

Draft Policy Recommendations to be discussed by the COMCEC Financial Cooperation Working Group in its 16th Meeting, for the Exchange of Views Session of the 37th COMCEC Session on “The Role of Islamic Finance in Supporting Microenterprises and SMEs Against COVID-19”

The 36th COMCEC Session agreed on “The role of Islamic Finance in Supporting Microenterprises and SMEs (MSMEs) Against COVID-19” as the theme for the Exchange of Views Session at the 37th Session of the COMCEC and requested the COMCEC Financial Cooperation Working Group (FCWG) to come up with concrete policy recommendations on this topic and report it to the 37th COMCEC Ministerial Session. Along with the issues related to MSMEs financing through Islamic finance, the FCWG also considered the challenges and possible policy options related to various aspects of MSMEs financing through Islamic banks. In this framework, the Working Group has come up with the following challenges and problems as well as the policy options for facilitating financing for MSMEs in the member countries.

CHALLENGES AND PROBLEMS CONCERNING MSMEs

- *MSMEs are the backbone of any economy, their financial demand in the financial system is not efficiently met nor addressed. Therefore, almost in each country, MSMEs are faced with a financial gap.*
- *Given financing lines to MSMEs remains in trade financing and loans in nature rather than equity financing in accordance with their particularities.*
- *Equity financing nature in financing MSMEs is very limited including PLS and risk sharing.*
- *Despite their importance for an economy, start-up financing for MSMEs is still limited, which does help sustain the development of the MSMEs.*
- *Underdeveloped capital markets and their relationship to MSMEs does not provide a room for exit strategies for MSMEs.*
- *Limited financing opportunities are available for SMEs, but financing for microfinance is primarily limited in the majority of the OIC countries.*

- *Poor ecosystem for the efficient development of the MSMEs sector.*
- *Public policies remain reactionary and responsive in nature rather than proactively developing an ecosystem for MSMEs.*
- *Not having a specialized institution coordinating the various aspects of the MSMEs.*
- *Where there is a specialised institution, their effective functionality and connectedness with the MSMEs remain an essential challenge.*
- *Need for developing entrepreneurship culture in a coordinated manner through the relevant ministries/institutions and chambers of commerce in the OIC countries.*
- *The need for education and training in accounting and management for MSMEs to conduct their businesses effectively to reduce the perceived risk vis-à-vis financial institutions.*

CHALLENGES AND PROBLEMS CONCERNING ISLAMIC BANKS FOR FINANCING MSMEs

- *Shareholder-based governance and economic paradigm prevents Islamic banks from embedding their operations into Islamic logic principles to directly work in the real economy, which minimises financing facilities available for MSMEs.*
- *Risk-shifting institutional nature of Islamic banks as opposed to the risk-sharing through PLS (profit and loss sharing) modes of financing limits the positive role Islamic banks for MSMEs financing beyond mere trade financing.*
- *Institutional logic related shortcomings in the provision of qard al-hassan financing for short-term needs of MSMEs.*
- *Poor institutional set-up and specialism as well as commitment to deal directly with the risk management aspects of MSMEs financing.*
- *Lack of authentic product development for the changing nature of MSMEs financing and operations through the Islamic logic.*

- *Prevailing conservative attitude towards the risk-averse nature of efficiency in Islamic banks prevents financing start-ups and developing exit strategies related to equity financing in Islamic banks in their relations with the MSMEs.*
- *The growing need for developing projects for MSMEs, including collaborating with the other relevant institutions in the public and private domain.*

POLICY RECOMMENDATIONS

In light of the above-mentioned challenges and problems, FCWG came up with a set of policy recommendations:

a. Governance and Public Policy

- *Promoting Islamic banks from the existing shareholder-based governance model to stakeholder governance system for the benefits of MSMEs.*
- *Encouraging Islamic banks to focus on Islamic logic in their operations rather than competing with conventional banks in the dual banking system.*
- *Supporting collaborative institutional development between the private and public sectors supporting the MSMEs as well as sectorial institutional formation among the MSMEs to represent their particular interest to reach domestic and international markets to enhance a robust financial and economic position to become financing worthy.*
- *Encouraging Islamic banks to internalise sustainable development as an objective function.*
- *Developing training programs on Fintech skill development for MSMEs by public agencies in collaboration with Islamic banks.*
- *Encouraging Islamic banks to focus on serving communities rather than the markets, including extending financing for MSMEs.*
- *Ensuring effective coordination of the public policy and private sector development strategies for MSMEs and their financing through Islamic finance and banking.*

- *Encouraging MSMEs to cooperate with other market-supporting institutions and agencies and other risk-management mechanisms to enhance their institutional and financial stability.*
- *Promoting entrepreneurship culture among the youth by the private and public sector through the necessary institutional arrangements.*
- *Encouraging Islamic banks for developing entrepreneurship projects for the youth.*

b. Institutional Setting

- *Developing a specialised institutional set-up consistent with the Islamic banks' main objectives to facilitate the process of extending financing and ensuring collaboration with the public and private agencies (joint fund) to overcome the constraints of the market logic.*
- *Establishing specialised institutional settings to educate and train MSMEs in their accounting and management skills and processes to manage their risks in an effective manner with a view to securing financing from Islamic banks.*
- *Improving an alternative institutional setting as a joint venture between Islamic banks and public and private agencies for financing MSMEs to overcome the constraints of the market logic.*
- *Developing the necessary technological infrastructure for MSMEs to initiate new business models and promoting Fintech based solutions with a view to actualize next stages of Islamic financing institutional development.*
- *Enhancing the capacity of the member countries for efficient reporting and disclosure of regular data for the MSMEs with the ultimate aim of developing OIC wide standardized databases on MSMEs by utilizing the existing facilities and mechanisms within the OIC.*
- *Developing a specialised institutional setup for every aspects of MSMEs from their start-up to exit stages for serving a single window for MSMEs.*

c. Legal and Regulative Environment

- *Ensuring the effectiveness of dual banking system to enable Islamic banks and financial institutions to operate within Islamic objective function of optimality between financial and social objectives.*
- *Determining the nature of regulations developed for Islamic banks and finance in accordance with economic and social imperative of Islamic logic.*
- *Developing specialised Islamic banking and finance law in line with the distinctive nature of these institutions.*
- *Promoting PLS (profit and loss sharing) and risk-sharing business nature of Islamic banking with the provisions from the regulators.*
- *Developing new regulations for Islamic FinTech to enhance outreach and impact, including Islamic financing for MSMEs.*

d. Regional and International Cooperation

- *Harmonizing the definition of MSMEs among the OIC member countries by taking into consideration the regional and national differences.*
- *Promoting exchange of experiences and good practices of the various agencies in the OIC member countries concerning MSMEs financing and operational aspects.*
- *Facilitating experience sharing vis-à-vis Islamic financing for MSMEs among the OIC member countries.*
- *Encouraging member countries having a well-developed ecosystem and financial architecture relating to Islamic banking and finance to share their experiences with the member countries in need.*

- *Developing special mechanisms within the OIC to elaborate on the issues related to MSMEs.*