SME Financing

Presented to:

State Bank of Pakistan

April 6th, 2015

Enclude

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Contents

Some Related Definitions

SMALL AND MEDIUM ENTERPRISES (SMEs)

There is no standard, global definition of what constitutes a SME. In the Asia Pacific region SMEs are generally defined as small enterprises; more than 95% of them employ less than 100 people.

SUPPLY CHAIN

A supply chain allows the flow of products or services, information and finance from the source to the customer through a network of suppliers, manufacturers, distributors, and customers.

VALUE CHAIN

A chain of activities that add value as a product or service moves through the supply chain.

Some Related Definitions

- **SME finance** is the funding of small and medium enterprises.

- **Agricultural SME finance** is defined as financial services for small and medium enterprises engaged in agricultural production (i.e., farming) and production-related activities, such as input supply, processing, trade, wholesaling, and marketing at all levels.

Definition of Small Enterprise - SBP

A Small Enterprise (SE) is a business entity which meets both the following parameters:

- Number of Employees *Up to 20

*including contract employees

- Annual Sales Turnover Up to Rs. 75 million

Definition of Medium Enterprises - SBP

- **Definition of Medium Enterprise**

  Medium Enterprise (ME) is a business entity, ideally not a public limited company which meets both the following parameters:

- **Number of Employees**
  - 21-250 (Manufacturing & Service MEs)
  - 21- 50 (Trading MEs)

  * Including contract employees

- **Annual Sales Turn-Over**

  Above Rs 75 million and up to Rs 400 million

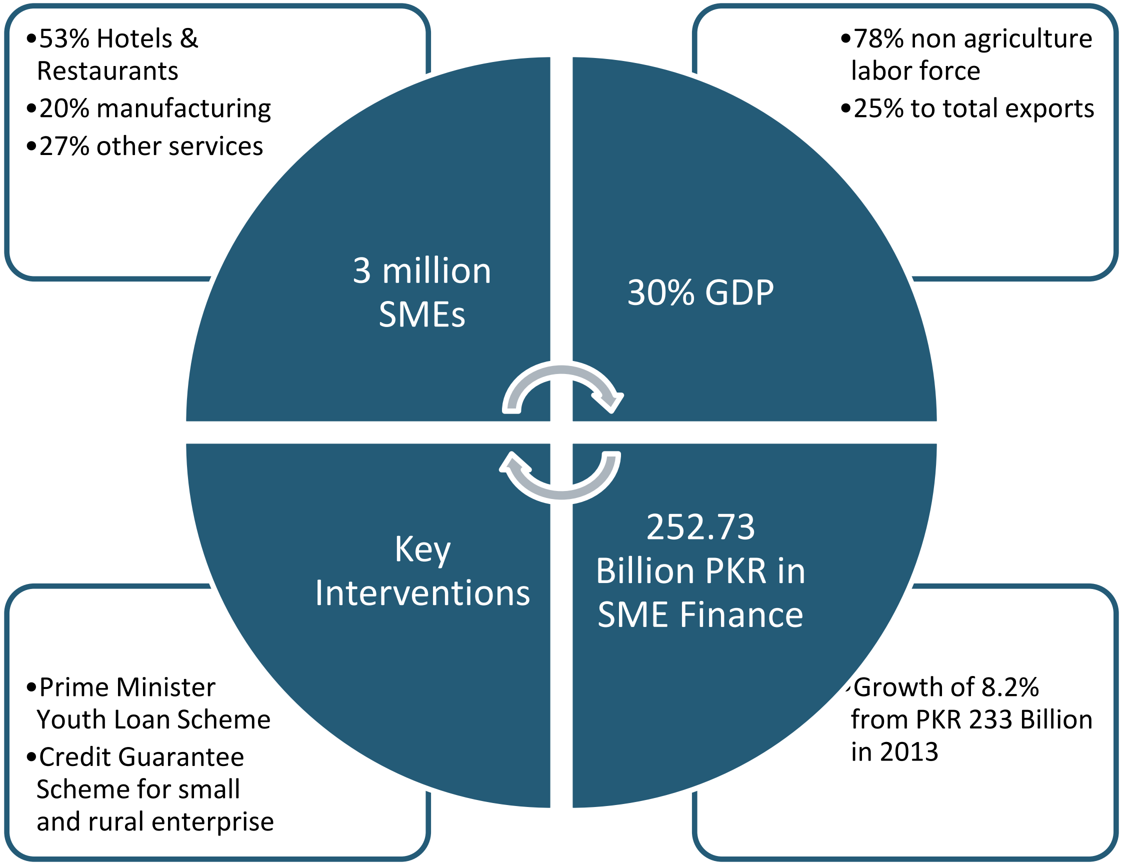
  (For all types of Medium Enterprises)

SME according to various Institutions

Institution	Small	Medium
SME Bank	Total Assets of Rs. 20 million	Total Assets of Rs. 100 million
Federal Bureau of Statistics	Less than 10 employees	N/A
Punjab Small Industries Corporation	Fixed investment. up to Rs. 20 million excluding land and building	N/A
Punjab Industries Department	Fixed assets with Rs. 10 million excluding cost of land	
Sindh Industries Department	Entity engaged in handicrafts or manufacturing of consumer or producer goods with fixed capital investment up to Rs.10 million including land & building	
State Bank of Pakistan (SME Prudential Regulations)	An entity, ideally not being a public limited company, which does not employee more than 250 persons (manufacturing) and 50 persons (trade / services) and also fulfills one of the following criteria: (i) A trade / services concern with total assets at cost excluding land and buildings up to Rs 50 million. (ii) A manufacturing concern with total assets at cost excluding land and building up to Rs 100 million. (iii) Any concern (trade, services or manufacturing) with net sales not exceeding Rs 300 million as per latest financial statements.	

Source: SMEDA

SME in Pakistan



Source: State Bank of Pakistan

SME in Pakistan

- Agriculture comprises 20 to 25 percent of the National Income and around 60 percent of the population lives of agriculture and related services. Except for some indirect taxes, this segment of the economy (agriculture and related services) is not taxed and remains undocumented and to a very large extent, thrives on cash based (not banking) transactions.

- Most small businesses avoid the tax collector or if they do come into the net, they are forced to keep most of the income off the books so as to negotiate the least costly extortion.

- Thus banks and financiers cannot(and rightly do not), have faith in the SME's books of account

FINANCIAL NEEDS OF SMES

- **Fixed assets** – to pay for the fixed assets to start any business SMEs need access to finance.
- **Salaries and expense** – to run the business, operating expense and salaries are required in a timely manner.
- **Utilities** – other than salaries need to be paid for in a timely manner
- **Periodic fixed assets** – a business may require at every cycle a certain amount of investment in fixed assets.
- **Low income period** – with seasonality and trend affecting the market there are low income periods for which the SMEs need to plan for.
- **Emergency needs** – these can come up in the form of both personal and professional.
- **Ramp-up** – this will require additional investments as increase in firm production ahead of anticipated increases in product demand will require making these investments upfront.
- **Loan repayment** – the loans taken by the borrower need to be paid back in time.
- **Raw material / working capital** – there is a continuous need for raw materials and working capital to run any business.

Sources of Finance

#	SOURCE	CHARACTER	CAPACITY	CAPITAL	COLLATERAL	CONDITIONS
1	ADVANCE (BUYERS/ CUSTOMERS)	▲				
2	CREDIT (SUPPLIERS)	▲	▲			
3	FACTORING		▲			
4	FAMILY AND FRIENDS	▲				
5	FINANCIAL INSTITUTIONS	▲	▲	▲	▲	
6	IPO/SHARES		▲		▲	
7	MICRO FINANCE INSTITUTIONS	▲	▲			
8	OWNER'S EQUITY			▲		
9	REGISTERED MONEY LENDERS	▲	▲			▲
10	UNREGISTERED MONEY LENDERS	▲	▲			▲
11	VENTURE CAPITALISTS	▲				▲
12	SALES/REVENUE		▲			

Matching SME Sources with SME Needs

#	SME SOURCES OF FINANCE	FIXED ASSETS	SALARIES	UTILITIES	PERIODIC FIXED ASSETS	LOW INCOME PERIOD	EMERGENCY NEEDS	RAMP-UP	LOAN REPAYMENT	RAW MATERIAL / WORKING CAPITAL
		SME NEEDS								
1	ADVANCE (BUYERS/ CUSTOMERS)		▲	▲	▼		▲	▲	▲	
2	CREDIT (SUPPLIERS)					▲		▲		
3	FACTORING		▲	▲	▼			▲		
4	FAMILY AND FRIENDS	▲	▼	▼	▲	▲	▲	▼	▼	
5	FINANCIAL INSTITUTIONS	▲	▼	▼	▲	▼	▼	▼	▼	▲
6	IPO/SHARES									▲
7	MICRO FINANCE INSTITUTIONS				▲	▼				
8	OWNER'S EQUITY	▲	▼	▼	▲	▲	▲		▲	▲
9	REGISTERED MONEY LENDERS				▲	▲		▼	▼	
10	UNREGISTERED MONEY LENDERS				▼	▲	▲	▼	▼	
11	VENTURE CAPITALISTS	▲								▲
12	SALES/REVENUE		▲	▲	▲		▼	▲	▲	

CHARACTERISTICS OF SME LOANS

#	SOURCE	COLLATORAL (Y/N)	ONE TIME OPPORTUNITY (Y/N)	TRANSACTION COST (Y/N)	INTEREST (H/M/L/N)	INTERFERENCE (H/M/L/N)
1	ADVANCE (BUYERS/ CUSTOMERS)	No	No	No	No	No
2	CREDIT (SUPPLIERS)	No	No	No	No	No
3	FACTORING	No	No	Yes	Low	No
4	FAMILY AND FRIENDS	No	Yes	No	No	Low
5	FINANCIAL INSTITUTIONS	Yes	No	Yes	Medium	No
6	IPO/SHARES	No	Yes	Yes	No	High
7	MICRO FINANCE INSTITUTIONS	No	No	No	High	No
8	OWNER'S EQUITY	Yes	Yes	No	No	No
9	REGISTERED MONEY LENDERS	No	No	No	Medium	No
10	UNREGISTERED MONEY LENDERS	No	No	No	High	No
11	VENTURE CAPITALISTS	No	Yes	Yes	No	High
12	SALES/REVENUE	No	No	No	No	No

Borrowing Cause

- The borrowing cause or causes are events in the asset conversion cycle or other balance sheet or income statement accounts that have caused , or will cause, cash outflow to exceed cash inflow for some time. Example are sale growth, slowdown in operating cycle, and expansion of fixed asset.

KEY TYPES OF RISKS ASSOCIATED WITH SME BUSINESSES

- Succession Risk
- Management & Planning Risk
- Lack of Documentation / Transparency
- Single Buyer / Supplier Risk
- Limited access to Debt Market (Limited financial capacity)

RISK MITIGATION IN LENDING TO SMEs

- Extent / Amount and Type of lending must be based on Cash Flows
- Assessment of “True” Cash Flows / Income Estimation
- Market Reputation
- History with other Banks / FIs
- Credit / Limit Structuring
- Succession Planning & Management Quality
- Industry / Market Outlook
- Collateral considerations
- Close and Frequent Customer Contact, especially after disbursement

Challenges to SME in Pakistan

- Poor record keeping by SMEs, particularly accounting information and other business documentation.
- Low productivity and their inability to improve quality of products over time.
- Poor operational performance.
- Problems with packaging bankable loan requests by SMEs.
- Limited knowledge of financing options for SMEs.
- Lengthy and cumbersome application procedures, which discourage both SMEs and Banks.
- High transaction costs owing to size of transaction, vis-à-vis volume of transactions which discourages banks.
- High turn around time owing to lack of timely and quality information from SMEs.
- Lack of skills in banks for identifying needs and structuring the delivery of financial assistance to SMEs.
- Lack of expertise in banks for appraising/structuring SME Projects.
- Stringent collateral requirements and other banking regulations.
- General risk aversion by banks.

Challenges to SME in Pakistan

- Govt. & SME Interaction
- Taxation
- Technology
- Market & Industry Information
- Environmental issues & compliance
- Social compliance issues
- Intellectual Property Rights

World Bank Survey – Key Issues

Issues Identified	Percentage
• Lack of finance	55%
• Shortage of skilled labour	39%
• Getting business site	38%
• Bribes	21%
• Orders/Marketing of Product	28%
• Lack of Knowledge	12%
• Government interference	12%
• Raw Material	10%
• License for work	8%
• New Technology	8%

The solution to address these problem

- Banks to set up special purpose vehicles (SPV, say SME Funds) to finance SMEs. The financing could be in the form of debt and perhaps some equity, which the SME could buy back over time.

- The bank would finance a SME only if it agrees to outsource the accounting function to a licensed accounting firm (such a firm is likely to itself fall in the SME category, these will not be big firms but small ones all over the country). The bank would appoint the accounting firm and the firm would be accountable to the bank.

- The key requirement would be for the government to recognize/license the firm and accept the tax return filed by the accounting firm as final and there would be no interaction between the tax collector and the SME owner. The government would have a right to pick out random cases for a tax audit but here again, it would be the accounting firm that would be accountable and not the SME.

The solution to address these problem

- The bank may also arrange third party audit for such cases it feels necessary.

- The government has had a successful experiment of this nature, when it allowed the clearinghouse at the stock exchange to calculate and collect capital gains tax and immunized the stock traders from having to deal with the tax collector. Initially, when the tax was introduced trading volumes had dried up but when the clearinghouse was given the role of assessing and collecting the tax, activity came back in full swing.

Benefits

- Banks will be willing to finance SMEs once they are assured of transparency of their business.
- SMEs will not be fearful of documentation.
- The government will start collecting taxes that it currently does not.
- Documentation will help better management &planning of the economy.
- SMEs will not be held back for lack of finance.

Some initiatives by SBP for SME Borrowers

Export Finance Scheme

Credit Guarantee Scheme

SBP Refinancing Scheme Facility to SME

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Export Finance Scheme

- Markup to be charged at 2% by the banks from SME without changing the end user rate
- Financing limit to SME's sanctioned to 10% while corporate lending to 90%
- Limits are adjusted in a way that it does not disturb the existing corporate lending of Banks
- A reasonable transition period is given to the banks to adopt this mechanism for limit allocation and adjust their corporate clients share accordingly

Credit Guarantee Scheme

- A program that ensures partial repayment of the loan in order to incentivize lender to lend to borrower who lacks access to credit
- Targeted to Small Enterprise and Farmers
- Risk sharing with participating FIs by guaranteeing up to 40%of PFIs financing to small enterprises and farmers
- SBP will select 5-7 FIs that will participate in this scheme subject to their financial health
- Pricing of Loans will be done as per the market markup rate under this scheme however except for those in under SBP refinancing facility to SMEs

SBP Refinancing Facility to SME

Scope

- Financing shall be available to wide range of SME Clusters
- Only SME borrowers, as defined in Prudential Regulations for SMEs
- Financing shall be available for purchase of new imported/local plant & machinery for
- Financing facilities shall be available through all commercial banks and Development Finance Institutions BMR of existing units and setting up of new SME units
- Financing shall be available for a maximum period of ten years including a maximum grace period of six months.

SBP Refinancing Facility to SME

Rate of Service

The rate shall be determined on the basis of average weighted yields of last two auctions of 3, 5, 10 years PIBs

Tenor	Rate of Refinance	Banks'/DFIs' Spread	End Users' Rate
Up-to 3 years	5.50%	2.50%	8.00%
Over 3 years and up-to 5 years	6.25%	2.75%	9.00%
Over 5 years and up-to 10 years	7.00%	3.00%	10.00%

SBP Refinancing Facility to SME

List of SME Clusters

1) Rice Husking,
2) Cotton Ginning,
3) Power Looms,
4) Dairy & Livestock,
5) Cutlery & Stainless Utensils,
6) Surgical Instruments,
7) Marble & Granite,
8) Engineering Goods, (Electronic),
9) Fisheries,
10) Packaging / Processing of Fruits / Vegetables,
11) Furniture,
12) Gems & Jewellery,
13) Sports Goods,
14) Agro-based Industry

SME Lending Process

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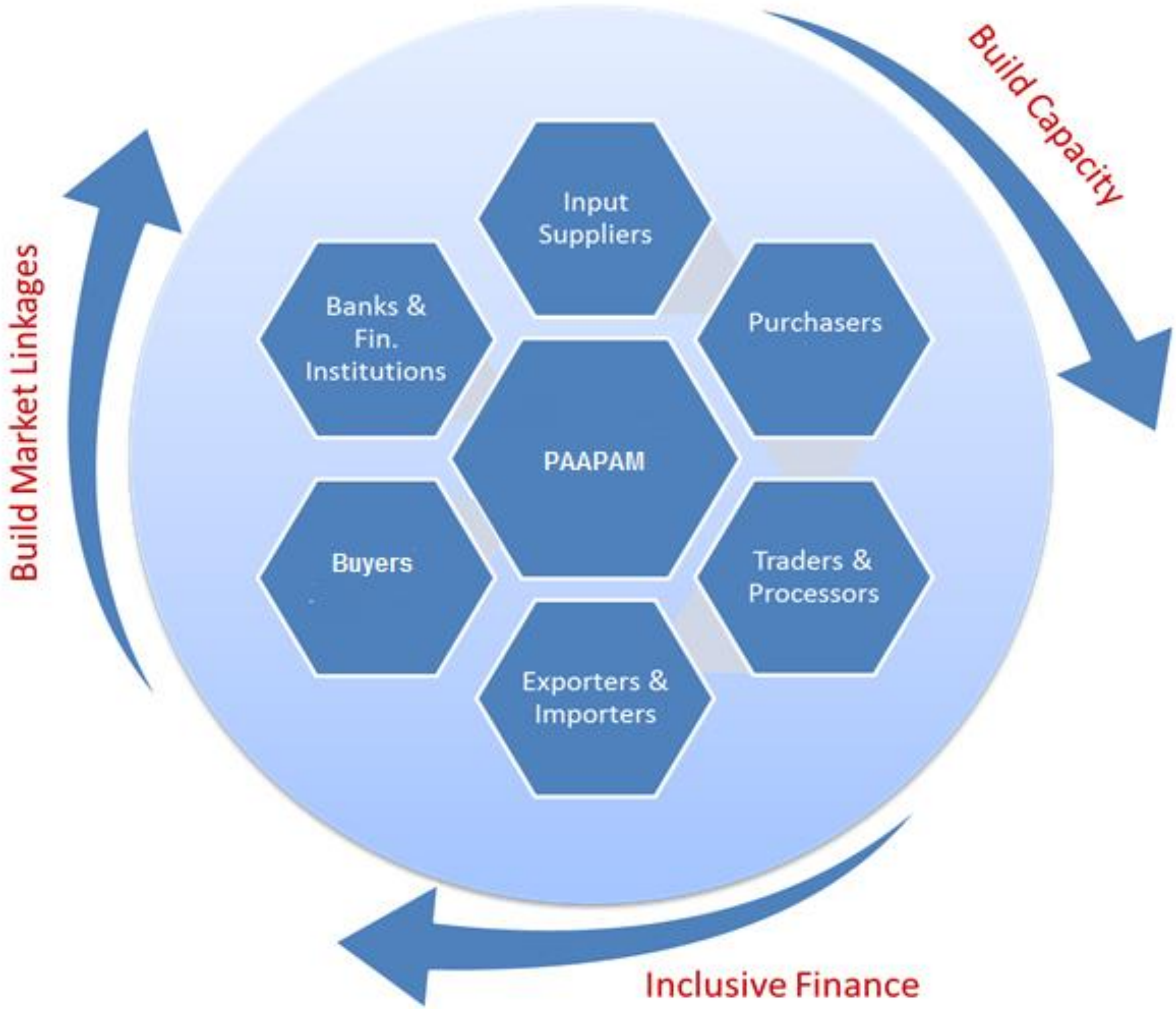
PRINCIPLES OF LENDING

- THE BORROWER’S (FIVE C'S OF CREDIT)
- Character
- Capacity (to repay) / Cash Flows
- Capital (own contribution)
- Conditions (industry / economy / overall environment in which the customer operates)
- Collateral

“Character” comes before anything else and “Collateral” is always the last

A FINANCIAL LENDING FRAMEWORK



The 5C's of Credit - Character

Character	Even though the loan is for your business, the person responsible for paying back the loan is you. It is your reputation and character that the bank will consider, including:
	Do you have experience in running a business?
	Do you have the required technical skills for the business?
	Do you have the Personal Entrepreneurial Characteristics required?

The 5 C's of Credit - Capacity

Capacity	This is an evaluation of your business ability to repay the loan. The bank needs to know how you will repay the funds before it will approve your loan. Capacity is evaluated by several components, including the following:
	Can the business generate enough to pay the loan with interest, including a security margin?
	When can the loan be repaid?
	What are the effects of seasonal fluctuation, production and price variations on the loan?
	How does the business compare to others within the same sector or activity?

The 5 C's of Credit - Capacity

The Repayment Capacity Indicator

$$\frac{\text{Cumulative Net Cash Flow over Loan Period (C)}}{\text{Total Loan Repayment plus Interest (D)}} > 2$$

Inflows	Month	1	2	3	4	5	6	7	8	9	10	11	12
Sales													
Wages													
Remittances													
Loans													
Other sources:													
TOTAL (A)													
Outflows													
Farm / business inputs:													
Capital equipment:													
Household expenses													
Other expenses													
Debt repayments													
TOTAL (B)													
MONTHLY NET CASH FLOW (A – B)													
CUMULATIVE NET CASH FLOW (C)													
LOAN REPAYMENT PLAN (D)													
Revised Monthly Net Cash Flow													
Revised Cumulative Cash Flow													

The 5 C's of Credit - Capacity

The Repayment Capacity Indicator

- Calculated by adding all monthly balances during the projected loan term, divided by the total amount to be repaid (principal and interest)

- Cumulative net cash flow must be higher than the total repayment; therefore, this indicator must be greater than 1

The 5 C's of Credit - Capacity

The Repayment Capacity Indicator

- As it is prudent to have a substantial security margin for unforeseen events, most lenders recommend the ratio should be at least 2:1
- Loan assessment should include sensitivity analysis of how adverse circumstances could undermine repayment capacity and put loan repayment at risk

The 5 C's of Credit - Capital

Capital

A company's owner must have his own funds invested in the company before a financial institution will be willing to risk their investment. Capital is the owner's personal investment in his/her business which could be lost if the business fails.

The single most common reason that new businesses fail is undercapitalization. There is no fixed amount or percentage that the owner must be vested in his/her own company before he is eligible for a business loan.

The 5 C's of Credit - Conditions

Conditions	The conditions and terms of the loan are another factor. How much finance is needed? For how long? For what will it be used? How often will you make repayments (e.g. weekly or monthly)? The FI granting the loan may have some more question like the following:
	Must have an active bank account with the respective bank/financial institution
	Must have savings in your account
	Business should be officially registered
	Local business regulations should have a Tax Payers Identification Number (NTN)

The 5 C's of Credit - Collateral

Collateral

Collateral is property or an object of value, which a credit grantor can take and sell in case of default.

A secured loan is one in which collateral is required as security to the lender.

An unsecured loan is one where there is no collateral required; just an agreement to repay what is owed as agreed.

Some financial institutions allow for an alternative to collateral, at least in part:

Guarantors: a person that knows you well and agrees to be responsible for your repayments in case you fail to pay

SME Financing – Section B

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Prudential Regulations – SBP Guidelines on SME

The potential for this sector to contribute to the economic development objectives of Pakistan, including generating employment, increasing incomes, and reducing poverty is the justification for a strategy of support to unleash the sector's potential. The key motive is:

- Economic growth (increase /enahnce income levels)
- Competitiveness and
- Job creation (reduce unemployment level)

Steps to be taken by Banks / DFI's

The Regulatory Framework will bear its intended results, **only** if the Banks/DFIs take the necessary steps including the following:

- **Strategic change**
- **Use relevant/practical cash flow estimation techniques**
- **Program-based lending & down scaling strategies**
- **Research & development**
- **Risk Management**
- **Market segmentation**
- **Origination, credit appraisal and monitoring mechanism**
- **Technology and Documentation**
- **Internal audit and control**
- **Financial awareness**

SME Credit Cycle

- SME - Credit Cycle
  - Product development
  - Market Segmentation & acquisition,
  - Administration/disbursement & monitoring (Account Maintenance),
  - Collection & recovery
  - MIS (Focal Point)

*Given the nature of product proposition, strong emphasis is laid down on client visits (relationship building & understanding of business dynamics)

*Clearly defined delegation of authority levels (ownership, responsibility & accountability)

5 C's of Credit

- Collateral – Discretion up to 5 Million
- Capacity to repay – Sources for repayment of Finance (Business & others)
- Credit worthiness / Character - Credit Bureau reports (Positive & negative data), Utility Bills, market repo etc
- Capital – Net worth & Equity levels
- Conditions – Business & economic conditions

Credit Scoring

- A **credit score** is a numerical expression based on a level analysis of a person's credit files, to represent the creditworthiness of that person. A credit score is primarily based on credit report information typically sourced from credit bureaus.
- The performance definition risk score (its stated design objective) is to predict the likelihood that a consumer will go 90 days past due or worse in the subsequent 24 months after the score has been calculated. The higher the consumer's score, the less likely he or she will go 90 days past due in the subsequent 24 months after the score has been calculated
- Credit Scoring – reduces judgmental decision making process & brings in objectivity

The interpretation of a credit score will vary by lender, industry, and the economy as a whole.

**Experian, CIBIL, Equifax, FICO*

Types of Credit Scoring

- A, B, C & F Scoring

- Assign score/Weightage based on available data (internal & external data interface) however credit score card development requires a lot data consolidation, modelling & analysis (considerable size of data strings/information/vintages to make the judgment objective).

- Thick & thin bureau results & new to industry, have different weightages.

SE Financing – Pre-requisites (SBP Guidelines)…

The Credit Policy for SME’s shall cover the following minimum points:

- Frequency of visits to the borrowers’ - at-least Annually
- Hypo Stock reports – at-least Semi-annually
- Insurance Coverage for Hypothecated Stock Mandatory – (Optional in case of SE’s up to 1MM)
- BBFS (fact sheet)
- Credit bureau (thick bureau, thin & new to industry)
- TCF Principle
- Pricing
- Monitoring & Utilization of loans against intended purpose

…SE Financing – Pre-requisites (SBP Guidelines)

- MIS (Performance analysis)
- Distribution strategy & delivery channels (branchless banking, telemarketing etc)
- Capacity building (bench strength) and staff training
- Relationship building & one window operation (window of opportunity – existing Clientele)
- Grievance policy - customer care / complaint resolution system

Clean Exposure on Personal Guarantee

- Banks/DFIs can take **clean exposure** (facilities secured **solely against personal guarantees**) on an SME borrower up to **Rs 5 million <u>based on Risk profile</u>**.
- Personal Guarantee is mandatory (unless secured against liquid assets)
- Undertaking for accumulated exposure
- Clean exposure under SME **does not** include the clean consumer financing limits (Credit Card and Personal Loans etc)

Per Party Exposure - PPE

Small Enterprises

- Small Enterprise can avail exposure up to Rs 15 million from a single Bank/DFI or from all Banks/DFIs.
- Cumulative Exposure of 15 Million max

Medium Enterprises

- The maximum exposure of a bank/DFI on a single Medium Enterprise shall not exceed **Rs 100 million**.
- The **total (cumulative) exposure** (including leased assets) availed by a single Medium Enterprise from the banks/DFIs shall not exceed **Rs 200 million.**

Repayment Capacity of the Borrower and Cash Flow Based Lending – SE's

- Normally, SE's do not maintain proper financial accounts for the satisfaction of the banks/DFIs.
- Their record generally contains sale/purchase books and cash received/paid records in a rudimentary form.
- Banks/DFIs shall use **relevant/practical cash flow estimation techniques and other proxies** to assess repayment capacity of SE borrower. To supplement, banks/DFIs are encouraged to use the available sector/cluster specific financial models that can capture cost structure, revenue streams and margins in the sectors.
- For **program-based lending**, banks/DFIs, as a substitute, may also use **Income Estimation Models** to assess repayment capacity of the borrowers.

Loan Disbursement Pattern

Size of Firm	Age of Firm (years) % age of Total				
No of Employees	0-5	6-10	11-20	21 and more	All Firms
0-10	0%	0%	0%	0%	0%
11-49	0%	35%	0%	0%	29%
50-99	100%	67%	75%	15%	50%
100 or more	100%	75%	75%	83%	80%
All Sizes	50%	67%	64%	50%	59%

Source: Dr. Ehsan ul Haq, Dr. Faisal Bari, LUMS; *Barriers in SME Growth - 2002*

Collateral Valuation

- For valuation of securities against loans up to Rs. 5 million, banks/DFIs at their own discretion may either use the services of their own evaluating staff or the services of PBA approved evaluator.
- However, valuation of securities for loans above Rs. 5 million shall be done only by an evaluator on the approved panel of PBA.

Collections & recovery

- Recovery - fair debt collection & use of technology driven parameters (SMS notifications etc)
- Grace Periods & Payment Holidays (requirement of introducing industry specific Repayment cycles)
- General reserve
- Classification & provisioning

Role / Use of Technology

- Mobile data & Information (Biometric validation)
- Online Branches / Branchless Banking
- Re-payment Options - Omni / Branchless Banking
- Internet Banking – Skype (Live chat), E-mails plus transactions
- Credit review Approval Process – Quick TAT (Online systems)
- Credit Scoring

Thank You

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