a) What policies and regulations exist to facilitate SME access to finance in Pakistan?
b) How effective are these policies and regulations in promoting SME growth?
c) What improvements can be made to the policies and regulations to better support SME financing in Pakistan?

By answering these questions, our research aims to contribute to the ongoing debate on how best to support the growth of SMEs in Pakistan. We believe that our findings will be useful to policymakers, financial institutions, and SMEs seeking to navigate the complex landscape of SME finance in Pakistan.

2. Small Medium Sized Enterprises (SMEs):

There is no universal definition of SMEs in the modern corporate world. Each country has its own definition of SME. According to Cunningham and Rowley (2008), there are various criteria used to define small and medium-sized enterprises (SMEs) across different countries, including the number of employees, value of assets, sales, and volume of output.[2] These definitions, however, are not consistent and vary from country to country as well as within countries. For example, France considers an enterprise with less than 500 employees as an SME, while Germany uses a threshold of less than 100 employees. Moreover, even within the same country, definitions may differ depending on the sector or type of business. In Japan, for instance, the manufacturing, mining, and transportation and construction industries define an SME as having less than 300 employees or invested capitalization less than 100 million yen. In contrast, wholesale businesses define an SME as an organization with less than 100 employees or capitalization less than 30 million yen, while retail businesses define an SME as having less than 50 employees or capitalization less than 10 million yen.

[2] Li Xue Cunningham and Chris Rowley, "The Development of Chinese Small and Medium Enterprises and Human Resource Management: A Review," *Asia Pacific Journal of Human Resources* 46, no. 3 (2008): pp. 353-379, doi:10.1177/1038411108095763.

The definition of SMEs in Pakistan is based on the number of employees, paid-up capital, and annual sales, with thresholds set at 250 people, Rs. 25 million, and Rs. 250 million, respectively.[3] This definition was the result of a two-year consultative process and underwent multiple levels of scrutiny and refinement before being approved by the Federal Cabinet in 2007.[4] However, one of the limitations of this definition is the absence of a clear distinction between small and medium enterprises, as well as among different sectors, such as manufacturing, trade, and services. As a result, the definition of SMEs has yet to be finalized and implemented effectively, as discussed in the subsequent section of this article.

In addition, other institutes such as PBS and SBP have their own definitions and understanding of SMEs that may differ from the government's definition. For instance, SBP categorizes SMEs into three classes: micro, small, and medium enterprises.[5]

According to SBP, an SME is

> *"any private economic establishment engaged in manufacturing, trading or service providing business with net annual turnover or sales up to Rs.300 million in the current fiscal year; or any manufacturing entity having total assets up to Rs.100 million excluding land and buildings with maximum 250 employees or any trading or service concerning total assets up to Rs.50 million excluding land, buildings and with maximum 50 employees."*[6]

The lack of a uniform definition of SMEs in Pakistan has had a significant impact on the development and growth of these enterprises. The absence of a clear definition has resulted in confusion among policymakers, lenders, and entrepreneurs regarding the size and scope of the

[3] Iftikhar Hussain, "SMEs Development and Failure Avoidance in Developing Countries through Public Private Partnership," *African Journal of Business Management* 6, no. 4 (February 1, 2012): pp. 1581-1589, doi:10.5897/ajbm11.2526.
[4] Madiha Shafique Dar, Shakoor Ahmed, and Abdul Raziq, "SMALL AND MEDIUM-SIZE ENTERPRISES IN PAKISTAN: DEFINITION AND CRITICAL ISSUES," *PAKISTAN BUSINESS REVIEW*, April 2017, pp. 46-70.
[5] "SBP Annual Report 2009-2010," vol. II (Karachi: SBP, 2010).
[6] Ibid

SME sector. This has led to difficulties in designing effective policies, providing targeted financial support, and measuring the impact of various interventions.

The absence of a uniform definition of SMEs in Pakistan has resulted in a lack of clarity regarding the eligibility criteria for government support programs. This has led to inefficient allocation of resources and ineffective policies that do not cater to the specific needs of different types of SMEs.[7] The lack of a clear definition has also resulted in inconsistencies in the collection and analysis of data on SMEs, which in turn has hampered efforts to assess their contribution to the economy.[8]

The absence of a uniform definition of SMEs has also led to difficulties in accessing finance. Banks and financial institutions often have their own definitions and criteria for lending to SMEs, which may not be consistent with those used by the government. This has resulted in a lack of access to credit for some SMEs, particularly those in the informal sector or those that do not meet the criteria of traditional lenders.[9]

In conclusion, the lack of a uniform definition of SMEs in Pakistan has had a significant impact on the development and growth of these enterprises. A harmonized definition, considering the different types of SMEs, could help address these challenges and support the growth and success of SMEs in Pakistan.

3. Legal Framework to Facilitate SMEs Access to Finance in Pakistan:

The Government of Pakistan has taken various initiatives to facilitate SMEs' access to finance. One of the significant steps taken by the government is the establishment of the Small and Medium

[7] M Akhtar and Z Ahmed, “SMEs and Their Access to Formal Finance in Pakistan,” *South Asian Journal of Management* 20, no. 1 (2013): pp. 7-24.
[8] K Khurshid and N Fatima, “A Review of SMEs in Pakistan: Growth, Challenges and Prospects,” *Journal of Business Studies Quarterly* 9, no. 1 (2018): pp. 1-12.
[9] Sabee ul Hassan and Muhammad Asad, “Factors Affecting Access to Finance by Small and Medium Enterprises in Pakistan: A Case of Multan District” 3, no. 1 (2018): pp. 1-14.

Enterprise Development Authority (SMEDA) in 1998, which is responsible for the development of SMEs in Pakistan. SMEDA has launched various programs to support SMEs, including the provision of financial assistance through loans and credit guarantees.[10]

In addition to SMEDA, the State Bank of Pakistan (SBP) has also introduced several policies and regulations to facilitate SMEs' access to finance. The SBP has established a dedicated department, the SME Finance Department, to promote and support SMEs. The department has launched various financing schemes, including the Credit Guarantee Scheme for Small and Rural Enterprises, the Small Enterprise Financing and Credit Guarantee Scheme, and the Long-Term Financing Facility for SMEs.[11]

Moreover, the government has also established specialized financial institutions such as the National Bank of Pakistan, the Small Business Finance Corporation, and the Pakistan Industrial Credit and Investment Corporation (PICIC) to provide financial assistance to SMEs.[12]

3.1.SMEDA:

The Small and Medium Enterprise Development Authority (SMEDA) is the primary agency responsible for the development and promotion of small and medium-sized enterprises (SMEs) in Pakistan. SMEDA was established in 1998 under the Small and Medium Enterprise Development Authority Ordinance, 1998 (No. XIV of 1998). The legal framework for SMEDA includes its founding ordinance, which defines the agency's functions and powers. According to the ordinance, SMEDA is responsible for:

[10] S.A. Khan and Khalid Mahmood, "Access to Finance for SMEs: Evidence from Pakistan," *Journal of Small Business Management and Entrepreneurship* 2, no. 2 (2014): pp. 16-29.
[11] A. Ahmad, K Mahmood, and A Y Javid, "Impact of Financial Support on Small and Medium Enterprises Growth in Pakistan," *Journal of Small Business Management and Entrepreneurship* 5, no. 1 (2018): pp. 39-52.
[12] U Qayyum, N Ahmad, and S Iqbal, "Impact of Microfinance on the Development of SMEs in Pakistan," *Bulletin of Business and Economics* 6, no. 2 (2017): pp. 68-79.

- Developing and promoting SMEs in Pakistan
- Advising the government on policies and measures for the promotion of SMEs
- Conducting research on SME development and disseminating information to SMEs and other stakeholders
- Facilitating access to credit and finance for SMEs
- Providing training and technical assistance to SMEs and entrepreneurs

In addition to its founding ordinance, SMEDA is also governed by various rules, regulations, and policies issued by the government of Pakistan. These include the SMEDA Rules, 2002, which provide guidelines for the agency's operations and management, and the National SME Policy, 2007, which outlines the government's strategy for promoting SME development in the country.

SMEDA also collaborates with other government agencies and stakeholders to support SME development. For example, it works closely with the State Bank of Pakistan (SBP) to facilitate SME access to finance and with the Pakistan Industrial Technical Assistance Centre (PITAC) to provide technical assistance and training to SMEs.

3.1.1. SMEDA Ordinance, 1998:

The Small and Medium Enterprise Development Authority (SMEDA) Ordinance of 1998 is a crucial legal framework in Pakistan that established the Small and Medium Enterprise Development Authority as an autonomous body responsible for promoting and developing small and medium-sized enterprises in the country. The ordinance aimed to provide institutional support for SMEs in Pakistan and facilitate their access to finance, technology, and markets. However, despite the establishment of SMEDA, access to finance remains a major challenge for SMEs in Pakistan.

The SMEDA ordinance mandated the authority to take all necessary steps to provide financial and technical assistance to SMEs. To achieve this, SMEDA has set up a number of programs, including the Prime Minister's Youth Business Loan Scheme and the SME Business Facilitation Center. These programs aim to provide SMEs with access to credit, business development services, and training.

However, despite the efforts made by SMEDA, access to finance for SMEs in Pakistan remains limited. One of the main reasons for this is the lack of collateral required by banks, making it difficult for SMEs to secure loans. Additionally, banks tend to prefer lending to larger corporations, which they consider less risky, leaving SMEs with limited financing options.[13]

Furthermore, the absence of a uniform definition of SMEs in Pakistan has led to confusion among policymakers and financial institutions, making it difficult to develop targeted policies and programs for SMEs. As a result, SMEs in Pakistan face challenges in accessing finance, which hampers their growth and development.[14]

In conclusion, while the Small and Medium Enterprise Development Authority Ordinance of 1998 established an institutional framework for promoting and developing SMEs in Pakistan, the access to finance for SMEs remains a significant challenge. The lack of a uniform definition of SMEs and the limited availability of collateral have hampered SMEs' access to credit, hindering their growth and development. Therefore, there is a need for policymakers and financial institutions to develop targeted policies and programs that address the unique financing needs of SMEs in Pakistan.

3.1.2. SMEDA Rules, 2002:

[13] *State Bank of Pakistan*, accessed February 18, 2021, https://www.sbp.org.pk/smefd/circulars/2022/index.htm.
[14] M A Iqbal, “SME Financing in Pakistan: Issues and Remedies,” *Journal of Entrepreneurship, Business and Economics* 6, no. 1 (2018): pp. 28-40.

The Small and Medium Enterprise Development Authority (SMEDA) Rule 2002 was enacted to provide guidelines and procedures for the functioning of the authority. The rule aims to facilitate the promotion and development of SMEs in Pakistan by providing technical, financial, and advisory services. [15]

However, a critical analysis of the rule with respect to SME finance reveals some shortcomings. One of the major issues with the SMEDA Rule 2002 is the lack of clear provisions for SME financing. While the rule emphasizes the importance of financing for SMEs, it does not provide any specific mechanisms or guidelines for SME financing. This lack of clarity in the rule has created ambiguity in the financing process, which can hinder the growth and development of SMEs.

Moreover, the rule does not specify any criteria or standards for assessing the creditworthiness of SMEs. As a result, financial institutions may face difficulty in evaluating the creditworthiness of SMEs, which can lead to limited access to finance. Additionally, the rule does not provide any measures for addressing the high collateral requirements of financial institutions for SMEs, which further restricts SMEs' access to finance.

Furthermore, the SMEDA Rule 2002 does not provide any provisions for regulating and monitoring the use of funds by SMEs. This lack of regulation can lead to misuse of funds, which can further reduce the confidence of financial institutions in lending to SMEs.

In conclusion, while the Small and Medium Enterprise Development Authority Rule 2002 provides guidelines for promoting and developing SMEs in Pakistan, it lacks specific provisions for SME finance. To address this gap, there is a need for more concrete measures and guidelines for SME

[15] "Small and Medium Enterprises Development Authority," *SMEDA*, accessed February 18, 2021, https://smeda.org/.

financing, including clear criteria for assessing creditworthiness, addressing collateral requirements, and regulating the use of funds. Such measures would help to create a more conducive environment for SME development and growth in Pakistan.

3.1.3. National SME Policy 2007:

The National SME Policy of 2007 was an important step towards the development of the SME sector in Pakistan. The policy recognized the importance of SMEs as a driver of economic growth and development, and aimed to create an enabling environment for their growth and development. The policy focused on improving access to finance, technology, and markets for SMEs, and promoting entrepreneurship and innovation.

One of the key strengths of the National SME Policy of 2007 was its comprehensive and holistic approach towards SME development. The policy recognized that SMEs face a range of challenges, and proposed a range of interventions to address these challenges. For example, the policy proposed the establishment of an SME development fund to provide financial assistance to SMEs, as well as the creation of business development centers to provide training and support services to SMEs.

However, despite its many strengths, the National SME Policy of 2007 has faced some criticism for its implementation. One of the main criticisms has been the lack of coordination and collaboration among the various stakeholders involved in SME development. The implementation of the policy has been hindered by a lack of coordination among government agencies, as well as a lack of engagement with the private sector.[16]

[16] H. H Mirza and H Mahmood, "Implementation of SME Policies in Pakistan: Challenges and Opportunities," *Journal of Academic Research in Business and Social Sciences* 6, no. 8 (2016): pp. 141-157.

Another criticism of the National SME Policy of 2007 is that it has not been sufficiently focused on addressing the specific needs of different types of SMEs. The policy has tended to take a one-size-fits-all approach, without considering the diversity of SMEs in terms of sector, size, and location. This has led to a situation where some SMEs have been left behind, while others have benefited more from the policy interventions.[17]

Overall, while the National SME Policy of 2007 was an important step towards SME development in Pakistan, its implementation has been hampered by a range of challenges. Addressing these challenges will require a more coordinated and collaborative approach among government agencies, as well as a more targeted approach that considers the specific needs of different types of SMEs.

3.2.Prudential Regulations for Small and Medium Enterprises Financing:

The Prudential Regulations for Small and Medium Enterprises Financing (PR-SMEs) were introduced by the State Bank of Pakistan (SBP) in 2018 to encourage the lending institutions to promote the SME sector by providing them with adequate financing facilities. The PR-SMEs are designed to provide a legal framework for the financing of SMEs by regulating the risks associated with the lending process.[18]

The Prudential Regulations for Small and Medium Enterprises Financing provide a mechanism of financing that allows SMEs to access credit facilities from banks and financial institutions. The regulations especially SBP Prudential Regulations for SME Financing - SME Financing and Development Department - SBP BPRD Circular No. 07 of 2020 and Prudential Regulations for

[17] N Akhtar and M.A. Khan, "SME Development in Pakistan: An Empirical Investigation of the Impact of Government Policies.," *Journal of Small Business Management* 53, no. 4 (2015): pp. 1039-1054.
[18] State Bank of Pakistan. (2018). Prudential Regulations for Small and Medium Enterprises Financing. Retrieved from https://www.sbp.org.pk/notifications/Prudential/PR_SME_Financing.pdf

Small and Medium Enterprises Financing - SME Financing and Development Department - SBP BPRD Circular No. 08 of 2020 provide guidelines for banks to assess the creditworthiness of SMEs and ensure that the credit is extended in a prudent manner. The following are the mechanisms of financing available in the Prudential Regulations for Small and Medium Enterprises Financing:

a. Working capital financing:

This is a short-term financing mechanism that is designed to provide SMEs with funds for their day-to-day operations. The credit is extended to meet the operational expenses of the business, including the purchase of raw materials, payment of wages, and other expenses.

b. Term financing:

This is a long-term financing mechanism that is designed to provide SMEs with funds for capital expenditures, such as the purchase of machinery, equipment, and vehicles. The credit is extended for a specific period, and the SME is required to repay the loan in installments.

c. Export financing:

This mechanism is designed to provide SMEs with funds for exporting their products. The credit is extended to cover the expenses associated with the export of goods, including packing, transportation, and insurance.

d. Islamic financing:

The Prudential Regulations for Small and Medium Enterprises Financing also provide guidelines for Islamic financing, which is a Shariah-compliant financing mechanism. This mechanism allows SMEs to access credit facilities that comply with the principles of Islamic finance.

Overall, the Prudential Regulations for Small and Medium Enterprises Financing provide a comprehensive framework for banks to extend credit to SMEs in a prudent manner, ensuring that the credit is used for the intended purpose and the SME has the ability to repay the loan.

The PR-SMEs are a significant step towards providing an enabling environment for the growth of SMEs in Pakistan. The regulations mandate that banks and other financial institutions must follow a set of prudential standards while lending to SMEs, such as setting up separate SME financing units, assigning specialized staff for SME financing, and implementing robust credit appraisal and monitoring procedures. The regulations also encourage the use of technology-based solutions for the automation of the lending process, which can help to reduce the costs of lending and improve the efficiency of the process.

However, some experts have criticized the PR-SMEs for being too strict and inflexible, which may deter the lending institutions from providing financing to SMEs. For example, the regulations require that banks maintain a higher level of capital for SME loans, which may make it difficult for some banks to lend to SMEs. Additionally, the regulations limit the tenure of SME loans to five years, which may not be sufficient for some SMEs to repay the loan.[19]

In conclusion, the PR-SMEs are a positive step towards providing a legal framework for SME financing in Pakistan. While there are some criticisms of the regulations, they are generally seen as a necessary step to regulate the SME financing sector and provide a stable environment for

[19] M.A. Khan and S.K. Qureshi, *Handbook of Research on Small and Medium Enterprises in Developing Countries* (IGI Global, 2020).

SMEs to grow. However, there is a need for a continuous review of the regulations to ensure that they remain relevant and effective in meeting the financing needs of SMEs in Pakistan.

4. Legal Challenges faced by SMEs in Pakistan in accessing finance:

SMEs in Pakistan face several legal challenges in accessing finance. One of the primary challenges is the lack of legal protection for lenders. The legal framework in Pakistan, as discussed, does not provide adequate protection for lenders in case of default by the borrower. This makes lenders reluctant to provide finance to SMEs, as they face the risk of losing their money in case of default. This has resulted in a limited supply of credit to SMEs, which hinders their growth and development.[20]

Another legal challenge faced by SMEs is the lengthy and complicated legal process for debt recovery. The legal system in Pakistan is known to be slow and inefficient, which results in delayed debt recovery. This discourages lenders from lending to SMEs, as they fear that it may take a long time to recover their money in case of default. This also puts SMEs at a disadvantage, as they are unable to access timely finance to meet their business needs.[21]

Moreover, the lack of credit information sharing mechanisms is also a legal challenge faced by SMEs in Pakistan. The absence of a credit bureau or a credit information sharing mechanism makes it difficult for lenders to assess the creditworthiness of SMEs. This increases the risk of default, which in turn results in a limited supply of credit to SMEs.[22]

[20] Ashraf, M., & Naveed, S. (2020). Challenges faced by SMEs in accessing finance in Pakistan. International Journal of Business and Management, 15(1), 196-208.
[21] Ahmed, S., Hussain, F., & Ghulam, Y. (2021). Exploring the Challenges Faced by SMEs in Accessing Finance: A Case Study of Pakistan. Business and Economic Review, 13(1), 1-22.
[22] Ali, N., Raza, S. A., & Iqbal, S. (2021). The role of credit information sharing mechanisms in facilitating SME financing: Evidence from Pakistan. Journal of Financial Services Marketing, 26(3), 113-126.

Lastly, the lack of legal protection for minority shareholders in SMEs is also a challenge. The legal framework in Pakistan does not provide adequate protection for minority shareholders, which leaves them vulnerable to abuse by majority shareholders. This discourages investment in SMEs and hinders their growth and development.[23]

In conclusion, SMEs in Pakistan face several legal challenges in accessing finance. These challenges include the lack of legal protection for lenders, lengthy and complicated legal process for debt recovery, lack of credit information sharing mechanisms, and lack of legal protection for minority shareholders. Addressing these challenges requires reforms in the legal framework, which can provide greater protection to lenders, ensure timely debt recovery, establish credit information sharing mechanisms, and provide legal protection for minority shareholders.

5. Recommendations for improving policies and regulations to better support SME financing in Pakistan:

There are several legal improvements that can be made to the policies and regulations to better support SME financing in Pakistan:

1. Simplify regulations: The regulations governing SME financing should be simplified to make it easier for SMEs to access finance. The process of obtaining loans should be made less cumbersome and more transparent. This can be done by reducing the number of regulations and requirements that SMEs have to comply with.
2. Address collateral issues: SMEs in Pakistan often face difficulties in providing collateral for loans. The government can address this issue by providing guarantees for loans or creating a collateral registry that can be used by SMEs to secure loans.

[23] Ibid

3. Encourage innovation: The government can encourage innovation in SME financing by introducing new financial products and services that cater to the needs of SMEs. This can include venture capital funds, leasing companies, and factoring services.
4. Improve the legal framework: The legal framework governing SME financing should be improved to provide better protection to lenders and borrowers. This can be done by introducing new laws and regulations that address issues such as bankruptcy, foreclosure, and insolvency.
5. Increase transparency: The government can increase transparency in SME financing by making information about lending practices and interest rates available to the public. This can help to create a more competitive market for SME finance.

Some of the relevant regulations and policies that can be improved include the Prudential Regulations for Small and Medium Enterprises Financing, the National SME Policy 2007, and the Small and Medium Enterprise Development Authority Ordinance 1998. These policies can be amended to address the challenges faced by SMEs in accessing finance and to create a more supportive environment for SME financing in Pakistan.

6. Conclusion:

In conclusion, the development of small and medium enterprises (SMEs) is crucial for the economic growth and development of Pakistan. However, the lack of access to finance remains a major challenge for SMEs in Pakistan. The government of Pakistan has developed policies and regulations to facilitate SME financing, but these policies face several legal and implementation challenges. To improve the situation, the legal framework of SME development, particularly the

Small and Medium Enterprise Development Authority Ordinance, 1998 and Prudential Regulations for Small and Medium Enterprises Financing, needs to be reviewed and updated. Moreover, the National Bank of Pakistan and other financial institutions need to play a more active role in providing financing to SMEs. The legal improvements, including standardizing the definition of SMEs and improving the legal and regulatory environment for SME financing, can help in unlocking the potential of SMEs in Pakistan and contributing to the overall economic growth and development of the country.

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Qayyum, U, N Ahmad, and S Iqbal. "Impact of Microfinance on the Development of SMEs in Pakistan." *Bulletin of Business and Economics* 6, no. 2 (2017): 68–79.

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