

## 4. Improving Financial Access for Small and Medium Enterprises (SMEs)

*There are 3 million SMEs in Pakistan; they constitute more than 90 percent of all private enterprises in the industrial sector, employ nearly 78 percent of the nonagriculture labor force, and contribute over 30 percent to GDP. Small and micro enterprises have seen a worsening of access to finance; they internally finance 90 percent of working capital and 81 percent of new investment. In contrast, medium-size enterprises and those with a credit history have seen an improved access to finance. Studies estimate an SME credit demand gap of Rs 277 billion (compared with current SME credit of Rs 400 billion). However, enterprises do not seem to be excluded from financial markets because of poor performance. Instead, an incomplete legal and regulatory framework and non-SME-friendly products and procedures hamper increased SME lending. Indirect costs—legal fees, collateral registration, and documentation—make bank lending expensive for SMEs. A typical small business loan requires up to 27 steps for the bank and nine meetings with clients.*

*An enabling role has been played by the expansion of Credit Investment Bureau's (CIB) scope in 2006; the SME Policy 2007, which emphasizes SME access to finance; and, above all, the new SBP Prudential Regulations for SMEs. However, banks continue to find it difficult to serve SMEs profitably for several reasons. First, the legal framework (namely, the secured transactions regions and, to a lesser extent, the credit information infrastructure) limits the pool of potential applicants. Second, bank products are not tailored to SMEs, resembling instead corporate lending practices. Finally, banks do not have organizational structures and monitoring tools conducive to achieving high efficiency. SME demand-side factors, including limited SME accounting, budgeting, and planning capacity further constrain the market. Continued promotion of an enabling environment for SME lending and a large-scale downscaling effort involving both the public and private sectors can forge rapid growth in SME lending. Increasing access to finance for SMEs could also be facilitated by attracting an institutional investor with a track record in SME lending and assisting other banks to go down market.*

### 4.1. Access to Finance for SMEs: Supply-side Evidence

#### **SMEs account for a substantial part of the economy, yet small enterprise lending remains limited.**

There are about 3.2 million enterprises in Pakistan, of which about 3 million (93 percent) are SMEs. SMEs spread across the economy with varying density: Most are in wholesale and retail trade and restaurants and hotels (53 percent), followed by other services (27 percent) and the manufacturing sector (20 percent).<sup>61</sup> The SMEs census shows that SMEs contribute over 30 percent to the GDP and 25 percent to the country's total export earnings, and they employ close to 70 percent of the labor force in the manufacturing industry, services, and trade. Their share in the manufacturing value addition is estimated to be around 35 percent. Despite the importance of SMEs in the economy, as of December 2007 fewer than 200,000 borrow from the banking sector and SME lending volumes (that is, loans of up to Rs 75 million) account only for 16 percent of total credit. Although no disaggregated supply-side data are available, demand-side data and interviews with banks have shown that there is a particularly acute financing gap for loan sizes between Rs 100,000, the maximum loan size that Microfinance Institutions (MFIs) can offer, and Rs 5 million, the loan size range required mainly by small businesses.

**Private banks are the leading lenders in the SME finance market.** Four of the five banks with the highest number of individual shares in SME finance portfolios are private commercial banks. Among the public sector banks, National Bank of Pakistan (NBP) has slightly more than 8 percent of the total SME financing extended by the banking sector. The public sector banks (Bank of Punjab, Bank of Khyber, and First Women's Bank Limited) have the third largest share of SME financing, after the big-five banks and private banks. Islamic banks are also making significant improvements in capturing the SME finance market. Among these, Meezan Bank has the highest outstanding portfolio, approximately Rs 3.7 billion,

<sup>61</sup> Economic Survey 2008.

followed by Dubai Islamic and Dawood Islamic banks. Specialized banks' share in SME financing extended by the banking sector is low, 2.19 percent; SME bank has the largest portfolio, Rs 8 billion. Foreign banks play a negligible role in SME finance (Table 4.1).

**Most loans to SMEs go to finance working capital.** SBP data show that a major portion (71 percent) of SME borrowing is spent on working capital, followed by trade financing and long-term / fixed investment (December 2007). The breakdown of lending to SMEs, by type of facility, is presented in Table 4.2

**Table 4.1: Distribution of SME Finance among Banks**

| Banks                                    | % Share in SME Finance Portfolio |
|--|----------------------------------|
| Big-five banks                           | 43.40                            |
| Habib Bank Limited                       | 15.55                            |
| National Bank of Pakistan                | 7.86                             |
| Allied Bank Limited                      | 7.46                             |
| Muslim Commercial Bank Limited           | 6.72                             |
| United Bank Limited                      | 5.81                             |
| Private banks (excluding big 5)          | 44.36                            |
| Public sector banks (excluding NBP)      | 4.82                             |
| Foreign banks                            | 0.42                             |
| Islamic banks (excluding Al-Baraka Bank) | 4.82                             |
| Specialized banks                        | 2.19                             |

Source: SBP,

Note: SBP figures for 1<sup>st</sup> quarter 2008, rescaled to add up to 100.

**Table 4.2: Breakdown of Lending to SME by Type of Facility (Rs billion)**

| Type of Facility | Dec 04 | Dec 05 | Dec 06 | Dec 07 | Mar 08 |
|------------------|--------|--------|--------|--------|--------|
| Fixed investment | 23.9   | 34.1   | 41.8   | 60.3   | 47.9   |
| Working capital  | 204.2  | 267.7  | 308.4  | 309.1  | 293.3  |
| Trade finance    | 55.9   | 59.6   | 58.1   | 67.9   | 61.6   |
| Total            | 284    | 361.4  | 408.3  | 437.4  | 403.4* |

Source: SBP

\* Provisional figure

#### 4.1.1. Government Policies to Improve Financial Access to SMEs]

**The Government of Pakistan (GOP) and SBP have introduced policies to improve the legal framework and create a demonstration effect.** The GOP and SBP have launched a number of initiatives to support the growth of SME lending. These can be broadly grouped in two areas: initiatives aiming at facilitating SMEs provision of collateral and credit history and activities aimed at creating a demonstration effect for other financial institutions, that is, financing technical assistance for selected financial institutions to increase SME lending, thus showing to other market participants that the SME segment is indeed a profitable one and ultimately creating competition in the segment. Finally, to monitor SME lending, the SBP has introduced a more detailed SME definition on a pilot basis and requires banks to report on their SME portfolio on a quarterly basis.

**SBP has made two unsuccessful attempts to increase lending to SMEs; firstly through the creation of an effective secured transactions system and secondly through the relaxation of collateral requirements.** The traditional corporate lending products of Pakistani banks emphasize security, especially immovable collateral, audited financial statements, and business plans, rather than doing first-hand research on cash flows and business performance. This makes it more difficult for financial institutions to extend loans to SMEs, whose collateral is limited and movable, and which do not find financial statements and business plans easy to produce. The general resistance of banks to accept movable collateral is compounded in Pakistan by a secured transactions system that makes it unsafe to lend to a sole proprietor by collateralizing the loan with a movable asset. Currently, only limited liability companies can register, and hence notify to the public at large, a lien over movable assets. They do so in the company registry, which is not available for unlimited liability companies, as these are not registered (more details on this are provided in section 4.3). To remove this barrier for sole-proprietor SMEs, the SBP has attempted to introduce a registry for liens over movable assets. However, encountering delays in

setting the new system in place, the SBP introduced a regulation in 2004 allowing uncollateralized lending for loans up to Rs 3 million and without financial statements for loans up to Rs 10 million. Despite the new legality of this lending, the lending practice is proving too risky for conservative Pakistani banks.

**To facilitate the creation of a credit history for SMEs, SBP has promoted the establishment of credit bureaus, both public and private. However, despite their improved performance, their coverage is limited, especially for smaller borrowers.** Not unlike other countries, Pakistani SMEs have no or little formal credit history; this makes formal financial institutions more hesitant to lend to the segment. To promote the creation of formal credit histories by small businesses, SBP founded a public CIB in 1992. The CIB records both positive and negative information about companies, as well as all the assets they use as collateral for the loans. CIB performance was enhanced in 2006 with the introduction of an e-CIB system, which improved speed, reliability, and security of data. In that same year, CIB coverage was expanded to all loan sizes. In addition to the state-owned CIB, two privately owned credit bureaus now operate in the country. Despite their improved performance, credit bureaus cover only 10-20 percent of the borrowers and very few SMEs requiring loans smaller than Rs 6 million. This is partly because the banks lend to this segment and partly because the bureaus do not collect information from the telecom and utility companies, which could substantially contribute to building a credit history for SMEs.

**To create a demonstration effect for other market participants, the GOP has supported the creation of a specialized SME Bank, which, in three years since its inception, has served a mere 1 percent of the market.** To challenge the market and demonstrate that the SME segment is not only viable but very profitable, the GOP created a bank dedicated to serving only SMEs (Box 4.1). SME Bank was created by merging two failed state-owned banks. In 2007, two years after starting operations, SME Bank had only 2,200 clients (1.2 percent of total SME borrowers) and offered less than 2 percent of total SME finance extended by the banking sector.

#### **Box 4.1: SME Bank**

To act as a catalyst for the SME market, in 2002 the GOP created SME Bank Ltd through the merger of two failed Development Financial Institutions, the Regional Development Finance Corporation (RDFC) and Small Business Finance Corporation (SBFC). SME Bank received a commercial banking license in 2004 and started operations in mid 2005. Its current shareholders are the Federal Government (92.68 percent) and six banks (7.32 percent). The bank was poised to be privatized shortly after becoming operational. However, the Supreme Court decision to reverse the Pakistan Still Mills privatization, the fact that the SME bank was a small-ticket item, in the privatization list and the increasingly deteriorating security situation in the country have put the privatization on hold.

SME Bank operates a total of 27 branches: 13 commercial banking branches and 14 recovery branches. In December 2007, its total assets were Rs 6.6 billion, and its net outstanding loans amounted to Rs 2.1 billion. As of 2007, the bank had only 2,200 clients or 1.2 percent of total SME borrowers in the country for an average loan size of Rs 840,000 over the three years. In theory, the bank provides loans of terms up to seven years. In practice, however, working capital loans of up to Rs 500,000 are given up to a term of three years, and asset finance up to four years; in exceptional cases, the term can be up to five years.

Despite this growth, SME Bank has not been able to meet the credit needs of the SME sector; this stems from its use of traditional lending technology that does not distinguish between large corporations and small businesses, inappropriate product design, and its lengthy application procedures (it takes on average 40 days to receive a loan). Unlike at other SME banks, SME Bank loan officers do not have a bonus system based on the performance and size of the loan portfolio that they generate and manage.

A comparison with successful SME banks in the region and beyond is presented in the table below. Pakistan's SME Bank has by far the worst portfolio performance with 72 percent of the gross loan portfolio in volume classified as loss. The limited attention paid to lending is also reflected in the bank human resource policy of employing only a small number of loan officers, less than one per branch.

*Source:* Author's interview with SME Bank management

| <b>Results for Selected Small Business Banks (December 2007)</b>   |                           |                         |                                       |                          |
|--|---------------------------|-------------------------|---------------------------------------|--------------------------|
|  | <b>Pro Credit Ukraine</b> | <b>BancoSol Bolivia</b> | <b>BRAC Bank Bangladesh</b>           | <b>SME Bank Pakistan</b> |
| Total assets (million \$)  | 454                       | 269.9                   | 676.1                                 | 107.4                    |
| Year of establishment  | 2001                      | 1992                    | 1999                                  | 2002                     |
| Number of outlets or branches  | 71                        | 49                      | Branches: 36<br>SME unit offices: 392 | 27                       |
| Number of loan officers  | 246*                      | 297*                    | 1,369                                 | 18                       |
| Average time to disburse a loan (days)   | 5                         | 5                       | 15                                    | 40                       |
| Gross loan portfolio (million in \$)   | 389.2                     | 209                     | 473.2                                 | 126.6                    |
| Average loan size outstanding (in \$)  | 7,358                     | 2,360                   | 4,067                                 | 13,703**                 |
| Portfolio at risk (PAR) >30 days   | 0.98%                     | 1%                      | 18%                                   | 72%***                   |
| Total assets for holding/fund (in \$)  | 6 billion                 | 140.3 million           | 2.4 billion                           | Not Applicable           |
| <i>Source:</i> Pro Credit Ukraine; BancoSol, Bolivia; BRAC Bank, Bangladesh; SME Bank, Pakistan.                               |                           |                         |                                       |                          |
| * Data for 2005. **Average loan size disbursed (\$). ***Percentage of the portfolio classified as loss as per SBP regulations. |                           |                         |                                       |                          |

**Lack of shareholders with the required know-how is the primary reason for the failure of SME Bank to catalyze the market.** A number of factors, but most notably two, have contributed to the failure of the SME Bank experiment. First, because the intended privatization of the bank never took place, the bank does not have institutional investors with the know-how required to support the bank (for example, the board did not give clear and ambitious quantitative targets to bank management). Secondly, being created from what remained of two failed institutions meant that SME Bank management had to expend energy on restructuring rather than expanding and modifying its operating model to serve a new market segment.

**The GOP has funded technical assistance for NBP to enter the SME segment, with some success.** Starting in 2005, the GOP facilitated the delivery of technical assistance to the NBP to substantially expand SME lending. Lending on a cash-flow, not collateral, basis was introduced, and loan officers were put on performance-based contracts. NBP has achieved some promising results after three years (Box 4.2). Nevertheless, while the program has certainly increased NBP's lending to SMEs, the size of the SME loan portfolio remains quite small. By comparison, similar programs in China over the same time period expanded to loans for an average of \$10,000 with a portfolio at risk (PAR) >30 days of 1 percent, totaling \$380 million in 15 regions in the country (see Box 4.4 in section 4.3). The Pakistan program's limited success is most likely attributable to the lack of competition. While downscaling programs with state-owned banks can work, usually they are combined with downscaling programs for faster-moving private banks, which implement the required changes at a faster pace.

#### **Box 4.2: National Bank of Pakistan's SME Lending**

NBP is a state-owned bank with the largest branch network (1,243 branches) in the country. Its total assets exceeded \$12 billion in 2007. In 2005, NBP signed a technical assistance agreement with ShoreBank International under a U.S. Agency of International Development (USAID)-financial sector project to substantially increase small business lending (loans typically under Rs 2 million). As part of the agreement, Shore Bank International introduced a bonus system for its loan officers based on the number of loans issued and quality of the performance of the loan they managed. Loan officers were trained in the new lending methodology and onsite support was provided to active branches. NBP and ShoreBank International are continuing to work together on a new bilateral agreement paid for by NBP that runs through 2009.

Initially, the task of convincing loan officers and managers to focus on small enterprise loans proved to be difficult. The branches lacked a performance-based culture, and there were many management layers. Most credit decisions were based on the basis of immovable collateral. The challenge for the ShoreBank International team was to shift

the focus from collateral to underwriting on cash flows and business performance. After extensive fieldwork, forms and formats were designed to assess repayment capacities based on projected cash flows and financial ratio analysis. In addition, a tool was developed to assist loan officers in converting informal cash book receipts into standard financial documents. But more important than the underwriting approach was the need to effectively motivate loan officers to leave their branch offices to market and underwrite new loans at the business premises.

The start was slow, but the key step in the process was introducing a regular monitoring report that was shared at all levels of NBP, providing a transparent measure of progress. This report, circulated at least monthly, served to stimulate interest and keep senior management and branch-level teams focused on measurable objectives. NBP's loans to SMEs increased starting in June 2006. Over the first 18 months of the agreement, 658 loans were issued for a total loan portfolio of Rs 1.4 billion. Data on performance of outstanding loan portfolio are presented in the table below.

**Portfolio Quality of the SME Lending Program (November 30, 2007)**

|                                      |                |
|--------------------------------------|----------------|
| Number of loans                      | 510            |
| Amount of outstanding                | Rs 813,089,934 |
| Amount of outstanding loan portfolio | \$13,439,503   |
| Average loan size                    | \$26,352       |
| Number of overdue loans >90 days     | 8              |
| % of overdue loans (volume) >90days  | 2%             |

Source: ShoreBank International staff

**In addition, SBP has introduced a more detailed SME definition on a pilot basis and requested banks to report quarterly; although this is a step in the right direction, the brackets are too many which makes banks reporting too complex.** To monitor SME lending, SBP created an SME department and now requires banks to report all loans smaller than Rs 75 million on a quarterly basis. Thus, implicitly, SBP has defined SME loans as those smaller than Rs 75 million; this definition is intended to facilitate bank reporting. While this could allow tracking of lending to the segment to begin, the breakdowns are too many and might actually discourage banks from reporting accurate information.

**Table 4.3: Credit to the Private Sector: A Profile (Rs billion)**

| Sector of the Economy | December 2004 |           | December 2005 |           | December 2006 |           | December 2007 |           |
|-----------------------|---------------|-----------|---------------|-----------|---------------|-----------|---------------|-----------|
|                       | Amount        | Share (%) | Amount        | Share (%) | Amount        | Share (%) | Amount        | Share (%) |
| Corporate             | 873           | 53.9      | 1,076.20      | 52.7      | 1279.1        | 53.3      | 1520.1        | 56.3      |
| SMEs                  | 284           | 17.5      | 361.4         | 17.7      | 408.3         | 17        | 437.4         | 16.2      |
| Agriculture           | 119.3         | 7.4       | 138           | 6.8       | 141.9         | 5.9       | 150.8         | 5.6       |
| Consumer finance      | 152.6         | 9.4       | 252.8         | 12.4      | 325.2         | 13.5      | 371.4         | 13.8      |
| Commodity operations  | 122.1         | 7.5       | 140.6         | 6.9       | 171.9         | 7.2       | 148.4         | 5.5       |
| Staff loans           | 40.8          | 2.5       | 42.4          | 2.1       | 48            | 2         | 52.2          | 1.9       |
| Other                 | 28.6          | 1.8       | 31.6          | 1.5       | 26.4          | 1.1       | 20.6          | 0.8       |
| Total                 | 1,620.40      | 100       | 2,043.00      | 100       | 2,400.80      | 100       | 2700.9        | 100.0     |

Source: SBP

**Government efforts to increase SME access to financing have had modest results, with loans to SMEs declining as a percentage of total lending.** Against the backdrop of a growing banking sector, SME lending has witnessed a slight downward trend over the period 2004-07. SMEs accounted for 16.2 percent of total credit to the private sector in 2007, down from 17.5 percent in 2004. In contrast, both corporate and consumer finance grew, from 54 percent to 56 percent and from 9 percent to 14 percent, respectively, in the same period (Table 4.3). The average SME loan has also slightly increased in size, reaching Rs 2.4 million.

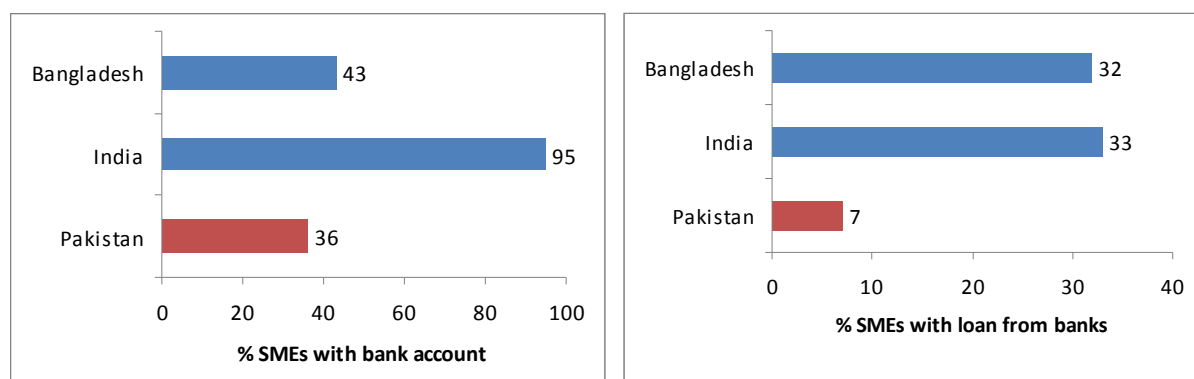
## 4.2. Access to Finance for SMEs: Demand-side Evidence

To complement the broad picture of SME financial access presented from supply indicators, this section measures access from the demand side. The analysis presented here is mainly based on the 2005 urban demand survey, conducted by KfW. The survey covered 510 SME businesses operating in manufacturing, trade, and other service sectors in the Punjabi cities of Faisalabad, Gujranwala, Lahore, Sargodha, and Sialkot. The survey defined SMEs as those businesses employing not more than 100 permanent employees. (See Annex 4.1 for detailed description of the survey building blocks, methodology, and sampling).

The analysis here also draws on the 2005 European Commission Survey and the 2002 and 2007 Investment Climate Assessment (ICA) surveys (World Bank 2003 and 2009). The European Commission Survey covered 100 manufacturing SMEs in the golden triangle,<sup>62</sup> while the 2002 and 2007 ICA surveyed 965 and 1,184 enterprises, respectively, in manufacturing and services in urban Pakistan.<sup>63</sup> It should be stressed that, although the definitions of SMEs used by the European Commission and ICA surveys vary slightly from those used in the KfW survey, the difference is negligible and their key findings on financial access (access, sources, obstacles) coincide. All the data presented here, unless specifically mentioned otherwise, refer to the 2005 KfW dataset.

Although a considerable number of Pakistani SMEs have a bank account, few borrow from banks. The SMEs have also more limited access to finance than their counterparts in India and Bangladesh. Thirty-six percent of Pakistani SMEs have a bank account, while only 7 percent had at least one loan outstanding in the previous three years (2002–05). In comparison, in 2006, 43 percent of SMEs in Bangladesh, and 95 percent in India, had a bank account,<sup>64</sup> and 32 percent and 33 percent, respectively, had a loan from a bank. Moreover, it should be highlighted that Bangladeshi and Indian SMEs also have access to finance from other financial institutions, mainly MFIs in Bangladesh and finance companies in India.

**Figure 4.1: Access to Finance for SMEs in Pakistan, India and Bangladesh**



Source: India ICA 2006 Manufacturing Enterprise Survey, Bangladesh 2006 Rural MSME Finance Services Survey, Pakistan KfW Demand Survey 2005

<sup>62</sup> An SME study was conducted by the European Commission in 2005 under its Pakistan Financial Services Sector Reform Program. The SME definition used was: small (medium) enterprises that employ up to 50 persons (51–250 persons), assets excluding land and building not more than Rs 30 million (Rs 30–100 million), and sales up to Rs 100 million (up to Rs 300 million).

<sup>63</sup> The 2002 ICA survey defines small enterprises as those employing 1–19 employees and medium enterprises as those employing 20–99 employees. The same definition of firm size is used for the analysis of the 2007 ICA in this current study.

<sup>64</sup> Data for Bangladesh is based on the 2006 Rural MSME Finance Services Survey, which includes 226 SMEs in cities outside of Dhaka and Chittagong. Data for India refers to ICA 2006 manufacturing enterprise survey, which includes 2460 firms in 16 states across India; only data for SMEs (enterprises with less than 100 employees) was used in this analysis.

**Over the 2002–06 period, SME access to finance increased, though this is attributable to increased access for medium enterprises rather than for the whole segment.** The number of enterprises that reported having at least one outstanding loan or overdraft facility increased substantially from 2002 to 2005 (ICA 2002 and 2007). However, when disaggregating the data, access to financial services has increased only marginally for small enterprises (from 10 percent to 11 percent) and has increased substantially for medium-size enterprises (from 27 percent to 43 percent). This finding is in line with the result of interviews with banks that identified a financing gap at the bottom of the market (Rs 100,000–5 million).

**During the same period, enterprises that had a credit history found it easier to access finance.** Firms covered in the KfW survey that had applied for loans in the 2002–04 period were asked whether access to bank loans had become easier over the period, and 53 percent claimed that it was very/fairly easy in 2004 versus 33 percent in 2002.

**Improvement in access to financial services mainly for medium-size enterprises and for enterprises that already have a credit history is probably a short-term outcome of the privatization.** Immediately post privatization, as banks reduce nonperforming loans, reorganize, and start expanding their portfolios, they tend to apply stricter risk-management rules and to focus on more-established clients. This, combined with a reduction of mandated lending to smaller clients and government-financed products, often causes a short-term reduction in lending to the lower end of the market. Only after competition in the more-established segment has intensified do banks start focusing on a lower segment.

**The SME market gap is estimated at Rs 277 billion.** The KfW survey asked respondents to estimate the amount of external financing required to finance working capital and fixed investments in 2005. Based on these estimates, the potential market size for serving small businesses is approximately Rs 300 billion (see Box 4.3). More than 90 percent of this demand is still unserved, making small business finance a highly attractive venture for profit- and growth-oriented banks in Pakistan. Huge credit demand coupled with minimal supply promises high profit margins and strong growth for banks going down market. Thanks to the large market size, banks will be able to sustain growth rates in SME loan portfolios for years to come if they could understand well this particular market segment and change their banking practices to effectively cater to the needs of small businesses.

**Box 4.3: How Big is the Potential Market for Providing Credit to SMEs?**

Although it is impossible to precisely quantify the overall demand for credit by small businesses in Pakistan, an approximation can be attempted by extrapolating from the results of the 2005 KfW urban demand survey. According to Small and Medium Enterprise Development Assistance estimates, there are close to 3.2 million micro, small, and medium-size enterprises in Pakistan.

Close to half of all businesses surveyed required external financing of Rs 100,000–5 million. (Eighty-two percent of respondents needed loans for working capital and 61 percent of this demand fell into the Rs 100,000–5 million range; 40 percent of the respondents needed loans for fixed capital, of which 74 percent fell into the Rs 100,000–5 million range.) Fifty percent (61 percent of 82 percent) of SMEs require financing in the Rs.100,000–5 million range, and there are around 1.6 million such enterprises. However, not all of these will qualify for bank loans.

Assuming that 70 percent of firms that want to borrow are creditworthy and that 70 percent of these are borrowing at the same time, there are around 8 million eligible SMEs in Pakistan. All of these clients want to borrow working capital, and around 500,000 want to borrow to finance fixed investments. For the sake of simplicity, it is assumed that fixed investment borrowers are a subset of the larger group needing working capital and only 20 percent of all potential borrowers will get a parallel loan.

Survey results indicated that, in the case of working capital, 85 percent of clients require loans in the 100,000–1 million range, while 15 percent require loans of up to Rs 5 million. In the case of fixed investments, loan requirements are nearly evenly split. Forty-nine percent of clients wish to borrow in the lower range, while 51 percent want to take out a loan of between Rs 1 and 5 million.

**Amounts and Purposes of Loans Required by Small Businesses**

| Loan Purpose      | Lower Range<br>(Rs 100,000–1 million) | Upper Range<br>(Rs 1–5 million) | Total Borrowers |
|-------------------|---------------------------------------|---------------------------------|-----------------|
| Working capital   | 680,000                               | 120,000                         | 800,000         |
| Fixed investments | 78,400                                | 81,600                          | 160,000         |

The absolute minimum total loan volume required by small businesses can be derived by multiplying the number of borrowers in each category by the minimum loan amount. In other words, all lower-range borrowers are assumed to require only Rs 100,000. Upper-range clients are assumed to require exactly one loan of Rs 1,000,000 each.

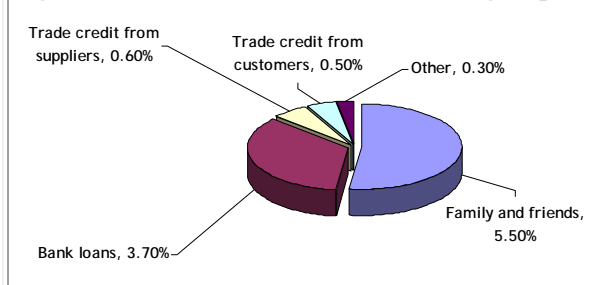
**Minimum Credit Needs of Small Businesses in Pakistan**

| Loan Purpose      | Lower Range<br>(Rs 100,000–1million) | Upper Range<br>(Rs 1–5 million) | Total Credit Needs     |
|-------------------|--------------------------------------|---------------------------------|------------------------|
| Working capital   | 68,000,000,000                       | 120,000,000,000                 | 188,000,000,000        |
| Fixed investments | 7,840,000,000                        | 81,600,000,000                  | 89,000,000,000         |
| <b>All loans</b>  |                                      |                                 | <b>277,000,000,000</b> |

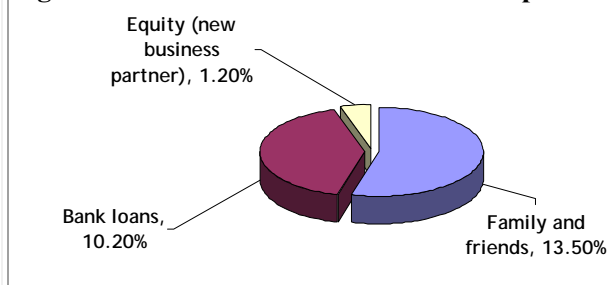
While calculating the total credit demand, only minimal loan amounts were taken into account for working and fixed capital needs. Hence, the total credit demand can be safely rounded up to close to Rs 300 billion and perhaps even higher.

**SMEs use limited bank funding for both working capital and fixed investments; formal funding is even more limited for small than for medium enterprises.** Approximately 89 percent of working capital and 75 percent of fixed investments were financed from retained earnings in 2003-05 and the percentages are even larger for micro and small enterprises: 90 percent for working capital and 81 percent for new investment (Figures 4.2 and 4.3). Microenterprises also do not substitute banks with MFIs, but rather borrow more from family and friends. This is explainable by the more acute gap that there is in the market for loan sizes between Rs 100,000 and Rs 5 million (equivalent to between \$1,280 and \$64,000). This segment is also not served by banks for the reasons mentioned above, or by the microfinance sector, which is legally bound to lend up to Rs 100,000 and traditionally focused on the lower end of the market.

**Figure 4.2: External Sources of Working Capital**



**Figure 4.3: External Sources of Fixed Capital**



Source: KfW Demand Survey 2005

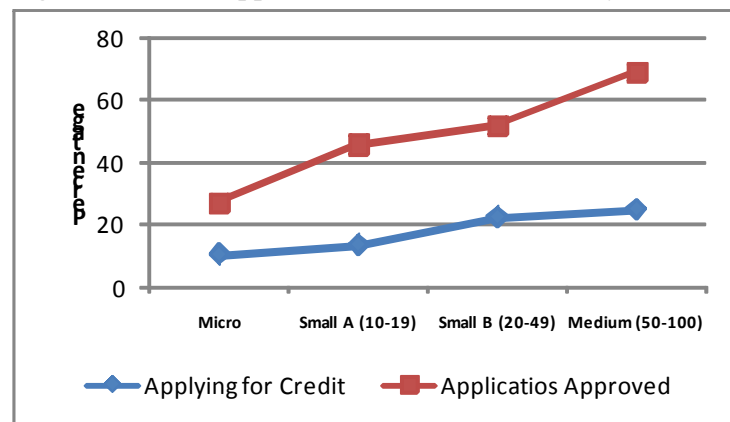
**Not only do microenterprises apply less frequently for loans; when they do, they are much more likely to be rejected than medium ones.** Access to credit becomes progressively more constrained as the size of the enterprise becomes smaller: only 10.7 percent of microenterprises applied for credit compared with 25 percent of medium enterprises, and nearly 75 percent of them were refused a loan whereas over two-thirds of medium enterprises managed to secure the loan for which they applied (Figure 4.4)

**Table 4.4: Ease of Obtaining Credit 2002-04**

|                  | 2002 (%) | 2004 (%) |
|------------------|----------|----------|
| Very easy        | 0        | 27.8     |
| Fairly easy      | 33.3     | 25       |
| Fairly difficult | 27.3     | 16.7     |
| Very difficult   | 39.4     | 30.6     |
| Total            | 100      | 100      |

Source: KfW Demand Survey 2005

**Figure 4.4: Loan Application and Disbursement by Firm Size**



Source: KfW Demand Survey 2005

**Enterprises do not seem to be excluded from financial markets because of poor performance.** The European Commission survey reports that 60 percent of the SMEs have profit margins in the range of 5-10 percent, while 12 percent have higher profit margins of 15-20 percent. This is corroborated by SME owners' favorable perceptions of their own business performance in the preceding two years (2003-05). Over 60 percent think that business has improved, while only 12 percent think that business has declined (Table 4.5). It would seem that many SMEs are excluded from financial markets not because of bad performance but because of a gap in the market.

**Table 4.5: Business Development in the Past 24 Months**

|                        | Micro | Small A<br>(10-19) | Small B<br>(20-49) | Medium<br>(50-100) | Total |
|------------------------|-------|--------------------|--------------------|--------------------|-------|
| Declined significantly | 3.7   | 4.2                | 2.2                | 1.9                | 3.3   |
| Declined somewhat      | 8.9   | 8.4                | 10.8               | 7.7                | 9     |
| Remained the same      | 30.7  | 13.7               | 23.7               | 30.8               | 26.3  |
| Improved somewhat      | 39.6  | 38.9               | 33.3               | 26.9               | 37.1  |
| Improved significantly | 17    | 34.7               | 30.1               | 32.7               | 24.3  |
| Total                  | 100   | 100                | 100                | 100                | 100   |

Source: KfW Demand Survey 2005

sources, SMEs rank banks only third, after nongovernmental organization MFIs and family/friends. Other sources are preferred because of lower direct and indirect costs (50 percent), because banks do not offer Islamic banking products (24), and because banks require a lot of collateral (10 percent). Direct costs include interest and fees, indirect costs the cost of producing the required documents, time the owner needs to spend with bank officials, and length of the process, which translates in missing earning opportunities)

**Banks require immovable collateral almost exclusively.** Firms interviewed in the 2007 ICA survey reported that banks accept almost exclusively immovable assets and personal assets of the owner (also mainly immovable assets) as collateral; 92 percent of the interviewed SMEs had to provide immovable assets only or immovable and movable assets, with the latter in a secondary amount.

**Table 4.6: Demanded Loan Product Features**

|   | Mean |
|---|------|
| Low direct and indirect cost                                | 4.37 |
| Convenient repayment period                                 | 4.39 |
| Absence of requirement for immovable property as collateral | 3.94 |
| Convenient location of financial institution                | 3.81 |
| Quality of service of financial institution's staff         | 3.75 |
| Availability of other financial services from same provider | 3.63 |

Source: KfW Demand Survey 2005

important" and 5 being "very important" (Table 4.6). For the respondents, low direct and indirect cost and convenient repayment period are the most important features of a loan product and must be emphasized in the design of a loan product. The constraints to improving SME access to finance are noted in section 4.3.

#### 4.3. Constraints to Improving SME Access to Finance

**Pakistani banks treat SMEs as large corporate enterprises, when in fact SME lending has more similarities with consumer finance.** In recent years, SME lending in relative terms has decreased, while lending to corporate and consumer finance have grown. This is mainly because banks make little or no distinction between larger corporations and SMEs in terms of product and procedures. Similarities between consumer and SME finance include low-value transactions and sensitivity to loan delivery time. However, unlike consumer finance, SME lending requires a more individualized assessment of cash flows, because SMEs often have limited and sometimes inaccurate written statements.

**SMEs are characterized by limited formality and are sensitive to loan delivery time and complex procedures.** SMEs are usually small, family-owned businesses, run and managed by one or two people taking full responsibility for all aspects of the business. These individuals typically know their business well but lack the skills to produce written business and financial plans and are discouraged by the extensive documentation requirements of banks. Moreover, when such enterprises require financing, they

**When asked, SMEs state that banks are only the third preferred source of borrowing, mainly because of high direct and indirect costs and complex products.** Of the 85 percent of the sample that did not apply for credit in 2002–05, the majority (54 percent) cited availability of other sources of financing as the reason.

When asked to rank their preferred

**These findings are corroborated by the features that SMEs look for in loan products: low direct and indirect costs, convenient repayment periods, and no requirements for immovable collateral, in very close order.**

Respondents assessed the importance of each aspect of borrowing on the scale of 1 to 5, 1 being "least

usually need it immediately, because their management rarely plans operations far in advance. It also is common that these enterprises have limited or no formal credit history, lack formal financial statements, and possess few immovable assets. Business and household finances are strongly intertwined, and are mainly cash. It should be noted that the banking needs of SMEs are very different from those of large corporations, and even among the SMEs, product preferences differ significantly.

**Large volumes, efficiency, and quality are key to profitable small business lending.** To profitably serve SMEs, banks need to minimize transaction costs and generate a large number of high-quality loans. As in similar activities with small profit margins, banks need to increase revenue by making many loans while lowering expenses—for example, by making loan officers more productive and avoiding bad loans.

**An incomplete legal and regulatory framework and lack of SME-friendly products and procedures hamper increased SME lending.** Banks in Pakistan find it difficult to serve SMEs profitably for several reasons. First, the legal and regulatory framework (namely, the secured transactions regions and, to a lesser extent, the credit information infrastructure) limits the pool of potential applicants. Second, lending products and bank procedures are more suited to large corporations than smaller enterprises. Finally, banks do not have organizational structures and monitoring tools conducive to achieving high efficiency.

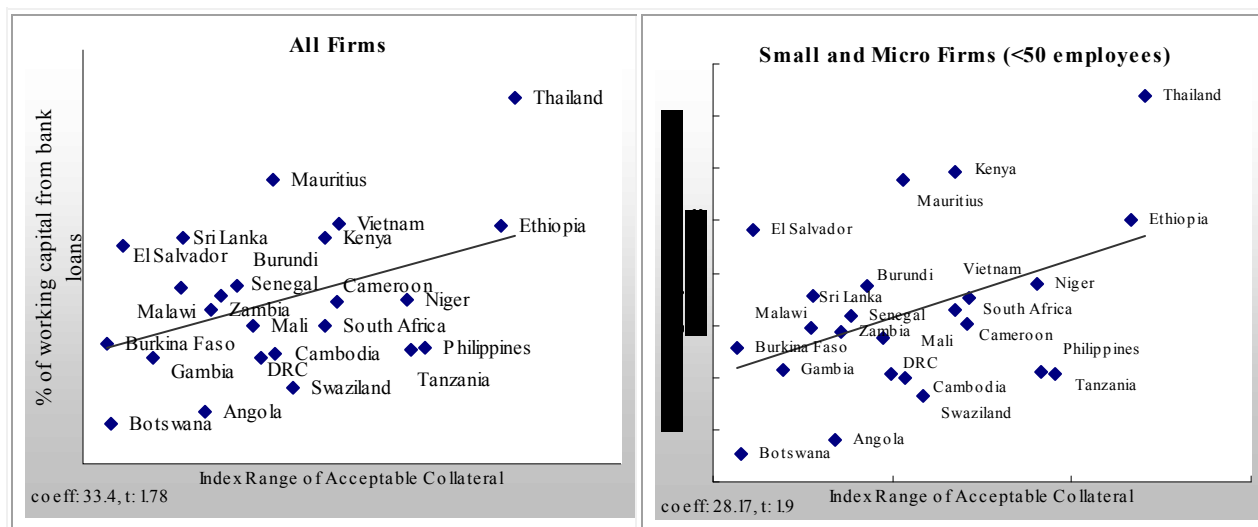
**In spite of substantial improvements of the legal and regulatory framework, work remains to be done in the area of secured transactions.<sup>65</sup> Progress has also been substantial on creating credit bureaus, though more could be done to facilitate the creation of credit histories by SMEs.** In spite of the reform that the GOP and SBP initiated five years ago, there is still no coherent secured transactions regime and no registry where unlimited liability companies can register a lien on movable assets. SBP has tried to compensate for this by waiving collateral requirements for very small loans (SME prudential regulation). However, banks have proven to be too risk averse to take full advantage of the regulation and still prefer loans collateralized with immovable assets. Both a well-functioning secured transactions regime and a more complete credit information system could help gap the bridge between demand and supply of SME lending.

**An effective secured transactions regime plays a vital role in a country's financial system.<sup>66</sup>** By expanding the pool of assets that can be offered as collateral, a secured transactions system can help expand financial access for those who were previously excluded or had only limited financial access. Furthermore, a reformed secured transaction regime can promote access to credit and allow credit to be extended on better terms, by improving transparency in determining the debtor's creditworthiness and by increasing security in establishing claimants to collateral. Empirical evidence from a number of developing countries suggests that an increase in the index of acceptable collateral is associated with better financial access to bank loans for firms, including for SMEs (Figure 4.5).

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<sup>65</sup> SBP, in cooperation with ADB, have recently completed a detailed study on improving the secured transactions regime and the public registry office, incorporating issues of the creation of interest over movable assets and charge for SMEs and rural finance.

<sup>66</sup> Secured transaction is defined as any transaction, regardless of its form, that is intended to create a security interest in personal property or fixtures, including goods, documents, and other intangibles. A security interest is a right given to one party in the asset of another party to secure payment or performance of an obligation. Collateral constitutes the assets over which security is granted

**Figure 4.5: Bank Access Increases with a Wider Range of Acceptable Assets to Secure a Loan**

Source: World Bank (2008a)

Note a: A cross-country regression of the % of firms with working capital funded by bank loans on the index of acceptable collateral shows that a 10% increase in the index is associated with a 3.3% increase in firms using bank loans to fund working capital (t-stat: 1.78.)

Note b: A cross-country regression of the % of small firms with working capital funded by bank loans on the index of acceptable collateral shows that a 10% increase in the index is associated with a 2.8% increase in small firms using bank loans to fund working capital (t-stat: 1.78.)

**The existing secured transactions system has major deficiencies that limit, in particular, SME use of movable collateral.** Key components of an effective secured transactions regime are:

1. Creation: establishing a claim to property to secure payment of credit
2. Priority: determining ranking of claims over collateral
3. Publicity: making priority interests publicly known
4. Enforcement: repossessing collateral and selling it for satisfying claims

Annex 4.2 presents a detailed analysis of the secured transactions regime in Pakistan, and underscores several shortcomings of the system including certain legal provisions that slow down enforcement, the lack of specialized courts, and the absence of a comprehensive, single registry for all moveable charges in respect of all types of debtors (corporate or otherwise). The system's main limitations include:

*Multiple laws and systems:* In Pakistan, there is no simple, unified statute pertaining to the creation of security over movable property. The multiple laws and systems create uncertainty and difficulties in using movable property as collateral. Another important limitation is that the debtor must possess any collateral being pledged. In addition, the legal framework for enforcement against not-yet-existent collateral is weak. This affects the use of agricultural products (such as future crops), inventory, or after-acquired property as collateral, and would make it difficult for many small businesses that do not have a significant amount of other classes of assets beyond after-acquired property to obtain secured credit.

*Availability of secured transactions over movable property only to registered companies:* Another important limitation is that the system of secured transactions over movable property is available primarily to registered companies only. This is because the registration of security interests is generally only available for registered companies (unless the assets being used are themselves subject to registration), and not for any other organizations or business entities falling outside of the Companies Ordinance, 1984. This strongly discriminates against small businesses, which are not registered companies.

*High transaction costs:* There is no unified registry for all types of security interests granted by all types of entities on all types of movable property. Pakistan has a mixed system of Asset-Based Registries and an Entity-Based Registry. Not all registries operate on a notice filing basis and entire agreements need to be filled. In addition, presently, only the companies' registry is available online and is networked across the country. With a paper-based system, verification of collateral becomes a time-consuming process that does not allow potential lenders real-time searches of existing liens. This substantially increases the transaction costs of filing security interests.

*Slow enforcement process:* Enforcement of debt recovery is slow in Pakistan. A security holder has to file a suit in court to recover his claim. However, for financial institutions, expedited procedures are available under the Financial Institutions (Recovery of Finances) Ordinance, 2001. But even in these cases, should the debtor dispute the enforcement by the creditor (which is usually the case), a fairly lengthy court procedure will ensue. In practice, if a financial institution is enforcing its security right under the special summary procedures, it would take one and a half to two years for the enforcement to be completed. In other cases, it may take 10–15 years or more. By this time, most movable property would have lost its value, thus discouraging financial institutions to accept such collateral.

**Having a formal credit history is particularly important for SMEs, which are often less known entities to the banking community.** Credit registry, through which lenders share information about their clients' repayment records, is an established way of enhancing the ability of borrowers to signal a good credit record. Credit registry is even more important for SMEs, many of which have had limited contact with the banking community (64 percent of the Pakistani SMEs do not have a bank account), less formal accounts, and a more limited ability to produce a written business plan. While progress on the credit infrastructure has been substantial, work remains to be done. In particular, the inclusion of information from utilities and telecom providers in the registry could greatly facilitate the creation of credit history for SMEs. This information could then be used as the platform through which SMEs can in the future show a track record of repayment to banks.

**Bank procedures and policies used for SME lending are too complex, making them time consuming and costly for both parties.** Banks apply the same rules and policies to small enterprises as they apply to large corporations; as a result, a typical small business loan requires up to 27 steps for the bank (or 20 hours) and nine meeting with clients (or 10 hours of the potential borrower). Total time taken to obtain a loan can vary from 30 to 45 days on average. Such long and expensive procedures limit the number of loans that can be made a month per loan officer. Furthermore, it translates into missed business opportunities for SMEs, because the manager/employee must spend time away from the business to complete procedures to obtain a loan. In addition to these high transaction costs, indirect costs in terms of legal fees, collateral registration, and documentation make bank lending expensive for SMEs.

**Banks have limited specialization in SME lending and no measures of SME business performance.** Banks further shy away from SMEs due to lower value per transaction and distinctive features of SMEs, which are considered an additional credit risk. Bank SME lending is thus mainly driven by risk concerns and no attention is

**Table 4.7: SME Application Process for Bank Loans**

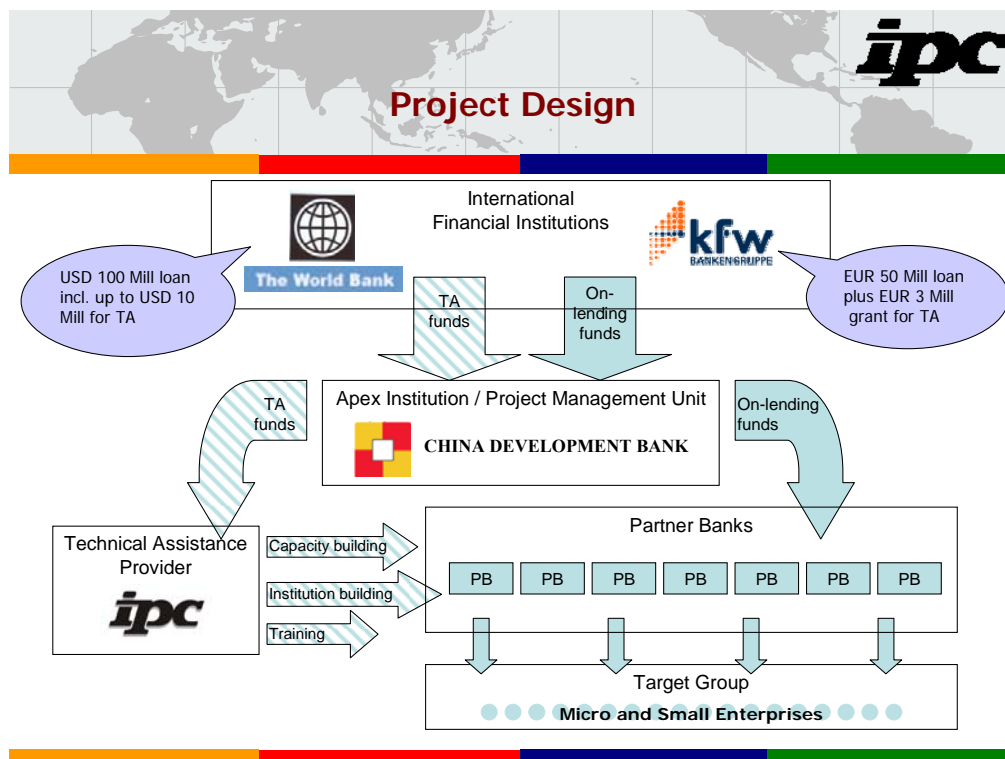
| Indicator              | Average Number |
|------------------------|----------------|
| Steps                  | 27             |
| Meetings with borrower | 9              |
| Staff involved         | 8              |
| Borrower time (hours)  | 10             |

*Source:* Authors' calculations.

really paid to efficiency, which is the key to serve this particular market segment profitably. Risk concerns must carefully be balanced against considerations of customer orientation and efficiency when designing products and procedures for small clients. To achieve higher efficiency, specialization of staff, training, and procedures are essential. In Pakistan, banks do not engage sufficiently in such practices.

#### Box 4.4: China SME Lending Project

Since 2005, China Development Bank has sponsored technical assistance programs with lines of credit to encourage banks to increase SME lending. The program, which is funded by KfW and the World Bank, includes both privately and state-owned banks. The key components of the program are represented graphically below. As illustrated, each participating bank signs a binding performance agreement (indicating, for example, how many loan officers will be devoted to the new product, how many loans will be disbursed per month, and the PAR to which the banks commit).



About 12 banks in China have participated in the program, and six of them have already successfully graduated. All banks have some sort of local government or government enterprise ownership, except for one bank, which is fully privately owned.

The program has achieved very impressive results: as of June 2008, three years since the start of its operation, \$380 million had been disbursed with an average loan size of less than \$10,000 and PAR for less than 30 days at less than 1 percent. The program had expanded to 15 regions and 42 percent of the loans had been disbursed in rural areas. Product profitability assessments show that most participating banks broke even within two years of starting the micro, small, and medium enterprise (MSME) loan business. The most profitable bank had a return on assets of more than 4 percent after three years of operation.

There are various incentives for banks to join the program. First, MSME lending is profitable and the consultant working with the bank helps the bank to build a model that can track that lending. Second, lending to MSMEs allows the participating banks to diversify their portfolio and hence their risk. Third, the technical assistance provided under the program forces bank management to think of their risk management practices for all lending products (although changes are introduced only for MSMEs). Lastly, participating banks mitigate financial risks by diversifying their sources of funds with sub-loans from the China Development Bank.

Key features behind the success of the products include: (1) an efficient decision-making process, thanks to which a customer usually gets a small loan within three days; (2) equal loan repayments required to be made by customers every month, allowing the bank to closely monitor the risk especially in the early days; and (3) flexible collateral requirements make micro loans more accessible to smaller clients. In some cases, collateral requirements are waived altogether.

Source: Discussion with *Internationale Projekt Consult (IPC) GmbH*, World Bank staff, and China Development Bank.

Most Pakistani banks do not have specialized loan officers, training, and procedures for SME lending. Additional efficiency gains could be achieved by measuring this type of lending and aligning staff rewards to the quality of the portfolio they manage. Even though Pakistani banks have sophisticated management information systems, they do not currently use them for monitoring the efficiency of individual staff members and lending departments, and staff rewards are usually unrelated to their performance. An example of a successful downscaling program for banks is presented in Box 4.4.

#### 4.4. Helping Banks Serve SMEs

***To bridge the gap between supply and demand, the GOP and SBP could continue to promote an enabling environment that facilitates SME lending.*** This includes, first and foremost, creating a complete and well-functioning secured transactions regime. Security interests over movable assets should be easy and allowed on most assets and by every entity (both physical and juridical persons). Priority rankings should also be clearly defined among those who might have claims on property offered as collateral. The new secured transactions regime should also include a place (such as a registry) for making priority interests publicly known, and enforcement of security interests for all assets should be fast and cheap. Secondly, to facilitate the creation of a credit history for SMEs, SBP should also ensure that the credit bureau collects information from utility and telecom companies. Thirdly, to facilitate SME lending monitoring, SBP should mainstream the piloted reporting requirements and simplify bank reporting for SME portfolios to include volumes and number of loans only in four sub-brackets (Rs. <2M, Rs. 2-6M, Rs. 6-25M and Rs. 25-75M).

***The GOP should also continue to promote initiatives aimed at proving a demonstration effect, since an enabling environment is a necessary but not sufficient condition for SME lending expansion.*** These include attraction to the market of an institutional investor that has a track record in SME lending. This should ideally be achieved by selling the SME bank or giving controlling rights on its board to an institutional investor. To stimulate competition in the market from the very beginning, the GOP could also support long-term technical assistance programs for selected banks. As illustrated by the China MSME lending program (see Box 4.4), for this program to be successful, the GOP needs to ensure correct market incentives are in place. Key features of programs that have worked include:

*1. Long-term technical assistance is required to ensure that the necessary substantial changes take place.* Lending to small businesses requires profound changes in the way commercial banks operate. With its high transaction costs, small business lending is only profitable if done in high numbers with excellent portfolio quality. It is therefore important to provide banks long-term support in this challenging process. Technical assistance to improve lending technology should focus on: reducing transaction costs for both the bank and the client, increasing loan officer productivity (in terms of number of loans disbursed), and maintaining high portfolio quality.

*2. Selection of bank advisors and content of the technical assistance are key to success.* The technical assistance package should be comprehensive, because the changes that are required are substantial. In addition to its scope, the success of the technical assistance program will depend upon three elements: selection of committed banks, selection of consultancy firms with a strong record in banking, and close monitoring by a fully dedicated and experienced staff. The technical assistance should include redesigning bank products to meet client needs, a robust management information system, and use of staff incentives linked to their performance.

*3. A mix of committed banks should participate in the program to create competition among them.* Technical assistance should be provided only to those banks that are fully committed to SME lending. Serving such enterprises requires a change in the entire corporate culture and in the way banks operate. Thus, only banks whose investors are willing to engage in such substantive transformations should be

offered technical assistance. Often, banks with a large banking network and a focus on retail lending have a comparative advantage in entering this market segment. Smaller banks could also be targeted, however, to act as catalysts. Many countries have developed specialized SME programs in state-owned banks with large networks. However, success usually takes a few years, because, as was just noted, the changes required are substantial and banks take time in implementing them. It is therefore essential that technical assistance be also given to small, faster-moving private banks, which transform at a faster speed but may reach stagnation due to their smaller networks.

*4. Performance agreements for banks participating in the program are key.* Furthermore, performance agreements should also incorporate terms on the number and volume of loans disbursed and outstanding by a given date, as well as portfolio quality indicators such as keeping PAR over 30 days to less than 3 percent. The technical assistance should last at least two years and performance agreements should be monitored on a monthly basis so that timely remedial measures could be undertaken when targets are not met.

In sum, while policy efforts have had some success, more work is needed, especially on bank downscaling products. Few SMEs in Pakistan borrow from banks, as compared with SMEs in other countries in the South Asia region including India and Bangladesh. In spite of substantial improvements of the legal and regulatory framework, work remains to be done in the area of secured transactions. Progress has also been substantial on credit bureaus, though more could be done to facilitate the creation of credit histories by SMEs. Access to finance for small and micro enterprise is particularly stalled. Yet those are the entities most likely to contribute to employment and poverty reduction. Together with micro-clients, discussed in the previous chapter, and remittance clients, the object of the following chapter, the underserved micro and small enterprises require urgent policy making to expand access to finance.