SME Financing – Issue and Prospects

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I would like to congratulate SMEDA on bringing together all the stakeholders together to discuss the issue related to financing of SMEs in Pakistan. I have listened to the presentations and also the interventions from the floor very carefully. Let me therefore share my thoughts with you on this important topic.

We should start with the basics. As you have heard, from the presentations this evening, there is a tremendous demand of bank credit by the SMEs who are at present meeting most of their financing needs through friends, relatives and other informal sources. At the same time the banks have surplus liquidity which they would like to deploy to earn a decent rate of return on their depositors' funds. But there is a market failure in so far as the demand and supply are not being cleared and there is a disequilibrium in the credit market for SMEs. The banking business is characterized by asymmetric information. The borrowers' willingness and capacity to service a loan on time is known to him. But this information is not available to the lender. In order to compensate for this information asymmetry the lender asks for securities and collaterals from the borrowers. Thus the collateral acts as a key input into the process of financial intermediation. As the small businesses cannot offer adequate collateral the banks are unable to determine whether the borrower possesses technical, managerial and marketing skills that will allow him to generate adequate cash flow and repay the loan on time. The process of financial intermediation therefore breaks down for the SME borrowers. In order to revive this process, the banks have to be reassured that the borrowers' technical capacity, management and marketing skills are being taken care of and at the end of the day they will have sufficient cash flow to service their debt to the banks. .

Financing issue therefore needs to be looked, not in isolation, but in a holistic way. A large number of players have to be involved in contributing to the success of the SMEs. At least there are as many eleven different stakeholders who have to work together in a coordinated and cohesive manner to ensure that these market failures in case of SME credit market are removed and the process of financial intermediation takes place.

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First, the government and the regulatory agencies such as the State Bank of Pakistan should provide conducive enabling environment for SMEs to operate. This means that macro economic policies are sound, regulatory regime is supportive and legal system enforces contracts and property rights. There ought to be a level playing field for both the small and large entrepreneur and there is no preferential treatment for any particular class. In the past the SROs were being used to favour certain individuals or tariffs were raised to protect selective groups or banks loans were given to supporters of the ruling parties. In the past four years, however, these practices have been done away and neither any SRO has been issued not any preference in the tariff has been given. A level playing field exists for all businesses – small or large – in the economy.

The SBP reviewed its own role to determine whether or not it was creating any hurdles in the way of lending to SMEs. We found out that the same prudential regulations which applied to corporate borrowers were also made applicable to consumer, SME, Micro finance although the requirements were different for each market segment. We therefore decided to formulate a separate set of regulations for SMEs. After consultation with the SME Associations, SMEDA, provincial departments and the banks the prudential regulations have been completely rehashed and finalized. These prudential regulations will be announced shortly. The "One shoe fits all sizes" syndrome has been replaced by a tailor made approach responsive to the specific need of each market segment. We hope that once these regulations are applied a number of existing constraints that have been spelled out in the presentations today will hopefully be removed and the banks will be in a better position to disburse loan to SMEs without fear of violating the regulations.

The second player in this process is the Provincial and the local Governments. They have to allocate and earmark land for setting up industrial estates and deliver the infrastructure facilities in these estates. The economies of agglomeration dictate that if clusters of same industries are relocated in the same vicinity the suppliers of raw materials and components, and providers of services and marketing of output also move to the same areas. The logistics management and reduction in transportation cost reduce the unit cost of production and distribution for a single enterprise and also improve the reliability and timeliness in the delivery of products. In many countries such zones and clusters have worked very well and helped small and medium enterprises to become more competitive.

The third player is the Provincial Small Industries Corporations which used to provide common technical service centers such as design, fabrication, foundry, repair workshops, marketing outlets and other services to the SMEs. As these services cannot be justified at each enterprise level the pooling and provisioning did help the SMEs in accessing the facilities at affordable costs. As the performance of this type of public sector corporations has not been very satisfactory in the past it is time to consider a public-private partnership in which the management and operations of these facilities and centers are entrusted to the private partners.

Fourth, organizations such as SMEDA have to play a critical role in the business developments support, advisory services and managerial training of SMEs. For example, most small enterprises do not maintain proper accounting of their operation and do not have a trained accountant on their staff. This impedes their ability to access credit from commercial banks. SMEDA can organize training courses in accounting and assign these certified trainees to work on a Part –time basis with a number if enterprises. Simple accounting software packages are now available for small businesses and these can be profitably used in a large number of SMEs. SMEDA can design simplified standardized book keeping, inventory management and ledger forms which can aid in the preparation of financials.

Fifth, there is a widespread network of technical and vocational training institutes and polytechnics throughout the country. Those who graduate from this institute are unable to find suitable remunerative jobs. On the other hand, the SMEs lack adequate technicians and trained manpower who have the requisite skills to help them in the production of their goods and services. Thus, there is a mismatch between the demand and supply of this type of manpower. The provincial governments who own these institute should examine the contents and curriculum, pedagogical tools, evaluation and assessment procedure, incentive structure for the faculty members and bring about the necessary changes to align the supply of the graduates with the emerging needs of the SME sector. Synergies can be generated if some of the institutes are located in the clusters and apprenticeship and internship programmes are instituted to give practical hands-on training to the students.

Sixth, the SME Bank alone cannot cater to the needs of the entire sector but it could develop a prototype of program lending, credit appraisal and delivery methodology, standardized documentation, monitoring mechanisms which can be replicated and followed by other commercial banks. The SME Bank can produce experienced and skilled professionals who are specialists in the SME credit for the whole industry. But for this to happen the SME Bank itself has to be restructured and equipped with the right set of personnel who are not only adept technically but have the right attitude of collaboration and partnership with the small entrepreneurs. They have to be adroit relationship managers holding hands of their clients and helping them in the nurturing and growth of their business.

Seventh, the commercial banks, leasing industry, modarabas themselves have to develop dedicated groups for servicing the SMEs. They should establish their presence and branches at the clusters and places such as Daska, D.I.Khan, Wazirabad, Khairpur, Kotri, Gwadur which have large untapped potential. If the SME branches of the banks remain limited to a few big cities you will never be able to make a profitable business out of the SME sector. The balance sheet, cost of funding, the geographical spread do confer a big advantage to the big banks and if they do not make innovative use of technology, skills, systems and procedures to capitalize on this advantage they will soon be marginalized by the intrusion of more agile and nimble small private banks. The banking industry has to invest in people, processes and systems to minimize their risks and enhance their returns on the SME segment.

I am optimistic that this can be achieved because of the happy experience we have had with agriculture lending during the last three years. As you know, agriculture is the only sector for which the SBP has mandatory targets assigned to each of the five banks. Until a few years ago the banks were quite willing to pay the penalties to the SBP for not meeting these targets. I found this to be a highly anomalous situation as the whole purpose of mandatory credit was to make sure that the small farmers receive credit from the banking system and improve their productivity and incomes. It was not that the SBP should feel satisfied that it was collecting money for non performance of the banks while the most vital sector of our economy remained deprived of bank credit. We, therefore, commissioned a group consisting of the bankers and farmers and asked them to come up with modifications in agriculture credit scheme whereby the banks will have the incentive to direct lending to small farmers. The report of this group was adopted by the SBP and its recommendations were issued as instructions to all the banks. You will be pleased to note that in 1999-2000, the five big banks had disbursed about Rs.5 billion only for agriculture credit but in 2002-03 all the commercial banks had increased the amount disbursed to Rs. 22 billion. Recovery rate was 95 percent and all the big five banks exceeded their targets by a margin. In next two years I expect that commercial banks will surpass the ZTBL in agriculture credit.

You can see that once a situation is created where incentives of borrowers and lender are aligned we have a win-win situation for both the parties. The SBP would like to learn from this experience and apply the lessons for bringing about a win-win situation for SME lending also. I am confident that the banks will be able to earn good margins on their lending to this sector and the entrepreneurs will be able to expand their operations and become more productive and profitable.

Eighth, the Institute of Bankers (IBP) has to play a role. As this is a new field of endeavor the banking staff have to be imparted training in credit appraisal, documentation, approval, monitoring and recovery and this can be done under the auspices of IBP. Program lending is not well known in Pakistan and thus the master trainers have to be brought in from outside for a limited period of time. They will design and deliver training of trainers. These trainers will, in future, multiply the courses and a critical mass will be generated.

Ninth, the large firms have a major role to play in the promotion and growth of SMEs through sub-contracting arrangements. These large firms can also leverage their standing with the financial institution by borrowing at fine margins in their own name and advancing this to their sub-contractors and vendors. They can deduct the amounts advanced from the payments due for the goods supplied or services rendered. As they know their subcontractors better than the banks the low cost of financing supplied through this mechanism will also benefit the large firm as the costs of their inputs or components will also be lower. This is already successfully happening in the auto industry in Pakistan. The large auto manufacturers have entered into alliances, subcontracts, and other arrangements with a myriad of a small and medium scale auto component and parts assemblers and manufacturers. Hundreds of new SMEs have been setup or existing SMEs have expanded in response to the growing demands of the automobile production in the country. As the economies of scale took hold, unit cost of the auto parts industry declined and they were able to export to the Middle East. This example illustrates the huge potential of exploring subcontracting arrangements in other industries for employment and SME sector promotion.

Finally, the associations of SMEs should launch awareness programmes among their members about the opportunities that are already available, assist them in linking up with the appropriate support institutions, listen to the genuine difficulties and problems faced by their members and articulate them to the right quarters. In other words, they should tamper their role of advocacy and pushing a charter of demands for concessions from the government or lower preferential interest rate from the banks with that of a facilitator and honest broker. As I have sketched above there are too many players who can make the lives of SMEs either tough or helpful. It is the task of the Associations to strive for coordination between different agencies and institutions as their focus is exclusively the interest of the small entrepreneur. But to succeed, they have to move out of big cities and setup their branches and offices in small towns and clusters where the SMEs are located.

In the end let me say that the SBP would very much like the SME financing to become a mainstream activity of the banks in Pakistan. The banks have a vested interest in doing so because if all the above players I have mentioned above play their due role they (the banks) will earn more profit from the SMEs instead of investing in T-bills or lending to big name corporates.