SMALL & MEDIUM ENTERPRISES DEPARTMENT STATE BANK OF PAKISTAN.

SME FINANCE QUARTERLY REVIEW– FIRST QUARTER 2008

Issue 02

Special Points of Interest:

- International Best Practices in SME Finance
- Country in Focus; South Korea

Inside this Issue

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1- Overview

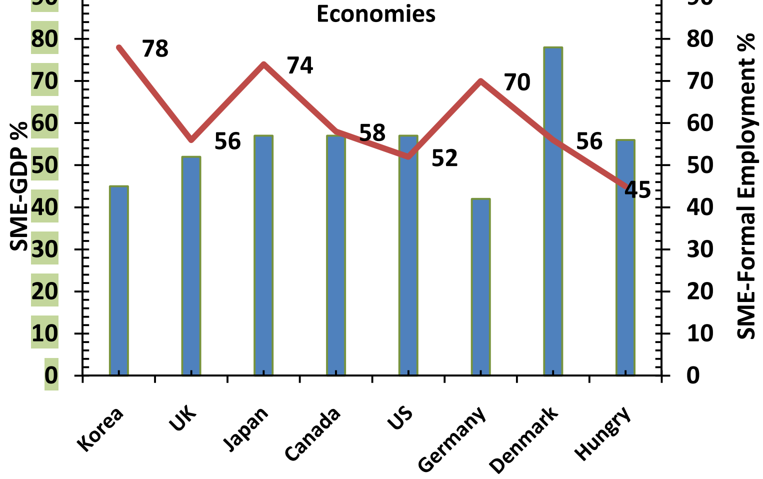
1.1 - SMEs; Importance for & Contribution to National Economy:

There is no denial to the fact that small and medium enterprises role in the economies of developed and developing countries has been of utmost importance. This sector runs the lifeline of economies of countries. SMEs significance becomes more prominent in social and economic development reflecting upon their peculiar characteristics associated with this segment of the economy. Employment generation, poverty alleviation, accelerated growth, bridging the gulf of income inequality , and formation of forward and backward linkages are the special features of SME sector in countries passing through an economic transition phase from developing status to developed one.

1.2 - International Perspective:

A synopsis of major developed and emerging economies reveal that SMEs have been serving as respirator in achieving the high standards of economic development. The contribution of this sector towards GDP, value addition, export earning and employment has been of immense importance in carrying forward the economic objectives of developing countries. Almost all the developed nations are benefiting from the valuable contribution of SME sector to the consolidation and promotion of their economies. Countries like USA, UK, Germany, Canada, and Japan have greatly focused and invested in SME sector which is paying the fruit in the form of greater contribution to economic development of these countries **See Figure 1.2**[1]. Likewise, emerging economies like China, Thailand, Malaysia, Brazil, South Korea and India etc. prominently personify the promising role of the SME sector in shining of their economies.

Figure No.1.2- Contribution of SMEs to International Economies



1.3 - SMEs; The Case of Pakistan:

Like many developing countries, in Pakistan, there are 3.2 million Economic Establishments[2], 44% in rural areas and 56% in the urban areas. Out of these, a total of 99.06% employed 1—10 persons, clearly indicating that these establishments fall under the definition of SMEs. Similarly, individuals own about 97% of such establishments, where 53% of the establishments belong to wholesale & retail trade and restaurant & hotel sectors, 20% are part of the manufacturing sector and 22% fall in community, social and personnel services sector. In Pakistan the SME sector is confronted with a number of demand and supply side constraints blocking the way for a smooth growth of this sector. SME sector issues pertinent to demand side comprises of Lack of book-keeping at SMEs, missing succession planning, rare strategic objective or business

[1] SMEs across the Globe: A New Database by Meghana Ayyagari, Thorsten Beck and Asli Demirgüç-Kunt
World Bank Review on Small Business Activities 2003.

[2] Economic Census of Pakistan-National Report May 2005(www.statpak.gov.pk)

planning, low level of financial literacy, unskilled human resource etc. While supply side obstacles constitute, Non aggressive lending strategies by Banks, absence of specific products offered for SMEs, perceived to be high risk area by banks etc.

2- SME FINANCE- A Snapshot

2.1 - Total Advances:

The banking industry's exposure towards the SME sector is the second largest after corporate finance. In Pakistan corporate sector takes away the major chunk of credit extended by the banking system. While SME finance follows by grabbing second biggest pie of total credits. At the end of first quarter of the current year the SME sector's outstanding credit stood at Rs. 403.4 billion in absolute terms. This constitutes about 14.5 % of total credit of banking industry **See Figure 2.1**. During the first quarter of current year a reduced growth of 7.7%, has been recorded in SME advances. The relative decrease in growth of the SME finance in first quarter of 2008 may be attributed to the seasonal variations and cyclic nature of businesses which receive the bulk of SME finance. At the same time a considerable portion of loans also matured in the first quarter of the year. However in absolute terms the advance in first quarter of the year 2008 stood at Rs 403.4 billion compared to March 2007 position of Rs. 387.1. This clearly shows that in absolute terms SME finance portfolio has increased during one year time at the end of March of 2008. For the last two years the SME sector has been witnessing a consistent low growth in SME finance due to a variety of factors such as higher inflation, economic instability, low level of banking industry eagerness to penetrate in the market, capacity constraints of banks to tap the potential market, and major demand side obstacles which are hindering the growth of SME sector in Pakistan.

2.3 - Facility Wise Financing:

The nature of financing facilities displays that major part of advances is utilized for working capital finance followed by trade finance and fixed investment respectively. Working capital finance accounts for 72.8%, trade finance 15.3 % and fixed investment 11.9% of financing to

Figure No.2.1-SME Total Outstanding Amount

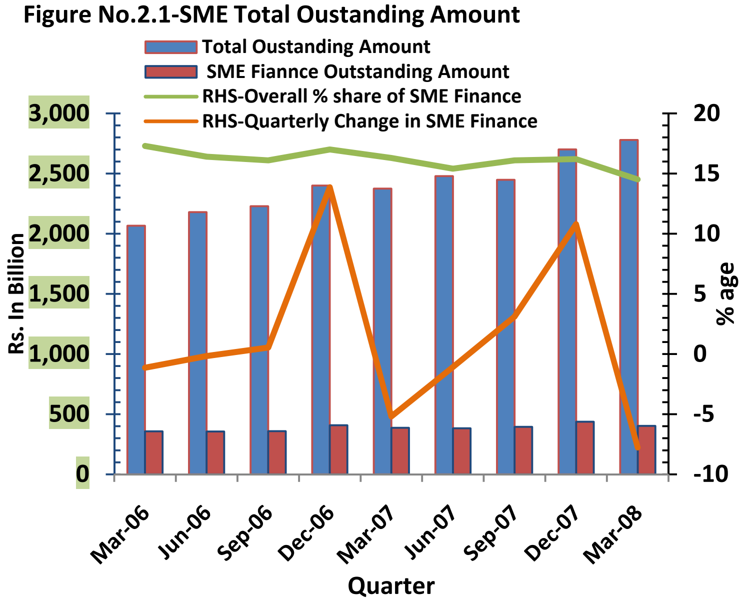
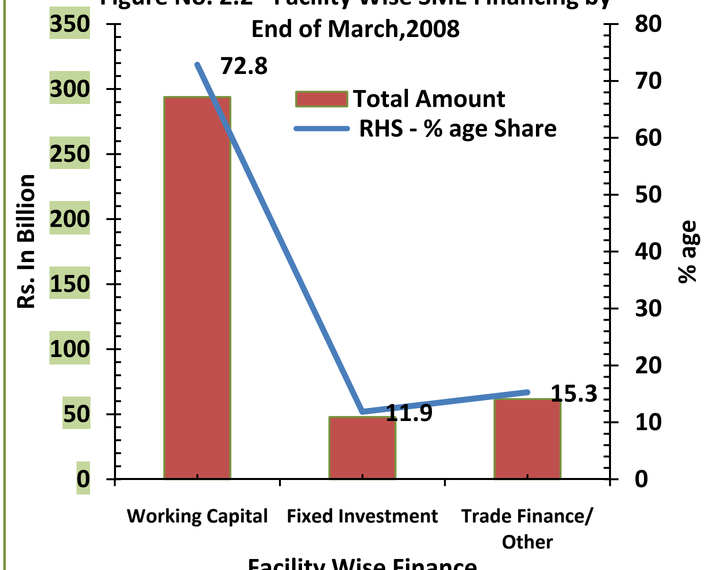


Figure No. 2.2 - Facility Wise SME Financing by End of March,2008

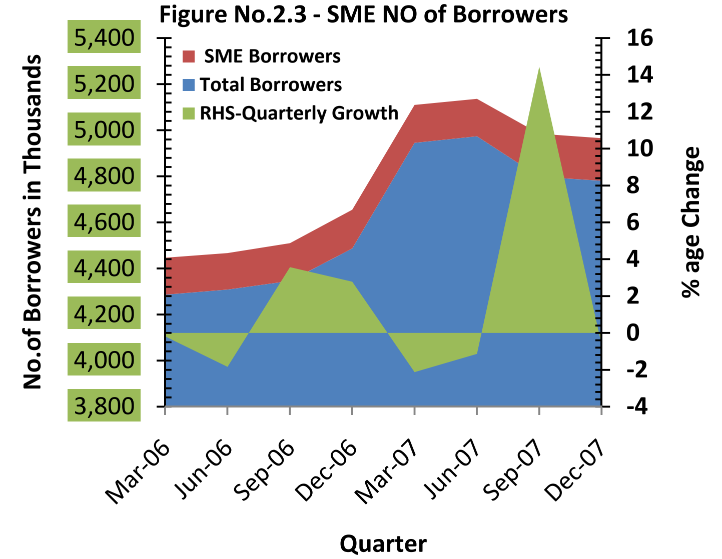


SMEs at the end of March 2008. The basic factor for the predominant portion of working capital finance is the SMEs lack of capital for inventory and day to day operations. While most of the SMEs do not have objectively defined plans for the expansion of capacity which is the main cause of meager share of long term finance as well. The absolute amount for working capital finance stands at Rs. 293.9 billion at end of March 2008, recording a growth of 4.9% for the first quarter of 2008, ***See Figure 2.2.*** Trade finance has received an amount of 61.6 billion showing 9.2% of growth followed by Fixed Investment of Rs. 47.9 billion at the end of March 2008.

2.3 - SME Number of Borrowers:

The outreach of banking industry has increased incredibly in the SME sector. The number of borrowers has shown promising momentum in past few years. At the end of December 2007 SME borrowers stood at 185,039, while at end of March 2006 the number of borrowers remained at 161,008. Though the increase in the number of borrowers may not be highly impressive however it is still satisfactory keeping in view the overall SME financing scenario in Pakistan. Almost 14.93% growth in the number of borrowers was recorded from the period March 2006 to December 2007, ***See Figure 2.3***. However, as is evident during the first quarter due to seasonal variations, and specific business cycles not only the maturity of loans becomes much faster but the number of borrowers also comes down to some extent. This trend has been witnessed over the past few years due to concentration of credit sector which are seasonal in nature. The negative trend in growth for first quarters of previous and current years can be witnessed in the figure too, as is mentioned above.

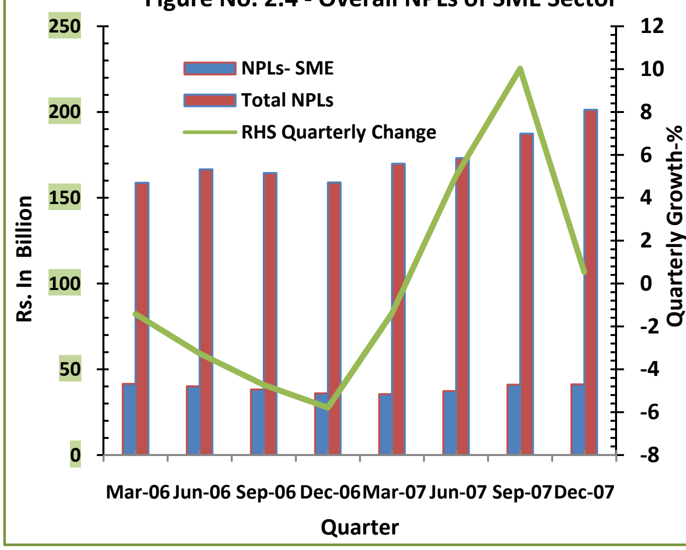
Figure No.2.3 - SME NO of Borrowers



2.4 - NPLs of SME Finance:

Total NPLs of the SME sector stood at Rs. 41.3 billion constituting 9.5% of total SME Finance at the end of December 2007. While SME NPLs are 20.5% of Total NPLs of Rs. 201.3 billion of banking industry at the end of December 2007. A close look at the SME sector NPLs behavior reveals that it has been roaming in between the range of Rs. 35 billion to Rs. 41 billion for the period March 2006 to December 2008. As can be easily witnessed the percentage change in same period remains at almost zero. This clearly indicates that over the years the absolute amount of SME finance has increased

Figure No. 2.4 - Overall NPLs of SME Sector



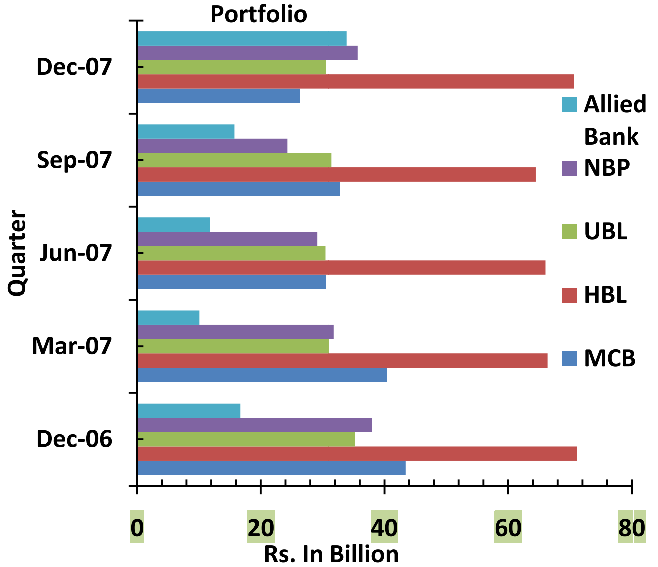
but NPLs have been maintained at the same level ranging between 20%-26% of total NPLs of the industry. The ***Figure 2.4***, also depicts that total NPLs of the industry increased; while NPLs of SMEs remained at same level.

3- Bankwise Distribution Of SME Finance

3.1 - Big Five Banks:

The share of five big banks i.e. Habib Bank Ltd, Allied Bank Ltd, MCB Bank Ltd, National Bank of Pakistan, United Bank Ltd; constitutes about 45.07 % of the total SME finance portfolio at

Figure No.3.1 - Big Five banks SME Finance Portfolio

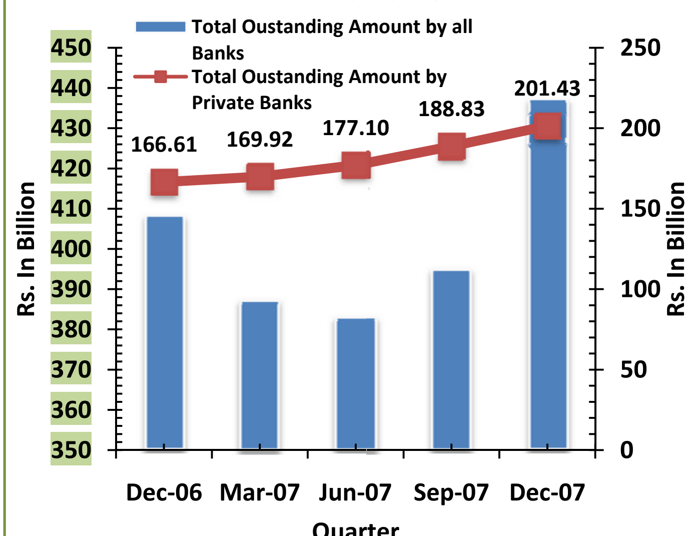


the end of December 2007. In absolute terms the amount advanced by big five stood at Rs.197 billion of total Rs. 437 billion at the end of same period ***See Figure 3.1***. The share of big five banks have reduced gradually over the past three years as its share was 50% at the end of December of 2006.The growth rate for big five banks remained witnessed a reduction of 3.16% from Dec-06 to Dec-07. Of the big five banks HBL has the lion's share of about 16.15% of the total SME finance extended by banking industry till end of December 2007. While NBP, ABL, UBL and MCB follow with 8.16%, 7.75%, 6.98% and 6.03% respectively of total SME finance at the end of December 2007. MCB's share has reduced from 10.64% to 6.98% for period December 2006-December 2007, while that of ABL has increased from 4.09% to 7.75% for the same period.

3.2 - Private Banks (Excluding Big Five Banks):

Private Banks have been doing well in SME finance arena for the last two years, since it has recorded consistent growth. The share of private banks was about 46.06% of total SME finance portfolio at the end of December, 2007. Absolute amount outstanding of the private banks remained Rs. 201 billion surpassing the absolute amount of big five banks, ***See Figure 3.2***. Among the private banks NIB Bank retains 9.33% of total SME finance portfolio at the end

Figure No.3.2 - Private Sector Banks Credit Distribution



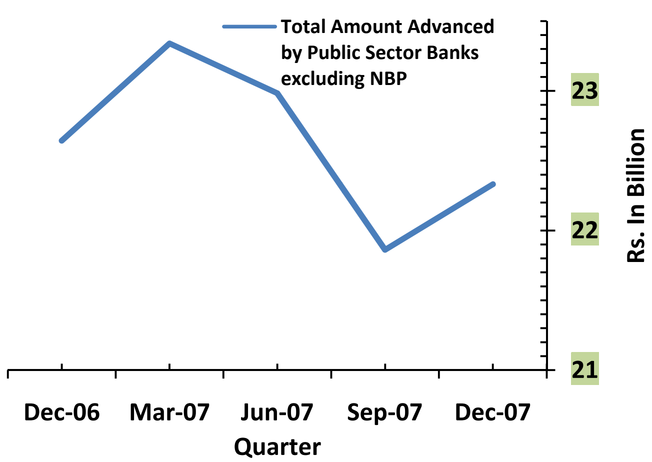
of December 2007. NIB has shown impressive performance by increasing its SME portfolio from Rs.9.3 billion to Rs. 40.7 billion during the period December, 2006 - December, 2007. During the same period NIB has shown a growth of 337% in its portfolio. In Private Banks category Bank Alfalah, Askari Bank and Faysal

Bank each has a share of 8.14%, 5.84% and 3.01% respectively of total SME credit by the end of December 2007. For the last quarter of 2007, private banks have recorded a growth of 6.6%, while a growth of 7.11% was recorded for the period Dec-06 to Dec -07.

3.3 - Public Sector Banks (Excluding NBP):

Public sector banks have third largest share in SME finance after Five Big Banks and Private Banks. This category is composed of Bank of Punjab, Bank of Khyber and First Women Bank Limited. Public sector banks constitutes about 5% of total SME finance by the end of December 2007, while in absolute terms these banks had advanced Rs.21.8 billion by December 2007, ***See Figure 3.3***. An analysis of this category reveals that BOP is the leader by securing 3.5 % share, followed by BOK with 1.09% share of total SME credit by the end of December 2007. However, public sector banks have shown a relative decrease in SME finance growth of 1.4% for the period Dec 06- Dec 07

Figure No.3.3 - Public Sector Banks(excluding NBP) SME Credit



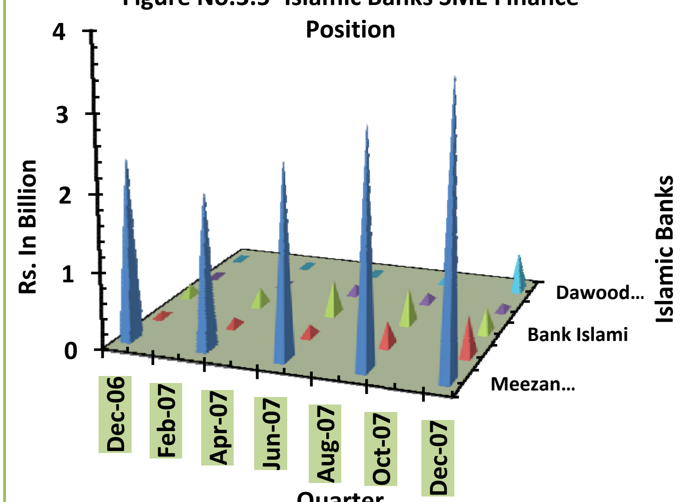
3.4 - Foreign Banks:

The foreign banks share in SME finance is very meager amounting to 0.44% of total SME finance. Their total outstanding amount by end of December 2007 stood at Rs. 1.9 billion. A reduction of 3.9% has been recorded in SME finance portfolio of foreign banks during period Dec 06 - Dec 07. The leaders in this category are Al-Baraka and Citi Bank with both receiving a share of 0.19% and 0.17% respectively of total SME finance by December 2007. Together both these bank's outstanding portfolio was about Rs. 1.5 billion at end of December 2007, which is the major chunk of portfolio of foreign banks operating in Pakistan. However, over the years share of foreign banks has been very low since these banks do not actively target the SME sector.

3.5 - Islamic Banks (Excluding Al-Baraka Bank):

Islamic banks constitute about 5% of total SME finance portfolio. Their outstanding amount remained at Rs. 21.8 billion by the end of December 2007. For the past two years no significant improvement has been made by Islamic banks towards capturing SME finance market as they have been hovering around 5%

Figure No.3.5 -Islamic Banks SME Finance Position



of the total SME finance portfolio. Under this category Meezan Bank has the largest outstanding amount of Rs. 3.7 Billion followed by Dubai Islamic and Dawood Islamic Bank jointly forming Rs. 1.37 billion in SME finance portfolio by the end of December 2007, ***See Figure 3.5***.

3.6 - Specialized Banks:

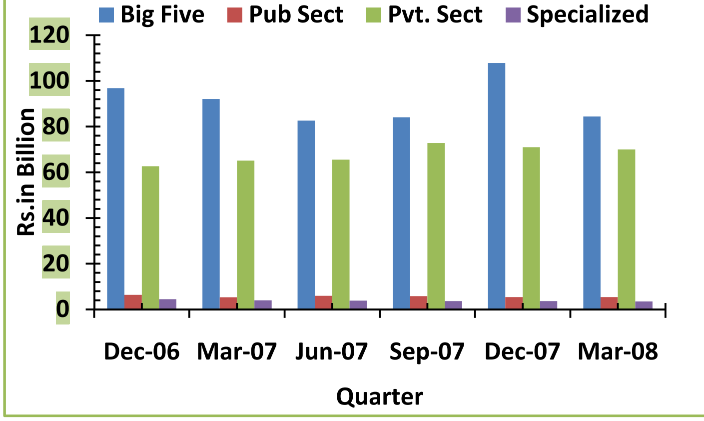
The absolute amount dispersed by the specialized banks to the SME sector had mounted to about Rs. 10 billion by December 2007. This constitutes about 2.27% of total banking portfolio of the banking industry extended under the head of SME finance. Having a close look at SME finance performance of the specialized banks displays that their portfolio has been hovering around Rs. 10 billion for the last few years. SME Bank has the largest portfolio of Rs.7 billion constituting about 1.84% of total SME finance outstanding credit by the end of December 2007. Specialized banks portfolio has reduced by 5.3% during the period Dec 06 - Dec 07.

4- Sectoral Distribution Of SME Finance:

4.1 - Manufacturing Sector:

Manufacturing Sector receives the largest outstanding amount of SME finance forming about 42% of total sectoral distribution of SME finance. By end of March 2008, it has received an amount of Rs. 166.2 billion in absolute terms as outstanding SME Finance. While the absolute amount extended to this sector was Rs. 168.2 billion as of March 2007. Manufacturing SMEs have been one of top credit availing sector over the last four to five years. Out of total manufacturing sector SME credit Big Five banks have advanced Rs. 84.4 billion, Private Banks Rs.70 billion and Public sector Banks (Excluding National Bank) have advanced Rs.5.4 billion to the manufacturing sector by the end of March 2008, ***See Figure 4.1***. For the first quarter of 2008, manufacturing sector's SME finance growth has declined by 12.6%. Likewise, the growth in this sectors financing has also declined slightly by 1.14% during the period of March 2007-March 2008. The outstanding share of Foreign, Islamic and specialized banks is very nominal towards this sector under the head of SME finance.

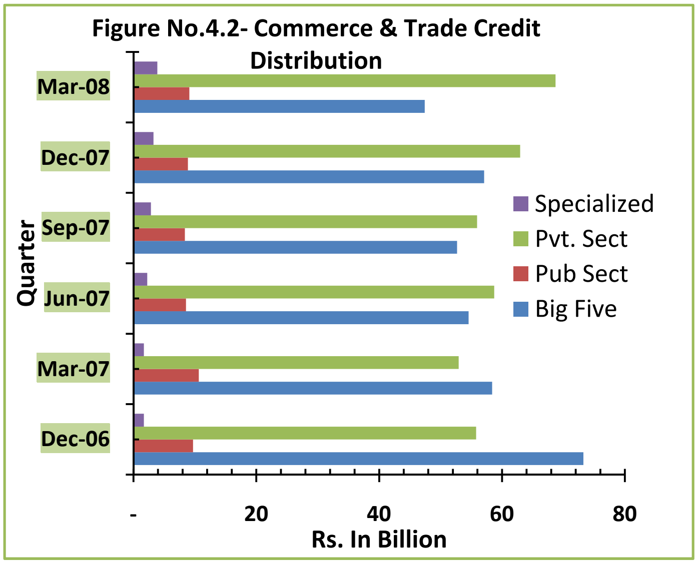
Figure No.4.1 - Manufacturing Sector Credit Distribution



4.2 - Commerce & Trade:

Commerce & trade is the second largest sector receiving the major portion of SME finance. In aggregate this sector has availed Rs.132 billion out of total Rs. 403.4 billion of SME finance by end of March 2008. This sector constitutes 32.7 % of the total sectoral credit availed by SMEs. In this category the private sector banks lead with a portfolio of Rs.68.7 billion followed by big five banks with Rs.47.4 billion by the end of March 2008. The public sector banks (excluding National Bank) have maintained an amount of Rs. 9 billion which is more than their absolute amount extended to the manufacturing sector, ***See Figure 4.2***. This sector has also witnessed a reduced growth of 2% for the first quarter

2008. However, the growth of commerce & trade has moved upward by 5.4% for the period of March 2007-March 2008.



4.3 - Construction:

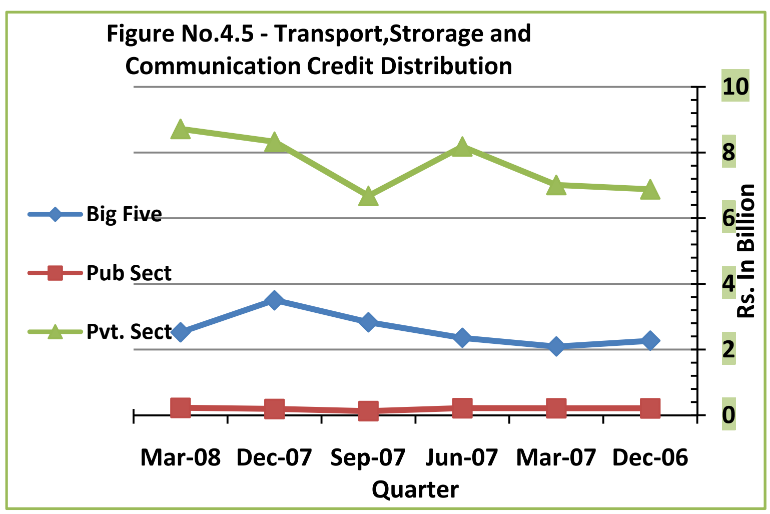
Construction sector constitutes about 4% of the total SME Finance by the end of March 2008. In absolute terms this sector has received Rs. 16 billion leveling the same amount extended to this sector in the last quarter of 2007. This sector has also shown a positive growth of 8.8% for the period March 2007- March 2008. The source of bulk of advances in construction sector is Private sector banks which extended an outstanding amount of Rs. 8.9 billion, followed by big five banks with an amount of Rs.4 billion by the end of March 2008. The share of public sector (excluding National Bank of Pakistan) stands at Rs. 2.8 billion by the end of March 2008. Though this sector has shown some positive growth, however tight monetary policy and less conducive economic conditions restrained this sector's finance growth to a great extent.

4.4 - Real Estate, Renting and Business Activities:

The total outstanding credit advanced to this sector stands at Rs. 11.2 billion of the total SME finance portfolio by the end of March 2008. This forms about 2.8% of the total sectoral credit distribution at the end of March 2008. SME finance in this sector has recorded a reduced growth of 25.3%, for the first quarter of the current year. While a 14.7% negative growth has also been recorded for the period March 2007-March 2008. Distribution of total outstanding credit extended to this sector displays that Private sector banks (other than big five banks, Islamic Banks, and Specialized Banks) have advanced an amount of Rs. 6.5 billion followed by big five banks 4.2 billion at the end of March 2008. This relatively slow growth of real estate business may be attributed to the fact that after the booming of this sector five years back it has become less active due to tight economic conditions of the country.

4.5 - Transport, Storage & Communication:

The share of this sector in total sectoral distribution of SME finance stands at 3% by the end of March 2008. Total outstanding amount



in this sector was recorded at about Rs.12 billion by end of first quarter of the current year. This sector has recorded a promising growth of 24.64% for period March 2007-March 2008. Private sector banks share in this sector stands at Rs. 8.7 billion followed by big five banks with Rs. 2.5 billion by the end of March 2008, ***See Figure 4.5***.

5- International Best Practices In SME Finance:

Across the globe SME Finance was provided special attention by the private and public sector due to its peculiar nature and important contribution to the economy. Private sector particularly the banking industry targeted this sector in a unique and different approach to tape business opportunity at the maximum. Usually the SMEs are characterized with such features that extending finance to this sector is not an easy task for the bankers since the commonly used yardstick for corporate finance by banks is not appropriate for SME finance criteria. In many countries the banking industry diverted towards innovative approaches for exploiting the potential of SME sector through designing of specific SME products, risk criteria, SME Financial reporting standards and special lending techniques. Likewise, the public sector has also played an instrumental role in provision of a hassle free business environment in the form of effective policies, conducive regulatory framework and institutional support in chalking out a sustainable macroeconomic SME supportive framework in many of developed and developing countries of the world. Some of the best international practices in SME finance are succinctly discussed in this section to explore the possibility of adoption of these ideas to our market condition and circumstances.

5.1 - Credit Scoring for SME Finance:

One of the credit decision assessing tools used extensively in developed and underdeveloped countries is Credit Scoring for SMEs. Across the globe the SME Credit Models are derived on qualitative and quantitative methodologies. Though quantitative based credit scoring are the most desirable but a common feature of SME sector is lack of reliable and credible data which obstructs the development of such models. However, in absence of reliable data the alternative approach towards credit scoring model could be incorporation of qualitative factors which might serve the purpose as per market dynamics. In such circumstances one probable model tested & practiced globally is Judgmental Model commonly known as Expert Systems. These models help structure Credit Policies and Management Risk practices into a mathematical model that ranks applicants according to risks. The necessary condition for the Statistical Models of Credit Scoring is the availability of Historical Data on consumers, however, in case of Judgmental Models this condition is discarded off. The other important advantage which these Expert Systems carry is that they can be applied to a range of new segments since qualitative factors are focus of these models.

As per our prevailing Marketplace of SME sector, kicking off with Judgmental Model of Credit Scoring in commercial banks can be a good initiative. While few years down the road these models can be converted into Statistical Models when sufficient data over a period should be available to utilize it for quantitative based Credit Scoring Model. To ensure the fulfilment of this objective, need of the hour is development of the capacity of Commercial Banks especially at upper tier of Management. To provide strategic orientation to the Management of Banks, they are to be enabled to design and develop customized Judgmental Scoring Models for SME finance. This shall certainly provide a much needed impetus to SME finance conception in the commercial banks.

5.2 - Financial Innovation

Usually the products offered by the commercial banks cater to the needs of corporate, commercial and consumer sector. While the SME sector is also tapped by the same products. But there is no one size that fits all. The unique nature of SMEs lends them special attributes which could not be catered by the General Products offered for Corporate or Commercial sector by the banking industry in Pakistan. This fact necessities the triggering of Financial Innovation in SME Finance viz. Designing of SME Specific Products to tape this huge market. Some of widely practiced methodologies internationally in product development are:

5.2.1 - Program Based Lending:

Program Based Lending is a methodology via which banks establish a general eligibility criteria based upon thorough market research and need analysis to meet specific financing requirements of businesses in a particular industry, through establishing acquisition and delivery channels for quick processing of large volumes. Various risks including credit, market, operational, etc are identified at the initial stage of development and their mitigating factors are put in place. This approach streamlines credit decision process on the basis of objective pre-established criteria with an approach to minimize reliance on exaggerated or inaccurate information provided by customer. It also helps to target those segments of industry which are presently ignored by financial institutions. Using these methodologies Financial Institutions get deeper penetration into the target market by going to the customers' doorstep, whereas in case of Relationship banking the outreach is limited**.** Program based lending in Pakistan can be a success provided due diligence and proper capacity development is carried out in the commercial banks.

5.2.2 - Cash Flow Based Lending:

Traditionally the banks extend loans to SMEs against collateral and financials which they have to offer to financial institution if they are to get finance. Lack of skills, expertise and resources obstructs the SMEs to maintain proper financials as it turns out to be a difficult task for them. In such situation the banks emphasize on financials and other related documents, that aggravates the problem for SMEs to have readily access to finance. Generally SMEs are run by sole proprietorships and they do not keep financials or even if books are maintained by SMEs they are in crude form. Extending finance on cash flow basis can greatly facilitate not only SMEs but also financial institutions in reaching to large market segment. Under this approach the cash flows of business are estimates or worked out and on same basis finance is provided to the SME. Banks have to venture in this area provided their capacity is rightly build to assess the potential of prevailing market dynamics.

5.2.3 - Risk Mapping in SME Finance:

Generally risk is prime factor described by the banks, obstructing the way into venturing in SME Finance. SME Finance area is perceived highly risky arena by bankers with conventional mindset. However, the fact lies somewhere else as SMEs no doubt have a certain degree of risk associated with but it can be mitigated once adequate and specially customized risk assessing tools and techniques are designed. This can only be possible once risk assessing faculty of banks is properly trained and equipped with right kind of knowledge and skills.

6- Country In Focus: South Korea

In Korea the number of SMEs is approximately 3 million. SMEs account for 99.9% of the entire enterprises and 88.1% of the total employment (10.77 million employees). SMEs are of varying size, sector and form in Korea. About 88.3% of total SMEs are smaller enterprises (with less than 10 employees), 8.5% are small enterprises (with 10~50 employees) and 3.1% are medium enterprises (with 50~300 employees). Realizing the instrumental role of Korean SME sector, the government of Korea with support from private sector has taken a number of steps including of establishment of Specialized Institutions to strengthen and enable a financially sustainable SME sector. Readily access to finance from banking sector to SMEs has always been a core issue in developing countries where Korea was no exception. However a helping hand was extended to SME sector through establishment of institution like Korean Credit Guarantee Fund (KCGF), Kibo Technology Fund, Korean Export Insurance Corporation, Small & Medium Business Administration, and Exim Bank of Korea.

Some of the successful Institutions supporting the SME Finance Structure of SMEs are discussed in brief

6.1 - Korea Credit Guarantee Fund (KODIT)

KODIT is a Public Financial Institution established in 1976 under Korea Credit Guarantee Fund Act. The primary objective behind establishment of this institution was to provide credit guarantee services to small and medium enterprises which lack tangible collateral. The core theme of extending credit guarantees to enterprises is to lessen the risk faced by financial institutions involved in financing of SMEs with little or no tangible collateral. Efficient and effective Credit Risk Management mechanisms are of utmost importance for credit guarantee institutions as its vision lies in minimization of default rates. The Korean Credit Guarantee Fund has designed an extensive risk management system to counter potential risks leading towards a higher default probability.

Basically, KODIT administers three different types of capital funds:

1. Capital Funds of Credit Guarantee Scheme
2. Capital Funds of Credit Insurance Scheme
3. Capital Funds of Infrastructure Credit Guarantee Scheme

KODIT is heading towards one of most modern institution in risk management as it has started to introduce Credit Var System to monitor the aggregate risk of KODIT. Likewise, program like Risk Adjusted Performance Measures (RAPM) shall provide a boost to institution-wise risk management system in KODIT. Industry evaluation system is an integral part of KODIT serving the objective to assess industry specific risks in credit evaluation of companies. The industry research department provides financial trends of industries, changes in business environment and information about competition in the market. Dealing in credit guarantee business KODIT has shielded itself in effective and efficient manner through establishment of a comprehensive and self-sustainable risk management system, performance assessment and organizational structure.

6.2 - KIBO Technology Fund:

KIBO was founded in 1989 by the Korean Government as a non-profit guarantee institution under the special enactment, "Financial Assistance to New Technology Businesses Act". In an attempt to help SMEs overcome above difficulties in financing, Kibo launched its technology guarantee service. Various technology guarantee schemes were set up with the purpose of covering the losses incurred when borrowers default on loans. The purpose of such schemes is also to encourage financial institutions to lend to SMEs with viable projects and good prospects of success but which are unable to provide adequate collateral or which do not have a suitable record of financial transactions to prove creditworthiness. Technology is thought to be the most important asset of a business concern which determines the future of the company. However, until recently, it has hardly been accepted as collateral in financial institutions. KIBO initiated the technology appraisal service by launching Technology Appraisal Center (TAC) in 1997 in order to introduce credit guarantee facilities which are provided based on the technological capabilities of business enterprises. In an attempt to expand its technology appraisal power, Kibo also reorganized its infrastructure of the technology appraisal manpower.

6.3 - Small & Medium Business Administration (SMBA)

SMBA was established in 1996 with the objective to provide a boost to the SME sector growth in Korea. SMBA provides a number of major services to SMEs which are as follows:

- Revitalizing Start-ups and Enhancing Entrepreneurship
- Providing Effective Financial Services
- Strengthening Capacity Building of Human Resources
- Strengthening Marketing Capability of SMEs
- Building Technological Innovation Capacity of SMEs
- Fostering Venture Businesses
- Providing Service for Micro-enterprises and Conventional Markets
- Guide for SMEs
- SMEs' Counseling System

6.4 - Korean Export Insurance Corporation (KEIC)

KEIC was established in 1996 as an official export insurance agency under Ministry of Commerce, Industry and Energy. The National Assembly approves the underwriting limits and contributions to KEIC. Its mission is to provide export insurance, overseas investments and credit guarantees for promotion of overseas business activities. KEIC provides domestic exporters with 13 types of export insurance and one export credit guarantee. It offers export credit research and information services on importers and their countries and collects export receivables.

6.5 - Lessons to Learn:

The initiatives taken by Korea to provide a boost to SME sector in general and provision of readily access to finance in particular have proved immensely successful. Although almost all of such institution are operating under the public sector umbrella, however, their ability to survive and sustain financially in an increasingly competitive global environment has been attributed to few pivotal factors such as (i) Comprehensive Risk Mitigation Mechanism at institutional level (ii) Professional Management (iii) Effective and Efficient Public Intervention

(iv) Coordination among different institutions
(v) Specialized institutions for specific areas.

One of the important aspects of these Korean institutions to survive and operate efficiently under public sector umbrella is their ability to architect a comprehensive risk management mechanism. Despite the fact that public intervention may not be highly desirable phenomenon in free market economy, Korea is doing it in a very professional manner which is evident from the crucial and much needed support which these institutions have been providing to SMEs over the years.

In developing countries like Pakistan where a number of complex and systematic problems and constraints associated with the SME sector, it becomes more prominent to evolve a comprehensive SME finance structure through establishment of effective public-private partnerships. A vibrant and proactive private sector responding quickly to the market variations is most desirable phenomenon with special reference to SME. However, as per own circumstances and private sector enterprise development pace it has been becoming increasingly evident to lend a helping hand toward the development of SME sector either through complete or partial public intervention to initiate the process of SME finance development structure in Pakistan. Development of alternative financing mechanism for SMEs can help a lot in diversifying the sources of finance for SMEs while at the same time creating competition among different financial institutions including banks. Effective and Efficient Coordination & Cooperation among the different stakeholders including regulators, government organization, SME and banks towards the crystallization of common objective of proliferation of quality and quantum of finance to the SME sector is the call of the day.

SME FINANCE; SBP VISION

SBP has been paying special focus towards the financial inclusion of underprivileged sectors of economy such as SMEs. The development of SME finance has been the driving theme for the policy makers and regulators for the last few years. SBP leading from the front has taken a number of significant initiatives to ensure the smooth and increased flow of finance to this underserved sector of the economy. Some of important steps taken by SBP for the promotion of SME finance are:

7.1 - SME Finance Strategy:

In order to tape this sector through formal sources of finance especially through banking sector SBP developed a strategic financial roadmap document for SME finance in Pakistan, for next five years, known as SME Finance Strategy of SBP. Primarily this strategy deliberates upon the various issues associated with SME sector which hinders the growth of finances in this sector. This strategy presents a comprehensive framework of solutions and suggestion of how to improve financing activities in SME sector through formal sources especially banks. The promotion of SMEs through adequate availability of needed financing is one of the important objectives of SBP's policy initiatives. Towards this end market driven support programs are important to attain sustainability, maximize potential for cooperation with the private sector, and to minimize distortions in the economy. A close assessment of the historical trends, capacity of financial institutions and the potential of SMEs, indicate that the credit from the banking sector for SMEs needs to increase to the level of Rs. 1,000 billion by the end of June 2012, to achieve projected economic growth, employment and other macro-economic targets.

7.2 - Establishment of SME Finance Help Desk:

The underlying primary objective behind the establishment of an SME Help Desk at the SBP is to provide an enabling regulatory and policy framework to facilitate the extension of finance to SMEs. The SME Help Desk shall provide valuable assistance / guidance / information to the stakeholders such as SMEs, Banks, DFIs, SMEDA, Chambers of Commerce and Industries, other Public and Private sector organizations on issues falling in the domain of the SBP. In addition to this function, the SME Help Desk is to act as communication link between Banks and SMEs to improve their mutual financial relationship. The Help Desk will also serve as a formal forum where the stakeholders could register their grievances and can also provide their feedback/suggestion to improve to existing regulatory and policy environment. The Help Desk can be accessed through the link
http://www.sbp.org.pk/help/index.asp.

7.3 - Special Initiatives:

Provision of readily access to finance to the underserved sectors such SMEs has been the focus areas for SBP. Various direct and indirect measures have been taken in this direction to flourish SME finance in country. Some of the key steps so far initiated by SBP are briefly elaborated as under:

7.3.1 - SME Credit Rating Agency:

In light of the perceived risks attached with financing by banks to SME sector, the need for independent credit opinions are increasingly becoming indispensable for ensuring required flow of credit through banks. Globally, the concept of SMEs rating has gained popularity as it reduces the burden on banks by providing risk mapping of entities. SME Credit Rating Agencies provide a comprehensive, transparent, affordable and independent rating to SMEs, which places them in an advantageous position for getting competitive interest rates and enhanced credibility. Ultimately, the flow of credit from formal sources becomes smooth and more accessible. SME ratings would surely play a pivotal role in boosting SME Finance through provision of better understating of risks associated with the sector. The countries like India and Japan have their specialized SME Rating Agencies which provide independent credit opinions exclusively to SMEs. In light of the above, we have adopted a Two Pronged Strategy for Promotion of SME Ratings in Pakistan. On one hand, we are constantly encouraging the two existing credit rating agencies to venture into SME rating business, while on the other side SBP has developed a **"Concept Paper on SME Credit Rating Agency"** for Pakistan.

7.3.2 - SME Private Equity Fund:

The available formal sources of finance to SME sector mainly attribute to the banking sector. The financing needs of SME sector still at large remain unfulfilled through the formal sources. Debt financing is usually secured by those SMEs that have already been established and moving on a growing path. However, almost 90% of newly established SMEs are self-financed usually by their owners. The lack of formal equity financing facilities, for new entrants, from formal sources is a major obstacle in growth of SMEs.

Globally, the private equity financing facilities such as Venture Capital industry prevails in developed and developing countries, which are duly supported by government and the regulators, to provide equity financing facilities to SMEs. In countries where the capital markets have not been able to provide equity financing to SMEs, public intervention in the form of **SME Private Equity Fund** is deemed as a more appropriate tool. The establishment of such a fund would not only create the much needed equity financing source but would also play an important role of a catalyst in initiating the development of Equity Finance Industry for SMEs in Pakistan. In light of its importance SBP is also promoting the idea to establish a private equity fund in Pakistan for SMEs. SBP has prepared an initial concept paper, keeping in view the peculiar dynamics of SME sector, which presents a conceptual framework for the establishment of the Fund exclusively meant for equity financing.

7.3.3 - SME Credit Guarantee Fund:

The National SME Policy-2007 recommends establishment of Credit Guarantee Agency for providing incentives and risk coverage to banks. SBP and SMEDA are the principal initiators for implementation of this recommendation. SBP taking on the initiative reviewed the available literature on credit guarantee schemes practiced worldwide to acquaint itself with the concept of Credit Guarantee schemes with particular focus on their objectives, functions & operations of such schemes in other parts of the world. In this connection SBP formulated a Concept Paper on **Credit Guarantee Scheme** with special reference to Pakistan. This paper reflects on the experiences of different countries across the world and provides a brief of recommendations regarding the establishment of credit guarantee mechanism in Pakistan. In order to go ahead with its implementation we have already taken feedback from PBA and we plan to coordinate with other stakeholders that also include IFIs.

7.3.4 - Capacity Development Programs:

The capacity development of institutions vis-à-vis SME sector, engaged in provision of formal sources of finance lays down a critical base for further improvement in smooth flow of finance. SBP has been paying focused heed towards the capacity development of banks in SME finance area to lift up prevailing SME finance portfolio and extend its outreach. The Human Resource Skills level in banks currently involved in extension of SME finance needs further improvement, which is proving a halt to the overall integrated efforts for broadening the coverage in this sector. In this connection, SBP chalked out a two tier Capacity Development program for banks in SME finance at NIBAF, Islamabad in April 2008. Likewise, SBP has also been conducting seminars and workshop in SME clusters on improving the delivery channels of credit for SME finance.

ANNEXURE

CREDIT TO SME SECTORS

All Commercial Banks (Rs in Millions)

Sr #	SECTORS	Mar-06	Jun-06	Sep-06	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08
		Amount	Amount	Amount	Amount	Amount	Amount	Amount	Amount	Amount*
A	Fishing, fish farming, aquaculture and related service activities	937	911	1,028	605	808.3	867	801	770	678.8
B	Mining and Quarrying	682	822	861	996	994.0	790	1,414	1,260	1,092.7
C	Manufacturing	151,152	152,370	147,846	172,148	168,156.6	159,800	168,425	190,312	166,246.7
D	Ship breaking and waste / scrape (junk) etc.	907	953	1,394	491	430.4	539	431	343	254.3
E	Electricity, gas and water supply	1,543	1,755	2,169	2,343	2,636.6	2,618	3,173	4,682	4,195.8
F	Construction	12,083	12,835	13,187	14,890	14,692.8	16,230	19,085	16,014	15,989.5
G	Commerce and Trade	125,475	123,475	126,274	143,112	125,148.6	125,785	121,766	134,581	131,903.8
H	Hotels, restaurants and clubs etc	2,211	2,420	2,840	3,617	3,501.0	3,050	3,599	3,315	3,179.1
I	Transport, storage and communications	8,378	8,906	8,889	9,749	9,609.6	11,093	9,996	12,542	11,977.7
J	Real estate, renting and business activities	13,377	10,262	11,676	13,091	13,141.7	12,749	11,920	15,016	11,212.2
K	Education	1,253	1,742	2,249	2,094	1,705.8	1,670	1,893	2,196	2,383.2
L	Health and social work	1,518	1,898	2,071	2,094	2,343.2	2,542	2,714	4,279	4,924.6
M	Other community, social and personal service activities	5,184	6,440	8,890	6,207	7,234.6	10,305	10,455	7,726	7,165.3
N	Other private business es	27,384	31,063	31,588	36,511	36,107.9	34,467	33,709	40,173	42,169.2
	TOTAL	352,086	355,851	360,962	407,947	386,511	382,503	389,382	433,209	403,373.0

Source: Statistics Department, SBP

* Provisional Figures