



**WORLD BANK GROUP**

Finance & Markets

Global Islamic Finance Center

***SMEs' Access to Finance in South Asia:  
Can Islamic Finance be the Catalyst?***

***World Islamic Finance Forum (WIFF) 2016  
'Roadmap for Future and Critical Success Factors'  
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**Tarik Akin**  
Islamic Financial Services  
Board (IFSB)  
Kuala Lumpur, Malaysia  
[tarik.akin.hks@gmail.com](mailto:tarik.akin.hks@gmail.com)


**Ayşe Nur Aydın**  
The World Bank Global  
Islamic Finance  
Development Center  
Istanbul, Turkey  
[aaydin@worldbank.org](mailto:aaydin@worldbank.org)

**Zamir Iqbal, PhD.**  
The World Bank Global  
Islamic Finance  
Development Center  
Istanbul, Turkey  
[ziqbal@worldbank.org](mailto:ziqbal@worldbank.org)

# Road Map

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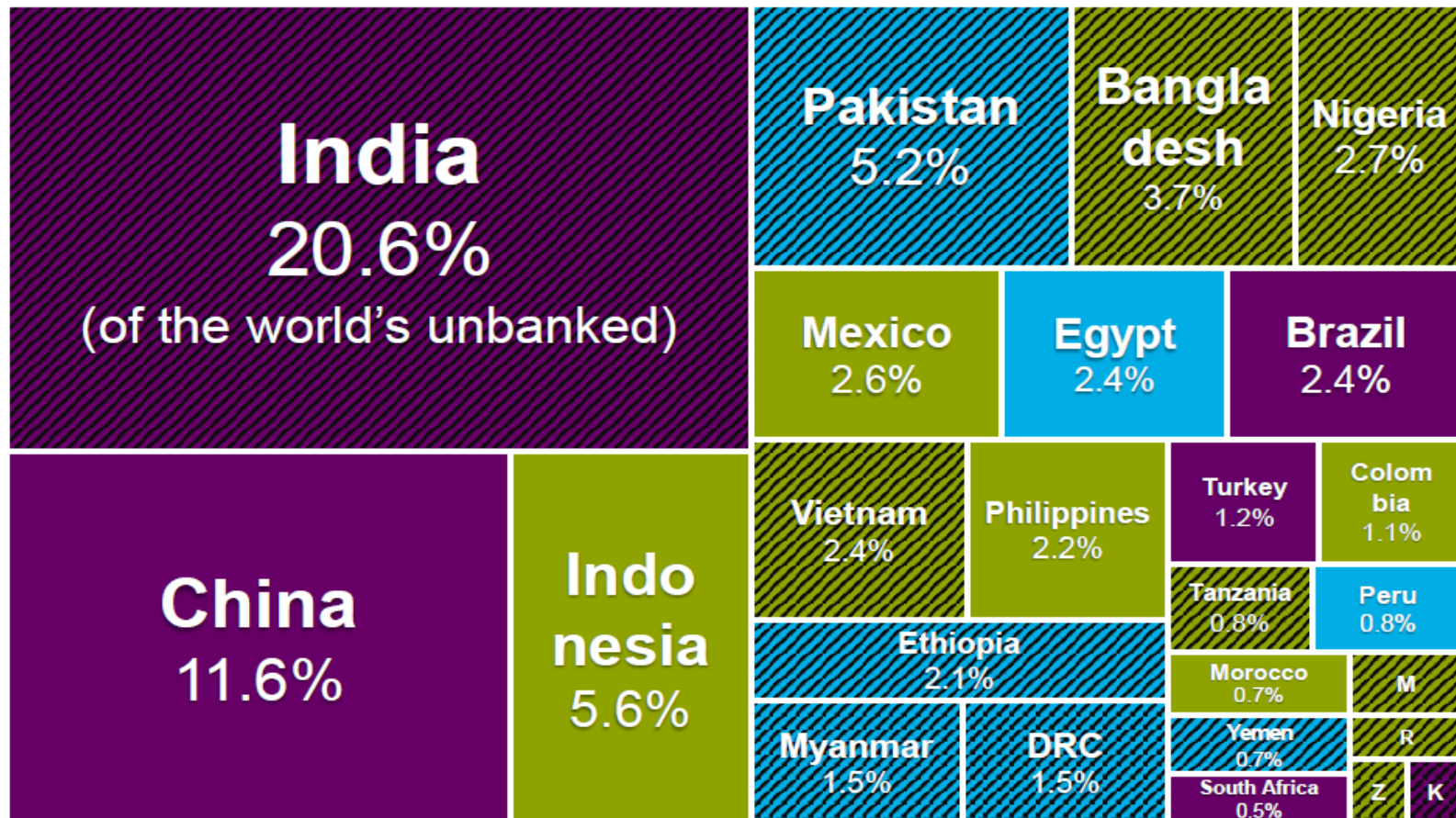
- I. Motivation for the study: Why access to finance matters?**
- II. Empirical Study**
- III. Islamic Finance as a Catalyst for Access to Finance?**

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- I. **Motivation for the study: Why access to finance matters?**

# 2014: 25 Focus Countries: 73% of the world's unbanked

**Out of 73% of the world's unbanked, 22.2% are Muslim countries.**

Countries prioritized based on share of unbanked, IDA, and FCS: 2014 FINDEX



IDA countries: % Access: 0% - 25% 26% - 50% 51% - 100%

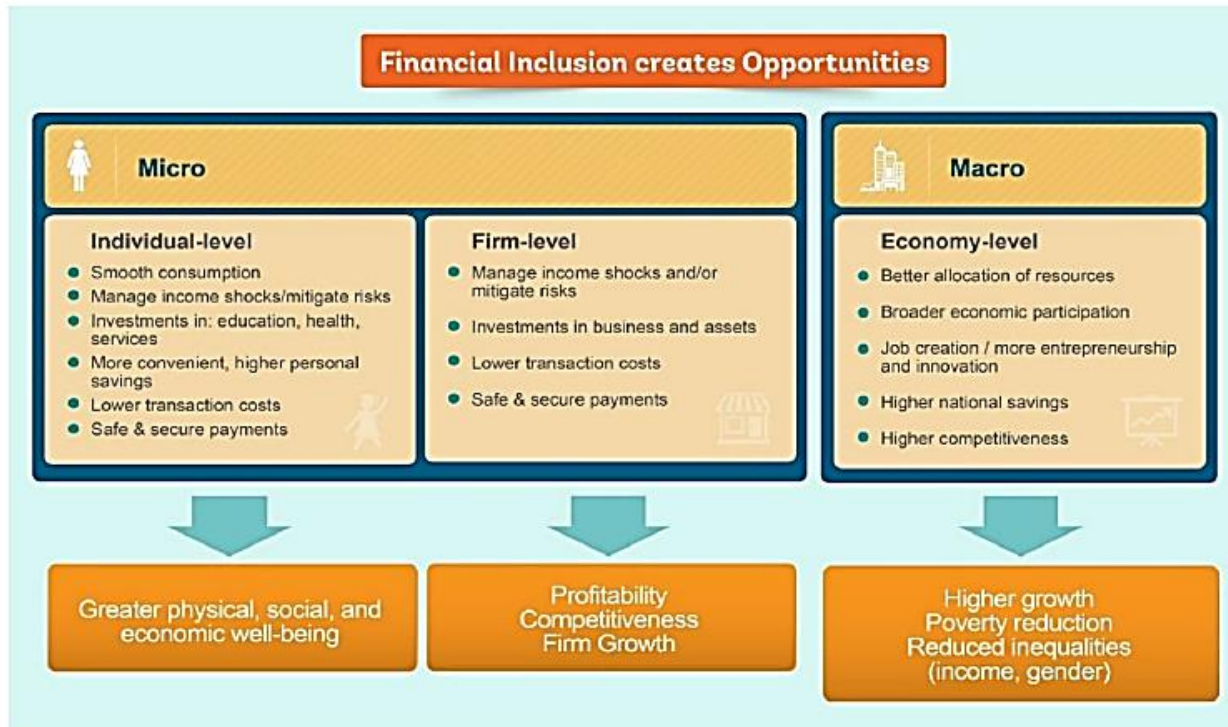
M: Mozambique 0.4%; K: Kenya 0.3%; Z: Zambia 0.2%; R: Rwanda 0.2%  
NB Yemen will be replaced with Cote d'Ivoire due to severe insecurity.

# Universal Financial Access (UFA) 2020 Goal

By 2020, adults globally should have access to an account or electronic instrument to store money, send and receive payments as the basic building block to manage their financial lives

## Why it matters

- Strong link to Twin Goals: poverty reduction and income effects
- Enabler for WBG and country development goals



# Employment Contribution of SMEs

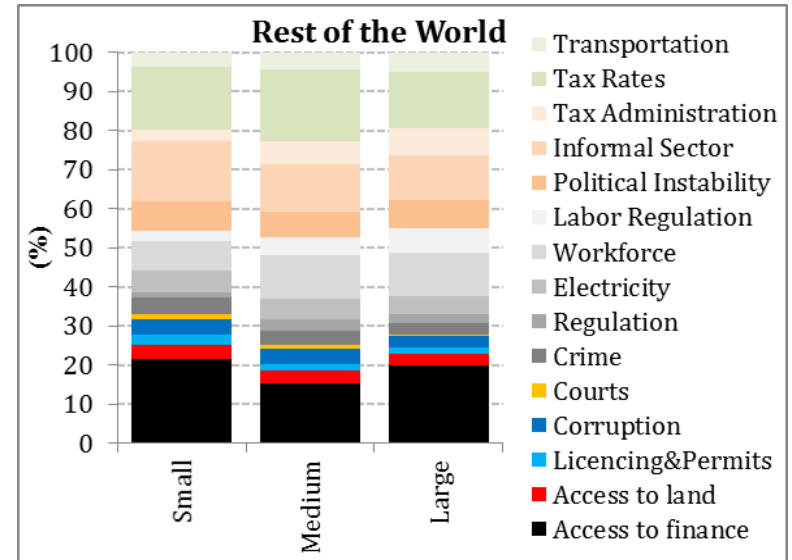
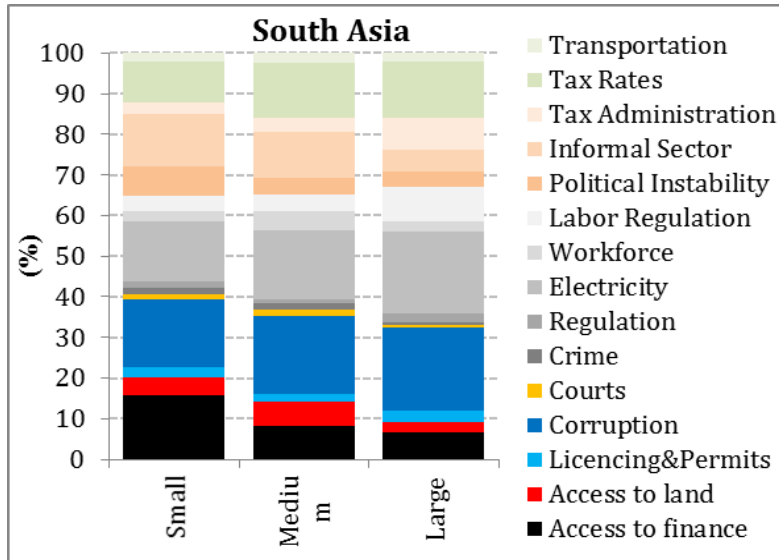
| Region                       | Total Number of SMEs (million) | Formal SMEs (million) | Total Credit Gap* |
|------------------------------|--------------------------------|-----------------------|-------------------|
| Europe and Central Asia      | 20                             | 3                     | 10%               |
| East Asia and Pacific        | 188                            | 12                    | 92%               |
| South Asia                   | 78                             | 2                     | 36%               |
| Middle East and North Africa | 21                             | 2                     | 10%               |
| Sub-Saharan Africa           | 40                             | 4                     | 22%               |
| Latin America and Caribbean  | 52                             | 3                     | 27%               |
| <b>Total</b>                 | <b>399</b>                     | <b>26</b>             | <b>57%</b>        |

\*Includes both of underserved and unserved SMEs

Source: (Stein, et al., 2013)

- SMEs employ the largest number of people in aggregate and are responsible for 57.8% of total new jobs created at the global level.
- There are around 400 million SMEs in the developing world, in which only 26 million is formal.
- SMEs have considerably high level of credit gap, which can be defined as the supply and demand difference in accessing bank credit for SMEs.

# Main obstacles affecting current operations and growth

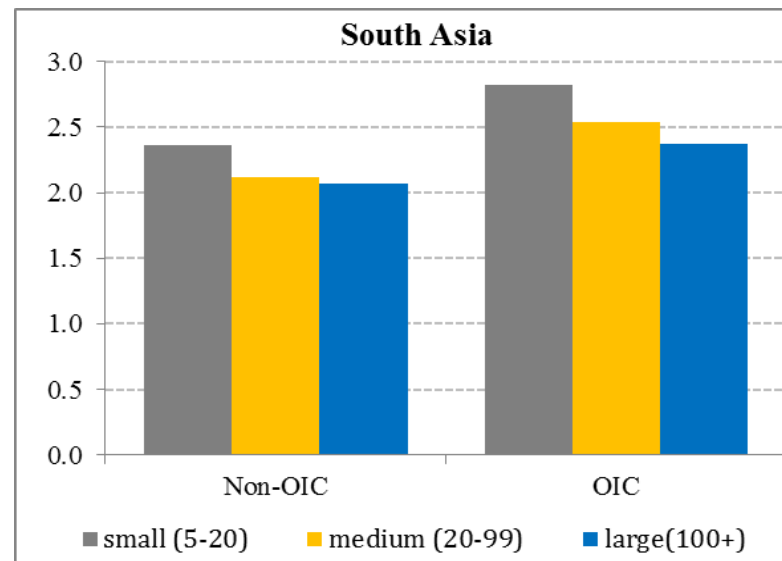
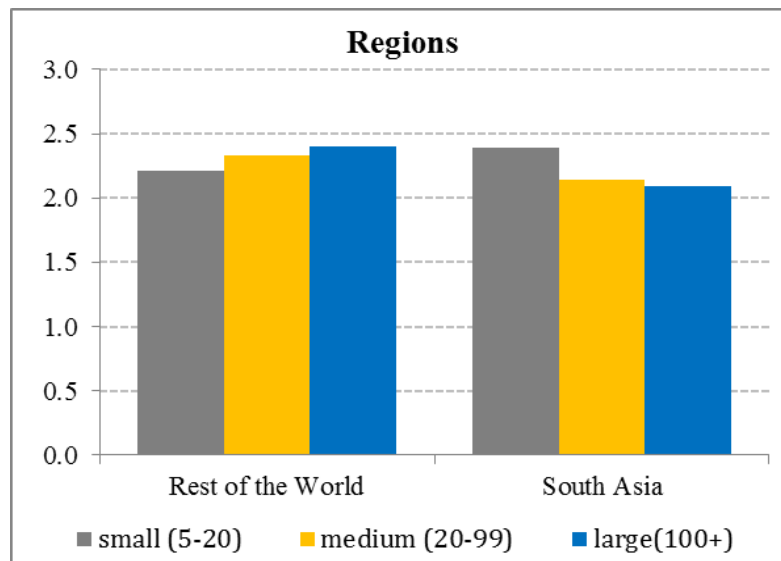


Source: WB Enterprise Surveys, Authors' calculations

- The main obstacles affecting the growth of SMEs in the South Asian region are
  - corruption
  - access to electricity
  - access to finance
  
- Large firms in South Asian countries enjoy a greater freedom in obtaining credit.

Note: Paper uses the World Bank classification of South Asia region which includes Afghanistan, Bangladesh, Bhutan, India, Nepal, Pakistan and Sri Lanka.

# Degree of Having Difficulty in Access to Finance



Source: WB Enterprise Surveys, Authors' calculations

- **Small firms** in South Asia experience a **much higher** level of difficulty in access to finance.
- **All firms**, regardless their size, in **OIC member** countries in South Asia have a **much higher degree** of difficulty in access to finance.



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## **II. Empirical Study**

# Methodology

## Firm Characteristics

- Firm Age
- Sectoral Decomposition
- Location of Firm
- Firm Ownership
- Export Orientation

## Seemingly Unrelated Regression (SUR) Model

$$y_{ij} = x'_{ij}\beta_j + \varepsilon_{ij}, i = 1, \dots, N$$

A two-step regression strategy is followed:

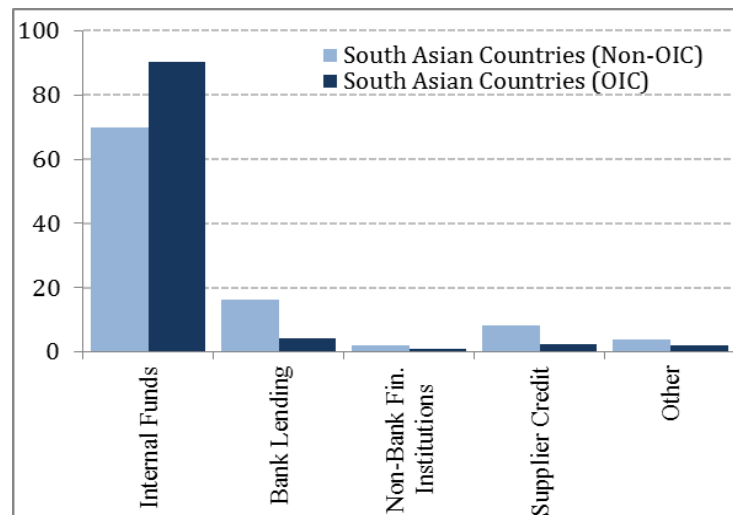
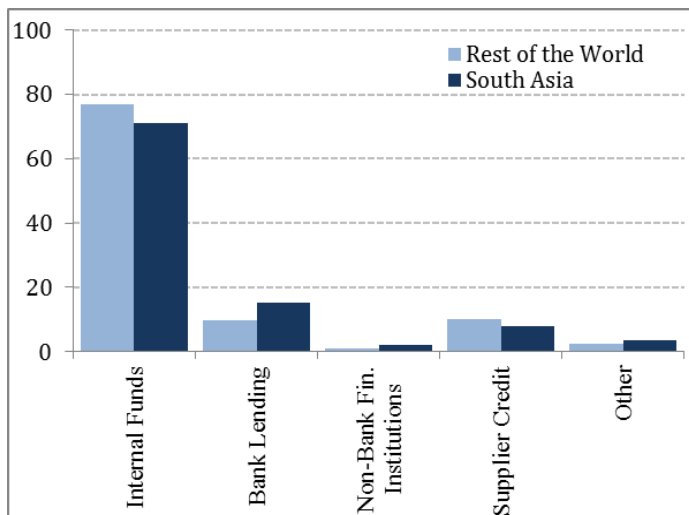
- In the first step, the SUR framework is estimated and then the most statistically insignificant covariate is dropped from the right hand side (RHS) for each of the equations.
- In the second step, the system is re-estimated without the dropped covariates. In this way, the RHS varies in an immaculate way so as to employ the SUR system to work in line with the theory.

## Regression Variables

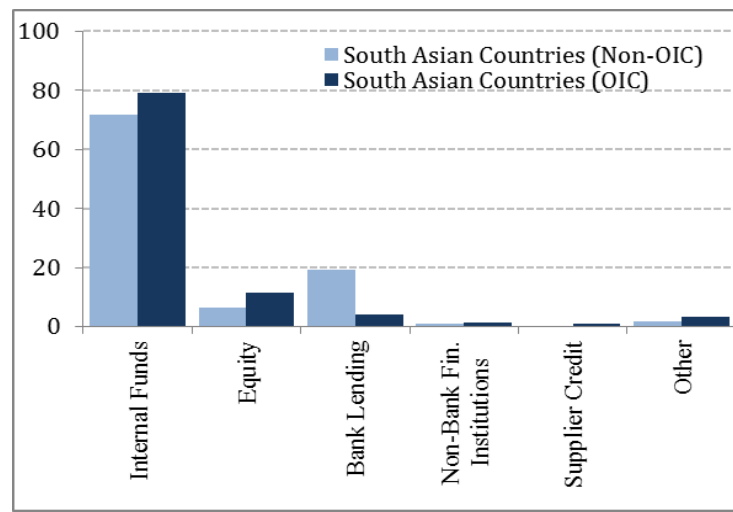
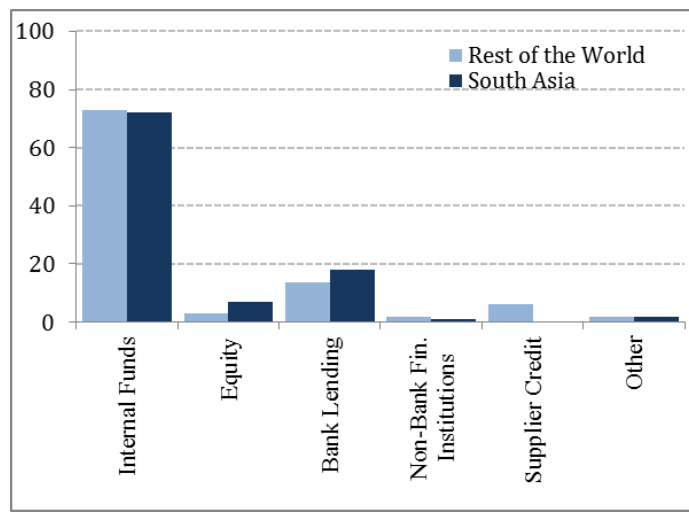
| Variables | Names               | Description   |
|-----------|---------------------|---|
| OIC       | OIC Member          | OIC membership dummy, =1 if OIC member in South Asia              |
| SME       | SME dummy           | SME dummy, =1 if the firm is an SME                               |
| OIC*SME   | OIC*SME             | Interaction variable  |
| Acc       | Access to Finance   | Dummy if the biggest obstacle is access to finance (m1a)          |
| Age       | Age                 | Age of firm in years  |
| Manu      | Manufacturing       | Dummy variable, =1 if the main activity of firm is manufacturing  |
| Serv      | Services            | Dummy variable, =1 if the main activity of firm is services       |
| Expo      | Export Share        | Share of export in total sales (as % of total)                    |
| Loc       | Location            | Location of the firm, see footnote 9 for further information      |
| Cor       | Corporation         | Dummy variable, =1 if legal status of firm is corporation         |
| Sole      | Sole Proprietorship | Dummy variable, =1 if legal status of firm is sole proprietorship |
| Part      | Partnership         | Dummy variable, =1 if legal status of firm is partnership         |
| SME*Acc   | SME*Access to Fin.  | Interaction variable  |

# Results – Determinants of SME Financing

## Sources of Working Capital Financing



## Sources of Fixed Capital Financing



# Results – Determinants of SME Financing

## Seemingly Unrelated Regression: Source of Financing for Working Capital

|                            | Internal Funds | Bank Financing | Non-Bank Financial Institutions | Supplier Credit | Other    |
|----------------------------|----------------|----------------|---------------------------------|-----------------|----------|
| <b>OIC Member</b>          | 0.18***        | -0.15***       | -0.06***                        | -0.04**         | -0.02    |
| <b>SME dummy</b>           | 0.09***        | -0.11***       | -0.03***                        | 0.02            | 0.04***  |
| <b>OIC*SME</b>             | -0.04**        | 0.05**         | 0.05***                         | -0.03           | -0.02    |
| <b>Access to Finance</b>   | -0.05**        | 0.06***        | 0.03                            | -0.01           | -0.01    |
| <b>Age</b>                 | 0.03***        | -0.03***       | -0.01                           | 0.02*           | -0.00    |
| <b>Manufacturing</b>       | 0.04***        | dropped        | -0.07***                        | -0.02           | -0.05*** |
| <b>Services</b>            | 0.10***        | -0.10***       | -0.03*                          | -0.02           | 0.02     |
| <b>Export Share</b>        | 0.02**         | -0.02*         | -0.00                           | dropped         | -0.01    |
| <b>Location</b>            | 0.12***        | -0.17***       | dropped                         | 0.04***         | 0.05***  |
| <b>Corporation</b>         | dropped        | -0.03**        | -0.01                           | 0.07***         | -0.01    |
| <b>Sole Proprietorship</b> | 0.17***        | -0.26***       | -0.01                           | 0.16***         | 0.02**   |
| <b>Partnership</b>         | 0.07***        | -0.10***       | -0.04                           | 0.06*           | dropped  |
| <b>SME*Access to Fin.</b>  | -0.01          | -0.02          | 0.02                            | 0.02            | 0.05**   |
| <b>N</b>                   | 11,839         | 11,839         | 11,839                          | 11,839          | 11,839   |
| <b>R-square</b>            | 0.0941         | 0.133          | 0.00603                         | 0.0130          | 0.0137   |

# Results – Source of Financing for Working Capital

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- (i) **OIC countries** variable is the most important determinant of resorting to the **internal funds in working capital** finance, which is then followed by the sole proprietorship dummy and operating in the services sector.
- (ii) Sole proprietorships and firms in locations with small populations have the most difficulty in getting bank loans.
- (iii) Reverse sign between internal financing and bank lending in almost all of the covariates indicates that **internal funds and bank loans are very close substitutes** in South Asia..
- (iv) Another means of financing that the OIC countries **lack in access to finance** is the **supplier credit**.
- (v) For almost all of the means of working capital finance, **SMEs in the OIC countries are in a disadvantaged position** compared to their peers and lack of finance opportunities divert them to depend more on internal finance.

# Results – Determinants of SME Financing

## Seemingly Unrelated Regression: Source of Financing for Fixed Capital

|                              | Internal Funds | Equity  | Bank Financing | Non-Bank Financial Institutions | Supplier Credit | Other   |
|------------------------------|----------------|---------|----------------|---------------------------------|-----------------|---------|
| <b>OIC Member</b>            | 0.08***        | 0.08*** | -0.13***       | -0.08***                        | 0.07**          | 0.01    |
| <b>SME dummy</b>             | 0.07***        | -0.01   | -0.06***       | -0.02                           | 0.00            | -0.02   |
| <b>OIC*SME</b>               | -0.04          | -0.02   | 0.02           | 0.05*                           | 0.06*           | 0.05*   |
| <b>Access to Finance</b>     | -0.04          | -0.03   | 0.04           | 0.03                            | -0.02           | 0.03    |
| <b>Age</b>                   | -0.01          | -0.00   | 0.02           | 0.00                            | 0.01            | -0.03*  |
| <b>Manufacturing</b>         | 0.04           | -0.03   | -0.02          | -0.01                           | dropped         | 0.01    |
| <b>Services</b>              | 0.07**         | -0.04   | -0.07**        | 0.02                            | 0.02            | 0.07**  |
| <b>Export Share</b>          | -0.04**        | dropped | 0.02           | 0.01                            | 0.11***         | 0.02    |
| <b>Location</b>              | 0.09***        | -0.05** | -0.07***       | dropped                         | -0.01           | 0.03    |
| <b>Corporation</b>           | dropped        | 0.06**  | -0.04***       | 0.04                            | 0.00            | -0.03*  |
| <b>Sole Proprietorship</b>   | 0.09***        | 0.05    | -0.15***       | 0.02                            | 0.03            | 0.03    |
| <b>Partnership</b>           | -0.04*         | 0.08**  | dropped        | -0.03                           | 0.00            | dropped |
| <b>SME*Access to Finance</b> | 0.02           | 0.01    | -0.03          | 0.01                            | 0.02            | 0.02    |
| <b>N</b>                     | 3,193          | 3,193   | 3,193          | 3,193                           | 3,193           | 3,193   |
| <b>R-square</b>              | 0.0422         | 0.00849 | 0.0601         | 0.00845                         | 0.0274          | 0.0176  |

# Results – Source of Financing for Fixed Capital

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- (i) SMEs in an OIC member country has a big cumulative effect on the firms' **use of internal funds** and **only export-orientation has a significantly negative effect** on the use of the internal funds.
- (ii) OIC member countries resort **more** to issuing **equity**.
- (iii) SMEs in the OIC group **do not benefit from the banking sector** compared to their counterparts.
- (iv) Having a **sole proprietorship has also a big negative impact** on SMEs' access to bank lending in the **OIC sample**. SMEs in the OIC sample has negative overall effect of accessing to the non-bank financial institutions.
- (v) In addition, SMEs in the OIC group have better access to supplier credit.
- (vi) To sum up, SMEs in the OIC group are **disadvantaged** compared to their peers in, especially accessing to **bank credit**.

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### **III. Islamic Finance as a Catalyst for Access to Finance?**



# Islamic Finance and Exclusion in South Asia

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Percentage of Islamic banking share, Muslim population and financial exclusion due to religious reasons in South Asian countries

| Country     | % of Islamic banking share | % of Muslim population | Financial exclusion based on religion |
|-------------|----------------------------|------------------------|---------------------------------------|
| Afghanistan | NA                         | > 99.0                 | 24.7                                  |
| Bangladesh  | 19.4                       | 90.4                   | 3.9                                   |
| Bhutan      | 0                          | < 1.0                  | 0.7                                   |
| India       | 0                          | 14.4                   | 4.4                                   |
| Nepal       | 0                          | 4.6                    | 2.5                                   |
| Pakistan    | 9.8                        | 96.4                   | 6.8                                   |
| Sri Lanka   | 1                          | 9.8                    | 14.4                                  |

- Great disparity of Islamic finance development exists among South Asian countries.
- Although Islamic banking is already operating in Bangladesh and Pakistan, there is a sizeable Muslim population in Afghanistan, India, and Sri Lanka which could also be catered by Islamic products.
- Financial exclusion based on the religion is an indicator of those who have excluded themselves voluntarily due to lack of Shariah-compliant financing in the country.

# Islamic finance has certain features which give it the potential to effectively support SME financing, and economic growth and development

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Participatory and risk-sharing financing

Emphasis on materiality (asset-based)

Real Sector Financing

Entrepreneurship

Notion of Economic and Social Justice

# Interventions from Islamic Finance to Overcome SMEs' Access to Finance

| Key Constraint to SMEs' Access to Finance  | Potential interventions from Islamic Finance   |
|--|--|
| <p><b>Limited or no access to bank lending.</b></p>  | <ul style="list-style-type: none"> <li>(i) Review and revise regulatory framework to develop authentic risk-sharing financial intermediation.</li> <li>(ii) Develop information and credit registeries</li> <li>(iii) Enable credit guarantee programs</li> </ul>  |
| <p><b>Limited or no access to supplier credit or asset-based finance.</b></p>  | <ul style="list-style-type: none"> <li>(i) Develop Shariah-compliant movable collateral mechanisms.</li> <li>(ii) Forge partnerships with suppliers and leverage supplier credit to supplement working capital financing.</li> <li>(iii) Explore securitization of Murabahah portfolios.</li> <li>(iv) Develop non-bank financial institutions to mobilize market-based financing for SME's working and fixed capital using sale and trade based instruments.</li> <li>(v) Develop lease financing.</li> </ul> |
| <p><b>Export orientation has a negative effect on the use of internal funds indicating less dependency on internal funds for SMEs associated with exports.</b></p> | <ul style="list-style-type: none"> <li>(i) Standardize and develop financing mechanisms for trade financing.</li> <li>(ii) Consider securitization of exports receivable</li> </ul>  |
| <p><b>Use of and access to capital markets for working and fixed capital needs is negligible in OIC member countries.</b></p>                                      | <ul style="list-style-type: none"> <li>(i) Development of products through non-banking channels based on risk-sharing principles.</li> <li>(ii) Develop ways to mobilize market based finance through capital markets, i.e. Sukuk.</li> <li>(iii) Leverage Financial Technology and digital platforms to reduce information symmetries to encourage risk-sharing financing.</li> </ul>   |

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THANK YOU...

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E-mail: [feedback@worldbank.org](mailto:feedback@worldbank.org)

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