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Bridging the SME Financing Gap in Pakistan through Islamic Finance: A Policy Review

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ABSTRACT

This study investigates the latest developments in promoting SMEs in Pakistan by the Government and other stakeholders. It also maps SME issues with Islamic finance solutions. The study is based on a literature review, categorizing policies and regulations from SMEDA and SBP, along with other research and reports. Despite advancements in SME policies, SMEs lack awareness and proper business education. Islamic banks are hesitant to fund SMEs due to documentation issues. Solutions include consultancy services, training programs, and awareness sessions in Islamic finance. This research assists SME operators and stakeholders understand government assistance and legislation for SMEs. It also advises Islamic banking and financial institutions on tailored solutions for SMEs.

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Introduction

It is a fact that SMEs play a vital role in any economic growth, and therefore, they are known as the backbone of the economy. Currently 5.2 million SMEs are in Pakistan (8% manufacturing and 32% services sector SMEs) which represents the 90% of business contributing 40% to the Gross Domestic Product (GDP) and contribute 30% of export of Pakistan, besides this great numbers of SMEs the total private financing received by these SMEs is only 6 to 7% only (CCP, 2023). Prior studies PMN, (2013a) suggest an increased number of SMEs in Pakistan, which reported 3.8 million Micro Small Medium Enterprises (MSMEs) in Pakistan, 70 per cent of which can be classified as small enterprises. According to Nenova et al. (2009) MSMEs in Pakistan account for 30 per cent of the GDP. Their contribution to export earnings is estimated at 25 per cent (Afraz et al., 2013). These MSMEs are working in the trade, services, and manufacturing sectors. According to a Gallup survey conducted from 2000 to 2004 on SMEs in Pakistan, above 90 per cent of enterprise businesses are run through SMEs. Its contribution to employment is approximately 80 per cent of the country's labour force, except for the agricultural force (Gallup Pakistan, 2004).

A report by State Bank of Pakistan (2017) suggests that in December 2021, SMEs received Rs. 524 billion, which was Rs. 284 billion in 2013, suggesting a significant increase in financing available to SMEs. Even though SMEs significant role in the economic growth of the country, there is a significant gap in financing SMEs by providing them a sufficient financing percentage from Islamic Banking Institutions, as the portfolio for SMEs in June 2024 was 1.9 percent the second lowest of overall financing from Islamic Banking Sectors while the highest share was 5.3 received from IBIs in March 2014. 3.7 percent portfolio recorded in June 2019, and the gradual decrease in financing SMEs, in the last 5 years, from Islamic Institutions, shows a clear gap between IBIs and SMEs (Islamic Banking Bulletin). Besides this, State Bank of Pakistan (2017) reported the need to remove the structural barriers to enhance the financing for SMEs. Fanta (2016) reported that SMEs provide 60 to 70% employment to the world population and 50% of the world's GDP, which suggests underfinancing of SMEs in Pakistan in comparison to the world. In (IFC, n.d.) report, 40% or 65 million SMEs in developing economies face a shortage of 5.2 trillion in financing. The above information is enough to understand how valuable SMEs are, as they contribute to GDP, generate employment, and facilitate export earnings; as a result, they help the country in economic growth and job creation. SMEs have the potential to contribute to job creation 10x times more than the current number of jobs (NBDP, 2022). Prior studies reported the significance of SMEs in the creation of jobs and the economic development of a country. They serve as an engine of job creation (Birch, 1987; Neumark et al., 2011; Ayyagari et al., 2011), especially for low-income countries. SMEs are one of the most important job creation source. The majority of jobs are created by micro, small, and medium-sized businesses (MSMEs), which are regarded as the foundation of low-income nations. They also make a substantial contribution to economic growth.

The micro, small, and medium enterprises (MSMEs) are believed as the backbone of low-income countries, contribute significantly to economic growth, and create new jobs to employ the largest number of people (Ayyagari et al., 2011). Hence, SMEs are playing a significant role in the development of an economy. The importance of SMEs is not limited to emerging, middle-, and lowincome economies; developed economies also heavily depend on SMEs for financial gains, such as employment, enhancing business and economic activities. Over 95 percent of business firms in OECD economies are SMEs, and they account for more than 60 percent of all jobs, and more than half of the value added by the business sector (Organisation for Economic Co-operation and Development, 2019). Ayyagari, Juarros, Martinez Peria, & Singh, (2021) suggest that increased access to finance results in higher employment growth, especially among micro, small, and medium enterprises. Hallberg (2001) reported that "SMEs are the emerging private sector in underdeveloped countries and thus form the base for private sectorled growth". In addition to facts and figures, SMES must face financing constraints which may limit their ability to play their role in job creation and economic development. Thus, these benefits can be realized only when SMEs survive and grow by overcoming the financing constraints.

Islamic shariah-compliant sources of finance can provide the desired capital to businesses. According to Islamic shariah, Islamic banks are not allowed to enter into interest-based transactions, and only shariah-compliant activities are allowed. Therefore, Islamic banks can be a significant source of capital for SMEs. Islamic banks, like traditional banks, are not willing to provide financing to SMEs (Huda, 2012; Raza et al., 2017). And the same is the situation in Pakistan. Therefore, this study aims to find the reasons for the reluctance of Islamic banks to provide capital to SMEs.

The Qualitative research approach is used in this study to examine these issues, focusing on regulatory framework analysis (e.g., A. SMEDA reports, SBP policies). According to the data, Islamic banks made very small percentage of the financing of SMEs in 2024 (SBP, 2024), even though SMEs made up 90% of all businesses. This review revealed important obstacles: 85 percent of entrepreneurs named energy crises and financing accessibility as their top barriers, while 43 percent of entrepreneurs lack formal education (Figure 1), which limits their ability to navigate financing options (Figure 2). These revelations highlight the need for customized solutions, like language-specific Islamic finance awareness campaigns and expedited documentation procedures. The main research question is: What are the key SME challenges and Islamic finance solutions in Pakistan?

The following is the structure of the study. A review of the existing literature and official policies of the government of Pakistan is presented in Section 2, Section 3 deals with research methodology, Section 4 provides findings and discussion, and a conclusion is presented in Section 5.

Literature Review

SME Definition:

Before 2000 it was very difficult to prescribe a specific definition for small enterprise, and we had only two standards to distinguish between small and large enterprises either through under factories act 1934 or through its size, so enterprise was considered as small one if it was not registered with labor department under factories act 1934 or if it contained less than 10, 100 or even 250 employees it would think to be as small enterprise Gallup Pakistan (2004).

According to Prudential Regulations for small and medium enterprises financing (May 2016) issued by the state bank of Pakistan, the definition of SME has separately been prescribed, and two parameters have been set for both small and medium enterprises in terms of employees' quantity and annual sales turnover as with the following; a small business or enterprise (SE) is an entity which fulfils the following parameters: the number of employees must contain up to 50 persons which include contract employees too, and annual sales turnover must reach up to Rs. 150 million according to prudential regulations for SME Financing, (2016).

However, medium enterprise (ME) is a business entity that fulfils the subsequent parameters; the number of employees, including contract employees, must be 51-250 in manufacturing and services sectors and 51-100 in trading whereas, annual sales turnover must be above Rs 150 million and up to Rs 800 million for all types of Medium Enterprises according to prudential regulations for SME Financing, (2016).

The State Bank of Pakistan has set the above parameters to distinguish between Small and Medium Enterprises, and both the small and medium enterprises must meet both of the parameters set to be categorized as either small or medium ones. However, in a case when a business or an entity cannot meet both parameters, let's suppose one small enterprise fulfils one parameter of SE, and the other parameter falls within the category prescribed for ME or the above limit for medium enterprise then that business or an entity would be considered as Commercial or ME/ Corporate business. For example, a small enterprise contains up to 50 people with annual turnover above Rs. 150 million then due to the second parameter is not as per SE so this business would be called a Medium Enterprise because it fulfils the parameter of annual sales turnover, which is set for medium enterprise and the same case may be with medium enterprise when one parameter is as per ME for example; the number of employees is in between 51 to 250 under manufacturing, services and trading businesses but annual sales turnover is above Rs. Eight hundred million then will have to consider this business commercial or corporate due to its access turnover.

Importance of Stakeholders in any system:

It is a fact that a system cannot produce the fruit unless it's all stakeholders play their role properly. It is very important in any economic/financial system, not only to sustain but also to become stronger than before, that beneficiaries and practitioners at joint ventures play their role primarily, and theorists and regulators help both of them to join their hands for the betterment of the economic cycle, secondarily.

No one can ignore the importance of an entrepreneur/businessperson in any economic growth, as they cannot stop themselves from giving equal importance or an inch above the customers or clients; therefore, it is necessary to know the needs of beneficiaries and the role of practitioners. Similarly, it is also helpful to seek guidance from secondary supporters like theorists and regulators, as each has great importance in this regard.

SME Sector (As Beneficiaries / Practitioners) in Pakistan Current Situation:

SME as beneficiaries include public/customers, clients and employees, suppliers, and financiers (direct & indirect). There are other types of beneficiaries too, like transporters etc. the other side SMEs as practitioners are entrepreneurs/businessmen and managers if any etc. economic survey conducted in 2008 as cited in Nenova et al. (2009) concludes that about 3.2 million enterprises exist in Pakistan, out of which about 3 million are SMEs, almost 93 per cent of all enterprises. There are 53 per cent of SMEs in trading, 27 in Services, and 20 per cent in the manufacturing sector. This census shows that the contribution of SMEs to GDP is more than 30 per cent and 25 per cent to the export income, and they employ nearly 70 per cent of the labor force in all types of business enterprises, including trading, services, and manufacturing. It is estimated that SMEs' share in the manufacturing value addition is 35 per cent.

Trends in SME financing in the three industries of trading, manufacturing, and services are revealed by the data from 2016 to 2024 in Table 1 Sector-wise SME Financing.

1. **Trading Sector:**

   From Rs 131.63 billion in 2016 to Rs 244.15 billion in 2024, the trading sector displayed a steady rise in funding. Approximately Rs 28.83 billion was added between 2023 and 2024, which was the period of greatest growth. The trading sector's importance to the economy is reflected in its steady growth, which suggests a high demand for financing.

2. **Manufacturing Sector:**

   Finance for the manufacturing sector grew as well, rising from Rs 173.88 billion in 2016 to Rs 234.64 billion in 2024. Nonetheless, there were variations in funding, especially from 2019 to 2023, when it dropped from Rs 212.74 billion in 2018 to Rs 204.43 billion in 2023. The industry recovered in 2024, as evidenced by financing of Rs 234 billion, which showed a resurgence of manufacturing investment.

3. **Services Sector:**

   Financing for the services sector increased significantly between 2016 and 2024, rising from Rs 89.14 billion to Rs 162.56 billion. Between 2023 and 2024, there was the biggest increase, with financing increasing by about Rs 39.78 billion. The expansion of the services sector's economic role and the rising need for financing in this area are both highlighted by this growth.

4. **Overall SME Financing:**

   Overall, the data shows that SME financing has grown significantly in the manufacturing, services, and trading sectors, with the trading sector showing the steadiest growth. The manufacturing sector's volatility points to different levels of investment, while the services sector's expansion shows how important it is becoming to the economy.

Table 1: Sector-wise SME Financing (in billion PKR)

SMEs Sector	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**
Trading	131.63	156.38	160.96	159.47	160.34	181.12	199.59	215.32	244.15
Manufacturing	173.88	185.73	212.74	197.96	202.64	225.57	214.77	204.43	234.64
Services	89.14	100.42	139.76	119.80	118.80	117.41	126.13	122.78	162.56
Total	394.65	442.00	513.46	477.23	481.78	524.09	540.49	542.53	641.30

It is worth mentioning that Islamic banks and IBDs have contributed a great share of SME financing from 2014 to 2024, which was Rs. 15.14 billion in Dec-2014 and reached Rs. 78.24 billion in Dec- 2024 Table 2 shows the gradual increase in total SME outstanding (Rs. in billion) shared by Islamic Banks and IBDs:
The SME Finance Annual Review data offers a thorough summary of the outstanding SME financing from 2014 to 2024 that was provided by Islamic Banks and Islamic Banking Divisions (IBDs).

From 2014 to 2022, the financing provided by IBDs exhibited a steady upward trend, reaching a peak of Rs 26.57 billion. This suggests a significant increase in the financing of SMEs by Islamic banking divisions. The financing saw a significant decline in 2023, falling to Rs 14.83 billion, before rising to Rs 18.60 billion in 2024. Market conditions or modifications to policies impacting SME financing may be the cause of this variation.

Trends in Islamic Banks Financing
The financing of SMEs by Islamic banks has increased dramatically, rising from Rs 6.09 billion in 2014 to Rs 59.64 billion in 2024. This significant increase demonstrates how Islamic banks are increasingly helping SMEs. Before experiencing a significant increase to Rs 59.64 billion in 2024, the financing peaked in 2018 at Rs 45.68 billion and stayed pretty steady between Rs 40 billion and Rs 45 billion until 2023.

Overall SME Financing
As mentioned in Table 1, between 2014 and 2024, the total amount of SME financing provided by Islamic banks and IBDs increased steadily from Rs 15.14 billion to Rs 78.24 billion. This suggests a significant expansion in the financing options available to SMEs via Islamic banking channels. Significant annual increases in total financing were observed, especially from 2016 to 2017 and again from 2023 to 2024. Periods of improved financial support or advantageous economic conditions for SMEs are indicated by these jumps.

Table 2: Islamic Banks and IBDs SME Outstanding (Rs billion)

Category	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
IBDs	9.05	9.84	7.76	8.86	11.10	12.45	16.74	22.93	26.57	14.83	18.60
Islamic Banks	6.09	10.99	21.27	31.79	45.68	45.21	40.16	38.23	36.00	42.34	59.64
Total	15.14	20.83	29.03	40.65	56.78	57.65	56.90	61.16	62.57	57.17	78.24

Source: SME Finance Annual Review.

Bank Categories
Table 3 shows the financing provided by different banking categories.

Domestic Private Banks
The amount of money provided by domestic private banks has steadily increased, rising from Rs 264 billion in 2016 to Rs 361 billion in 2024. Between 2017 and 2018, there was the biggest increase, amounting to about Rs 43.32 billion. The overall trend shows robust and consistent growth in SME financing by domestic private banks, except for a minor decline in 2019 and 2023.

Public Sector Commercial Banks
Public Sector Commercial Banks' financing has also been on the rise, rising from Rs 98.21 billion in 2016 to Rs 204.36 billion in 2024. The biggest increase in financing, of about Rs 65.51 billion, happened between 2022 and 2024. This expansion shows how Public Sector Commercial Banks are becoming more involved in helping SMEs.

Other Banks
Over time, the amount of money provided by other banks varied, going from Rs 67.93 billion in 2016 to Rs 49.12 billion in 2022 before rising sharply to Rs 75.35 billion in 2024. The variations show that different banks have different levels of support and investment for SMEs.

In 2024, the total amount of SME financing was Rs 641.35 billion, up from Rs 394.55 billion in 2016. While financing increased significantly in 2018 and 2024, the overall trend indicates consistent growth. This increase is indicative of a favorable economic climate for SMEs and reflects the general growth of SME financing across all banking groups. With variations in Other Banks, the data shows strong growth in SME financing across Domestic Private Banks and Public Sector Commercial Banks. The general pattern indicates a favorable and growing environment for SME financing.

Table 3: Bank Categories (Rs billion)

Banking Group	2016	2017	2018	2019	2020	2021	2022	2023	2024
Domestic Private Banks	264.37	299.68	343.00	319.65	324.60	344.80	352.52	323.31	361.64
Public Sector Commercial Banks	98.21	100.31	113.03	100.62	105.41	128.37	138.85	161.60	204.36
Other Banks	67.93	42.54	57.43	56.97	51.77	50.93	49.12	57.62	75.35
Total	394.55	442.53	513.46	477.23	481.78	524.09	460.21	542.53	641.35

Note: Figures are in Rs billion.

SME Sector (As Government of Pakistan and Regulator) in Pakistan Current Situation:

The Government of Pakistan and SBP's role has always been very supportive and encouraging to facilitate SMEs, and therefore, they have taken several initiatives and introduced many policies to help SMEs in getting finance from both Banks and other financial institutions smoothly. Nenova et al. (2009) have divided the initiatives taken by GOP and SBP into two major parts; one is to facilitate SME to increase the growth of lending, while the other side to motivate the financial institutions by making them realize that SME financing is profitable and ultimately to create a kind of competition among them and for this they have given a detailed definition of SME separately and asked the financial institutions to report every quarter about SME financing. Nenova et al. (2009) have further discussed two unsuccessful attempts made by SBP to increase lending to SMEs: creating the secured transaction system and giving relaxation in collateral requirements. The reason is that financial institutions seek securities, a financial statement with audit and business plans to rely on SMEs to produce loans rather trust on their business performance and collateral securities in abundance with immovable assets are ever found with SMEs, due to which SBP has removed this constraint by introducing a registry system for a lien over movable assets.

SME Regulations Step by Step:

The following sub-sections provide a brief detail about the policies and ordinances related to the SME sector, issued by different regulatory bodies in Pakistan.

Presidential Ordinance for the Promotion of SME:

Government of Pakistan has played a vital role in the establishment of SME businesses in Pakistan. On 12 August 2002, an ordinance was issued and published for general information by the President of Pakistan following the growth and development of SMEs in Pakistan (Gazette of Pakistan, Extraordinary, 12th August 2002). This ordinance aimed to promote and expand SME businesses throughout the country and encourage and facilitate SME financing by making policies and providing support services to SMEs. Under the ordinance, the establishment of the authority, its power and function, funds and their utilization, creation of the board, chairperson, etc., were prescribed only to help SME develop and grow their businesses in Pakistan (Gazette of Pakistan, Extraordinary, 2002). This ordinance was a great initiative taken by the government of Pakistan, which established the first brick to motivate Small business owners to take the step to start their businesses.

SME Policy, 2007 for the Promotion of SME by SMEDA:

Government of Pakistan has not stopped here after the issuance of the Gazette. As SME was in the main leading role to generate employment, reduce poverty and ultimately establish an economic cycle, the GOP established an SME Task Force through Notification No.1(68)/2003-Inv-III issued on 29th January 2004 under the Ministry of Industries and Production including both public and private members (SME Policy, 2007). The SME Task Force's job was to work effectively and address the four major areas:

1. Business Environment
2. Access to Finance
3. Access to Resources and Services and
4. SME Definition, Feedback, Monitoring, and Evaluation Mechanism

The Task Force recommended that there should be a separate policy and regulations for SMEs, along with its proper definition. Moreover, an SME support mechanism, policy evaluation, and review system should be established (SME Policy, 2007). This shows that the GOP's eye was on SMEs promotion from day first.

Prudential Regulations for SME Financing (2013) by SBP:

Before 2003, Banks and DFIs had the interest to finance large and medium-sized enterprises, and they were not interested in financing with SEs in their business; and because of this, SBP revised the definition of SME, which was prescribed in Prudential Regulations issued in 2003 after segregation between ME and SE in 2013 PRs so that SEs access to finance become easier than ever along with some specific regulation for small enterprises to help banks and DFIs to set their strategies when financing with small enterprises (Prudential Regulations for SME Financing, 2013).

The second major work done through PRs (2013) was the exposure limit for both SE and ME to be addressed in PRs for SME Financing (2013), which was not previously mentioned in the SME Policy (2007). Under regulation no. SE-2, Rs up to 15 million can be availed from a single bank/DFI or all banks/DFIs by a single small enterprise entity. However, Medium Enterprise can avail a maximum of Rs. 200 million but a single bank/DFI cannot cross the limit of Rs. up to 100 million for a ME. the other regulations were also made to help both SME and Banks/DFIs equally to promote SME Financing according to Prudential Regulations for SME Financing, (2013).

Prudential Regulations for SME Financing (2016) by SBP:

Revised PRs issued under the umbrella of the SBP Team for SME Financing (2016) also had some changes with the increased limit for SE Financing from Rs. up to 15 million to Rs. up to 25 million, which can be availed from a single bank/DFI or all banks/DFIs. However, the exposure limit for ME financing remained the same as previously mentioned in SME Financing (2013), Rs. up to 200 million (including leased assets) with one exception that a single bank/DFI was allowed to finance Rs. up to 200 million whose maximum limit for ME financing was Rs. One hundred million (2013). On the other side, banks/DFIs were also allowed to deduct the liquid assets from SMEs to calculate the per-party exposure limit (Prudential Regulations for SME Financing, 2016). This entails that the GOP wanted to promote SE Financing from a lower to an upper limit than ME financing.

Policy for Promotion of SME Finance (2017) by SBP:

On 22nd December 2017, SBP announced its new Policy for Promotion of SME Finance. This is another step taken by SBP to support SME Financing, mainly in three major areas:

1. To improve the regulatory framework in three directions: a) by revising PRs from time to time, b) to strengthen the secured transaction framework, and c) to introduce SME targets.
2. To develop a market environment with the help of the SME supportive refinance scheme, risk coverage scheme, and Islamic Financing of SME, cluster survey, and non-financial advisory service.
3. And most importantly, to improve capacity building between bankers and SMEs through awareness creation (Policy for Promotion of SME Finance, 2017).

SBP has also announced its key benchmarks, which are to be achieved by the year 2020. SBP, in line with its strategic direction, has declared that by the end of 2020, it is going to increase:

1. SME share from existing 8 per cent to 17 per cent in the private sector and
2. To take borrowers from an existing number of 174,000 to 500,000 persons (PoP of SME Finance, 2017).

SME has always been the key priority for SBP; that's why it has introduced nine key pillars of the new Policy for SME Financing (2017). Pillar number 7 is very important in this regard as it states that SBP, SMEDA, and SECP will jointly work, and they also make structured (in coordination with each other) calendars and programs for SMEs every year. It is also expected that the Non-Financial Advisory Service (NFAS) will improve accessibility for SMEs to financial solutions, and NFAS will try to enhance the relationship between bankers and SMEs (Pop of SME Finance, 2017).

"SMEDA's 2021–25 Policy: Enhancing SME Competitiveness through Financial Inclusion and Regulatory Reform"

SMEDA's National SME Policy 2021–25 for Pakistan seeks to facilitate business transactions to promote the growth and prosperity of small and medium-sized enterprises (SMEs). The main goals of the policy are to reduce taxes, streamline bureaucracy, and offer loans without collateral, particularly through the Asaan Finance Facility for SMEs. It also expands the supply of industrial land and makes it easier for SMEs to enter new domestic and international markets. Tax breaks and business support will be given to female entrepreneurs in particular. The strategy's overall goals are to boost exports, create jobs, and grow the SME sector by 2025 while enhancing the efficiency and availability of government aid.

Table 4: Summary of SBP and SMEDA SME Policies (2002–2021)

Year	Institution	Policy Title / Initiative	Key Features
2002	SBP	SME Prudential Regulations	Introduced dedicated prudential regulations to facilitate SME financing, aiming to improve access to credit and formalize lending practices.
2007	SMEDA	National SME Policy 2007	Aimed to promote SME growth through regulatory reforms, access to finance, and support services. However, its impact was limited due to nonalignment with evolving business environments.
2013	SBP	Revised Prudential Regulations for SME Financing	Updated regulations to distinguish between small and medium enterprises, enhancing credit access, especially for small enterprises. Emphasized cash flow-based lending and simplified documentation.
2013	SBP	Prime Minister's Youth Business Loans Scheme	Launched to provide subsidized loans up to PKR 2 million to young entrepreneurs, with a focus on women (50% allocation), requiring minimal collateral.
2016	SBP	Amendments to SME Prudential Regulations	Increased the annual sales turnover limit for small enterprises from PKR 75 million to PKR 150 million and the employee limit from 20 to 50, broadening the SME classification.
2017	SBP	Policy for Promotion of SME Finance	Comprehensive policy covering regulatory relaxations, financing targets, refinance and risk coverage facilities, value chain financing, adoption of technology, and capacity building of bankers and SMEs.
2021	SBP	SME Asaan Finance (SAAF) Scheme	Introduced collateral-free loans up to PKR 10 million with a fixed markup of 9% and government-backed risk coverage ranging from 40% to 60%. Included an Islamic variant (I-SAAF).
2021	SMEDA	National SME Policy 2021–25	Aimed to enhance SME competitiveness and formalization through simplified regulations, tax incentives, collateral-free financing, infrastructure development, market access, and promotion of women entrepreneurship.

Practical Applications of Islamic Finance in SME Development: The Case of Meezan Bank:

The following sub-sections provide the success stories related to the application of Islamic finance particularly related to Meezan Bank in SME sector.

Meezan Bank & Finja - Digital Islamic Financing for Small Retailers (2020)

In September 2020, Meezan Bank, in collaboration with Finja, initiated a Shariah-compliant digital financing solution for MSMEs, particularly neighborhood Karyana stores. The initiative responded to increased demand for localized retail during the COVID-19 pandemic and sought to bridge the financing gap faced by underserved businesses. Through a fully digital process, MSMEs could access unsecured Islamic financing with real-time approvals and disbursement via Meezan's Smart Wallet. This collaboration highlights the potential of Islamic fintech to enhance financial inclusion for small businesses in Pakistan

(Meezan Bank, 2020).

Meezan Bank Launches I-SAAF – Shariah-Compliant SME Financing (2021)

On December 23, 2021, Meezan Bank became the first financial institution in Pakistan to operationalize the Islamic SME Asaan Finance Scheme (I-SAAF), under the State Bank of Pakistan's SAAF initiative. The program offers Shariah-compliant short- and long-term financing of up to PKR 10 million at a subsidized rate of 9% per annum, targeting creditworthy SMEs unable to secure traditional loans due to collateral constraints. As the only Islamic bank among the selected institutions, Meezan's role underscores the viability of faith-based finance models in promoting SME development and financial access in a structured policy environment (Meezan Bank, 2021).

Meezan Bank's Key Initiatives Highlights (2022 to 2024)

Meezan Bank has strategically prioritized to support SMEs through a variety of Shariah-compliant financing initiatives. In 2022, Meezan Bank's SME financing portfolio was worth PKR 17.8 billion, which grew by 14% to PKR 20.3 billion in 2023 with over 2,100 to 2,200 customers subsequently (Meezan Bank, 2023). Surprisingly, in 2024, the SME portfolio grew by 38% and reached the highest peak worth PKR 28.2 billion. Under I-SAAF scheme, Meezan Bank facilitated 1,000 SME customers with over Rs 10 billion (Meezan Bank, 2024). This gradual and steady increase in the SME financing portfolio reflects the real concern to promote SME financing by Meezan Bank as the largest, premier Islamic Bank in Pakistan. It also indicates that the regulator SBP is playing a pivotal role in enhancing SME financing through its directives to IBDs. Below is the table that highlights SME key initiatives across the years and provides consistent growth not only in SME portfolio size but also the increase in the several customers:

Table 5: Summary of Meezan Bank's SME and Supply Chain Financing Initiatives (2022–2023)

Initiatives	Total Disbursement / Portfolio	Number of Customers
Digital Financing for SMEs	Rs 17.3 billion	20,187 transactions
Islamic SME Asaan Financing (I-SAAF)	Rs 2.76 billion	373 customers on-boarded
Commercial Fleet Financing for SMEs	Rs 7.0 billion	350 total customers (240 SME-specific)
PMYBL & ALS (Youth Entrepreneurship)	Rs 343 million	78 customers on-boarded
Supply Chain Financing for SMEs (SCF)	Rs 3.9 billion	465 customers

Source: Annual Report – Meezan Bank (2023)

Limitations in Existing Literature:

Policy documents, institutional reports, and publications from organizations like the State Bank of Pakistan (SBP) and SMEDA are examples of secondary sources that are frequently used in the majority of the studies that are currently available on SME financing and Islamic banking in Pakistan. These resources help comprehend the larger regulatory and policy framework, but they often do not adequately convey the real-world difficulties that SMEs encounter on a daily basis. One prevalent problem in the literature is that results are typically derived from context-specific data, which makes it challenging to generalize them outside of the immediate context. These studies' generalizations are thus still constrained. This disparity underscores the necessity of conducting more thorough research that draws from a variety of data sources, particularly those found within the SME sector. The generalizability of these studies is thus still restricted. The need for more grounded research that integrates a variety of data sources, particularly from within the SME sector itself, is highlighted by this gap. Because of this, the present study recognizes these gaps in the literature and expands on them to provide a better understanding.

Research Methodology

To synthesize existing findings and present a cogent analysis of the potential demand for Islamic finance among SMEs as well as the supply capabilities of Islamic banking institutions, this study uses a literature review methodology, especially SMEDA policy documents. A well-known and useful method for comprehending the theoretical and practical facets of less-studied fields is the literature review, especially when it comes to Islamic banking and finance (Triki and Bluejeaned, 2017; Raza et al., 2024). Significant trends, obstacles, and opportunities in the uptake of Islamic financial services can be identified, thanks to this methodology.

Understanding the practical aspects of SME financing requires a thorough review and analysis of governmental policies. This study looks at government regulations about financing SMEs to give a thorough picture of the situation as it stands nowadays.

The study's initial aim was to gather primary data by interviewing small business owners. But as the study progressed, it became evident that SME owners' participation would be difficult, mostly because of their informal structure and restricted availability for official interviews. Because of this, the emphasis naturally moved to a policy review, mainly using SMEDA documents and associated institutional reports. This strategy made the most of the data and resources that were practically available while allowing the study to stay true to its goals.

Findings and Discussion

The SME problems and suggested solutions by Islamic Finance

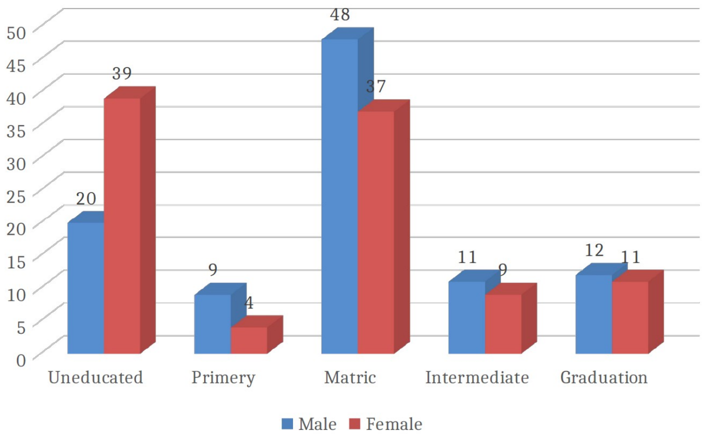
The section below provides the recommended solutions for the problems found during the study.

Problem and Suggested Solution: Low or No Educated SME Entrepreneurs:

Small and Medium Entrepreneurs who have mostly low or no education, which is shown in the following bar diagram:

Figure 1: Educational situation of SME Entrepreneurs

Source: Aslam, (2013), Redrawn by the author

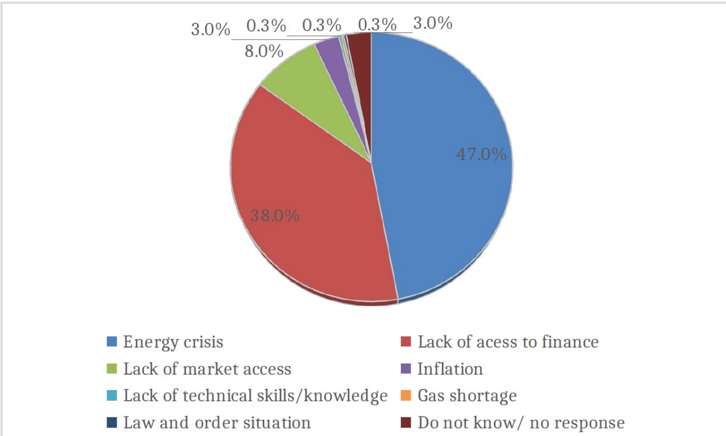


From Figure 1, it can be easily identified that 29% of male and 43% of female SME entrepreneurs are uneducated or only primary educated. Most are meteoric, and few have more than matriculation. Due to low or no education, they cannot read and understand the policies, procedures, and they cannot benefit properly from Government initiatives. For example, they don't know what has been done in the past 20 years for promotion by SMEDA, SECP, and SBP. Another barrier can be defined as that most content is in English, and almost all SME Entrepreneurs are not able or not comfortable reading and understanding English. Some of them only understand their mother tongue/ regional language, but most of them are comfortable using Urdu as a mode of communication.

Training and Consultancy can become alternatives to formal education. There should be awareness sessions for SMEs in Urdu and also in regional languages. These sessions should communicate to SMEs about initiatives and facilities offered to them in the last 20 years. The important and relevant material should also be translated into Urdu and regional languages. In this way problem "Low or No Educated SME Entrepreneurs" can be solved.

SME self-identified Problems & Solutions: Energy Crises, Lack of A2F:

Figure 2: SME Challenges and problems
Source: Aslam, (2013), Redrawn by the author



As per the above reference, SMEs' major problems (85%) are energy crises and lack of access to finance. If we analyse, both problems are mainly a lack of access to finance because alternative energy solutions can control the energy crisis after getting and arranging finance. Abdulsaleh and Worthington (2013) also concluded that a lack of finance is a crucial problem for SMEs. Due to these problems, SMEs' growth, profitability, and innovation processes cannot be properly implemented.

The problem can be solved by better management, proper accounting and costing, and applying for Islamic finance. The understanding of Islamic Banking and Finance by Small and Medium Entrepreneurs is also a question mark. Most of them still don't understand Islamic Modes of finance like Murabahah, Musawamah, Salam, Istisna, Ijarah, Musharakah, and Mudarabah. Due to a lack of knowledge, there are three categories of masses:

1. Who does not understand the difference between Islamic and Conventional Banking and Finance, and due to front front-end similarity of both systems' transactions. Most of them avoid the banking and financial system. Those who do not understand the difference between Islamic and Conventional Banking and Finance, but trust religious scholars and execute the transactions with only Islamic Banking and financial institutions.

2. Those who do not care about the difference between Islamic and conventional banking systems. They use both systems as per their needs, requirements, and attractive packages/rates.

There is a need for extensive awareness campaigns for the first and second categories, including training sessions in the short term and different academic programs.

Problems and Solutions: Unstandardized/Non-synced regulations and support from Government Institutions (Also corruption and hectic procedures)

Dar et al. (2017) conducted research and concluded that SMEs have an important role in GDP, but in Pakistan, they have many difficulties in playing their role for the economy, even though there was no standardized definition of SME. The authors compared SME definitions of SMEs within and outside of Pakistan. Currently, SBP, SMEDA, and SECP are working together to overcome this situation State Bank of Pakistan (2017), but there is also a need to plan and make joint efforts to eliminate corruption & hectic procedures.

Proposed Finance provider identified Problems & Solutions: SME is Undocumented & Non-systemized sector of the economy:

Another research study conducted by the International Finance Corporation - World Bank Group (2014) disclosed huge unserved and underserved SME sectors in Pakistan, a good opportunity for Islamic Banking and Financial Institutions (IBFIs). This IBFIs management claims that they have over-deposited and insufficient opportunities for investment and financing in the country. They are reluctant to needy the SME sector because they do not have valid and reliable documented accounting and other management systems, making it highly risky. If IBFIs invest and finance this high-risk sector, their Capital Adequacy Ratio (CAR) may be disturbed according to Regulations.

For these issues, finance providers or SMEs can get the help of management and accounting consulting firms which can provide their services in a cost-efficient manner due to expertise, the economy of scale etc. for these reasons, management and accounting consultants may not charge a very high price, they may focus on the number of customers on standardized products. They may use success stories of past SMEs, but current MNCs and local champions like Imtiaz and PnG, who systematized their work, are famous. They may use earning patrons like Google/newspapers, etc. (Service provider, user, and third party) in which fees are not charged or very minimally charged from the direct user, but the third party pays due to long-term benefits, like advertisers, etc. So, sponsor(s) may be required. These sponsors can be from the following:

- Islamic banking and financial institutions
- Small and Medium Enterprise Development Authority (SMEDA)
- Associations and bodies of SME on Local or international
- SBP and Other Govt. Institutions like SECP & SMEDA
- Other International and National Institutions.

Conclusion and Recommendations

This study aims to explore the reasons why Islamic banks are reluctant to provide financing to SMEs and provide possible solutions to these problems. Despite the significant regulatory efforts, improvement in policies and regulations about SMEs in the last many years, SME owners lack awareness about these developments and are also not up to date with these regulatory and policy changes. Furthermore, SME owners lack proper business education and understanding of Islamic Banking and Financial systems. Islamic Finance is the perfect solution for SME problems. Most SME owners are reluctant to interest-based banking and the financial system due to religious reasons, but at the same time, they don't know about the Islamic Modes of finance as a solution to their problems. This highlights a significant gap in awareness regarding Islamic financial instruments. Bridging this gap is the need for both Islamic banks, SME owners, and academia, which can be filled by the joint efforts of shariah scholars and Islamic Bankers, and SME owners by conducting Islamic Finance Trainings and awareness sessions, including Islamic Finance in academic programs and other ways of teaching and communication. The State Bank of Pakistan (SBP) has started efforts to fill the gap with the collaboration of major business schools in Pakistan, including IBA, LUMS, and IM Sciences Peshawar.

Islamic Banking and Financial institutions are reluctant to provide funds to SMEs due to the lack of documentation in SMEs. These issues can be resolved by providing package deals to SMEs from Islamic Banking and Financial institutions, for example, 1. Consultancy & training for proper organizational structuring 2. Awareness sessions regarding Islamic financial system awareness & various financing options, 3. Additional value-added services like warehousing, etc., in case some regulatory constraints create some issues with Islamic banks, according to the law about real business involvement. In that case, Mudarabah companies can be utilized to bridge the gap between the real and financial sectors of the economy.

Limitations and future research

Using a qualitative and exploratory methodology, this study mainly uses secondary data from publications like the Islamic Banking Bulletin, reports from the Small and Medium Enterprises Development Authority (SMEDA), and policy documents from the State Bank of Pakistan (SBP). As the study takes place in the legal and political context of Pakistan, the findings presented here are specific to this context and cannot be directly applied to other regions. This study focuses primarily on the SME sector, which remains largely undeclared and informal. Since many SME owners are reluctant to take part in official inquiries or surveys, engaging with this sector can be especially difficult. These factors make the findings difficult to generalise. Future research could build on this study by using primary data to better understand the realities faced by SMEs and provide more wellfounded answers to the problems discussed here.

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