Policy for

Promotion of SME Finance

Infrastructure, Housing & SME Finance Department

State Bank of Pakistan

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Executive Summary

Banking industry of Pakistan started focusing on small and medium enterprise (SME) sector during the period of 2004-2006 because of which SME financing (Rs. 408 billion) reached at 17 percent of total private sector financing by banks & DFIs in December 2006. However, following the economic slowdown since 2007-08, SMEs became less profitable and highly risky ventures for bankers. SBP has been making efforts and playing supportive role due to which SME financing started rising from 2013. The outstanding SME financing crossed Rs 400 billion in December 2016 compared to Rs 284 billion in December 2013, which was 9 percent of total private sector credit.

SBP initiatives to support SME financing mainly include i) improving regulatory framework through revising prudential regulations, strengthening secured transactions framework and introduction of SME targets, ii) market development through SME supportive subsidized refinance schemes, risk coverage scheme, Islamic SME financing, cluster surveys and non financial advisory service and iii) improving capacity building and awareness creation of bankers and SMEs.

Under National Financial Inclusion Strategy (NFIS) and strategic direction of SBP, SME sector has been identified as one of the key priority areas. In line with the strategic direction of SBP, key benchmarks to be achieved by 2020 are i) to increase SME share from existing 8 percent of private sector credit to 17 percent and ii) to increase number of borrowers from existing 174,000 to 500,000.

In order to achieve these objectives, a policy has been prepared for promotion of SME finance (conventional & Islamic) in Pakistan. There are 9 key pillars of this policy which include improving regulatory framework, upscaling of micro finance banks, risk mitigation strategy, simplified procedures for SME financing, program based lending & value chain financing, capacity building & awareness creation, handholding of SMEs, leveraging technology and simplification of taxation regime.

Overview of SME Finance in Pakistan

State Bank of Pakistan (SBP) gives immense importance to priority sectors of the economy due to their economic and developmental contributions in Gross Domestic Product (GDP), employment generation and poverty alleviation etc. Among the priority sectors, the small & medium enterprises (SMEs) take a central role as they play an important role in an economy. SMEs dominate the world economy in terms of number of firms operating within the sector and employment generated by this sector. Significance of SMEs is also evident from the fact that they constitute over 90 percent of estimated 3.2 million business enterprises in the country[1]. In overall macroeconomic terms, SMEs (defined on the basis of number of employees) contribute 30 percent to GDP of the country and 25 percent in export earnings, again endorsing the significance of the sector to our economy.

The period 2002-07 was a take-off period for SME credit market in Pakistan. In the aftermath of 9/11, the banking system received a huge influx of liquidity that needed to be placed in profitable avenues. However, overall in those years, the government's appetite for bank funding was subdued. Therefore, banks increased their lending operations, and significantly expanded their menu of products as well as clientele. SMEs were amongst the major beneficiaries. This period was also characterized by an extremely conducive macroeconomic environment for businesses.

The favorable macroeconomic and investment conditions began to deteriorate from 2008 and onwards (the crises period). Not only the global financial crisis triggered an uncertainty, but the growing security concerns and widening energy imbalances in the country also strongly dented domestic business prospects. During this time, overall SME sector suffered from the spillover impact of sluggishness in the larger corporate sector. SMEs could not address their cash flow constraints by borrowing from banks due to high interest rates and their reluctance to lend to SMEs due to rising bad debts. This primarily explains the risk aversion of banks to SME lending and their preference to stay distanced from the SME development agenda (during 2009-2013). During this time, the overall macroeconomic environment was also not favorable. An additional factor of high fiscal burden significantly increased government's appetite for funds from the banking system.

From 2013 and onwards, overall macroeconomic conditions started improving. The situation has favoured the SMEs in conjunction with the support of SBP's facilitative role to enhance access to credit.

[1] SME Policy 2007, SMEDA - Ministry of Industries, Production & Special Initiatives, Government of Pakistan

As of December 31, 2016, total number of SME borrowers stood at around 177,000 and outstanding SME financing of banks/ DFIs was Rs 401 billion[2] showing an increase of 31 percent on Y-o-Y basis. The share of SME lending as percentage of total credit to private sector was 9 percent as of Dec 31, 2016.

International experiences

SME sector development is a cross-cutting area in wider global agenda such as climate change, gender empowerment, and poverty reduction. Countries like India, Turkey, Germany, Japan, Bangladesh and South Korea have taken effective measures to promote access to credit to SMEs which have shown improved results. A comparison of SME initiatives taken by India, South Korea, Germany and Bangladesh is appended at Annexure-I.

SBP's Interventions for Promotion of SME Finance

Given the importance of SMEs in economic development, SBP has adopted a facilitative role, to encourage smooth flow of financing to SMEs. In this regard, SBP has taken following initiatives:

- A separate set of prudential regulations specifically for SME sector was issued by SBP in 2003 with a revision in 2013 wherein small enterprises (SEs) and medium enterprises (MEs) were separately defined and more specific and simpler regulations for SEs and MEs were prescribed.
- SBP facilitated approval of "The Financial Institutions (Secured Transactions) Act, 2016[3]" from the Parliament to facilitate SMEs and agri borrowers to access credit from banking sector by using their movable assets as collateral.
- SBP assigned SME financing targets to banks and DFIs for the first time in 2016 in order to enhance access to credit to this sector. To cater to Islamic financing needs of SMEs, SBP is persuading Islamic Banking Institutions (IBIs) to extend financing by assigning them SME financing targets. SBP has also advised banks and DFIs to put in place proper structures with regards to SME financing.
- SBP is offering different risk coverage and refinance schemes for SMEs, details of which are given in Appendix-II. A brief of these schemes is given below:

[2] As per data reported to Infrastructure, Housing & SME Finance Department
[3] http://www.sbp.org.pk/smefd/2016/FinancialInstitutionsAct-2016.pdf

- SBP launched 'Credit Guarantee Scheme (CGS) for Small and Rural Enterprises' in March 2010 in collaboration with UK's Department for International Development (DFID). Under this scheme, risk coverage of upto 60 percent is provided against credit losses of participating financial institutions on their lending to micro, small and rural enterprises.
- In order to improve access to finance for women entrepreneurs in underserved areas of the country, 'Refinance and Credit Guarantee Scheme for Women Entrepreneurs in Underserved Areas' has been offered by SBP under which financing at subsidized rate (upto 5 percent) alongwith risk coverage is available for setting up of new businesses or expansion of existing ones.
- SBP has introduced SME-related refinance facilities for purchase of new imported/ local plant/ machinery and new generators, for adopting renewable energy projects using solar, wind, bio gas and other renewable energy sources and for storage of agricultural produce.
- SBP is facilitating federal government to promote SME financing in the country through mark-up subsidy and risk coverage schemes. Prime Minister Youth Business Loan Scheme is one of such schemes.
- SBP is also collaborating with provincial governments to facilitate in developing customized refinance and credit guarantee schemes in their respective provinces. SBP, in collaboration with Sindh Enterprise Development Fund (SEDF), has launched a 'M*ark-up Subsidy and Guarantee Facility for Rice Husking Mills*' in Sindh under which SBP provides the refinancing facility and SEDF provides mark up subsidy and risk coverage. SBP is supporting Government of Punjab in designing subsidized refinance scheme for BMR of SMEs in Punjab and credit guarantee scheme for small enterprises in Punjab.

Moreover, capacity building and awareness creation of bankers and SMEs are one of the key areas focused by SBP.

Though above mentioned efforts have brought improvement in SME financing portfolio of banks, however, a large number of SMEs are still financially excluded. In order to address this issue and enhance access to credit to SME sector, SBP has prepared a policy for promotion of SME finance.

Benchmarks for 2020

In line with strategic direction of SBP, following are the key benchmarks to be achieved till 2020:

- Increase SME share from existing 8 percent private sector credit to 17 percent by 2020
- Increase number of borrowers from existing 174,000 to 500,000 by 2020

Pillars of Policy for Promotion of SME Finance

Pillar # 1: Improving Regulatory Framework

Revision/ Amendments in Prudential Regulations

SBP continues to take measures to enhance access to finance for SMEs. Apart from number of other initiatives, SBP periodically revises/ amends its regulatory framework in line with changing market dynamics. Following are the revision/ amendments made under this policy:

- As per existing regulations, banks/ DFIs are maintaining general reserve equivalent to 1 percent of the secured Small Enterprise (SE) portfolio and 2 percent of the unsecured SE portfolio, to protect them from the risks associated with the economic and cyclical nature of this business. In order to facilitate SE financing, the general reserve requirement against unsecured SE financing is being reduced from 2 percent to 1 percent, while general reserve requirement against secured portfolio is being withdrawn. The above reserve requirement shall be maintained only for the performing fund based SE portfolio of banks/ DFIs.
- Condition of obtaining insurance for financing upto Rs 2 million (previously Rs 1 million) has been made optional for SE and ME financing.
- Program-based products (including those of Islamic banking) are now allowed to be approved by Chief Executive Officer (CEO)/ President/ MD of the bank/ DFI on the recommendation of the concerned committee.
- Banks and DFIs have been advised to formally establish and structure their SME banking research & development divisions.
- Simplified Loan Application Forms (LAF) for SE and ME have been developed in consultation with banks and other stakeholders which will be launched by Pakistan Banks' Associations (PBA). Since these forms cover all information required in Borrowers Basic Fact Sheet (BBFS), therefore, requirement to take BBFS separately under 'Regulation SME R-2: Borrowers Basic Fact Sheet and e-CIB Report' has been withdrawn.
- Banks have been advised to reduce turn around time (TAT) for processing of SE loans from 30 working days to 15 working days (from the date of receipt of complete information). TAT for ME loans has been set at 25 working days from the date of receipt of complete information.

Relaxation in Credit Risk Weights to calculate CAR

Presently, SEs and certain MEs are considered under retail portfolio and are assigned 75 percent risk weight for the calculation of risk weighed assets (RWA) under Basel framework. However, banks have the discretion to treat them as corporate entities assigning these enterprises the risk weights as per their credit rating. Given the current risk weights, banks have to allocate a significant amount of capital against SME financing to meet the Capital Adequacy Ratio (CAR) requirement. Therefore, in order to avail this preferential risk weight of 75 percent, SBP has relaxed the eligibility criteria of retail portfolio by increasing the existing upper limit for retail exposure from Rs 75 million to Rs 125 million.

Targets for SME Financing

Under current target regime, SME financing targets are assigned to banks (including Islamic banking institutions (IBIs)) and DFIs on institution basis. SBP had advised banks & DFIs to allocate themselves region wise targets for 2017. From January 01, 2018, SBP will assign provincial targets for SME financing to banks (conventional and IBIs). SBP (BSC) offices will be involved in monitoring mechanism. Going forward (from January 01, 2019), gender-wise targets as well as separate targets for small and medium enterprises will also be assigned to banks and DFIs.

Refinance Facility for SMEs

SBP offers different refinance schemes through its refinance window to ensure adequate supply of cheap funds to different sectors. New refinance facilities for certain priority sectors have been introduced. These sectors include IT, furniture, surgical goods, dates processing, gems & jewellery, leather industry, fruits, vegetables & food processing and packaging, printing & packaging.

Pillar # 2: Upscaling through Microfinance Banks (MFBs)

It has been observed that due to very small loan of size of low-end SE borrowers, commercial banks are reluctant to lend to them. Moreover, microfinance banks (MFBs), being governed and supervised under Microfinance Ordinance 2001, can lend to micro enterprises upto Rs 500,000. Therefore, low-end SEs remain financially excluded. In order to address this issue, SBP is developing legal and regulatory framework for graduating eligible MFBs into MSE banks. In the meanwhile, financing limit of eligible MFBs has been increased from Rs 0.5 million to Rs 1 million. Such loans will also be eligible for risk coverage under existing Credit Guarantee Scheme. Moreover, there will be regulatory measures and caps applicable for eligible MFBs.

Pillar # 3: Risk Mitigation Strategy

Compared to corporates, SMEs are confronted with challenges such as low access to financial resources, low equity ratio and low profit margins which make them vulnerable to external shocks. Main reasons for reluctance of banks to lend to SMEs include i) lack of strategic focus on part of banks, ii) SMEs are perceived as high risk projects considering the industry's NPL ratio in SME credit, iii) fewer financing products/options for SMEs, iv) corporate finance mindset, and v) absence of SME R&D centers in banks. Proper risk management and mitigation strategies can help in identifying significant risks and their timely mitigation.

For the purpose of risk mitigation, SBP has been managing Credit Guarantee Scheme since 2010 to encourage lending towards collateral deficient borrowers by providing risk coverage to banks against their lending to such borrowers. Following changes are being made to improve risk coverage framework of SMEs.

Inclusion of low-end medium enterprises in Credit Guarantee Scheme (CGS)

The current Credit Guarantee Scheme is for small and rural enterprises only. Going forward, new low-end MEs will also be included under the scheme. In this respect, parameters and eligibility criteria will be announced inJanuary, 2018.

Establishing Credit Guarantee Company

It has been decided to convert the existing Credit Guarantee Scheme into a Credit Guarantee Company that will function as an independent entity. Consultants have been engaged for developing a business plan for the proposed Credit Guarantee Company. Efforts will be made to make the company operational by December 31, 2018.

Supporting Provincial Risk Sharing Schemes

SBP is coordinating with provincial governments to facilitate them in their efforts to enhance SME credit. In this regard, different provinces have approached SBP for provision of risk sharing facilities for lending to SMEs. SBP is facilitating the provincial governments in their refinance and risk sharing schemes.

Setting up of E-Registry

As discussed earlier, a new law named "The Financial Institutions (Secured Transactions) Act, 2016" has been passed and an E-Registry is in process of being established to facilitate SMEs and Agri borrowers to access credit from banking sector by using their movable assets as collateral.

Pillar # 4: Simplified Procedures for SME Financing

Simplification of Loan Application for SMEs

The lengthy documentation and complex loan application forms make potential SMEs to avoid formal banking channel. In order to facilitate SMEs to apply for the loans, as mentioned under Pillar 1, SBP, in coordination with stakeholders, has prepared separate simple application forms for SEs and MEs containing all key requirements. These forms will be launched from the platform of PBA. Moreover, credit processing time for SE loans has been reduced from 30 days to 15 working days only. Further, maximum turn-around-time for loan processing of MEs has also been fixed at 25 working days. Accordingly, requirement of Borrower's Basic Fact Sheet for SMEs has been withdrawn. Additionally, it is highly desired for banks to delegate the credit approval authority.

Small Enterprise Loan Documentation Manual

Banks may be facilitated by developing a simple document manual of all sample forms that banks require with an application form. Necessary training and awareness on these documents will be given to bankers as well as to SME clients to make them understand the banking procedures for easy access to finance. In this regard, PBA has been asked to coordinate with banks to prepare standardized SE loan documentation manual.

Pillar # 5: Program Based Lending & Value Chain Financing

It is highly desired to encourage program-based lending. For this purpose, banks/ DFIs may take benefit from cluster surveys arranged by SBP. Banks can study requirements of a cluster and then design customized products to cater to their requirements. Banks'/ DFIs' respective product programs may carry objective/ quantitative parameters regarding eligibility of borrowers. Banks/ DFIs will also have to develop strategies for improving delivery channels, adoption of credit scoring technology, improving understanding of the target market through field work and research, and putting in place strong marketing and SME sales teams.

Moreover, SBP encourages banks to initiate value chain financing (VCF). Going forward, banks will be assigned targets for VCF (as already done by SBP in agriculture financing). Banks have also been advised to establish and structure SME Research and Development (R&D) set-up to effectively undertake the above activities.

Pillar # 6: Capacity Building & Awareness Creation

Capacity building and awareness creation of bankers and SMEs is one of the priorities of SBP. SBP, in collaboration with other training institutes, regularly organizes capacity building programs for banks and SMEs. Special focus is being given to skill development of SMEs and improving their understanding of banking procedures. In this regard, National Institute of Banking and Finance (NIBAF) will take lead in imparting training programs. The awareness creation programs will be conducted by SBP (BSC) in coordination with SBP.

Further, a Centre of Excellence for SME banking & finance will also be established in collaboration with NIBAF and other institutions. This centre will work with renowned international and local institutions to impart quality training to banks (conventional & Islamic) and SMEs. The centre will also liaise with SMEDA and other financial institutions to create awareness on banking products.

Pillar # 7: Handholding of SMEs – Non Financial Advisory Service (NFAS)

Handholding of SMEs is one of the priorities mentioned in this policy. For this purpose, the 3S forum (SBP, SMEDA & SECP) will work together and prepare structured and coordinated yearly calendars/ programs for SMEs. SBP, in coordination with IFC and SMEDA, is trying to improve scope of NFAS. NFAS is expected to improve SMEs' accessibility to financial solutions and enhance the relationship between banks and SMEs.

Banks have been advised to introduce NFAS with the aim of developing the capacity of SMEs to better manage different aspects of their businesses. SBP will closely liaise with SMEDA to bridge the gap between SMEs and financial industry. This will enable banks to increase their customer base.

Pillar # 8: Leveraging Technology to Promote SME Financing

Use of technological innovations in SME finance paves the way for the banks to deliver their financial services to target clients at relatively low cost. The use of technology also reduces banks' cost of searching and exploring potential clients. Although branchless banking, internet banking and SMS alert services are becoming common, technology can further be used in other banking services like cash management (by integrating payrolls, trade credits & receivables), credit origination (through online credit applications) and other services.

Since Pakistan has been actively utilizing technology for improving its payment system, banks are encouraged to effectively use technology and branchless banking for promotion of SME financing through digital credit, client profiling, payment solutions, etc. Further, an innovation challenge fund will also be launched to explore new solutions to promote SME financing through technology. SBP will also be collaborating with universities and FinTech companies to initiate pilot projects for the purpose.

SBP has also recommended Ministry of Commerce to encourage SME startups to export their handicrafts and other items. In this regard, it is recommended to create a Marketplace Website for on-boarding these entrepreneurs on a single platform.

Pillar # 9: Simplifying Taxation Regime for SMEs

Small businesses are mostly owned by proprietors or partners who prefer to avoid inclusion in tax net. Therefore, due to lack of organized and formal structure, banks and DFIs are reluctant to finance these entities. Thus, a large part of small & medium businesses remain deprived of bank finance and resultantly fail to grow. The Technical Committee of SMEs (under NFIS) is deliberating to prepare recommendations to resolve the taxation issues of SEs and MEs. Some of these recommendations are as follows:

- Tax rate reduction on banks' income derived from SME financing
- Tax holiday on income of eligible start-ups and women SE borrowers (eligibility criteria and tenure for holiday to be finalized in consultation with Ministry of Commerce and Federal Bureau of Revenue)
- Reduction in sales tax on service sector SEs & MEs

Annexure-I

Country Specific SME Sector Initiatives

Below gives a comparison of SME initiatives taken by India, South Korea, Germany and Bangladesh.

Attributes	Countries			
	India	S. Korea	Germany	Bangladesh
Specialized Banks for SME Sector	✓	✓	✓	✓
Specialized Bank Branches for SME lending	✓	✓	✓	✓
Credit Guarantee Institutions	✓	✓	✓	✓
SME priority sectors advances / low interest rate lending to SMEs	✓			✓
Annual lending targets for SMEs	✓			✓
Composite loans by Banks to SMEs	✓			
• Term Loans	✓			
• Working Capital Loans	✓			
Cluster financing of SMEs	✓	✓	✓	✓
• Provision of specialized branches for clusters	✓	✓	✓	✓
Provision of Loans without collateral/ third party guarantees	✓			✓
Credit rating of SMEs				
• Mandatory				
• Optional	✓	✓	✓	✓
Provisions for debt restructuring of advances for sick units	✓	✓	✓	
Training Institutes for Entrepreneurs (supported by Financial Institutions)	✓	✓	✓	
Priority for Women Entrepreneurs				✓
Priority financing for Research and Innovation		✓	✓	
Financing support for SME sector exports		✓	✓	

Source: Country reports

Annexure-II

SBP's Refinance and Credit Guarantee Schemes for Promotion of SME Financing

Following refinance and credit guarantee schemes have been launched by SBP:

Refinancing Facility for Modernization of SMEs

Under this scheme, financing is available for the purchase of new imported/ local plant & machinery for balancing, modernization and replacement (BMR) of existing SME units and/ or setting up of new SME units and purchase of new generators of upto 500 KVA. Maximum period of financing is ten years including six months grace period. Mark up rate under the scheme is upto 6.0 percent (2 percent SBP refinance rate and 4 percent banks' spread).

Financing Scheme for Renewable Energy

Under this scheme, end borrowers can avail financing of up-to Rs 6 billion at a subsidized rate of 6 percent for upto 12 years for installation of upto 50 MW hydro, solar, wind, bio gas and other renewable energy projects. Further, the scheme also incentivizes establishment of small scale renewable energy solutions of less than 1 MW to promote solar usage among consumers.

Financing Facility for Storage of Agricultural Produce

Under the facility, financing is available at subsidized rate of 6 percent on long term basis for establishment, expansion and BMR of steel/ metal/ concrete silos, warehouses & cold storage facilities for storage of agricultural produce.

Refinance and Credit Guarantee Scheme for Women Entrepreneurs in Underserved Areas

In an effort to improve access to finance for women entrepreneurs in the underserved areas of the country, a refinance and credit guarantee scheme is offered by SBP under which financing is available for setting-up of new businesses or expansion of existing ones. SBP's refinance rate is kept at 0 percent while end user rate is upto 5 percent. Additionally, 60 percent risk coverage is also available against outstanding principal of banks. Under this scheme, financing limit is upto Rs 1.5 million for a period of 5 years. It is pertinent to mention that at least 20 percent limits have been allocated for financing in Balochistan.

Credit Guarantee Scheme for Small & Rural Enterprises (CGS)

SBP launched 'Credit Guarantee Scheme (CGS) for Small and Rural Enterprises' in March 2010 in collaboration with UK's Department for International Development (DFID). Under this scheme, risk coverage of upto 60 percent is provided against credit losses of participating financial institutions on their lending to micro, small and rural enterprises. The extent of risk coverage is linked with the level of loan collateralization. The lower the loan collateralization, the higher is the risk coverage extended under the scheme. Through this, the scheme aims to encourage lending towards fresh and collateral deficient borrowers. In addition to this, risk coverage of 60 percent is provided against all loans extended to women borrowers, start-up businesses and small, rural and micro enterprises operating in the under-served areas of the country.

Facilitation to federal & provincial governments

SBP is facilitating federal and provincial governments to promote SME financing in the country through mark-up subsidy and risk coverage schemes. Prime Minister Youth Business Loan Scheme is one of such schemes.

SBP, in collaboration with Sindh Enterprise Development Fund (SEDF), launched a 'mark-up subsidy and guarantee facility for rice husking mills' in Sindh. Under this scheme, SBP provides the refinancing facility and SEDF provides mark up subsidy of 4.75 percent plus risk sharing of 30 percent against lending for the purpose of BMR of the rice husking mills of Sindh. End-borrowers are 2 percent per annum, while banks are paid a margin at 4.75 percent.

SBP is also supporting Government of Punjab in designing a subsidized refinance scheme for BMR of SMEs in Punjab. Further, Punjab Government is evaluating the possibility of establishing a credit guarantee company in Punjab.

Further, SBP has held meetings with relevant departments of Government of Balochistan for facilitating them in launching a financing facility for priority sectors of Balochistan. Government of KPK has also been approached to consider offering such schemes in KPK.

Awareness creation and capacity building of SMEs are top priority areas for SBP. One of these initiatives includes organization of SME expo/ *melas* in various cities of Pakistan. SME expos/ *melas* are quite effective in engaging the local SMEs and in creating awareness about SBP financing schemes. Officials from SME associations actively and frequently participate in these expos/ *melas* and share the information about various challenges faced by SMEs along with proposing possible solutions. SBP BSC plays an active role in organizing and managing these events due to its presence in various regions.