

# Factors Related to the Financial Assistance of SMEs Through Kafala Programmes in Saudi Arabia

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## Abstract

Based on a literature review yielding 11 useable papers, importance of SMEs to Saudi economy, problems of banks in lending to SMEs and problems of SMEs to access finance and the government solutions to these problems, primarily by implementation of kafala programme, were discussed. The effectiveness of kafala programmes in terms of actual achievement of access to finance and increased capabilities of SMEs were discussed based on the sourced reports.

There is definite lack of objective studies on effectiveness of kafala programmes on financial performance of SMEs which have received the assistance. Research on these aspects will alone indicate whether the programme was truly effective, rather than just providing assistance.

It was concluded that the extent of access to finance and developing business capabilities of SMEs have significantly improved due to the implementation of kafala programme for the purposes. Further progress towards the achievement of the full potential will come through the implementation of Vision 2030.

**Keywords:** Kafala, SME, Saudi Arabia, Saudi Vision 2030

## Introduction

This is a review paper on factors related to kafala system of financial assistance to SMEs in Saudi Arabia. The word “kafala (or kefala)” means sponsorship. Hence, kafala system is a sponsorship system. Many applications of kafala system exist. In one such application, this system is used for monitoring migrant labourers engaged in construction and domestic sectors of the Middle East countries including Saudi Arabia. However, the context reviewed here is kafala financial assistance given to small and medium enterprises (SMEs) in Saudi Arabia.

The kafala programme for easy financial assistance to SMEs in Saudi Arabia was launched in 2006. The programme is a collaboration between the Ministry of Finance of Saudi government represented by Saudi Industrial Development Fund (SIDF) and the banks. The banks provide loans to SMEs, about 80% of which is guaranteed by SIDF.

So many factors led to the decision of the Saudi government to sponsor financial lending of banks to SMEs. In this paper, these factors will be examined in detail with help of available publications.

## Methodology

Available literature on factors related to introduction of kafala and progress of financial lending by banks were obtained by searching Google Scholar and Google. The search yielded 11 usable papers. These are discussed under different subsections below.

## **Review**

### **Importance of SMEs in Saudi economy**

One report by Jureidini (2017) gives the following details of the current status. As in many other countries, SMEs generate employment and contributes to the economic growth of Saudi Arabia. About 99 percent of businesses in Saudi Arabia are SMEs. These cater to about 64 percent of total employment in the country.

In another report (GCF, 2015), SMEs constitute about 99% of business establishments and contribute 62% of the employment. SMEs have excelled in technology sector, especially in e-commerce. They also contribute to agricultural sector in eastern provinces. They have also become important components of value chains of big corporates.

### **Problems banks have regarding financing of SMEs**

It is not easy to motivate commercial banks to raise their lending level to SMEs. Only less than 2% of total lending by KSA banks goes to SMEs, when the main problem for SMEs is the lack of access to finance. Lack of SME transparency, poor credit information from credit registries and bureaus, and weak creditor rights and risk assessment problems were listed as problems banks face in lending to SMEs in MENA region, in a joint report of United Arab bank and World Bank (Rocha, Farazi, Khouri, & Pearce, 2011). However, credit guarantee schemes have facilitated some large scale SME lending. Improvement of financial infrastructure, greater and deeper coverage by credit bureaus, simplification of collateral requirement to include movable assets, increasing competition between lending institutions, solving weaknesses in insolvencies and credit reporting regimes, direct policy interventions through banks, lower reserve requirements, subsidized lending and guarantee schemes have been suggested by the authors.

Lack of collateral, poor financial performance, infeasible business plans, incomplete information and projects not qualifying for the Kafala programme were reasons of banks for not lending credit to SMEs in Saudi Arabia, as was revealed in a doctoral thesis by Waked (2016). The difficulties of SMEs in this respect, were related to high collateral requirements, high interest rates, long time lag to get insufficient loan challenging loan criteria and application conditions imposed by the banks.

According to the (IFC, 2014), lack of capabilities for effective businesses management leading to inefficient operations structure, weak financial reporting and unviable operations with high levels of debt and SMEs operating mostly in the informal sector are some difficulties banks have in financing them. Most banks do not have the capabilities to lend to the SME sector, as their lending processes are inadequate and there is no SME-specific products or portfolios even in the case of Islamic products. There is lack of trained staff and the outreach is inadequate. The significant risks involved together with high costs of transactions/servicing the SME customer also deter banks from targeting the SME sector. These institutional gaps force the banks to lend only to emerging and medium and large-sized businesses as these are safer investments than SMEs, for which the banks already have the capabilities.

### **Problems of SMEs in accessing bank credit**

In a study by Ahmad (2012), financial support, bureaucracy, lack of credit options and unfriendly business environment were identified as the problems experience by micro and small business enterprises in Saudi Arabia.

## **Government Initiatives to promote SMEs**

The significant role of SMEs for national development was long recognised by Saudi government. As a result, the government has incorporated significant strategies for the promotion of SMEs in its Vision 2030 document. The plan, under Saudi Vision 2030, is to enhance the contribution of SMEs to the GDP from the current 20 percent to 35 percent. The most important method for this is to increase their access to funding. This involves a significant strategy of encouraging financial institutions to enhance their SME funding from the current below 5% to 20 percent of all the loans given by them. A General Authority for Small and Medium Enterprises (Monsha'at) was established in 2015, with the aim of increasing the contribution of SMEs to the economy from 500 billion Riyals in 2014 to 2 trillion Riyals by 2030. Monsha'at will implement strategies which can promote innovation, facilitate funding, and create jobs for male and female Saudis. Monsha'at will hold conferences and exhibitions to enhance communications. These conferences and exhibitions will also provide a number of platforms for young Saudis to get increased access to finance and collaborate with established companies. A conference named BIBAN aims these objectives. Restriction of SME market only to professional investors and reforms in Saudi capital markets are taking place in line with these aims of the Saudi government. According to another report (National, 2017), the deployment of 4 billion SR for exclusive financing of Saudi SMEs is expected to create 58000 jobs by 2027 by way of a Public Investment Fund (PIF). Considering the heavy investment, the jobs target seems modest. The fund will also facilitate private sector investment, innovation and exports. The deployment of PIF is expected to contribute 400 million SR to the GDP and 2600 jobs by the end of 2020. These will rise to 8.6 billion SR contribution to the GDP and create 58000 jobs by 2027. Shortage of skills is a serious problem in the case of SMEs, especially in Saudi Arabia. The government wants to solve this problem through specific efforts in its Vision 2030. The aim is to decrease unemployment from the current 11.6% to 7 percent by 2030 and to increase female participation in the workforce from the current 22 percent to 30 percent through skill enhancement steps. An exclusive stock market for SMEs is being considered as per the report of Reuters (2016). Arab News reports about the offer of support to SMEs by the parallel market Nomu. Small and Medium Enterprises Authority (SMEA), if the SMEs are brought in line with their international peers, another 1.1 Trillion SR could be to the GDP of the country. Increasing entrepreneurship, enhancing the contribution of SMEs to the GDP and contributing to job creation are the three thrust areas of SMEs. Musharakah programme has also been started to facilitate the growth of start-up SMEs, which is a part of the SR4 billion fund.

Government and private sector initiatives in SME sector were listed in a report by GCF (2015). As banks are hesitant to finance SMEs, the kafala programme was meant to remove this bottleneck so that SMEs can develop faster. SME-focused funding by private local and foreign investors to an extent of 3 billion SR has been initiated. In spite of all these efforts, only 30-35% of non-oil GDP is accounted by SMEs against 45% of other comparable economies. This is mainly because SMEs are active mostly in non-productive sectors like retail and small trade. Duplication of efforts by various agencies and inadequate focus on priority areas in financing are the reasons. National SME strategy, an SME master plan, establishment of a National SEM council for policies, integration and coordination, focus on high priority areas like skill and capability building, development of human capital, access to finance and markets are suggested.

Using primary as well as secondary sources, Khan (2013) found that the entrepreneurship growth ecosystem in Saudi Arabia is incomplete and the available ones are still in their early stages.

There are serious inadequacies in effective intervention at strategic, institutional and enterprise levels so that entrepreneurship development can be promoted and streamlined. Here, streamlining could mean channelling SMEs towards the non-oil sectors of high growth potential. Lack of data and access to data were two limitations given by the author.

As per the data given in IFC (2014), Saudi Arabia has 12 banks which together have 65% SME proposition, in which 64% are Islamic banking offers. Saudi Arabian SMEs have the highest preference of 90% for Islamic banking products. In spite of high enabling environment, achievements in SME financing both commercial and Islamic in Saudi Arabia, had only been moderate. High potential for about 2.6 to 4.0 billion USD has been estimated for SME financing in Saudi Arabia. Targeted sectors in Saudi Arabia are: manufacturing, trade and commerce and services. Out of these, only manufacturing can contribute significantly to GDP of the country. This also means, there are many other important sectors excluded from the focus.

### **Reason for Saudi government for implementing kafala route of assisting SMEs.**

The objectives of kafala programme, as given in Proven (2016), are-

- 1) Assisting SMEs to obtain Islamic finance for developing and expanding their business activities. *The Islamic financing does not approve charging interest for the loan.*
- 2) Supporting the competitive abilities of local enterprises to have a positive impact on the economy. *The entrepreneurs lack competitive abilities to run a business profitably. Unless it earns profit, the bank cannot get back its loan, since Islamic financing works like equity participation. Continuous loss leads to closure of the business and if a large number of SMEs close down, the purpose is lost leading to heavy drain of bank funds which could have been used otherwise. The entrepreneurs become unemployed again.*
- 3) Developing the SME sector to achieve the objectives of supporting the economy. *SMEs contribute significantly to reduce unemployment and to national economy.*
- 4) Increasing job opportunities by training and hiring Saudi nationals. *Saudisation is implicit in kafala assistance programme.*
- 5) Expanding and developing the businesses of SMEs in potential growth areas. To move away from oil economy, other potential areas suitable for SMEs have been identified.
- 6) Encouraging financial institutions to work closely with SMEs. *SMEs cannot be left to their own fortunes, as the young entrepreneurs lack business and financial skills. So, the banks work with SME entrepreneurs.*
- 7) Achieving integration with large corporate businesses. If this is possible, profitability of SMEs is higher. So, becoming suppliers or service providers to large corporates is a promising potential area for SME activity.
- 8) Increasing the variety of imports in the economy. *Some SMEs can work as importers of essentials to national economy. Value added exports of imported products and services is another potential area.*

From the above list of objectives of kafala programmes, the elements of that makes them effective are easily identifiable. From a strictly financial sense, SMEs should run efficiently to create profits by which they can develop further and also repay the loan under the kafala terms.

The selected financing route for assistance is Islamic financing. An article in Investopedia by Ross (2017) discusses the essential details of Islamic financing concept. Briefly, it is a sharia-compliant method of raising capital in which the financial institution shares in the profit and loss of the enterprise that it underwrites in any of mudarabah, musharakah, murabaha), 'ijarah/'ijar or

a rarely used salam and 'istisna. Based on these forms of financing, the basic types of permitted investment vehicles are only equities and fixed income funds.

### **Benefits already achieved by kafala programmes**

According to the report of Proven (2016), 8500 SMEs have been assisted for a total amount of 17 billion SR since its inception in 2006 to 2016. In 2016 alone, 51 guarantees worth 20 million SR was disbursed. The programme is judged as highly successful by the banks as well as the government. Apart from finance with government guarantees, the banks provide training programmes to SMEs on business management skills in collaboration with reputed international organisations. More than 56 training programmes have been completed till 2016.

As about 60% of Saudi population consists of the youth, it is difficult to find routine employment for all of them. One way to solve high rates of unemployment is to make them entrepreneurs for which financial assistance and training are important. Supporting young men and women for entrepreneurship and innovation is a key aspect of the Saudi Vision 2030. Empowerment of Saudi youth to start SMEs expand them to medium and large scale organisations have been aimed at. It is also part of Saudi effort to diversify from oil economy. The aim is to raise the contribution of SMEs to GDP from the current 20% to 35%.

According to the International Finance Corporation (World Bank) report (IFC, 2014) Out of a total of 344611 SMEs, 150719 were unserved, 114631 were under-served and 79261 were well-served in the case of Saudi Arabia, in spite of comparatively high potential, favourable enabling environment and good demand-supply relationship. Islamic banking has also been growing tremendously for increasing adoption of kafala programmes to assist SMEs in Saudi Arabia, if the portfolio of products and services are expanded to the needs of SMEs.

### **Financial performance of SMEs which received kafala assistance**

This is an important point. Unless the SMEs show good business performance, there is no use of any assistance to them. Researches measuring performance have merely believed the answers of survey participants, rather than their declared financial performance data and objectively analyse them.

Thus there is a definite lack of objective studies on effectiveness of kafala programmes on financial performance of SMEs which have received the assistance. Research on these aspects will alone indicate whether the programme was truly effective, rather than just providing assistance.

### **Conclusions**

Kafala programme, implemented by the Saudi government in 2006, has already shown promising outcomes not only in improving their access to finance, but in developing various competencies for efficient and effective management of their businesses. Still, there is long way to go to achieve the full potential of SMEs to contribute to the economic growth of the country. Implementation of Vision 2030 will take the country towards greater economic achievements in which SMEs will play significant roles.

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