# SME Financing: Issues and Strategies

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Welcome address at the Conference on SME Financing: Issues and Strategies held in Lahore on May 10, 2005.

Mr. President,

Distinguished Guests,

Ladies and Gentlemen:

It is an honour for me to welcome you all and particularly Mr. President to this Conference on SME Financing: Issues and Strategies. I wish to thank you Mr. President, Sir, for your continued support in our efforts to develop a vibrant SME sector as an integral part of the poverty reduction strategy. You have spelled out this strategy on several occasions very clearly and I would like to dwell upon it this morning. But I would like to assure you that this conference is a modest contribution towards the fulfillment of that strategy. I would also like to welcome our foreign speakers and wish them a pleasant stay in our country.

The overall objective of the Conference is to bring together all the stakeholders in the SME sector to generate debate on the issues confronting the sector and look at the various strategies being developed at the regulatory and policy level to increase the flow of credit and financial services to this very important sector of our economy. The speakers of this Conference will provide us with valuable insight into main issues as well as some of the "nuts and bolts" of how to do SME finance more profitably, as the State Bank is not going to force the banks to undertake lending operations which are not profitable. The international speakers will share with us the best practices that have successfully worked elsewhere and we can explore ways of adapting them to our own situation. Let me also remind you that lending to SMEs, if developed and practiced on modern lines shall primarily remain a profitable options for banks and can guarantee earning for banks at a rate higher than the lending to corporate clients.

There exists strong evidence that SMEs expansion boosts employment more than large firm growth because SMEs are more labour intensive. In Pakistan, the SME sector contributes 30 percent towards the country's GDP, along with agriculture provides 90 percent of the jobs, accounts for 35 percent of the value added in the manufacturing industry and generates 25 percent of manufacturing sector export earnings ($ 2.5 billion). Given its huge potential for generating employment, the Government has identified the SME sector as one of the leading sectors along with agriculture and construction and housing which will spearhead its efforts towards generating employment to alleviate poverty in the country within the framework of the Pakistan Poverty Reduction Strategy Paper.

While the sustained and long-term growth of the SME sector in Pakistan remains constrained by a number of factors that include skills shortage, scarcity of capital goods, poor management, lack of data on the sector, resistance to change and marketing difficulties especially for export-oriented SMEs; by far the biggest problem facing the sector is the unavailability of adequate financing facilities. The problem of limited access to credit for the SMEs is not exclusive to Pakistan as a recently conducted World Business Environment Survey covering 4000 firms in 54 countries found that SMEs cited inadequate access to finance as their primary constraint to growth. This sector is characterized by information asymmetries; the creditors' search costs, information acquisition and processing costs exceed the returns. Hence, there is risk aversion by the banks towards extending credit to small and medium enterprises. It is relatively easy to lend to large corporates where the economies of scale, published financial information, collaterals and creditworthiness parameters favour such types of lending. As the small businesses cannot offer adequate collateral, the banks are unable to determine whether the borrower possesses technical, managerial and marketing skills that will allow him to generate adequate cash flows and repay the loan on time. The process of financial intermediation therefore breaks down for the SME borrowers.

A sustainable solution requires that we take a more holistic view of this problem, instead of looking at the issue of financing to the SMEs in isolation. A large number of players have to be involved in contributing to the success of the SMEs. There are number of different stakeholders who have to work together in a coordinated and cohesive manner to ensure that these market failures in case of SME credit market are removed and the process of financial intermediation takes place. These include the government and the regulatory agencies such as the Small and Medium Enterprise Development Authority (SMEDA) and SBP, provincial and local governments, SME Bank and other commercial banks engaged in SME financing

First of all, the government and the regulatory agencies such as the State Bank of Pakistan need to provide a conducive and enabling environment for SMEs to operate. This requires that the macro economic policies are sound, the regulatory regime is supportive and the legal system is able to enforce contracts and property rights. There ought to be a level playing field for both the small and large entrepreneur and there is no preferential treatment for any particular class. In the past the SROs were being used to favour certain individuals or tariffs were raised to protect selective groups or banks loans were given to supporters of the ruling parties. In the past five years, however, these practices have been done away and a level playing field now exists for all businesses – small or large – in the economy.

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

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

The SME Bank, which was established in the public sector in 2002 to provide financing to the SME sector, is another important player in the sector. However, it alone cannot cater to the needs of the entire sector but it could develop a prototype of program lending, credit appraisal and delivery methodology, standardized documentation, monitoring mechanisms, which can be replicated and followed by other commercial banks. The SME Bank can produce experienced and skilled professionals who are specialists in the SME credit for the whole industry.

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

Besides banks and DFIs, Leasing Companies and Modarabas are also the right vehicles for delivery of credit to the SME sector. Unfortunately with the exception of one or two leasing companies they have limited their activities so far to large urban areas and have not opened up their doors for business in those cities and towns where the clusters of SMEs do exist. As they face tough competition from banks in leasing business, it is expected that they would diversify both in product lines as well as in geographical coverage.

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

**SME Financing and SBP – Achievements and Strategies**

In recent years, the SBP has reviewed its own role to determine whether or not it was creating any hurdles in the way of lending to SMEs. We found out that the same prudential regulations which were applicable to corporate borrowers were also made applicable to consumer, SME and micro finance although the requirements were different for each market segment. We therefore decided to formulate a separate set of regulations for SMEs, which were developed after extensive consultations with the SME Associations, SMEDA, provincial departments and have been in force since January 2004. With the enforcement of these regulations a number of constraints in SME financing have been removed and the banks now in a better position to disburse loan to SMEs without fear of violating the prudential norms. The new prudential regulations for SMEs do not make it mandatory for banks to require collateral but allow them to take into consideration asset conversion cycle and cash flow generation as the basis for loan approval. We would be willing to further improve and strengthen these regulations if any practical difficulties arise in their implementation.

The SBP has geared up its efforts towards providing policy advice to relevant stakeholders in the SME sector especially the banks/DFIs. For this purpose, a separate SME Department has been recently established in the SBP, which will organize itself internally to respond to the financing needs of SMEs by inducting skilled manpower and training of younger staff. The newly established department is tasked with creating a conducive macro-prudential environment for banks/DFIs to increase the flow of credit to SMEs; to promote a strategic focus on SMEs on the part of the banks/DFIs and to help banks/DFIs adopt best practices in the development of their SME business lines;

Our short-to-medium term strategic plan also envisages Financial Sector Deepening and Broadening of Access to formal sources of finance by the SMEs as one of our top priorities for the next five years. For the SMEs, as an initial step, delivery of credit by banks will be monitored and intermediary/technical support organizations will be encouraged to assist the SMEs in preparing bankable proposals. In the medium term, the staff of the banks will be trained in program lending. SBP will also endeavor that a guarantee scheme is established by the Government of Pakistan (GoP) to share the credit risk of the financing banks. To pursue this strategy, close coordination will be established with the SMEDA.

The SBP is also expanding the scope and coverage of its existing on-line Credit Information Bureau by including all loan amounts. This database will be a powerful tool for all the banks and financial institutions in mitigating risks in lending to SMEs. Under the framework of our strategic plan for 2005-2010 we will also explore the possibility of allowing the setting up of private sector credit bureaus that will incorporate a lot more information on credit history and behaviour of borrowers.

The State Bank, with the help of ADB's SME Sector Development Program, will also provide capacity building support to a select group of banks for SME lending including

SME Bank. This project will revitalize the SME lending by the participating financial institutions and will be a prototype for other financial institutions who could see financing to SMEs as profitable business ventures.

The SME Bank is being restructured under the SME Sector Development Program of ADB making it a viable Bank catering to the needs of SMEs in the country. SBP has also issued a commercial banking license to SME Bank. We hope that SME Bank would take a lead in developing innovative lending technologies and program lending tools where standardized credit scoring methodology may be used for each sub-sector rather than always relying on the current method of scrutiny and appraisal of each individual proposal. The present methods and documentation are onerous for small entrepreneurs and relatively costly for the banks. SME Bank has to experiment and come up with the standardized set of easy to fill but fully informational documentation, specification of risk parameters, credit appraisal and delivery techniques.

Today, most big industrial establishments depend on SMEs for their value addition. It is on record in most emerging markets that the fastest growing export industries (cotton weaving, textiles, surgical instruments, carpets, leatherwear, etc) have been dominated by SMEs. Thus, SMEs have played very significant roles in reducing the poverty levels in many developing countries. Emphasis has been placed on pro-poor growth led by the private sector especially through SMEs. Sectors such as agriculture, services, manufacturing with heavy content of labor-intensive activities have received much support by the Governments because of their potential for reducing poverty. These countries have also successfully integrated their SMEs with the large corporate sector through sub contracting. Sub contracting by the large firms has proved to be an extremely useful and efficient way of integration across the size and scale. Automobile industry provides an excellent example of this business model whereby 60-70 percent of the components and parts in the manufacturing of cars and 90-95 percent in case of motorcycles are provided by small vending industry. A vast network of showrooms and service stations again owned by small entrepreneurs are the example of forward linkages between the large manufacturers and SMEs. This model can be replicated in case of other industries also. This will ensure that both the large manufacturing and SME sectors grow organically through the forces of interdependency. There is no substitute for economics of scales and the SMEs due to smallness of their size cannot excel in it and harvest its benefits. This makes their integration with the corporate sector more vital. I would urge upon the SMEDA and other government sector organizations involved in the SME policy formulation to take up this challenge of integrating SMEs with the corporate sector.

Let me conclude by restating the fact that SMEs will continue to play a very important and vital role in our economy where the twin problems of unemployment and poverty constitute major development challenge. Well targeted government intervention in this sector remains indispensable provided such interventions do not displace the private sector. Given the quality of participants in the conference, I am convinced that useful policy recommendations will emerge at the end of the different sessions. I thank you Mr. President once gain for vision and leadership in the economic revival of this country and your personal support to the State Bank of Pakistan. I look forward to your guidance in creating an enabling environment for the promotion of SMEs in the country.

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