# Quarterly SME Finance Review

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Infrastructure, Housing & SME Finance Department

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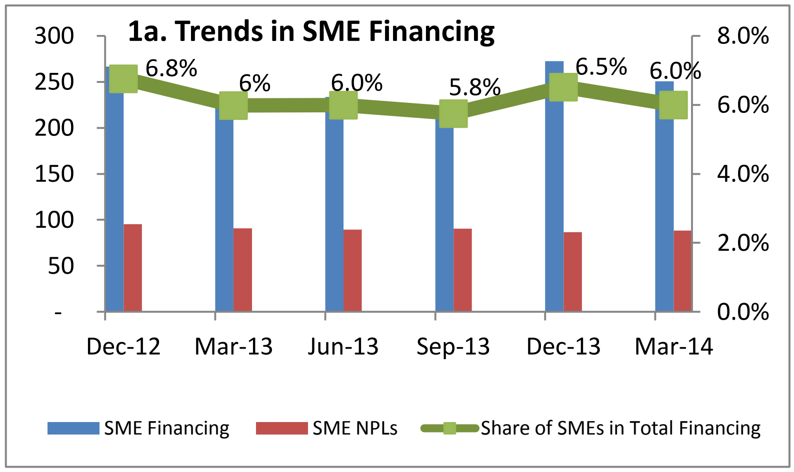
## Executive Summary

Although SME Financing of Banks/ DFIs has declined during the quarter Jan-Mar. 2014, long term trend reflects signs of improvements in SME Financing. The revised Prudential Regulations for SMEs issued in May, 2013 are proving to be an encouraging factor for the banks to rethink their SME financing and consolidate their positions in this vital segment of the economy. The overall improvement in economic conditions with steadily growing private sector financing has also its spillover effects on increasing financing to the SMEs which will expectedly continue to improve in the coming months. The increased demand of financing from SMEs provides an opportunity to the banks/ DFIs to develop new lending products/ programs for capturing profitable niches in growing SME sectors. Among the initiatives during the period, State Bank has revised its Refinance Scheme to incorporate additional incentives for the Banks/ DFIs to extend refinancing facilities to their SME exporters. State Bank has also inked a Memorandum of Understanding with SMEDA which calls for improving coordination between the two regulatory authorities on their measures for increasing share of SMEs in formal financing.

**Trends in SME Financing:**

The SME financing of the banks/DFIs posted lower growth when compared to previous quarter. Despite of this overall decline in SME financing, the long term declining trend in SME financing of banks/DFIs which ensued 5 years ago seems to have started waning in the wake of improvements in major economic indicators during the last few months and issuance of revised SBP Prudential Regulations on SME financing in May, 2013. As an indication of this reversal in long term trend, SME financing has shown a Y-o-Y increase of 7.2 percent when compared with March, 2013. A further break up shows that the decline in SME financing during the quarter may be attributed to cyclical effects in SME financing. Generally, SME financing depicts a cyclical trend, decreasing during the first half of the year but picking up in the 3rd quarter reaching the peak at the end of fiscal year. This cyclical trend is reflected primarily in ups and downs in working capital financing position of banks/DFIs which represents a major portion of SME financing.




The decline in the quarter under review may continue in the next quarter till June, 2014, however, this decline will be short term and SME financing will expectedly continue to witness consolidation in its growth trend in the final half of the current fiscal year.

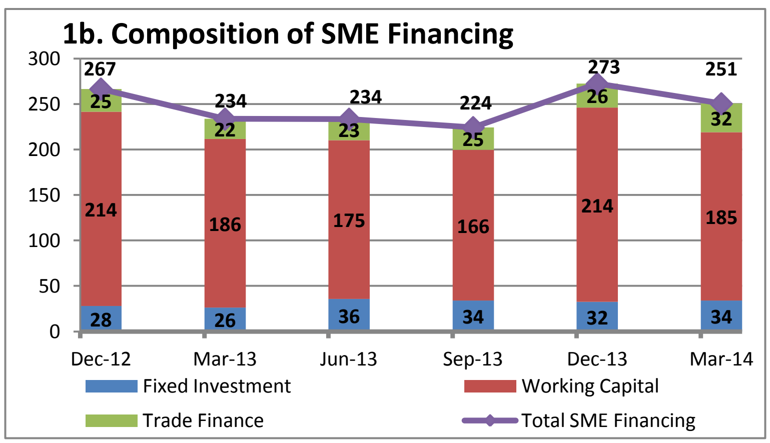
Although the number of SME borrowers declined by 2% during the quarter from 136,940 in December 2013 to 134,166 in March 2014, the Y-o-Y trend has witnessed an increase of more than 4% when compared with the March, 2013 position of SME borrowers which is in line with the growth trends of SME financing. A smaller decline in number of borrowers compared with the decline in SME financing amount is also in line with the cyclical effects of small pickup of working capital financing by SME borrowers during the first half of the year.

**Table 1: SME Financing profile**

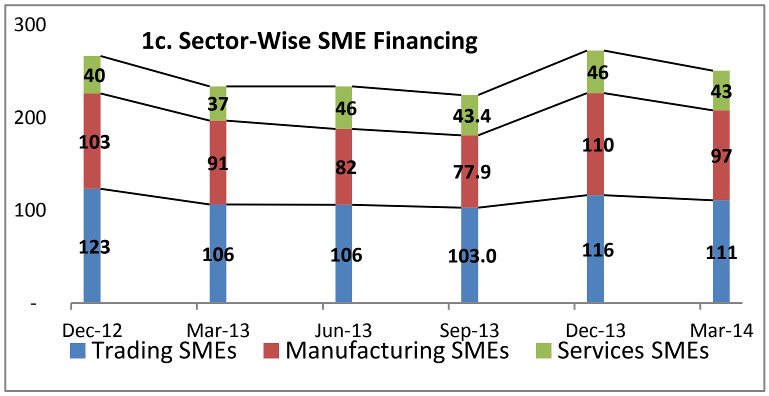
| Category | Periods (Amts in Rs. Billions) | | | Change | |
|---|---|---|---|---|---|
| | Mar-13 | Dec-13 | Mar-14 | Quarter | YoY |
| Total SME Exposure | 233.73 | 272.53 | 250.58 | -8.05% | 7.21% |
| Total Financing to the Pvt Sector | 3,906.52 | 4,181.94 | 4,176.5 | -0.13% | 6.91% |
| SME exposure as % of Total advances | 5.98% | 6.52% | 6.00% | | |
| SME NPLs: absolute amount | 90.72 | 86.62 | 88.23 | 1.86% | -2.75% |
| NPLs as % of total SME exposure | 38.82% | 31.78% | 35.21% | | |
| No. of SME borrowers | 128,563 | 136,940 | 134,166 | -2.03% | 4.36% |

As regards non-performing loans, the absolute magnitude of overall NPLs of industry which decreased in the second half of last year has shown a small increase during the quarter under review. In percentage terms, SME NPLs increased by 1.9% during the quarter. Notwithstanding with this increase a predominant portion of SME NPLs of banks/DFIs is a build-up of NPLs during the last many years which have remained in the SME NPLs due to lower tendencies of banks/DFIs to clean up their SME portfolios through write-offs. In this context, therefore, a Y-o-Y decline in SME NPLs of 3% when compared with the SME NPLs position in March, 2013 may be seen as an indication that banks may have started cleaning their balance sheets (and SME financing positions) by writing-off some outstanding loans which have longer delinquency periods and thus have little prospects of recovery in the coming months. The ratio of SMEs NPLs to the total SME financing increased to 35% in March, 2014 from 32% in December 2013 primarily due to decline in outstanding SME financing during the quarter. The Y-O-Y comparison shows that NPLs ratio is decreased by 9.3% from 38% in March 2013. If the long term trend of decrease in non-performing SME portfolios and growth in SME financing persist, the current excessively high NPL ratios of banks/ DFIs may normalize and even start to conform with overall delinquencies in private sector financings of banks/ DFIs to the corporate and commercial borrowers in coming months.

Facility-wise breakup shows that the working capital financing constitutes around 73% of total SME financing followed by fixed investment and trade finance with their respective shares of 14% and 12%. The facility-wise distribution of borrowers also depicts a similar scenario and further accentuates this view of tilt of banks towards working capital financing to SME borrowers. The share of working capital decreased during the quarter with the increased shares among trade and fixed investment financing but this may be due to the earlier noted cyclical trend in SME financing i.e. the cyclical effects in SME financing are concentrated in short term working capital financing.



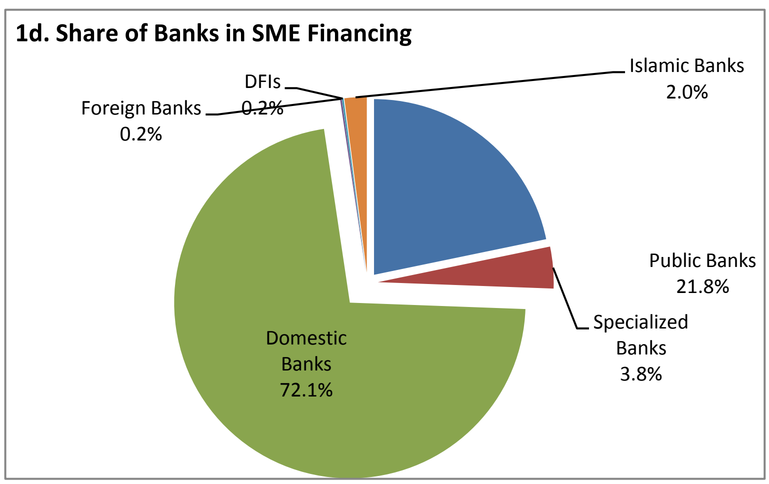
The shares of trading, manufacturing and services sectors in total SME financing remained stagnant without any significant change over the quarter and on Y-o-Y basis. As a normal trend, the manufacturing and trading SMEs pick up around 80% of the SME financing with a fluctuation margin of ±5% while the remaining is picked up by the service sector SMEs.



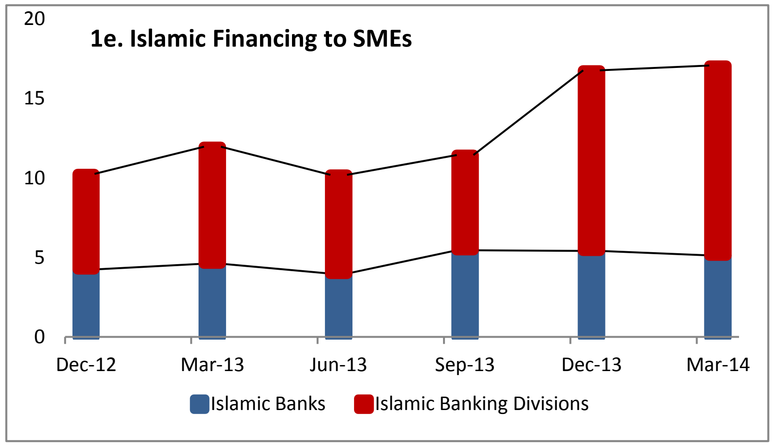

The SMEs with up-to 20 employees availed 60% of the total financing to the SMEs primarily because of a large number of lower end trading and services SMEs availing financing facilities from banks & DFIs. On the contrary, manufacturing SMEs with up-to 20 employees availed 41% of financing to the SME manufacturers.

A loan size wise review shows that around 86% SME borrowers are using loans of upto Rs 3 million and their share in total SME Financing is only 20%. In fact, a major number of SME borrowers, around 63%, is availing loans of upto 0.5 million. In order to adequately capture even larger segment of these largely untapped small enterprises, the banks/DFIs have to develop capacities in terms of human resources, branch infrastructure and IT and deploy reasonable controls and procedures.

Bank-wise distribution of SME financing shows that the share of Private Sector Banks (17 institutions) in total SME loans outstanding is highest as 72.1% (decreased from 73% at the end of previous quarter). Private Sector Banks are followed by Public Sector Banks (NBP, FWBL, BOP, BOK, and Sindh Bank) which shared around 21.8% (increased from 21% at the end of previous quarter) of total SME outstanding amount.




A healthy emerging trend is a continuously rising trend in SME financing by the Islamic Banks (IBs) and Islamic Banking Divisions (IBDs) of conventional banks (collectively termed as Islamic Banking Institutions – IBIs). Although the SME financing of IBIs has maintained its level of the previous quarter, their share increased by 43% over the full year from March, 2013. The decline in overall SME financing with moderately increasing trend in Islamic SME financing increased the share of IBIs by more than 10% over the period under review. This further indicates that share of IBIs in total financing will continue increasing in the coming quarters. Overall, the share of Islamic SME financing in total SME financing increased to 6.8% (6.2% as of Dec. 2013 and 5.1% as of Mar. 2013).




**Major Initiatives undertaken and Progress on earlier Initiatives**

The major new initiative in SME financing during the month period under review was formulation and launching of Prime Minister's Youth Business Loans. A brief on the initiatives and progress on earlier initiatives of the State Bank during the quarterly period under review are summarized below:

**Prime Minister Youth Business Loans Programme:**

The Prime Minister Youth Business Loans Programme Programme which was formally launched by the Prime Minister on December 7, 2013 is aimed to provide loans to unemployed youth for establishing or extending business enterprises in order to promote self-employment in the country.
PMYBL Application Forms are available at all the branches of NBP, FWBL, SMEDA and website of these institutions.
As of June 30, 2014, over 57,000 applicants received approvals for financing under the Scheme. Prime Minister chaired the first balloting of PM Youth Business Loans which was held in Islamabad on February 28, 2014. In the first balloting, 5,414 applications from 92 districts with aggregate loan amount of Rs 5.8 billion were declared successful on the basis of population of each province. Out of these 5,350 approved loans belonged to NBP while the rest 64 loans from FWBL. Province-wise position of successful applications in balloting transpired that 76.25% of successful applications were from Punjab, 12.47% from KPK, 6.43% from Sindh, 1.4% from Baluchistan, 1.39% from AJK, 1.94% from Islamabad and 0.13% from Gilgit-Baltistan. Prime Minister also chaired second balloting of PM Youth Business Loans held on June 4, 2014 at Islamabad. In 2nd balloting, 5,169 loans application with loan amount of around Rs 5 billion were declared successful.

**Secured Transaction Reforms:**

Secured Transaction Framework calls for existence of a modern Secured Transaction Law that provides for establishment of Secured Transaction Registry in the country, which will register charge on assets especially moveable assets of the borrowers.

Implementation of Secured Transaction Reform Framework shall generate the following benefits:

- Enable SMEs and Agri borrowers to use their assets especially moveable assets as collateral to obtain loans, thus enabling them to use a broader scope of assets as security for availing loans.
- Provide cheap & simple mechanism of online registration & search about encumbrance on assets.
- Provide clear rules on priority of creditors' claims on securities.
- Provision on effective enforcement of security will boost lenders' confidence in case of default

In view of the above, State Bank, with the financial support of DFID UK, is implementing Secured Transaction Reform (STR) Project. SBP has hired the services of legal consultants for drafting of Secured Transaction Law. During period under review, SBP organized Project Committee (PC) meeting and a Video Conference (VC) with World Bank to discuss and provide feedback on second draft of Secured Transaction Act. In the light of Project Committee members' feedback and VC discussions, the consultants submitted revised draft of the STR Act in June 2014, which was also shared with PC members for their feedback. After finalization of the Draft Secured Transaction Act by Project Committee, the same shall be forwarded to GOP for approval from the Parliament.

**Memorandum of Understanding (MoU) with SMEDA:**

A Memorandum of Understanding (MoU) was signed between the Small and Medium Enterprises Development Authority (SMEDA) and the State Bank of Pakistan (SBP) in SMEDA Head Office, Lahore on Monday, 24th March, 2014. Sardar Ahmad Nawaz Sukhera, CEO SMEDA and Syed Samar Hasnain, Director Infrastructure, Housing and SME Finance, State Bank of Pakistan signed the MoU. The MoU has been a result of the joint deliberations held between the two organizations over the last few months, where earlier, meetings were held between the Governor SBP and CEO SMEDA and teams from the two organizations. Through the MoU, both the organizations will join hands in facilitating and supporting SMEs in increasing their share in formal credit and providing new venues for formal financing.

**Credit Guarantee Scheme for Small and Rural Enterprises**

SBP launched a Credit Guarantee Scheme (CGS) for Small and Rural Enterprises in March 2010, which allows banks to develop a portfolio of fresh borrowers who are creditworthy, but the banks are shy away from such customers due to perceived high risks, small ticket size, issues in documentation and collaterals, etc. The Scheme shares 40% of credit losses of lending banks on their loans to Small and Rural Enterprises.

State Bank allocated Credit exposure limits of Rs. 6.56 billion (SBP Guarantee Coverage Limit of Rs. 2.62 billion) for the CY 2013 to 10 banks selected as Participating Financial Institutions (PFIs) under the Scheme. The Scheme has been well-picked. The net utilization of the guarantee limits by the banks as of end of the year was 64% with sanctioned loans of Rs. 4.19 billion to 6,268 borrowers. However, this figure does not include 3,555 guaranteed loans with sanctioned amount of Rs. 2.14 billion which have already been closed. State Bank is in final stages of allocating fresh limits to the banks under the Scheme till December 31, 2015.

**Mark up Subsidy and Guarantee Facility for the Rice Husking Mills in Sindh**

The objective of the Mark up Subsidy and Guarantee Facility for the Rice Husking Mills in Sindh is to help the sponsors of rice husking mills of Sindh to undertake projects of BMR for increasing effecinecy of their mills. Under this Scheme, SBP provides mark up subsidy of 6.25% and credit risk sharing facility of up-to 30% against the long term loans extended to rice husking mills of Sindh under the SBP Refinancing Scheme for modernization of SMEs. In view of the huge benefits of the structure of the Scheme, the Governor State Bank has invited other provinces to consider initiating similar mechanisms of lending to selected SME segments in their provinces from their budgetary resources and offered SBP's full support for such programs.

**Training Programs for Banks**

State Bank has conducted a number of training programs for the banks during the six-monthly period under review:

- **Awareness Programs for the Prime Minister's Youth Business Loans Program:** State Bank arranged a series of training workshops on PM Youth Business Loans Programme so as to create awareness among the field staff of banks about structure of the programme for its smooth implementation and also motivate them to actively participate in identification and evaluation of viable business proposals of the prospective borrowers. During the quarter under review, State Bank in coordination with NBP and SMEDA, conducted five Training Workshops for all banks across Pakistan/AJK in major cities to apprise them about salient features of the PM Youth Business Loans Programme which was formally launched by the Prime Minister on December 7, 2013. The Programme is aimed to provide loans to unemployed youth for establishing or extending business enterprises in order to promote self-employment in the country.

- **SME Finance Grass Root Cluster Training Program:** The SME Finance Grass Root Cluster Training Program was successfully delivered on February 20–21, 2014 at SBPBSC – Lahore in collaboration of State Bank of Pakistan (SBP) and National Institute of Banking & Finance (NIBAF). The main objective of the program was enriching in depth knowledge and understanding of SME finance for commercial banking and finance professionals due to the growing importance of SME finance in the banking sector. Fifty-two officers from various banks participated in this training program. The course covered SME Finance – Regulatory and Policy Framework, Basic Understanding of the SME Market and Cluster Dynamics, Effective Marketing of SME Products, Cash flow based SME Lending; Program based Lending and Risk Management in SME Lending.