Developing SME Sector in Pakistan

Concluding address at the Habib Bank Seminar on
'Small and Medium Enterprises' held at Karachi on Janury 15, 2002

The diagnosis of the problems afflicting the SME sector in Pakistan is very well established by now. The papers delivered at this seminar have presented both the qualitative and quantitative data and information about the existing contribution and future potential of the sector. The Government policy and priority to SMEs have been reiterated by the Chief Executive in his address on December 16, 1999. The key support institutions such as SME Bank and SMEDA have been restructured. It is now high time that we should move from the phase of analysis and diagnosis to action that can spur small and medium entrepreneurs to realize their potential.

The question that this seminar has focused is most pertinent: Why is that the SMEs do not have adequate access to financing from the formal sector? It is not only true in Pakistan but all developing countries that the SMEs are underserved. The reason for this outcome has been theoretically and empirically elaborated i.e. it is a classic case of market failure. This sector is characterized by information asymmetries as the creditor's search costs, information acquisition and processing costs and screening costs exceed the returns. Hence there is a risk aversion by the banks towards extending credit to small and medium entrepreneurs. It is relatively easy to lend to large corporate where the economies of scale, published financial information, collaterals and creditworthiness parameters favor such type of lending.

What is the international and cross-country experience about dealing with this market failure? After all there are a large number of success stories where financing has turned around the SME sector. We should learn from these countries and attempt to apply these lessons to our own situation. In my opinion, we need to adopt a multipronged approach to attack this problem.

First, the large and well established firms and companies should enter into subcontracting arrangements with SMEs in their own respective areas of specialization. As the track record, relationship and creditworthiness of these large companies with the banks are already known to the banks these companies can leverage this capacity for those SMEs which are the suppliers of goods and services to them. The large companies acquire adequate information about these sub-contractors through their dealings with them and this information can then be either shared with the banks for direct lending or guarantee or surety or indirectly for on-lending to these sub-contractors. The large companies confer a lot of externalities by assisting these firms in designing, quality control, technical know-how etc. and helping improve their productivity. Some of the SMEs through this process will mature and cross the threshold and become eligible for direct borrowing from the banks without the need for any intervention by the large companies.

Second, such as social intermediation has become an integral part of Microfinancing we need an analogous arrangement for SME sector. The intermediary which can be a public, private or non-governmental entity can provide services such as technical know-how, marketing, managerial skills, accounting and book keeping, preparation of basic financial statements. The SMEs may pay for these services as it will improve the bankability of their proposals and requests for fixed capital as well as working capital. At present there is a gap between small enterprises which are incapable of presenting the documents required by the banks and the insistence of the banks that they cannot appraise credit risk unless the necessary cash flow projections and other information becomes available. SMEDA has been mandated by the Government to provide these services but we need a lot more entities in this field. The competition between these entities will reduce intermediation costs to the SMEs.

Third, the Provincial Governments have a large number of technical and vocational institutes working all over the country. But unfortunately they are supply driven and most of the graduates of these institutions are not properly equipped or trained to respond to the market demand for various kinds of skills. This creates a paradoxical situation where thousands of graduates produced by these institutes every year remain unemployed, underemployed or utilized sub-optimally while the economy continues to suffer from shortages of skills such as air conditioning mechanics, plumbers, motor technicians, electronic diagnostician, para medical personnel, agriculture support staff, book keepers, accountants. These skills are badly required by the small and medium enterprises and thus it is imperative that the contents and methodology of the courses offered at these technical and vocational institutes are redesigned and realigned with the requirements of the economy and SME sector particularly. The Government of Punjab has taken some initiative in this connection and if they are successful it is quite likely that the other provinces may follow the suit. Managerial training and entrepreneurial training are two other areas which are missing at present and need to be built in. As general productivity levels of SMEs rises through the skill upgradation the banks will be in a better position to mitigate their risks of lending to SMEs.

Fourth, the formation of SME Bank in the public sector should be considered in a broader context. This bank, just like Khushali Bank for microfinance sector, is intended to act as a protype for other SME Banks in the private sector. Just one bank cannot simply cover the whole vista of SME financing within the country. We conceive SME Bank as taking the lead in developing a portfolio approach or program lending tools where standardized credit scoring methodology is used for each sub-sector rather than the current method of scrutiny and appraisal of each individual proposal. The present methods and documentation are onerous for small entrepreneurs and relatively costly for the banks. SME Bank has to experiment and come up with the standardized set of easy to fill but fully informational documentation, specification of risk parameters, credit appraisal and delivery techniques and new and innovative products and services which are in heavy demand by the SMEs. These business models, products, services, techniques developed by SME Bank can then be applied and replicated by other banks planning to enter this particular market segment. The externalities in form of the spill over effect from a public good i.e. SME Bank will thus benefit the private providers of credit.

Fifth, Habib Bank is to be commended for its decision to assign 21 branches exclusively for dealing with the SMEs. The relationship management and holding hands by bank staff will provide a constant source of feed back for improving products and services. This will also enhance the capability of Habib Bank staff in assessing, managing and unbundling the different kinds of risks inherent in SME lending. I hope that other large commercial banks with a vast distribution network will be able to follow the example of Habib Bank and a new Customer Relationship Management model will soon emerge for the small and medium entrepreneurs.

It may be pertinent to ask the question: while all the above measures are being assigned to various economic players what is the State Bank itself doing to promote lending to SMEs? Let me recapitulate briefly the actions we have either initiated or are in the process of taking. First, we have designed a new set of prudential regulations specific to the SME sector which have been circulated to SME Bank and SMEDA for consultation with stakeholders. Once their feedback is received we intend to revise these regulations and issue them for compliance. I believe that this will be a major step forward as the present regulations are ideal for corporate sector but inappropriate for the small and medium enterprises. This relaxation of prudential regulations should remove one of the main hurdles in the way of widespread coverage of this sector.

Second, we are working with the World Bank to set up a Credit Information Bureau in the private sector which will assemble the data and current status of small borrowers. The information flows to the banks based on this source will improve their credit risk appraisal capacity and ultimately reduce the non-performing loans in the portfolio.

Third, the State Bank is examining the possibility of a Credit enhancement Fund for SMEs on the lines of the Funds set up in various other countries. IFC and ADB are being approached to assist us in evolving this product.

To sum up, the economic policy makers have identified SME as one of the priority drivers of economic growth and employment in the country, introduced some of the institutional infrastructure to support this sector and is contemplating changes in regulatory environment. The financial sector institutions should position themselves in entirely different ways to accelerate lending to SMEs while maintaining a risk profile that is within acceptable tolerance limits.