INTERNATIONAL JOURNAL OF RESEARCH IN COMMERCE & MANAGEMENT

A Monthly Double-Blind Peer Reviewed (Refereed/Juried) Open Access International e-Journal - Included in the International Serial Directories

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   RESULTS & DISCUSSION

   FINDINGS

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CONSTRAINTS IN FINANCING OF SMEs: A CONCEPTUAL PAPER IN THE PERSPECTIVE OF PAKISTAN

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ABSTRACT

The limited availability of financing and least financing channels to Small Business Enterprises (SMEs) is significant issue for policy developers and has been a deeper interest for researchers all over the world. Desired financing for smooth and efficient running of the operations of SMEs is major barrier as compared to large size firms. The conceptual paper focuses upon the factors, which hinder the lending institutions to fulfill the financing needs of SME and tries to discuss pros and cons of such obstacles faced by SME in Pakistan. It is obvious from literature review that financing facilities and improvement of SME have positive relation almost all over the world i.e. in respect of fiscal growth and employment. Relationship among factors and lending facilities is major concern of this paper. Goal of this study is to provide theoretical analysis and justification of those factors, which hinder the financing facilities to SMEs in Pakistan. This paper also focuses upon the requirement of lending institutions in different areas upon which the financing facilities are decided and challenges in this regard. The methodology in this paper will also equip the researcher to get better information on specific financial need of SMEs to quench the thirst of lending institutions requirement in friendly manner so that growth and prosperity of country will be achieved.

KEYWORDS
SMEs, financing facilities.

1. INTRODUCTION OF SMEs

Small Business Enterprises (SMEs)have been a topic of utmost significance as they perform key role in development of any country irrespective of the nature of economy (developing or developed). SMEs not only provide major revenue to economy but also generate employment opportunities.Nowadays,a country cannot get standard of growth without active role of SME sectorand that is why it always remainsindebted to this sector. SME sector is key player that promotes positive trade balance, competitive advantage, increased export level, job opportunities, diversified businesses, entrepreneurship trend in country, acceleration in the economic development and gigantic poverty reduction factorin country (Mudassir, Marryam 2012).

Pakistani economy undoubtedly is SME economy as it is the second most important sector of economy after agriculture. Around 3.2 million are registered business that offered 99% of employment opportunities according to Federal Bureau of Statistics (FBS). FBS claims that contribution of SME in Pakistan is significant in 2011; SME contributed 40% in GDP with RS 140 billion in exports. Share in GDP was 10% more in 2011 as compared to previous three years. Punjab was leader in SME as 65% business activitieswere being operated in Punjab while the rest was there in other three provinces.

The limited availability of financing and minimal financing channels to SMEs are significant issue for policy developers and have a deeper interest for researchers all over the world.

SME sector was major indicator of progress in country during 2005. Pakistan was ranked 135th out of 174 countries on Human Development Index (HDI). Contribution in growth rate from SMEs is higher than the contribution made by large size businesses.This sector has also increased prosperity level in low or middle income masses of Pakistan. SME sector contributed approximately 30% in GDP in 2007 and this contribution rose up to 40% till 2011.As per the claim of International Trade Center, SMEs have provided 35% of employment opportunities in Pakistan. A large number of researchers have argued that SME is disadvantageous toget desired external finance as compared to large size firms. This happens because of different nature of financing requirementsof SMEs. (Naveed and Anas 2012)

Large firms have advantage of access to the capital market and get a quick financing at low cost but this is not the case with SMEs in Pakistan owing to high level of regulatory and other constrains. Equity portion of SMEs at market level is very minimal that compels them to get financing from government grants, banks' loans and different types of interest-bearing financing. Such nature of different accesses leads the SMEs towards fluctuations in their own policies. The essential requirements from lending institutions do not exactly match the ability of SMEs by making it tougher to get financing at appropriate and affordable terms and conditions.

There are diverse types of financingsavailable to SMEs in Pakistan, which are channelized through financial institutions. Government of Pakistan also tried to deal with the problems of limited availability of financing, lack of awareness by strengthening this sector throughSmall and Medium Enterprises Development Authority (SMEDA). Afew burning questionsarise here;do the essential requirements formulated by financial institutions meet the desires of Pakistani SMEs?Do the essential requirements set by lending bodies are aligned with the abilities of SMEs? Are SMEs able enough to get financing by meeting essential requirementsfrom financial lenders? Are owners or managers of SMEs are competent to meet the banks' requirements and switch the opinions of lending institutions in favor of their business? If all these question are not in the favor of SMEs then how they would elaborate constrains faced by them. This conceptual study will answer all of these questions. Specifically, this study is more inclined to get the theoretical improvement in framework and analysis in context of small and medium business enterprises along with factors affecting the lending institutions to grant loans in Pakistan. The challenges and issues about the requirements of lending bodies to SMEs are also important.

2. LITERATURE REVIEW

2.1 DEFINITION OF SME

Different countries across the globe try to interpret the definition of SMEs in respect of their economic, social and infrastructural setup. The definition of developing and developed countries varies and not challenged anywhere owing to their unique circumstances. Pakistan's Small and Medium Enterprises Policy 2007 elaborates the definition in two respects i.e. number of employees and annual turnover. In national policy of SME business is up to size of 250 employees, paid up capital up to Rs. 25 million and annual turnover up to Rs. 250 million. SMEs are also further divided into different categories by different people i.e. micro, small and medium size businesses.

TABLE 2: SME DEFINITIONBY SME POLICY 2007

Business type	Number of employee	Amount of capital	Annual turnover
SMEs	Up to 250	Up to RS. 25 millions	RS. 250 millions

2.2 FACILITIES AVAILABLE TO SME IN PAKISTAN

Diverse nature of businesses in SME requires different types of customized financing for their unique operations. This leads the banking sector and financial institutions to launch broader types or products to fulfill the requirements of SMEs. According to SMEDA reports, financing needs of SMEs are poised on three stages like start up, expansion and rehabilitation. Recently, banks are major players to provide the financing to SMEs but Islamic financing products are also getting popularity with the passage of time. Limited and regional facilities of Islamic financing reduce the usage of conventional loans in SMEs. The facilities available to most segments of SME in Pakistan include conventional loans, operating and financial lease, leasing of hire purchase, bill of exchange, banker acceptance, revolving credit facility and factoring.

Government of Pakistan is also providing facilities to SMEs for prosperity of economy.Small and Medium Enterprises Development Authority (SMEDA) was incorporated in 1998 under the Ministry of Industry and Production. It has brought a revolution and launched different programs and policies to support and strengthen SMEs in Pakistan with clear-cut objectives. SMEDA provides different facilities to this sector including the accessto international grants, facilitation in securing financing,identification of opportunity on the basis of demand and supply, conduct seminar and training workshops and support in business development.

International agencies and donors also play a major part to enhance the effectiveness and efficiency of SME sector. Pakistan gets grants from different international and regional institutes to foster the financing and infrastructural harmony in SME. Most im0protanaly, the use of such aid in efficient manner is questionable in context of Pakistan and requires much attention of higher authorities. Some of the international donor agencies are listed below:

- United National industrial development organization (UNIDO)
- U.S agency for international development (USAID)
- Canadian international development agency

2.3 MAJOR CHALLENGES FACED TO SME IN PAKISTAN

SME sectorin Pakistan faces three types of challenges i.e. asset financing, regulatory requirements and infrastructural. Asset financing is prominent among all and requires immediate action of government to boost this flourishing section of economy. Government is trying to put concentration on this segment through international collaboration and enthusiastic efforts. Government of Pakistan has launched different entities through Trade Development Authority of Pakistan, SMEDA, NPO and PSICto boost the performance of sectorwith crystal clear objectives but despite of all these sincere efforts and measures,the goal to get the maximum benefits from this sector is quite far from true destination and requires attention on priority basis.

Asset Financing:

- Collateral issue
- Absence of suitable banking product aligned SME needs
- Lack of awareness and access for SME
- Absence of credit enhancement and other alternative

RegulatoryEnvironment for SMEs:

- Taxation
- Labor law

Infrastructural Challenges:

- Less trained management and HR skill
- Skilled labor

2.4 THE BARRIERS TO SME ACCESS TO FINANCE OPERATION

Literature review on economic growth and firms financing shows that shortcomings to get finance is key constraint to SME growth. Schiffer and Weder (2001) argued empirically that large firms have greater edge in borrowing-related decisions from market than SME and this particular obstacle is ranked at top in the growth of SME.Furthermore, World Bank also claims that credit availability to SME is most pressing issue in any economy especially developing counties. These constraints are owing to financial sector policy biases, limited knowledge on the part of banks, information differences and high degree of exposure involved in lending to SMEs. Stiglitz & Weiss (1981) verified that finance to SMEs may be tough decision for lending bodies because of informational asymmetry and adverse selection problems. Beck et al. (2005) described that size, age, policy and management of SME are key factors that determine nature of constraint in finance related issues.

Lending entities are often classified into two categories i.e. a transaction lending that primarily focuses upon quantitative nature of data (financial statements) and relationship lending that significantly focuses upon qualitative nature of information. SMEs mostly get financing through relationship lending in developing counties. (Berger, 2005)

3. THEORETICAL FRAMEWORK OF THE STUDY

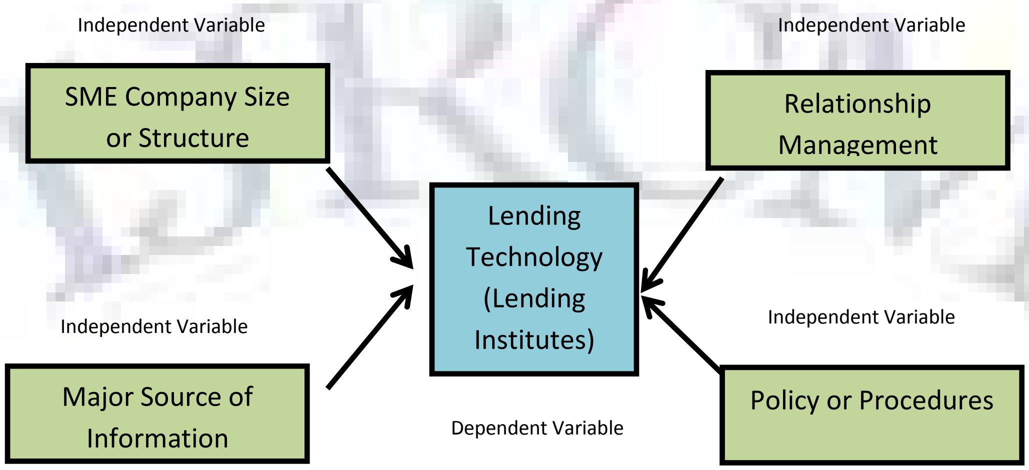

TABLE: 3 SMES SIZE OR STRUCTURE

Micro size of SMEs	1-5
Small size of SMEs	5-100
Medium size of SMEs	100-250

3.1: EFFECT OF COMPANY STRUCTURE ON LENDING DECISIONS

Kunt and V (2005) haveconducted a survey at firm level in fifty four economies and found that major constraints of SMEs are financial, regulatory and corruption, which hinder the optimal growth rate in specific economy. The study revealed major constraintsin getting financing from lending entities are firm size.Smaller firms are severely affected to finance their operations owing to their size in contrast with large firms. In developing countries, legal or regulatory constraints along with corruption issues affect more than firm size. The study also described that corruption of any kind in banking staff also affect the firm's growth in short-run and it often happeneddue to asymmetric information. The paper also suggested to improve regulatory and financing development in best interest of small and medium size businesses.

Burger and Gregory (2006) discussed the finance availability issue to SMEs and behavior of lending technologies to finance the operations of SMEs. Banking lending decisions are mostly dependent upon the structure and environment in which they operate the business. Small businessesare more likely to get financing on the basis of soft information (relationship lending).

Bakker at el. (2004) tried to focus upon the lending decisions of banking on factoring. Factoring is a particular type of lending that is granted on the basis of account receivables and getting popularity with the passage of time especially in working capital needs. Though factoring ratio varies across the globe but a significant amount of lending is involved in this mechanism. This paper argue with solid empirically evidence that factor has advantage over other types of lending in SMEs in developing countries.

Klapper (2006) found empirically that factoring is larger in percentage in developed countries rather than developing countries and mitigates the issue of collateral financing by diversifying the risk of SMEs.

Berger (2006) argued banking lending decisionsare sometime based uponsome defined rules to accept or reject the application especially in SMEs. Some banks use credit score to reduce cost. This mechanism excludes the SME sector to get finance due to low credit score. Large firms with better infrastructure get better grades and access the availability of credit easily. Some banks use the credit score calculated by other banks and decide credit extension on their discretion that may not be beneficial to small and medium size businesses.

Uchida at el. (2006) conducted the study in Japan to ascertain the relevancy of different lending institutes that promote SME sector. Small banks and other lending institutions having impelled amount of soft information usually decide about lending to SME sector on the basis of soft information (relationship lending).

3.2 IMPACT OF POLICY TO GET FINANCING

Nadar at el. (2011) focused on virtual teams in manufacturing SMEs and found a positive effect on the performance of businesses. The SMEs having policies in favor of virtual teams had more growth rate as compared to ones without policies for virtual teams. The paper concluded that policies of SMEswere prominent factor in profitability and growth.

Karl (2011) studied the impact of generic strategies (cost, differentiation) on the performance of SMEs. The author conducted longitudinal study form 1991-2002 and found that combination of strategies is viable option for long-run and the firms consistent in specific policy (strategy) have advantage over other firms, which have no policy during the entire period.

Paul at el. (2011) studied critical factors affecting Customer Relationship Management (CRM) on SMEs and traced relationship between CRM and efficiency of SMEs through quantitative methods in Ireland. Online survey was conducted on 1,485 SMEs and it was concluded that SMEswere not following CRM practices at the extent of large firms but the tendency to follow the CRM practices was increasing with the passage of time.

Maria (2012) has conducted a study on the policies of small firms about innovation. Typically, innovation has been found to be associated with large businesses but it doesn't mean that there is no active role of SMEs in the area on innovation. Through quantitative study, it has been made obvious that SMEshave been also the main producers of innovation in every field.

Evelyn (2012)has ascertained different reasons for not accepting loan application from SMEs by the banks in Tanzania. Interview method has been used to collect theprimary data along with secondary data, which has concluded that lack of awareness, poor presentation of documents, improper collateral, different financial product of banks and limited knowledgehave been the main reasons.

3.3 IMPACT OR REGULATOR REQUIREMENT ON LENDING DECISIONS

Mudassir (2012) has investigated relationship in lending to SMEs and large businesses. Pakistan is facing the problems of high inflation rate and high interest rate at the same time. Loan availability between SME and large businesses have negative relation, which shows that SMEs have faced the limited availability of credit during period of high inflation owing to intense legal requirements by the lending institutions.

It is eminent that the growth of SMEs is a better mechanism to eradicate poverty in the country. Maryam (2012) has found empirically that SMEs have larger impact on poverty reduction in trade liberalization contrast to large size businesses.

Ammar (2012) has traced down the factors limiting the growth of SMEs in Pakistan. Pakistan has been ranked below average in Asia in the context of SMEs supporting activities (budget, employee, facilities). The paper has also revealed many obstacles in growth of SME sector and shed light on legal and regulatory requirement fulfilled by SMEs.

3.4 RELATIONSHIP LENDING (SOFT INFORMATION)

It has been proved that SMEs mostly get relationship lending owing to their weak or smaller size infrastructure that does not support the entity to get financing from capital market. Especially, relationship lending is common in developing countries including Pakistan, Bangladesh and Nigeria. SME sector should focus on soft information (relationship lending) rather than transaction lending. SME must adopt policies to get financing through this mechanism for the future growth and better financing terms and conditions. (Paul et al. 2011)

4. CONCLUSION

This particular study focuses upon the conceptual framework of factors, which influence lending institutes to channelize the finance towards SMEs in Pakistan. Theoretical conclusion drawn from the literature supports that company size (structure), relationship to lending technologies, source of information, policy or procedure adopted, monitoring strategies adopted by lending institutions haverelationship and huge impact on decision making processes of lending institutions. Lending bodies formulate specific strategies according to the said factors and channelize resources by analyzing information gathered on the basis of these factors. Our findings would help the SMEs to shape their policies according to the requirementsof lending institutions in the best interest of SMEs. Small and Medium Enterprises may launch proposals to get financing by in-depth analysis of such constraints and factors. They may also immune to rejection of financing needs at affordable terms and conditions.The findings of this paper would also help lending entities to understand specific financial needs of SMEs and devise financial products aligned with SMEs requirements. SME sector should focus on soft information (relationship lending) rather than transaction lending. SMEs must adopt policies to get financing through this mechanism for the future growth and better financing conditions. It may be imagined that easy access to lending institutes would help Pakistani SMEs to boost economic activity, uplift living standard of masses, dramatic increase in export, better employment opportunities, positive GDP with poverty alleviation as a target in long-run.

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