Banking for Small and Medium Sized Businesses

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The purpose of today's presentation is to provide some insights to the financing for Small and Medium sized businesses. From a bank's point of view

- They are a hybrid of corporate and consumer exposures.
- This is not a homogeneous group. "S" are different from "M".
- Traditional processes for risk assessment and management need to be modified to manage these exposures.
- They represent opportunity for both the asset and liability business.

SMEs have some common characteristics

- They exist because the owner has a particular skill or a unique business idea.
- Usually the owner is the manager.
- The business focus on a small range of products that it sells to a small range of customers.
- Generally there is limited understanding of finance and accounting.

- A business must be categorized based upon its productivity. Sales is generally a single measure of the productivity of a business. Due to problems with disclosure sales cannot be used as a measure of productivity for SMEs.
- The productive assets comprising ***MANPOWER, FIXED ASSETS, INVENTORY*** and ***FINANCIAL ASSETS*** are used as proxy to productivity for SMEs. These are therefore classified on the basis of:
  - Number of employees
  - Balance Sheet size
  - Sales
- There is no universally accepted definition of SME; it depends upon who is defining it. European Union defines SME as businesses employing fewer than 250 employees, while Canada defines SMEs as those businesses employing less than 500 people.

Challenges for SME financing

1. SME owners find bank processes complicated.
    - Business plans
    - Loan application and processing
    - Loan documentation
2. SME owners find loan costs high.
    - Mark up rates
    - Cost of mortgages
    - Insurance and other security related costs
3. Do not find cross over to the formal sector attractive enough.
    - Lack of disclosure
    - Majority prefer to remain sole proprietorships
    - Find corporate reporting requirements cumbersome
    - View corporate reporting requirement with suspicion
    - Consider cost of incorporating an avoidable over-head

Challenges for SME financing-Banks

- Cost of processing and maintenance is high
- Difficulty in reliable risk assessment
- Industry diversity is a challenge
- Geographic dispersion challenges human resource capacity

SME is very large business segment in any country:

- According to the Word Bank note on Pakistan SME Policy 90% of business fall in the category of SME.
- There are more than 20 million SMEs operating in the European Business Zone.
- In India it is estimated that 38 million people are employed in this sector.

Two stage credit approval process

Filter + Detailed Assessment = Approval

Credit Scoring

- Size of the facility
- Financial variables
- Industry
- Management

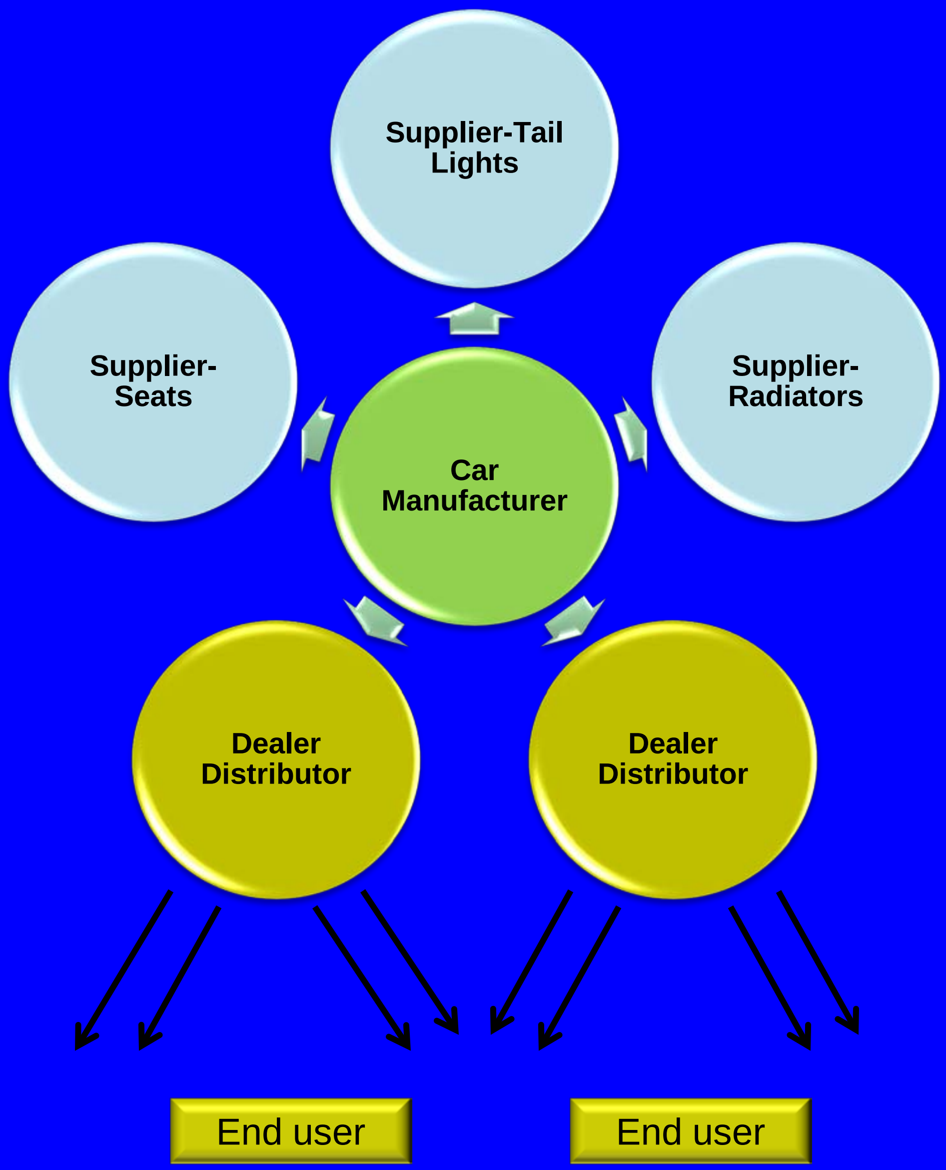
Judgmental

- Detailed financial analysis
- Site visit
- Management assessment

Approval

Value chain analysis will identify:

- *Opportunities for leveraging existing banking relationships and for cross selling*
- *Better understanding of credit risk*



Identify industry clusters to create focus and identified knowledge pool

Faisalabad
- Textile Garments
- Textile finishing
- Hand looms
- Furniture

Gujranwala
- Fans
- Rice processing
- Ceramics
- Furniture

Badami Bagh
- Importers of automotive parts
- Steel furnaces
- Steel Re-rolling

SITE Karachi
- Steel Re-rolling
- Textile Garments
- Light Engineering

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- SME contribute about 78% of non-agricultural labour force and over 30% of GDP
- Outstanding loans to SME eased by 4.1% on a year-on year basis to Rs. 334 billion representing just 9.6% of the total outstanding banking sector credit.
- 90% of the borrowing by SMEs was for working capital requirement.
- NPL ratio for the SME sector was 29% for the period ending December 31, 2010.

Conclusion

1. The market is large and under exploited
2. Lack of disclosure is too simplistic a view to categorize this sector unattractive. Further, this is not going to go away we need to find surrogates for income and profit estimation
3. SMEs offer excellent potential for the liability and fee generating business and are not a source of high yielding assets only
4. We are passing through a business cycle and current under performance of the SME portfolio should be a reason for introspection