Special Section 1

SME Growth in Pakistan: Addressing Access to Finance Issue

Small and medium enterprises (SMEs) are a major contributor to inclusive economic growth and poverty reduction (see **Box SS1.1**). There might be difference in SMEs' contribution to relative economies, however its significance is globally agreed upon. Pakistan is no exception to this having SME sector constituting 90 percent of all economic establishments. The SME in Pakistan contributes substantially to both; the GDP growth and export earnings[1]. The sector's significance towards resource distribution can be gauged from its absorption of 78 percent of non-agriculture labour force[2]. While there is global consensus on the key role of SMEs, all stakeholders believe that lack of access to finance is a major obstacle in the sector's growth. SMEs in Pakistan are confronted with a similar challenge as indicated by the small share of SMEs' loan in total loan portfolio of the banking industry[3]. This special section focuses on strategies that can be opted on both demand and supply side

Box SS1.1: Importance of SME

Contribution of SME towards economic development of any country can be broadly categorized into three main areas;

1. **As an engine of growth**: SMEs have great potential for employment creation and are also a major source of innovation due to their distinct flexibility characteristic
2. **Essential for a Competitive & Efficient Market:** SMEs have got greater flexibility and high turnover with an easy entry and exit characteristic leading to larger number of SMEs in an economy. Consequently the chances of greater efficiency become higher through competition among large number of enterprises. SMEs not only complete the supply chain but also work as nursery for larger firms. Moreover these enterprises as sub-contractors of large firms play a critical role in the efficient working of large firms
3. **Poverty Reduction & Equitable Income Distribution:** SMEs are considered relatively more labour intensive and their employment creation characteristic make them critical for poverty reduction and equitable distribution of resources. These enterprises are considered an important source of employment for young, unskilled and women and therefore can contribute significantly towards the inclusive growth of any economy

Sources: Promoting SMEs for Sustainable Development, *World Business Council for Sustainable Development (2004)*

F. Qimiao (2003).Importance of SMEs and the Role of Public Support in promoting SME Development, *A Policy Dialogue Workshop at Russia*, World Bank

[1] *SME Financial Review; Second quarter 2007, Small and Medium Enterprises Department, State Bank of Pakistan*

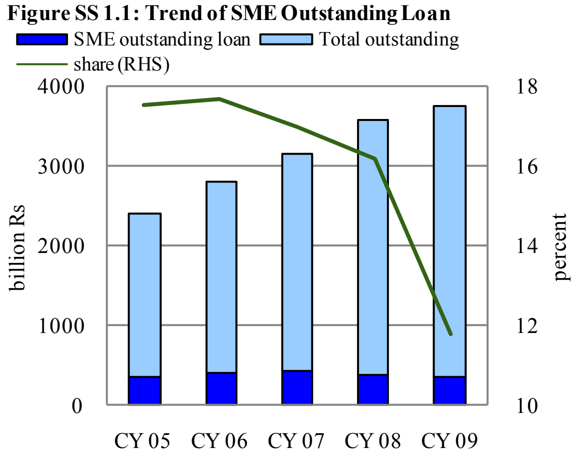
[2] ibid

[3] The share of SME loan in overall loan portfolio is 11.8 percent while SME loan portfolio constitutes only 7 percent of GDP

to overcome the challenge of constrained financing for SMEs. For supply side, this section covers only the banking industry.

Like other developing countries, inadequate financing of SMEs in Pakistan is a result of disequilibrium in the SME credit market. This implies that demand and supply of SME financing do not clear each other due to mismatch of issues of both sides. On supply side, banks shy away from lending to SMEs due to; (i) highly risky sector because of its greater sensitivity to economic fluctuations; (ii) lack of collateral; (iii) lack of credible data on market size; (iv) creditors' high search cost[4]; (v) high processing cost, etc. On demand side, SME industry cannot address concerns of banks due to; (i) smaller size; (ii) limited management capabilities; (vii) limited resources in keeping business account with banking requirements, etc. These concerns of both sides show that banks are risk averse and are reluctant to extend credit to SMEs while SMEs cannot afford meeting banking requirements. In the recent slowdown of the economy, the mismatch between demand and supply of credit market of SME may worsen further signifying the need for intervention.

Figure SS 1.1: Trend of SME Outstanding Loan



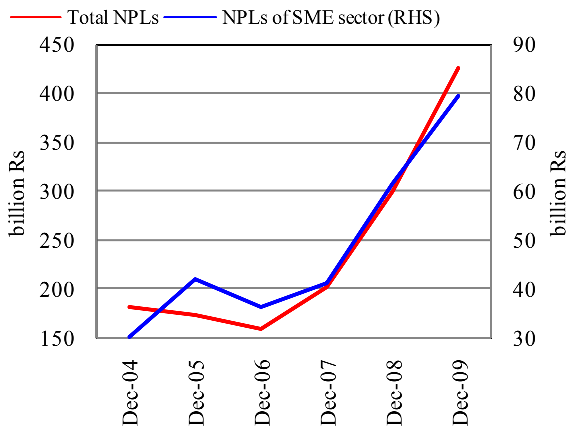
During the current economic downturn in the country, financial indicators depict a declining trend in SME financing. On the basis of SME potential, institutional capability and historical trend, the State Bank of Pakistan signaled in 2007 that the banking credit for the sector needed to be increased up to Rs 1000 billion in 2012 to be consistent with the projected macro-economic targets of growth and employment[5]. However, the negative growth rate in outstanding loan amount of the sector and its falling share in overall loan portfolio over the last two years have made the target difficult to be achieved. The outstanding loan amount has declined from Rs 361 billion in 2005 to Rs 348

[4] Term taken from H. Ishrat (2003) speech on : SME financing: Issues & Strategies
[5] *SME Financial Review; Second quarter 2007, Small and Medium Enterprises Department, State Bank of Pakistan*

billion in 2009 while the SME share in overall loan portfolio has dropped from 17.5 percent to 10.2 percent during the same period (see **Figure SS1.1**).

This situation is further complicated by a rise in NPLs following the overall rising trend in NPLs of banking industry. Absolute amount of SME NPLs has jumped from Rs 30 billion in 2004 to Rs 79.2 billion in 2009 while its share in overall NPLs of banking industry has increased from 16.7 percent to above 18 percent over the said period(see **Figure SS 1.2**). This is concerning as banks are generally reluctant in extending credit to SMEs can be discouraged further in the face of rising NPLs. Though the importance of SMEs during the period of economic slowdown has increased due to their distinct characteristics of reducing income inequality and poverty reduction, banking sector has become more cautious in extending credit to the sector. The importance of SMEs in promoting inclusive economic growth in the backdrop of economic slowdown, calls for policy intervention to remove the impediment of constraint financing. Economic literature[6] has got evidence in favour of intervention for the growth of the industry. (See **Box SS1.2** for cross country SME policy comparison)

Figure SS 1.2: Trend of NPLs



Case for Intervention to Improve Access to Finance for SMEs in Pakistan

As a result of economic slowdown and limited financing avenues, major challenges faced by SMEs in obtaining finance have been amplified. Considering the earlier discussed factors that inhibit the finance expansion for SMEs, alternative options are being introduced on both demand and supply side to minimize the mismatch of issues between the two sides.

[6] *Sources (1)) D.Asli & B. Thorsten (2006). Small and Medium-size Enterprises: Access to Finance as Growth Constraint. (2) Promoting SMEs for Sustainable Development, World Business Council for Sustainable Development(2003)*

A. Supply Side Policies

1. **Credit Information Bureau (CIB):** Centralised data base like CIB can remove one of the major concerns of high search cost of creditors for banks. State Bank of Pakistan has established the CIB as a support service for banks helping them in minimizing their risk while extending credits. This may improve access to finance for SMEs by enabling banks to introduce customized products like cash flow based lending while making an assessment of a client on basis of his credit history. Banks can get greater support in this regard if the information of CIB is complemented with the information of credit rating agency for SMEs. Realising this, SBP is encouraging current rating agencies like PACRA and JCR-VIS to extend their expertise in this sector. Moreover, to develop skills of commercial bankers for risk management of this sector, SBP has conducted a credit scoring training program, and is also planning to implement credit scoring techniques for SMEs in banks.

2. **Credit Guarantees Schemes (CGS):** These are used to assist under developed industries like SME to overcome the problem of constrained financing. Credit guarantee schemes helps in buffering funding difficulties[7] as ;
   (i) Higher risk premium makes lending too expensive for SME borrowers to utilize the option.
   (ii) Lack of sufficient collateral disqualify some SME borrowers from availing credit.

Lack of collateral has been recognized as a central issue in having the challenge of constrained financing for SME industry. Lending data for SMEs depicts that the share of collateral based lending for small and medium enterprises in the country is more than 90 percent of the total loan outstanding amount of the sector[8]. This implies that banks are secured against the high risk of the sector through collateral and do not appear inclined towards clean lending (without collateral). This signifies that small enterprises especially start-ups are facing more problems in having access to finance as they do not have enough assets to offer as collateral. Therefore the sector is in need of schemes like CGS for its smooth growth. SBP is currently working on CGS and will introduce the scheme in near future. However, this scheme needs to be implemented with cautious planning and effective monitoring. This is due to the fact that these kind of schemes;

[7] *Chapter 2; Banking and Credit, The SME Financing Gap (Vol.1): Theory and Evidence*
[8] *Development finance Quarterly Review , September 2009, State Bank of Pakistan*

- May affect efficiency of the banking sector especially in terms of development of new customized products.
- May lead to adverse selection problem.
- May also suppress efforts of the industry to become sustainable or efficient enough to generate its own resources.

The CGS may be introduced with a clear and strict phasing out plan that acts as buffer and avoids negative consequence of subsidy.

To encourage financing for SME sector SBP has introduced refinance initiatives like Agricultural Loans Refinancing & Guarantee Scheme, Refinance Schemes for BMR in SME Clusters-Ginning, Rice Husking and Alternate Energy up to 10 MW and has also extended scope of long term financing facility(LTFF) by including SME clusters.

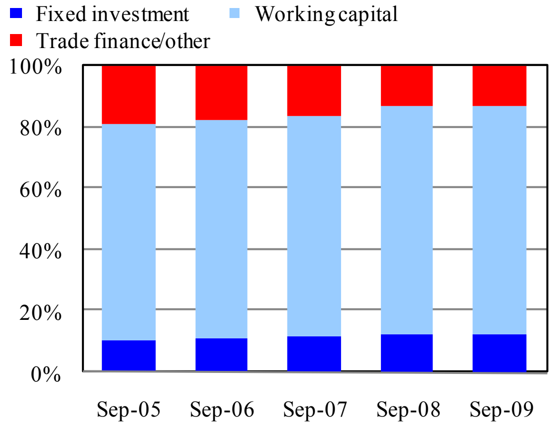
3. Specialized Financial Institutions: Considering the distinctive nature of SMEs, the government has already established a specialized SME bank for the sector. Since SME bank is responsible for extending subsidized credit, therefore it focuses more on small enterprises compared to medium enterprises. This is because of the realization that small enterprises have got greater difficulty in securing finance compared to medium sized firms.

SME bank has been given the target of developing customised lending products, procedures and monitoring mechanisms, etc. so that they can be adopted by commercial banks. However, the impact of specialized banks has remained limited; specialized banks'[9] contribution towards the overall lending of the SME sector is less than 3 percent of the total lending to the sector[10]. To encourage banks to contribute more towards the growth of the sector, SBP has introduced customised regulations for SME financing (see **Annexure SS1.1**) and is also encouraging banks to introduce innovative products and financing techniques to create a level playing field for SMEs. SME Finance Gross Root Cluster Training Program is a significant example in this regard where commercial bankers have been trained in areas like cash flow based lending; program based lending, credit scoring, SME risk management and prudential regulations, etc. Moreover work is under progress to allow upscaling of micro finance banks to advance loans to SMEs.

[9] These banks include SME bank, Zari Tarqiati Bank Limited (ZTBL), Punjab Provincial Corporative bank Limited (PPCBL) and Industrial Bank limited (IDBP).
[10] Borrowers of specialized banks are only 18 percent of total borrowers of the sector.

4. Venture Capital (VC): Facility wise financing for SMEs depict that working capital constitutes the major share; above 70 percent, of total financing of SME (see **Figure SS1.3**).This implies that start-up projects are facing greater problem of having access to capital as compared to on-going firms.VC can be an effective option for start-up businesses. Venture capital by definition is an equity type financing that is targeted towards start-up industries to support their growth and development. Since this funding is similar to share rather than loan, therefore it does not incur extra cost for businesses. This implies that return on funds invested through VC in any business depends upon the profitability of that business.

Figure SS 1.3: Facility Wise Financing



Government is aware of the utility of this option and efforts are being made to develop VC market. However, to establish this market some significant steps are required to encourage domestic and foreign investors for the establishment of Fund Management Company (FMC). These steps may include the reduction in the capital requirement for the establishment of FMC from US $ 4,200,000 to international standard of US $ 100,000; issuance of contract for longer term and establishment of secondary markets, etc. The government has provided tax exemption till 2014 and Security Exchange Commission of Pakistan (SECP) has also issued regulations for private equity and venture capital fund. However, effective governance and monitoring may ensure the effectiveness of VC.

B. Demand Side Policies

1. **Sub-Contracting of large firms with small firms:** This can help in fostering the growth and sustainability of small and medium enterprises. This option can work through the following two channels:

   (i) Large firms may act as guarantor for small and medium enterprises for having an easy access to formal financing avenues. These large firms may also advance credit to small and medium enterprises.

(ii) Large firms can also assist in the growth of small and medium enterprises by providing them certainty in their business growth.

This mechanism is popular in countries like Taiwan, Korea China, and Japan where SME growth is a success. In Pakistan, the successful example of sub-contracting can be observed in automobile industry where automobile manufacturers have sub-contracted with small and medium enterprises of the sector[11]. However, this option is dependent upon the willingness of large firms and capability of small and medium enterprises in utilizing this financing opportunity. For the said condition to be fulfilled, following strategies can play a facilitating role:

a) **Awareness Raising Programs:** Awareness programs about available opportunities for SME financing and sector's critical role in the overall industrial growth of the country (see **Box SS1.1**for details) can act as convincing factors for both large and small firms to exercise the option of sub-contracting. Government can intervene by arranging these awareness progarmmes in consultation with SME association in the country. SBP is also in the process to undertake financial literacy program for building awareness of SMEs about banks and their targeted products.

b) **Business Development Support for SMEs:** This mainly refers to advisory services for SMEs for developing their skills and enhancing capabilities to capitalize on all available financing options in the market. Realizing this requirement, the government has established Small and Medium Enterprise Development Authority (SMEDA) in 1998 and recently has also established Pakistan Enterprises Competitiveness Support Fund (CSF) with the help of USAID and Business Support Fund (BSF). Government can enhance the effectiveness of these advisory services by encouraging private sectors to enter in this area. With more service providers in the market, not only more establishments under the umbrella of SMEs will be able to have advisory services but competition among these service providers will also help in improving the efficiency of these service providers.
To improve access to finance for SMEs, SBP is currently working on the implementation of Secure Transaction Framework that will enable SMEs to offer their moveable assets as collateral. This initiative is likely to

[11] H.Ishart (2003) SME Financing-Issues and Prospects, Key Note address at the SMEDA-IBP seminar, Lahore

expand financing avenues for the sector by allowing SMEs to access collateral based lending.

Conclusion: All stakeholders recognize the importance of SME sector for economic development and consider constrained financing as major hurdle for the development of the industry. The negative impact of constraints on demand and supply side seems amplified during the period of economic slowdown. This scenario demands an effective and proactive intervention on both demand and supply sides. Intervention can produce desired impact when e implementation is complemented with a conducive regulatory environment and adequate infrastructure development. Moreover coordination among stakeholders and consistency in policies will play a leading role in bringing positive impact the growth of the industry.

Box 2: Cross Country Comparison

Countries	SME Definition	SME Contribution	Intervention Programs	Features
India	The Small Scale Industries are industrial enterprises in which the investment in fixed assets does not exceed Rs 10 million.	SMEs constitute 80 percent of the country's industrial enterprises and contributes 35 percent of exports and employs 70 percent of the labour force (2008)	Priority Sector Lending Facility	Under this facility, 40 percent of net bank credit of public and private sector banks is earmarked for priority sectors including SME
	The category of Small Scale Services include enterprises where investment in fixed assets excluding land and building does not exceed Rs one million`		Credit Guarantee Fund Scheme for Micro and Small Enterprises	32 percent of net bank credit of foreign banks is earmarked under this scheme for priority sectors of which 10 percent is allocated to SMEs
Pakistan	Small and Medium Enterprise (SME) means an entity which employs up to 250 persons in case of manufacturing or service concern and 50 persons in case of trading concern while its net sate sales assets does not exceed Rs 300 million. However the criterion in terms of assets is their cost value up to Rs 50 million (excluding land and building) for trading and service concern and up to Rs 100 million for manufacturing concern.	SME constitutes 90 percent of the economic establishments and contributes 30 percent of GDP and 25 percent of export earnings and also employs 78 percent of non-agriculture labor force	SME Bank	The bank provides subsidized loans to the sector
			Small and Medium enterprise Development Authority(SMEDA)	The public-private partnership in the name of SMEDA has got objective of providing consultancy services to small and medium enterprises as well as to create a conducive policy environment for SME growth in the country.
Indonesia	SMEs are enterprises that have less than 100 employees	Small enterprises contribute 41 percent of GDP and 89 percent of the total employment while medium size enterprises account for 16 percent of GDP and 10.55 percent of the employment (2000)	Credit For people's Business	This scheme allows credit of up to Rp 500 million per borrower at a maximum interest rate of 16 percent per anum return
China	SMEs are companies that have sales of RMB30 million to RMB400 million with a workforce ranging from 400 to	SMEs contribute 58.5 percent of GDP, 62.3 percent of export in value	Innovation Fund (1999) and SME Development (2004) and (2008)	This fund provides direct loans to SMEs

	3,000 employees*.	terms, 46.2 percent of tax revenue and 40 percent of the total employment (2008)	Technological Innovation Fund	This fund provides monetary support to SMEs for technology up gradation
Singapore	SMEs are enterprises that have less than 100 employees In manufacturing sector; enterprises that have an investment of less than S $ 12 million in fixed assets are considered SMEs.	SMEs constitute 90 percent of the enterprises and contribute 42 percent of GDP and employ more than half of the labour force (2007)	Start-up Enterprise Development Scheme	According to the scheme, SPRING[**] will invest a matching dollar for every dollar an investor puts into the country's based start-up businesses, up to a maximum of $ 300,000
			Micro Loan Programme	Under this program loans up to $ 50,000 are extended to fund daily business operations for businesses having less than 10 employees
			Enterprise Investment Incentive Scheme	Under this scheme investors can deduct up to $ 3 million worth of losses against their taxable income if investment is made in new venture
Malaysia	SMEs are enterprises that have less than 75 employees and assets valuing not more than RM 2.5 million	SMEs contribute 32 percent of GDP, 19 percent of exports and employs more than 50 percent of the labour force (2005)	Small and Medium Industries Development Corporation Matching Grants	Under this scheme the grant is provided for · business start-ups, · improvement in products and processes · certification and quality management system · development and promotion of halal products etc
Thailand	SMEs are enterprises that have less than 200 employees for labour intensive ventures and have investment of less than 100m Baht for capital intensive projects	SMEs contribute 37.8 percent of GDP and employ75 percent of the labor force (2005)	Financial Promotion Programs	The program supports operations of the Small and Medium Enterprise Development Bank of Thailand and the Small Business Credit Guarantee Scheme (2000)
			Capacity Building Fund	The fund provides financing for consulting services, expansion in export market and application for intellectual property rights

			Various Loans Programmes of SME Bank	The bank extends loans including Food Safety Loans, one Tambon One Product Loans and other fast track loans etc

Sources:(i) Enterprises in Asia: Fostering Dynamism in SMEs; Asian Development Bank Report 2009

(ii) Towards the Recovery: Challenges and Opportunities facing Asia's SMEs, Economist Intelligent Unit 2010

(iii) M. Thamrong (2007);" Opportunities for SMEs in Thailand", Thailand Board Of Investment, Japan.
(iv) APEC and SME Policy: Suggestion for an Action Agenda (www.apec.org.au/docs/iss1.htm)(accessed on)(20th Feb'2010)
(v) The Small and Medium Enterprise(SME) Annual Report 2008 (www.smidec.gov.my/node/4920/0(accessed on)(20th Feb'2010)

(vi) S.G. Aruna (2003);"Small and Medium Enterprise Development in Sri-Lanka: A Review"

* H.Lauren (2009); SMEs in China";Industry Outlook
* * SPRING Singapore is the enterprise development agency for growing innovative companies and fostering a competitive SME sector.

` Rs. In the box refers to Indian rupee

<table>
<tr><th colspan="3">Annexure SS1.1: Comparison Between Commercial Banking Regulation and SME Regulation</th></tr>
<tr><th rowspan="2">Areas</th><th colspan="2">Regulations</th></tr>
<tr><th>Corporate Sector</th><th>SME</th></tr>
<tr><td>Limit on Clean Facilities</td><td>Banks/DFIs shall not provide clean financing facility in any form of a sum exceeding Rs 500,000 to any one person</td><td>Banks/DFIs are allowed to take clean exposure up to Rs 3 million provided that funded exposure should not exceed Rs 2 million</td></tr>
<tr><td>Aggregate Exposure of a Bank/DFI</td><td>The aggregate exposure of a bank/DFI against all their clean lending shall not at any point in time exceed the amount of their equity(Unsecured TFCs and sub-ordinate loans are exempted)</td><td><table><tr><td>Classified SME Advances /Total portfolio of SME Advances (%)</td><td>Max. Limit</td></tr><tr><td>< 5%</td><td>No limit</td></tr><tr><td>< 10 %</td><td>3 x equity</td></tr><tr><td>< 15%</td><td>2 x equity</td></tr><tr><td>>= 15 %</td><td>Upto the equity</td></tr></table></td></tr>
<tr><td>Margin Requirement</td><td>Banks/ DFIs are free to determine the margin requirements on facilities provided by them to their clients taking into account the risk profile of the borrowers in order to secure their interests. However this relaxation shall not apply in case of items imports of which are banned by government. Banks/DFIs will continue to observe margin restriction on shares/TFCs as per instructions under prudential regulation (R-6) along with the cash margin requirement of 100 percent on caustic soda for opening Import Letter of Credit</td><td>Same as Corporate Sector Regulation</td></tr>
<tr><td>Cash Flow Backed Lending</td><td>Banks/ DFIs shall specifically identify the sources of repayment and assess the repayment of the borrower on the basis of assets conversion cycle and expected future cash flows. In order to add value, the banks/DFI are encouraged to assess conditions prevailing in the particular sector/industry they are lending to and its future prospects. The rationale and parameters used to project the future cash flows shall be documented and annexed with the cash flow undertaken by the bank/DFI.</td><td>Same as Corporate Sector Regulation. However, recognising the inability of SMEs' in preparing future cash flows it is expected that in such cases banks/DFIs shall assist borrowers in obtaining information and no SME shall be declined access to credit merely on this ground.</td></tr>
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