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Innovative solutions to tap "Micro, Small and Medium Enterprises" (MSME) market

A way forward for Islamic banks

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Abstract

Purpose – The purpose of this paper is to indicate an innovative solution to address the financing issues faced by "Micro-, Small and Medium Enterprises" (MSME) in emerging economies.

Design/methodology/approach – Islamic Financial Institutions (IFIs) especially Islamic banks are competing for high net worth individuals, whereas the MSME sector is largely untapped. A collaborative model for IFIs is suggested, to explore the MSME sector. Islamic Non-Banking Financial Institutions (NBFIs) are operating in these markets through their extensive gross route networks. The multistep collaborative model proposes "Special Purpose Entity (SPE)" partially owned by a single Islamic Bank or consortium and NBFI/s. SPEs can be incorporated with a defined scope, focus areas, risk profile, budget and shareholding patterns.

Findings – Risk and profit sharing instruments also known as *Musharakah* and *Mudarabah* have less than 6 percent share within total financing offered by Islamic banks globally. Risk sharing products offered by Islamic banks are not targeting this sector due to the underdevelopment of instruments, lack of knowledge and resources. Proposed SPEs can operate regionally with a concentration on specific business sectors.

Originality/value – The SPE model would enable Islamic banks to enter the huge MSME market while mitigating risk. On the contrary, it would enable the large segments of emerging economies (bottom 40 percent population of developing nations) to get involved and actively play their role to attain long-term development goals.

Keywords Developing countries, Islamic banking, Economic development, Special purpose entity (SPE), Micro-, small and medium enterprises (MSME), Non-banking financial institutions

Paper type Research paper

1. Introduction

The Islamic banking sector is a dominant part of Islamic finance industry. According to Islamic Financial Service Board (IFSB, 2016), there are more than 300 Islamic Finance Institutions (IFIs) providing financial services in more than 50 countries, with assets close to US$1.9 trillion. The exponential growth of Islamic finance industry explains the market needs for financial services based on values of risk sharing instead of risk transfer, which is the basic principle of Islamic finance industry and central component of shared prosperity. The objective of IFIs is promotion of equitability through wealth creation, distribution and circulation by providing equitable investment opportunities and fulfilling financing needs of the existing customers. These institutions are also playing a vital role in the inclusion of new customers, the ones who decided not to use the existing financial system due to personal or religious reasons.

According to IFSB (2015), the size of Islamic banking industry stands at US$1.48 trillion in terms of assets. The enormous growth can be attributed to multiple factors. The foremost

JEL Classification — G21, G23, G28, G32, H81, I38. KAUJIE Classification — I67, L5

is the expansion into new international markets as well as the transformation of the existing system in current operational markets, besides competing with the conventional financial system. According to Bankscope data, there were 161 Islamic banks globally at the end of 2014, depicting double digit growth compared to last year. The oil price fluctuations since 2014–2015 changed liquidity position in oil exporting nations, especially Gulf Cooperation Council countries, resultantly increasing demand for sustainable financial services. The Islamic banking industry also came to positive light for having negligible impact during global financial crisis of 2008–2009 that made a huge dent on conventional financial industry's strength and resilience. This brought the Islamic banking industry at forefront to compete with a conventional system in different markets around the world.

The literature on Islamic banking explains its distinctive features compared to conventional financial institutions, though both are operating in common markets with similar functions. The distinction in approach is explained by various studies (Askari and Mirakhor, 2014; Chapra, 2000; Henry and Wilson, 2004; Iqbal and Molyneux, 2005; Iqbal and Mirakhor, 2011; Wajdi Dusuki and Irwani Abdullah, 2007; Warde, 2000; Wilson, 2000). These distinctive features include fairness in dealings, transparency, risk sharing, innovative products for existing and new customers, besides the efforts for balanced social values reflecting the underlying objective of shared prosperity envisioned by Islamic economics. The expectations of positive impact and contribution of IFIs toward real economy are rather the main objectives of Islamic economics that these institutions are supposed to achieve (Iqbal and Mirakhor, 2004).

The study is organized as follows: in next section, we would explore the recent studies and other literature to understand the actual impact of IFIs on real economy. Section 3 includes the detailed explanation of "Special Purpose Entity (SPE)" model to improve the financial access and inclusion of new customers and financing for Micro-, Small and Medium Enterprises (MSMEs) market. Section 4 covers the case of Saudi Industrial Development Fund (SIDF) KAFALH, which is designed to provide guarantees for small and medium enterprise (SME) loans and Section 5 concludes our study.

2. Islamic Financial Institution's (IFIs) impact on real economy

2.1 IFIs and financial inclusion

Financial inclusion represents generally ease of access, availability and usage of financial system. It explains the diverse concept of inclusive development or shared prosperity to cater poverty around the world. The concept of financial inclusion across countries, for developed economies, is more about knowledge and availability of fair and transparent products, whereas in developing economies, it's about access to financial products and basic knowledge to interact with financial institution. There are studies such as Beck *et al.* (2007) validating the strong correlation between ease of access to financial services and reduction in poverty.

Although Islamic economic teachings are based on the concept of shared prosperity, the lack of access to financial services and instruments or utilization issues due to religious reasons can have strong impact on efforts to reduce poverty and attain development goals. IFIs can play a vital role to address issues related to inclusion and resultant inequality. IFIs have the ability to design the innovative equitable wealth distribution instruments to cater the needs of masses in developing economies. These instruments can mobilize resources and fulfill the liquidity needs of different segments of society (Iqbal and Mirakhor, 2012).

According to World Bank and Islamic Development Bank Group (2016) on Islamic banking, the level of religiosity in Muslim-majority countries is 85 percent, whereas almost 9 percent of their population is not using any kind of financial services due to religious reasons. It's a huge gap, more than 40m individuals can be included into the main stream financial system by enhancing reach and financial literacy about the availability of IFIs a nd Islamic instruments. Another important aspect is the number of banks offering Islamic financial services in the existing markets are very low except few countries

(Zulkhibri, 2016). Limited geographical reach as measured by such banks per 10,000 square kilometers is another important phenomenon explained in Table I.

The recent literature suggests the need for enhanced financial inclusion by providing more and diverse and integrated Islamic banking Institutions, while improving the geographical presence of existing IFIs. There is a need to improve financial literacy by providing awareness about Islamic financial instruments especially focusing on market needs with risk sharing credentials.

2.2 IFIs and market concentration

The theory of Islamic banking is distinctively known to be based on risk sharing principles for the equity-related *Shariah* principles (i.e. *Musharakah* and *Mudharabah*), but there is a gap between theory and market practices. IFIs were supposed to provide alternative financing opportunities and fill the financial exclusion gap left by conventional financial system and not to adopt a widely mimicking approach.

If we look at the recent statistics regarding financing provided by the Islamic banking sector, 25 percent of financing facilitates the consumer durables, whereas 16 percent of financing goes to real estate and construction, 12 and 8 percent to manufacturing and trading accounts, respectively (World Bank and Islamic Development Bank Group, 2016). All these sectors are important for economic development and shared prosperity. But a deeper exploration of assets side of aggregate Islamic banking balance sheet would reveal the hidden challenge and reasons of growth stagnation. *Murabahah* and deferred sales contracts are the most dominant form of financing provided by Islamic banks globally and accounts for more than 78 percent of total assets. Lease and hire purchase contracts constitute almost 11 percent, whereas risk and profit sharing instruments also known as *Musharakah* and *Mudarabah* have less than 6 percent share within total financing offered by Islamic banks globally.

The gap between aspirations and reality is clearly visible in Figure 1. The asset side of Islamic banks shows that banking institutions are mainly focused on debt-based instruments such as *Murabahah* and deferred sales contracts, as the easiest instrument to mimic the conventional ones. The actual risk sharing products that are distinctive feature of Islamic banks such as *Musharakah* and *Mudarabah* are not clearly visible on aggregate Islamic banking balance sheet. The design of market competition with the conventional financial system by offering Islamic versions of famous market products is not new, rather recognized many years ago by Iqbal and Molyneux (2005).

Competing for high new worth individual in operational markets and capturing market share from conventional banks by mimicking Islamic banking products with conventional banking products is the approach adopted by majority of Islamic banks. This approach has worked in terms of improved results as Islamic banks are experiencing exponential growth in

Table I.
Financial inclusion and IFIs in selected Gulf Cooperation Council (GCC) countries

Economy	Religiosity (%)	Number of IFIs	Islamic assets per adult[a]	Number of IFIs per 10m adults	Number of IFIs per 10,000 km^2
Bahrain	94	32	29,194	301.6	421.05
Kuwait	91	18	28,102	87.2	10.10
Oman	–	3	–	14.4	0.10
Qatar	95	14	13,851	86.5	12.08
Saudi Arabia	93	18	1,685	9.2	0.08

Note: [a]Islamic assets per adult ($)/Size of Islamic assets in the banking sector of an economy per its adult population
Source: Global Report on Islamic Finance, World Bank (2016)

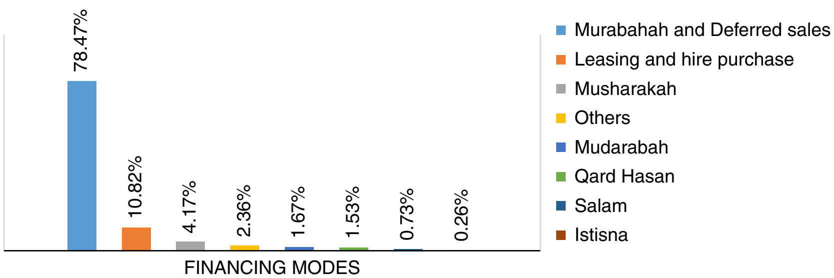
terms of total assets as well as increase in their market share, but this diverted their attention as well, from real economy to financial securitization to mitigate their financial risk. This simple approach has attracted conventional banks to diversify their existing product line by offering Islamic banking products besides conventional products. For example, after the introduction of Islamic banking services in Pakistan, which formally initiated after the registration of first Islamic bank known as "Meezan Bank" in 2002, many conventional banks started offering Islamic banking products to retain their existing customers.

This is beyond any doubt that Islamic banking products offered by Islamic banks or Islamic division of conventional banks in different countries are according to sharia board guidelines. The issue is with the market focus, one possible explanation of this strategy is extreme inequality around the globe. Almost half of the world's wealth is owned by just 1 percent of the population (Fuentes-Nieva and Galasso, 2014), whereas richest 10 percent of the population hold 86 percent of the wealth (Credit Suisse, 2013). With such extremely skewed operational environment, Islamic banks are focusing on points having enough financial resources to fulfill their banking needs with sharia compliant products and have sustainable growth for foreseeable future. One can expect that after accumulating enough resources, these institutions would focus on neglected sectors of emerging economies as well. By enhancing financial inclusion and providing financial services to underprivileged and MSMEs, Islamic banks can contribute in poverty reduction while making it possible to attain development goals with ease.

2.3 IFIs and micro-, small and medium enterprises (MSMEs) market

SMEs and start-ups are pillars of both developed and developing economies in terms of economic growth, sustainability, employment opportunities and business integration. In developing economies, SMEs contribute up to 60 percent in employment opportunities and up to 40 percent in national income (Ayyagari *et al.*, 2011). Accommodating various definitions of SMEs with respect to the number of employees, total turnover and working capital, several studies have confirmed the central role played by this sector in national economies (World Bank-IDB-IRTI, 2015). Given central role of SMEs, the support setup for the existing and new ventures in various countries is not significant compared to their actual participation. Multiple challenges including access to finance, technology, market, skilled human resource and legal frame work are the reasons for the underdevelopment of this sector in many developing countries.

Access to finance is the most prominent challenge faced by this sector, according to IFC (2017), MSME market is facing US$2.4 trillion financing gap. This is huge challenge for international financial institution, governments, and national financial sector of respective countries. The situation is more severe in developing nations, where 55–68 percent SMEs are financially underserved or not served at all.



Source: World Bank (2016)

Figure 1. Islamic modes of financing by Islamic banks

The role of Islamic banks in financing MSME market is almost insignificant due to risk associated with this sector. According to the survey of Islamic bank offerings for SMEs (IFC, 2014), only 16 percent banks offer products for this sector, whereas the portfolio penetration rate is much lower and stands at 11 percent. In another similar survey conducted by IFC (2014), SMEs operating in Muslim-majority countries prefer financial products based on Islamic principles. Although there is a large demand from the MSME sector as shown in Figure 2, Islamic banks are rather incapable or reluctant to cater this demand.

An alternative approach to fulfill the financing needs of MSME is Non-Banking Financial Institutions (NBFIs), although the NBFI sector is small in many developing countries, Islamic NBFIs are emerging with the passage of time, for example, in Pakistan the Islamic NBFI sector has experienced the growth of more than 200 percent from 2010 to 2015 (SECP, 2016). Islamic NBFIs are operating in emerging MSME markets through their extensive gross route networks, such as *Akhuwat* (Pakistan), *Dompet Dhuafa Republika* (Indonesia), *Waqaf Al Noor* (Malaysia) and *The Fa'el Khair Program* (Bangladesh) that are few prominent examples of innovative solutions to explore the MSME market. These organizations are based on philanthropic principles, so their operation model needs basic modifications to fulfill the Islamic banking risk mitigating criteria. A survey of 36 providers of Islamic microfinance products to SMEs (Sanabel, 2012) showed only 15 percent of providers were Islamic banks, whereas 49 percent financing share was covered by non-governmental organizations and 24 percent by NBFIs. This explains the huge demand for Islamic finance products by the MSME sector, and NBFIs can play a role to fulfill these financing needs. In next section, we would explore the possibility of collaboration between Islamic Banks and Islamic Non-Banking Financial Corporations (NBFIs) to explore the large MSME market in emerging economies.

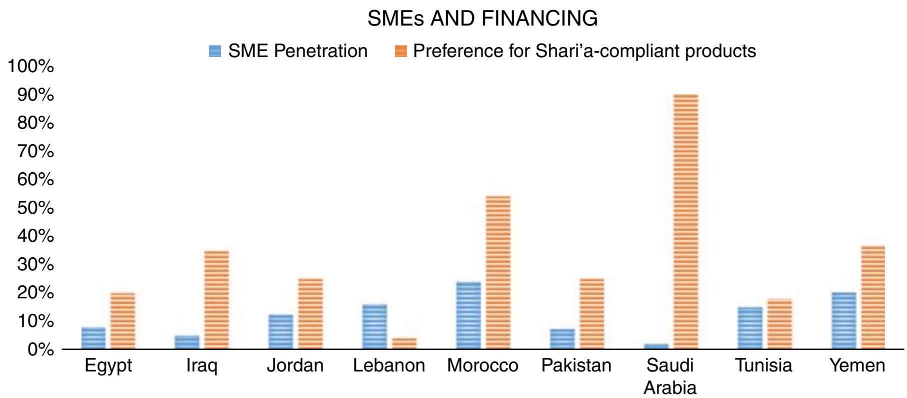
3. The way forward, a collaborative Islamic financial institution

The extensive literature review on Islamic banking and IFIs reveals the following patterns:

(1) IFIs are competing with conventional financial institutions in financial markets around the world.

(2) IFIs are mimicking the conventional products for their *Shariah* compliant products for quick access to market.

(3) IFIs are focusing on high net worth individuals to cater their financial needs by offering Islamic banking products.



Source: IFC (2014)

Figure 2.
SMEs and Financing, market penetration rate in selected countries compared to demand for Islamic financing products

(4) Islamic banks can attract financially excluded individuals due to religious reasons because of their sharia compliant products and services.

(5) Islamic banks are concentrating on debt-based instruments such as *Murabahah* as their major financing product in their operational markets.

(6) Lack of resources integration between Islamic banking and Islamic social finance (i.e. *Zakat, Waqf* and *Sadaqah*).

(7) Concentration of wealth and prevalence of inequality do push existing and new Islamic banks to focus on markets with enough resources and compete with conventional as well as other Islamic banks.

(8) High risk in MSMEs market make it unattractive for Islamic banks as well as other major IFIs to explore, operate and expand.

(9) Islamic NBFIs are playing an active role in MSME sectors instead of banking institutions.

(10) Due to limited resources Islamic NBFIs are unable to fulfill needs of MSME market.

Indeed, there are shortcomings, but Islamic banks are fulfilling the financing needs in major markets around the globe. Increasing financial inclusion, reducing poverty and paving the way for shared prosperity need collaborative efforts by not only Islamic banks but NBFIs, including *Zakat* and *Waqf* institutions and governments of respective countries.

We propose "SPE" model, a collaborative effort by different institutions to provide financing solutions to MSME market, such as Islamic Banks, NBFIs, including *Zakat* and *Waqf* institutions and Government. Collective and integrated efforts would reduce the risk for banking institution through government guarantees, increase their geographical presence, enhance financial inclusion and access through NBFIs extensive network and resultantly would contribute toward shared development as well as prosperity.

3.1 Special purpose entity (SPE) model

The "SPE[1]" model is proposed to fill the financing gap for the neglected MSME sector with institutional and governmental collaboration. Being the real growth and development contributor in developed and developing economies, the MSME sector can flourish with better financing access and advancement opportunities. On the contrary, the SPE would be useful to diversify Islamic Banking assets while providing liquidity to NBFIs for SME financing projects. MSME projects fulfilling SPE financing criteria can receive financing guarantee from central, provincial or local government to mitigate the higher risk for financial institutions.

As explained in Figure 3, SPE is collaborative effort by multiple financial institutions and government. Roles and responsibilities of each SPE formation partner are intended to achieve the underlying objectives regarding financial access, inclusion and to enhance IFIs role in real economy.

3.1.1 Key features of SPEs. SPEs are designed to focus on the designated geographical region as well as the segment of MSME sector. Multiple SPEs working in the same geographical region for different segments would enable existing small business and new ventures to locate the funding source with ease compared to choosing from multiple financing institutions with complex offerings.

Regional focus. SPEs would be incorporated with operational market limitations in terms of geographical area or region. This would allow SPEs to focus on that particular area by increasing financial literacy and enhancing financial inclusion. Without regional limitations, SPEs may not have to dig deep into single market as they can easily find potential customers with good financial literacy to utilize their products at the national level.

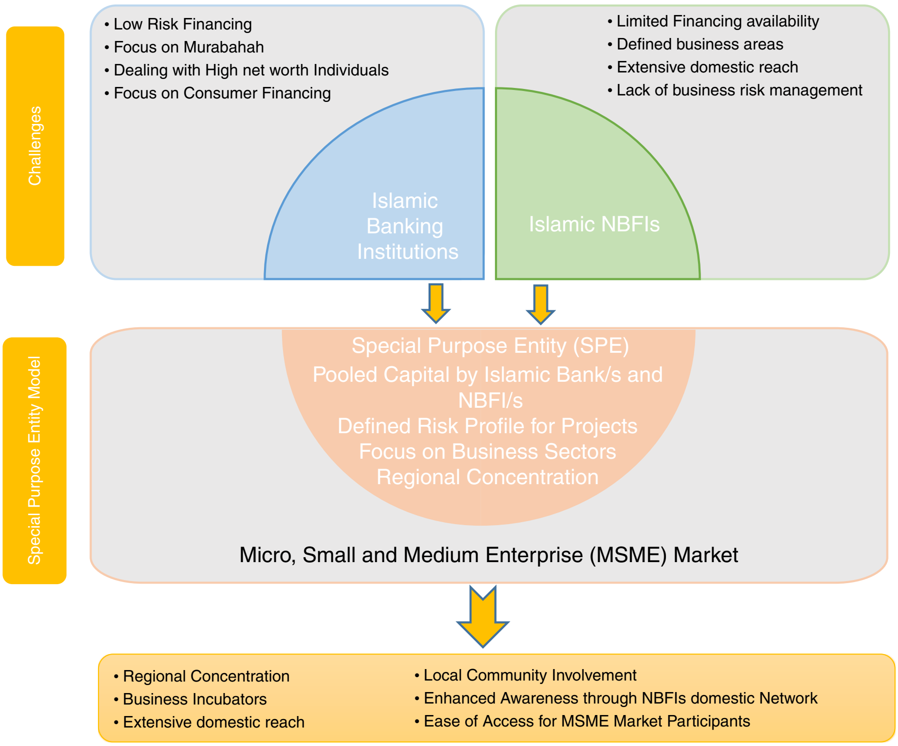


Figure 3.
Special purpose entity model for micro, small and medium enterprise market

Segment focus. There are many segments within the MSME sector: startups, high-tech ventures, established SMEs and microfinancing are few to mention. SPEs would be segmented specific according to our basic model. Though there can be exception in certain regions according to their social and economic structures, being focused on single segment enables SPEs to explore that particular area and achieve operational efficiency due to dealing with similar projects. Designing SPEs would explore the particular segment and work on potential customers by improving financial literacy and inclusion resultantly.

Figure 4 shows the pattern of collaboration required for the formation of SPE and resultant flow to cater the needs of specific regions and sections of MSME market. Roles and responsibilities of formation partners and objectives of SPEs are explained in Figure 5.

3.1.2 Role of government and financial institutions. Central, provincial or local government. The implementation of multiple policy measures is a difficult task especially for governments in developing or poor countries. There is a limitation regarding resource availability and allocation, governments have to adopt an optimal allocation policy to cater the needs of different sectors in economy. The MSME sector needs special attention to achieve long-term development goals, and, for this reason, there are special policy measures across many developing nations to boost investment and growth of this sector. One can find examples of such MSME support programs in almost every emerging economy.

Effectiveness of such MSME support programs is the key to understand the growth trajectory of this sector in any economy. If government decides to support the MSME sector through credit guarantees and regulatory push, it can be much more effective compared to providing direct financing or subsidies. That can be the reasonable explanation of different credit guarantee programs related to SMEs in many developing

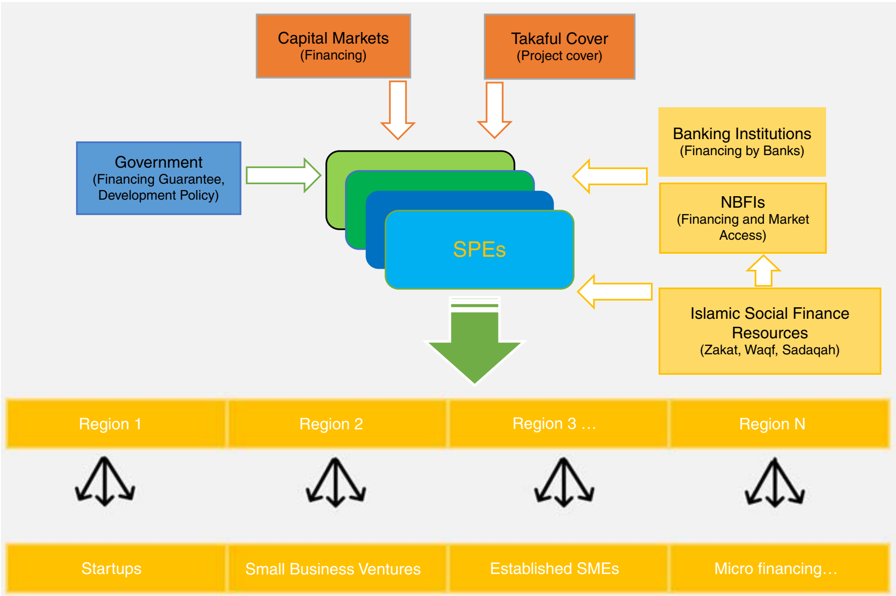


Figure 4.
Collaboration and flow pattern

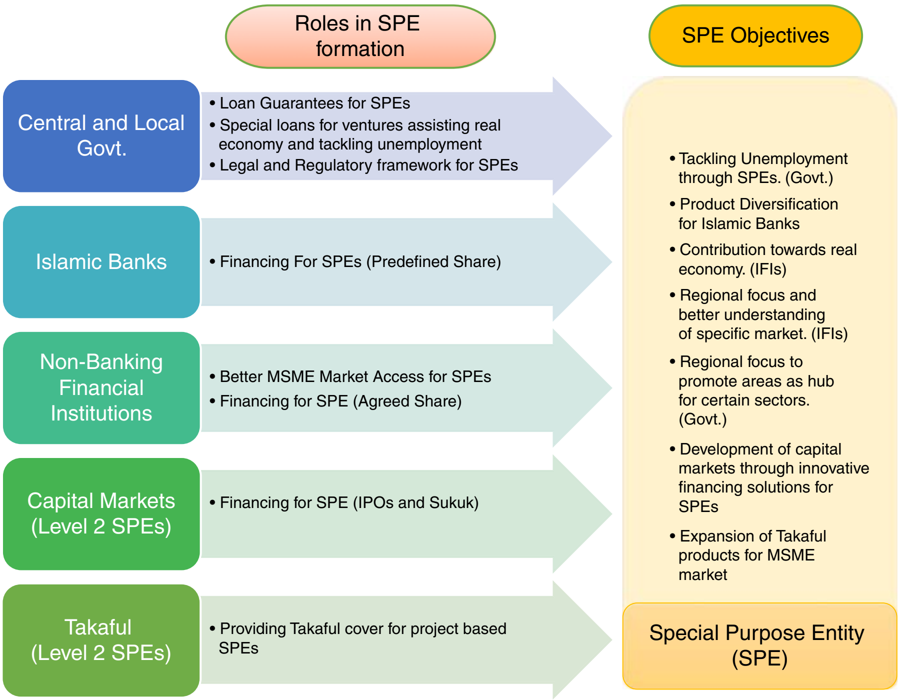


Figure 5.
Roles and responsibilities of partners at formation stage and underlying objective of SPE

countries (World Bank-IDB-IRTI, 2015). A prominent example is the "KAFALH or credit guarantee" program operational in Turkey, Saudi Arabia and Jordan. (Propose to include Islamic social finance resources (i.e. *Zakat, Waqf* and *Sadaqah*)).

With the exiting SME credit guarantee program, the loan approved by conventional or Islamic banks can be guaranteed under the umbrella of such system. It would eliminate the risk factor for financing institution that is Islamic bank in our case and ease the process of obtaining financing for SMEs. There are issues about financial literacy as well as program awareness; the SMEs that are already a part of financial system and utilizing services of Islamic banks would avail this program. There are no efforts to enhance the financial inclusion and provide access to SMEs being excluded from the current system. SPE model addresses these issues beside enhancing credit guarantee programs by focusing on the following features:

- extension of credit guarantees through KAFALH program for all financing provided through SPE;
- each SPE can operate within specific geographic area, or region; and
- each SPE can provide financing to specific segment within the MSME sector.

These measures would ensure that the efforts must be made by SPEs to provide financial access within their operational area and market segment. The marketing campaigns to enhance financial literacy within particular region would automatically increase financial inclusion of the ones, considered below par formerly.

The SPE model can be helpful to achieve another important governmental policy goals of regional integration. By allocating SPEs certain regions and segments to focus, government can designate those regions for specific products or startups, to attract human capital. For example, in Saudi Arabia, "Ministry of Finance" or authority dealing with SPEs can designate "Jeddah" as hub for technology startups. To implement this policy, SPEs focusing on technology startups within Jeddah city and surrounding region should be incorporated. SPEs would start their operations, by marketing and providing innovative risk sharing products to technology startups, the strategy would attract human capital focusing on technology startups from all over the country to this region. With additional branding efforts, the city can attract human capital from international market as well.

Role of Islamic banks. Islamic banks are playing an active role as prominent IFI in their markets. Due to different limitations (as discussed in Section 2), they have to compete with conventional as well as other Islamic banks to have sustainable assets side with adequate liquidity flow. Islamic banks are mostly focusing on debt-based instruments such as *murabahah* and deferred sales contracts to retain their profitability:

- SPE model enables Islamic banks to provide financing to MSME sector perceived as risky, by mitigating risk through "KAFALH" or credit guarantee program. After the elimination of risk factor Islamic banks can allocate enough resources for these markets because Islamic banks can diversify their existing assets portfolio without increasing their risk profile.
- After mitigating risk through KAFALH programs, risk-sharing products can generate good returns for Islamic banks due to exponential productivity and profit generation capabilities of MSMEs.
- Region- and segment-specific SPEs provide opportunities for Islamic banks to focus on different regions as well as segments of the MSME sector.

Islamic banks are supposed to provide a major chunk of financing for SPEs. As "KAFALH" program eliminates the risk for SPE projects, the investment in SPE can be major breakthrough for Islamic banks to penetrate into regional markets and improve their growth and profitability. The segment and region specific SPEs can open up innovative means for bank portfolio diversification besides expansion into new markets by providing services to financially excluded segments of society.

Non-Banking financial institutions. NBFIs are fulfilling the needs of customers who are unable to reach proper financial institutions. Besides the enormous growth of Islamic NBFIs in different markets, this segment of Islamic financial industry is mostly underdeveloped.

NBFIs are very important in the SPE model due to their extensive outreach network. Although entering into a new market or focusing on specific segment, the most important consideration is to understand the market dynamics. A survey by Banerjee *et al.* (2013) on Indian microfinance schemes explains the factors behind success or failure of such schemes. The people or prospective customers approached by financing agencies for their microfinance projects played a critical role in diffusion of positive or negative information about those schemes. If people contacted initially were of good repute and had extensive network of human connections, then the word of mouth created positive impact and the schemes received affirmative response. On the contrary, if persons contacted initially were not influential, then the schemes were unable to create a dent on social structure of society and overall the schemes were unable to approach its potential customers and cover their target markets. Figure 6 depicts this phenomenon with the help of two networks, “a” and “b.” The network with single node having connections with all community members is shown as “a,” whereas the network “b” has multiple central nodes but a sparse community structure. Understanding the network structure of market and utilizing the connections are important for SPEs, and NBFIs can play a vital role in this regard.

NBFIs can help the SPEs to explore the markets by utilizing their existing network. These institutions can also share financing burden and profitability ratio according to SPE formation agreements between collaborating institutions.

Capital markets and takaful (Level 2 SPEs). Islamic capital markets or Islamic products in conventional capital markets are also emerging with the passage of time and growth of other IFIs. SPEs operating in different geographical markets focusing on specific segments would be categorized according to their operational efficiency, market reach and profitability ratios after their initiation. Their performance and rating can enable certain SPEs to obtain more financing directly from capital markets and use Takaful cover for their projects. By continuing our example of SPEs covering “High-tech Startups” in Jeddah and surrounding areas, their performance can be tracked by their projects and returns from those projects, these financial entities can easily obtain financing from capital markets through initial public offerings or Sukuk offerings. Depending on their financial history “Takaful” cover can be placed instead of other guarantees. Figure 7 shows the process of SPE upgradation after fulfilling the regulatory requirements.

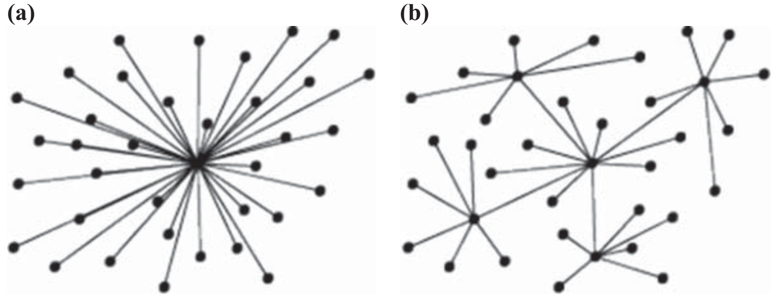


Figure 6. Networks with (a) single central node and (b) multiple central nodes

3.1.3 Objectives of SPEs. The incorporation of SPEs would enable these entities to fulfill the underlying objectives taught by Islamic economics and can be explained as follows:

(1) Financial inclusion: SPEs can improve financial inclusion by marketing their risk sharing product and enhancing financial literacy of their potential customers.

(2) Better access: SPEs can provide access to financially excluded areas as well as enhance their understanding about innovative product offerings.

(3) Portfolio diversification: SPEs would enable Islamic banks to diversify their existing investment portfolio and provide innovative products to different segments of economy.

(4) Development goals: SPEs can help governments to tackle unemployment, reduce poverty and inequality by providing loan guarantees for MSME market.

(5) Regional integration: SPEs can facilitate the process of regional development and integration by focusing on specific regions and segments of MSME market.

(6) Development of Islamic capital markets: the next level SPEs can generate financing through Islamic capital markets and play their roles in the development of these financial markets.

(7) Takaful: by using Takaful cover for different projects, the next level SPEs can contribute to the development of the Islamic Insurance sector.

4. The case of Kafalh program

4.1 SMEs loan guarantee program (KAFALH)

The Saudi Ministry of Finance and SIDF initiated the KAFALH SME financing guarantee program in 2006 to improve the financing for MSME sector. The program works in collaboration with financial institutions mainly Islamic and conventional banks by covering lenders risk up to 80 percent in the case of repayment issues, partial or complete default. Since its inception, the program achieved remarkable growth and success in terms of providing guarantees for SMEs to avail financing for their operation projects or expansion plans.

According to SIDF, main objectives of the "KAFALH Program" are as follows:

(1) development of the SME Sector by providing valuable financing;

(2) equality through distribution of income;

(3) enhancing capital investment in communities;

(4) increasing national production;

(5) increasing volume and quality of goods and services available in market;

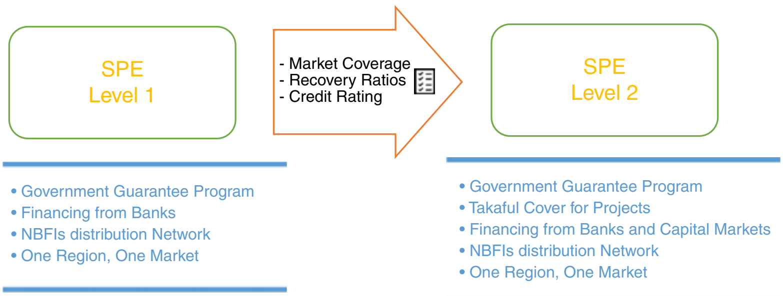


Figure 7.
SPE upgradation process and benefits for next level entities

(6) integration of SMEs with large corporations;
(7) development of neglected areas in different provinces;
(8) diversify exports and increasing volume;
(9) countering unemployment issues through the SME sector; and
(10) attracting SMEs to avail funding for better future prospects.

Since its inception, the program received overwhelming response and extended financing guarantees to more than 7,222 SMEs, with almost 15,000 number of guarantees as shown in Figure 8.

4.2 Current model of KAFALH

In current operational model, the SMEs having knowledge of the KAFALH program can obtain financing. SMEs has to approach the financial institution with business plan to justify the financing requirements, and bank can accept and proceed with KAFALH guarantee or reject the application according to their set standards, the process is shown in Figure 9.

With the KAFALH program, the financing becomes more and more accessible to the SME sector and the program filled the important gap to some extent. The default rate of guaranteed financing stands to about 1 percent in 2014. Almost 49 percent of the value of financing received guarantees from this program, whereas maximum coverage goes up to 80 percent. This clearly depicts the potential for more financing and strict requirements being enforced by banks.

The current KAFALH model is designed to fill the financing gap for existing SMEs already working with financial institutions but unfortunately ignore the financial inclusion of excluded segments of MSME market. We propose the application of the SPE model for the KAFALH program to include neglected areas and segments of SME market.

4.3 SPE model for KAFALH

In the SPE model, the KAFALH program can be included as a "Government's initiative" to provide guarantees for SPEs financing operations. As the system is already in place, the

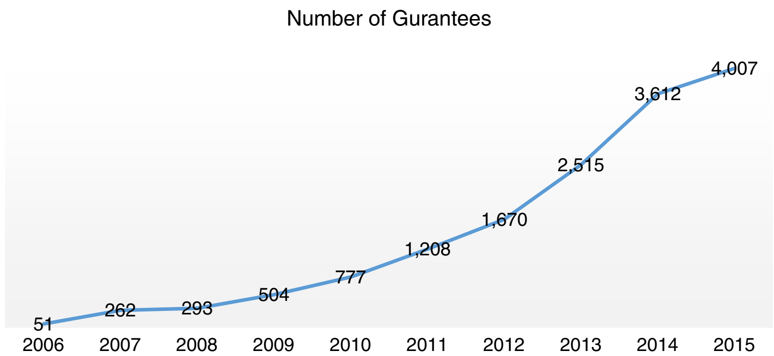


Figure 8. Number of Guarantees by KAFALH program since its inception

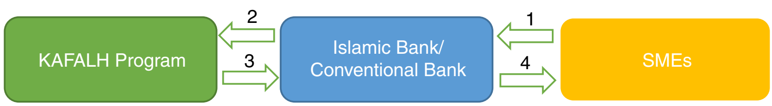


Figure 9. Decision-making process of KAFALH program

banking institutions and NBFIs can combine their efforts to establish specialized entities to focus on certain geographical regions and segments of MSME market to utilize the full potential of available financing guarantees.

The SPE model can help to attain long-term goals of "Vision 2030." The government can designate each region to focus on particular product or service, and SPEs can provide the financing with the help of KAFALH guarantees as shown in Figure 10. This would enable every region to develop their specialty and have competitive edge in it, and this approach can attract financial as well as human capital from all over the region. Regional development and integration can pursue national development goals, and regions can play their role in a much better way to realize goals of "Vision 2030." Technical details such as, size of SPE, share of financing by financial institutions, optimal size of target market, geographical limitations, segment focus and extent of utilization of capital markets would be focus of our upcoming studies.

5. Conclusion

IFIs are operating in more than 50 countries around the world. These institutions can play an important role to increase financial inclusion, reduce poverty and inequality due to underlying principles of risk sharing instead of risk transfer. Besides tremendous growth in markets share, Islamic banks are facing criticism for focusing on high net worth individuals and well-served segments of society. The MSME sector is a vital component of developed and developing economies. Due to a higher level of risk associated with financing arrangements, Islamic banks rarely focus on this area to provide much needed financing. We proposed a collaborative SPE model to deal with associated risk by government's involvement through the credit guarantee program. Islamic banks can provide financing to large segments of society and play their role in economic development. NBFIs can be a part of SPE by providing financial resources as well as their extensive knowledge of regional markets to focus on particular geographical regions and market segment. SPEs can utilize Islamic capital markets to generate more capital and obtain Takaful cover for specific

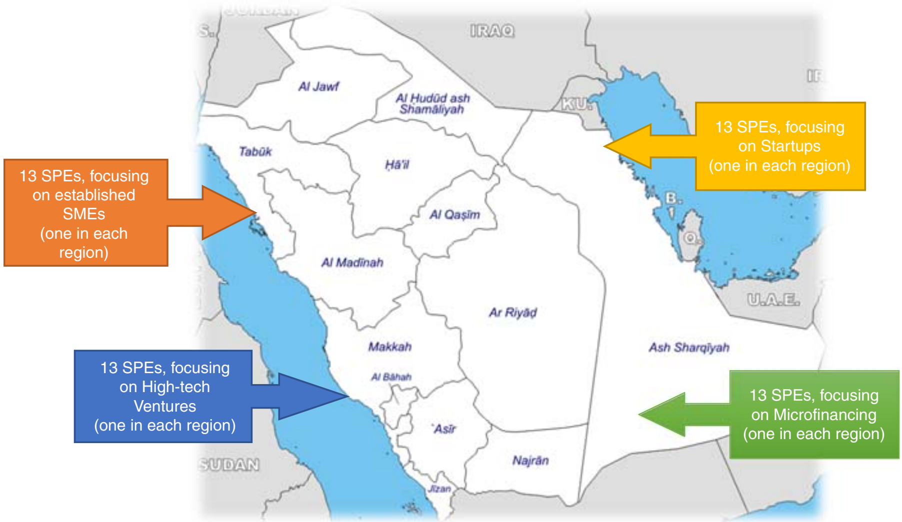


Figure 10.
SPEs in Saudi Arabia using existing KAFALH program

Note: There are 13 Administrative regions in Kingdom of Saudi Arabia
Source: Wikimedia Commons

projects at later stage. Geographical focus and MSME market segment limitations for SPEs would encourage the entities to explore their target market and utilize the available financing. The KAFALH Program by the Ministry of Finance and Saudi Industrial Development Funds is prominent example of government's push to provide financing to the important SME sector. By using the SPE model KAFALH program can serve SMEs all over the country and fulfill objectives associated with "Vision 2030" including regional integration, industrial expansion and development of startup culture among others.

Glossary

GCC	Gulf Cooperation Council
IDB	Islamic Development Bank
IFC	International Finance Cooperation
IFIs	Islamic Financial Institutions
IFSB	Islamic Service Financial Board
IPO	Initial Public Offering
IRTI	Islamic Research and Training Institute
MSMEs	Micro, Small and Medium Enterprises
NBFIs	Non-Banking Financial Institutions
SIDF	Saudi Industrial Development Fund
SME	Small and Medium Enterprise
SPE	Special Purpose Entity
SPV	Special Purpose Vehicle

Note

1. The proposed SPE model is rather completely different from special purpose vehicle (SPV) used by financial entities for securitization, bond issuance and other off-balance sheet transactions. The SPVs also known as "Paper Tigers" are commonly used by IFIs as well. Our model suggests totally a different type of entity having actual presence in different geographical regions instead of just paper-based entity.

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