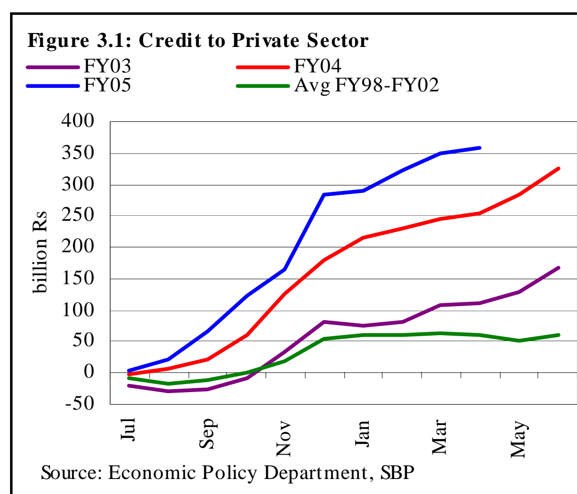
3 Bank Credit

Continued implementation of banking sector reforms, excess liquidity with banks and a growth-oriented monetary policy, are some of the major factors which have led credit to touch phenomenal levels from FY03 onwards,[1] such that each year's credit performance paled in comparison with the next. This is particularly true for private sector credit, as reflected in **Figure 3.1**. The financial sector in Pakistan,[2] which is heavily skewed towards banks, has disbursed an incremental credit amount of Rs 415 billion during CY04, with total outstanding bank credit at Rs 1.62 trillion at end-CY04, exhibiting a growth of 34.4 percent over end-March CY04 (see **Table 3.1**).

Figure 3.1: Credit to Private Sector



Source: Economic Policy Department, SBP

In a way, the growth process works like a chain; credit disbursed in one year boosts aggregate demand which leads to further demand for credit in the next year. Whereas credit distribution has largely been broad-based, in particular, easy availability of agriculture credit from commercial banks, increased regulatory focus on SME finance and a shift in consumer expenditure patterns due to an easy access to credit facilities at low interest rates, gave the economy a demand-pull stimulus which was later translated into growth in investments.[3]

Table 3.1: Total Bank Credit at end-period for CY04

Outstanding amount in billion Rupees

	Mar-04		Jun-04		Sep-04		Dec-04		CY04	
Sectors	Amount	Share	Amount	Share	Amount	Share	Amount	Share	Abs. change	% growth
Corporate sector	653.00	54.2	741.40	54.9	768.00	54.4	873.00	53.9	220.00	33.7
SMEs	225.20	18.7	231.70	17.2	240.60	17.0	284.00	17.5	58.80	26.1
Agriculture	102.70	8. 5	108.70	8.0	117.80	8.3	119.30	7.4	16.60	16.1
Consumer finance	83.00	6. 9	103.20	7.6	130.60	9.3	152.60	9.4	69.60	83.9
Commodity finance	70.60	5. 9	90.00	6.7	85.00	6.0	122.10	7.5	51.50	72.9
Staff loans	39.60	3. 3	39.70	2.9	40.00	2.8	40.80	2.5	1.20	3.1
Others	31.30	2.6	36.10	2.7	29.50	2.1	28.60	1.8	-2.70	-8.7
Total	1,205.40	100.0	1,350.8	100.0	1,411.5	100.0	1,620.4	100.0	415.0	34.4

Source: Banking Supervision Department, SBP

In particular, the availability of bank financing for the purchase of consumer durables (especially electronic items), automobiles, real estate etc. has increased the demand in these sectors which has led

[1] The discount rate cut of November 2002 is a particular reference point for this growth process.
[2] This chapter discusses bank credit for the calendar year 2004. Data in Table 3.1 is based on Quarterly Financial Statements of banks.
[3] This has also created inflationary pressures in the economy, as discussed in Section 3.2.

to increased capacity utilization in the *cement, construction, electronics, automobiles* and *chemicals* (*paints and varnishes*, in particular) industries, as well as the need to invest in additional production capacity. Credit to the textile sector (25 percent share in total credit at end-CY04) has also registered an increase under the Textile Vision 2005 program.

With the increase in credit, another notable development is the increase in the aggregate number of bank borrowers in the last few years. This is the outcome of banks' efforts to diversify their loan portfolios and increase the accessibility to bank finance across various sectors of the economy. As shown in **Table 3.2,** there has been an increase of around 1.6 million in the total number of borrowers over CY02, registering a growth of over 88 percent in the last two years. Major increases in the number of borrowers have been observed in the agriculture, consumer and SME sectors. The consumer sector in particular, has shown a tremendous growth in CY04 in comparison with CY03. In fact, given the number of products available within its ambit, consumer finance has become the most diversified sector with the largest number of borrowers of total bank credit. This is followed by the agriculture sector where around 92,319 new borrowers have availed credit facilities during CY04. In the SME sector, around 14,585 new borrowers were given access to bank financing in CY04.

Table 3.2: Growth in the Number of Borrowers

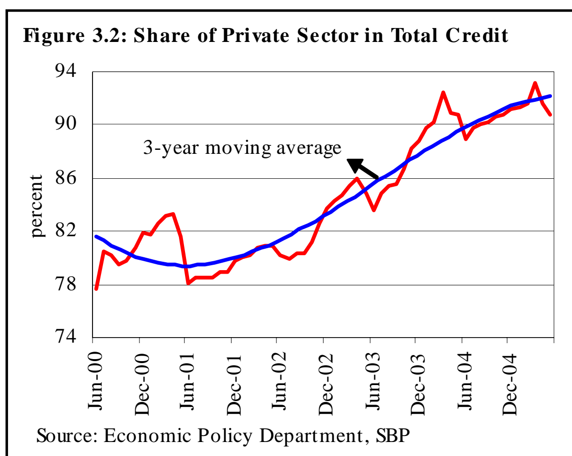
at end period

	CY02	CY03	CY04
Corporate sector	14,256	17,743	19,333
SMEs	67,520	91,663	106,248
Agriculture	1,339,961	1,411,508	1,503,827
Consumer finance	252,156	721,201	1,619,207
Commodity finance	1,458	2,069	3,207
Staff loans	72,570	69,796	72,633
Others	56,683	63,696	73,735
Total	1,804,604	2,377,676	3,398,190

Source: Banking Supervision Department, SBP

While the corporate sector was the major recipient of bank credit, with Rs 220 billion incremental credit in absolute terms, credit growth in the consumer sector saw the largest increase of almost 84 percent over end-March CY04. SME financing at end-CY04 touched Rs 284 billion, registering a growth of over 26 percent. Growth in Agriculture credit is not far behind at 16.1 percent. Commodity finance has also shown a remarkable increase of Rs 51.5 billion over end-March CY04 due to the increased involvement of the private sector in commodity operations. Staff Loans have shown a marginal growth of 3.1 percent, whereas the share of the 'others' category has declined since end-March CY04 due to the improved re-classification of loans into relevant categories.

Figure 3.2: Share of Private Sector in Total Credit



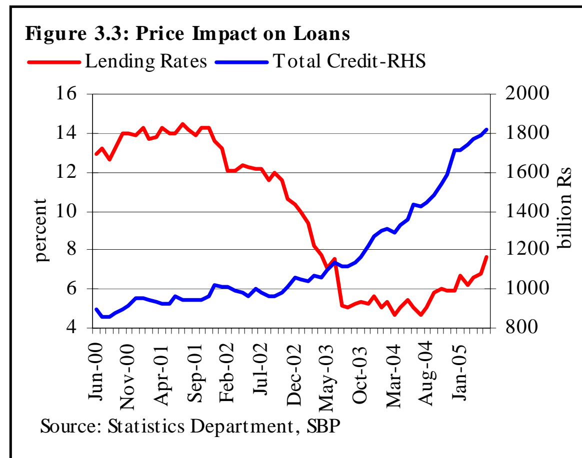
Source: Economic Policy Department, SBP

It is interesting to note that the distribution of credit among the public and private sector has changed considerably over time. As can be seen from **Figure 3.2**, the share of private sector credit in total credit has increased in recent years. In addition to the increased pace of activities in the private sector in a low interest rate environment (see **Figure 3.3**),[4] this is also due to the better financial health of

[4] Potential impact of the increase in the weighted average lending rates since the discount rate hike in April 2005 is discussed in Section 3.2.

public sector enterprises due to which they have actually retired their bank debt in the preceding four years (see **Figure 3.4**). Moreover, government borrowings for commodity operations have also reduced primarily because the private sector was encouraged to undertake commodity finance operations.

Figure 3.3: Price Impact on Loans

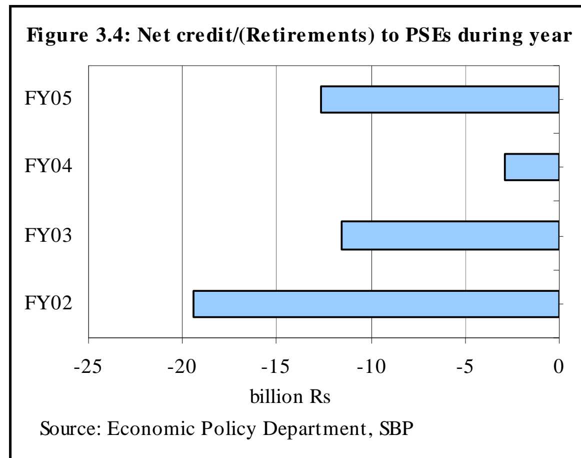


Source: Statistics Department, SBP

3.1 Sector-wise Allocation of Bank Credit

This section discusses the sector-wise growth in credit and its economic implications, in addition to analyzing factors which have influenced the demand and supply of credit in recent years. Incremental credit activities of the first quarter of CY05 are also discussed.

Figure 3.4: Net credit/(Retirements) to PSEs during year

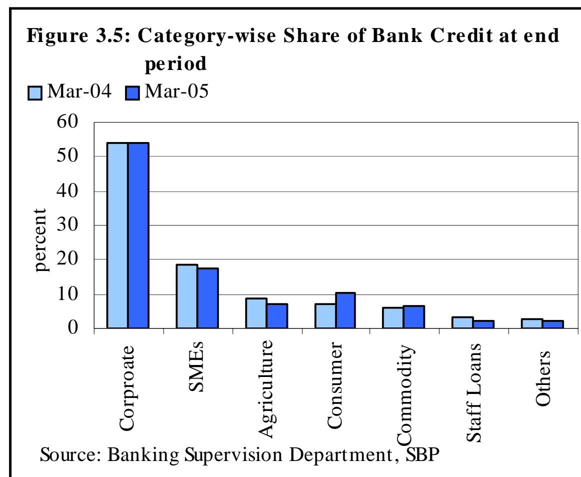


Source: Economic Policy Department, SBP

The composition of bank credit at end-March CY05 shows that the corporate sector continued to dominate the overall loan portfolio of banks with a 54.1 percent share (see **Figure 3.5**), at roughly the same level as the end-March CY04 share of 54.2 percent.

This is followed by the SME sector with a 17.2 percent share of total bank credit at end-March CY05. Consumer financing has shown a tremendous growth in recent years and its share in total credit has reached 10.4 percent by end-March CY05, from 6.9 percent at end-March CY04. Agriculture and commodity finance jointly contribute around 13.8 percent of bank credit**.** Finally, the 'other' loans category and staff loans constitute around 2.1 percent and 2.4 percent share of total credit respectively.

Figure 3.5: Category-wise Share of Bank Credit at end period



Source: Banking Supervision Department, SBP

3.1.1 Agriculture Credit

In broad terms, Agriculture credit refers to: (i) Farm credit for inputs, (ii) Farm Development Finance, (iii) Finance for the purchase of agricultural machinery and equipment, and (iv) Financing for livestock farming.[5]

The Agriculture sector which contributes 23 percent to the national income of the country[6] is in many ways the mainstay of the economy.

[5] (Draft) Prudential Regulations for Agriculture Financing 2005, State Bank of Pakistan.

[6] Economic Survey 2004-05.

In previous years, agriculture credit used to be available from specialized institutions[7] only, while commercial banks generally had a limited scope of operations in this area. However, in recognition of the importance of agriculture in economic development, banks have been encouraged to deploy their resources to promote the growth of this sector, with the result that there has been a major shift in the provision of agriculture financing from ZTBL to commercial banks in the last couple of years (see **Box 3.1**).

The pattern of institutional shift discussed in **Box 3.1** is reflected in **Table 3.3**, which shows details of disbursements from FY00 to FY05 for two broad categories of financial institutions, commercial banks, and ZTBL and Cooperatives. As shown in the table, agriculture credit disbursements have grown by a tremendous amount in comparison with FY00.

Table 3.3: Institutional Share in Disbursement

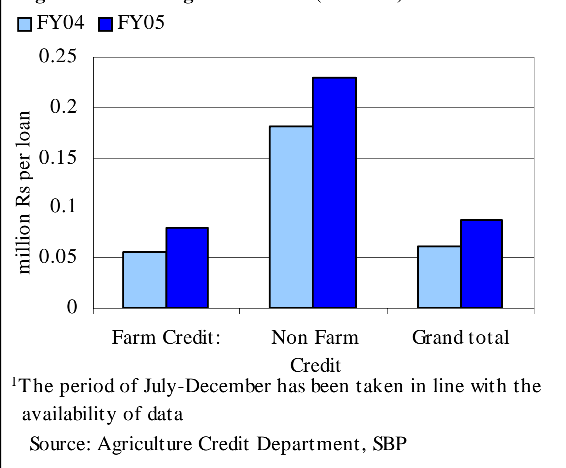
Amounts in billion Rupees, share in percent

	Commercial Banks		ZTBL & PPCBL		All Banks
	Amount Disbursed	Share	Amount disbursed	Share	Amount disbursed
1999-00	9. 31	23.4	30.38	76.54	39.69
2000-01	12. 06	26.9	32.73	73.08	44.79
2001-02	18. 08	34.5	34.24	65.44	52.32
2002-03	24.16	41.0	34.76	58.99	58.92
2003-04	35. 95	48.9	37.5	51.05	73.45
2004-05	63.72	58.6	45.02	41.4	108.74

Source: Agriculture Credit Department, SBP

Given the active participation of commercial banks in this sector, agriculture credit has seen a tremendous growth in recent years which in turn has had a significant impact on the overall growth in the agriculture sector. Some contributing factors in this credit growth are the increased prices of fertilizers and other agriculture inputs which not only raised the financing requirements of the farmers but also increased the average agriculture loan size[8] (see **Figure 3.6**). Factors like the continuous efforts of financial institutions to boost tractor financing and other equipment like tube wells etc have had a positive impact on the growth of agriculture credit. In addition, the increased emphasis on the building/purchase of farm godowns and cold storage has also created a demand for agriculture credit. In this way the scope of the Agriculture Credit Scheme which was previously limited to production loans for inputs has been broadened to the whole value chain of the agriculture sector. From an economic growth perspective, the growth of agriculture credit by 21.2 percent at end-March CY05 over end-March CY04 is quite encouraging as it has strong positive implications on overall agriculture production, given the dependence of a large section of the population on this sector for earning their livelihood.

Figure 3.6: Average Loan Size (Jul-Dec)[1]



[1]The period of July-December has been taken in line with the availability of data

Source: Agriculture Credit Department, SBP

However, the dependence of this sector on factors such as weather conditions exacerbates the underlying risk factor of such financing activities in terms of its impact on the repayment capacity of the borrowers and thus the quality of the loan portfolio.

---

[7] Such as Agriculture Development Bank of Pakistan (ADBP), which is now Zarai Taraqiati Bank Ltd (ZTBL).

[8] The size of the loan depends on the value of underlying collateral; higher the value of the collateral, larger would be the loan size, and vice versa.

In order to maintain the current pace of growth in credit to the agriculture sector, while keeping the risk factor at a manageable level, SBP is in the process of finalizing the Prudential Regulations for Agriculture Financing to guide banks in adopting a standardized approach in providing financing facilities to this sector while safeguarding their interest.

Box 3.1: Institutional Shift in Agricultural Credit

Due to the adoption of focused policies, agriculture credit has expanded considerably in the recent past, not only in terms of volume but in the composition of institutions responsible for catering to the financing needs of this sector. Initially, Cooperatives were the major sources of agriculture credit, followed by the Agricultural Development Bank of Pakistan (ADBP), now known as Zarai Taraqiati Bank Limited (ZTBL). From its inception in 1961, when Agricultural Development Finance Corporation and the Agricultural Bank of Pakistan were merged and renamed as ADBP, it was the single largest provider of agriculture credit. The main responsibility of ADBP was to give investment or development lending, in addition to lending for production purposes, while cooperatives and commercial banks dealt mainly in production loans i. e. lending for the purchase of seasonal inputs like seeds, pesticides, fertilizers, etc.

Commercial banks[1] joined this field after the introduction of the “Agricultural Loans Scheme” in 1972-73 supported by the “Loans for Agricultural Purposes Act, 1973”. For the first time mandatory credit targets were fixed for commercial banks. Banks were penalized for not achieving their mandatory targets by depositing the amount equivalent to the shortfall with SBP at a zero percent interest rate. SBP shared the risks of banks by compensating them for bonafide losses up to 50 percent. Although commercial banks participated in the agriculture finance activity but the increased pace of agricultural lending has been witnessed only since FY00 and now they have the largest share in total agriculture credit.

SBP has greatly facilitated commercial banks in advancing agriculture loans in order to benefit from their extended branch network and outreach. After liquidation of the Federal Bank for Co-operatives (FBC) in October 2002, SBP has been providing credit lines to the Punjab Provincial Cooperative Bank Ltd (PPCBL) on the basis of the Government of Punjab guarantee in order to maintain the pace of cooperatives’ lending to cooperative societies, members, farmers and growers.

To avoid the problems and complexities[2] experienced with the Agricultural Loan Scheme FY73, the revamped Supervised Agricultural Credit Scheme was introduced in FY01. Fifteen local advisory committees were established at SBP BSC (Bank) offices for a quick resolution of local issues. Another important development was the inclusion of Domestic Private Commercial Banks in Agriculture financing from FY02. The above-mentioned scheme included 150 additional agriculture related items for enhanced coverage, and indicative cost per acre for five major crops, which was also revised during FY04.

The “Revolving Credit Scheme”[3] was introduced in FY03 to facilitate farmers in availing timely credit by avoiding unnecessary documentation and bank visits. The Scheme offers automatic renewal and the added convenience of full repayment (principal and mark-up) by the borrowers once a year, at a time of their convenience. Commercial banks lend directly to farmers but they can also utilize the channel of ZTBL, micro credit institutions and NGOs, to avail their extended outreach, in case of a lack of their own direct access to certain areas and this lending is considered as part of their mandatory targets.

SBP has increased the limit of credit against personal surety from Rs 50,000 to Rs 100,000 and there is no restriction on providing credit on provision of proper collateral. SBP has also revised indicative per acre credit limits for various crops for meeting the increased credit requirements of the farmers. Another important development pertaining to agriculture credit is the restructuring of ZTBL and the reduced mark-up rate from 14 percent to 9 percent (with a further 1 percent reduction in mark-up rate in case of timely or early payment of installments) for loans advanced by ZTBL.

---

[1] Including: i) Allied Bank of Pakistan Ltd., ii) Habib Bank Ltd., iii) Muslim Commercial Bank Ltd., iv) National Bank of Pakistan, v) United Bank Ltd

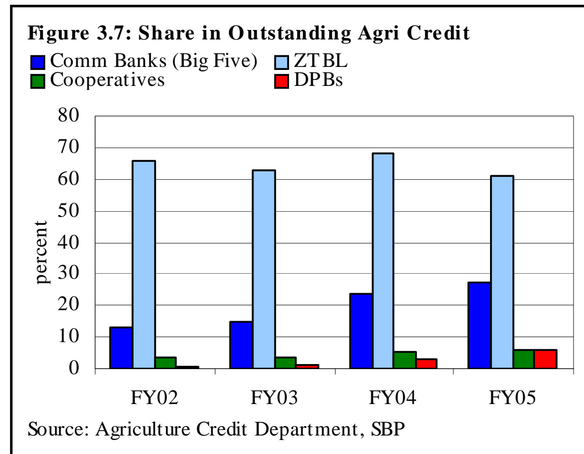
[2] Issuance of Pass Book/Khasra/Fard Jammabandi etc. by revenue officers was difficult especially in Sindh and Balochistan. Lengthy documentation and limited scope with territorial jurisdiction was another constraint.

[3] ACD Circular No ACD/1035-1039/PD (P) –08/2001 dated April 25, 2001

[4] ACD Circular No. ACD/2014-2034/PD (P)-08/2004 dated August 04, 2004

Institution-wise data shows that the big five commercial banks have the largest share in the credit disbursed to the agriculture sector during FY05, followed by ZTBL and DPBs. The share of ZTBL, which although captures the largest share in outstanding credit, is gradually being taken over by the commercial banks (see **Figure 3.7**), both the big 5 and the other domestic private banks.

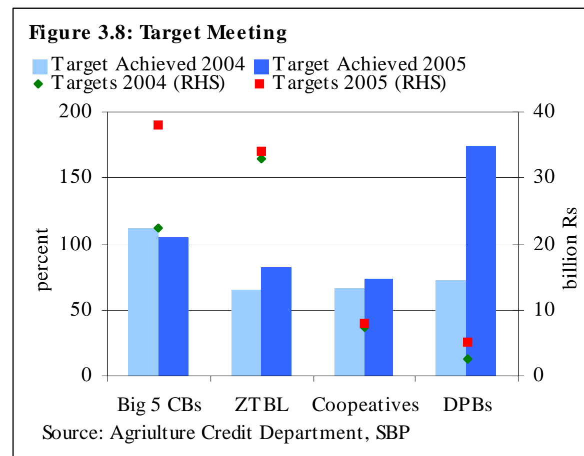
Figure 3.7: Share in Outstanding Agri Credit



Source: Agriculture Credit Department, SBP

In terms of meting the annual targets for disbursement, DPBs have outpaced other institutions remarkably. DPBs made actual disbursements of Rs 8.7 billion, over and beyond the annual target (see **Figure 3.8**). This was followed by the big 5 commercial banks who also exceeded the target during FY05. ZTBL and Cooperatives have yet to achieve their targets,[9] though their performance is better in FY05 compared with FY04.

Figure 3.8: Target Meeting



Source: Agriulture Credit Department, SBP

A holding-wise and commodity-wise analysis of agriculture credit also reveals a similar trend of increased circulation of credit through out the sector. The share of the farm and non-farm sectors was 85.8 and 14.2 percent during FY05 out of a total disbursement of Rs 108.73 billion, as compared to 86.8 percent and 13.2 percent for the farm and non-farm sector respectively during FY04. This distribution of credit is crucial for the growth of the agriculture sector as concentration of credit within few sub sectors or categories will not only skew the growth process but also hamper the overall equitable growth of the sector.

Holding-wise Credit Disbursement

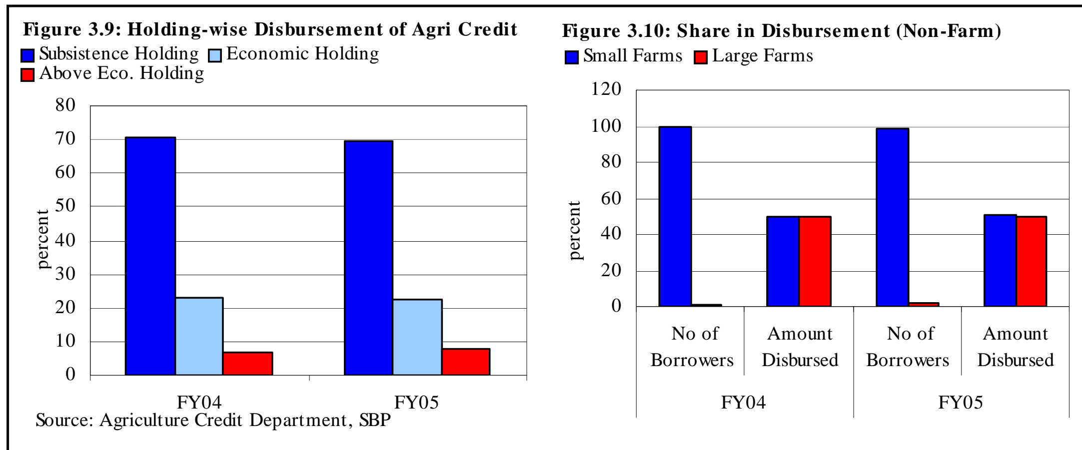
A holding-wise credit analysis reveals an encouraging fact in that most of the available resources are utilized by the most deserving segments of the farmers' community. As shown in **Figure 3.9,** 70.0 percent of the total farm credit is used by the subsistence level land-holders while economic and above economic holders have shares of 23.0 and 7.0 percent respectively.

In a similar vein, the non-farm sector has a share of 51.0 percent and 49.0 percent for small and large farms respectively.

Comparison of the number of borrowers with their share in total agriculture disbursement shows an almost similar pattern in case of farm sector loans, at 75.3 percent for subsistence level land holding, 21.5 percent for economic land holding and 3.2 percent for above economic land holding.

[9] Targets are specified on an annual basis.

In case of the non farm sector, the situation is reversed (see **Figure 3.10**). In case of large farms, 1.8 percent of the borrowers received 49.3 percent disbursements during FY05.

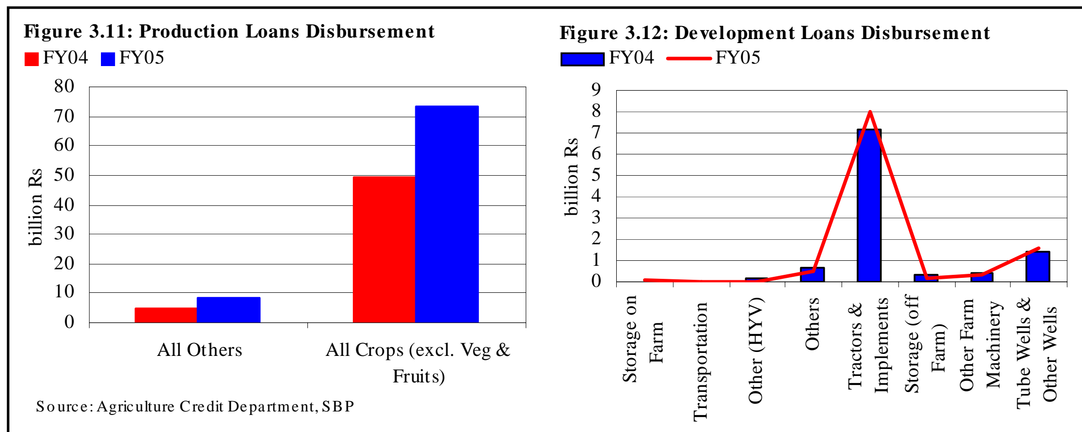


Farm & Non Farm Credit Disbursement

Farm credit comprises of development loans as well as production loans. A detailed analysis of production loans shows that for fruit, horticulture and vegetables, the level of disbursement remained almost the same in FY05 while for crops and all other purposes it recorded an increase (see **Figure 3.11**).

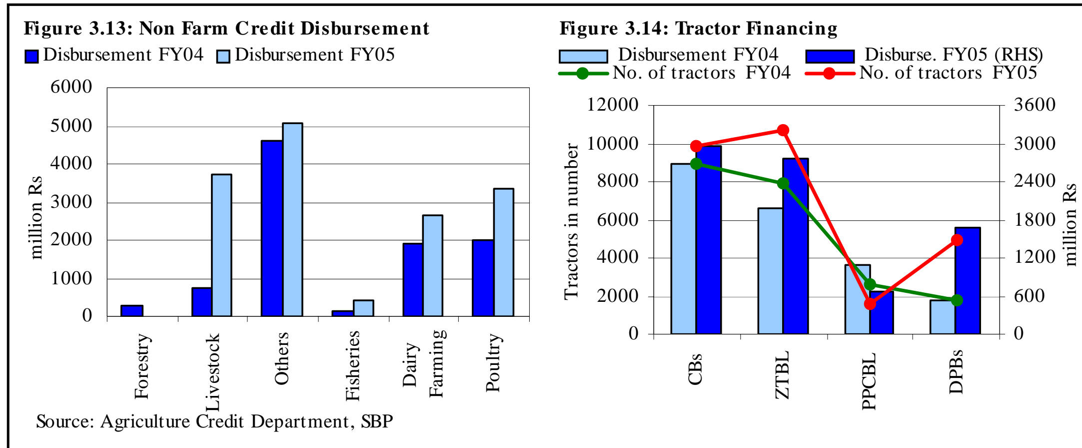
Although development loans have declined from 16.0 to 11.6 percent as compared to production loans, it should be noted that this is just due to the introduction of the revolving credit scheme,[10] otherwise there is an increase of 5.6 percent in the disbursement of development loans.

This overall increase is shared by many categories as the *Godown and cold storage on farm* recorded an increase of 14.5 percent (the most required investment of the sector), *Transportation* 26.9 percent, *Tractors and Implements* 1.2 percent and *Tube wells and Machinery* 1.0 percent (see **Figure 3.12**).



[10] The revolving credit scheme was introduced in June 2003 and banks disbursed actively under the scheme during FY05. As this scheme is for working capital, consequently the share of production loans outpaced the share of development loans.

Non farm credit witnessed an increase of 57.2 percent as it received Rs 15.3 billion during FY05 as compared to Rs 9.7 billion during FY04. Interestingly, all categories of non farm credit (except forestry) shared this increase. An even more encouraging development is the record increase of 385.5 percent in *Livestock* followed by 184.8 percent in *Fisheries*, 68.3 percent in *Poultry* and 38.8 percent increase in *Dairy Farming* (see **Figure 3.13**).

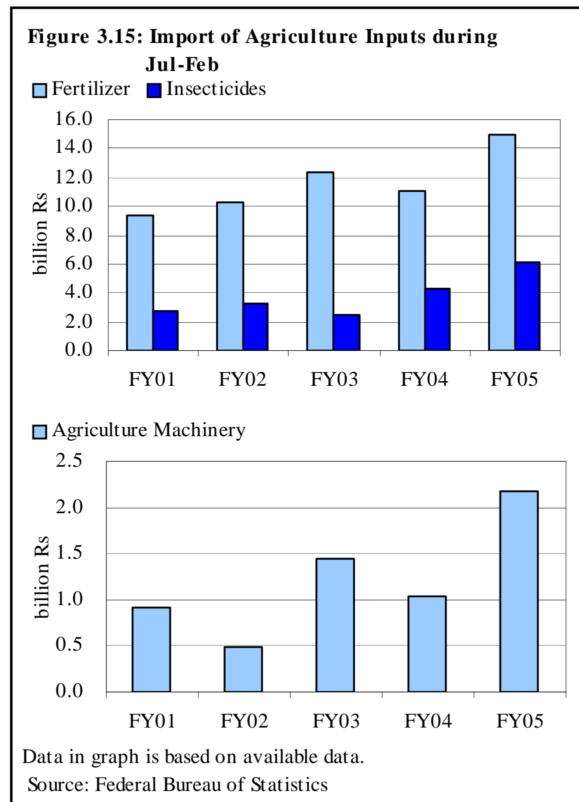


Source: Agriculture Credit Department, SBP

Tractor Financing

Tractors can be categorized as a major source of mechanization in the farm sector, due to their multi-purpose usage.

Tractor finance registered an increase of 28.8 percent during FY05 as compared to FY04, and similarly an increase of 28.0 percent in the number of tractors financed (see **Figure 3.14**). This boost in tractor financing is due to the collective efforts of almost all financial institutions, as they performed well in this sub-sector both in terms of the amount disbursed and the number of tractors financed.



Data in graph is based on available data.
Source: Federal Bureau of Statistics

Going forward, the increased use of fertilizers, import of agricultural equipment, pesticides, high quality seeds (see **Figure 3.15**), ongoing improvisation in production techniques etc. are some of the factors which are expected to maintain a sustained demand for credit in this sector.

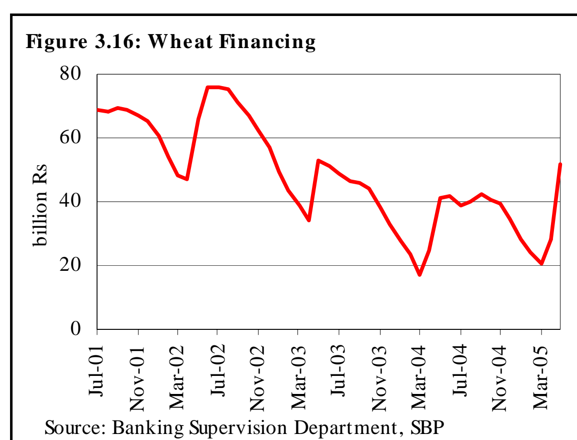
3.1.2 Commodity Finance

Commodity finance refers to the provision of bank credit to both the public and private sector for the procurement of commodities like wheat, rice, sugar, cotton, etc. Private sector commodity financing is usually done to procure cotton and public sector commodity operations are mainly for wheat.

Since the data on private sector commodity finance is not available, the following discussion is based on public sector commodity operations.

Wheat financing has the largest contribution (around 60 percent at end-FY05) in overall commodity operations. The operations start and peak in the third quarter of the fiscal year following the season of wheat harvest. **Figure 3.16** shows that the outstanding volume of wheat procurement operations, besides being erratic, has generally been declining since the last three years. This is due to the fact that SBP, with an aim to deregulate the wheat procurement process, encouraged banks to provide financing facilities to the private sector for the procurement and storage of wheat.[11]

Figure 3.16: Wheat Financing



Source: Banking Supervision Department, SBP

Following this, bank credit to the public sector for commodity operations started to decline until the third quarter of FY04 when SBP imposed margin restrictions on fresh disbursements to the private sector for wheat procurement. The mark up rates for private sector commodity finance are linked with the market-based 6-month T-bill rate. Anecdotal evidence suggests that when the interest rate reached historic lows in FY03 and FY04, an incentive was created for the private sector to borrow funds at lower rates, procure and hoard wheat in order to control the supply and earn margins. This led to supply shortages of wheat in the market leading to a sharp rise in wheat and flour prices in the country. To discourage this practice, SBP imposed a cash margin of 50 percent on credit to the private sector for wheat procurement and banks were asked to adjust their advances by the end of the first quarter of FY05. As a result, during FY05, government borrowings for commodity operations again started to rise. The bumper wheat crop during the period has also been one of the reasons of a higher volume of wheat financing.

3.1.3 Consumer Finance

The term 'Consumer finance' refers to any financing which is allowed to individuals for meeting their personal or household needs. Facilities categorized as consumer financing include Mortgage finance, auto and personal loans, and credit cards.

Prior to FY02, consumer financing facilities were only provided by some foreign banks and a few privatized banks in Pakistan. However, during FY02 an increased focus on consumer financing was observed in the banking industry, mainly due to a low interest rate environment, increased liquidity due to the reverse capital flows and workers' remittances, and an enabling regulatory environment.[12] The major factor which induced SBP to encourage consumer financing in Pakistan was (1) to give the economy a demand-pull boost given that it had been in the clutches of a decade-long recession; (2) to enable banks to diversify their loan portfolios in a low interest rate environment; and (3) to provide the middle class, the backbone of the economy, an easy access to bank credit. Three years later, it can safely be said that all these objectives have been achieved.

Total consumer financing reached Rs 152.6 billion by end-CY04, exhibiting an increase of Rs 69.6 billion over end-March CY04 (see **Table 3.4**), with the largest growth in Mortgage Loans of 205.4

[11] Please see BPD Circular Letter No. 33 dated December 3, 2001.

[12] For details, please see BPD Circular No. 18 dated July 30, 2002 and BPD Circular No. 27 dated October 7, 2002.

percent. Credit card financing also increased by 45 percent (its share however has declined from 11.7 percent at end-March CY04 to 9.3 percent at end-CY04.

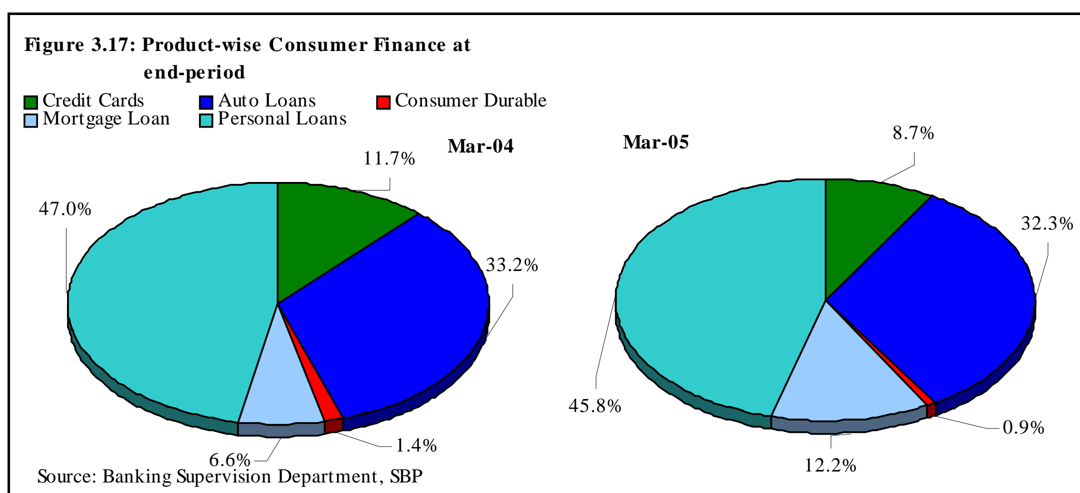
Table 3.4: Quarter-wise Consumer Financing at end-period for CY04
(Outstanding amount in billion Rupees)

	Mar-04		Jun-04		Sep-04		Dec-04		CY04	
	Amount	Share	Amount	Share	Amount	Share	Amount	Share	Abs. change	% growth
Credit cards	9.70	11.7	11.20	10.9	12.70	9.7	14.10	9.3	4.40	45.0
Auto loans	27.60	33.2	33.10	32.1	41.60	31.8	49.60	32.5	22.00	79.9
Consumer durables	1.20	1.4	1.40	1.4	1.80	1. 4	1.60	1.1	0.40	37.3
Mortgage loans	5. 50	6. 6	8.30	8.0	12. 0	9.0	16.70	11.0	11.20	205.4
Personal loans	39.0	47.0	49.20	47.7	62.10	47.6	70.50	46.2	31.50	80.8
Total	83.0	100.0	103.20	100.0	130.60	100.0	152.60	100.0	69.60	83.9

Source: Banking Supervision Department, SBP

Taking into account incremental credit for the first quarter of CY05, as shown in **Figure 3.17**, the share of personal loans in total consumer finance has declined slightly to 45.8 percent at end-March CY05 compared with 47.0 percent at end-March CY04. In absolute terms, personal loans have exhibited an increase of Rs 42.2 billion, an increase of 108 percent from March CY04 to March CY05. Interestingly, the share of auto loans has remained roughly the same compared to end-March CY04, however upto end-March CY05, auto loans have increased by Rs 29.6 billion. Housing finance is the only category the share of which has increased tremendously as compared to end-March CY04. These loans have increased by Rs 16.2 billion exhibiting a growth of 294 percent from end-March CY04 to end-March CY05. This is primarily due to fact that the mortgage finance product is a relatively recent occurrence, and its portfolio is now beginning to grow.

Figure 3.17: Product-wise Consumer Finance at end-period



Source: Banking Supervision Department, SBP

This rising amount of consumer credit, in some analysts' view, is a source of concern as banks are largely dealing with individuals whose credit history is usually not known or available through a centralized database. However, up till now, the ratio of non-performing loans to total consumer loans has remained quite minimal (around 1.1 percent at end-June FY05). This is mainly because of three reasons: (1) banks' credit assessment techniques in this area have improved over time; (2) the development of credit information bureaus in the private sector, which are working together with banks to gradually enhance their span of coverage of consumer credit history, in addition to the enhanced data availability with SBP's Credit Information Bureau which will soon start to maintain

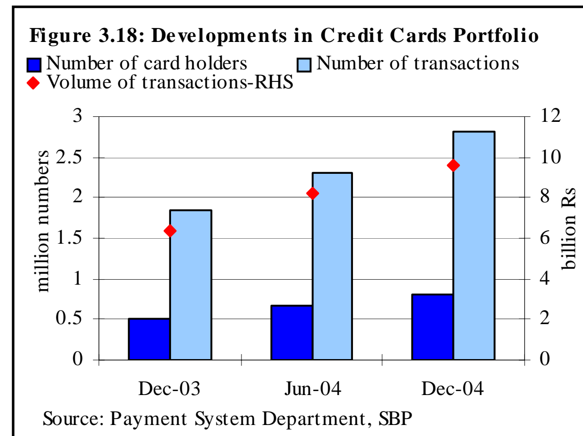
both the positive and negative credit history of all customers availing financing facilities from banks.[13]

Credit cards

Credit cards could perhaps be termed as the first consumer financing product in Pakistan as they were introduced in the early 1990s. Initially, the product was offered by only a few foreign banks exclusively for large corporate clients. Following their lead, other banks also entered the credit card business and currently there are multiple cards being offered by almost all banks.

Given the stiff competition in the banking industry in the area of consumer financing, banks have considerably relaxed the eligibility criteria in order to reach a wider section of the target market, and continue to offer various schemes and promotions in order to get an edge over competing products. In line with the development of the consumer finance market, banks have worked to provide more convenient repayment modes to their customers. With an aggressive focus on increasing their customer base, door to door marketing and aggressive advertising campaigns by the banks have attracted people from the middle class segment by providing them the facility to spend now and pay later. All these measures have yielded positive results and the use of credit cards has increased manifold during the past few years. This can be seen through the rising number of both credit card holders and the volume of transactions taking place (see **Figure 3.18**).

Figure 3.18: Developments in Credit Cards Portfolio



Source: Payment System Department, SBP

Auto loans

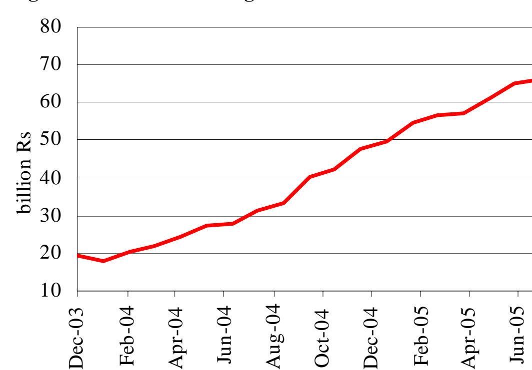
Auto loans have proved to be one of the most popular consumer financing products in recent years. With increased competition in this area, banks are currently providing a wide array of auto finance schemes with varying terms and conditions. For instance, some banks are providing both the conventional (financing) and Islamic (leasing) products to attract the maximum number of clients.

This increased purchasing power with consumers for automobiles has also led to a substantial rise in car prices, reflecting excess demand in the automobile industry. Given the limited supply in face of such increased demand, car dealers started to take advantage of the situation by charging premiums over and above the market price for the immediate delivery of a vehicle. Banks in turn, were forced on the basis of consumer demand, to take into account the premium factor when giving auto loans, and started financing the premium amount as well. But this gave a negative signal to the market and car dealers were encouraged to keep on raising the premium amount. In order to restrict speculative activities associated with premium financing, in January FY05, SBP restricted banks from financing the premium amount.[14] The impact of this restriction is shown in **Figure 3.19**, where the steep pace of increase in outstanding auto loans has started to flatten from February FY05 onwards.

[13] For details, please see Chapter 2, section 2.1.4.
[14] Please see BPD Circular No. 2 dated January 28, 2005.

Recent evidence, and the trend shown in **Figure 3.19,** suggests that this was a temporary occurrence and outstanding auto loans have continued to increase at a steady pace in the last few months which probably reflects buyers' preference to wait for a number of months for the delivery of locally manufactured cars in the absence of premium financing.

Figure 3.19: Outstanding Auto Loans



Source: Statistics Department, SBP

Housing finance

The history of institutional housing finance in Pakistan dates back to 1952 when House Building Finance Corporation (HBFC) was established to address the demand for housing finance. After a period of four decades, during the 1990s, three new housing companies were established in the private sector for this purpose. However, none of these companies was able to capture a sizeable share of the housing finance market and HBFC continued to enjoy an almost monopoly status in this area. For around five decades, the volume of housing finance remained quite small, reflecting a number of constraints in undertaking this business, despite the significance of and demand for housing finance in a developing country such as Pakistan (see **Box 3.2**). These included (a) lack of competition in the financial sector in offering this facility, resulting in higher than average interest rates; (b) a weak legal framework which entailed considerable delays in realizing the collateral proceeds in case of default; and (c) disorganized state of the real estate market,[15] given the problems associated with establishing the ownership title of the property placed as collateral for such loans.

Box 3.2: The demand for Housing Finance in Pakistan

According to the Ministry of Finance, "Pakistan has over 19.3 million housing units in the country. About 24.8 million housing units for a population of 148.7 million people are required. Hence, a shortfall of 5.5 million houses is estimated as of end June 2004. On an annual basis, we need 570,000 units against the actual supply of 300,000. Thus, there is an annual shortfall of 270,000 units and the backlog is rising". These estimates clearly reflect the demand for housing units every year resulting from increasing population and urbanization.

Despite the existing demand in the economy, housing finance constitutes only 1 percent of the GDP in Pakistan, which is significantly lower than the ratio of even other developing countries. According to another estimate, in India, which is the most advanced market in South Asia, the mortgage to GDP ratio is around 2 percent compared to 51 percent in USA. However, even if one were to benchmark Pakistan with more comparable counterparts, the ratio ranges between 15-20% for South East Asian countries.

Source: Economic Survey 2002-03, and Housing Finance and the Economy: Regional Trends South Asia; Perspectives, by Renus. Karnad – Executive Director, Housing Development Finance Corporation Ltd, India - June 2004

However, with the advent of the Financial Institutions (Recovery of Finances) Ordinance promulgated in 2001,[16] banks have been empowered to dispose off their real estate collateral to realize loan proceeds in case of default without resorting to the court of law.[17] This facilitated the legal environment for commercial banks, and it has now been three years since the banking sector took up this business. Their mortgage finance products are designed with competitive rates and simple eligibility criteria, due to which the mortgage finance business has finally set off in the right direction. Due to the increased pace of activity in this area, the share of housing finance in total consumer

[15] Please see Economic Survey 2002-03.
[16] For details, please see Chapter 2 : Financial Infrastructure : An Assessment.
[17] Once the required notice of one month has been served to the customer in response to which he does not take any action.

finance has also increased significantly, from 6.6 percent at end-March CY04 to 12.2 percent at end-March CY05.

Availability of housing finance products has had a direct influence on the demand for real estate in the country and is partly responsible for the exorbitant rise in prices in the real estate market during the last two years, which reflected the interest of both speculative investors and genuine buyers.[18] Banks' exposure against real estate has increased tremendously both due to (1) new loans taken for housing and (2) increase in the average loan size against real estate[19] which is a cause for concern for the banking sector given that the share of loans against real estate collateral is over 20 percent.[20] At one point, this factor also impacted the growth of mortgage financing because individuals could no longer afford to buy property within the cap on financing imposed by SBP. However, keeping in view the inflated real estate prices, SBP removed the maximum per party limit of Rs 10 million and allowed banks to determine the maximum limit in accordance with their internal credit policies and credit worthiness of the borrower.[21] At the same time, in order to restrict the usage of bank financing for speculative transactions in the real estate market, SBP asked banks to disburse credit against land strictly for construction purposes and only in tranches as per the construction schedule.[22]

There are several macroeconomic and institutional requirements which need to be addressed in order to ensure a stable growth of housing finance in the country, which include: (1) first and foremost a stable macroeconomic environment which enhances the borrowers' repayment capacity in the long run; (2) further strengthening of the legal frame work (specially with reference to foreclosure laws); (3) minimizing the risks associated with mortgage lending; for this purpose banks can focus on asset securitization;[23] (4) Strengthening of credit assessment procedures and a close monitoring of the loan portfolio. In particular, when property prices rise at a geometric progression, banks should focus more on the present and future repayment capacity of the borrowers instead of relying on the collateral whose value is no longer determined by market fundamentals; (5) Sophisticated risk management systems, to optimize the credit risk-reward ratio; (6) Streamlining the documentation process related to property ownership, so that these transactions could be carried out efficiently and economically; and (7) an adequate appraisal and valuation process of the property being used as collateral. This process could either be undertaken internally, or banks can outsource such services from independent appraisal agencies.

Personal Finance

The prudential regulations for consumer finance define personal loans as loans given to individuals for the payment of goods, services and expenses. There are actually three categories of personal finance; (1) clean lending which is not linked to any specific purpose;[24] (2) loans for the purchase of

---

[18] Some financial experts view the availability of housing finance as the sole causal factor in the rise in real estate prices, which is only partly true. At least two major factors which have caused the rise in property demand can be identified; (1) the reverse capital flight which resulted in excess liquidity post 9/11; and (2) the ban on institutional investments in NSS, because of which maturing investments could not be rolled over, and also the declining rates on NSS instruments which have made these instruments unattractive. Since investment in the stock market is a risky venture for most individual investors, investing in real estate was seen as one of the few avenues available into which this excess liquidity was directed. Because of these two reasons, there was substantial liquidity within the system which facilitated the demand for housing.

[19] For details, please see, "The State of Pakistan's Economy", report for Q3-FY05, State Bank of Pakistan.

[20] It should be recalled that increased reliance on the housing sector was one of the major factors behind the systemic banking crisis during the 1990s in the East Asian economies.

[21] Please see BPD Circular No. 10 dated March 19, 2005.

[22] Please see BPD Circular Letter No. 13 dated March 29, 2005.

[23] For details, please see Chapter 2 : Financial Infrastructure: An assessment, and Chapter 5: Dynamics of the Banking Sector.

[24] Banks can only lend up to Rs 500,000 to a single borrower under this category.

consumer durables; and (3) secured lending, including revolving finance secured against government securities and other liquid assets.

In comparison with other consumer finance products, the terms and conditions of personal loans are the most convenient from the borrowers' perspective. The clean lending category is especially very popular given that banks, in their efforts to cross-sell products, offer such loans to their credit card customer and/or their depositors, in addition to the primary target market of employees of reputable organizations. Since there is no requirement for hypothecation or mortgage of collateral in such financing facilities, loan processing is quick and hassle-free for both the banks as well as the customers. Moreover, interest rates so far have been low and the monthly installments are relatively smaller than other products. Therefore customers with large outstanding bills of credit cards and auto loans usually take these loans to pay off other debts. Personal finance has the largest share in total consumer financing in Pakistan with an outstanding amount of Rs 81.2 billion at end-March FY05.

The fact that personal loans are unsecured and are not linked to a specific purpose of utilization is also perceived as a growing cause of concern due to the probable speculative use of these funds in the real estate and equity markets.

3.1.4 Corporate Sector Credit

Corporate credit primarily refers to advances that are provided to both private and public sector corporations, government corporations formed under special charters/statutes, and other entities which do not come under the definition of SMEs. Basically, three financing facilities are available for the corporate sector; (1) fixed investment which includes advances for the purchase of land, building or machinery etc. and is usually for longer tenors; (2) working capital, a short-term facility which supports the current operations of a business enterprise mainly to finance the operating cycle; and (3) trade finance which is a short-term credit facility extended to exporters and importers to finance their trade activities.

The trend of corporate credit in Pakistan is quite in contrast with those observed in emerging market economies of Latin America and Asia (excluding India and China). In these economies bank lending to the corporate sector as a percent of GDP is declining and financing through domestic and international bonds has increased manifold in the recent past (see **Box 3.3**). In Pakistan, although the issuance of long-term bonds by corporate entities has increased significantly in the recent past, bank lending still constitutes the bulk of corporate sector finance, which constitutes around 54 percent of total bank loans at end-March FY05. During the year, corporate sector loans increased by Rs 271.4 billion, mainly for working capital and fixed investment purposes.

Box 3.3: Global Trends in Corporate Finance

Bank lending has remained the dominant source of corporate finance in all the emerging markets, despite the increasing importance of domestic and international bonds as a potential source of funding. In Asia, although bond finance has reached almost 30 percent of GDP, bank finance constitutes around 50 percent of GDP. In Latin American countries, bank lending to the corporate sector is around four times the level of bond debt. Trend analysis shows that bank lending to emerging market corporates has increased from 40 percent of GDP in 1995 to 60 percent in 2003. However, this trend changes if China and India are excluded from the group, and shows a decline from 33 percent to 30 percent of GDP. In Latin America, domestic bank lending has contracted from 27 percent of GDP in 1995 to 17 percent in 2003. Besides cyclical forces, the decline in bank lending (with the exception of India and China) could be attributed to a tightening of regulations, crowding out by the government or household sector or because of the disintermediation facility provided by the capital markets.

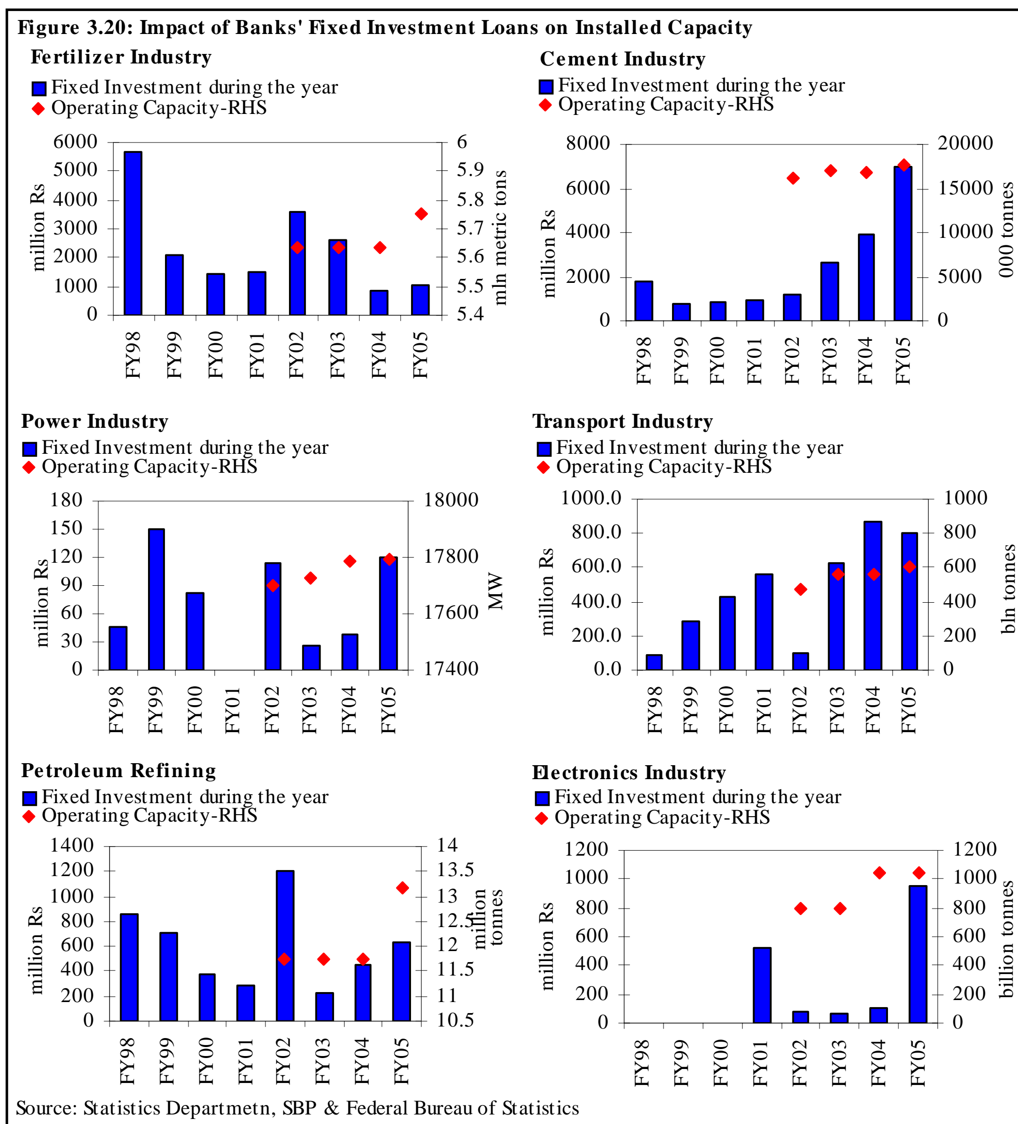
Source: Corporate finance in emerging markets, Chapter IV Global Financial Stability Report, Market Developments and Issues, April 2005.

Working Capital and Fixed Investment Financing

The spurt in economic activities during the last three years has increased the demand for working capital and fixed investment loans from the banking sector. This is due to the fact that the increase in aggregate demand in the economy has increased the capacity utilization in the industrial sector to the point where it became essential to raise the level of installed capacity. Specifically, capacity utilization in a number of manufacturing industries including electronics, automobiles, cement, fertilizer, steel and chemicals, has gone up to more than 80 percent, at which point it becomes almost inevitable to increase the capacity to sustain price stability.

As a result, these industries have started expanding their businesses by taking fixed investment loans from banks for the purchase of Plant and Equipments, and for BMR activities. **Figure 3.20** shows that there has been an increase in operating capacity during the last three years which is expected to increase further given the recent disbursements of fixed investment loans, especially in cement, fertilizer, textiles, electronics, power generation, transport and petroleum refining industries.

Figure 3.20: Impact of Banks' Fixed Investment Loans on Installed Capacity



Source: Statistics Departmetn, SBP & Federal Bureau of Statistics

From end-March CY04 to end-CY04, fixed investment loans have increased by Rs 87 billion (see **Table 3.5**). In addition to the industries mentioned above, telecommunications is another sector which has registered large increases in fixed investments in the recent past.

Table 3.5: Quarter-wise Corporate Sector Credit at end-period for CY04
(Outstanding amount in billion Rupees)

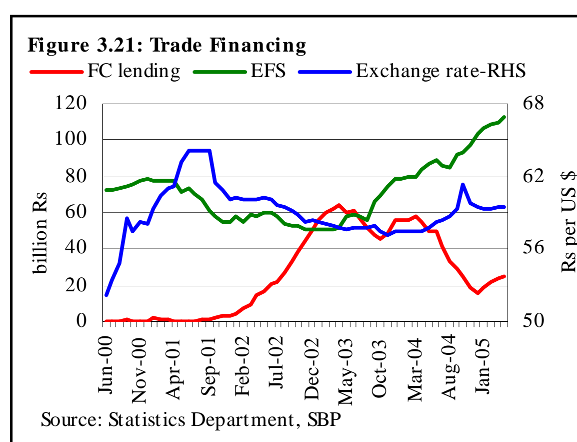
	Mar-04		Jun-04		Sep-04		Dec-04		CY04	
	Amount	**Share**	**Amount**	**Share**	**Amount**	**Share**	**Amount**	**Share**	**Abs. change**	**% growth**
Fixed investment	269.21	41.2	322.60	43.5	339.50	44.2	356.20	40.8	87.00	32.3
Working capital	228.91	35.1	250.30	33.8	267.90	34.9	341.80	39.2	112.90	49.3
Trade finance	154.89	23.7	168.50	22.7	160.60	20.9	174.90	20.0	20.00	12.9
Total corporate	653.01	100.0	741.4	100.0	768.00	100.0	873.00	100.0	220.00	33.7

The impact of increased utilization of the installed capacity is visible in the working capital loans from banks. This implies an increase in raw material requirements**,** increase in production span, and thus a further increase in demand for working capital loans. This can be seen through a Rs 112.9 billion increase in working capital loans by the corporate sector during the period.

Trade Finance

It was only subsequent to 9/11 when the value of the dollar started depreciating against the Rupee, that the demand for foreign currency loans appeared. Before that, SBP's Export Refinance Scheme (EFS) used to be the primary mode of export financing in Pakistan. During FY03, foreign currency loans registered a tremendous growth while the demand for EFS loans remained low. However during FY04, the retirement of foreign currency loans started, mainly due to (1) expectations of Rupee depreciation in the market; and (2) interest rate differential between EFS rates and LIBOR which, for the most part, remained below 1 percent throughout FY04 as a result of which demand for EFS loans re-emerged (see **Figure 3.21**). During the first half of FY05, the widening trade deficit continued to exert an upward pressure on the exchange rate and foreign currency loans continued to decline. However, this time around, the pace of decline was much faster in comparison with FY04, as the exchange rate was moving up much more sharply. This trend was discontinued once the exchange rate stabilized after reaching its peak during October FY05 and the interest rates on EFS loans widened the interest rate differential again. In fact, during July to December FY05, foreign currency lending declined by Rs 33.6 billion and EFS lending increased by Rs 14.9 billion. Subsequently, during January to April FY05, foreign currency lending increased by Rs 9.2 billion whereas EFS lending increased by Rs 8.4 billion.

Figure 3.21: Trade Financing



Source: Statistics Department, SBP

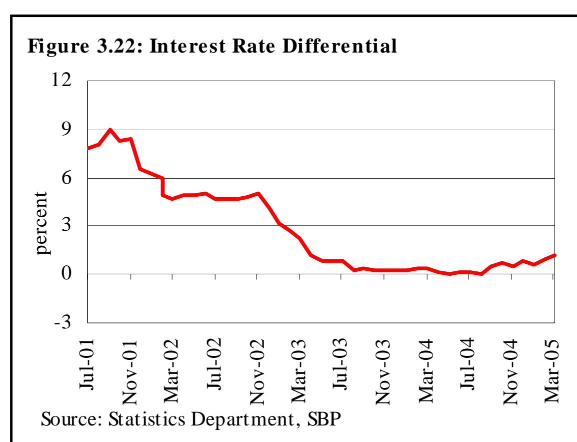
The following sections discuss in brief the various financing facilities being provided by SBP to banks in the area of Trade finance.

Export Refinance[25]

With the objective of providing adequate financing facilities for the promotion of exports, SBP introduced an Export Refinance Scheme (EFS) to the scheduled banks with effect from February 27, 1973, against loans given for non-traditional and newly emerging export industries. In the initial phase, SBP provided finance for all commodities except cotton, cotton textile, yarn, wool, leather, sports goods, surgical instruments, etc. However, the list of eligible commodities for EFS was revised from time to time in line with the domestic and international market conditions. Besides commercial banks, PICIC and IDBP were entitled to the refinance facility from SBP up to 80 percent of the credit provided by them.

Over the years, EFS has provided concessionary[26] financing to exporters giving them an incentive to compete in international markets. It was only four years back (in 2001)[27] that SBP also allowed foreign currency lending against FE-25 deposits to exporters, which enabled them to borrow funds from banks at a rate (benchmarked with US $ LIBOR) which was significantly lower than the Rupee lending rates. Throughout FY03 however, EFS rates continued to decline, which served to narrow the interest differential between domestic and foreign lending rates (see **Figure 3.22**). In FY04, EFS rates remained almost stagnant and the differential remained close to zero. However, since June 2004, EFS rates have started to increase and up till July 2005, SBP has increased EFS rates by 550 basis points, which has been a source of discomfort to the exporter community. However, in the recent past, EFS circular issued in July,[28] SBP has changed the methodology of determining EFS rates, which are now determined on the basis of the weighted average yields on six-month T-bills during the preceding 3 months.[29]

Figure 3.22: Interest Rate Differential

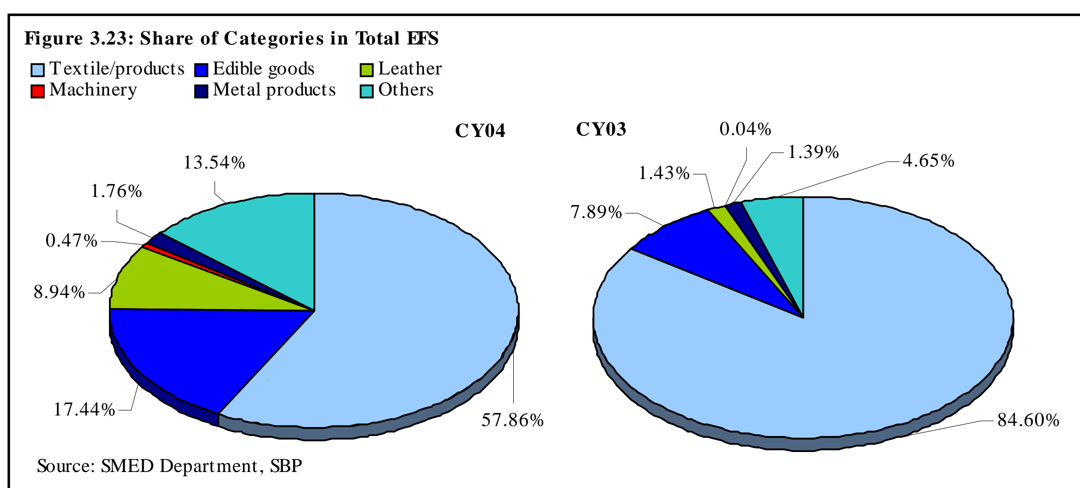


Source: Statistics Department, SBP

During CY04, SBP provided refinancing of Rs 24.6 billion under this scheme to banks, compared with Rs 28.1 billion in CY03. Commodity-wise data shows that the distribution of overall financing was relatively more broad-based at end-CY04 compared with end-CY03 (see **Figure 3.23**).[30] Textile and textile products in particular constituted around 85 percent of total financing during 2003 while the shares of other sectors remained quite insignificant. However, during 2004, the scope of financing was extended to other sectors a well, causing the share of the textile sector to decline to around 57.8 percent of total financing. As can be seen from the figure, shares of leather products, edible goods and miscellaneous industries increased considerably during 2004.

[25] Total credit reported for scheduled banks also contains the EFS volume. EFS is being discussed here separately in order to highlight the role of refinancing facilities being provided by SBP.
[26] Banks can charge exporters a margin of 150 bps over and above SBP's refinancing rate.
[27] For details, please see BSD Circular No. 19 dated March 31, 2001.
[28] See BPD Circular No. 21 dated June 30, 2005
[29] Effective from 2001, the EFS rate was determined on the basis of 6-month T-bills and was adjusted on a monthly basis with the movement of the weighted average yields during the preceding month.
[30] Category-wise data for EFS is available on a calendar-year basis.

Figure 3.23: Share of Categories in Total EFS



Source: SMED Department, SBP

Long term finance for export oriented projects (LTF-EOP)

Whereas EFS is primarily a short-term facility of a maximum period of 180 days, the recently introduced scheme for providing "long term financing of export oriented projects" (LTF-EOP)[31] has a maximum tenor ranging from 2 to 7 and a half years. The purpose of this scheme is to enable financial institutions to provide financing facilities at competitive rates for the import of machinery, plant and equipment (not manufactured locally) by export-oriented units. This step was taken to help exporters in upgrading their existing production base. Under this scheme, banks are encouraged to give preference to the SME sector by utilizing upto 50 percent of the available limit for meeting the financing needs of this sector.

The eligibility criteria of this scheme entails that only those projects or units can avail this financing facility which export at least 50 percent of their total production. Banks which do not have any experience of project-finance, or are CAR non-compliant, are not eligible to provide LTF-EOP financing. Interest rates under this scheme are based on the weighted average yields on 12-month T-bills and 3 and 5 year PIBs, keeping in view the period of financing. Banks however can earn a spread of 3 percent on the financing provided by them.

At end-June 2005, the total sanctioned financing under this scheme had reached Rs 3.3 billion against the total available limit of Rs 11.4 billion, out of which only Rs 0.1 billion has been utilized (see **Table 3.6**). So far, almost all of the financing has been made to the textile sector and SMEs have yet to avail the scheme.

Table 3. 6: Summary of LTF-EOP at end June 2005

million Rupees	
Total (Current) limit under LTF-EOP	11,439.0
Total financing approved under LTF-EOP	3,301.7
Total balance remaining	8,137.3
Total amount utilized	109.8
Amount sanctioned but not utilized	3,191.9

Source: SMED Department, SBP

Scheme for financing local sales and Export of Locally Manufactured Machinery (LMM)

In 1973, SBP introduced another scheme for financing local sales, at concessionary interest rates by PICIC and IDBP, and export of LMM by commercial banks. These institutions were entitled to obtain refinance from SBP up to 80 percent of the credit provided by them. The refinance facility to

[31] Please see BPD Circular No. 14 dated May 18, 2004.

PICIC and IDBP was provided at the bank rate[32] while in the case of commercial banks, it was provided at 2 percent less than the bank rate.

The operating mechanism of this scheme was based on two parts; Part-A, which refers to local sales, was intended to facilitate prospective entrepreneurs who wanted to set up projects in Pakistan based on the LMM scheme, and Part-B, which was for export sales where facilities were available for both pre- and post-shipment purposes. This scheme has played a vital role in the development of the engineering industries in Pakistan, creating an effective demand for machinery items manufactured and assembled in the country. At end-FY05, total financing under the LMM scheme has reached Rs 5.2 billion within which most of the financing has been given to the textile sector.

During July 2004, certain crucial modifications were made in the LMM scheme in line with the changing economic environment.[33] In specific terms, these modifications have been made to particularly address the needs of the SME sector. According to this modified scheme, financing is not available for trading purposes or for subsequent sale by a supplier. Moreover, facilities under the modified scheme have been restricted to the purchase of LMM for setting up new projects or BMR of existing projects relating to specified industries, and the earlier Part-B (export sales) has become a part of the Export Refinance Scheme.

SBP has recently increased the rate of service charges on different tenors under the LMM scheme[34] in line with the change in the EFS rate.

3.1.5 SME Financing

One of the major objectives of financial sector reforms in Pakistan was to enable banks to direct funds to sectors which have a greater significance in terms of economic and social growth and have so far been largely under-served. Small and medium enterprises (SMEs) is one such area.

In specific terms, an SME is an entity which is not a public limited company, which does not employ more than 250 people (if it is a manufacturing / service concern,) and 50 people (if it is a trading concern) and also fulfills one of the following criteria: (i) A trading / service concern with total assets excluding land and buildings up to Rs 30 million; (ii) A manufacturing concern with original value of total assets excluding land and building up to Rs 50 million; (iii) Any concern (trading, service or manufacturing) with net sales not exceeding Rs 300 million as per latest financial statements. An individual can also be categorized as an SME.[35]

SME credit is an effective tool for poverty alleviation. The interim PRSP (Poverty Reduction Strategy Paper)[36] highlights the importance of pro-poor growth led by the private sector especially through SMEs. The Strategy Paper identifies four sectors, namely agriculture, SMEs, IT (information technology) and energy (gas and coal). These sectors are generally labor-intensive and their development eventually leads to job creation.

In this context, the role of the Small and Medium Enterprises Development Authority (SMEDA) is very encouraging. SMEDA provides a number of services to SMEs including business plan development service, technical and financial advisory service, training and development, marketing,

---

[32] Bank rate was the rate at which SBP used to provide discounting facilities to the commercial banks. However, this has been replaced by the repo rate which is the rate applied for repurchase agreements between SBP and commercial banks.
[33] Please see BPD Circular No. 25 dated July 24, 2004.
[34] Please see BPD Circular No. 22 dated June 30, 2005.
[35] Prudential Regulations for SME Financing, State Bank of Pakistan.
[36] Pakistan Interim Poverty Reduction Strategy Paper, jointly prepared by Policy wing, Finance Division and Poverty Reduction Cell, Planning Commission, Government of Pakistan, 2001.

policy planning and legal services etc. However, the most notable service that SMEDA provides to SMEs is business 'matchmaking' where it provides SMEs a platform to explore different operational areas using SMEDA's data base. Through SMEDA, SMEs can sell their businesses, seek joint ventures, form equity partnerships and look for agents and distributors.[37]

In order to promote SME financing, SBP recently arranged a conference with the objective of bringing together all the stakeholders of the SME sector to generate debate on the issues concerning the sector and assess the various strategies being developed at the regulatory and policy level to increase the flow of credit and financial services to this sector (please see **Box 3.4**). Moreover, SBP has also formed a new SME department which is responsible for devising appropriate policies and strategies in order to promote the growth of this sector.[38] SBP continues to encourage banks to meet the financing needs of the SMEs so that banks can continue to diversify their loan portfolio, while efficiently deploying the available funds to the under-served sectors. As mentioned earlier, by end-March CY05, total SME financing through commercial banks touched Rs 294.8 billion, exhibiting a 31 percent growth over end-March CY04 (see **Figure 3.24**). Most of the lending has been made for the working capital requirements of the existing units, reflecting increased capacity utilization. Trade financing has also registered a 25.5 percent growth by end-March CY05. However, the outstanding amount of fixed investment loans has not shown any marked improvement.

Box 3.4: Key Recommendations for the Development of SME Finance in Pakistan[1]

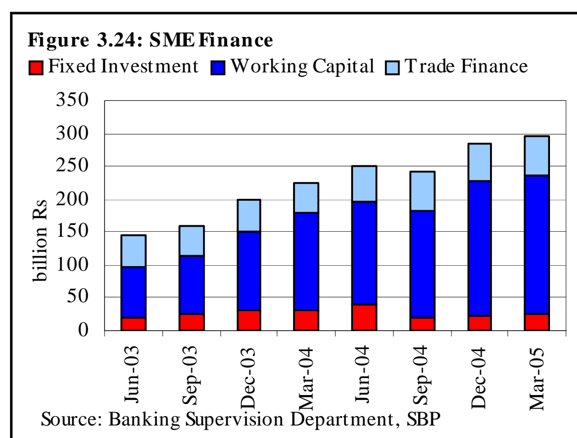
1. The mechanism of providing SME finance should be based on 'relationship banking'. In this context, banks can get the available information from SMEDA and other local organizations, and appoint relationship managers who are equipped with the relevant expertise pertaining to the industrial activities of a particular city or area.
2. Banks should develop one or two specific SME products in consultation with SMEDA and the Export Promotion Bureau.
3. An important step for banks is to recruit fresh people from local areas and train them on credit assessment tools such as cash flow lending and credit appraisal processes pertinent to SME financing. This is important because local people have a better knowledge of the area, local industrial activities and repayment capacity of the borrowers.
4. Banks should standardize and simplify the requisite documentation, and publish and print them in Urdu and regional languages. This is how banks can improve communication with their borrowers which would serve to bring a large segment of population under their clientele.
5. Banks should develop Islamic banking products for SMEs as there are a large number of SME customers who do not avail riba-based conventional banking services due to religious reasons. Doing so is even more possible now that SBP has allowed banks to open stand-alone Islamic banking branches. Particularly in areas like D. I. Khan, Swabi, Charsada, Loralai, etc. availability of Islamic banking products is likely to impact the demand for SME finance.
6. Banks should invest in information technology in order to track and monitor a large number of loan accounts and their performance. By developing such capabilities, banks can also use various analytical exercises including stress testing and trend analysis through which they can be more proactive in tracking loan performance. Adequate risk mitigation tools should be utilized by banks to ensure a smooth running of business. For instance, banks can use tools like credit insurance, third party guarantees, risk based pricing, etc.
7. To make SMEs more bankable, adequate geographic coverage should be given to the staffing process at SMEDA.
8. Role of private credit bureaus and rating agencies should be encouraged so that banks are provided with the requisite information about potential customers.

[1] This section is based on the recommendations discussed in the "Conference on SME financing-Issues and Strategies" held in Lahore on May 10 – 11, 2005.

[37] www. SMEDA.org
[38] Please see HRD Circular No. 9 dated April 9, 2005.

SME bank, which was formed by merging RDFC[39] and SBFC[40] in 2002 for the purpose of providing specialized financings services to the SME sector, has a financing portfolio which includes loans for working capital and medium to long term financing, program lending and leasing through its subsidiary, SME Leasing. Key areas in which SME bank has provided program lending facilities include CNG stations, health development, surgical instruments, fan manufacturers, power looms, etc. It is also offering customized financing for power looms up gradation, Beacon house school systems, carpet manufacturers, gems & Jewellery, etc.

Figure 3.24: SME Finance



Source: Banking Supervision Department, SBP

However SME bank alone can not cater to the financial needs of the entire SME sector in Pakistan given that it only has 10 branches for business operations (and has now obtained a commercial bank license). Commercial banks need to continue their active role in this sector as these banks have a wider outreach and can tap the available potential at far-flung places. However there are certain issues which are impeding the growth of SME Finance. These pertain to both the demand and supply of SME finance as detailed below.

Demand side issues in SME finance

- Taxation laws discourage SMEs from sharing their estimates of future income streams. Since these estimates are important for banks' credit appraisal processes, SMEs rely more on internal finance.
- There is a lack of attention on book-keeping practices in SMEs, because of which they can not fulfill the documentation requirements for formal financing.
- SMEs also do not have the expertise for loan proposal formulation.
- SMEs usually do not have access to information regarding the various modes of financing offered by banks.

Supply side issues of SME finance

- Banks are usually hesitant in providing finance to the SME sector, as this sector is inadequately capitalized and is thus more vulnerable to economic shocks.
- As mentioned earlier, SMEs usually do not have developed means of financial management, which makes it difficult for banks to target potential customers.
- Just like SMEs, there is a lack of expertise on the part of financial institutions to evaluate SMEs' credit cases.
- Provision of inadequate collateral also prevents banks from increasing their focus on SME finance.
- Banks do not have much market information about SMEs and thus are not in a position to evaluate the underlying risks of their businesses.

In addition to the issues highlighted in **Box 3.4**, the most important factor for the growth of SME finance in Pakistan is an in-depth analysis of the SME sector at both a micro and macro level, which

[39] Regional Development Finance Corporation.
[40] Small Business Finance Corporation.

would help in identifying potential sub-sectors. Banks are also required to develop both financial and sectoral credit appraisal expertise so that they can distinguish between the credit evaluation process of SME finance from the traditional corporate sector credit. In this context, lending infrastructure which includes legal, judiciary and bankruptcy laws, tax and other regulatory measures are likely to have a direct impact on the availability of SME finance (see **Box 3.5** for various countries' experience on SME Finance).

3.1.6 Micro Finance

Micro finance[41] refers to the provision of a broad range of financial services such as deposits, loans, payment services and insurance, to poor and low income households and their micro enterprises. In Pakistan, the maximum loan size that a micro finance institution (MFI) can extend to a single borrower is Rs 100,000.[42] Micro finance is altogether a different business compared with other financial services with a specific set of objectives and processes. It can be termed as one of the poverty alleviation tools as it provides financial resources to a particular set of clients who do not have access to formal bank financing. By providing an access to financial resources, micro finance enables the poor to enhance their income-generation prospects which in turn reduces their vulnerability to external factors. For instance, in economies like Pakistan, where agriculture income provides a major source of living, people in rural areas are quite vulnerable to seasonal slumps and other contingencies; one bad crop and the whole family goes into destitution for a number of months. With micro finance not only can the poor manage household expenses, they can also invest in health and education.[43]

Different countries across the globe have now realized that providing access to micro finance is vital for the achievement of their development goals (see **Box 3.6**). Usually, these kinds of services are provided by NGOs and other welfare organizations. Since the types of businesses and the underlying risks of micro finance are of a different nature in comparison with other banking services, specialized institutions are needed to provide this facility to the poor.

In Pakistan there are three specialized institutions established to undertake micro finance business and there is potential for more institutions keeping in view the poverty dynamics in the country. At present, microfinance services in Pakistan are serving only 6 to 7 percent of the potential clients.

During CY04, outreach of micro finance institutions increased considerably mainly due to a sharp rise in the number of branches of Khushali Bank (see **Table 3.7**). At end-CY04, 75 branches of these institutions were actively involved in providing micro finance facilities to the country. A new Micro Finance institution, Network Micro finance bank Ltd, has also started operations in the last quarter of CY04. An operating license has also been issued to Rozgar Bank Limited which will also serve as a micro finance institution.

Table 3.7: Micro Finance Outreach

(amount in Rupees)	CY02	CY03	CY04
Institutions' age (Yrs)	2	3	4
No. of branches	39	56	75
Total numbers of borrowers	56,939	95,090	177,648
Numbers of new borrowers	56,939	38,151	82,558
Total numbers of depositors	2,773	10,150	18,589
Numbers of new depositors	2,773	7,377	8,439
Average loan size	6,232	7,969	7,340
Average deposit size	23,231	38,625	25,229
Outstanding loans (millions)	493.094	735.98	1,536.65
Outstanding deposits (millions)	64.419	392.05	468.97

Source: SMED Department, SBP

[41] As defined by the Asian Development Bank (ADB).
[42] The amount also defines the term 'microfinance' which varies from country to country.
[43] For details on the impact analysis of micro finance on poverty alleviation, please see the "State of Pakistan's Economy" report for Q1-FY05, State Bank of Pakistan.

There are now over 177,000 borrowers in comparison to only 95,000 at end-CY03. Number of borrowers of First Micro Finance Bank Ltd[44] (FMFBL) has more than doubled during CY04.

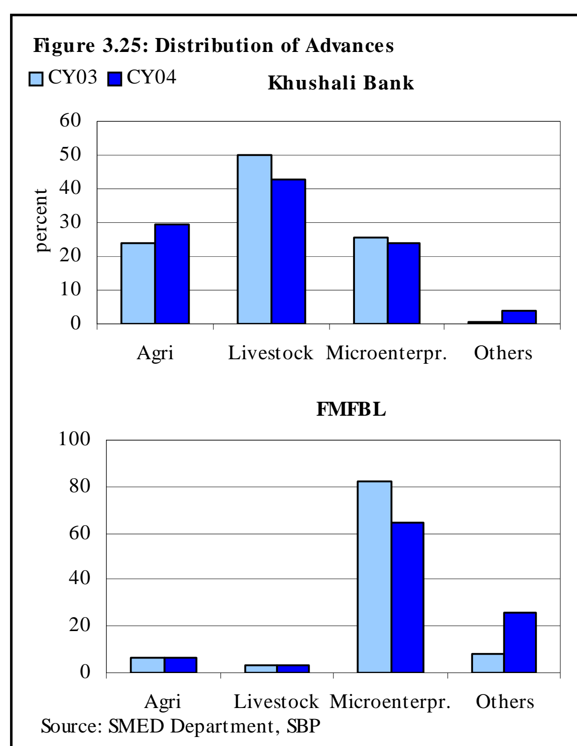


Figure 3.25: Distribution of Advances
Source: SMED Department, SBP

Outstanding advances have also more than doubled during CY03 at Rs 1.5 billion. Majority of these advances, around 86.5 percent, have been extended by Khushali Bank. Most of these loans have been deployed in the agriculture and livestock sectors, in addition to micro enterprises. As shown in **Figure 3.25,** the advances of Khushali Bank are mostly spread among the three categories mentioned above with the livestock sector constituting a major share of its advances. On the other hand, FMFBL has concentrated more on micro enterprises.

However, the share of micro enterprise in FMFBL's advances has declined and that of other sectors has increased in CY04. Clearly, distribution of loans in a few sectors is more desirable from a risk view-point, as compared to concentration in a particular sector.

Liability analysis of the MFIs shows that borrowings are still the major source of funds for MFIs as the share of borrowings to total liabilities has increased from 75.2 percent in CY03 to 83.3 percent in CY04. However, institution wise data shows a completely contrasting picture. Khushali Bank has still not undertaken deposit taking activities and relies heavily on borrowings from international financial institutions. This is reflected in the 98.5 percent borrowings to liability ratio of Khushali Bank at end-CY04, resulting from an increase of Rs 1.2 billion in borrowings during the period. In sharp contrast to this, First Microfinance bank relies only on deposits for funding and does not have access to credit lines from any financial institution.

Asset structure, on the other hand, has changed tremendously in the preceding four years. **Figure 3.26** shows a declining share of investments in total assets substituted by a rising share of advances. This is quite a healthy sign as it indicates that MFIs are focusing more on lending activities which is pivotal for poverty alleviation in the economy.

With respect to the impediments in the growth of microfinance and the steps needed to be taken, the following excerpt from a World Bank publication might be worth mentioning : "the real challenge facing the microfinance industry today is scaling up services to reach the estimated three billion people in developing countries who still lack access to formal financial services. Successful microfinance institutions have proven that providing financial services to the poor can be an effective means of poverty reduction and be a profitable business".

[44] First Micro Finance Bank Ltd.

Around the world, the major impediment to the development of sustainable microfinance is the limited level of formal institutional and managerial capacity in this area. In addition, there is also a shortage of institutions that can provide secure **s**avings facilities to the poor and can mobilize their domestic savings for lending.

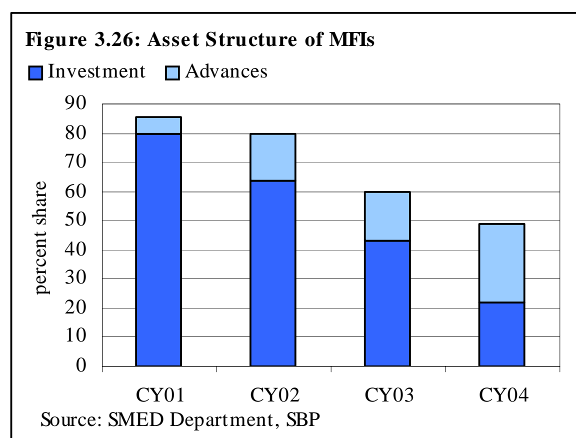


Figure 3.26: Asset Structure of MFIs
Source: SMED Department, SBP

High-performing microfinance institutions have started to develop innovative methodologies to extend credit, savings and other services to poor clients. A number of banks and other institutions with nationwide distribution networks are beginning to take an active interest in reaching needy clients. Progress made in information technology has the potential to lower the cost and the risk of providing microfinance to the poor. The challenge before us is to mobilize this knowledge and apply it on a vaster scale, creating financial systems that work for the poor and boost their contribution in economic growth.

3.2 Changing Credit Profile-Potential Risks and Mitigants

This section discusses the various risks associated with the increased exposure of banks to relatively new areas of financing, along with potential mitigants.

The major potential risk that arises out of an expanding loan portfolio in terms of volume and diversification is the inherent risk of lending i.e. the repayment capacity of the borrower. This can be determined by various factors which can be divided into two categories; (1) for circumstantial defaulters, the overall macroeconomic environment, corporate sector profitability, inflated asset prices, weather conditions (in case of agriculture finance), and (2) for willful defaulters, credit evaluation of customers according to specified credit policies and the existence of credit information bureaus.

3.2.1 Changing Macroeconomic Environment

During the last three years, interest rates have been at historic low levels thus providing a conducive environment for the expansion of economic activities. Business entities have not only been able to restructure their balance sheets by replacing high cost debt with low cost financing, they have also been able to increase their earnings due to the scope of increased business operations. Moreover, smaller business entities which could not afford bank financing earlier were able to do so in this environment. However, the interest rate structure is changing gradually. For the past year or so, the rise in interest rates has been gradual, but the preceding few months have witnessed a sharp rise in interest rates[45](see **Figure 3.4**) particularly following the hike in discount rate by SBP during April 2005. In this context, it has to be seen whether banks would be able to continue to expand their businesses given that in the preceding three years, low financial charges were one of the major factors for credit demand in the economy. The repayment capacity of the borrowers who borrowed at floating rates is also vulnerable to these factors.

In order to maintain the asset quality of their portfolios, banks can adopt a more realistic forward looking approach, i.e. evaluate borrowers on the basis of their expected future income streams in line

[45] Average lending rates have increased by 164 bps by end-FY05.

with future business forecasts, and forecast financial expenses on the basis of estimating a realistic increase in interest rates.

3.2.2 Corporate Profitability

Corporate earnings have been quite stable for the last three years due to the prevalent economic and political stability in the country, and low financial costs. As banks' exposure on the corporate sector continues to dominate its loan portfolio, the sustained financial health of this sector will remain quite crucial for systemic financial stability. However, bank credit to the corporate sector has become increasingly more broad-based in contrast to earlier years, when only a few major industries used to constitute the bulk of outstanding credit. As a result, banks' credit risk is not concentrated in a few sectors anymore and thus the possibility of a systemic crisis does not seem likely. In this context, the role of SECP would be vital in maintaining a proactive regulatory framework which works as a mitigant of systemic risk while aiming at fostering the growth of the corporate sector.

3.2.3 Inflated Asset Prices

The tremendous growth in auto and mortgage finance has pushed up the prices of these assets, and has created inflationary pressures in the economy. Since most of the consumer lending is secured, the risk of default on these loans is directly related to the value and the nature of the underlying collateral. In this context, asset prices play an important role in determining the size of the losses incurred by banks. In order to avoid problems related to the deterioration in value of the underlying collateral for a loan, banks have to rely more on the future income streams of the borrowers in making their credit assessment, until such time that the asset prices are rationalised.

3.2.4 Credit Information Bureau

The existence of credit information bureaus is crucial for the development of a sound asset base. These bureaus collect data from financial institutions on the credit facilities availed by their borrowers along with their repayment history, consolidate these details in a centralized database and provide credit reports to banks to assist them in their credit appraisal process. Access to such information considerably improves the financial institutions' ability to assess the credit risk pertaining to a borrower. It is important to note that whereas negative information prevents banks from lending to defaulters of other institutions, positive information enables them to make an accurate estimate of the debt burden ratio which is a crucial factor for risk assessment.

SBP set up its CIB unit in January 1992 and it is currently offering online credit information services to its stake holders. Through CIB, SBP collects credit data for all borrowers with financing facilities of Rs 500,000 and above from all banks. It is mandatory for banks to obtain a credit report from CIB prior to extending any financing facility. In earlier years, CIB used to maintain only default data, however now the database is in the process of being enhanced to incorporate positive information on borrowers as well, and in the coming months, CIB will eliminate the minimum limit of Rs 500,000 and will collect credit data for all borrowers, irrespective of the loan amount. In addition to SBP's Credit Information Bureau, there are a few companies in the private sector which also collect and provide credit information to banks for a fee.

3.2.5 Finance for Equity Investments

Given that clean personal loans usually do not have a pre-specified purpose of utilization, it has been observed that certain customers have been availing such facilities from banks to invest in the stock market, which has contributed to speculative activities. SBP has taken notice of such activities and

has recently prohibited banks from using proceeds of such loans for investing in the stock market through Initial Public Offerings (IPOs).[46]

3.3 Conclusions and Future Outlook

From the above discussion, it can be concluded that microeconomic factors indicate that banks are making efforts to maintain their asset quality by giving more weightage to credit assessment policies. Moreover, banks are now in a better position in terms of loan diversification in various sectors such that financial distress in any particular sector might not affect the overall asset quality of the bank. However, changing macroeconomic factors may hinder credit growth in the months to come as the lending rates have started to rise. Moreover, as discussed above, banks are also vulnerable to inflated asset prices which can jeopardize their earnings.

The pace of credit growth in the coming months can be analyzed on the basis of the following: (1) Asset price impact; anecdotal evidence suggests that real estate prices in particular have seen a downward adjustment in recent months following the KSE-100 Index correction during March 2005. In addition, with the prohibition of financing premiums on automobile prices coupled with the reduction in custom duties of imported cars in the Federal Budget for 2005-06, growth in auto loans is also expected to stabilize, if not decline.

Notwithstanding the total exposure of bank credit collateralized by equity stocks, the prices of shares also seem to have stabilized after increasing erratically through most of FY04 and FY05. The asset price impact would take the form of a decline in the average loan size against these assets, with an overall impact on the volume of new loans; (2) Pricing impact; the presence of high inflation in the economy continues to persist, and the real weighted average lending rates were negative up till June 2005. Although SBP has increased the pace of monetary tightening, real returns are still negative. The demand for credit in coming months, therefore, might not be affected by the nominal cost of borrowing; (3) Market expectations; a major factor that will determine the growth of credit is the expectation of the prospective investor about the trend in interest rates.

Keeping in view the growth momentum that the economy has achieved and the conducive business environment, it is quite unlikely that rising interest rates would give a major set back to credit demand. Nonetheless, the pace of credit expansion might slow down in comparison to the last few years.

[46] Please see BPD Circular Letter No. 27 dated July 13, 2005.

Box 3.5: Country practices to promote SMEs and SME Finance

(a) Malaysia

With an objective to enhance SMEs' access to financing, in May 2003, Bank Negara Malaysia established a comprehensive SME Special Unit. Initially, the major function of this unit was to provide information on the various sources of financing available to SMEs, facilitate loan applications, address problems faced by viable SMEs in securing financing and provide advisory services on other SME financial requirements. Later, however, the unit was also given the responsibility to facilitate loan restructuring under the Small Debt Resolution Scheme (SDRS). In relation to this, Bank Negara Malaysia is also setting up a customer service centre as a reference point to facilitate a rapid and efficient response for the public in general and the SMEs in particular on financial matters. At present, SME finance constitutes around 40 percent of outstanding business loans of Malaysian banks. During 2004, commercial banks provided US$ 8.3 billion loans to 92,000 SMEs in the country. During Jan-Mar 2005, US$ 2.1 billion loans were approved.

(b) France

During July 2003, the French parliament adopted a new law for encouraging economic initiatives. To achieve the aim listed in this new legislation, in August 2003, several measures were announced by the small business ministry which include: (1) establishing local investment funds with SMEs and new businesses as principal target; (2) providing tax incentives to investments in SMEs; (3) allowing direct access to bank financing to selected business support services; (4) cutting the interest rate to facilitate access to bank finance. In addition, there are several other measures that were taken to ensure growth in the SME sector. These include measures to simplify the business creation environment, encouraging employees to create their own businesses, facilitating the purchase and transfer of businesses and reducing the risks of personal entrepreneurship in SMEs.

(c) United Kingdom

In UK, the business environment has undergone several changes over the last 6 years to be more supportive of enterprise. Because of greater macroeconomic stability, business survival rates have improved. Around 8 percent more businesses survive for a period of three years or more today than ten years ago. This is mainly because UK government's aim is to develop an entrepreneurial culture throughout the country and address the prevailing market failures. The UK government has been working to address the financial constraints faced by SMEs by taking a number of fund intervention measures, which include (1) establishing regional venture capital funds that will provide around £270 million across England for small businesses with growth potential; (2) community development venture funds that provide financial resources to deprived areas; (3) launching enterprise capital funds that invest in small high growth businesses in funding rounds up to £2 million.

(d) India

Reserve Bank of India provides clear guidelines for directing credit to the SME sector. Domestic scheduled banks are required to allocate 40 percent of net credit to priority sectors which includes agriculture, small scale industries (SSI), etc. For foreign banks, a target of 32 percent has been stipulated out of which, aggregate credit to SSIs should not be less than 10 percent of the net bank credit. Under the mid-term review of annual policy for 2004-05, the composite loan limit for SSI entrepreneurs has been enhanced from Rs 5 million to Rs 10 million. Further, in order to encourage securitization of loans to SSIs, banks are allowed to treat their investments in securitized assets pertaining to the SSI sector as direct lending to the priority sector. During 2003-04, bank credit to SSIs increased by 9 percent as against an increase of 6 percent during 2002-03. At end-March 2004, banks' financing to the SSI sector had reached Rs 658.5 billion compared to Rs 604 billion at end-Mar 2003.

(e) Germany

In 2000, there were 2. 89 million non-financial enterprises subject to turnover tax in the group of small and medium sized enterprises with less than EUR 50 million in annual turnover; these made up 99.7% of all enterprises subject to turnover tax. They generated 43. 4% of all turnover reported in the turnover tax statistics. According to an estimate, in Germany SMEs employ around 70 percent of overall work force and provide 83 percent of all vocational training. For German SMEs, bank loans play an important role in the External financing of corporate activities.

The share of bank loans in total financing declines as the size of the company increases which shows that the relative importance of bank financing is more important for SMEs than for the large corporates. For smaller firms, i.e. those with an annual turnover of less than EUR 12.5 million, the share of bank loans to total liabilities range from 33 percent to 40 percent (1996). Bank lending in Germany is usually exercised through establishing a close and long-term relation ship between customers and banks. Probability of default is calculated on the basis of a scoring model applying logit analysis (usually known as the Z-score). "The knowledge of the individual default risk measured by the German Z-Score allows for the calculation of a borrower's approximate risk adequate cost of debt and can thus lead to a detection of potential hold-up situations. This may lead to more efficient decisions on when and how to search for new lenders".

References

(1) Towards an Enterprising Europe, a paper by the French, German and UK governments, 26th January 2004.
(2) Trends and Progress of Banking in India, 2004.
(3) Presentation by Director, SME Special Unit, Central Bank of Malaysia in the conference on "SME Financing: Issues and Strategies", May 10 – 11 2005, Lahore, Pakistan.
(3) Bundesbank, Monthly Report, October 2003.
(4) Credit Scoring and Relationship Lending: the case of German SMEs, Patrick Behr, University of Frankfurt1 André Güttler, University of Frankfurt2, Dankwart Plattner, KfW Group3 Version 15. March 2004.

Box 3.6: Impact analysis of MFIs: Country Findings

A study of "Society for Helping to Awaken Rural Poor through Education"-SHARE clients in India has documented that three-fourths of clients who participated in the program for extended periods saw significant improvements in their economic well-being (based on sources of income, ownership of productive assets, housing conditions, and household dependency ratio) and that half of the clients graduated out of poverty. There was a marked shift in the employment patterns of clients—from irregular, low-paid daily labor to diversified sources of earnings, increased employment of family members, and a strong reliance on small businesses. Over half of SHARE clients indicated that they had used their micro enterprise profits to pay for major social events rather than taking debt to meet such obligations.

A detailed impact assessment study of BRAC (Bangladesh Rural Advancement Committee) in Bangladesh suggested that members who stayed in the program for more than four years increased household expenses by 28 percent and assets by 112 percent. Another analysis of household level data demonstrated that access to financial services enabled BRAC clients to reduce their vulnerability through smoothing consumption, building assets, and receiving services during natural disasters.

A comprehensive study of microfinance conducted by the World Bank in the early 1990s on three of the largest programs in Bangladesh—Grameen Bank, BRAC, and RD-12—found that female clients increased household consumption by 18 takas for every 100 takas borrowed, and that 5 percent of the clients graduated out of poverty each year by borrowing and participating in microfinance programs. More importantly households were able to sustain these gains over time.

Source: Is Micro Finance an effective strategy to reach the Millennium Development Goals? By Elizabeth Littlefield, Jonathan Morduch, and Syed Hashemi- January 2003 (http://www. cgap. org/docs/FocusNote_24. pdf)