An Analytical Over View of Bank Loans Extended to SMEs in Pakistan

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Abstract
Small and Medium Enterprises are the back bone of economy and are considered to be locomotive for the economic development for the developed as under developed economies. In the present economic scenario no one can ignore the importance and role played by SMEs in the overall rise of standard of life, reduction in poverty, provision of employment, foreign exchange earnings and GDP growth. Economy of Pakistan has substantial potential for the growth of this segment but unfortunately desired benefits could not be obtained for variety of reasons including political instability ,continuity in economic priorities and policies ,law and order situation prevailing in the country ,lack of infra-structure ,energy crisis ,most important hurdle is access to bank lending at concessional rates. The central bank of the country with collaboration of SMEDA is playing an important role to make bank finance available which is as important for SMEs as oxygen for human body but so far desired results could not be achieved in true sense as banks are shy to allow lending facilities, most importantly due to lack of collateral to cover the risk. SBP reports revealed that cash flow based lending is discouraged instead collateral based lending is focused. Bank lending allowed to SME sector comprises around 6 % of total finance allowed to private sector ,out of which major portion is extended within the limit of 0.5 million and only 5 % of total SME finance is extended as clean loan.

Key Words: *SME, Bank Loans, SBP, Pakistan*

Introduction:

Definition of SME

SME is a term used for business sector which falls in the category of Small Office –Home Office size and large enterprise. SMEs are broadly defined on the basis of number of employees' engaged, capital invested and business turn over. In developing countries small business means having 50 numbers of employees and medium size business having more than 50 and not more than 99 number of employees. But authorities in Pakistan have not a single definition for SMEs. SMEDA (Small and Medium Development Authority) defines it on the basis of earning (productive) assets and the number of employees engaged in economic activity. According to SMEDA it is an enterprise which does not engage more than 250 employees and its annual business turnover is not more than 250 million in PKR terms. The central bank of the country in its prudential regulations (PRs) defines SMEs as it is ideally not a public limited company and does not engage more than 250 employees. However it has further divided in sectors as under,

Parameter /Industry	**Trading**	**Manufacturing**	**Services**
No of Employees	50	250	250
Total Assets	50	100	50
Total Sales Turnover	300	300	300

Assets are earning assets excluding land, building and plant

State Bank of Pakistan has revised its prudential regulations and defined the segment by separating the SE (Small Enterprise) and ME (Medium Enterprise).Accordingly SE is defined as under

Small Enterprise

No of Employees	**Annual Sales Turnover**
Up to 50 *(including contract employees)*	Up to 150 M

Medium Enterprise

No of Employees	Annual Sales Turnover
51-250 (Manufacturing & Service MEs) 51-100 (Trading MEs) *(including contract employees)*	Above Rs 150 million and up to Rs 800 million (All types of Medium Enterprises)

United States of America (USA)

In United States of America Small Business Act defines small business is a concern that is independently owned, operated and is not dominant in its field of operations with fewer than 500 employees.

United Kingdom (U.K.)

In UK Small business is an entity having annual business turnover not more than £2.8 million and have not engaged more than 50 employees and medium sized entity is an enterprise having annual business turnover of not more than £22.8 million with maximum 250 number of employees and a balance sheet total of not more than £11.4 million as defined in sections 247 and 249 of the Companies Act 1985.

European Union (EU)

In European Union SME is classified in three different categories; micro, small and medium-size. The category of micro, small and medium-sized enterprises (SMEs) is made up of enterprises which can engage fewer than 250 employees and have annual business turnover up to 50 million euro, and/or balance sheet total not exceeds 43 million euro. In case of small enterprises enterprise can engage fewer than 50 persons with annual businesses turnover or balance sheet total should not exceed 10 million euro whereas micro unit is one which can employ up to 10 employees with annual business or annual balance sheet total which should be within the limits of 2 million euro”

BROAD INDUSTY GROUPS OF SMEs

1. Manufacturing: The enterprises engaged in the manufacture or production of goods eg. Textile, chemicals, vehicles, beverages, medical and optical instruments, household and other personal goods, etc

2. Trading (Wholesale & Retail): The enterprises engaged in the retail and wholesale trading of goods, including their repair and maintenance.

3. Services: The enterprises engaged in providing or rendering of services and include, though not restricted to, transport, communication, hotels, education, health and social work.

Significance of SMEs

- Since overhead cost of employees is lower than the larger firms hence it provides low cost employees with greater employment opportunities
- It is a good source of export earnings due to low-cost labor is engaged in producing export goods. Hence supports in balance of trade of the country.
- It is a linkage between rural industrialization and most planned urban sector hence boost and assists in local and regional development.
- It is helpful to achieve equitable and fair distribution of wealth

- Since SMEs are engaged to use indigenous/local produced raw material hence have positive impact on balance of trade.
- It inculcates an environment of entrepreneurial and self-reliant culture by combining capital and skills together kills through a variety of lending techniques and skill development schemes.

Challenges Faced by SMEs in Pakistan

Lack of Proper Infrastructure: Poor roads and transportation system, energy crisis, lack of industrial space at concessional rates and unstable prices mechanism badly affects the growth with stability of the economy in general and SME in particular.

Lack of marketing facilities: SMEs do not allocate sufficient funds for marketing rather depends on sales through sales staff which is also a barrier in creating brand and enhancing loyal customer base

Lack of Information Communication Technologies: The importance of information is not realized in true sense by SMEs which is also a big hurdle in exploring new markets and on line marketing of products at competitive prices

Lack of access to Finance: It is a major issue, entry and growth of new entity is very difficult without external resources. Banks are shy to provide loans to SME for establishing new units as well as to existing units with mindset that the SMEs are not strong enough to bear the cyclical economic shocks and may commit default.

Poor Educational System: SMEs are basically managed by one person or a group (mostly by family) does not possess a sound knowledge and skills of entrepreneurship hence may not be able to operate in a sophisticated manner.

Law & Order issues: After 9/11 Pakistan is in the state of war in terror hence it is quite difficult to enter and grow the business at desired pace as uncertainty prevails in the entire country.

Regulatory Complexities: It is unfortunate that country on hand is facing terrorist activities on the other the cancer of corruption which has gripped entire system therefore SMEs are encountered with several difficulties in registration and compliance of laws which are only complied against out of packet payment.

Shortage of Skilled manpower: The majority of work force is uneducated and unskilled which cannot meet the quality standards of modern era hence SMEs are compelled to engage unskilled manpower to carry on the operations.

Problem Statement

In Pakistan major chunk of credit is taken by corporate sector and SME is second largest segment availing the finance. In Pakistan there are more than million SMEs which constitute above 90 percent of private sector enterprises in industrial sector provides around 78 percent employment to non agriculture work force and contributed more than 30 percent to GDP. Despite that SME is facing major problem of access towards formal finance from banking industry. In this research study attempt have been made to explore the reasons as to why banking industry is reluctant to take exposure in SMEs and the issues which hinders bank lending in Pakistan.

Specific Objectives of Study

- An overview of SME Sector in Pakistan
- To analyze the factors hindering the growth of SME
- The factors responsible for poor access of Bank lending

- Role of Central Bank to ensure proper share of loans to SMEs

Research Methodology:

The research is based on secondary data ,data was collected from Data was collected from secondary sources; annual reports of commercial banks ,SBP publications ,latest available quarterly report on SME up to March 2016 was reviewed minutely. Research papers, research Journals, Economic Survey of Pakistan, NBP Economic Bulletin, IBP Quarterly Journal to analyze and conclude the role of financial institutions played in extending loan facilities to SME sector. An attempt was made to analyze the loan allowed in percentage terms with overall loans extended to private sector and infected portfolio as well. More role of central bank was also reviewed in formulating policy guide loans to help out this most important segment and implementation thereof.

Review of literature

SMEs play an important role in the development of world economies and are accepted as driving force for economic growth and development (Sas Aruwa, 2013).

Kashif, Hamid and Abaid Ullah in 2006 explored that SMEs have performed as key player in the economic growth of world as they are able enough to manage and control the resources in a well-organized way for the uplift of society (Hannah Galvin).

According to Sherazi, Iqbal, Asif, Rehman & Shah 2013 SMEs in Pakistan, are considered to be the life blood of economy as SMEs play an important role in economic development and is considered as a source of survival in worst economic circumstances

Ou & Haynes, 2006; Cook, 2001 have pin pointed the availability of finance as a key factor for successful operation of SME sector. Wu, Song, & Zeng, 2008 has examined that financial needs for SMEs vary from initial sources such as owners' equity ,their savings and retained earnings to formal outside funding inter alia include financial support from family and friends, trade credit (Abouzeedan, 2003) ,angel financier , venture capitals (He & baker, 2007), Chittenden, Hall, & Hutchinson, 1996 explored formal external funding sources by financial institutions and securities markets. According to the financial growth cycle paradigm proposed by Berger and Udell (1998) proposed financial needs of SMEs vary during the different phases of life cycle of the firm.

Challenges Faced by SME in Pakistan

An overview of Economy of Pakistan;

Pakistan is at number six population wise; its population is around 189 M .Pakistan is agri based economy, it contributes more than one-fourth of output and two-fifths of employment. Pakistan is producing enough food grain items to feed its population besides is third largest exporter of rice and is in big five major textile producing in the world. Agriculture is now more than crops, within agriculture a significant change was witnessed. Dairy, livestock, mutton, beef, poultry and other similar products is around 50% of total agriculture It is at third number in producing milk in the world.

Pakistan's GDP growth gradually increased on year basis since 2012. Official numbers which do not portray true picture as major portion of economy is informal; unemployment is around 6 to 7 % underemployment remains on very high side. Pakistan has somehow succeeded to restore its macroeconomic stability, Pak Rupee remained quite stable after heavy depreciation in near past. Remittance from abroad is more than $1.5 billion per month which is major source of income. Despite poor export performance, inflation remained under control and current account deficit was narrowed down, mostly due to downward trend in oil prices globally. Pakistan and China has started implementation of CPEC "China-Pakistan Economic Corridor", both countries agreed to invest $46 billion on infrastructure and energy sector.

Contribution of SME towards economy of Pakistan

According to IFC 2012, around 3.2M businesses units are participating in economic activities to earn profit out of which around 3 million are SMEs which means that more than 90 percent share is contributed by SME shaving considerable contribution of 30 percent to GDP and 25 percent towards earnings of the country and providing employment to more than 70% of work force. In recognition of the contribution made by SMEs federal authorities and central bank in particular and all stake holders in general have taken bold steps to boost this important sector which include establishment of SME department in SBP ,SME Bank ,issuance of separate prudential regulations for SE & ME and Small and Medium Enterprises Development Authority (SMEDA).In spite of continuous efforts initiated by the stakeholders for the growth and development of this important segment desired goals could not be achieved as the sector is encountered with many challenges and problems as under,

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Issues & Challenges in SME Financing

Banks are primarily reluctant to accept risk in this segment as according to them ratio of default is high at early as well as growth stage .The another issue is improper record keeping and maintenance of financial records. SMEs lack skilled staff to prepare their books and resultantly banks feels difficulty while accessing the genuine need of the business. Besides the information pertaining to SME is unreliable.

As SMEs cannot afford to offer adequate collateral and the financial institutions are unable to decide whether this sector possesses technical knowhow, marketing and managerial techniques that ensure the generation of desired cash flows for timely repayment of the loan. Resultantly the process of financial intermediation breaks down for this important segment. The central issue is therefore lack of collateral though the SMEs have ideas to do start the business but have no tangible asset to offer for comfort of Banks. Moreover Financial Institutions perceive that SMEs are usually unable to overcome contingency shocks.

Role of SBP in Growth of SMEs

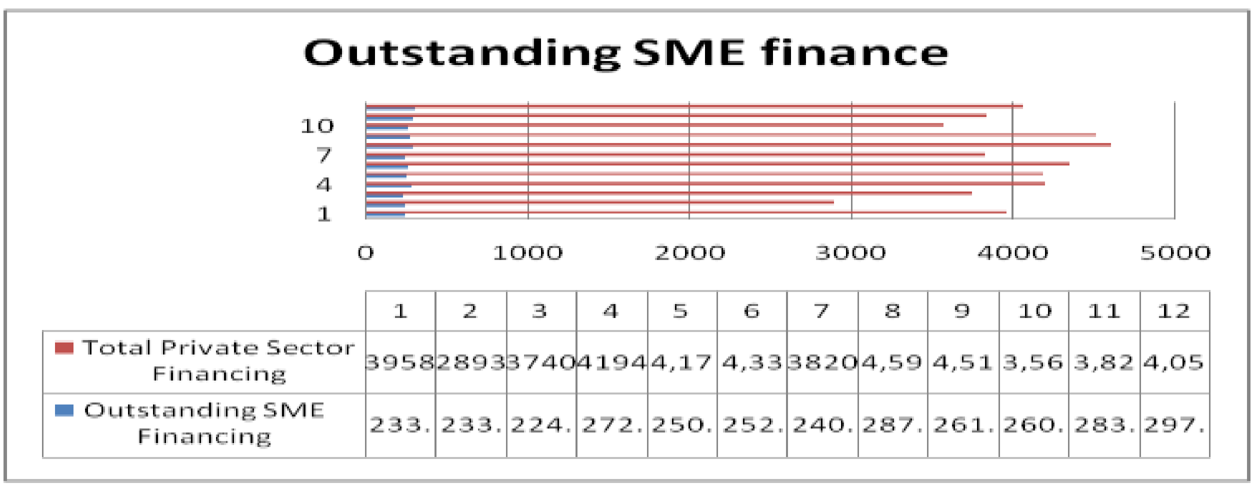
As discussed earlier the significance of SMEs, their contribution to GDP growth, creation of employment and earning of foreign exchange by boosting exports. Keeping in view the same the central bank is actively engaged for growth and development of SME banking. SBP has taken several policy initiatives including issuance of separate set of PRs for Small & Medium Enterprise (SE & ME), implementation of SMEs supportive financing schemes such as credit guarantee scheme (CGS), refinance schemes for SMEs, PM Youth scheme and capacity building programme.

During last few years SME has been remained in focus for policy makers, State Bank of Pakistan is also paying focused attention for SME financing. The central bank has taken bold steps for the promotion of SME financing, which include,

- Establishment of Separate Division for SME
- Issuance of Separate Set of PRs (Prudential Regulations) for SE & ME
- Establishment of help desk to support SME Finance
- Formation of Strategy for SME Finance
- Developed concept paper on SME Credit rating agency
- Concept Paper on SME private equity Fund.

Role played by banking sector for SME Finance

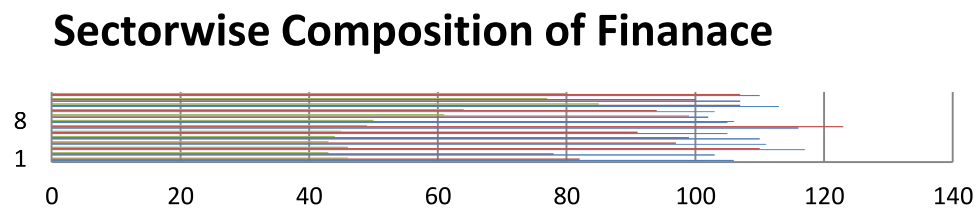
Commercial banks of the country both nationalized as well as private are playing an encouraging role in providing financing facilities to the SME sector. Despite several hurdles currently over a dozen of banks are actively participating in extending finance to SME, varieties of products have been tailored to boost the sector. The major contribution is made by five big (namely NBP, HBL, UBL, MCB and ABL) which is around 43 % share in bank lending and remaining 57 % is allowed by all remaining banks including Islamic banks.



Source: SBP

The data analyzed and concluded that around 6 % of private sector lending is allowed to SMEs, whereas SMEs constitute 90 % of total business units and the number of SMEs availing upto June 2016 is 164733 which are around 5.5 % of total SMEs engaged in economic activities. Moreover the share of finance to SME is majorly covered by domestic banks which constitute around 66.5 % and 26.5 % is contributed by public banks ,specialized banks share is around 3.1 %,Islamic banks 3.7 % and remaining 0.2 %by DFI and foreign banks.

Sector wise Composition of SME Finance



	1	2	3	4	5	6	7	8	9	10	11	12	13
Services	46	43	46	43	44	45	49	50	61	64	85	77	80
Manufacturing	82	78	110	97	99	91	123	106	99	94	107	100	107
Trading	106	103	117	111	110	105	116	105	102	103	113	107	110

Source: SBP

The sector wise composition of SME finance depicts that trading sector has been provided 41 % to trading, 38 % manufacturing and 21 % to services on average basis which means maximum focus is on trading activities**.**

Loan size-wise Review:

According to SBP loans up to Rs 5 million constitute around 37 % of total SME Finance which covers 93 % of total borrowers around 150,000 borrowers, a large number of SME borrowers fall in this category with limit of 0.50M .Loans over Rs. 5 million with maximum limit of Rs. 30 million has 38 % share of total SME finance while loans above Rs. 30 million with maximum limit of Rs. 50 million had a share of 11 % and loans above Rs. 50 million had a share of 15 percent.

Clean lending Vs Collateral based lending:

While going through the various reports on SME finance it has been revealed that maximum 5 % of total finance was allowed as clean loan which portray the mindset of bankers that they are reluctant to allow finance without any tangible assets despite the fact that SBP in their revised version of PRs (Prudential Regulations) has allowed clean facility of 5 million vide PR # 4 (PRs issued in May 2016.

Conclusion:

Despite considerable contribution of SMEs in country's economy and push from SBP bankers are still reluctant to allow cash flow based lending instead of collateral based lending. It is also disappointing that only 5.5 % of SME sector is provided lending facilities out of which majority falls in the category of loan amount below 0.500M. Maximum loan is allowed to trading sector. Major portion of finance is provided by private banks which is around 67 % .The loan amount is around 1 percent of GDP which is quite negligible and it constitutes around 6 % of private sector lending which is also alarming situation.

Recommendations:

Federal authorities should focus to provide business environment in the country by addressing highlighted issues in general and financing issues in particular. Central bank although is primarily responsible for monetary policy of country, should allocate ceiling of credit limits for SMEs and inculcate culture of cash flow based lending to overcome the fear of SME loan default. The government of Pakistan should make the loans available at concessional rates and defaulted loans should properly be compensated to banks. The challenges are going to be redoubled after CPEC and WTO hence steps should be taken to ensure uninterrupted supply of raw material to manufacturing sector without any abrupt price variation with control over energy crisis a major hurdle in manufacturing industry.

Financial institutions are required to expand outreach of SME financing to under privileged areas of the country. Staff of Banks should not only be well familiar with products meant for SMEs but also should be willing to serve.

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