Islamic Republic of Pakistan

# Data Collection Survey on SME Finance in the Islamic Republic of Pakistan

# Final Report

August 2018

JAPAN INTERNATIONAL COOPERATION AGENCY

IMG Inc.

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# Map


Map No. 4181 Rev. 1 UNITED NATIONS
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Department of Peacekeeping Operations
Cartographic Section

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# Acronyms

| | |
|---|---|
| ADB | Asian Development Bank |
| BDS | Business Development Services |
| CAR | Capital Adequacy Ratio |
| CGC | Credit Guarantee Company |
| CGS | Credit Guarantee Scheme |
| CPEC | China-Pakistan Economic Corridor |
| DCA | Developmental Credit Authority |
| DFI | Development Financial Institution |
| DFID | Department for Foreign International Development |
| DFR | Draft Final Report |
| EFF | Extended Fund Facility |
| EOBI | Employees Old Age Benefits Institution |
| FATA | Federally Administered Tribal Areas |
| FBR | Federal Board of Revenue |
| FIIP | Financial Inclusion and Infrastructure Project |
| FIP | Financial Inclusion Program |
| FR | Final Report |
| FY | Fiscal Year |
| GCC | Gulf Cooperation Council |
| GDP | Gross Domestic Product |
| GoP | Government of Pakistan |
| ICR | Inception Report |
| ICRU | Investment Climate Reform Unit |
| IDA | International Development Association |
| IFC | International Finance Corporation |
| IMF | International Monetary Fund |
| IPU | Investment Promotion Unit |
| ITR | Interim Report |
| JICA | Japan International Cooperation Agency |
| KPK | Khyber Pakhtunkhwa |
| LLC | Limited Liability Company |
| ME | Medium Enterprise |
| MFB | Microfinance Bank |
| MFI | Microfinance Institution |
| MoC | Ministry of Commerce |
| MoF | Ministry of Finance |
| MSME | Micro, Small and Medium-sized Enterprises |
| NBMFI | Non-Bank Microfinance Institution |
| NFAS | Non-Financial Advisory Service |
| NFIS | National Financial Inclusion Strategy |

| | |
|---|---|
| NIBAF | National Institute of Banking and Finance |
| NPL | Non-performing loan |
| NSS | National Savings Scheme |
| NTN | National Tax Number |
| OLP | Orix Leasing Pakistan Limited |
| OJT | On-the-Job Training |
| PAAPAM | Pakistan Association of Automotive Parts & Accessories Manufacturers |
| PFI | Participating Financial Institution |
| PKR | Pakistan Rupia |
| PLGMEA | Pakistan Leather Garment Manufacturers and Exporters' Association |
| PPP | Public Private Partnership |
| PSIC | Punjab Small Industries Corporation |
| PSIF | Private Sector Investment Finance |
| ROA | Return on Assets |
| ROE | Return on Equity |
| RSP | Rural Support Program |
| SBP | State Bank of Pakistan |
| SE | Small Enterprise |
| SECP | Securities & Exchange Commission of Pakistan |
| SEDF | Sindh Enterprise Development Fund |
| SIMAP | Surgical Instrument Manufacturers Association of Pakistan |
| SME | Small and Medium-Sized Enterprises |
| SMEDA | Small and Medium Enterprises Development Authority |
| TDAP | Trade and Development Authority of Pakistan |
| UNIDO | United Nations for Industrial Development Organization |
| USAID | United States Assistance for International Development |
| VCF | Value Chain Financing |
| WALR | Weighted Average Lending Rate |

Exchange Rate (August 2018)
USD 1 = JPY 110.5
PKR 1 = JPY 0.89

# Summary

## Introduction

Accounting for 40% of GDP and 40% of exports and employing 80% of workers in non-agricultural sectors, Pakistan's small and medium-sized enterprises (SME) sector plays a pivotal role in the country's economic growth, employment creation and poverty reduction.[1] However, SME finance in Pakistan, which is indispensable for SME development, represents only 9% of outstanding loans to the private sector in amount as of the end of 2016 with only 6% of SMEs receiving loans from banks.

This "Data Collection Survey on SME Finance in Pakistan", contracted by JICA to a Japanese consulting firm, IMG Inc., aims to collect information and propose Japanese government support for the improvement of SME access to finance in Pakistan. The manufacturing sector was set as the priority sector for JICA assistance in Pakistan.

In order to prepare multiple options for JICA to promote SME finance in Pakistan, this Survey was conducted through a literature review and information collected through field surveys (from January to March 2018 and in July 2018) of the financial and Micro, Small and Medium-sized Enterprises (MSME) sectors. Institutions related to SME finance the JICA Survey Team visited included governmental institutions such as the State Bank of Pakistan (SBP) and the Ministry of Finance (MOF), commercial banks, donor agencies and other institutions. The JICA Survey Team also conducted interviews with government institutions, SMEs and associations in order to identify constraints on SME finance from SMEs' perspectives. Interviewed SME sub-sectors included Textile, Gem and Jewelry, Marble Processing, Leather Goods, Sports Goods, Surgical Instruments, Auto Parts and Light Engineering.

## Chapter 1 Pakistan's Macroeconomic Overview

Pakistan's overall macroeconomic performance significantly improved during the three-year period of 2013-2016 under the IMF's Extended Fund Facility (EFF) program. Structural reforms were implemented in taxation, the financial and the energy sector.

Real GDP growth rate hit in FY17 the highest (5.3%) in the last ten years, and the growth is expected to increase to about 6% over the medium term. On the other hand, deficit in balance of payment has been widened largely by China Pakistan Economic Corridor (CPEC)-related imports, higher oil prices and reduced remittances. Despite this deficit and weaker export performance, the authorities have still not allowed exchange rate flexibility. Consequently, the gap between the nominal and real effective exchange rates has been widening with the PKR/USD rate further appreciating by 3.4% in real effective

[1] Government of Pakistan, "Pakistan Vision-2025",2014; SMEDA, "Opportunities for Trade and Investment in SME Sector Pakistan", 2016

terms in FY17 (13% cumulatively over the past three years). This demonstrates the limited autonomy allowed to SBP.

Fiscal balance improved significantly due to IMF's EFF, after which fiscal performance has deteriorated. Tax collection by both the central government and provinces did not perform as expected. Combined with an unprecedented increase in development spending in FY17, the overall fiscal deficit (excluding grants) reached 5.8% of GDP in FY17.

The public debt from FY16 (68.6% of GDP) declined slightly to 68.1% of GDP in FY17 due to stronger PKR forex rates, continued economic growth, and government repayments to the banking sector. It should be noted that domestic debt composition has shifted towards shorter maturity instruments, exposing the government to refinancing risk and greater sensitivity to interest rate volatilities.

SBP maintained the policy rate at 5.75% throughout FY17. Helped by the reduced net government borrowing from banks in FY17 and the low real interest rate environment, credit to the private sector (mainly in the manufacturing sector) grew by 16.8% in FY17, expanding by PKR 748 billion over the FY16 level.

Under the IMF program, structural reforms were implemented in key areas such as the energy and financial sectors and the business climate. Successful efforts to improve the business climate and financial access for MSME have begun to take effect. In the financial sector, undercapitalized banks and the level of high non-performing loans (NPLs) were appropriately addressed.

## Chapter 2 SME Sector in Pakistan and their Support

Since there is no uniform definition of SMEs in Pakistan, the Survey follows the definition used by SBP that defines small enterprises (SEs) and medium enterprises (MEs) in terms of the number of employees and annual turnover. Moreover, two sub-categories are added: Lower-end SEs (11 to 30 employees) and Upper-end SEs (31 to 50 employees). The differentiation is crucial for the design of supports appropriate to SMEs' size.

The Survey Team selected eight target sectors, where the majority of manufacturing SMEs are operating: Textile, Gem and Jewelry, Marble Processing, Leather Goods, Sports Goods, Surgical Instruments, Auto Parts and Light Engineering. Many SMEs share the same constraints on their economic activities, irrespective of the sector they are working in.

The most crippling obstacle SMEs face is a lack of funds. They have not been able to obtain loans from banks or other financial institutions due to several factors such as a lack of collateral, non-transparent accounting and financial institutions' lack of understanding of the SME sector. Thus most SMEs rely on informal financial support from their friends and relatives or credit-sales by their suppliers.

Another major issue is obsolete technologies. Many SMEs use old equipment and machines that are not suitable for complex processing and consume a lot of electricity and materials. Upper-end SEs understand the necessity to upgrade their machinery to improve efficiency and product quality while most lower-end SEs are not much aware of the need due to their insufficient knowledge about the latest technology.

Human resources are also a major problem. Many lower-end SEs have difficulty in securing a sufficient skilled workforce when receiving orders. A majority of the labor force are illiterate and uneducated, partly because the number of training institutes for workers is not enough. Therefore, SMEs have to offer high wages to employ skilled labor when necessary.

Many SMEs also face difficulty in procuring good quality raw materials. Most materials are available in the domestic market; but their quality is often unknown or low, and the variety is limited. As is often the case with most SMEs, unpredictability of orders does not allow SMEs to stock raw materials, resulting in a longer lead time.

## Chapter 3 Financial Sector Overview and SME Finance

Growth in private sector credit in Pakistan stalled until recently after the economic crisis in 2008. Deterioration in the fiscal balance from FY10 to FY14 increased the cumulative amount of government debt, the interest rates of which remained much higher than current levels during this period. Therefore, commercial banks invested in government paper to earn “risk-free” profits instead of extending credit to private sector businesses, which caused the “crowding-out” of private sector credit.

Besides the low level of credit to the private sector as a whole, the performance of SME finance deteriorated significantly after 2008. SME credit represented only about 1.2% of GDP with an alarmingly high NPL ratio of 34%.

Since 2013, however, SME credit has been recovering largely due to the improved macroeconomic performance, amounting to PKR 401 billion as of end 2016, increasing by 31.5% from PKR 305 billion at end 2015. The SME NPLs ratio improved from 35.8% (end 2012) to 20.3% in the end of 2016 and 21.1% in September 2017.

While the growth in SME lending in the recent past has been an encouraging trend, the penetration of SME finance still remains very low at 7.8% of the total private sector credit as of September 2017, compared to SBP’s target that is 15% by 2020. As advances to deposits ratios were lower than 50% in the last three years, the main cause of the low penetration is not the banking sector’s lack of liquidity, but it can be found in a combination of various socio-economic conditions in Pakistan.

Donors have been using financial schemes that help enhance banks’ risk-taking capacity thought without providing direct funding. Such schemes include SBP’s Credit Guarantee Scheme (CGS) for SMEs funded by DFID, IFC's risk sharing facility (RSF), and Developmental Credit Authority (DCA) of USAID; all of which partially cover banks' losses in different ways.

Supply Chain Finance (SCF) has been also promoted by SBP and donors as one of the most promising tools for financing SMEs (especially SEs). SCF can allow SMEs to borrow against their customers' creditworthiness instead of their own with reduced collateral requirements. Karandaaz and IFC in particular have been providing business advisory services and financial assistance to promote SCF among commercial banks.

## Chapter 4 Financial Access and Inclusion for SMEs

The primary causes for the low penetration of SME finance in Pakistan are categorized into three groups: regulatory constraints; demand side constraints (capacity issues of SMEs); and supply side constraints (capacity issues of the banking sector). SMEs' informality and lack of collateral are often cited as the largest demand side constraints. The degree and characteristics of "informality" and "lack of collateral," however, are different based on the size of the SMEs.

Given the level of formality and reliability in the enterprises' accounting and transaction records, commercial banks consider only limited liability companies (LLCs) as formal enterprises. Most MEs and upper-end SEs that have eagerness to grow are registered as an LLC while most of lower-end SEs are not registered, staying informal.

While the status of an LLC provides an enterprise with a better opportunity for a large amount of loan, better access to foreign markets, and direct access to government tenders, an LLC must comply with government regulations. While tax evasion is the primary reason for many enterprises not to formalize their status in Pakistan, the difficulty of complying with all government regulations, including company registration, is also an important element that discourages enterprises from formalizing.

SMEs' lack of collateral, another major demand side issue, does not necessarily mean that SME owners do not have assets to pledge for collateral. Even when SE owners have real estate that has value to fully or partially secure a loan, its collateralization process can be too cumbersome for them. Even if Commercial banks are discouraged to lend to SMEs since enforcement of a mortgage often needs to be brought to court, with the settlement of a case taking five to ten years.

Many banks in Pakistan have adopted SCF for SMEs to reduce SMEs' collateral requirements. One of the large banks has already taken a further step by eliminating all collateral requirements within SCF. This recent evolution indicates that banks in Pakistan are gradually moving in the direction of less dependency on collateral.

# Chapter 5 Proposed SME Support by JICA

There are different conceivable options for JICA financial assistance. JICA has two schemes for its financial assistance for SME development: (a) sovereign loan to be provided to the Ministry of Finance of Pakistan; and (b) Private Sector Investment Finance (PSIF), which is a loan or equity investment directly provided to enterprises in Pakistan. Options that are presented for JICA's financial assistance include: (1) Loans to commercial banks for on-lending to SMEs; (2) Loans to MSE banks for on-lending to large micro-enterprises and lower-end SEs; (3) Equity investment in MSE banks; (4) Loans to Non-Bank MFIs for on-lending to micro-enterprises; (5) Foreign currency loan (stand-alone) for on-lending to export-oriented SMEs; (6) JICA/IFC collaboration to create a fund for offering foreign currency loans or a Risk Sharing Facility to banks; (7) Equity investment in CGS for SME finance; (8) Programmatic loan for SME development; and (9) Loans to Leasing Companies.

Below are presented the areas where JICA technical assistance would be recommended for advancing the financial inclusion of lower-end SEs, upper-end SEs and MEs with a special focus on the manufacturing sector.

| Support area | Lower-end SEs | Upper-end SEs | MEs |
|---|---|---|---|
| Knowledge on accounting/financing | Financial literacy<br>Book-keeping | Financial management | |
| Knowledge on business management | Basic business skills | Strategic planning | |
| Technical skills | Basic technical skills | Advanced technical skills | Production and quality management |
| Formalization | - | Streamlining of regulations and administrative procedures | - |
| Dialogue facilitation | Platforms to facilitate dialogue between SMEs and commercial banks | | |
| Capacity building for commercial banks | Seminars, training and consulting on international best practices to advance SME finance by commercial banks | | |

# Introduction

## 1 Background and Objective of the Survey

As of 2015, with a population 185 million the Islamic Republic of Pakistan's population is the sixth largest country in the world in terms of population. The fact that more than 50% of the population is below 19 years of age has made employment an imminent need of the country's growing population. "Pakistan Vision 2025", the long-term development plan announced in August 2014 that aims at a continuous economic growth of 8% per year until 2025, emphasizes "sustainable, inherent, inclusive growth" and "private sector-led growth" as important objectives to be achieved.

Accounting for 40% of GDP and 40% of exports and employing 80% of workers in non-agricultural sectors, Pakistan's small and medium-sized enterprises (SME) sector plays a pivotal role in the country's economic growth, employment creation and poverty reduction.[2] However, SME finance in Pakistan, which is indispensable for SME development, represents only 9% of outstanding loans to the private sector in amount as of the end of 2016 with only 6% of SMEs receiving loans from banks. The bottlenecks to SME finance are represented by financial institutions' lack of understanding of the SME sector and their excessive dependence on collateral as well as SMEs' lack of capacity and accountability in their operations and financial management. In order to promote SME development in Pakistan, a conducive environment that leads to an improvement in SMEs' access to finance needs to be fostered.

This "Data Collection Survey on SME Finance in Pakistan", contracted by JICA to a Japanese consulting firm, IMG Inc., aims to collect information and propose Japanese government support for the improvement of SME access to finance in Pakistan. The manufacturing sector was set as the priority sector for JICA assistance in Pakistan.

## 2 Survey Team Members

| Responsibilities | Name |
|---|---|
| Team Leader / SME Finance / SME Promotion | Shinichi Mori |
| SME Finance | Chikako Matsumoto |
| SME Diagnosis / SME Analysis | Gantumur Burneebaatar |
| SME Analysis | Jumpei Suenaga |

## 3 Survey Area

Major large cities, including Islamabad, Karachi, Lahore, Faisalabad and Sialkot.

[2] Government of Pakistan, "Pakistan Vision-2025",2014; SMEDA, "Opportunities for Trade and Investment in SME Sector Pakistan", 2016

# 4 Survey Methodology

This Survey was conducted through a literature review and information collected through field surveys of the financial and Micro, Small and Medium-sized Enterprises (MSME) sectors in Pakistan. Field surveys were conducted from January to March 2018 and in July 2018. The Survey work flow is presented in **Figure 1**.

During the field surveys, the JICA Survey Team visited the State Bank of Pakistan (SBP), the Ministry of Finance (MOF), the International Monetary Fund (IMF) and different donor agencies playing leading roles in Pakistan's macroeconomic management and/or SME finance. Interviews were also conducted with commercial banks that were proactively engaged in SME finance, as well as other institutions that were promoting financing to MSME. The following table shows the organizations visited by the JICA Survey Team in relation to the financial sector and SME finance.

**Table 1 Institutions related to SME finance visited by the JICA Survey Team**

| Category | Institutions and Departments |
|---|---|
| Government of Pakistan | • SBP: Infrastructure, Housing and SME Finance Department, Financial Stability Department, Economic Policy Review Department, Statistics and Data Warehouse Department, Agriculture Credit and Micro Finance Department<br>• MOF: Debt Policy Coordination Office, Economic Affairs Department, Joint Secretary in Banks and Finance |
| Commercial banks | • Dubai Islamic Bank, Meezan Bank, MCB Bank, National Bank of Pakistan, JS Bank, United Bank, Habib Bank, Habib Metro Bank, Faisal Bank, Soneri Bank, Samba Bank, Bank Alfalah, Silk Bank, Allied Bank, First Women Bank |
| Donor agencies | • IMF, World Bank, DFID, ADB, USAID, IFC |
| Other institutions | • Karandaaz, Pakistan Microfinance Investment Company, Pakistan Microfinance Network, Orix Leasing |

The JICA Survey Team also conducted interviews with government institutions, SMEs and associations in order to identify constraints on SME finance from SMEs' perspectives. Government institutions included federal agencies, provincial agencies, educational institutions as well as technical and vocational training institutions. The JICA Survey Team also interviewed SMEs recommended by industry associations. Interviewed SME sub-sectors included textile, gem and jewelry, marble processing, leather goods, auto parts and light engineering products. The SME development related organizations interviewed by the JICA Survey Team are presented in **Table 2**.

**Table 2 Organizations related to SME development interviewed by the JICA Survey Team**

| Category | Organizations |
|---|---|
| Federal agencies | • Ministry of Finance<br>• Securities & Exchange Commission of Pakistan (SECP)<br>• Trade and Development Authority of Pakistan (TDAP)<br>• Small and Medium Enterprises Development Authority (SMEDA)<br>• Engineering Development Board (EDB)<br>• Board of Investment (BOI) |
| Provincial agencies | • Sindh Enterprise Development Fund (SEDF)<br>• Sindh Department and of Industries and Commerce (SDIC)<br>• Punjab Small Industries Corporation (PSIC)<br>• Investment Climate Reform Unit (ICRU), Planning and Development Department, Punjab Government |
| Enterprise associations, Sector support enterprises[3] | • Pakistan Gems and Jewelry Development Company (PGJDC)<br>• Furniture Pakistan (FP)<br>• Pakistan Sugar Mills Association (PSMA)<br>• All Pakistan Marble and Granite Association (APMGA)<br>• Pakistan Association of Automotive Parts & Accessories Manufacturers (PAAPAM)<br>• Pakistan Foundry Association (PFA)<br>• Pakistan Hosiery Manufacturers Association (PHMA)<br>• Pakistan Ready Garment Manufacturers and Exporters Association (PRGMEA)<br>• Council of Power Loom Owners in Faisalabad (CPLO)<br>• Pakistan Leather Garment Manufacturers and Exporters Association (PLGMEA)<br>• Pakistan Glove Manufacturers and Exporters Association (PGMEA)<br>• Pakistan Sports Goods Manufacturers and Exporters Association (PSGMEA)<br>• Engineering Components and Machinery Manufacturing Association of Pakistan (ECMMA)<br>• Surgical Instruments Manufacturers and Association of Pakistan (SIMAP) |
| Educational institutions, Technical and vocational training institutions | • Technical Upgradation and Skill Development Company (TUSDEC)<br>• National Textile University (NTU)<br>• Gems & Jewelry Training and Manufacturing Center of Lahore (GJTMC)<br>• Leather Products Development Institute (LPDI) |

Based on the findings from the literature review and field surveys, the JICA Survey Team prepared options for JICA's financial and technical assistance to improve SME finance in Pakistan.

[3] Enterprises that were established by the Government of Pakistan to support priority sectors following the Pakistan Initiative for Strategic Development supported by USAID.

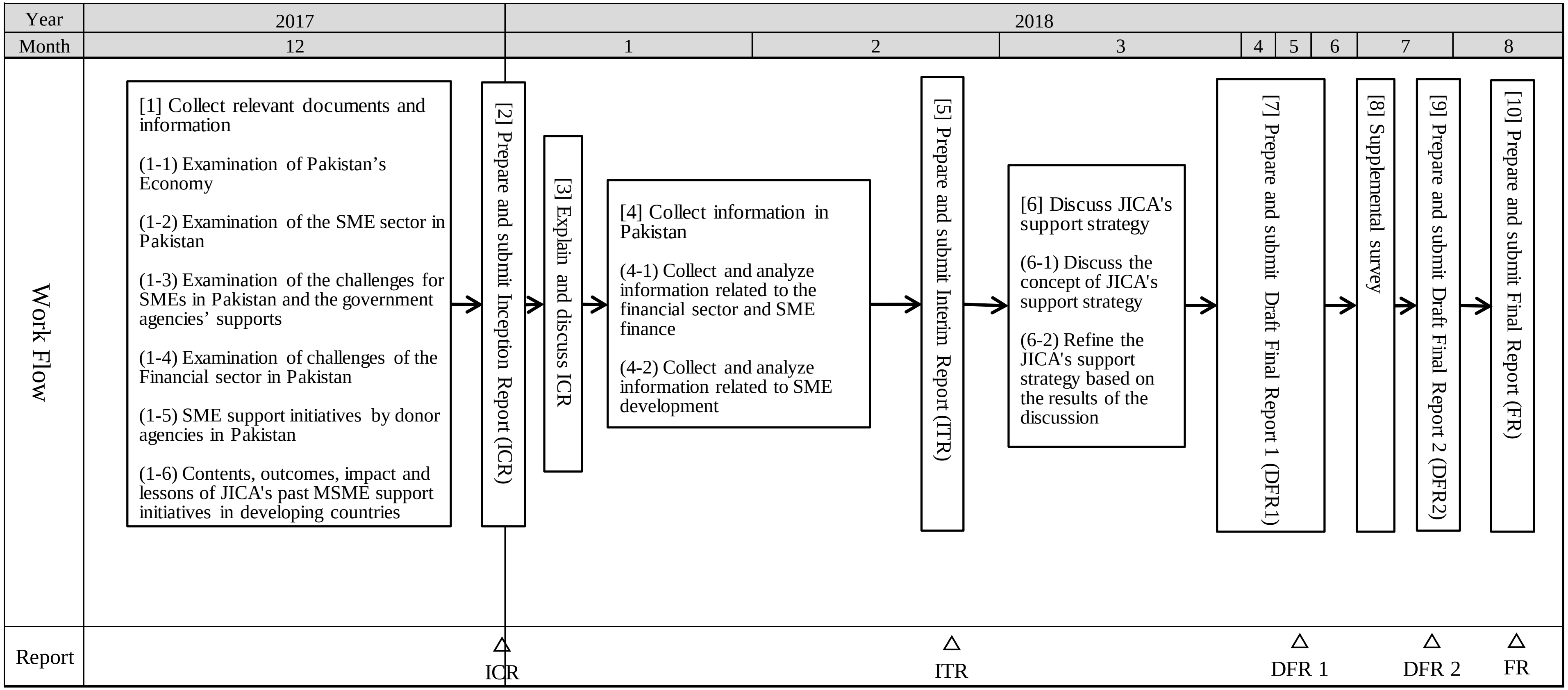



**Figure 1 Work flow**

# Chapter 1 Pakistan's Macroeconomic Overview

Pakistan's overall macroeconomic performance significantly improved during the three-year period of 2013-2016 under the IMF's Extended Fund Facility (EFF) program. The program was introduced in September 2013 and was completed in September 2016. During that period, economic growth gradually recovered and continued improving to reach in FY17 its highest level in the last ten years.[4] Key structural reforms were implemented, including reforms to taxation, the financial sector and the energy sector, along with the successful launch of new business climate reforms. Tax policy and administration reforms improved tax revenue, helping to reduce the fiscal deficit and to increase development and social spending, particularly on infrastructure and social safety nets. Similarly, with sensible policies and declining oil prices, inflation was contained and foreign reserves were rebuilt. Progress was also made towards the independence of SBP, and financial sector performance was reinforced.

Following the completion of the above-mentioned IMF program in September 2016, however, Pakistan's macroeconomic policy implementation has weakened. Consequently, gains in macroeconomic stability have begun to recede, manifesting in weaker fiscal consolidation and decreased balance of foreign reserves in FY17. The fiscal deficit in FY17 reached to its highest level compared to those in the last three years.

The following are Pakistan's latest macroeconomic outlooks as of end FY17.

## 1-1 Economic Growth

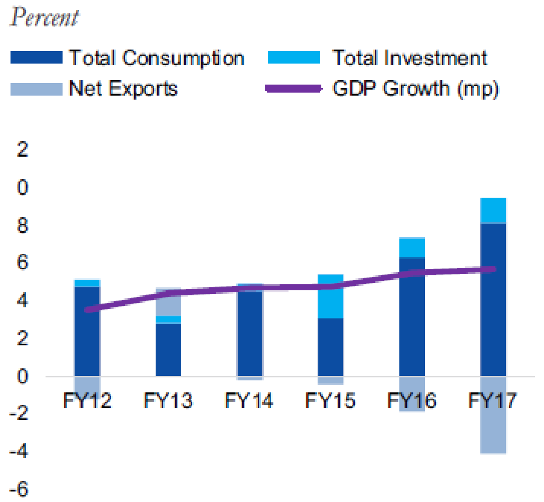
Buoyant activity in the real economy supported by a recovering agriculture sector and strong performance in private sector consumption and the service sector achieved a real GDP growth of 5.3% in FY17; higher than 0.8% in FY16. The FY17 growth rate was the highest level in the last ten years. The agricultural sector of which the GDP share is about 20% has recovered, registering a 3.5% growth compared to the previous year's growth rate of 0.3%. The service sector (60% of GDP) achieved a growth of 6%. On the demand side, the total consumption of which the private sector consumption takes up most contributed to 92% of the GDP growth. Rising income, higher domestic demand, service sector growth, moderate but steady growth in small-scale manufacturing, and agriculture sector recovery contributed to the growth of the private sector consumption.

Economic growth is expected to continue and reach 5.8% in FY19, and over the medium term, it is expected to increase to about 6%. Domestic demand is expected to remain strong with continuing strong machinery imports, fast growing iron/steel and auto sectors. Growth in Pakistan has been benefitting from rising investment related to the China-Pakistan Economic Corridor (CPEC).

However, tapering domestic cement manufacturing and decreased remittances may indicate a sign of slowing growth. Moreover, this positive economic outlook is contingent on the policy implementation

4 Fiscal Year of 2017. Pakistan's fiscal year starts on July 1$^{st}$ and ends on June 30$^{th}$.

that effectively manages both deteriorating fiscal and current account deficits.




Note: mp: market price

**Figure 2 Point contribution to GDP growth – aggregate demand**

Source: "Pakistan Development Update, Nov. 2017", The World Bank

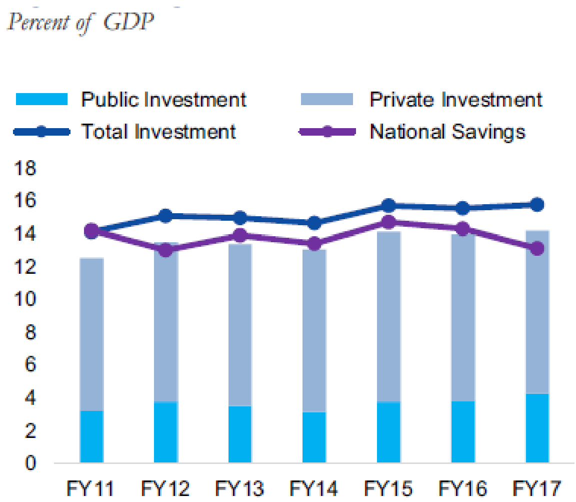



**Figure 3 Savings and investment**

Source: "Pakistan Development Update, Nov. 2017", The World Bank

## 1-2 Balance of Payment

Pakistan's foreign reserves declined from USD 18.2 billion at the end of FY16 to USD 16.2 billion at the end of FY17 due to a widening current account deficit and a mostly unchanged PKR/USD exchange rate. In FY17, the current account deficit widened to 4.1% of GDP, reflecting increasing imports (17.6%) and declining exports over the last few years. Exports also declined by 0.2% in FY17.

Increased imports related to CPEC investments, higher oil prices, and reduced remittances (-2.8%), are the primary factors for the widened current account deficit. International remittances, which had been less sensitive to previous international and domestic shocks, declined due to slower growth in the Gulf Cooperation Council (GCC) countries from which originate roughly two thirds of remittances to Pakistan.

**Table 3 Balance of payment summary**

USD billion unless mentioned otherwise

| | FY16 | FY17 |
|---|---|---|
| **i. Current account (A+B+C+D)** | **-4.9** | **-12.4** |
| **A. Trade balance** | **-19.3** | **-26.6** |
| Exports | 22.0 | 21.9 |
| Imports | 41.3 | 48.5 |
| **B. Services net** | **-3.4** | **-4.3** |
| of which, CSF | 0.9 | 0.6 |
| **C. Balance on primary income b** | **-5.3** | **-5.0** |
| **D. Balance on secondary income b** | **23.2** | **23.5** |
| of which, remittances | 19.9 | 19.4 |
| **ii. Capital account** | **0.3** | **0.3** |
| **1. Balance from current and capital accounts (i+ii) c** | **-4.6** | **-12.1** |
| **2. Financial accounts d** | **-6.8** | **-10.0** |
| **of which:** | | |
| Direct investment | -2.3 | -2.6 |
| Portfolio investment | 0.4 | 0.2 |
| Net acquisition of financial assets | 0.1 | 1.3 |
| Net incurrence of financial liabilities | 5.0 | 8.8 |
| **3. Errors and omissions** | **0.5** | **0.2** |
| Overall balance (-1+2-3) | -2.7 | 1.9 |
| **SBP reserves (excl. CRR, SCRR)** | **18.2** | **16.2** |
| **Memorandum items** | | |
| *Current account (percent of GDP)* | *-1.7* | *-4.1* |
| *Trade account (percent of GDP)* | *-6.9* | *-8.7* |
| *Export growth (percent)* | *-8.8* | *-0.2* |
| *Import growth (percent)* | *-0.2* | *17.6* |
| *Remittance growth (percent)* | *6.4* | *-2.8* |
| *Financial account (percent of GDP)* | *2.4* | *3.3* |

Notes: a) As per Balance of Payments Manual 6 (BPM6); b) In BPM6, the income account has been renamed 'primary income' and current transfers, 'secondary income'; c) A negative balance shows that the economy is a net borrower from the rest of the world; d) A negative balance highlights a net increase in the incurrence of foreign liabilities.

Source: "Pakistan Development Update, Nov. 2017", The World Bank (note: mp: market price)

IMF projected that the current account deficit would peak at 3.4% of GDP in 2019 as CPEC-related imports accelerate and could subsequently decline after 2019. It is, however, contingent on an exports recovery that is expected to be realized through a reduction in supply-side bottlenecks and an improvement in the business climate.[5] In light of the widening current account deficit, Pakistan will have to face an increasing need for external financing over the medium term, amounting to about 7.5% of GDP.

[5] "Pakistan Staff Report for the 2017 Article IV Consultation," May 31, 2017, IMF.

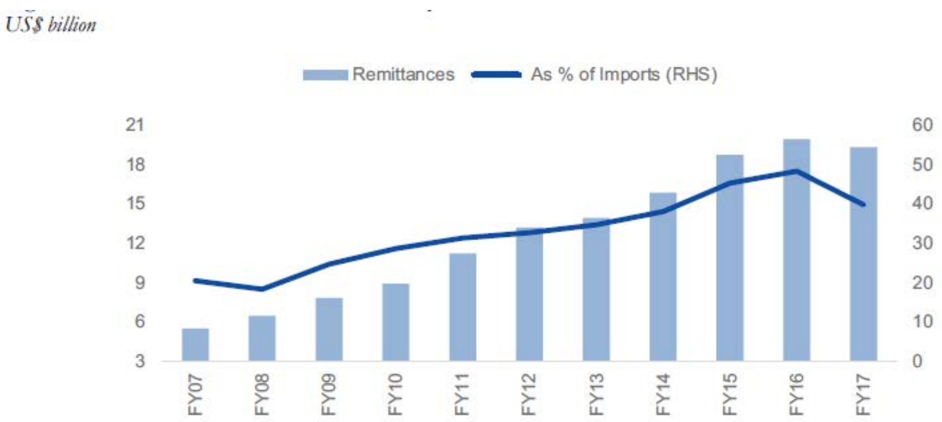



**Figure 4 Workers' remittances – a mainstay of the current account**

Source: "Pakistan Development Update, Nov. 2017", The World Bank

## 1-3 Foreign Exchange Rate

Pakistan appears to be maintaining a managed float exchange rate regime.[6] Despite recent current account deficits and weaker export performance, the authorities have still not allowed exchange rate flexibility. Consequently, the gap between the nominal and real effective exchange rates has been widening with the PKR/USD rate further appreciating by 3.4% in real effective terms in FY17 (13% cumulatively over the past three years). This demonstrates the limited autonomy allowed to SBP, and further reforms towards its independency have been pressed by the IMF and World Bank.[7]

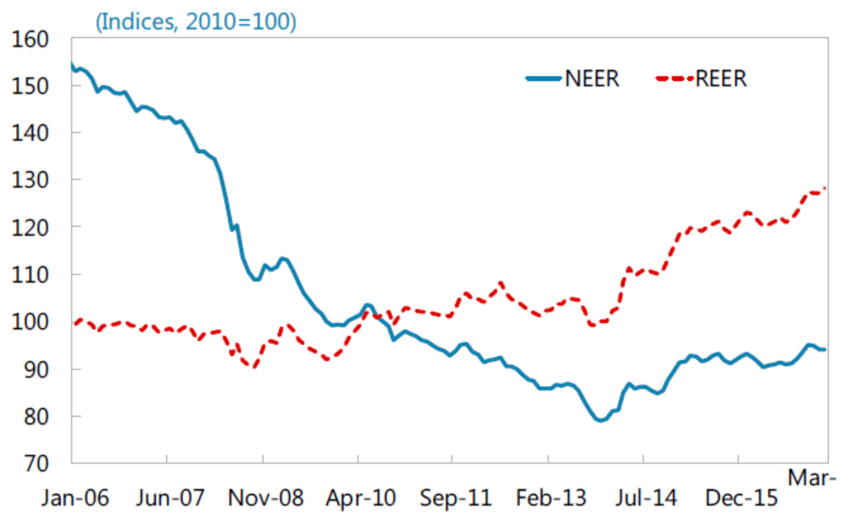



**Figure 5 Nominal and real effective exchange rate**

Source: "Pakistan Staff Report for the 2017 Article IV Consultation," May 31, 2017, IMF.

[6] "Pakistan Development Update, Nov. 2017", The World Bank. "Pakistan Staff Report for the 2017 Article IV Consultation," May 31, 2017, IMF.

[7] In mid-December 2017, PKR devalued against USD. USD/PKR rate was 110.5 as of Dec. 25, 2017. Further monitoring of the exchange rate is required.

### 1-4 Fiscal Balance

Under the three-year program of IMF EFF, reforms to tax policy and administration have promoted better revenue mobilization, and fiscal balances improved significantly. The fiscal deficit (excluding grants) was reduced to 4.6% of GDP in FY16. For the FY17 budget, the target deficit ratio was 3.8% of GDP, and fiscal responsibility legislation was revised to target further consolidation through the medium term.[8] However, after the completion of the IMF program, fiscal performance has deteriorated with lower than expected revenues. Tax collection by both the central government and provinces did not perform as expected. In particular, provinces that rendered fiscal surpluses during the IMF program period reverted back to deficits. Combined with an unprecedented increase in development spending in FY17, the overall fiscal deficit (excluding grants) reached 5.8% of GDP in FY17.

**Table 4 Summary of Pakistan's fiscal operations**

PKR billion unless mentioned otherwise

| | | | | Percent growth | |
|---|---|---|---|---|---|
| | **FY15** | **FY16** | **FY17** | **FY16** | **FY17** |
| **Total revenue** | **3,931** | **4,447** | **4,937** | ***13.1*** | ***11.0*** |
| Tax revenue | 3,018 | 3,660 | 3,969 | *21.3* | *8.4* |
| Federal | 2,812 | 3,377 | 3,647 | *20.1* | *8.0* |
| Provincial | 206 | 283 | 322 | *37.6* | *13.6* |
| Non-tax | 913 | 787 | 967 | *-13.9* | *23.0* |
| Federal | 838 | 693 | 888 | *-17.3* | *28.1* |
| Provincial | 76 | 93 | 79 | *23.4* | *-14.8* |
| **Expenditures** | **5,387** | **5,796** | **6,801** | ***7.6*** | ***17.3*** |
| Current *of which*: | 4,425 | 4,694 | 5,198 | *6.1* | *10.7* |
| Interest | 1,304 | 1,263 | 1,348 | *-3.1* | *6.1* |
| Defense | 698 | 758 | 888 | *8.6* | *17.2* |
| Development | 1,113 | 1,301 | 1,693 | *16.9* | *30.1* |
| Net lending | 27 | 13 | -13 | | |
| Statistical discrepancy | -178 | -212 | -78 | | |
| **Fiscal balance** | **-1,456** | **-1,349** | **-1,864** | ***-7.3*** | ***38.1*** |
| % of GDP | *-5.3* | *-4.6* | *-5.8* | | |
| **Memorandum items** | | | | | |
| GDP (nominal) | 27,443 | 29,103 | 31,862 | | |

Source: "Pakistan Development Update, Nov. 2017", The World Bank

[8] The amendments to the Fiscal Responsibility and Debt Limitation Act were passed through the Financial Act 2016. The amendments stipulate the medium-term plan for the government to reduce the public debt to 50% of GDP.

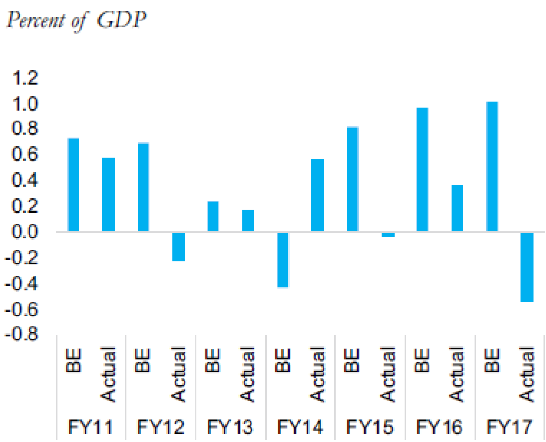



**Figure 6 Trend in provincial balances (budged vs. actual)**
Source: "Pakistan Development Update, Nov. 2017", The World Bank

While progress has been made in raising the revenue-to-GDP ratio and strengthening tax compliance, recent weaknesses in fiscal policy implementation and the FY18 budget imply that fiscal targets will not be achieved in the short-term. Moreover, pressure on the fiscal balance will be rising during the period leading up to the general elections in 2018.

### 1-5 Public Debt

The public debt (68.6% of GDP) from FY16 declined slightly to 68.1% of GDP in FY17 due to stronger PKR forex rates, continued economic growth, and government repayments to the banking sector. In FY17, 43% of the public external finance was provided through commercial loans of which more than 50% were from China.[9] It should be noted that domestic debt composition has shifted towards shorter maturity instruments, exposing the government to refinancing risk and greater sensitivity to interest rate volatilities.

### 1-6 Monetary policy and inflation

Headline inflation rose moderately, reaching 4.2% in FY17; still within the 6% target. This is attributed primarily to higher food prices and the fact that the nominal exchange rate maintained a rate higher than the real effective rate throughout the year. Core inflation also went up to 5.5% as of April 2017.

SBP maintained the policy rate at 5.75% throughout FY17. Helped by the reduced net government borrowing from banks in FY17 and the low real interest rate environment, credit to the private sector grew by 16.8% in FY17, expanding by PKR 748 billion over the FY16 level. The improved credit extension was broad-based in terms of financing instruments but was concentrated in the manufacturing sector.

[9] "Pakistan Development Update," Nov. 2017, The World Bank.

**Table 5 Monetary aggregates**

PKR billion unless mentioned otherwise

| | Stock | | Flow (July to June) | |
|---|---|---|---|---|
| | **End-Jun-16** | **End-Jun-17** | **FY16** | **FY17** |
| **Net foreign assets** | **1,008** | **602** | **195** | **(405)** |
| of which, SBP | 1,033 | 829 | 311 | (204) |
| **Net domestic assets** | **11,817** | **13,979** | **1,348** | **2,161** |
| Government borrowing: | 7,820 | 8,955 | 861 | 1,136 |
| Budgetary borrowing | 7,195 | 8,282 | 791 | 1,087 |
| from SBP | 1,442 | 2,350 | (487) | 908 |
| from scheduled banks | 5,753 | 5,932 | 1,278 | 179 |
| Commodity operations | 637 | 687 | 72 | 50 |
| Non-govt. sector borrowing: | 5,013 | 6,120 | 557 | 1,107 |
| Private sector | 4,450 | 5,197 | 446 | 748 |
| PSEs 1/ | 544 | 899 | 109 | 355 |
| Other items | (1,015) | (1,096) | (70) | (81) |
| **Broad money (M2)** | **12,825** | **14,581** | **1,543** | **1,756** |
| **Reserve money (RM)** | **3,974** | **4,868** | **832** | **894** |
| | | | | |
| **Memorandum item** | | | | |
| *Currency in circulation* | *3,334* | *3,911* | *779* | *577* |
| *Growth (y-o-y)* | | | | |
| *M2* | *13.7* | *13.7* | - | - |
| *RM* | *26.5* | *22.5* | - | - |
| *Currency in circulation* | *30.5* | *17.3* | - | - |

Note: Rounded off to the nearest value.

1/ Sum of credit to Public Sector Enterprises (PSEs) and PSEs Special Account-Debt Repayment with SBP/PSPC.

Indicators are reported in the Provisional Data on Monetary Aggregates released by SBP on a weekly basis.

Source: "Pakistan Development Update", Nov. 2017, The World Bank

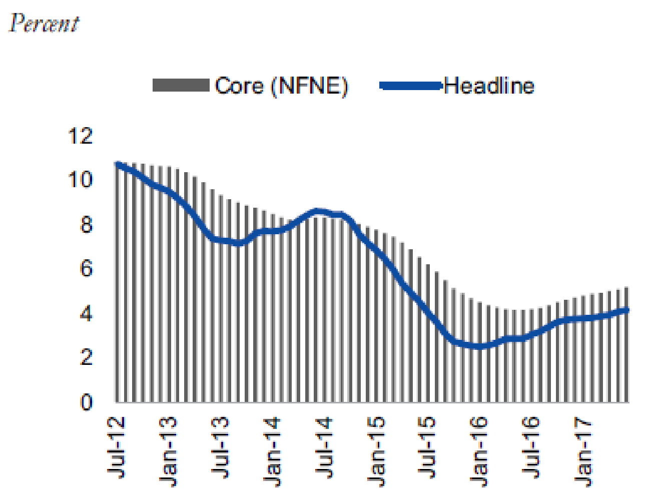



**Figure 7 Monthly moving average of core and headline inflation**

Source: "Pakistan Development Update, Nov. 2017", The World Bank

## 1-7 Structural Reforms

Under the IMF program, structural reforms were implemented in key areas such as the energy and financial sectors and the business climate. While progress has been seen, significant challenges remain.

Cash transfers to the poor continue under the Benazir Income Support Program (BISP) as part of the social safety net program.[10] Successful efforts to improve the business climate and financial access for MSME have begun to take effect. In the financial sector, undercapitalized banks and the level of high non-performing loans (NPLs) were appropriately addressed. In the energy sector, power outages that were one of the bottlenecks to business development in Pakistan have been addressed. On the other hand, public enterprises reforms and efforts to enable private sector participation have stalled significantly.[11]

On the fiscal front, Pakistan aims to increase tax collection to 15% of GDP by 2020. Reaching this target will require the next level of tax reforms, including broadening the tax base, tightening tax compliance, and reducing tax related administrative costs. Similarly, the government's upcoming Strategic Trade Policy Framework (2018–23) plans to address declining exports through tariff reforms, export diversification, and the integration of Pakistan's economy into global value chains.

[10] A federal unconditional cash transfer poverty reduction program, the largest single social safety net program, in Pakistan, launched in July 2008.

[11] IMF reports that annual losses by public sector enterprises amounted to 0.3% of GDP in CY16 and that their cumulative losses amounted to 3.8% of GDP ("Pakistan Staff Report for the 2017 Article IV Consultation," May 31, 2017, IMF). Such public sector enterprises include Pakistan International Airlines (PIA), Pakistan Steel Milles (PSM), Pakistan Railways and publicly-owned distribution companies (DISCOs) of the power sector. Pending privatization and partial privatization include those for PIA, PSM, Gujranwala Electric Power Company (GEPCO), DISCO and Kot Addu Power Company (KAPCO).

# Chapter 2 SME Sector in Pakistan and their Support

## 2-1 Overview of the SME Sector in Pakistan

### 2-1-1 Definition of SMEs

There is no uniform definition of SMEs available in Pakistan. Federal government agencies and SME development organizations, such as SME Bank, Small and Medium Enterprises Development Authority (SMEDA), the Federal Board of Revenue (FBR) and SBP, have each defined SMEs in different ways. The criteria used in their definitions vary across the organizations with, for example, SME Bank using only total number of assets as the criterion, while FBR uses only the number of employees and SBP the nature of the business, number of employees and annual sales.

The following table shows the SME definitions used by different organizations in Pakistan:

**Table 6 Definitions of SMEs in Pakistan**

| No | Organizations | Small enterprise | Medium enterprise |
|---|---|---|---|
| 1 | SME Bank | Total assets: PKR 20 million | Total assets: PKR 100 million |
| 2 | Federal Board of Revenue | Less than 10 employees | N/A |
| 3 | Punjab Small Industries Corporation | Fixed investment: Up to PKR 20 million excluding land and building | N/A |
| 4 | Punjab Industries Department | Fixed assets: PKR 10 million excluding cost of land | N/A |
| 5 | Sindh Industries Department | Equity engaged in handicraft or consumer and producer goods worth PKR 10 million | Number of employees: less than 250 (manufacturing)<br>or 50 persons (services). |
| 6 | State Bank of Pakistan | Number of employees: up to 50 | Number of employees: 51-250 for (manufacturing/<br>services).<br>Number of employees: 51-100 for (trading)<br>Annual turnover: above PKR 150 million and up to PKR 800 million |
| 7 | SMEDA | Number of employees: up to 250<br>Annual turnover: Up to PKR 250 million | |
| 8 | International Finance Corporation | Number of employees: 10 to 50<br>Total assets: USD 100,000 to USD 3 million<br>Annual turnover: USD 100,000 to USD 3 million | Number of employees: 50 to 300<br>Total assets: USD 3 million to USD 15 million<br>Annual turnover: USD 3 million to USD 15 million |

Source: Karandaaz, "Nature and Characteristics of SME Financing and NPLs in Pakistan", 2017

This Survey in principle follows the SME definition used by SBP with sub-categories for small enterprises "Lower-end small enterprises" (11 to 30 employees) and "Upper-end small enterprise" (31 to 50 employees) being added. Micro enterprises, which are defined by SBP as enterprises with up to 10 employees, are principally excluded from SMEs.

### 2-1-2 Number of SMEs

Reliable data on the current number of SMEs in Pakistan is not available. All organizations refer to the results of the Pakistan's 2005 Economic Census implemented by the Pakistan Bureau of Statistics.[12] Although information was collected from all of the 3.2 million enterprises that were identified at the time of the survey,[13] the number of enterprises has apparently increased drastically up to the present.[14]

The results of the census showed that 78.5% of the enterprises were engaged in tertiary industries (wholesale, retail, trade and service sectors), 20% in secondary industries (mining, power generation, gas and water supply, construction and manufacturing) and 1.5% in primary industries (agriculture, forestry, hunting and fishery). The number of the enterprises for each economic sector is shown in the table below:

**Table 7 Number of enterprises by economic sector**

| No | Economic sector | Number of enterprises | Share |
|---|---|---|---|
| 1 | Agriculture, forestry, hunting and fishing | 46,378 | 1.6% |
| 2 | Mining and quarrying | 713 | 0.02% |
| 3 | Manufacturing | 583,329 | 19.7% |
| 4 | Electricity, gas and water | 124 | 0.004% |
| 5 | Construction | 1,410 | 0.0% |
| 6 | Wholesale and retail trade and restaurants and hotels | 1,566,722 | 53.0% |
| 7 | Transport, storage and communication | 51,564 | 1.7% |
| 8 | Financing, insurance, real-estate and business services | 48,440 | 1.6% |
| 9 | Community, social and personal services | 659,641 | 22.3% |
| | Total | 2,958,321 | 100.0% |

Source: "Economic Census of Pakistan-2005"

The figure below sets out each economic sector's contribution to national GDP in FY15.[15] Service sector enterprises (all types of services: trade, restaurants, hotels, transport, storage, communication and other services) generated more than half of the GDP (52%). Construction enterprises' contribution is the lowest (2%), while that of manufacturing enterprises is the second lowest (12%).

[12] Pakistan's Economic Census-2005 is the latest survey. According to SMEDA, the Pakistan Bureau of statistics is planning to implement the next economic census in 2018.
[13] A total of 2,958,321 enterprises provided information during the census, based on which enterprises were classified into categories.
[14] According to SMEDA, the country's electricity supply companies were recording almost 4.0 million electricity connections for commercial-use at the end of 2017. It is not known to what extent this figure represents the number of SMEs.
[15] UN National Accounts Database (https://unstats.un.org), accessed on 24 December 2017

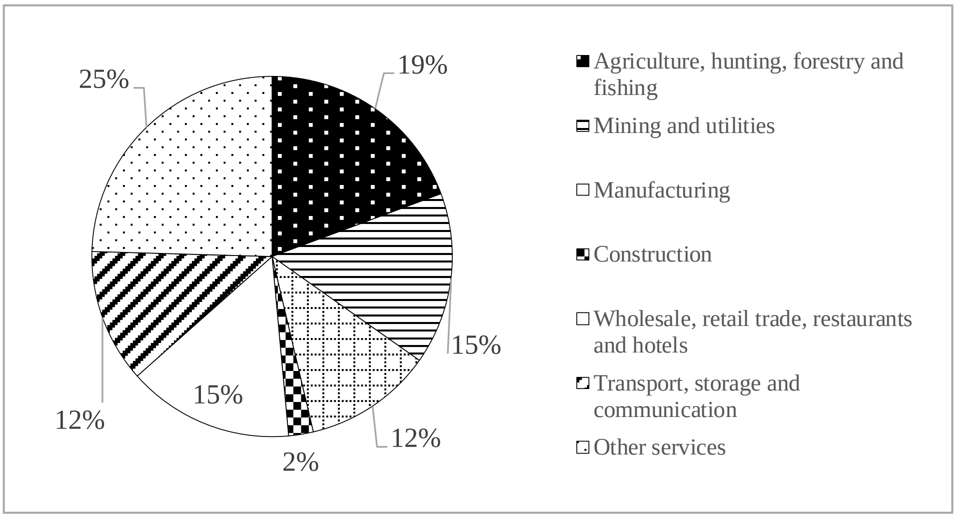



**Figure 8 Economic sectors' contributions to the Pakistan's GDP (2015)**
Source: "UN National Accounts Database"

The tables below show the number of enterprises by number of employees and annual revenue:

**Table 8 Number of enterprises by number of employees**

| Number of employees (persons) | Number of enterprises | Share |
|---|---|---|
| 1 to 5 | 2,794,217 | 94.45% |
| 6 to 10 | 136,135 | 4.60% |
| 11 to 50 | 26,352 | 0.89% |
| 51 to 100 | 1,042 | 0.04% |
| 101 to 250 | 383 | 0.01% |
| 251 or more | 192 | 0.01% |
| Total | 2,958,321 | 100.00% |

Source: Economic census of Pakistan-2005

**Table 9 Number of enterprises by sales**

| Annual Sales (PKR million) | Number of enterprises | Share |
|---|---|---|
| Up to 0.5 | 2,487,167 | 84.07% |
| 0.5 to 1 | 271,551 | 9.18% |
| 1 to 5 | 171,104 | 5.78% |
| 5 to 100 | 27,731 | 0.94% |
| 100 to 250 | 510 | 0.02% |
| Above 250 | 258 | 0.01% |
| Total | 2,958,321 | 100.00% |

Source: Economic census of Pakistan-2005

The census indicates that a majority of the enterprises in the country were very small in terms of number of employees and sales revenue (**Table 8** and **Table 9**). When the SME definition set for this Survey is applied, 99% of the enterprises are categorized as micro enterprises with employees up to 10 employees, and 94% of the rest of the enterprises (26,352) are categorized as small enterprises. Medium enterprises (1,425 enterprises) and large enterprise (192 enterprises) represent only 0.06% of the overall total.

### 2-1-3 Target Sector and Sub-Sectors of the Survey

This Survey focuses on SMEs operating in the manufacturing sector within Islamabad City, Punjab Province (where Lahore is the provincial center) and Sindh Province (where Karachi is the provincial center); across which the majority (83%) of the SMEs in the manufacturing sector are located (**Table 10**).

**Table 10 Number of the manufacturing SMEs by area**

| No | Areas | SMEs | % |
|---|---|---|---|
| 1 | **Target areas:** | **482,270** | **82.7%** |
| | Islamabad | 2,314 | 0.4% |
| | Punjab | 399,152 | 68.4% |
| | Sindh | 80,804 | 13.9% |
| 2 | **Other areas** | **100,903** | **17.3%** |
| | Pakistan total | 583,173 | 100.0% |

Source: Economic census of Pakistan-2005

Based on the information provided by SMEDA during the 1st field survey, the following SME sectors were selected as the target sectors of this Survey: (a) Textile; (b) Gem and Jewelry; (c) Marble Processing; (d) Leather Goods Manufacturing; (e) Sports Goods Manufacturing; (f) Surgical Instruments Manufacturing; (g) Auto Parts Manufacturing; and (h) Light Engineering. According to SMEDA, the majority of manufacturing SMEs operate in these sectors with each of the sectors having high potential in value addition, export, import substitution and job creation.

The next section introduces the overview of the target SME sectors using the secondary and primary data collected throughout the Survey.

## 2-2 Overview of the Target SME Sectors

### 2-2-1 Textile

Textiles are the largest manufacturing sector in Pakistan, contributing to more than 60% of the country’s export and comprising 40% of total employment. The sector is highly export-oriented; exporting 80%

of its total production in 2011-2012.[16] Total earnings reached USD 1.22 billion in 2014, and the sector is expected to continue growing since the EU has granted Pakistan the GSP-plus (Generalized System of Preference Plus) status, enabling the country to expand its markets in Europe.

The competitiveness of SMEs in this sector is rather low. The state of production facilities, the skills of workers and the production efficiency are far behind the standards of countries in South East Asia.[17] Although Pakistan's share of the international cotton market is 17%, its share of finished goods is less than 1%. Since the majority of export products have been low-value-added products such as cotton yarn, cloth, towels and bed linens, export performance has been highly affected by price fluctuations of these products in the international market. Export markets are limited to the USA, the UK and a few other EU countries. Technological renovation, product development and diversification, and market expansion are necessary to strengthen Pakistan's textile sector and its export capacity.

The textile sector consists of cotton ginning, spinning, fabric weaving and garment manufacturing; the fabric weaving, and garment manufacturing industries were selected for the Survey since a majority of textile SMEs operate in these sub-sectors.

The following is an overview of each of these sub-sectors:

**Fabric Weaving**

The actual number of weaving enterprises is not known due to the absence of reliable statistics. According to the SMEDA's cluster profiles, there are approximately 22,000 weaving enterprises in the sub-sector with most of them operating in Faisalabad. Except for large enterprises, most of them are un-registered SMEs.

The primary association for this sub-sector is the Council of Power Loom Owners (CPLO). According to the CPLO, among the 5,000 enterprises registered as members, 10% are relatively large, 30% are medium and the rest are micro and small enterprises. 300,000 looms are operating within Faisalabad with only 15,000 of those looms using modern technology (air-jet looms or shuttle-less looms); the rest are conventional power looms.[18]

The major raw material used in this industry is yarn. Enterprises use domestic coarse yarns for manufacturing thick fabrics and imported fine yarns for manufacturing thin fabrics. The fine yarns are imported mainly from Egypt, the USA and India.

[16] JICA, "Completion Report of Trade Policy Advisor (II)", 2013.
[17] JICA, "Completion Report of Trade Policy Advisor (II)," 2014.
[18] Out of the daily amount of fabrics being produced in Faisalabad that is around 10.4 million meters (in terms of grey fabrics), 80% is manufactured on power looms by SMEs and 20% is on modern looms by mainly large enterprises. The width of the fabrics produced on power looms is 65 inches, while that on modern looms is 145 inches.

While more than 100 different types of fabrics are being manufactured by weaving enterprises, the fabrics manufactured on power looms are of inferior quality and are unable to fetch high values on the international market. As power looms are slow and use significant electricity, production is not efficient as compared to modern looms. Moreover, their capability to handle complex fabric construction is limited. Due to the outdated machinery, Pakistan's weaving sector has been left behind the level of competitor countries such as Turkey, Indonesia and Korea. In order to be globally competitive, weaving enterprises need to introduce air-jet looms, shuttle-less looms and water-jet weaving machines that enable manufacturing of diverse quality fabrics.

Large enterprises export almost all of their fabrics, while SMEs sell their fabrics in the domestic market mainly through wholesale fabric dealers. Many SMEs do not have the financial capacity to purchase raw materials by themselves; they often produce fabrics using raw materials provided by their clients (or other weaving enterprises) and receive small payments for their work.[19] Their weak position due to a lack of working capital constrains their growth and competitiveness.

**Garment Manufacturing**

Although there are numerous domestic garment brands in Pakistan, most of them are not for export with most export-oriented garment manufacturers producing international brand products based on orders received from foreign apparel makers.

Production processes in a garment manufacturing enterprise are knitting, dyeing, washing, cutting, embroidery/printing, and stitching. As product designs are usually provided by clients, most SMEs do not have product design units. A majority of SMEs in Pakistan are engaged only in cutting and stitching with other processing such as dyeing, washing and printing being usually contracted out to enterprises that have relevant processing units.

Stitching machines are major production equipment for most SMEs. While most SEs and some MEs use older, conventional machines, only a few MEs use contemporary stitching machines. According to the Survey Team's interviews, SMEs do not have sufficient knowledge and information about recent trends in textile technologies. Some MEs that use the latest equipment and machinery also admit that their textile engineers and technical staff lack the knowledge and experience necessary to operate these machines properly. Technical staff's knowledge of proper methods or techniques for each production process is not sufficient either.

The raw materials for garment manufacturing are yarn, fabric, thread, accessories (zips, tags, labels and buttons) and consumables (detergents and chemicals for dyeing/bleaching). While fabrics are the main raw materials for most small enterprises, enterprises with their own knitting units do knit fabrics from yarn. Though Pakistan produces coarse cotton yarns of good quality (thick yarns with up to 40 counts),

[19] SMEDA, "Cluster Profile: Power Looms"

the quality of its fine cotton yarns (narrow yarns with counts more than 40) is low. As a result, fine cotton yarns and polyester yarns are imported from different countries.

Due to a lack of working capital, many SMEs purchase raw materials from domestic suppliers on credit for 1 to 3 months with interest of 2% per month. Almost all SMEs start production after receiving orders, showing samples, and getting approval from their clients. Since payment from their client is usually made 2 to 4 months after the delivery, SMEs often face shortages in working capital. Most of the enterprises interviewed by the JICA Survey Team emphasized that they often had to turn down orders due to the lack of finance.

Because of the nature of the garment manufacturing and the outdated low-productive machines, the sector is highly labor incentive. A majority of workers are hired temporarily, and thus move from one factory to another. Most workers are illiterate and uneducated with insufficient technical skills. In spite of the presence of training institutes for the textile sector (such as Pakistan Knitwear Training Institute and Pakistan Readymade Garments Technical Training Institute), most workers learn through On-the-job Training (OJT) at factories due to the following reasons: (a) employers' unwillingness to pay training fees or their low motivation to support workers due to the nature of temporary employment; (b) less effective training programs offered by training institutes due to their inadequate equipment and low skilled trainers; and (3) unwillingness of workers to attend trainings due to their illiterateness.

The figure below shows the main actors and value chain for the textile sector:

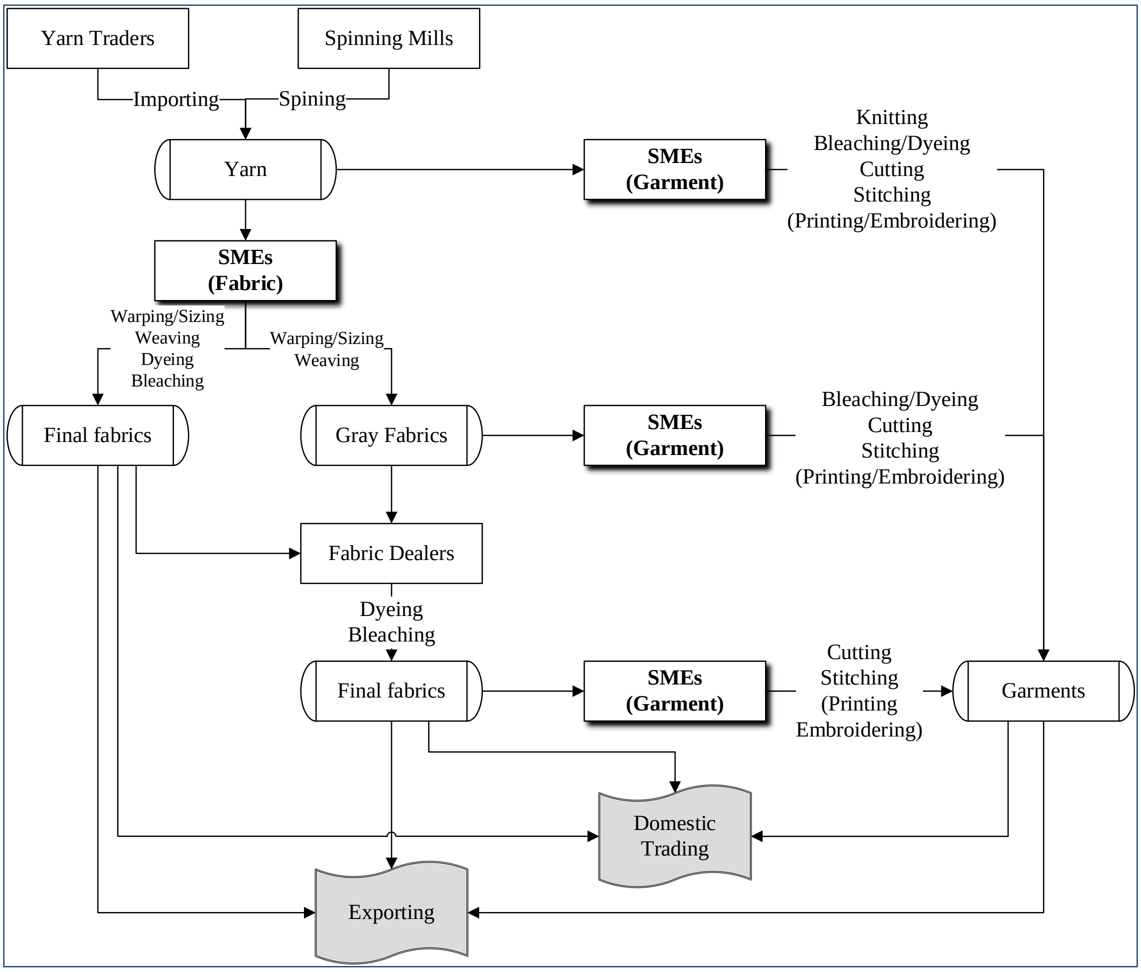



**Figure 9 Value chain of the textile sector**

Source: JICA Survey Team

### 2-2-2 Gem and Jewelry

Pakistan is rich in gemstones. Despite abundant deposits, the country's gem stone processing industry is not well developed. With the expanding domestic market for gems and jewelry, the sector is considered to have a high potential for growth. According to the Pakistan Gems and Jewelry Development Corporation (PGJDC), the sector consists of 90,000 enterprises (mostly SEs) providing job opportunities to 500,000 people. The total domestic consumption of precious metal in Pakistan is 170 tons/year (approximately USD 10 billion), while the annual export is around USD 450 million (2016).

Major gemstone deposits (16 types including ruby, emerald, peridot and sapphire) are located in the northern part of Pakistan. Gemstone mining is conducted solely by local people with no enterprises engaged in the mining of gemstones. Most miners operate in the territory of Baluchistan and Khyber Pakhtunkhwa for 3 to 4 months a year due to the Pakistan's climate and weather. Blasting, which destroys deposits of gemstones and damages half of extracted gems, is the only method of mining in use. Cutting and polishing techniques and machinery being used in gemstone processing enterprises are outdated and the quality of the processed gemstones does not meet the standards for international markets.

Under the above circumstances, 75% of the extracted gemstones are exported in the form of rough stone (without any processing). The major processes for gemstones after mining are grading, cutting and polishing. These processes are undertaken by small faceting, carving and bead making enterprises. According to PGJDC, only 9% of all extracted gems are exported in processed forms, while only 1% are finished jewelry sold in Pakistan. The rest are destroyed in the processing stage.

The main raw material in jewelry manufacturing in Pakistan is gold. As gold deposits are scarce in the country, most gold used in this sector is imported. 90% of the jewelry manufactured in Pakistan is sold within the country and the remaining 10% is exported through jewelry dealers. Jewelry manufacturers are mostly small enterprises, concentrated in Karachi and Lahore where 99% of manufacturing is conducted. Since most of the enterprises are specialized in one or two of jewelry manufacturing processes (casting, finishing, polishing and stone setting), a jewelry product goes through several enterprises until it becomes a finished product.

Almost all jewelry manufacturers use traditional methods and technologies that have been inherited within their families for generations. Although the skills of jewelry manufacturers as artisans are high, their traditional method of manufacturing is inefficient and time consuming due to the use of old, conventional tools. These traditions for maintaining techniques and technologies while passing them from generation to generation within their families are undermining the acceptance of modern equipment and adaptation to global demand patterns. Since traditional jewelry designs in Pakistan, which are similar to each other, are not so popular on the international market, finished products are mainly sold on the domestic market.

While raw materials (precious metals) are available within the country and can be easily purchased from domestic suppliers, information on their quality (purity) is usually not known. According to the enterprises interviewed during the Survey, certified assaying laboratories do not exist in Pakistan; therefore, SMEs often import raw materials by themselves depending on clients' quality requirement.

Most enterprises start production only after receiving orders from their clients. A few with their own brands produce unique products in a limited quantity to sell at their shops. For most jewelry manufacturers, major clients are jewelry retail shops; they sell their products to retailers on-credit and receive payments after 10 to 50 days.

According to the information provided by jewelry manufacturers, they often face shortages of funds especially when payments from clients are delayed. These enterprises help each other by sometimes sharing raw materials and orders. They often borrow money from family, relatives, and friends.

In addition to the shortage of working capital, obsolete technologies are a major constraint on the growth of the gem and jewelry sector, according to the Trade Development Authority of Pakistan (TDAP).[20]

The figure below shows the main actors and value chain of the gem and jewelry sector:

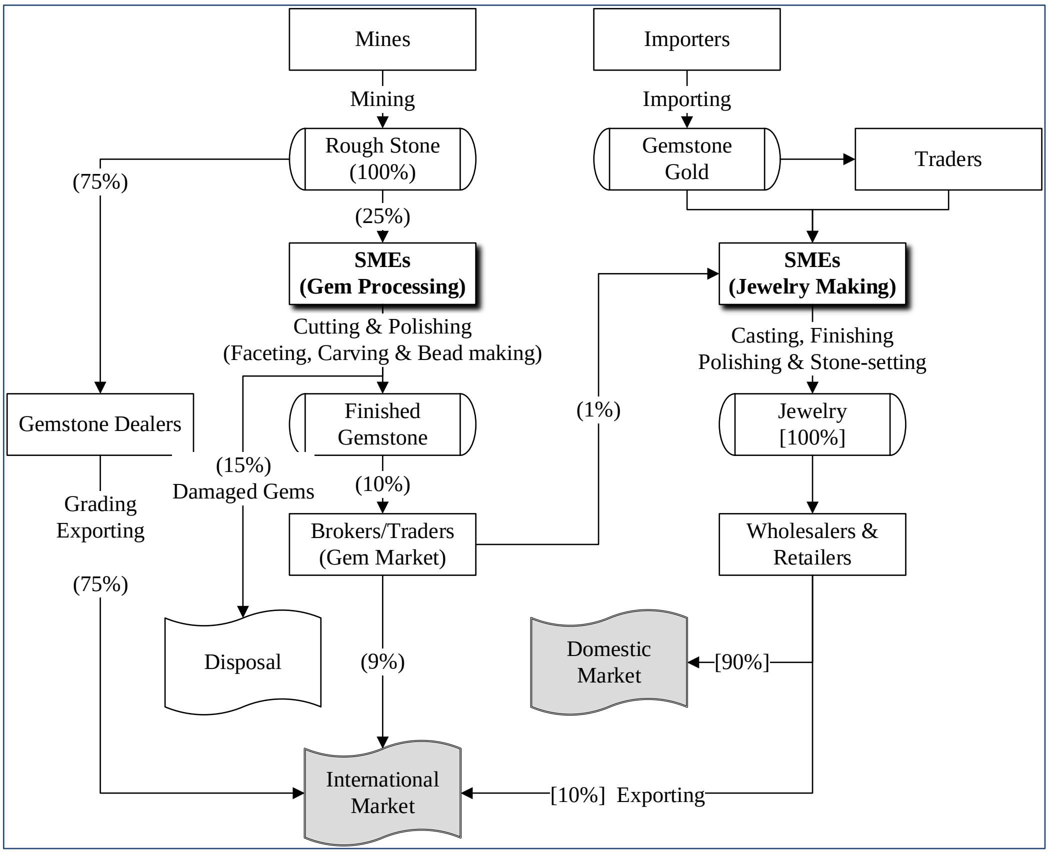



**Figure 10 Value chain of the gem and jewelry sector**

Source: Pakistan Gem and Jewelry Development Corporation (modified by the JICA Survey Team)

### 2-2-3 Marble Processing

Pakistan is one of the largest exporters of raw marble and marble products. Due to an increasing trend in the use of marble for construction, demand has been continuously rising both on the international and domestic markets. Pakistan exports around 30 kinds of marble to China, Saudi Arabia, the UAE, the Middle East, the USA, Italy and other EU countries mostly in raw form. Finished or semi-processed marble products represent only a small part of exported marble.

According to the SBP's sector analysis, the export of marble reached USD 51.7 million in 2014, which was four times larger than in 2012.[21] The annual growth rate during this period was 35%, mainly resulting from reconstruction activities in the Middle East. According to the All Pakistan Marble and

[20] Trade Development Authority of Pakistan, "Sectoral Competitiveness and Value Chain Analysis: Gems and jewelry," 2016.
[21] SBP, "Marble and Marble Products", 2015

Granite Association (APMGA), the industry is maintaining its growth due to the CPEC-driven increase in the demand for construction materials.

Major reserves of marble are found in Khyber Pakhtunkhwa (KPK), Federally Administered Tribal Areas (FATA) and the Baluchistan regions. While a majority of mines and quarries are concentrated in these areas, marble processing units are mostly located in Karachi, Lahore and Islamabad due to the ease of selling and distributing processed marble products in those areas. Except for a few large enterprises, most enterprises in the sector are small and family-owned.

Marble rocks extracted by the miners are crushed, cut and polished by marble processing enterprises to be sold to local and international markets in the forms of blocks, slabs and tiles. The majority of extracted marble is processed into slabs and tiles and used for construction purposes such as decorating wall, floor, stairs and other building components, while a small quantity goes to the handicraft industry.

Except for the locations managed by a few large enterprises, most mines and quarries use uncontrolled blasting; according to APMGA, approximately 60% of domestic marble is extracted by blasting. Marble extracted from this process is usually in bad shape, which causes more than half of usable marble to be ruined and/or wasted during processing stages (shaping into six-sided blocks).[22] While domestic marble is cheaper than imported, processing domestic bad-shaped marble entails high costs and substantial time; SMEs consequently sometimes import raw marble from China, Dubai and India for its reasonable price, variety of colors and ease of processing.

Slab processors purchase marble rocks directly from miners while tile processors purchase slabs either from slab processors or local dealers. Most SME processors use multiple suppliers to ensure consistent quantity and quality of raw materials. In most cases, payments to suppliers are made in cash on the spot. Only SMEs that have a strong trust relationship with suppliers are offered credit-purchases for up to 2 months.

Most SMEs sell their products in the domestic market. Since the domestic market does not require high quality products, most SMEs (slab and tile processors) use cheap equipment and machinery, such as conventional cutters and manual polishers (grinders).[23] Only a few large enterprises that have a complete range of machinery and equipment (such as gang saws, diamond cutters and auto polishers) are capable of processing marble in accordance with international standards.

Most SMEs sell their products at their factories to visitors while some operate retail shops on their premises. Successful upper-end small enterprises and medium enterprises work as sub-contractors for construction projects; receiving part of their payment at the time of delivery. Although the remaining payment is promised to be made within 1 month, the actual payment often takes up to 3 months.

[22] SMEDA, "The 5-year SME Development Plan", 2014
[23] SMEDA, "Cluster Diagnostic Study: Marble Processing"

The figure below shows the main actors and value chain of the marble processing sector:

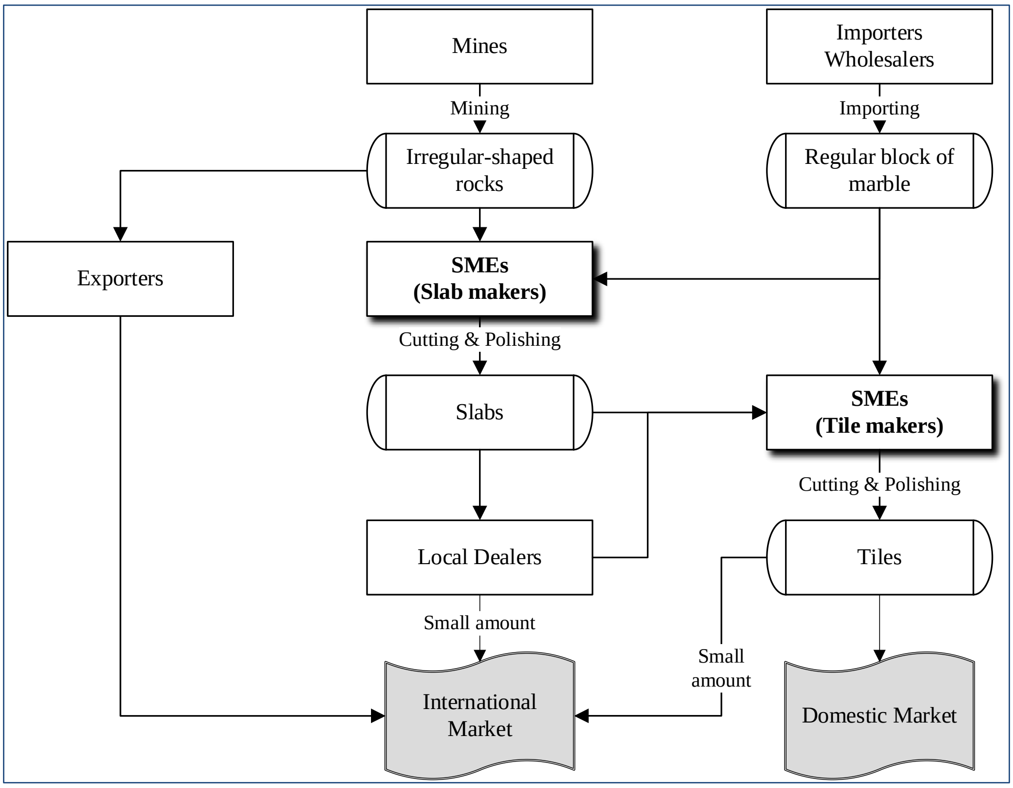



**Figure 11 Value chain of the marble processing sector**

Source: JICA Survey Team

### 2-2-4 Leather Goods Manufacturing

Recently, the leather processing sector in Pakistan has seen significant growth. Between 2014 and 2015, the growth rate of the sectoral production was 9.6% and it contributed USD 724 million to the country's export earnings in 2015.[24] The sub-sector is labor-intensive and creates employment for more than 500,000 people. Pakistan's share of leather goods products in the international market declined sharply in the late 2000s due to the energy crisis (shortage of electricity and gas), which continued for years.[25] Although the energy crisis has softened in recent years, Pakistan's position in the international leather market has not recovered due to cheap products from Turkey, Bangladesh and South Asian countries as well as a decrease in global demand due to recent warmer winters.

The two main clusters of the leather sector are found in Karachi and Sialkot where 90% of all leather products in Pakistan are manufactured. According to the Pakistan Leather Garment Manufacturers and Exporters' Association (PLGMEA), there are 17,000 registered leather goods exporters in the sector. 7,500 of them operate in Sialkot and contribute half of all leather goods exports. All enterprises in the

[24] GoP, "Pakistan Economic Survey 2014-15," 2015.

[25] According to SBP (2015), the leather export was USD 1 billion in 2013. The figure was 14% less than the export of 2008.

Sialkot cluster are SMEs with less than 200 employees; they are export-oriented and mostly family-owned. Major products are processed leather, leather gloves, leather garments, footwear and leather accessories. Most products are manufactured based on orders from international brands. Almost all leather products are exported with only those rejected for export being sold on the local market.

There are approximately 2,500 tanneries in Pakistan. While tanneries are scattered in different cities of the country (Karachi, Sialkot, Hyderabad, Multan and Kasur), the greatest concentration of tanneries is in Sialkot.[26] They process raw hides of buffalo or cattle, and skins of goats and sheep into leather sheets and supply them to leather goods manufacturers. Some of the tanneries export semi-processed skins (wet-blue) and leather sheets to China and other countries. Some medium-sized leather manufacturers have tannery units in-house and procures raw skins directly from farmers and local slaughter houses.

Although animal skins and hides in Pakistan are naturally of high quality, raw skins are highly damaged by skin parasite scars and mechanical cuts resulting from slaughtering processes. The contributing causes for this skin damage are: (1) low motivation of farmers to utilize veterinary services (especially anti-parasite treatments) for their livestock; and (2) Pakistan's traditional method of animal slaughtering during which skins of animals are removed manually with knives. According to leather garment manufacturers, 30% to 35% of the surface of a skin is not suitable for garments and an additional 10% to 15% is wasted during garment manufacturing process due to scars and cuts.

Approximately 30% of leather used in garment manufacturing in Pakistan is imported from Saudi Arabia, Iran, African countries, South Asian countries, Australia or New Zealand. Most SMEs use multiple suppliers to ensure consistent quantity and quality of raw materials.

Other raw materials used for leather goods are fabric, linen and accessories, such as zippers, buttons, labels and tags. Since foreign suppliers do not sell accessories in small amounts, most SEs purchase accessories from domestic accessory traders. Although there is an accessory factory in Karachi, its accessories are more expensive than those of accessory traders. Given the high prices and limited types of accessories sold in Pakistan, most MEs directly import from China, Hong Kong, Taiwan and Italy. Most of them import accessories after receiving orders; the long lead time due to importing of accessories often forces MEs to turn down urgent orders from clients.

Pattern making, cutting and stitching are the major production processes. Most SMEs use outdated low-productive machineries with most SEs using manual cutting. According to the PLGMEA, the equipment and machinery demanded by SMEs are 3D designer, multifunctional high-productive Surbo stitching machines (which also uses less electricity) and laser cutting machines.

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[26] Trade Development Authority of Pakistan, "Sectoral Competitiveness and Value Chain Analysis: Readymade Garments," 2016.

The sector is highly-labor intensive. A majority of workers are hired temporarily and work for several factories. The technical skills of workers are not sufficient for the same reasons as those of the textile sector. SMEs often face difficulty in hiring a sufficient number of temporary workers when orders are received.

Since leather tanning and leather products manufacturing is labor intensive and causes a negative impact on the environment, there is a global shift of the leather industry from developed countries to developing countries like Pakistan, India, Bangladesh, Sri Lanka and Thailand, providing Pakistan with an opportunity to expand its production.

The figure below shows the main actors and value chain of the leather goods manufacturing sector:

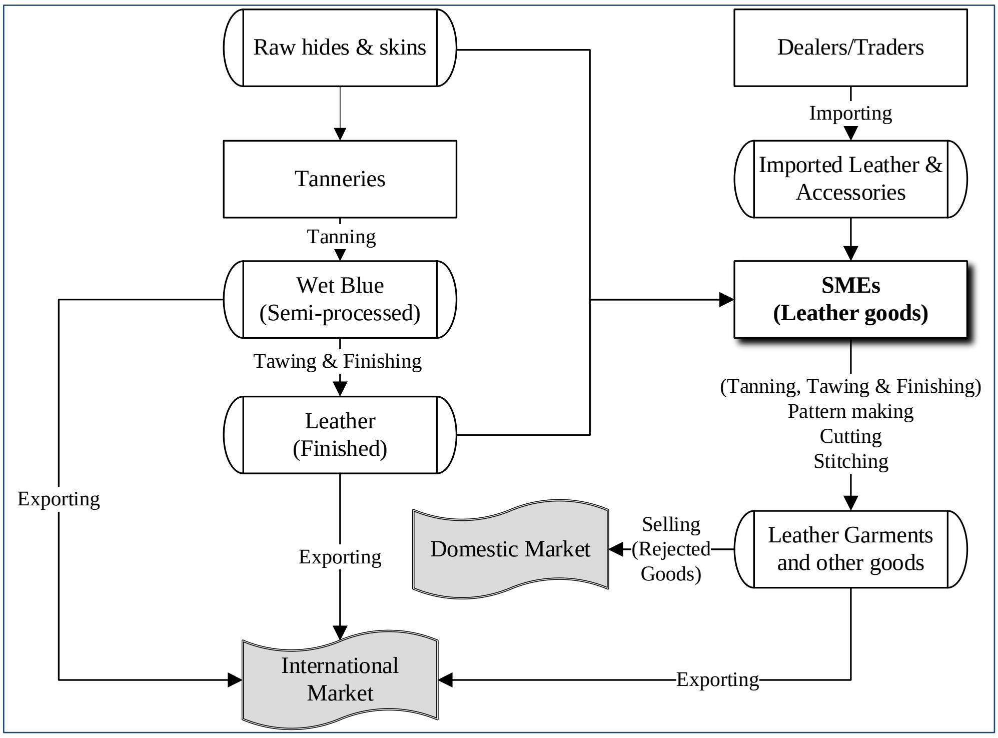


**Figure 12 Value chain of the leather goods manufacturing sector**

Source: JICA Survey Team

### 2-2-5 Sports Goods Manufacturing

Sports goods manufacturing is one of the export-oriented SME sectors in Pakistan. Almost all sports goods manufacturers are located in Sialkot. The sector consists of approximately 2,200 SMEs, which employ a total of more than 100,000 workers. The annual export earning is approximately USD 450 million.[27]

[27] SMEDA, “Sector analysis: Sports Goods”.

The products include hand stitched inflatable balls, sportswear, sports and outdoor gloves, accessories and various sports items such as boxing gloves, baseball bats, hockey sticks, and similar items. Among them, the flagship products of the sector are hand stitched soccer balls and sportswear as these products comprise nearly 80% of total exports for the sector.[28]

Although production processes and technologies differ by product, the technology level of the sector is rather low due to a lack of equipment and the latest machinery. Soccer ball manufacturing is mostly based on manual skills by craftsmen. Although the manufacturing of the other products is more mechanized, most of the equipment and machinery used by SMEs are low-productive conventional models. While production processes such as pattern-making and printing are usually conducted manually, processing such as fabric weaving, bleaching and dyeing (sportswear) are contracted out to different enterprises due to a lack of equipment.

Most raw materials used by SMEs (leather for balls; latex foam, leather and accessories for gloves; yarn or fabrics for sportswear; PVC leather and wood for other goods) are available on the domestic market; a majority of SMEs purchase raw materials from local mills, factories and dealers. In most cases, payments to suppliers are made in cash on the spot. Only SMEs that have a strong trust relationship with suppliers are offered credit-purchases for 2 to 4 months. Most SMEs start production after receiving orders, without stocking raw materials. A few SMEs that manufacture soccer balls and sports gloves directly import high quality leather and latex foam.

According to the Pakistan Sports Goods Manufacturers and Exporters Association (PSGMEA), upper-end small and medium enterprises have regular clients with whom they build strong trust relationships. A majority of them receive sufficient orders throughout the year. The clients are usually international brands of the US, the UK, EU countries, Australia and Japan.

Like other sectors, SMEs hire a considerable number of temporary workers. Most of the workers are illiterate and uneducated with insufficient technical skills. In spite of the presence of training institutes for garment stitching, pattern making and screen printing, most workers learn through OJT at factories similar to other sectors.

### 2-2-6 Surgical Instruments

The surgical instruments industry is also vibrant in Pakistan, mostly clustered in Sialkot. The sector comprises over 3,800 enterprises, 15% of which are upper-end small and medium enterprises with more than 50 employees while the rest are lower-end small enterprises. The industry employs around 150,000 workers. According to the Surgical Instrument Manufacturers Association of Pakistan (SIMAP), SMEs of the sector produce more than 15,000 different types of surgical, dental and other medical instruments, most of which are exported. SMEs mainly produce basic metal instruments such as forceps, scissors,

[28] SMEDA, “Sector analysis: Sports Goods”.

scalpels and cutters, which are sold under international brands. According to SIMAP, the export of surgical instruments totaled USD 358 million in 2016.

The production processes are forging, filing, heat treatment, grinding, polishing, and cleaning. According to SIMAP, most SMEs are capable of conducting only part of these processes by themselves due to a lack of equipment; they contract out part of the processing to vendors (mostly individuals and households) who are engaged in exclusively one or two of the above processes (mainly grinding and polishing).

A few upper-end small enterprises and medium enterprises have a complete range of processing equipment such as computer numerical controlled (CNC) machining centers, electro-polishing machines, lathes, laser cutter, welding, grinding, polishing and painting machines. However, many of these machines are obsolete, second-hand machines with some of them refurbished in Pakistan. The rest of the enterprises use conventional machines and simpler equipment. Technological renovation is one of the major requirements for the development of this sector.

The main raw material for surgical instruments is stainless steel. Suppliers for SMEs are local steel mills and metal traders. Depending on the availability of fund, SMEs purchase raw materials either in cash or on credit. Since interest of 2% to 3% per month is applied for credit purchase, most SMEs tend to pay for raw materials in cash at the time of purchase.

The following are problems and issues for the industry:

- Lack of skilled labor: According to SIMAP, workers learn skills through OJT at factories since there are no training institutes for the industry. There is a shortage of skilled workers; SMEs face difficulty in hiring skilled workers when they need to increase production. SMEs handle the issue by extending work hours or “borrowing” workers from other enterprises or vendors;
- Outdated technologies: Conventional tools, instruments and methods that were developed 60 to 70 years ago are used for production; productivity is low, requiring much labor. However, most lower-end small enterprises and vendors do not have knowledge on the latest machines; and
- Lack of funds and low access to finance: Except for a few medium enterprises, SMEs cannot obtain bank loans due to collateral requirements and high interest rates. As most SMEs cannot obtain loans, they turn to their relatives, family members and friends for financing.

The figure below shows the main actors and value chain of the surgical instruments:

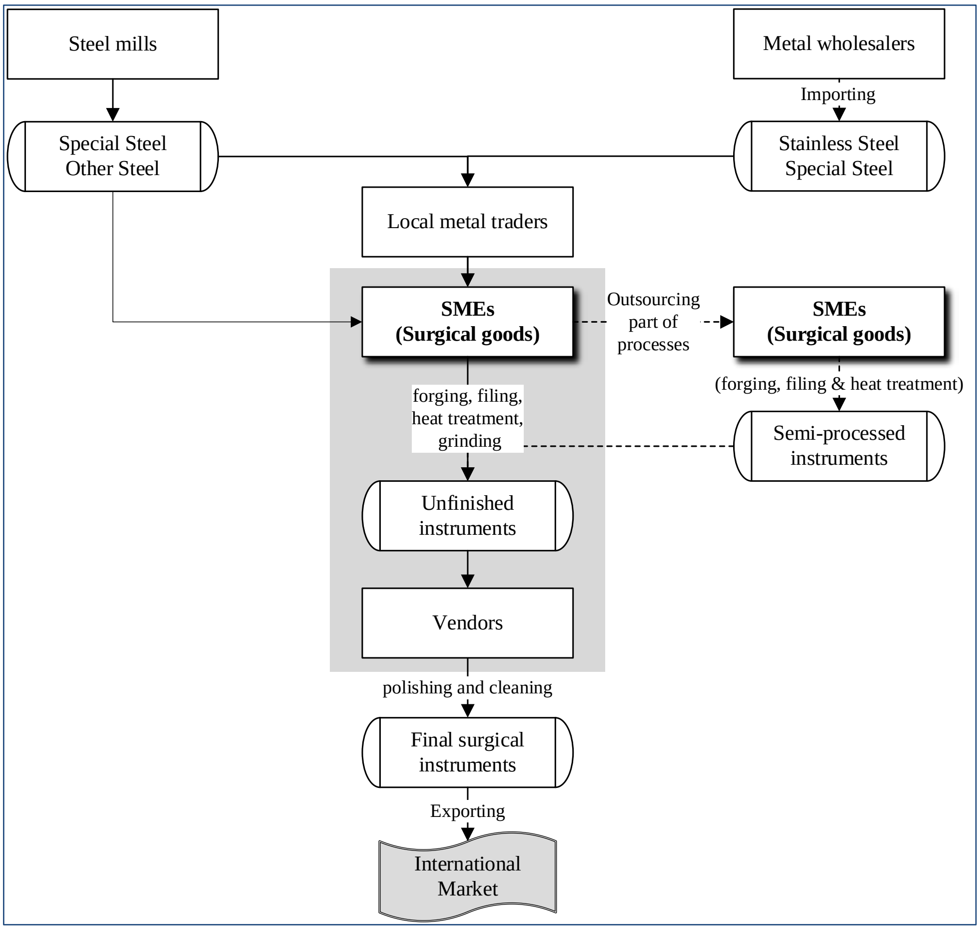


**Figure 13 Value chain of the surgical instruments manufacturing sector**

Source: JICA Survey Team

### 2-2-7 Auto Parts Manufacturing

The automotive industry comprises 3% (i.e. approximately 192,000 people) of Pakistan's total employment and produces 5% of Pakistan's GDP.[29] The amount of tax revenues from the automotive industry ranks second after the textile industry, which demonstrates its importance to the country.[30] Automotive manufacturers are large enterprises (Original Equipment Manufacturers: OEMs), while parts and accessories manufactures are mostly SMEs, except for a few large enterprises. The Pakistan Association of Automotive Parts & Accessories Manufacturers (PAAPAM) consists of about 350 manufacturers that produce 90% of domestic parts.[31] The government has been encouraging the use of domestically produced parts, but because of the low technological capacity of the parts manufacturers in Pakistan, automotive manufacturers still import a considerable amount of parts.

[29] JICA, "Detailed Design for the Project for Technical Support to Auto Parts Manufacturing Industry of Pakistan," 2015
[30] JICA, "Detailed Design for the Project for Technical Support to Auto Parts Manufacturing Industry of Pakistan," 2015
[31] JICA, "Completion Report of Automotive Industry Promotion Advisor (II)," 2016.

According to the PAAPAM, the auto parts industry has been growing drastically during the last 3 years with the average annual growth rate of 15%. The parts and accessories manufactured in Pakistan account for 50% to 60% of all automobile parts and 90% to 95% of tractor and motorcycle parts used in the automotive industry. The products range from simple rubber or molded plastic parts and accessories to metal sheet parts, forged items, various castings (cylinder block, cylinder head, gearboxes, center housing, and axle housing) as well as complex auto parts such as crank shafts, gears, ball joints and various assemblies. Most of the products are supplied to large-scale automobile, tractor and motorcycle assembling companies (OEMs) in Pakistan such as Suzuki, Toyota, Honda, Hyundai, Hino, Nissan, Isuzu, Millat Tractor Limited (a Massey Ferguson tractor assembler) and Al Ghazi Tractors Limited (a Fiat tractor assembler) as well as many medium-scale local enterprises that assemble Chinese motorcycles. Only a small quantity of automobile parts is exported.

The overview of the sector follows:

<u>Production and technology:</u> Unlike other sectors, enterprises in the auto parts industry are able to forecast the demand for their products several months in advance and make a production schedule since OEMs place orders at least three months in advance. The most common manufacturing processes undertaken by parts manufacturers are designing, casting, forging, sheet metal formation, welding, machining, heat treatment (tempering), surface treatment (polishing and finishing), and inspection and testing. Large and medium enterprises have complete production facilities in-house, while most micro enterprises and SEs are specialized in one or two production processes (mostly preparatory processes for raw materials, rough machining and surface treatment) and render their services to bigger enterprises. There are also SEs that manufacture tractor and motorcycle parts and supply them directly to assembling companies.

Irrespective of an enterprise’s scale, most manufacturing equipment and machines that auto parts enterprises use are old models and obsolete. Almost all production processes are manual and highly labor intensive. Moreover, improper layout of manufacturing units within factories and unorganized production flows among manufacturing units and facilities decrease production efficiency. While a majority of enterprises in the sector rely on outdated technologies, some MEs have started implementing BMR (Balancing, Modernization and Replacement of equipment) by using either their own financial sources or leasing services offered by commercial banks or leasing companies such as Orix Leasing Pakistan Limited (OLP). Responding to recent trends in the automotive industry such as: (1) OEMs’ intentions to replace some locally manufactured parts (such as forged front wheel hubs) with new models; and (2) the exporting tractors to African and Middle Eastern countries by Millat Tractor Limited in 2016; a number of enterprises, mostly MEs, are examining new technologies and planning to modernize or expand their manufacturing units. According to the auto parts manufacturers, they prefer to use Japanese technologies since their most important clients are Japanese OEMs. However, the obstacles encountered by those enterprises intending to introduce Japanese technologies is the high prices of Japanese equipment compared to those of Chinese equipment as well as the difficulty of purchasing Japanese equipment and machines due to the fact that Japanese equipment manufacturers hesitate to export machinery to countries like Pakistan where their after-sale service systems do not exist.

<u>Raw material procurement:</u> Auto parts manufacturers use various types of metallic materials, including sheets, castings, forgings, flat bars, angle bars, round bars and pipes with different chemical compositions. SMEs purchase around 80% of their raw materials on the domestic market from local steel mills, metal importers/traders and even scrap dealers.

According to the information provided by SMEs, the processing capacity of domestic steel mills decreased greatly following the closure of Pakistan Steel Mill in 2015. Presently, there are four steel mills operating in Pakistan and the total processing capacity of the mills is not sufficient to meet domestic demand for metallic materials. In most cases, steel mills process metallic materials in accordance with the specifications requested by their clients; due to the low processing capacity of the mills, delivery from the mills requires up to 2 months from the date of order. Therefore, SMEs purchase a considerable amount of metallic materials from metal traders who import materials from the USA, UK, China, Dubai and other countries, stock them, and sell them to local SMEs. According to the enterprises interviewed by the JICA Survey Team, some SMEs use metal scraps (mainly castings) either collected in the country or imported from abroad.

Since metallic materials supplied by domestic suppliers are of low quality and expensive with chemical composition not known, many MEs directly import metals (mainly special steel, such as spring steel sheet, hard tempered steel, dye metals and several types of stainless steel). The imported materials represent approximately 20% of all materials that enterprises use.

<u>Human Resource:</u> According to the interviews by the JICA Survey Team, bigger MEs, except for foundries, tend to limit the employment of temporary workers due to possible impacts on productivity and product quality. In contrast, the majority of workers in foundries and smaller enterprises are hired temporarily on a contract-basis; temporary workers are usually used for manual work, such as casting and preparatory tasks. According to the information provided by enterprises, the technical skills of permanent workers employed by MEs and upper-end SEs are high with these enterprises paying significant attention to human resource development. These enterprises recruit qualified engineers and technical staff, invite experts for in-house trainings and send their staff to trainings organized by their client OEMs. There are also MEs that have their own engineering school (such as Infinity Engineering PVT Co., Ltd) or intend to establish a technical training center (such as Progressive Engineering PVT Co., Ltd). However, these are the exceptions; like other SME sectors, a majority of workers in the auto parts industry are trained within factories through OJT.

According to PAAPAM, OEMs often organize technical trainings on quality control, quality improvement, cost reduction and improvement of material utilization for their vendors.

Financing and access to finance: According to the interviews by the JICA Survey Team, MEs with good reputations are able to deal with their suppliers, clients and commercial banks under favorable conditions. In many cases, they are offered two installments in making payments when procuring raw materials from their suppliers (half at the time of order and the remaining at the time of delivery), while SEs are required to make full advance payments at the time of order. Many MEs have strong relationships with commercial banks and are able to either obtain bank loans with lower interest rates (KIBOR+ 1% or 2% per year) or use running finance (overdraft) whenever they need additional fund for their working capital. Their clients transfer payments within shorter periods following product delivery (20 to 30 days on average) in comparison with that for SEs (2 to 3 months on average). Therefore, most MEs do not face difficulty in financing their operating expenses. For capital investments some enterprises have access to leasing services from commercial banks (such as United Bank and Bank of Punjab) or leasing companies (such as OLP) with low interest rates (approximately KIBOR+ 2% or 3% per year). By contrast, most SEs cannot obtain loans from commercial banks due to a lack of immovable assets that can serve as collateral and high interest rates on bank loans (more than 12%) that reflect the risks perceived by banks. Although equipment and machines can be obtained through leasing, the service is not affordable to SEs due to the high interest rates (around 12% to 16% per year) that are not negotiable, according to the SEs interviewed by the JICA Survey Team.

While the lack of collateral is a major hindrance to SMEs' access to finance, some of the auto parts manufacturing SMEs that directly supply parts to OEMs are benefitting from value chain financing offered by some commercial banks, such as Meezan Bank and Bank Alfalah. In the case of vendors of Millat Tractor Limited, the biggest tractor assembler in the country, creditworthy vendors have been provided with credit through the Corporate Vendor and Distributor Finance Program launched by Karandaaz Pakistan and Meezan Bank in 2016 (see "3-3-2 Karandaaz and IFC for Supply Chain Finance" for details).

### 2-2-8 Light Engineering Products

SMEs in the light engineering sector in Pakistan are mainly engaged in electrical appliance production, agricultural engineering, textile engineering and foundry. Their products range from electric fans, home appliances (such as washing machines, spin dryers, stabilizers, heaters and ovens), agricultural machinery (such as sugarcane crushers, seed spraying pumps, wheat threshers, rice threshers, maize shredders, seeders, rippers and shaft cutters), textile machineries (such as power looms, warping machines, sizing machines and towel machines), parts and accessories of agricultural and textile machinery, and other engineering components and implements. Most of these products are low-tech machines and equipment. The buyers are usually small businesses, farmers and households. Some machines, such as power looms, towel machines and wheat threshers, are being exported to Bangladesh, Sri-Lanka and a few African countries in smaller quantities.[32]

The major light engineering clusters are located in Gujranwala, Gujrat and Faisalabad of Punjab Province. Gujranwala and Gujrat are the clusters mainly for electrical appliances while Faisalabad is the biggest cluster for agricultural and textile engineering products. Due to the absence of reliable data about the sector, the number of enterprises engaged in light engineering is not known. Based on the sector profiles prepared by SMEDA and the information provided by the sectoral trade associations, it is likely that more than 80% of light engineering enterprises are SMEs with most of them being SEs. A majority of SEs are undocumented informal enterprises.

The overview of the sector follows:

Production and technology: The major production processes undertaken by light engineering enterprises in these areas are casting and fabrication. Casting includes processes such as mold making, core making or baking, melting, hot and rough casting, shot blasting and finishing while fabrication involves processing, such as machining, grinding, finishing and assembling. Large enterprises and MEs have complete production units while SEs tend to concentrate on products that can be manufactured mainly through the casting process and outsource other manufacturing processes to different enterprises. The sub-sector of electrical appliances is a vendor-based segment where each enterprise is specialized in one or two of manufacturing processes. Therefore, manufacturing of an electrical appliance usually involves multiple enterprises across the segment.

According to the trade associations and the enterprises interviewed by the JICA Survey Team, most equipment and machinery owned by SMEs are inefficient, obsolete models with low processing accuracy. With most manufacturing processes not mechanized, the quality of products is highly dependent on workers' technical skills. Since the current technology does not allow SMEs to meet quality requirements of highly-mechanized industrial sectors, the light engineering sector in Pakistan has not been able to expand the current market and attract new customers. As a result, a majority of enterprises of the sector have been operating at around 50% of their production capacities due to the inadequate demand for their products.[33] Although SMEs of the sector need technological modernization, many of them, mostly micro enterprises and lower-end SEs, lack knowledge and information on modern technologies. On the other hand, upper-end SEs and MEs that want to modernize their technology cannot afford expensive modern equipment and machinery.

Human Resource: The sector has a dearth of skilled and technically qualified labor. Many small business owners and almost all employees of light engineering enterprises are uneducated. According

[32] SMEDA, "Cluster Profile: Light Engineering in Faisalabad"

[33] According to the Pakistan Foundry Association, the annual production capacity of the entire foundry sub-sector is 400,000 tons, while the actual production volume was around 250,000 tons in 2017. All trade associations and enterprises interviewed by the Survey Team pointed out the low capacity utilization rate in the entire light engineering sector.

to SMEDA, only 1% of workers have completed technical trainings in technical and vocational education and training (TVET) institutions.[34] The main reasons for this are a reluctance by workers toward training due to their poor literacy as well as the limited supply and low quality of trainings offered by TVET institutions. The Engineering Component and Machinery Manufacturing Association of Pakistan (ECMMAP) pointed out that national technological universities and TVET institutions cannot develop skilled engineers and technical staff demanded by the industry due to their inadequate capacity, lack of training equipment and absence of modern technologies. Therefore, most enterprises train their workers by themselves at their factories.

<u>Raw Material Procurement:</u> The main materials used by light engineering SMEs are metallic materials, such as mild iron, cast iron, iron sheets, angle bars, round bars and pipes. SMEs purchase all these materials on the local market through metal traders and scrap dealers. According to the information provided by enterprises during the field survey, light engineering SMEs tend to purchase raw materials on 30 to 60-day credit and some pay an interest rate of 3% to 5% per month for their credit purchases.

<u>Marketing:</u> Smaller enterprises that manufacture agricultural and textile machinery sell their products through equipment and machinery dealers, while bigger enterprises sell their products through their agents or their own shops. Since machinery dealers usually make payments after selling products to end-users, SMEs are forced to wait until payments are collected from end-users, which could stretch to 5 or 6 months after the date of product delivery. Some enterprises receive partial, around 30%, payments 2 to 3 months after the date of product delivery.

Many enterprises (mainly micro and lower-end SEs) do not manufacture products based on orders. These enterprises manufacture machinery in small quantities and approach machinery dealers to sell their products. Sales of agricultural machinery are highly dependent on seasons; therefore, most enterprises engaged in agricultural machinery tend to manufacture several types of products that are used in different seasons of the year.

<u>Access to Finance:</u> Since most of the SMEs finance their expenses exclusively through their cash flow, their financial condition is highly dependent on when clients make their payments. Since most manufacturers of agricultural machinery receive payments only after their clients (dealers in most cases) sell their products to farmers, SMEs often face a shortage of funds for financing their operating expenses. When this occurs, SMEs' owners borrow money from their relatives and friends. When SMEs work as subcontractors of other enterprises, the latter often provide the raw materials. Many lower-end SEs suspend operations when they cannot finance their operating expenses.

According to the Foundry and Engineering Industry Owners Association (FEIOA), 30% to 40% of light engineering enterprises operate on rented land and facilities; these SMEs do not have sufficient

[34] SMEDA, "Cluster Profile: Light Engineering in Faisalabad"

immovable assets to collateralize bank loans. Even SEs with immovable assets do not try to obtain loans from financial institutions due to their small operating profits and little confidence in repaying the loans.

The sector has a strong presence in the local market as it supports enterprises engaging in different local industries. With proper support for technological modernization, research and development, and improved access to finance, the sector is expected to be one of the high-potential SME sectors that can contribute to import substitution for equipment and machinery (import of textile machines only amounts to approximately US$ 600 million on average annually).[35] There is also the potential for the sector to increase its export of agricultural and textile machinery to the African market, where end-users are not highly-dependent on sophisticated equipment and machinery.

The figure below shows the main actors and value chain of the light engineering products:

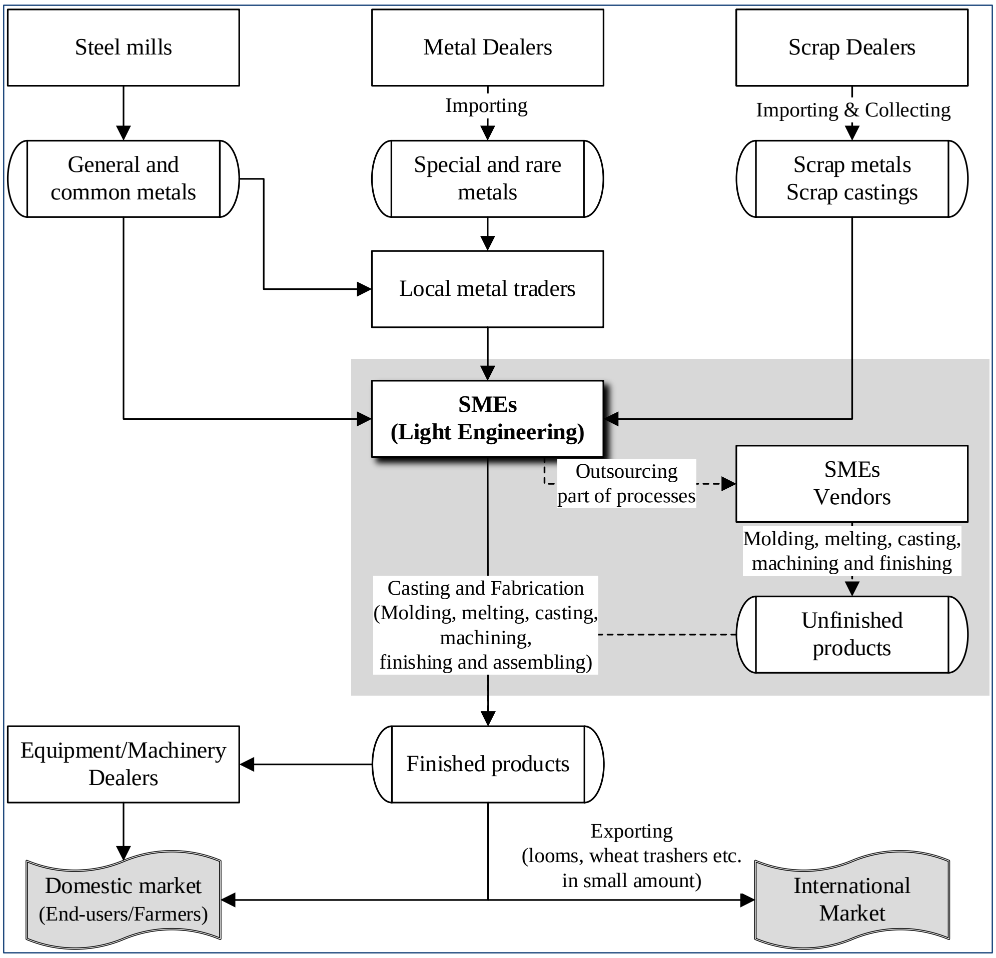


**Figure 14 Value chain of the light engineering sector**

Source: JICA Survey Team

[35] SMEDA, "Cluster Profile: Light Engineering in Faisalabad"

## 2-3 Current Condition of SMEs

### 2-3-1 Technology

The following are the major findings concerning the technological condition of the target sectors.

#### (1) Equipment and Machinery

Irrespective of the sector, the equipment and machinery that SMEs use are mostly obsolete and inefficient, requiring manual operation for complicated processing. Many enterprises across different sectors admit that their machines are not fit for complex processing, consume much electricity, cause material wastage and cannot achieve high quality results.

Since most lower-end small enterprises do not have sufficient knowledge about recent technologies and machines, they do not know the necessity of technological renovation. These SMEs tend to pay attention only to replacing or increasing their machinery; not to up-grading. On the other hand, upper-end small enterprises and medium enterprises understand the necessity to purchase modern equipment in order to improve productivity, accuracy, efficiency and product quality. As these machines are expensive, a majority of the enterprises prefer purchasing second-hand machines rather than buying new machines.

#### (2) Production Processes

Manufacturing a product requires many different processes. Most SMEs tends to have a few single-purpose processing units in-house and outsource processes that cannot be handled by their machines. This tendency was confirmed in many of the target sectors: textile, jewelry manufacturing, sports goods and surgical instrument manufacturing. This tendency affects production costs, overall lead time and the quality of products. In order to reduce factors beyond their control, many MEs, especially garment manufacturers, plan to expand their factories to accommodate upstream and downstream production processes (e.g. dyeing and washing units in the case of the garment industry).

Most enterprises in export-oriented sectors such as textile, leather and surgical instrument manufacturing work for international brands who provide them with product designs. Based on these circumstances, most enterprises do not have product design units.

#### (3) Production and quality management

SMEs do not have sufficient knowledge on production and quality management. Even some medium-scale garment manufacturers that use the latest equipment and technologies admit that their engineers and technical staff do not have sufficient knowledge on how to effectively use these machines and ensure high quality standards. For example, the colors and softness of fabrics and garments, which are dyed and washed with the latest technologies, are inconsistent with qualities not meeting required standards.

SMEs in almost all sectors want to conduct technological renovation and capacity development by establishing partnerships or joint ventures with Japanese enterprises.

### 2-3-2 Raw materials

Apart from accessories for the marble and garment sectors, both domestic and foreign-origin raw materials are sufficiently available on the domestic market. However, the problem relating to raw materials are their unknown or low quality with precious metals (jewelry), special steel (surgical instrument manufacturing, auto parts and light engineering products) and processed leather (leather goods manufacturing), and their limited variety for marble (marble processing) and garment accessories (textile and leather goods manufacturing).

While SMEs tend to purchase raw materials from domestic dealers, enterprises in the export-oriented sectors (e.g. garment, leather goods, sports goods and surgical instruments manufacturing) and auto parts manufacturers are more conscious of material quality; most MEs in these sectors directly import part of their materials. Some SMEs producing for the domestic market directly import raw materials due to the unknown quality and limited variety of materials being sold on the domestic market.

With orders not constant nor predictable, most SMEs do not know what materials they will use for the next order. Therefore, a majority of them do not stock raw materials and start procurements only after orders are placed. SMEs in the export-oriented sectors that have regular clients are capable of having stocks in advance.

### 2-3-3 Marketing

Most upper-end SEs and MEs are willing to participate in international and domestic exhibitions, fairs, shows, bazaars and trade delegations organized by TDAP or sectoral trade associations. During these events, enterprises display their products, explore recent trends in the market and technologies, and search for clients. All the trade associations and enterprises interviewed during the Survey expressed the importance of these events and the convening of B2B meetings.

Most lower-end SEs find their clients through their own networks. In most cases, they sell their products to wholesalers or retailers. Some lower-end SEs search for future clients through internet and email communications. Information from trade associations and local Chambers of Commerce and Industry also helps connect lower-end SEs to their clients.

There are also numerous intermediary companies in the textile sector, which connect textile SMEs with clients. Many small enterprises receive orders from these intermediary companies.

### 2-3-4 Human resources

SMEs tend to maintain a limited number of permanent employees and hire a large number of temporary workers when orders are received. Labor-intensive sectors, such as textile and leather garments, require a large number of temporary employees, while the jewelry and surgical instruments manufacturing sectors require a larger share of permanent employees due to their dependence on skilled labor.

According to this Survey's interview results, many lower-end SEs face difficulty in securing a sufficient workforce when receiving orders compared with upper-end ESs and MEs that have better chances of securing the necessary workforce by offering higher wages to temporary (skilled) workers. Most SMEs pay these workers based on their performances, such as the number of items processed.

Temporary workers organize themselves in groups with a network of these groups. Factories contact the representatives of workers' groups when receiving an order.

In general, the technical skills of workers are low. A majority of them are illiterate and uneducated. In spite of the presence of training institutes, most workers obtain skills through OJT at factories. The trade associations interviewed during the Survey claim that the number of training institutes is not sufficient, their trainers are not skilled, and their equipment and machinery are outdated.

### 2-3-5 Financing

According to the Survey's interview results, a majority of SMEs cannot obtain loans from commercial banks due to collateral requirements and high interest rates (12% to 15% per year).

Enterprises of export-oriented sectors emphasized that many SMEs want to participate in SBP's Export Finance Scheme that offers a subsidized interest rate (around 7% to 8%). However, most SEs cannot obtain the loan under this scheme due to collateral requirements. According to them, a majority of SEs are operating in rented facilities and do not have immovable assets for collateral. As for enterprises operating in their own facilities, the value of their assets, which is assessed as half of their market value, is lower than that required for collateral.

SMEs' need for finance is highly dependent on the period of time needed to collect payment from clients and the period of time needed to make payments to suppliers. According to the interview results, many SMEs purchase raw materials from domestic suppliers on credit for 1 to 3 months with interest of 2% per month (higher than the interest rate of commercial bank loans).

Since payments by their clients are usually made 2 to 4 months after delivery of products, SMEs often face difficulty in procuring raw materials due to insufficient funds. Most enterprises interviewed during the Survey emphasized that they are often forced to turn down orders due to the lack of finances. MEs and some successful upper-end SEs are in a better position to finance necessary working capital through their own sources.

Until the payments are made by their clients, most enterprises (mostly SEs) obtain raw materials on credit from suppliers, borrow raw materials from other enterprises, subcontract part of the process to other enterprises, and/or borrow money from family members, relatives and friends.

### 2-3-6 Problems and Challenges

According to the results of the interviews and literature reviews conducted by the JICA Survey Team, the following are the most common problems that the SMEs in Pakistan face:

- Difficulty in raw material procurement;
- Lack of and/or obsolete technology (equipment and machinery);
- Lack of funds;
- Insufficient knowledge and skills on management and marketing;
- Lack of skilled and experienced labor; and
- Bribery.

Among the above, lack of funds has been emphasized as the most serious problem in almost all the literature reviewed and the interviews conducted by the JICA Survey Team. SMEs in Pakistan have not been able to obtain loans from banks and other financial institutions due to several factors, including their inability to provide collateral, their non-transparent accounting and financial institutions' lack of understanding of the SME sector. Most SMEs rely on support from their friends and relatives and credit-sales by their suppliers. Many SMEs have to seek credit from informal money lenders.

**Figure 15** shows the results of a cause-effect analysis on the common problems of the SME sector.

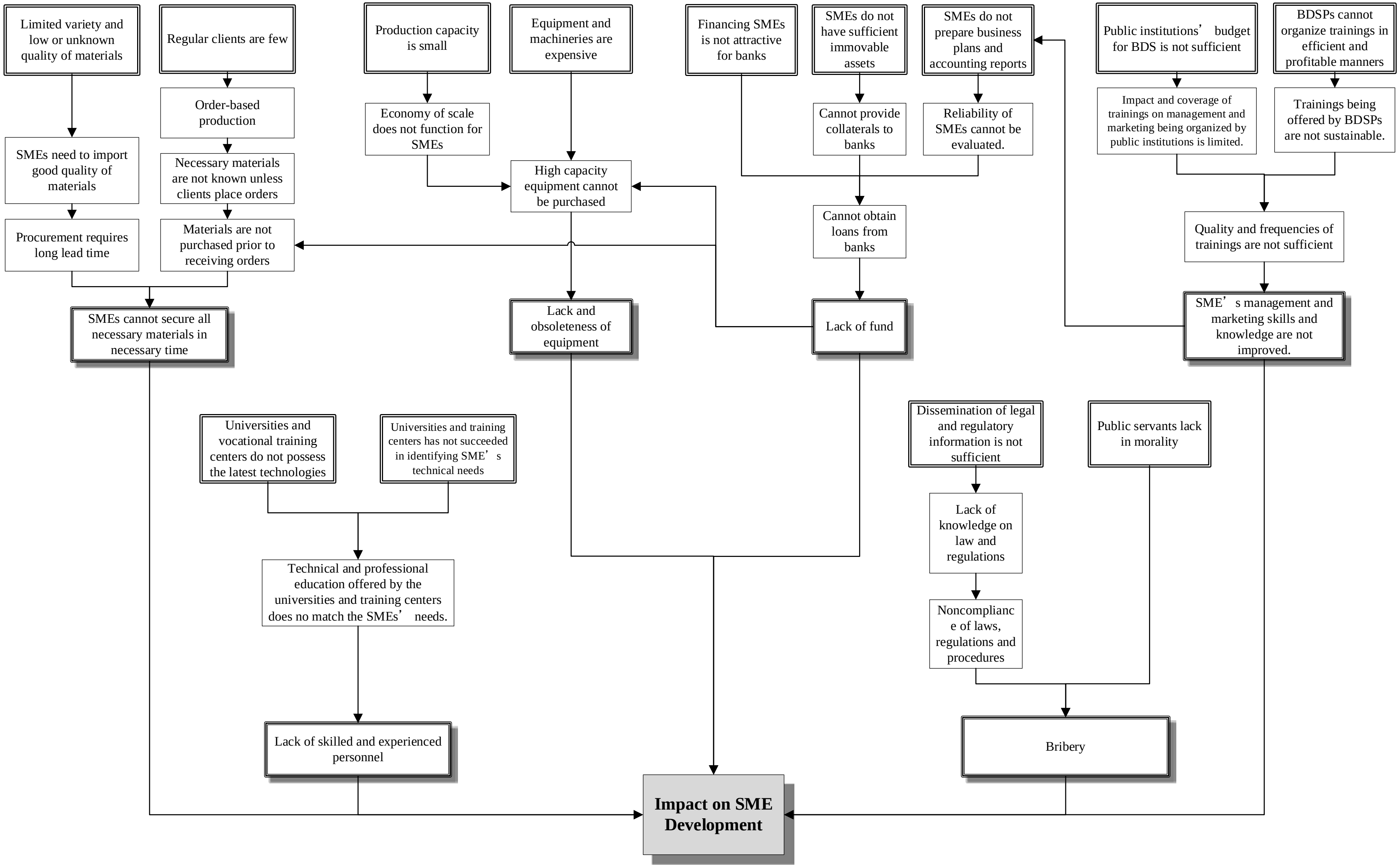


**Figure 15 Cause-effect analysis of the SME sector common problems**

## 2-4 SME Development Policy and Plans

The Government of Pakistan defines SME development as one of the main pillars for the country's economic growth in its development policy "Pakistan Vision 2025". The following three indicators are set in Pakistan Vision 2025 for the objective of SME development to be achieved by 2025:

- Increase SME sector employment by 10 million jobs from 14.9 million in 2014;
- Increase SME sector contribution to GDP to PKR 16 trillion from PKR 9.4 trillion in 2014; and
- Increase exports by SMEs to USD54 billion from USD18.2 billion in 2014.

According to Pakistan Vision 2025, major planned support for SME development are improvements to policies and legislation, provision of BDS, improvements to SME finance and improvement of SMEs' organizational capacities and improvements to infrastructure. The three pillars of the SME development plan in Pakistan Vision 2025 are: (1) policy advocacy with the Strategic SME Development Framework (2013-18); (2) development of the entrepreneurial ecosystem to support new enterprise creation and increase the scale of business; and (3) sector development plans for 13 priority sectors. Implementation of the activities will require involvement by the different public agencies.

In addition to the above, SMEDA has been preparing a new SME Policy. According to SMEDA, the policy will focus on issues relating to access to finance, business environment (rules and regulations), marketing and market access, technology, training and support to women entrepreneurship. The definition of SME will be standardized to be used by all government organizations in order to ensure effectiveness of SME support activities. A monitoring and evaluation system, comprised of (1) a committee that consists of representatives of relevant government organizations including SMEDA and other stakeholders, and (2) progress evaluation criteria; will be established for the evaluation of policy implementation. SMEDA will function as the secretariat that monitors activities to be conducted under the policy.

There are also policy documents promulgated by different federal agencies that support SME development. The summary of each of the documents is provided in "Annex 7 Summary of Recent SME Support in Pakistan".

## 2-5 Overview of SME Support Projects and Activities

In line with government policies, different domestic and international organizations have implemented projects and activities to support SMEs. Domestic organizations involved in SME development include the State Bank of Pakistan; federal government agencies operating under the jurisdictions of the Ministry of Industries and Production (MoIP), the Ministry of Finance (MoF) and the Ministry of Commerce (MoC); provincial government organizations; educational and vocational training institutions; and other non-profit organizations. Many of them offer SMEs professional and technical education; trainings on management, marketing, improvement of productivity, production management and quality control; and research and consulting services.

The major organization for SME development in Pakistan is SMEDA under MoIP. SMEDA’s SME development activities include:

(i) Consulting services related to productivity improvement, quality control, preparation of business plans, implementation of feasibility studies and consultation on legal issues;

(ii) Trainings on management, international trade, finance, accounting, intellectual property rights, productivity as well as technical trainings in different fields;

(iii) Support for female entrepreneurs;

(iv) Operation of an industrial information network and facilitation of information sharing among SMEs through a portal site;

(v) Public sector development programs; and

(vi) Cluster development.

Under the framework of its Public-Sector Development Program, SMEDA, in cooperation with private enterprises and the Chamber of Commerce and Industry, supports the operation and maintenance of Common Facility Centers (CFC) that aim to enhance the value addition of SME products by reducing costs and improving technologies.

Detailed information about the SME support activities conducted by SMEDA and other federal agencies is stated in “Annex 7 Summary of Recent SME Support in Pakistan”.

International organizations and donors including the World Bank, USAID, ADB, DFID, IFC and UNIDO have implemented many projects for the past decade to support the SMEs in Pakistan in the fields of entrepreneurship development, improvements to the business environment (including laws and regulations), increased competitiveness and SME finance. The project summaries are provided in “Annex 7 Summary of Recent SME Support in Pakistan”.

# Chapter 3 Financial Sector Overview and SME Finance

## 3-1 Financial Sector in Pakistan

### 3-1-1 Financial Sector Landscape

Over the last 25 years, Pakistan's financial sector has developed significantly, transforming from one dominated by underperforming state-owned banks to a more modern financial sector with close to 50 banks and other financial institutions. Diversity, depth and breadth of the sector, however, remains still limited among comparable emerging market economies, and further diversification and growth are required to accelerate the country's economic development. **Table 11** below illustrates the asset composition of the financial sector in Pakistan.

Per the data of June 2015,[36] the banking sector dominates the financial sector with its assets accounting for 74.7% of the sector's total assets. The remaining is comprised of 16.5% in the National Savings Scheme (NSS), 4.8% in insurance companies, 4% in nonbank institutions, and 0.1% in microfinance institutions (MFIs). The microfinance sector has been imparting a significant effect on improving the financial access and inclusion even with its small size in terms of assets.[37] Another sub-sector that is worth noting for its rapid growth is Islamic finance, accounting for 5.2% of sector assets.

[36] "IDA PAD for a Pakistan Financial Inclusion and Infrastructure Project," World Bank, May 15, 2017.
[37] See "Annex 5 Overview of Pakistan's Microfinance Sector and Micro Enterprise Lending" for the summary of the microfinance sector in Pakistan.

**Table 11 Financial sector asset composition**

| | Number of institutions | Assets (PKR, billion) | % of assets | % of GDP d |
|---|---|---|---|---|
| **Banking Sector** | | | | |
| Public sector commercial banks | 5 | 2,352 | 13.2 | 8.6 |
| Local private banks | 16 | 9,542 | 53.5 | 34.8 |
| Foreign banks | 5 | 224 | 1.3 | 0.8 |
| Specialized banks | 4 | 196 | 1.1 | 0.7 |
| Islamic banks | 6 a | 929 | 5.2 | 3.4 |
| Microfinance banks | 11 | 82 | 0.5 | 0.3 |
| | **45** | **13,325** | **74.7** | **48.7** |
| **Nonbank Financial Sector** | | | | |
| Insurance companies e | 51 e | 855 | 4.8 | 3.1 |
| *Modarabas* | 25 | 30 | 0.2 | 0.1 |
| Mutual funds | 180 | 449 | 2.5 | 1.6 |
| Investment banks | 3 | 7 | 0.0 | 0.0 |
| Leasing companies | 10 | 36 | 0.2 | 0.1 |
| Microfiannce institutions | 28 | 20 f | 0.1 | 0.1 |
| National Saving Schemes | 1 | 2,939 c | 16.5 | 10.7 |
| Development Finance Institutions b | 8 | 184 | 1.0 | 0.7 |
| | **306** | **4,520** | **25.3** | **16.5** |
| **Total financial sector** | | **17,846** | **100.0** | **68.5** |

Note: a) MCB Islamic Banks was granted an Islamic banking license in September 2015; b) Development finance institutions include House Building Finance Corporation and Bilateral Investment Firms; c) Includes prize bonds; d) According to SBP's Monetary Policy infromation Compedium, Nominal GDP in FY2015 was PKR 27.4 trillion (USD 261.6 billion); e) Includes non-life, life and public insurance companies; f) Estimates.
Source: World Bank. "IDA PAD for a Pakistan Financial Inclusion and Infrastructure Project," May 15, 2017.

The size of Pakistan's financial sector is about 68.5% of GDP, which is small among comparable emerging markets. As mentioned above, the banking sector dominates the financial sector of which the assets represent approximately 48.7% of GDP. In other emerging counties such as in India (79.8%) and Malaysia (202%), the share of sector assets to GDP is much higher.[38] Excluding the NSS, the nonbank financial sector accounts for only 5.8% of GDP. Insurance companies represent the highest share in the non-banking financial sector, but their outreach, measured as the number of institutions, is among the lowest across comparable economies. Mutual funds are growing with its share at 1.6% of GDP, but this is still low compared to India (5.6%) and Malaysia (34%). Leasing companies, modarabas,[39] and other development finance institutions are very small both in outreach and asset size.

Pakistan's equity market grew remarkably in 2016 with the benchmark KSE-100 Index growing by 45.7%, supported through the market reform efforts. Consequently, the Morgan Stanley Capital International (MSCI) Pakistan Index was reclassified from Frontier Markets to Emerging Markets in June 2017. As with the fixed income market, the primary debt market is still underdeveloped, dominated by government securities and lacking efficiency, depth and liquidity. Market participants are limited to banking sector investors, which constrains further development despite recent reforms to the regulatory

[38] "IDA PAD for a Pakistan Financial Inclusion and Infrastructure Project," World Bank, May 15, 2017.
[39] Modaraba (plural modarabas) is a form of financial contract in some Muslim countries in which the investor entrusts money to a financial manager. Any profits and losses are shared between them in an agreed manner.

framework and market infrastructure.

### 3-1-2 Interest Rate Environment

Stronger macroeconomic fundamentals helped by the IMF supported program, structural reforms, and low inflation allowed for a lower interest rate environment. SBP maintained the policy rate unchanged at 5.75% throughout FY17. However, on January 29, 2018, SBP raised the policy rate by 25bp to 6.0%. As shown in **Figure 16**, the weighted average lending rate (WALR) on incremental borrowing was 6.2% in December 2016 compared with 6.5% a year prior.[40] Since the change in the methodology to determine the deposit rate in FY14, deposit rates have declined, helping banks lower their cost of funding. The deposit rate on new deposits was 3.5% in December 2017, remaining almost at the same level in December 2016 after a reduction from 4.6% at the end of 2015.[41]

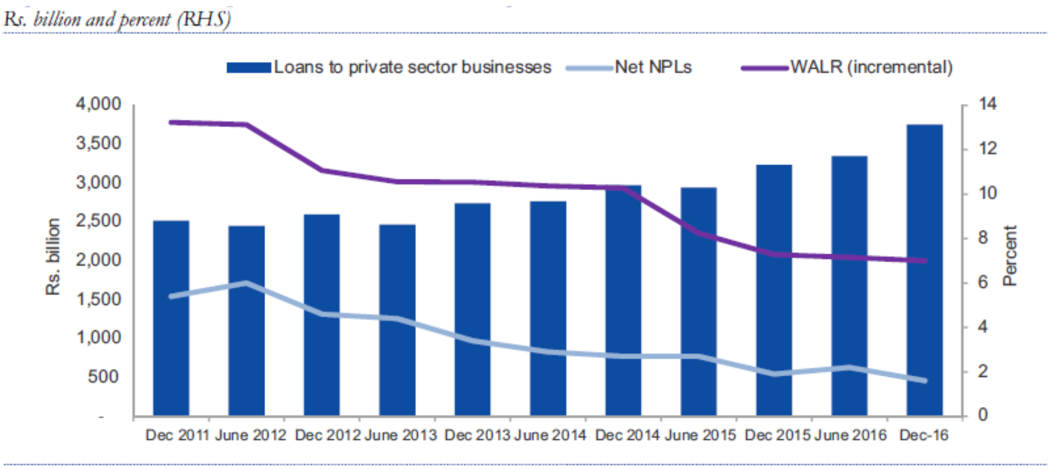


**Figure 16 Loans to private sector vis-à-vis lending rates and NPLs (2011-16)**

Source: "Pakistan Development Update, May. 2017", The World Bank

### 3-1-3 Dynamics of Public Debt and Private Sector Credit

Growth in private sector credit in Pakistan stalled until recently due to several macroeconomic factors. The global financial crisis afflicted the banking sector in Pakistan as in many other developing countries, and the slow economic recovery after the crisis discouraged the banking sector from extending credit to the private sector, while deterioration in the fiscal balance from FY10 to FY14 increased the cumulative amount of government debt. At the same time, interest rates during that time remained much higher at about 10.3% to 14.3% (FY09-FY14) than current levels. These macroeconomic factors created an environment that encouraged commercial banks to invest in government paper to earn "risk-free" profits instead of extending credit to private sector businesses. As shown in **Figure 17**, the amounts of public debt held by the commercial banks grew significantly until the end of FY16, which caused the "crowding-out" of private sector credit.

[40] Figures to be updated, pending new data to be issued by SBP.

[41] "Structure of Interest Rate – IV," SBP, Feb. 14, 2018.

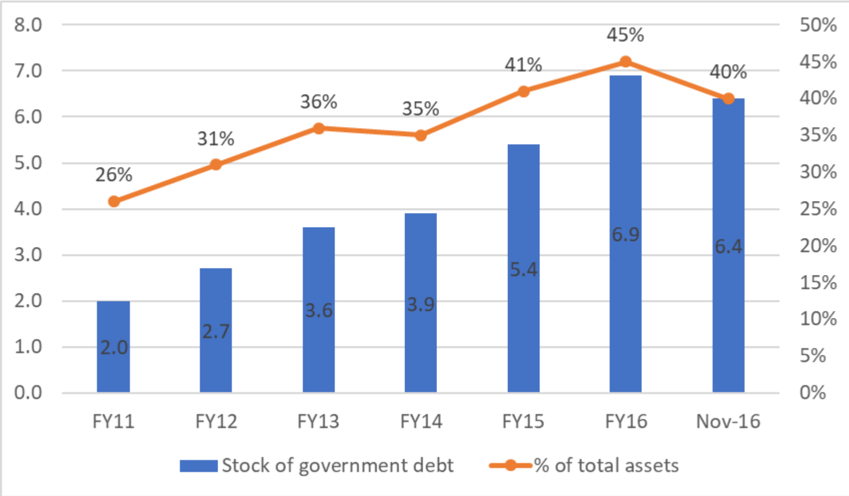


**Figure 17 Commercial banks' exposure to government debt**

Source: "Pakistan Development Update," May 2017, The World Bank

As was discussed in "Chapter 1 Pakistan's Macroeconomic Overview", the macroeconomic performance of Pakistan started to improve when the IMF program was introduced in September 2013 (in FY14), in particular in the areas of fiscal balance, inflation and interest rates. Improved fiscal balances, a lower real interest rate environment, and large amounts of repayments of government papers in the past few years have eased the "crowding out" effect on the private sector credit. With better economic prospects, credit to the private sector has been slowly growing as shown in **Table 12**. It grew by 16.8% in FY17, expanding by PKR 748 billion over the FY16 level.[42] It should also be noted that the banking sector is currently awash with liquidity, as indicated by advances to deposits ratios that were lower than 50% in the last three years, as compared to over 70% in the years during the financial crisis.[43]

**Table 12 Selected key indicators of the banking sector**

| Items | Dec-15 | Dec-16 | Sep-2017 |
|---|---|---|---|
| Profit Before Tax ytd | PKR 329 billion | PKR 314 billion | PKR 195 billion |
| Credit to Private Sector | PKR 3,880 billion | PKR 4,833 billion | PKR 4,735billion |
| Return on Assets Before Tax | 2.5% | 2.1% | 1.6% |
| Return on Equity Before Tax | 25.8% | 23.9% | 19.1% |
| Advances to Deposits Ratio | 46.4% | 46.6% | 48.3% |
| Liquid Assets / Deposits | 73.3% | 72.1% | 76.0% |
| Capital Adequacy Ratio | 17.3% | 16.2% | 15.4% |
| Gross NPLs to Loans | 11.4% | 10.1% | 9.2% |
| Net NPLs to Loans | 1.9% | 1.6% | 1.5% |
| 6-month KIBOR | 6.5% | 6.2% | 6.2% |

Source: "Pakistan Development Update," May 2017, The World Bank. "SME Financing Data Tables – September 2017," SBP. "Quarterly Performance Review of the Banking Sector (July-September 2017)," Financial Stability Department, SBP. "Economic Data" http://www.sbp.org.pk/ecodata/kibor/2017/Sep/kibor-29-Sep-17.pdf (Accessed February 23, 2018)

[42] "Pakistan Development Update", Nov. 2017, The World Bank.

[43] "Quarterly Performance Review of the Banking System (December 2008)," Banking Surveillance Department, SBP.

### 3-1-4 Financial Soundness of the Banking Sector

Financial soundness indicators of the banking sector remained generally good and profitable as **Table 12** shows, primarily because banks shifted their risk assets from private sector credit to risk-free government securities until the recent past. As shown in **Figure 17** during the period of FY12 to FY16, the banking sector assets achieved sizable growth notably with increased government borrowing.

The size of the government domestic debt held by the commercial banks peaked at PKR 6.9 trillion in June 2016 (end FY16), amounting to about 45% of commercial banks' total assets. Following this, both the amount of government domestic debt and its share of the total assets started to decline to about PKR 6.4 trillion and 40%, respectively, as of November 2016. Private sector credit has slowly recovered, but its total amount remained at PKR 4.8 trillion as of December 2016 (see **Table 13**). Consequently, the outstanding stock of government debt held by banks still outweighed their private sector loans, which was translated to reduced risk-weighted assets for the banking system. Though the trend in the growing amount of government paper held by the banks has been reversing since the end of FY16, a slightly declined capital adequacy ratio of 15.4% in September 2017 may be reflecting an end to this trend. NPLs are at their lowest level in the past eight years, indicating improved asset quality with the NPL-to-loans ratio at 9.2% in September 2017 as indicated in **Table 12**.

### 3-1-5 Composition of Private Sector Credit

During FY17, the improved credit extension was broad-based in terms of its uses (i.e. working capital, fixed investment, and trade finance).[44] The credit extension by industry was mostly concentrated in the manufacturing sector.[45] About 36% of loans to private sector firms are categorized as long-term.[46] SBP's data (**Figure 18**) in the most recent quarter (FY18Q1) indicates that the share of fixed investment loans was steadily increasing both for SMEs and large corporations, suggesting a broad-based enhancement of productive capacity.

[44] According to interviews with commercial banks, Habib Metropolitan Bank Limited is the leader in the field of trade finance, taking up about 40% of the market share for foreign exchange services

[45] Table 7: Credit to the private sector, "Pakistan Development Update", May 2017, The World Bank.

[46] "Pakistan Development Update", May 2017, The World Bank.

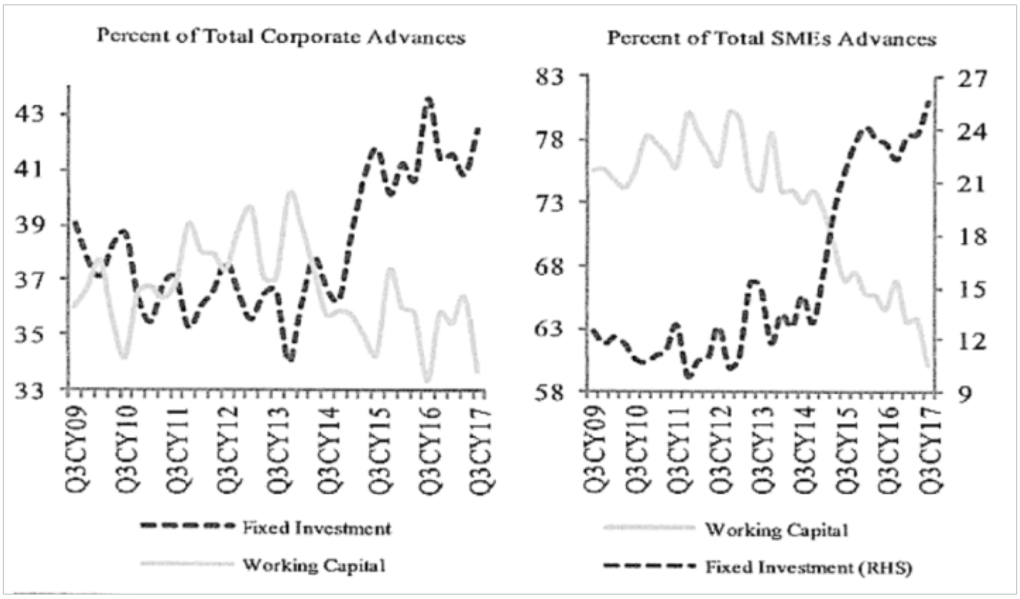


**Figure 18 Share of Fixed Investment**

Source: Quarterly Performance Review of the Banking Sector (July-September 2017), Financial Stability Department, SBP

## 3-2 SME Finance

### 3-2-1 SME Finance Landscape

From the early 2000s up to 2007, SME credit in Pakistan was increasing with the banking sector flush with a large inflow of liquidity backed by conducive economic conditions for businesses. The banking sector's absorption of government paper at that time was not significant. SMEs benefitted from increasing bank credit extended to the private sector. However, the performance of SME finance deteriorated significantly after 2008, following the economic slowdown experienced not only in Pakistan but globally, caused by the financial crisis. In addition, the economy in Pakistan suffered from growing security concerns and energy imbalances, which harmed the business performance of SMEs as well as large enterprises.

When the National Financial Inclusion Strategy (NFIS) was being written, SME credit represented only about 1.2% of GDP with an alarmingly high NPL ratio of 34%. The SME Bank, a government-owned entity, had been created in 2001 to advance SME finance.[47] By 2014, however, SME Bank was no longer able to extend new loans due to its extremely high NPL ratio of 82% and accumulated losses.[48] During the period from 2009 to 2013, commercial banks increased their holding of government paper and retreated from SME lending.

[47] A few representatives from the Pakistan Banks' Association mentioned a failure in business management as one cause of the closure of SME Bank. The Privatization Commission (PC) invited expressions of interest for dispossession of 93.88 per cent government shareholding in the SME Bank along with management control according to PROPAKISTANI, Feb. 5, 2017.

[48] "National Financial Inclusion Strategy Pakistan."

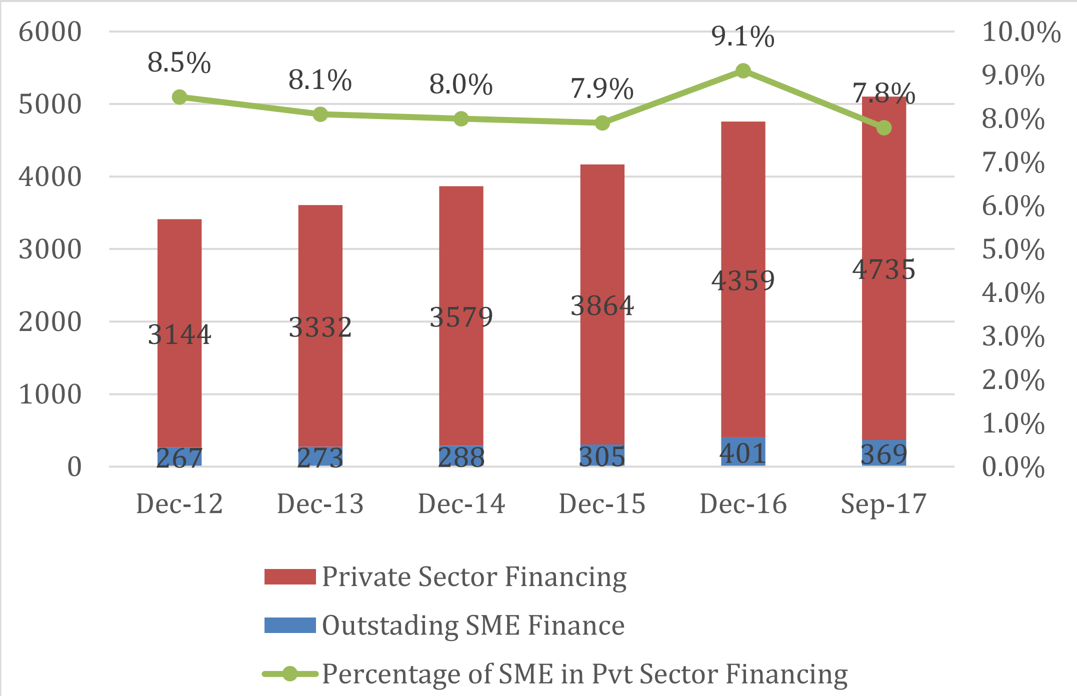


**Figure 19 SME outstanding vs. industry outstanding finance (PKR billion)**

Source: "SME Finance Annual Review 2016," Infrastructure, Housing & SME Finance Department, SBP; "SME Financing Data Table – September 2017," SBP.

**Table 13 SME financing trend**

| Category | Dec-12 | Dec-13 | Dec-14 | Dec-15 | Dec-16 | Sep-17 |
|---|---|---|---|---|---|---|
| Outstanding SME finance (PKR billion) | 266.51 | 272.53 | 287.88 | 305.09 | 401.28 | 369.81 |
| Annual growth of SME finance | N/A | 2.3% | 5.6% | 6.0% | 31.5% | (7.8%) |
| Outstanding private sector finance (PKR billion) | 3,144.23 | 3,331.54 | 3,579.18 | 3,864.49 | 4,359.18 | 4,734.64 |
| % of SME share of total private sector finance | 8.5% | 8.1% | 8.0% | 7.9% | 9.1% | 7.8% |
| SME NPLs as % of outstanding SME finance | 35.8% | 31.8% | 30.2% | 25.3% | 20.3% | 21.1% |

Source: "SME Finance Annual Review 2016," Infrastructure, Housing & SME Finance Department, SBP; "Quarterly Performance Review of the Banking Sector (July-September 2017)," Financial Stability Department, SBP

Since 2013, SME credit has been recovering, reflecting the improved macroeconomic performance and the slow growth in the private sector credit. SME credit amounted to PKR 401 billion as of end 2016, increased by 31.5% from PKR 305 billion at end 2015. SME credit as of September 2017 slightly decreased to PKR 370 billion as compared to that in December 2016. This decline, as per the SBP analysis, was not a sign of weakening SME lending performance, but rather it is attributed to an unusually strong advances flow to SMEs during the first quarter of FY17 caused by the SBP's policy measures.[49]

[49] "Quarterly Performance Review of the Banking Sector (July-September 2017)," SBP.

Private sector NPLs declined to 10.1% in December 2016.[50] With a large amount of loan loss provisioning (LLP) set aside by banks, net NPLs dramatically declined to 1.6% at the end of 2016 (see **Table 12**). Similarly, the SME NPLs ratio improved from 35.8% (end of 2012) to 20.3% in the end of 2016 and 21.1% in September 2017.[51]

While the growth in SME lending in the recent past has been an encouraging trend, the penetration of SME finance still remains very low at 7.8% as of September 2017, compared to SBP's target of 15% for the share of SME lending of the total private sector credit to be achieved by 2020.

To meet the target by the end of 2020, SME lending would need to grow by 24% annually, even with the private sector credit holding constant at the level of September 2017. If the private sector credit is assumed to grow at an average annual growth rate of the last five years (8.6%), the SME lending would need to increase by an annual growth rate of 35%.

As the data discussed above suggests, the banking sector in Pakistan has been flushed with liquidity, and a lack of liquidity is clearly not the cause for the low penetration of the SME finance. Rather, its reasons are found in a combination of various socio-economic conditions in Pakistan. Such conditions will be discussed in "4-2 Primary Constraints in Advancing SME Finance".

### 3-2-2 SME Finance by Facility and Industry

Uses of SME loans are largely categorized as working capital, fixed investment and trade finance. As shown in **Figure 20**, working capital dominates SME finance, representing about 60% of the outstanding SME loans as of September 2017. Fixed investment made up a share of 26% and the trade finance share was 14%. The share of fixed investment loans for SMEs as well as its amount in PKR have been increasing over the last three years. This may imply improved confidence among investors with a longer-term outlook on the domestic economy.[52] During interviews with select commercial banks, a few banks mentioned that the demand for capital expenditure loans would increase in the near future stemming from growing economic activities in Pakistan. SBP also indicated in their recent report that an increasing demand for capital expenditure financing would be anticipated in the future towards which banks are expected to adapt their business focus.[53] A few banks are willing to adapt to this new environment of stimulated demand among SMEs for fixed investment, while others seem to remain cautious and risk-averse because of a longer tenor and higher risks associated with fixed investment loans. In view of the growing need for financial access to support the expansion of production capacity among SMEs, appropriate policy guidance by SBP and donors' assistance may be necessary in order to harness the momentum of accelerating SME growth in Pakistan.

[50] "Development Update Pakistan," May 2017, World Bank.

[51] The Banking sector in Pakistan seemed to have applied a large amount of loan loss provisioning after 2014 which improved the private credit wide NPL ratio and the SME NPL ratio.

[52] "Quarterly Performance Review of the Banking Sector (July-September 2017)," SBP.

[53] "Quarterly Performance Review of the Banking Sector (July-September 2017)," SBP.

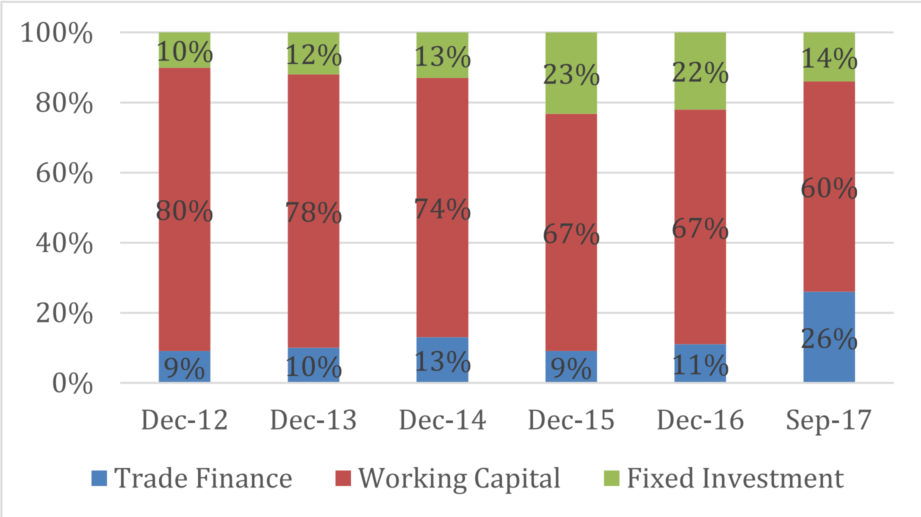


**Figure 20 Facility wise composition of SME financing (percentage)**
Source: "SME Finance Annual Review 2016," Infrastructure, Housing & SME Finance Department, SBP; SBP "SME Financing Data Tables- September 2017"

The industry-based composition of SME finance was 36% manufacturing, 38% trading, and 26% services as of September 2017. There has been a shift in the industry-based composition from the trading sector to the manufacturing and services sectors.

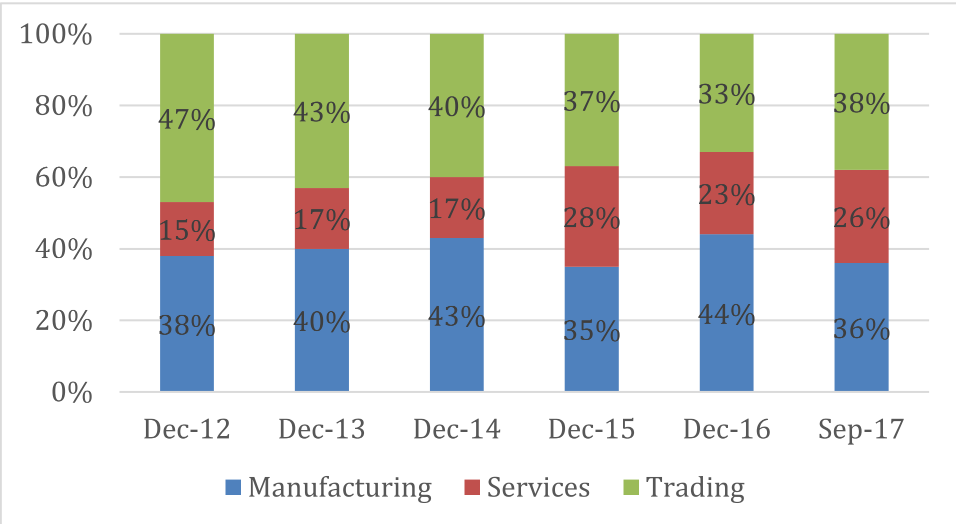


**Figure 21 Sectorial distribution of SME financing (percentage)**
Source: "SME Finance Annual Review 2016," Infrastructure, Housing & SME Finance Department, SBP; SBP "SME Financing Data Tables- September 2017"

### 3-2-3 SME Finance by Banking Groups

As of end 2016, 67% of SME credit was provided by domestic private banks, about 25% by public sector commercial banks, and the remaining 8% by the others, including DFIs[54] and foreign banks. The

[54] As of March 2017, DFIs included House Building Finance Company Ltd., PAIR Investment Company Ltd., Pak Brunei investment Company Ltd., Pak Libya Holding Company Ltd., Pak Oman Investment Company Ltd., Pak-China Investment

average loan size of the domestic private banks was about PKR 6.7 million, and about 22% of the SME borrowers received credit from them, as shown in **Table 14**. Public sector commercial banks extended credit to 53% of SME borrowers, but their average loan size was much smaller; about PKR 1 million. DFIs, which may have a special role in the SME finance, served only a small share (0.4%) of SME borrowers, but the average size was much larger at PKR 62.9 million.

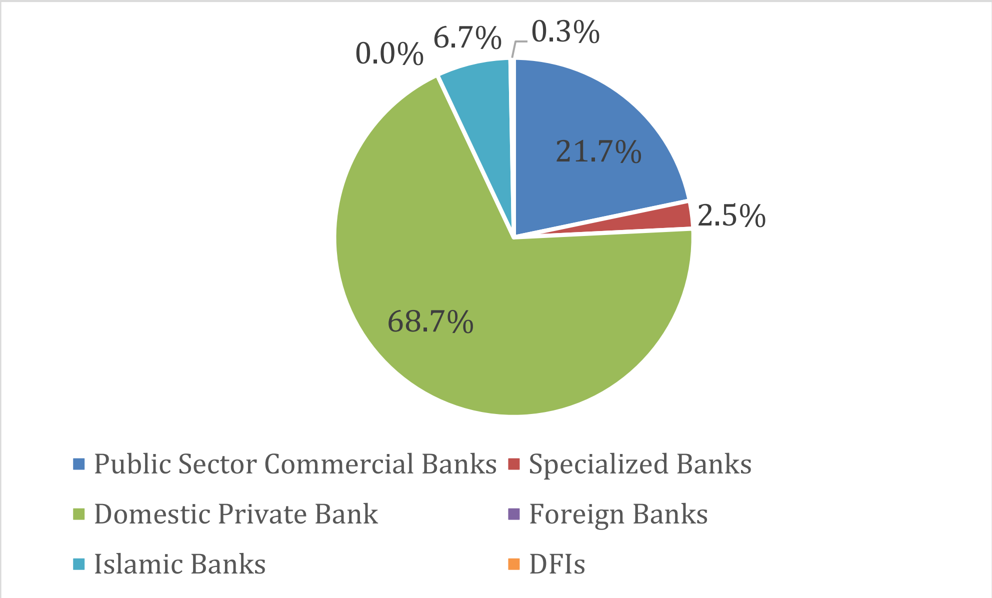


**Figure 22 Share of banks/DFIs in SME financing as of end 2017**

Source: SBP "SME Financing Data Tables- September 2017"

**Table 14 Bank wise average SME loan size and percentage share of borrowers (December 2016)**

| Institutions | Average SME loan size (PKR million) | Share of SME borrowers |
|---|---|---|
| Public sector banks | 1.0 | 53% |
| Specialized banks | 0.3 | 21% |
| Domestic private banks | 6.7 | 22% |
| Islamic banks | 4.1 | 3% |
| Foreign banks | 11.5 | 0.6% |
| Development financial institutions | 62.9 | 0.4% |

Source: "SME Finance Annual Review 2016," Infrastructure, Housing & SME Finance Department, SBP.

In Pakistan, Islamic finance is provided by both Islamic banks and Islamic finance divisions within conventional banks. Islamic SME finance has been increasing significantly since 2012. Between the end of 2015 and the end of 2016, it increased by 39% from PKR 20.8 billion to PKR 29.0 billion. The leader in Islamic finance is Meezan Bank accounting for 36% of the Islamic SME outstanding loans in 2016. Other leading banks are Albaraka Bank and Dubai Islamic Bank Pakistan Limited which provided 29%

Company Ltd., Pakistan Kuwait Investment Company Ltd., and Saudi Pak Industrial & Agricultural Investment Company Ltd. "Quarterly Compendium: Statistics of the Banking System, March 2017" Financial Stability Department, SPB.

and 18% of the Islamic SME outstanding loans in 2016, respectively.[55]

### 3-2-4 SME Finance and Performance of Commercial Banks in Pakistan[56]

According to the SBP's quarterly report,[57] Pakistan's banking sector is comprised by 34 banks in total as of September 2017 (see "Annex 1 List of Banks Operating in Pakistan"). 30 of them are commercial banks, out of which five banks are state-owned and the other five banks are foreign banks. Bank of Tokyo Mitsubishi UFJ is the only Japanese bank operating in Pakistan. The remaining four banks are specialized banks, one of which is SME Bank. SME Bank is in effect out of business and for sale (see "3-2-1 SME Finance Landscape").

The JICA Survey Team visited a total of 15 banks selected based on the recommendations by donors and SBP, all of which are local banks. These 15 banks are grouped into three categories by their asset size: namely large banks, medium size banks, and small banks.[58] In addition, the JICA Survey Team visited OLP which was recommended by a few donors. OLP has been recognized as an important financial institution that contributes to advancing the financial inclusion of SMEs in Pakistan. OLP has a strong business profile in the leasing industry with a stellar financial performance record, including a low NPL ratio for its SME portfolio.

**Outreach Capability**: Table 15 shows the number of branches and staff, as well as the number of staff per branch of the 15 commercial banks that the JICA Survey Team visited during the field study. There is a significant difference in the number of branches and staff among large banks, medium size banks and small banks. While there is not much difference in staff numbers per branch, there is a tendency for smaller banks to have more staff per branch than larger banks.

[55] "SME Financial Annual Review 2016," SBP.

[56] In this section, although all the tables include the data of First Women Bank, the data of First Women Bank was excluded in the analysis since the Bank carries a special mission of focusing on women borrowers and has performance problems, which would skew performance results of the select banks.

[57] "Quarterly Performance Review of the Banking Sector, (July-September 2017)," Financial Stability Department, SBP.

[58] Banks with total assets larger than KPR 900 billion are large banks. Banks with total assets larger than KPR 150 billion but smaller than KPR 900 billion are medium size banks. Banks with total assets smaller than KPR 150 billion are small banks. This grouping follows that of "Banking Survey 2016" by KPMG, May 2017.

**Table 15 Number of branches and staff [1/2/]**

| Banks | Legend | Number of Branches | Number of staff | Staff per branch |
|---|---|---|---|---|
| **Large Banks [2/]** | | | | |
| Habib Bank Limited | HBL | 1,796 | 17,303 | 10 |
| National Bank of Pakistan | NBP | 1,469 | 16,094 | 11 |
| United Bank Limited | UBL | 1,341 | 14,728 | 11 |
| MCB Bank Limited | MCB | 1,238 | 13,330 | 11 |
| Allied Bank Limited | ABL | 1,148 | 11,163 | 10 |
| Bank Alfalah Limited | BAF | 639 | 7,902 | 12 |
| **Medium Size Banks** | | | | |
| Meezan Bank Limited | Meezan | 571 | 9,493 | 17 |
| Habib Metropolitan Bank Limited | HMB | 307 | 4,621 | 15 |
| Faysal Bank Limited | Faysal | 355 | 6,395 | 18 |
| Soneri Bank Limited | Soneri | 288 | 3,725 | 13 |
| JS Bank Limited | JS | 307 | 4,509 | 15 |
| Dubai Islamic Bank (Pakistan) Limited | DIB | 200 | 2,828 | 14 |
| **Small Banks** | | | | |
| Silkbank Limited | Silk | 88 | 3,367 | 38 |
| Samba Bank Limited | SAMBA | 37 | 680 | 18 |
| First Women Bank Limited | FWB | 42 | 556 | 13 |

Notes:
1/ Data as of December 31, 2016. Source: Banking Survey 2016 - Commercial Banks Operating in Pakistan, KPMG.
2/ Large banks - total assets in excess of PKR900bn; Medium size banks - total assets >PKR150bn and <PKR900bn; Small banks - total assets less than PKR150bn.

The outreach capability through branches and staff of the large banks is far larger than that of the medium size and small banks, which is also reflected in the size of loan assets and that of deposits (Table 16).

**Table 16 Asset size, loans and advances and deposits of the select commercial banks[1/2/3/4]**
**(In billions of KPR, unless stated otherwise)**

| Banks | Legend | Total Assets | Net Assets | Loans and Advances | Deposits | Loan and Advance / Deposit (%) | Market Share( %) |
|---|---|---|---|---|---|---|---|
| **Large Banks** | | | | | | | |
| Habib Bank Limited | HBL | 2,507 | 196 | 817 | 1,886 | 42% | 13.8% |
| National Bank of Pakistan | NBP | 1,981 | 180 | 784 | 1,657 | 47% | 13.3% |
| United Bank Limited | UBL | 1,662 | 164 | 579 | 1,246 | 45% | 9.8% |
| MCB Bank Limited | MCB | 1,077 | 146 | 384 | 796 | 46% | 6.5% |
| Allied Bank Limited | ABL | 1,071 | 102 | 349 | 805 | 43% | 5.9% |
| Bank Alfalah Limited | BAF | 919 | 61 | 396 | 641 | 55% | 6.7% |
| **Medium Size Banks** | | | | | | | |
| Meezan Bank Limited | Meezan | 663 | 35 | 320 | 564 | 45% | 5.4% |
| Habib Metropolitan Bank Limited | HMB | 526 | 40 | 160 | 430 | 32% | 2.7% |
| Faysal Bank Limited | Faysal | 444 | 35 | 230 | 340 | 64% | 3.9% |
| Soneri Bank Limited | Soneri | 279 | 18 | 134 | 211 | 60% | 2.3% |
| JS Bank Limited | JS | 269 | 20 | 96 | 225 | 45% | 1.6% |
| Dubai Islamic Bank (Pakistan) Limited | DIB | 152 | 12 | 96 | 129 | 73% | 1.6% |
| **Small Banks** | | | | | | | |
| Silkbank Limited | Silk | 135 | 12 | 69 | 87 | 79% | 1.2% |
| Samba Bank Limited | SAMBA | 101 | 12 | 31 | 50 | 59% | 0.5% |
| First Women Bank Limited | FWB | 19 | 4 | 9 | 14 | 64% | 0.2% |

Notes:
1/ Data as of December 31, 2016. Source: Banking Survey 2016 - Commercial Banks Operating in Pakistan, KPMG.
2/ Large banks - total assets in excess of PKR900bn; Medium size banks - total assets >PKR150bn and <PKR900bn; Small banks - total assets less than PKR150bn.
3/Advance/Deposit = average loans and advances divided by average deposits.
4/ Market Share measured by the size of loans and advances.

**Exposure limit**: SBP sets separate exposure limits for small and medium enterprises per the "Prudential Regulations for Small and Medium Enterprises Financing (last revised on May 6, 2016)." Per party exposure limit for small enterprises is PKR 25 million from a single bank or DFI. Per party exposure limit for medium enterprises is PKR 200 million from a single bank/DFI or all banks/DFIs.

**Asset Size and Market Share**: Commercial banks in Pakistan in general seem to group loans to private sector companies into four categories: namely i) corporate loans; ii) commercial loans; iii) loans to medium enterprises; and iv) loans to small enterprises. Corporate loans are made to large corporations, while commercial loans are made to enterprises of which the size of business is between large corporations and medium enterprises. Such categorization is for banks' internal purposes only, and it is different from the definition of the SMEs adapted by SBP. For reporting purposes to SBP, all banks use the SBP definition, while banks may use the above categorization for their internal risk and financial management. Definition of commercial loans may be different by banks.

The average size of loan assets of the large banks is three times larger than that of the medium size banks, and it is 11 times larger than that of the small banks. Similarly, the average size of deposits of the large banks is four times larger than that of the medium size banks, and it is 17 times larger than that of the small banks. The average total assets and the average net assets of the large banks are about four to five times larger than those of the medium size banks, and they are about 12 to 13 times larger than those of the smaller banks. The small banks record the highest average Loan and Advance / Deposit ratio (69%), followed by the medium size banks (53%) and the large banks (46%). Lastly the market share (measured by the total amount of loans and advances) of the largest two banks took up more than a quarter of the market (27.1%), and the largest six banks in Pakistan amassed 56% of the market share, dominating the banking sector in Pakistan.

Earlier in this section, financial soundness of the banking sector as aggregate was discussed as generally good and profitable. Similarly, performance indicators of the select banks in **Table 17** also show their mostly healthy profitability and sound level of risk capital.

**Table 17 Performance indicators of the select commercial banks [1/2/3/4/]**

| Banks | Legend | Gross NPL (%) | Profit before Tax (in billions of PKR) | Banking Spread (%) | ROA (%) | ROE (%) | Capital Adequacy Ratio (%) |
|---|---|---|---|---|---|---|---|
| **Large Banks** | | | | | | | |
| Habib Bank Limited | HBL | 9.2% | 57 | 4.5% | 1.4% | 18.1% | 15.5% |
| National Bank of Pakistan | NBP | 18.5% | 38 | 5.5% | 1.3% | 13.1% | 17.2% |
| United Bank Limited | UBL | 9.1% | 47 | 3.7% | 1.8% | 17.5% | 14.9% |
| MCB Bank Limited | MCB | 6.1% | 37 | 4.6% | 2.1% | 15.4% | 19.7% |
| Allied Bank Limited | ABL | 5.9% | 24 | 3.5% | 1.4% | 15.3% | 20.9% |
| Bank Alfalah Limited | BAF | 4.8% | 13 | 3.8% | 0.9% | 14.3% | 13.3% |
| **Medium Size Banks** | | | | | | | |
| Meezan Bank Limited | Meezan | 2.1% | 11 | 3.7% | 1.1% | 20.5% | 12.9% |
| Habib Metropolitan Bank Limited | HMB | 12.4% | 10 | 2.2% | 1.5% | 19.6% | 18.4% |
| Faysal Bank Limited | Faysal | 13.1% | 7 | 4.2% | 0.1% | 13.2% | 14.6% |
| Soneri Bank Limited | Soneri | 7.8% | 3 | 2.5% | 0.1% | 10.3% | 14.1% |
| JS Bank Limited | JS | 3.4% | 4 | 3.4% | 0.1% | 12.7% | 15.7% |
| Dubai Islamic Bank (Pakistan) Limited | DIB | 2.5% | 1 | 4.3% | 0.1% | 18.8% | 11.2% |
| **Small Banks** | | | | | | | |
| Silkbank Limited | Silk | 8.4% | 1 | 7.7% | 0.1% | 5.5% | 10.7% |
| Samba Bank Limited | SAMBA | 7.7% | 1 | 1.2% | 0.6% | 4.5% | 23.9% |
| First Women Bank Limited | FWB | 20.7% | 0 | 5.0% | 0.0% | 0.4% | 46.6% |

Notes:
1/ Data as of December 31, 2016. Source: Banking Survey 2016 - Commercial Banks Operating in Pakistan, KPMG.
2/ Large banks - total assets in excess of PKR 900bn; Medium size banks - total assets > PKR 150bn and < PKR 900bn; Small banks - total assets less than PKR 150bn.
3/ Profit before tax of FWB was PKR 4mn.
4/ Banking Spread is the difference between the weighted average lending rate and the weighted average deposit rate.

However, First Women Bank, a state-owned bank, has a significantly high NPL ratio (20.7%) with a low Return on Assets (ROA) and Return on Equity (ROE) ratios, indicating an alarming state of very weak performance. Similarly, the NPL ratio of the National Bank of Pakistan (NBP), another state-owned bank, is very high (18.5%) with its Capital Adequacy Rate (CAR) being substantively high though its ROA and ROE remain at reasonable levels.

Gross NPL ratios remain at a historical low level with an average NPL ratio of 8.9% for the large banks, 6.9% for the medium size banks, and 8.1% for the small banks.[59] Total profits before tax of the 30

[59] The NBP's high NPL ratio raised the average NPL ratio of the large banks.

commercial banks decreased slightly by 1.6% in 2016 as compared to 2015.[60] Among the selected banks in **Table 17**, the banks for which profits before tax decreased more than 10% in 2016 were MCB Bank, Habib Bank (HBL) and Faysal. The average lending spread of the large banks was 4.3% with 3.4% and 4.5% for the medium size and small banks, respectively. ROE, ROA and CAR in **Table 17** indicate generally healthy financial performance of the selected banks. The CAR required by SBP is 10.65%, which all the selected banks met in 2016.

**SME Lending Performance by the Select Banks**: Among the select banks in **Table 18**, Bank Alfalah (BAF) (PKR 114 billion) and HBL (PKR 110 billion) had stellar performance with SME credit in terms of volume, which surpassed significantly that of the third and fourth best performing banks; UBA (PKR 35 billion) and NBP (PKR 32 billion). Moreover, the total SME credit provided by the six large banks amounted to PKR 300 billion, dominating substantively the SME finance sub-market. In terms of the share of SME loans over total loans, Silk Bank performed the best with 29% of their loans offered to SMEs, followed by BAF, JS Bank and HBL.

SME lending rates are usually quoted as spreads over 3-month or 6-month KIBOR. According to our interviews with the selected banks, large banks offer SME loans with KIBOR+2.5% to KIBOR+3.5%, except for BAF for which the lending rates may go up to KIBOR+8%. With the current KIBOR rate,[61] the lending rates offered by large banks would be between 8.96% and 10.06%. Likewise, the SME lending rates of medium size banks would be between 8.21% and 10.56%, and those by the small bank (Silk) would be between 11.46% and 11.56%.

[60] Banking Survey 2016, KPMG, May 2017.
[61] As of March 26th, 2018. 3-month KIBOR offer rate was 6.46% and 6-month KIBOR offer rate was 6.56%.

**Table 18 SME lending performance by the select commercial banks**

| Banks | Legend | SME loans (PKR billions) | SME loans/All Loans (%) | SME NPL (%) | SME Lending Rates (%) |
|---|---|---|---|---|---|
| **Large Banks** | | | | | |
| Habib Bank Limited | HBL | 110 | 13.5% | | 2.5% |
| National Bank of Pakistan | NBP | 32 | 4.1% | | 2.5%-3.5% |
| United Bank Limited | UBL | 35 | 6.0% | | N/A |
| MCB Bank Limited | MCB | 17 | 4.4% | | 3.0% |
| Allied Bank Limited | ABL | 22 | 6.3% | | 2.5%-3.5% |
| Bank Alfalah Limited | BAF | 114 | 28.8% | | 3%-8% |
| **Medium Size Banks** | | | | | |
| Meezan Bank Limited | Meezan | 14 | 4.4% | | 1.75%-3% |
| Habib Metropolitan Bank Limited | HMB | 15 | 9.4% | | 2.5%-3% |
| Faysal Bank Limited | Faysal | 16 | 7.0% | | 3.5%-4% |
| Soneri Bank Limited | Soneri | 13 | 9.7% | | 2%-3.5% |
| JS Bank Limited | JS | 23 | 24.0% | | 3%-4.5% |
| Dubai Islamic Bank (Pakistan) Limited | DIB | 8 | 8.3% | | 2%-4% |
| **Small Banks** | | | | | |
| Silkbank Limited | Silk | 20 | 29.0% | | 5.0% |
| Samba Bank Limited | SAMBA | 1 | 1.6% | | N/A |
| First Women Bank Limited | FWB | 2 | 22.0% | | Up to 4% |

Notes:
1/ Source: Banking Survey 2016 - Commercial Banks Operating in Pakistan, KPMG. Interviews with the banks during mid-January to early February 2018.
2/ Large banks - total assets in excess of PKR900bn; Medium size banks - total assets >PKR150bn and <PKR900bn; Small banks - total assets less than PKR150bn.
3/ Due to the lack of data of total loan amounts in 2017 by bank, SME loans/All loans uses the total loan amounts in 2016.
4/ Spread over KIBOR. SME lending rates are usually quoted as spread over 3-month or 6-month KIBOR.

**Collateral Requirement**: Lack of assets that may serve as collateral among SMEs has been identified as one of the primary reasons for SME's low access to finance in Pakistan. While the above-mentioned Prudential Regulations indicated that banks and DFIs may provide unsecured loans up to PKR 5 million,[62] most banks would not lend without collateral even for an amount less than PKR 5 million. Collateral requirements differ among banks, and the value of collateral required by banks would be between 125% and 200% of a loan amount. Most of the interviewed banks said that the e-registry of movable assets, which would become operational towards the end of 2018, would be very helpful in extending credit to SME borrowers. Among the 15 interviewed banks, only eight banks stated that they had used the Credit Guarantee Scheme (CGS) provided by SBP/DFID (see "3-3-1 Credit Enhancing Products and Schemes" for detailed descriptions related to CGS).

**Credit Assessment**: Most banks adopt a relationship-based model for SME finance. Bankers develop business relationships with SME clients through which they obtain data and information to assess

[62] Provided that borrowers offer personal guarantees.

clients' creditworthiness and manage credit risks. Banks usually assign relationship managers to SME borrowers. Relationship managers may visit clients on a regular basis to check how their factories and businesses are run, and they may need to understand their clients' business skills and experience, and even their personality traits. In general, SME bankers are required to acquire more hands-on knowledge of the businesses and industries of their clients.

Banks use the Electronic Credit Information Bureau (E-CIB) to check any delinquencies by SME borrowers. However, according to the banks, as E-CIB does not have data older than two years, they have to rely on other means or supplemental information and data. Since most SMEs in Pakistan are not registered, reliable financial data and business information are not available. Instead, banks usually conduct so-called "market checks," "peer checks," or "proxy checks" that use alternative data and information for credit assessment. Alternative information includes bank account statements of SME borrowers, agreements and contracts of business deals, utility billings and information provided by suppliers, buyers and competitors. For instance, bankers try to assess production volumes of manufacturing SMEs by analyzing their utility billings. If SME borrowers have a bank account, banks request their account statements to verify their business cash transactions. Some banks mentioned that they would not give credit to SMEs that do not have bank accounts, since data of SMEs' cash transactions is very important for credit assessment.[63] Compared to lending to large enterprises for which the size of loans is much larger than that of SMEs, per-loan formation cost for SME finance is usually higher because of the lack of economies of scale. Furthermore, the above-mentioned efforts by SME bankers in forming and maintaining loans add even more costs; this is one of the reasons why senior management of some banks is not convinced of the benefit of aggressively advancing SME finance.[64]

### 3-2-5 Financial Products for SME Finance

As described in "3-2-2 SME Finance by Facility and Industry", use of SME loans is largely categorized as working capital, fixed investment and trade finance. Working capital dominates SME finance, representing about 60% of the outstanding SME loans as of September 2017.

Interviews with commercial banks indicated that most of them do not have financial products customized for SME borrowers. They use standard and uniform products, such as "running finance," "demand finance," "letter of guarantee," "letter of credit," and other instruments for large enterprises as well as for SMEs. Recently, however, SBP and the donor community in Pakistan have been encouraging banks to use the financial method of "supply chain finance (SCF)" as a way of extending credit to SMEs. IFC and DFID through Karandaaz,[65] in particular, work with several commercial banks to develop and implement SCF in order to overcome some of the constraints of SME finance such as the lack of

[63] There are many SMEs that do not have bank accounts. According to some banks, some SMEs do not use bank accounts in order to avoid taxation or banking fees.
[64] A few banks confirmed that higher formation costs were one of the constraints of SME finance.
[65] More details are described in "3-3-2 Karandaaz and IFC for Supply Chain Finance".

collateral and higher credit risk of SMEs.

**Features of SCF**: SCF has been generally recognized as one of the most promising tools for financing SMEs (especially SEs), since SCF allows suppliers to borrow (usually) without collateral and with less expensive terms than financial institutions. SCF can be explained as a financial instrument to optimize the management of working capital or liquidity for business partners (e.g. buyers and suppliers) within supply chain processes. Supply chain processes in the context of SCF not only exist for manufacturing industry but in many other industries such as chemicals, food, pharmaceuticals, retail, and so forth. Many financial products and instruments fall under the term of SCF. Different types of SCFs are listed below:

| **Different Types of SCF** |
|---|
| Account payables related: Approved payables finance, Reverse factoring, Dynamic discounting. |
| Account receivables related: Receivables purchase, Invoice discounting, Factoring, Forfaiting. |
| Other types: Pre-shipment, Purchase order-based finance, Inventory finance, Warehouse finance. |

Among the varieties of SCF, the most widely used is “reverse factoring” that SBP and the donor community in Pakistan try to promote among commercial banks. Reverse factoring allows a supplier (i.e. SME) to receive a discounted payment of an invoice due to be paid by a buyer (an anchor company). The buyer pays at the normal invoice due date, whereas the supplier receives a discounted payment from the bank earlier than the payment due date. In this scheme, the bank makes an advance payment to the supplier based on the creditworthiness of the buyer and not that of the supplier. And because it is the buyer, usually a large company with a high-quality credit rating, that starts the process, it is the liability of the buyer that is engaged and therefore the interest rate applied for the deduction is less than the one the supplier would have obtained on its own account. In short, reverse factoring optimizes the efficiency of payment transactions within the supply chain, and by doing so allows suppliers to borrow against their customers’ creditworthiness instead of their own reducing costs across the supply chain.

| **ICT Platform for SCF**[66] |
|---|
| SCF usually involves an ICT platform that digitizes communications and transactions related to payments within a supply chain. On average, 80% of the resulting cost saving value is shared among the suppliers, the buyer, the bank and the ICT service provider. According to the study by Aite Group, the buyer may capture 35% to 50% of all savings, suppliers may get 25% to 45%, the bank may take 15% and the remaining 5% would go to the service provider. |

Most of the interviewed banks use SCF for SME borrowers, albeit with varying degrees of sophistication and breadth. SCF is meant to use invoices and account payables in lieu of collateral, but only four or five banks use SCF without requiring collateral from SME borrowers. This may indicate a need for deeper knowledge and education on the use and benefits of SCF among SME bankers.[67] In the

[66] Enrico Camerinelli, “A Study of the Business Case for Supply Chain Finance,” ACCA and Aite Group, 2014.
[67] On this point, the Survey Team recommends conducting further research on the extent of collateral requirements and types of collateral required for SCF in Pakistan.

interviews with banks, Honda, Suzuki, Nestle, Engro, Reckitt Benckiser, and Unilever were mentioned as anchor companies that use SCF in Pakistan.

## 3-3 Selected Ongoing Financial Assistance by Donors

As the list of financial and technical assistance provided by the donor community in Pakistan is provided in “Annex 7 Summary of Recent SME Support in Pakistan”. This section describes a few selected financial assistances by donors that are most relevant in formulating JICA’s financial assistance for SME finance in Pakistan.

### 3-3-1 Credit Enhancing Products and Schemes

One of the most crippling obstacles to banks in extending credit to SMEs stems from SMEs’ weak creditworthiness. SMEs’ lack of assets to offer as collateral, so as to enhance their creditworthiness, further worsens SMEs’ situation. Weak creditworthiness not only arises from the weaker business and financial management of individual SMEs, but also from their inherent vulnerability to the economic downturns due to a lack of economies of scale. Since shortages of funds in the banking sector are not a constraint on SME finance in Pakistan, donors have been using financial schemes that help enhance banks’ risk-taking capacity though without providing direct funding. Such schemes include SBP’s CGS for SMEs funded by DFID, IFC’s risk sharing facility, and Developmental Credit Authority (DCA) of USAID.

**Credit Guarantee Scheme of SBP and DFID**

CGS for small and rural enterprises was created within SBP in March 2010 with the funding provided by the Government of Pakistan and DFID[68] under the Financial Inclusion Program (FIP). The objective of the scheme is to improve the financial access of small enterprises and rural borrowers by enhancing their creditworthiness through partial credit guarantees.

[68] DFID provided GBP 13 million.

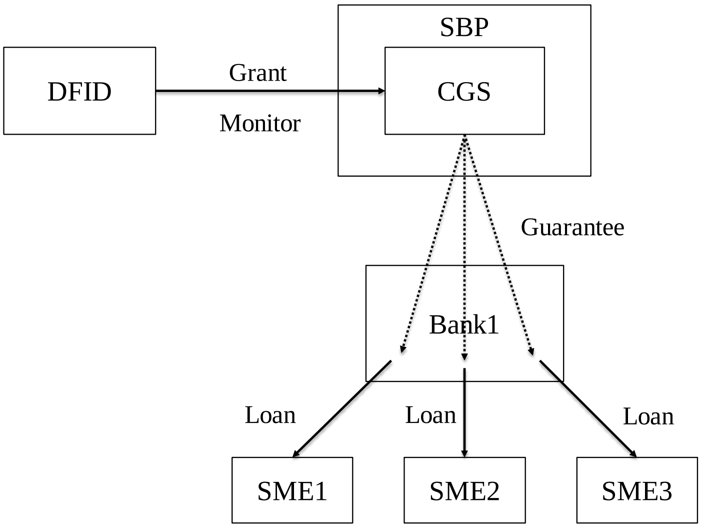


**Figure 23 Structure of the Credit Guarantee Scheme of SBP**

Source: JICA Survey Team

Following this, CGS began providing guarantees to MEs; correspondingly changing their name to the Credit Guarantee Scheme for Small and Medium Enterprises. The CGS resides within SBP and is managed by SBP with DFID monitoring its performance through quarterly reports and regular consultative meetings with SBP.

As illustrated in **Figure 23**, guarantees from CGS are provided for individual loans that are made to target borrowers by 21 participating financial institutions (PFIs); there are currently about 28,000 guarantee contracts under the CGS according to DFID.[69] CGS Guarantees cover up to 40% of loans in case of default, and guarantees are provided upon request by PFIs.[70] PFIs include banks, microfinance banks and DFIs. SBP allocates a limited amount of total guarantees to each PFI. DFID and SBP try to promote sector specific lending programs among the PFIs, and they encourage PFIs to apply CGS guarantees to SME loans in industry sectors selected by each PFI. For targeted sectors, CGS continues to provide PFIs with financial assistance (grants) that is equivalent to 2% of the allocated guarantee limit.[71]

During FY17, the risk coverage was raised from 40% to 60% for women borrowers, start-up businesses and small, rural and micro enterprises operating in the under-served areas of the country.[72] Risk coverage was amended to link with loan collateralization: the lower is the loan collateralization, the higher is the risk coverage extended under the revised scheme to allow banks to lend under-collateralized borrowers.

[69] Based on the interview with DFID in March 2018.

[70] The list of PFIs and their allocated guarantee limits and the utilization status of CGS as of September 2017 is shown in "Annex 3 Utilization Status of the Credit Guarantee Scheme of SBP".

[71] "SBP issues instructions under credit guarantee scheme for SMEs," June 19, 2017, PkRevenue.com This grant is provided by SBP (funded by DFID) to PFIs to develop sector-specific financial products for SME finance.

[72] For loans to women borrowers, start-up businesses and small, rural and micro enterprises operating in the under-served areas of the country, CGS pays to an originating bank 60% of the loss in case of loan default.

**Annual Reviews of the CGS by DFID**[73]

"Annual Review – Financial Inclusion Program (FY16/FY17)" by DFID evaluated the CGS as playing an important role in helping banks manage credit risks associated with SME lending. According to the review, the number of SMEs gaining access to finance through a CGS-backed loan was 22,909 in FY16 and 28,180 in FY17,[74] exceeding the targets of both fiscal years and recording a 23% increase from FY16 to FY17. The review also reported increasing CGS' utilization rates over the years; notably 69% in FY17. Similarly, the number of under-collateralised SMEs receiving CGS-backed loans was 2,943 in FY16, and 4,171 in FY17, which also exceeded the targets of both fiscal years.

In contrast, the targets for a sector specific approach were not met.[75] The targets for FY16 and FY17 were 30%, while the achievement was 8% and 21% in FY16 and FY17, respectively. The sector specific approach includes provision of a grant for technical assistance for designing and launching "sector specific products". However, only one bank took up this grant in FY17.

In addition, DFID reported some concerns regarding the very small number of claims against CGS-backed loans as well as the predominance of CGS usage by three banks; namely HBL, Muslim Commercial Bank and BAF.[76] Only a few loans defaulted among the guaranteed SME loans, which resulted in only 1% of the guarantees being called as of the end of FY17. While the low default rate indicates a positive result, DFID raised concerns that the CGS might not be effective enough in encouraging banks to extend credit to riskier or credit-constrained SMEs.

The existing scheme, however, has many other weaknesses. The CGS is not established as an independent entity with the guarantees being provided free of charge; distorting the market mechanisms. The FIP Program (funding resources) comes to an end in March 2020, which will require additional resources for continuing operations. In light of the above, CGS is currently under review for a comprehensive overhaul by SBP and DFID. The annual review by DFID indicated that the new CGS would be established as a Public Private Partnership (PPP) company with a more sustainable, larger-scale and market-based mechanism. According to SBP, the total amount of funds for a new credit guarantee company (CGC) are currently expected to be about PKR 10 billion; of which 90% would be provided by the public sector, including DFID and the World Bank, and the remaining 10% by local banks and insurance companies.

A business plan for a new CGC would be prepared by June 2018, and it is expected to become operational towards the end of 2018. After the CGS is fully revamped, the World Bank plans to provide

73 "Annual Review – Financial Inclusion Program (2016)," DFID. "Annual Review – Financial Inclusion Program (2017)," DFID

74 As of September 2017, 29,696 SMEs received CGS-backed loans according to "FIP Quarterly Progress Report, July-Sep 2017," DFID

75 This target was set by the agreement by CGS Technical Committee of SBP on a gradual shift to a sector-specific focus, through which 30% of the CGS portfolio adopts a sector approach in the first year (the review year), followed by 50% in the second year and 100% in the third year.

76 The usage by these three banks amounted to 63% of all CGS-backed loans in FY17.

funding in the amount of USD 33.1 million to capitalize the new scheme, provided that the new CGC meets its internal standards and conditions. DFID and the World Bank are holding quarterly coordinating meetings on the development of this business plan, which has been undertaken in close consultation with SBP.

**IFC's Risk Sharing Facility**[77]

A Risk Sharing Facility (RSF) is a financial product offered by IFC to banks that require credit risk protection but not funding (i.e. liquidity). Similar to USAID's DCA, RSF is a bilateral loss-sharing agreement between IFC and a bank in which IFC reimburses the bank for a portion of the principal losses incurred on an eligible loan portfolio. Unlike SBP's CGS, RSF is not attached to an individual loan but rather is an umbrella risk sharing facility covering a part of the loan portfolio (see **Figure 24**). A benefit of RSF is that it enhances banks' risk bearing capacity by sharing some of the risk of loss associated with the loan portfolio under the facility. Another benefit is that it improves a bank's risk-adjusted return and reduces the loan portfolio's economic capital allocation by reducing the bank's overall risk exposure since that portion of the loan portfolio covered by RSF carries IFC's high credit rating (AAA/Aaa).

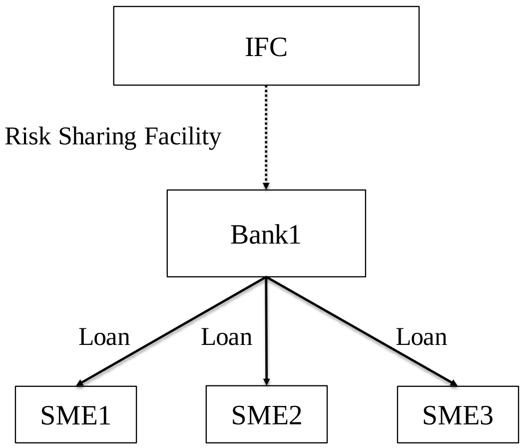


**Figure 24 IFC Risk Sharing Facility**

Source: JICA Survey Team

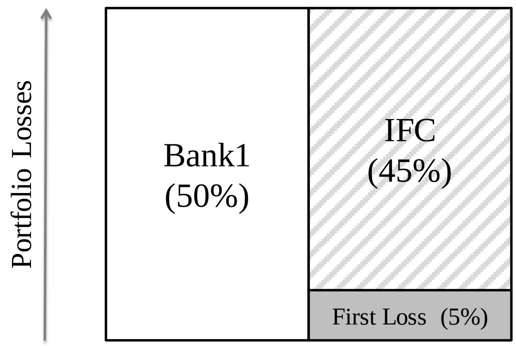


**Figure 25 Order of Portfolio Losses**

Source: JICA Survey Team

RSF typically reimburses a bank for a fixed percentage of incurred losses that exceed a pre-defined threshold or first loss (see **Figure 25**). The bank and IFC will agree prior to signing the RSF on the eligibility criteria specifying the loan assets to be covered under the RSF. The maximum risk sharing by IFC is 50%, and a service fee is charged. The risk share borne and the fee charged by IFC are determined through various financial and business parameters and the needs related to a beneficiary bank.

In offering RSF, IFC may also arrange for the provision of advisory services to help build and expand a bank's operational capacity.

[77] Although IFC's RSF is not used by banks in Pakistan, its features are described in this section as it is a facility in which JICA may consider participating.

**Developmental Credit Authority of USAID**

DCA is a USAID global program that provides partial credit guarantees to private sector lenders for loans to entrepreneurs, SMEs and other projects in developing countries. Their guarantees may cover up to 50% of the principal of a loan (interest is not covered). In Pakistan, DCA started in 2014 partnering with two commercial banks (JC and BAF), providing them with a total risk coverage of USD 48 million to SME loans.[78/79] DCA charges fees for guarantees varying depending on the risk profiles of banks and country risks. According to USAID, demand for guarantees by partner banks has been positive, and the share of SME loans to total loans of JS increased from zero to 12% over two years. Unlike the CGS by SBP, DCA guarantees are not attached to an individual loan, but are an umbrella arrangement provided to a bank through a risk sharing agreement (see **Figure 26**).

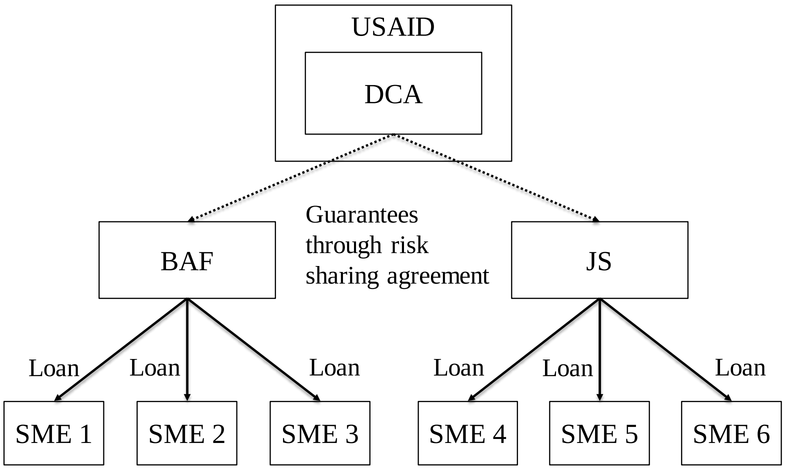


**Figure 26 Structure of DCA**
Source: JICA Survey Team

### 3-3-2 Karandaaz and IFC for Supply Chain Finance

As discussed in "3-2-5 Financial Products for SME Finance", SBP and the donor community have been promoting SCF for SME finance. Karandaaz[80] and IFC in particular have been providing business advisory services and financial assistance to promote SCF among commercial banks. IFC is currently working with BAF, Meezan and UBL to enhance their SCF, and IFC's advisory work is funded by Karandaaz. Karandaaz currently partners with three financial institutions: Meezan, BAF and OLP.

Karandaaz collaborates with Meezan under the Corporate Vendor and Distributor Program (a risk participation facility) with a total amount of USD 50 million under which Karandaaz and Meezan signed tripartite agreements with Engro Fertilizers, Atlas Honda, Pak Suzuki, Unilever Pakistan, Al Ghazi

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78 Out of UDS 60 million, USD 12 million is earmarked for the education sector.

79 Since USAID has not conducted a comprehensive evaluation of DCA in Pakistan, the information in this paper is based on an interview with USAID in Pakistan.

80 Karandaaz was established in 2014 and registered with the Securities and Exchange Commission of Pakistan as a nonprofit organization to promote access to finance for small businesses through commercially directed investments and financial inclusion for individuals. Its detailed activities are presented in "Annex 7 Summary of Recent SME Support in Pakistan".

Tractors, Millat Tractors, and Nestle to provide SCF.[81] These anchor corporations identify vendors and distributors with growth potential and provide visibility on their revenues and cash flows, which in turn supports the advancement of SCF.

**An excerpt from a news release by Karandaaz on the tripartite agreement with Atlas Honda**[82]

11-17-2015.

"Atlas Honda Limited today signed a corporate partnership agreement with Karandaaz Pakistan and Meezan Bank Limited to support the development of small and mid-size automotive part vendors in Pakistan. This is the first corporate partnership Karandaaz Pakistan and Meezan Bank have entered as part of the PKR 9 billion Corporate Vendor and Distributor Finance Program launched recently. The partnership will strengthen Atlas Honda's supply chain and distribution channels by providing access to finance (capital investment and expansion working capital financing) for Atlas Honda's small and mid-size vendors and distributors with growth potential. By identifying local vendors and distributors with profitable growth potential and good operating and credit history, Atlas Honda will help identify and direct credit to strategic vendors and distributors and promote localization of automotive parts and broad-based employment growth in Pakistan."

With BAF, Karandaaz signed a Risk Participation Agreement for a total amount of GBP 20 million under which Karandaaz has committed GBP 5 million and BAF has committed GBP 15 million. This partnership is aimed at scaling up five SME product programs designed by BAF, including SCF, fleet finance, dairy SCF, merchant finance and telco franchise finance. For the partnership between Karandaaz and OLP, there are two ongoing programs. One is a risk participation facility of USD 40 million that provides asset finance for capital investment in small businesses operating within organized supply chains.[83/84] The other is a loan in the amount of GBP 4.5 million to OLP to improve financial access for small enterprises.[85] OLP on-lends the funds to small enterprises to increase the share of small business borrowers in OLP's portfolio.

81 Karandaaz committed USD 10 million, and the rest is covered by Meezan.

82 https://karandaaz.com.pk/media-center/news-events/karandaaz-pakistan-meezan-bank-join-hands-with-atlas-honda-to-deepen-access-to-finance-for-small-and-mid-size-vendors-and-distributors/

83 https://karandaaz.com.pk/our-programs/karandaaz-capital/wholesale-investment/.

84 The contribution by Karandaaz carries the mark-up rate of Kibor+25pb for the unused portion of funds. The tenor of loans to eligible SMEs ranges between three to five years.

85 https://karandaaz.com.pk/media-center/news-events/karandaaz-invest-pkr-700-million-dfid-orix-leasing-strengthening-small-enterprises/

# Chapter 4 Financial Access and Inclusion for SMEs

## 4-1 Low level of Financial Inclusion in Pakistan

Financial access in Pakistan still remains low. According to the World Bank Global Financial Inclusion Database (FINDEX), only 13% of adults in Pakistan had access to a formal bank account as of 2014, which was much lower than those in Sri Lanka (83%), India (53%) and Bangladesh (31%).[86] Access to formal financial services is also limited; half of the population in Pakistan reported borrowing through informal channels.[87] Moreover, women are significantly excluded from the formal financial sector.

The private sector credit to GDP ratio in Pakistan remains very low at 15.4% as of 2015,[88] only higher than that of Afghanistan in the South Asia region. This implies that the financial intermediation requires further development for Pakistan to advance economic growth. SMEs are estimated to constitute about 90% of all enterprises in Pakistan.[89] Yet, only 4.7% of SMEs had access to bank credit as of June 2015, at the time NFIS was developed.[90]

As of September 2017, the total number of SME borrowers was about 174,000 which is still a fraction of the total number of SMEs. Similarly, the share of SME lending of total private sector credit still remains low at 7.8% despite improvements over the last few years.

**National Financial Inclusion Strategy**

In May 2015, the government of Pakistan launched the NFIS that defined their vision, goals and strategies towards financial inclusion and access. Its primary goal is to expand financial access to at least 50% of adults, and to increase the SME credit extension to 15% by 2020. Its priority areas are: i) digital financial services and payment systems; ii) microfinance, agriculture and housing finances; iii) SME finance, iv) Islamic finance; v) financial literacy and consumer protection; vi) insurance; and vii) pensions.[91] Key benchmarks for SME finance were later revised as follows:[92]

- Increase the SME credit share to 17% by 2020; and
- Increase the number of SME borrowers to 500,000 by 2020.

## 4-2 Primary Constraints in Advancing SME Finance

As discussed earlier, the low penetration of SME finance in Pakistan has been caused by a combination of various socio-economic conditions rather than any liquidity shortages in the banking sector. The following lists the primary constraints on the advancement of SME finance that were identified through

86 Asli Demirguc-Kunt, Leora Klapper, Dorothe Singer, Peter Van Oudheusden "Global Findex Database 2014 Measuring Financial Inclusion around the World," World Bank Group, April 2015.
87 "IDA PAD for a Pakistan Financial Inclusion and Infrastructure Project," May 15, 2017, World Bank.
88 "IDA PAD for a Pakistan Financial Inclusion and Infrastructure Project," May 15, 2017, World Bank.
89 "IDA PAD for a Pakistan Financial Inclusion and Infrastructure Project," May 15, 2017, World Bank.
90 "IDA PAD for a Pakistan Financial Inclusion and Infrastructure Project," May 15, 2017, World Bank.
91 "State Bank of Pakistan Annual Performance Review FY2016-17," SBP.
92 "Policy for Promotion of SME Finance," Infrastructure, Housing & SME Finance Department, SBP, December 22, 2017.

literature research and field interviews. Such primary constraints are categorized into three groups: (A) Policy, regulatory and legislative constraints; (B) Capacity issues and other constraints pertaining to SMEs (demand side constraints); and (C) Capacity issues and other constraints pertaining to the banking sector (supply side constraints).

(A) Policy, regulatory and legislative constraints

(a) A large number of unregistered SEs; SEs that remain informal without registration make banks' credit assessment very difficult, if not impossible.[93] Reasons for this include:

- Cumbersome and complex company registration processes for SEs;
- The user-unfriendly interface of the online registration system;
- Weak outreach by SECP to facilitate registration among SEs; and
- Lack of awareness among SEs of the merits of registration;

(b) Complex regulations and procedures for business licensing for SMEs;

(c) Cumbersome collateral (real property) registration processes and high collateral registration fees;

(d) Unfavorable corporate tax rates that may discourage SEs from being registered;

(e) Time-consuming and complex loss recovery systems for defaulted loans;

(f) Lending limits for SMEs determined by Prudential Regulations that may be constraining banks from extending credit to creditworthy SMEs (in particular to MEs); and

(g) Withdrawal fees applied to funds in bank accounts imposed by SPB regulations that may be discouraging SMEs from using bank accounts for their financial transactions.

(B) Capacity issues and other constraints pertaining to SMEs:

(a) Lack of collateral;

(b) Lack of financial literacy among SEs;

(c) Lack of capacity of SMEs to produce financial/business documentation required for a loan application;

(d) Lack of credible/verifiable financial data needed for banks to assess an SME's creditworthiness;

[93] There may be unregistered MEs. Official data on the number of registered MEs and that of SEs was not found during the research. Given the official definition of MEs that indicates a substantive number of employees and annual sales, we assume most MEs are registered in Pakistan.

(e) Double or triple bookkeeping to avoid taxation;

(f) Knowledge gaps on banking services and lack of awareness of the merits of recorded financial transactions, registration and business documentations (contracts, sales/purchase agreements, invoices, etc.);

(g) Lack of managerial skills in basic corporate finance and basic business management (e.g., strategy, productivity, efficiency, profitability, etc.); and

(h) Weakened competitiveness of Pakistan’s SMEs vis-a-vis cheaper Chinese products.

(C) Capacity issues and other constraints pertaining to the banking sector:

(a) Business model of commercial banks that may not be apt for lending to lower-end SEs;

(b) Lack of knowledge on international best practices of SME finance;

(c) Commercial banks’ lack of or weak experience of SME finance;

(d) Lack of or partial knowledge on financial products apt for SMEs and a limited product menu for SME finance;

(e) Use of a uniform credit risk model for both large corporations and SMEs of which the latter may need a customized credit risk model and management system;

(f) Lack of means to reduce high transaction costs inherent in SME finance;

(g) Weak awareness of CGS among commercial banks;

(h) Lack of sufficient talents and/or capacity to provide non-financial advisory services to SMEs that are required by SBP; and

(i) Shortage of staff who have interest in SME finance.

For preparing a support strategy for SME development, the differences in the status of financial inclusion by size of SMEs (i.e. MEs, upper-end SEs (relatively large-sized SEs with 30 to 50 employees) and lower-end SEs) must be well understood. As has been discussed in previous chapters, the largest constraints on advancing SME finance commonly cited by commercial banks in Pakistan are SMEs’ informality (mostly in the form of a lack of proper transactional and accounts records) and their lack of collateral; however, the degree and characteristics of “informality” and “lack of collateral” are different based on the size of the SMEs. In order to prepare a support strategy, detailed factors and root causes regarding these two elements need to be more closely examined with an emphasis on the differing challenges by the size of the enterprises.

### 4-2-1 SMEs' Informality

There seems to be no uniform or agreed definition for "informal" enterprise in Pakistan. Some organizations consider not only registered "limited liability companies" (LLCs) but also "sole proprietorships" and "partnerships" as formal enterprises. Many MSME apply for status as a sole proprietor at Federal Board of Revenues (FBR) or a partnership at a district office since they want to obtain a bank account in their own name that facilitates their business; having an NTN as a sole proprietorship or a partnership is a condition for opening such an account.[94] On the other hand, commercial banks in Pakistan consider only LLCs as formal enterprises, given the level of formality and reliability in the companies' accounting and transaction records. According to the JICA Survey Team's interviews with banks and industry associations, most MEs and upper-end SEs that have eagerness to grow are registered as an LLC, while most of lower-end SEs are not registered.[95] As of June 2015, approximately 60 thousand enterprises are registered as LLCs. Formalization, including company registration and licensing, is indispensable for SMEs to be able to receive sizable bank loans and play a role in boosting Pakistan's economic growth.

There are advantages and disadvantages to formalizing an enterprise in Pakistan. The following table summarizes the major advantages and disadvantages:

**Table 19 Advantages and disadvantages for formalizing an enterprise in Pakistan**

| Advantages | Disadvantages |
|---|---|
| (i) LLCs have an opportunity to receive a large amount of loan from banks as a result of transparency in their accounting and transaction records.<br>(ii) LCCs have better access to foreign markets due to their formal legal status.<br>(iii) LCCs have direct access to government tenders. | (i) Formal enterprises must comply with all acts and regulations of federal and local public agencies, including income tax, sales tax, Employees Old Age Benefits Institution (EOBI), local taxes, provincial social security, and the Shops and Establishments Act of the provincial labor department.<br>(ii) LCCs have an obligation to submit a number of documents to SECP and other government authorities as required by each act and regulation. |

Source: JICA Survey Team

While tax evasion is the primary reason for many enterprises not to formalize their status in Pakistan, the difficulty of complying with all government regulations, including company registration, is also an important element that discourages enterprises from formalizing. Since procedures and requirements for complying with government regulations are not straightforward and thus time-consuming, SMEs either abandon obtaining licenses or depend on intermediary agents, which involves additional costs.

It should be noted that in Pakistan being an "informal" enterprise does not mean that the enterprise cannot have a bank loan. Most banks in Pakistan provide loans to "informal" enterprises (sole proprietorships and partnerships) as long as these enterprises repay through a bank account and the

[94] NTN can be obtained online. Sole proprietorship and partnership are given a specific NTN different from individuals.
[95] No official data for the number of registered SMEs by size of enterprise is available.

repayment is ensured in some way. However, due to the constraints stated in “4-2 Primary Constraints in Advancing SME Finance”, the share of SMEs receiving a bank loan is still significantly small. Moreover, banks are not willing to extend a medium-sized loan (typically above PKR 10 million) to informal enterprises because these enterprises are considered to be risky due to the low level of transparency in their commercial transactions in comparison with LLCs.

While lower-end SEs that do not have basic business knowledge may not keep accounting records, upper-end SEs (such as those enterprises employing 30-50 workers) surely have some type of accounting records since it is very difficult to manage an enterprise of that size without maintaining such records. The problem with documentation of these enterprises rests not in the absence of documentation but rather in the “informality” of their documentation (namely, the lack of official or verifiable accounting books). Since SMEs do not want to let tax authorities know their transactions, they do not want to disclose their accounting information to outsiders. Once a bank, committed to penetrating the SME sector, such as Allied Bank or Bank Alfalah, has established trust with an enterprise, the enterprise will start sharing information on its accounting and business operations. Based on such information, the bank’s loan officer prepares the enterprise’s financial statements and other loan documents on behalf of the enterprise. Although it is a burden on the bank’s side, those banks emphasize that it is part of the role of their “relationship managers” or “loan officers dedicated to SME lending” and unavoidable for SME lending.

### 4-2-2 SMEs’ Lack of Collateral

Regarding collateral issues, it may be too general to state that SME owners do not have assets to pledge for collateral. Interviews with banks and SMEs revealed some more complex circumstances surrounding SMEs’ lack of collateral:

i) Since real estate in rural or underdeveloped areas do not have much monetary value or cannot be easily sold, banks tend not to accept real estate from those areas as collateral;
ii) While micro enterprise owners may not have real estate to pledge as collateral, SE owners (more than 10 employees) may have real estate that has value to fully or partially secure a loan, such as a house or land; however, these owners often are not willing to pledge their real estate because:
    a) When the property is owned by multiple family members (which is often the case), consensus on pledging the property for collateral cannot be easily attained;
    b) Businesses are not sufficiently protected by law due to the country’s weak law enforcement capacity; the possibility of default for reasons beyond the borrower’s control (such as a breach of contract by a supplier) is not negligible; and
    c) The administrative and transaction costs for the collateralization of properties seems to be too high for small businesses;
iii) Real estate (of enterprise owners) can be registered for collateral at the Revenue Department of the province within which the registry of personal land and mortgage is maintained. On the other hand,

there has been no registration system for SME (non-LLC) movable property, while collateral (movable and immovable property) of an LLC can be registered at the SECP. MOF is currently working on the establishing of an electronic registration system for collateralized movable assets with support from DFID; and

iv) Enforcement of a mortgage often needs to be brought to court, where it takes five to ten years to settle the case. This also has discouraged commercial banks from lending to SMEs even if the SMEs have collateral to pledge.

While the expanding CGS (see the next section) and establishment of an electronic registration of movable assets will greatly encourage commercial banks to extend loans to SMEs, problems related to the business environment as mentioned above (law enforcement, procedures of collateralization) need to be addressed simultaneously since CGS does not cover all losses.

Banks' proactiveness toward SME lending is reflected in their approaches to securing SME loans. Many banks in Pakistan have adopted SCF for SMEs that have direct business relationships with large corporate entities ("anchors"). In this framework, banks extend credits to SMEs based on the notes receivable issued by anchors or the SMEs' invoices to anchors (certified by anchors in some cases). These notes receivable and invoices have sufficient credibility to secure credit to SMEs.

Some banks still require SMEs, even in the case of SCF, to pledge a level of collateral 25-30% above the loan's value, while other banks with more experience in SME lending have started reducing collateral requirements within SCF. One of the large banks has already taken a further step by eliminating all collateral requirements within SCF. Having built confidence in SME finance, this bank will even test collateral free credit to SME customers that do not have transactions with anchors but have a sound credit history. This recent evolution indicates that banks in Pakistan are gradually moving in the direction of less dependency on collateral. Banks also have other types of alternative lending. Warehouse receipts have started being used for securing credit to farmers. One bank is now operating 6 warehouses throughout the nation on its own, through which the bank stores (controls) the SME borrowers' materials and products that secure the credit. Some banks are also entering into the leasing market.

## 4-3 Current status of SMEs' Financial Inclusion

The chart in the next page summarizes the current status of SME financial inclusion in Pakistan, highlighting the relationships between the size of SMEs (definition by SBP), status of formalization, (relative) capacity of pledging collateral, and the loan sizes being applied to each category of SME.

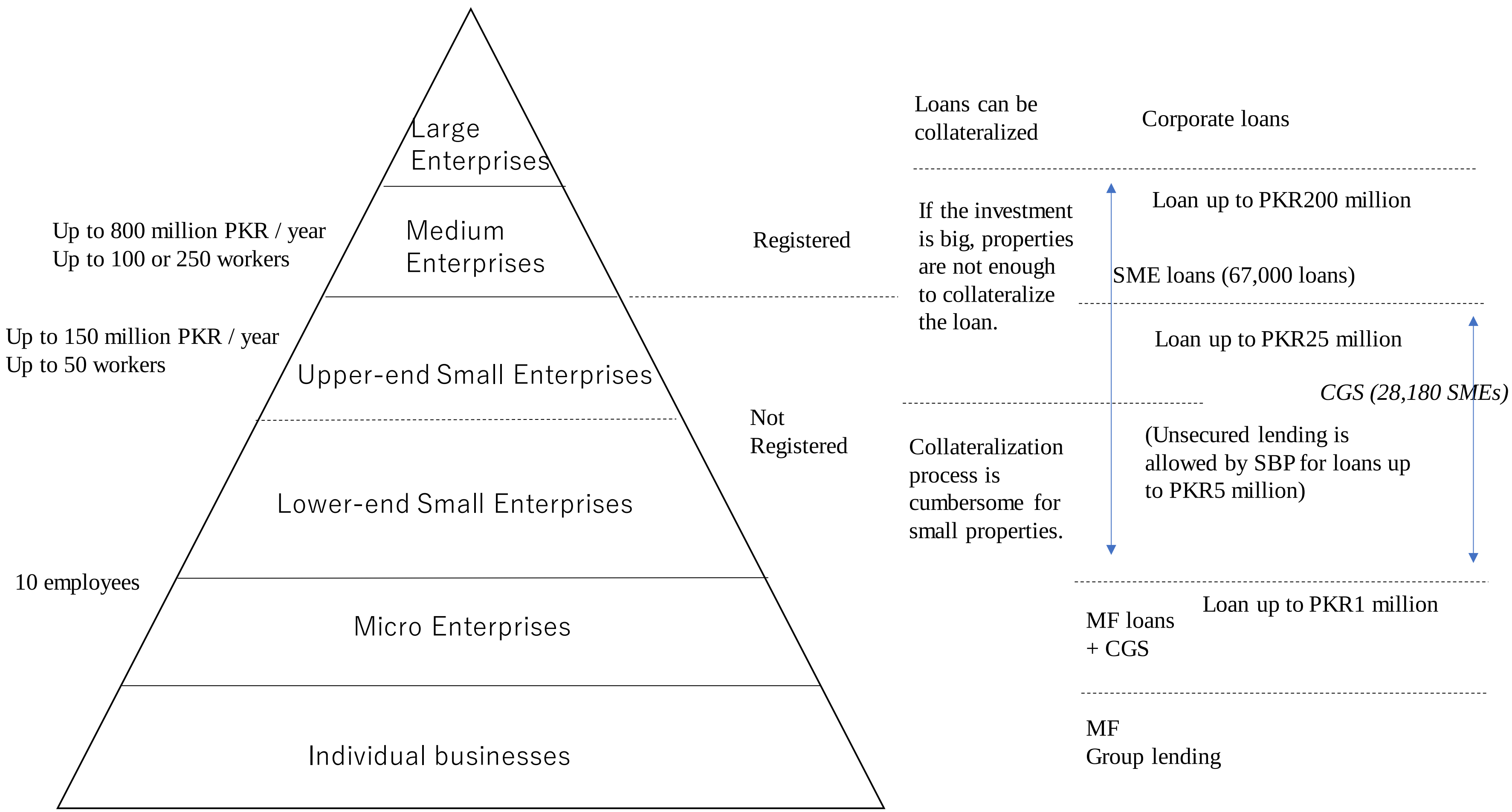


**Figure 27 Overview of SMEs' financial inclusion in Pakistan**

Source : *1 Karandaaz (2017) "Nature and Characteristics of SME Financing and NPLs in Pakistan" *2 DFID (2016) Financial Inclusion Program Annual Review – Summary Sheet

## 4-4 Reforms Targeting SME Finance

Aiming to achieve the NFIS goals by 2020, under SBP's leadership Pakistan renewed its efforts to develop its financial sector and improve inclusive financial access for SMEs over the past three years. Major reforms to the financial sector legislative framework took place, and various legislative acts are introduced or enforced, including:

- The Financial Institutions (Secured Transactions) Act;
- The Credit Information Bureaus Act;
- Amendments to the SECP Act;
- The Financial Institutions (Recovery of Finances) Act;
- The Deposit Protection Corporation Act 2016; and
- The Benami Transaction Prohibition Act.[96]

The most recent reform initiatives undertaken through SBP's leadership are summarized below;[97]

**Pillar # 1 Regulatory framework**

**(A) Revision/Amendments to Prudential Regulations**

(a) The general reserve requirement for unsecured SE finance is being reduced from 2% to 1%, while the general reserve requirement for a secured portfolio is being withdrawn;[98]

(b) Obtaining insurance for financing up to PKR 2 million (previously PKR 1 million) has been made optional for SE and ME finance;

(c) Program-based lending products (including those of Islamic banking) may now be approved by Chief Executive Officer (CEO) / President / Managing Director of a bank / DFI on a recommendation by a concerned committee;[99][100]

[96] 'Benami' transactions refer to transactions in which property is transferred to one person for a consideration paid by another person.

[97] "Policy Promotion of SME Finance," Infrastructure, Housing & SME Finance Department, SBP, December 22, 2017.

[98] General reserves are the retained earnings of a company/bank that are kept aside from a company's profits in order to meet future (known or unknown) obligations. Generally speaking, the general reserves of a bank serve to meet an unexpected large amount of loss with at a very low frequency, while loan loss provisions are meant to cover an expected loss or an average loss amount that occurs within normal business.

[99] Since SMEs' financial needs may vary depending on the different industry sectors, SBP promotes the use of "program-based lending" products that refer to lending products that are designed and developed for the specific financial needs of SMEs in different industry sectors. To facilitate banks' efforts to develop program-based lending products, SBP published the SME Sub-Sectors Profiling Reports for 21 sub-sectors. http://www.sbp.org.pk/departments/ihfd-ifc.htm

[100] According to the interviews with banks by the Survey Team, such approval used to be granted by SBP.

(d) Banks/DFIs need to create in-house SME banking research and development divisions.[101]

(e) Pakistan Banks' Associations (PBA) will launch Simplified Loan Application Forms (LAF) for SE and ME which will replace Borrowers Basic Fact Sheet (BBFS); and

(f) Banks have been advised to reduce the turnaround time (TAT) for processing SE loans from 30 working days to 15 working days (from the date of the receipt of complete information). TAT for ME loans has been set at 25 working days.

**(B) Relaxation of the Credit Risk Weights to calculate Capital Adequacy Ratios:** The upper limit for the retail exposure was increased from PKR 75 million to PKR 125 million to allow banks to apply the preferential risk weight of 75% to SME loans.[102]

**(C) Targets for SME Finance:** From January 1, 2018, SBP assigns provincial targets for SME finance to banks/DFIs in addition to the currently assigned targets for SME lending volume. From January 1, 2019, gender specific targets and separate targets for SMEs will also be assigned to banks and DFIs.

**(D) Refinancing Facility for SMEs:[103]** New refinancing facilities have been introduced to the priority sectors of IT, furniture, surgical goods, date processing, gems & jewelry, leather industry, fruits, vegetables & food processing, printing and packaging.

**Pillar # 2 Micro and Small Enterprises Banks**

SBP is developing a legal and regulatory framework for Micro and Small Enterprises (MSE) banks that provide financial services to large micro-enterprises and low-end SEs.

**Pillar # 3 Risk Mitigation Strategy**

**(A) Inclusion of Low-end Medium Enterprises in Credit Guarantee Scheme (CGS):** Low-end MEs become eligible for CGS, and parameters and eligibility criteria are announced in January 2018.[104]

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[101] One of the objectives is to accelerate the use of value chain finance for SME lending.

[102] Presently, SEs and certain MEs are considered under retail portfolio and are assigned 75% risk weight for the calculation of risk weighed assets (RWA) under the Basel framework. 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 PKR 75 million to PKR 125 million.

[103] SPB's facility that provides subsidized lending rates to SME loans in specific industry sectors and for selected purposes. See (d) Refinancing Facility for Modernization of SMEs, under Policies and Regulations in "Annex 7 Summary of Recent SME Support in Pakistan".

[104] MEs with annual sales turnover of up to PKR 300 million are eligible. The maximum financing limit for MEs under CGS is PKR 50 million, while the maximum financing tenor is five years. Only first time ME borrowers are eligible under CGS. First time borrowers refer to those SMEs that have not availed any financing facility from any financial institution. Eligible low-end MEs that do not have collateral that exceeds the value of the loan can avail risk coverage of 40% under this facility. Maximum of 20% of the allocated credit guarantee limit can be availed against financing to MEs under CGS; this does not restrict PFIs from using entire allocated limit for small, rural and micro enterprises. Source: SBP IH&SMEFD Circular Letter No.1, April 13, 2018.

**(B) Establishing a New CGC:** The existing CGS will be transformed into a CGC that will be an independent entity. Its business plan is being developed, and a new CGC will become operational by December 31, 2018.

**(C) Supporting Provincial Risk Sharing Schemes:** SBP is supporting the provincial governments in their refinance and risk sharing schemes to enhance SME finance.

**(D) E-registry of Movable Assets for Collateral:** The Financial Institutions (Secured Transactions) Act 2016 was passed to establish an e-registry that will enable SMEs and Agricultural borrowers to use their movable assets as collateral.

**Pillar # 4 Simplified Procedures for SME Financing**

PBA will coordinate with banks to prepare a standardized SE loan documentation manual together with sample loan application forms.

**Pillar # 5 Program-based Lending & Value Chain Financing (VCF)**

SPB encourages banks to use program-based lending by creating a strategic business model comprised of customized financial products, improved delivery channels, adoption of credit scoring technology, improving the understanding of industry clusters, and strong marketing and sales. SBP will also assign VCF targets for banks.

**Pillar # 6 Capacity Building & Awareness Creation among Bankers**

The National Institute of Banking and Finance (NIBAF) will take the lead in conducting training programs for the SME capacity building related to SME finance. SBP-BSC (Banking Services Corporation) will conduct awareness creation programs. A Centre of Excellence for SME Banking & Finance will be established to provide training both to banks and SMEs, including awareness programs on banking products, in collaboration with. SMEDA and other international and local institutions.

**Pillar # 7 Non-Financial Advisory Service (NFAS) for SMEs**

The 3S forum (SBP, SMEDA & SECP) will create yearly NFAS calendars and programs with IFC's assistance. NFAS is aimed to assist SMEs in building their business management capability. SBP advise banks/DFIs to provide NFAS to their SME borrowers.

**Pillar # 8 Leveraging Technology to Promote SME Financing**

SBP encourages banks to use technology, such as digital credit, client profiling, payment solutions, and other technologies. An innovation challenge fund will be launched to explore new solutions to promote SME finance through technology. SBP will also be collaborating with universities and FinTech companies to initiate pilot projects towards this purpose.

**Pillar # 9 Simplifying the Taxation Regime for SME Finance**

SBP's Technical Committee of SMEs (under NFIS) will recommend a simplified taxation system for SME finance. These recommendations may include:

- Tax rate reductions on bank income derived from SME finance;[105]
- A tax holiday for income from eligible start-ups and women SE borrowers; and
- Reductions in sales tax for service sector SEs & MEs.

A few highlights from the above reform initiatives are provided below.

In January 2016, SBP introduced **SME credit targets** for banks and DFIs. By the end of December 2016, PKR 401 billion in SME credit had been achieved, which exceeded the target amount of PKR 398 billion.[106] The target for the end of 2017 was PKR 500 billion.[107]

The Financial Institutions (Secured Transactions) Act 2016 has been approved, which allows registering charges on assets, especially **moveable assets**, for un-incorporated enterprises. SBP, the Ministry of Finance, DFID and the World Bank are working to establish the secured transactions registry that will become operational at the end of 2018.[108]

As part of the efforts to improve banks' capacity for SME credit assessment, SBP arranged for **Cluster Survey Studies** on key SME subsectors to collect and compile data on SMEs, in collaboration with IFC and Lahore University of Management Sciences (LUMS) with funding provided by DFID. In 2017, surveys for 21 SME sub-sectors were completed and their research reports published.

[105] Reduction in tax on the banks' income from SME finance may encourage commercial banks to extend credit to SMEs.
[106] "SME Finance Annual Review 2016," SBP.
[107] The result of 2017 will be reported, pending new data to be issued by SBP.
[108] "SME Finance Annual Review 2016," SBP. The interviews with SBP and the World Bank in January 2018.

# Chapter 5 Proposed SME Support by JICA

## 5-1 Financial Assistance

From the findings and analysis presented in the previous chapters, there are different conceivable options for JICA financial assistance. JICA has two schemes for its financial assistance for SME development: (a) sovereign loan to be provided to the Ministry of Finance of Pakistan; and (b) Private Sector Investment Finance (PSIF), which is a loan or equity investment directly provided to enterprises in Pakistan. Below options are presented for JICA's financial assistance along with details as to their relevance and effectiveness (see "Annex 4 Options for JICA Financial Assistance" for a summary).

(1) Loans to commercial banks for on-lending to SMEs

As described in "Chapter 3 Financial Sector Overview and SME Finance", since commercial banks in Pakistan have sufficient liquidity, they have no appetite for JICA Yen loans (i.e. "two step loans" that have been implemented in other countries) unless contextual circumstances drastically change, such as a sudden degradation of the Pakistan government's fiscal balance. Some banks may need foreign currency loans, which will be discussed in (5) below.

(2) Loans to MSE banks for on-lending to large micro-enterprises and lower-end SEs

Although commercial banks in Pakistan are increasingly interested in SME finance, most banks have yet to aggressively penetrate this market due to a number of constraints as listed in "4-2 Primary Constraints in Advancing SME Finance". Most SME loans are concentrated in the ME and upper-end SE segments, which are relatively more secure than loans to the lower-end SE segment owing to their collateral capacities. MFIs and Microfinance Banks (MFBs) cannot reach this segment since the current upper lending limit for them set by SBP is PKR 1 million.[109] As a result, there is a financing gap for lower-end SEs that need loans between PKR 1 million and PKR 5 to 10 million.

In order to open a new avenue for financial institutions to penetrate the small bank loan segment, SBP is in the process of developing a legal and regulatory framework for MSE banks that provide financial services to large micro-enterprises and lower-end SEs (see "4-4 Reforms Targeting SME Finance"). It is expected that once such a framework in place, existing commercial banks or MFIs will create subsidiaries to venture into this segment. At that time, the possibility of providing a loan (either sovereign or PSIF) to new MSE banks may be explored, although whether these banks will have a demand for liquidity from JICA is unknown, especially since they would be able to collect and mobilize deposits to finance their lending. As such, liquidity demand analysis needs to be conducted whenever

[109] The minimum capital required to be a commercial bank is PKR 10 billion.

new MSE banks are established. For sovereign loans, the same conditions as those being applied to the World Bank's line of credit to MFI under FIIP could be applied.[110]

(3) Equity investment in MSE banks

Equity investment in the above new MSE banks through the Ministry of Finance of Pakistan is not an option for JICA sovereign loan since JICA requires an equity participation by a Japanese corporation for equity-backed finance. On the other hand, PSIF could be applied should new MSE banks request JICA to enter into equity participation. Same as (2) above, it should be noted that the creation of new MSE banks may take some time.

(4) Loans to Non-Bank MFIs for on-lending to micro-enterprises[111]

Either JICA sovereign loans or PSIF loans could be provided to Non-Bank MFIs since there is a large demand for microfinance since MFIs are dependent on external financing. For sovereign loans, the same financing structure as that of the World Bank's FIIP could be applied; those loans could be channeled to MFIs through SBP.

(5) Foreign currency loan (stand-alone) for on-lending to export-oriented SMEs

According to IFC, there is demand among export-oriented SMEs for loans in foreign currency with longer tenors (3-5 years), and as such the banking sector is in need of foreign currency liquidity. That said, should JICA unilaterally provide commercial banks with loans (either sovereign or PSIF) without a partner, such as IFC, research on the potential participating banks' capacity and client base for foreign currency loans will need to be conducted (see "Annex 6 Proposed Support to" for details).

(6) JICA/IFC collaboration to create a fund for offering foreign currency loans or a Risk Sharing Facility to banks[112]

Two schemes are conceivable for joint financial assistance between JICA and IFC.[113] The first is to create a fund that offers risk sharing facilities to commercial banks. Such risk sharing facilities would have similar features as IFC's RSF in which IFC provides a partial guarantee over part of the SME loan portfolio of a commercial bank (see **Figure 24**). The second is a fund that would offer loans in foreign

[110] This was implied in the interview with the Joint Secretary of Banks and Finance of MOF conducted on 7 Feb 2018. Under FIIP, the World Bank has designated SBP as an apex agency for its line of credit to MFIs. Since SBP is prohibited from borrowing, an arrangement was made in which MOF transfers the funds from the World Bank to SBP as a grant, and then SBP on-lend funds to MFIs, MFBs and a wholesale lender. The conditions (lending rates, terms, etc.) for relending from SBP are yet to be decided.

[111] It should be noted that the main target of this financing scheme would be micro-enterprises, not SMEs.

[112] JICA's project loan scheme (sovereign loans) cannot be applied to a risk sharing facility due to the facility's stand-by nature. In contrast, a risk sharing facility could be supported by PSIF. In the case of loans in foreign currency, IFC would also prefer PSIF, not a sovereign loan, due to less involvement by the government of Pakistan in the facility.

[113] The feasibility of a fund creation for these schemes is being considered internally by both JICA and IFC as of the time of the preparation of this final report. In addition, IFC suggested that the fund may offer RSFs or forex loans to commercial banks in multiple countries in order to reduce up-front and running costs.

currency (most likely USD) to select commercial banks (see **Figure 28**). Commercial banks then would on-lend the funds to export-oriented SMEs that are in need of foreign currency to import materials and/or equipment. Under this scheme, SME borrowers would be export-oriented enterprises since otherwise they would be exposed to foreign exchange risks that may be beyond their financial risk management capacity.

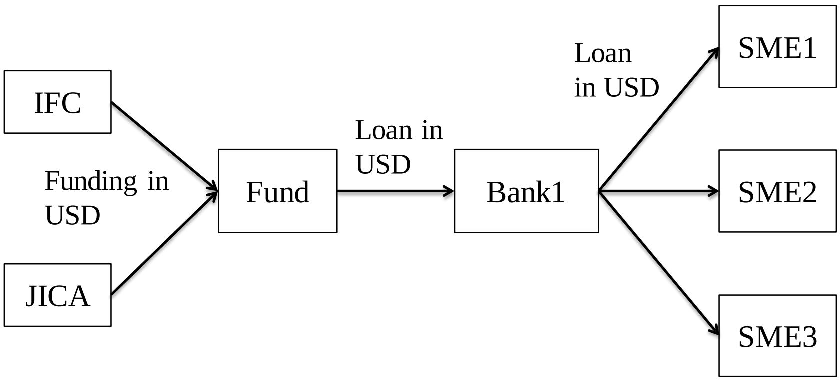


**Figure 28 Fund to provide foreign currency loans for export-oriented SMEs**
Source: JICA Survey Team

(7) Equity investment in CGS for SME finance

As described in “3-3-1 Credit Enhancing Products and Schemes”, the CGS operated by SBP provides all participating banks with incentives to enter the SME sector, which has habitually been perceived as “risky” by bank management. By offering to bear part of the losses from defaults, CGS incentivizes banks with little or no experience with SME lending to venture into the SME sector, while also enabling experienced banks to invest into rural and underdeveloped areas where real estate cannot be used for collateral.[114] According to the JICA Survey Team’s interviews with banks, there has not been large demand for long-term financing for SMEs since the environment surrounding enterprises, such as security issues and power shortages, has not been favorable for long-term capital investment. However, as discussed in Chapter 1, the current stable macro-economic environment, low interest rates and growing domestic demand are opening new opportunities for SMEs, especially those SMEs in the automotive sector, to expand their production capacity and upgrade their technologies by investing in facilities and equipment. That said, long-term loans will be in more demand in the near future and as will a guarantee scheme.

The existing CGS is being revamped to become an independent company for which SBP/DFID and the World Bank plan to provide capital. As discussed earlier, local commercial banks and insurance companies from the private sector are expected to provide funding for a new CGC. Given SMEs’ increasing financial needs backed by the Pakistan’s buoyant economy and the current small scale of CGS (even after possible capitalization by the World Bank); the new CGC, which is planned to be

[114] One bank is applying CGS to credit for agricultural crops to eliminate middlemen by directly linking up growers and buyers; CGS guarantees 60% of the credit, while the buyers agree to guarantee the purchase of produce which covers another 20-30% of the credit.

operational by the end of 2018, will likely need a large capital base to fully contribute to SME growth.[115] JICA could thus make an equity investment to CGC through either its (sovereign) programmatic loan or PSIF[116][117].

| **Collaborative opportunities with donors for JICA's financial assistance** |
|---|
| Collaboration with the donors that have been active in the field of SME finance in Pakistan for more than several years with hands-on experience and deep knowledge may be one of the most effective and efficient ways of utilizing JICA financial resources. Partnering with donors may also save on the financial and manpower costs of up-front investments to formulate a credit enhancing scheme or product, and instead may effectively leverage JICA resources in achieving larger developmental impacts and results. |

(8) Programmatic loan for SME development

Another option is that JICA provides a programmatic loan (policy loan) for SME development to the Government of Pakistan. When such a decision is taken, policy targets to be achieved and actions to be taken through the loan will need to be identified through discussions with the Ministry of Finance and SBP in reference to the status of reform implementation (see "4-4 Reforms Targeting SME Finance").

(9) Loans to Leasing Companies

According to the information from OLP, 85% to 90% of its portfolio is SME leasing with most of the SME customers being in the manufacturing sector such as auto parts factories. Given that the auto industry in Pakistan needs capital investment for the next 2 to 3 years, Leasing Companies are currently seeking external financial sources. JICA may be able to ply PSIF to extend a long-term loan to Leasing Companies.

## 5-2 Technical Assistance

In consideration of cost-effectiveness and feasibility (such as the availability of technical resources in Japan), below are presented the areas where JICA technical assistance would be recommended for advancing the financial inclusion of lower-end SEs, upper-end SEs and MEs with a special focus on the manufacturing sector.

[115] The demand for capital under the new CGC is being analyzed.
[116] JICA's project loan scheme (sovereign loan) cannot be applied to an equity investment (through Pakistani Government) into a guarantee scheme (CGC) since JICA rules do not allow an equity-backed loan except when a Japanese company is joining the equity.
[117] On condition that JICA's fund does not exceed 25% of the entire equity.

**Table 20 Areas where JICA technical assistance is recommended**

| Support area | Lower-end SEs | Upper-end SEs | MEs |
|---|---|---|---|
| Knowledge on accounting/ financing | Financial literacy<br>Book-keeping | Financial management | |
| Knowledge on business management | Basic business skills | Strategic planning | |
| Technical skills | Basic technical skills | Advanced technical skills | Production and quality management |
| Formalization | - | Streamlining of regulations and administrative procedures | - |
| Dialogue facilitation | Platforms to facilitate dialogue between SMEs and commercial banks | | |
| Capacity building for commercial banks | Seminars, training and consulting on international best practices to advance SME finance by commercial banks | | |

Source: JICA Survey Team

### (1) Technical Support to Lower-End SEs

Approaches taken by microfinance institutions may be effective for achieving financial inclusion for micro enterprises and lower-end SEs. These enterprises should be taught the importance of proper revenue and expense (as well as cash-flow) management and encouraged to open bank accounts with which they should develop capacities in saving and money management. Basic business skills (including simple book-keeping methodologies, marketing and product development) should be imparted to them. Technical education and vocational training schools should continue sending qualified human resources to these enterprises as well as providing opportunities for in-service training to enterprise workers.

### (2) Technical Support to Upper-End SEs

Many upper-end SEs do not have a corporate strategy; most of them are simply producing products based on orders from the buyers. These enterprises need to learn how to develop their comparative advantages and expand their markets, as well as how to make necessary investments. They also will need to understand that formalization is a prerequisite for growth. Workshops and training should be organized in which the advantages of registering as an LLC as well as the importance and methodologies of strategic planning and financial management are presented.[118] The workers of these enterprises often need to upgrade their skills, which could be supported through technical centers operating under the auspices of the Ministry of Industry and Production.

### (3) Technical Support to MEs

According to the literature review and interviews by the JICA Survey Team, most MEs are formal LLCs. That said, a number of MEs in Pakistan still lack the skills in strategic planning and financial management; workshops and/or short-term training would be effective to improve these enterprises' long-term performance (these could be provided in conjunction with bank loans). While these

[118] In order to encourage SMEs to register, one bank invites SMEs to workshops in which a documentary film on SME success stories is presented with the advantages of registering compared with obligation of tax payment emphasized. This bank even proposes lower lending rates or higher loan amounts as an incentive.

enterprises' technologies are more advanced than those of Pakistan's public agencies, they still need to strengthen their production and quality management skills in order to be competitive in the international market.

### (4) Technical Support to Facilitate Formalization of Enterprises

As discussed in "4-2-1 SMEs' Informality", formalization is indispensable to the financial inclusion of the SMEs that intend to grow. With a view to facilitating enterprise formalization, administrative and legal procedures in the implementation of regulations related to enterprise activities need to be simplified and streamlined. The regulations and procedures that should be reviewed include:

- SECP: Company registration (administrative procedures, application formats and examples, interface on the website, outreach policies, possibility of introducing simplified registration for small companies, etc.);
- FBR: income tax and sales tax;
- EOBI;
- Provincial local taxes (such as property tax);
- Provincial social security; and
- Shops and Establishments Act of the Provincial Labor Department

In Pakistan, BOI is primarily working for the improvement of the regulatory framework and business environment. The government is very keen to provide an enabling environment and the Prime Minister himself is much concerned with improving the ease of doing business in the country. The BOI's Board of Directors, headed by the Prime Minister of Pakistan, consists of 25 members from the public and private sector. BOI, in consultation with business associations, chambers of commerce and other relevant industry stakeholders, has proposed actions for improving the business environment to concerned authorities (i.e. Economic Coordination Committee (comprising all economic ministries) and Prime Minister's Secretariat). BOI has worked out a 100-day action plan to improve the business environment, which includes around 78 reforms; most of which are related to the SME sector. Although BOI's website claims that 52 reforms have already been completed, it does not mean that a high level of impact has been achieved; no objective evaluation on the level of achievement and impact has been conducted. Though it could be easy to introduce a new system, it would be very difficult to make that system operational. A new bottleneck may show up after one bottleneck is removed. It should be noted that ease of doing business requires strong commitment and intensive efforts for a long time. It is therefore recommended that JICA send a team of experts in process engineering to BOI who then can continuously provide concerned authorities with specific advice on the exact locations of bottlenecks, and how to remove them and assess the impact on the ground. It is recommended that this Team is recommended to work closely with SMEDA, which is capable of identifying problems in regulations and administrative procedures from SMEs' perspective. This team will also work in close coordination with the Investment Climate Reform Unit under the Planning and Development Department of Punjab Government and the Sindh Investment Climate Improvement Cell under the Sindh Board of Investment. The following chart sets out the project framework:

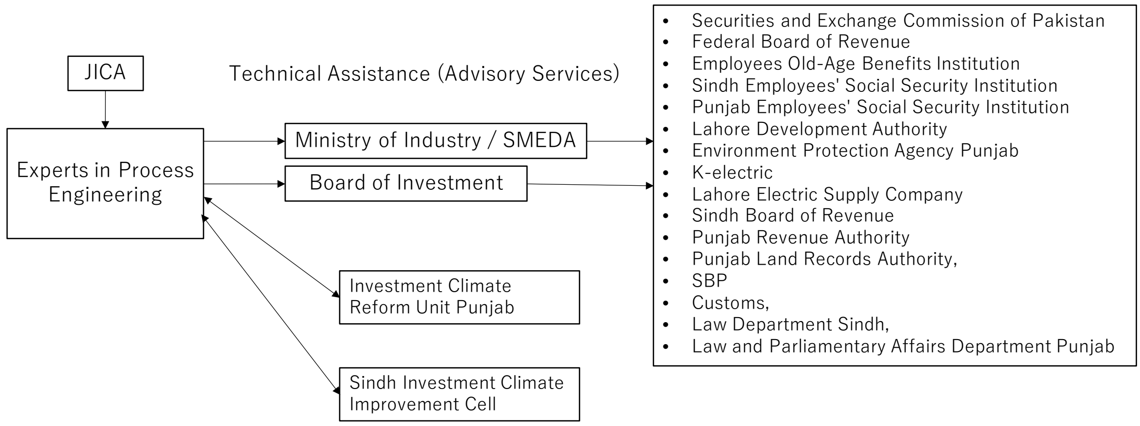


**Figure 29 Proposed JICA technical assistance for the improvement of business environment**

### (5) Facilitation of Dialogue between SMEs and Commercial Banks

As mentioned in "4-4 Reforms Targeting SME Finance", SBP has compiled data on key SME sub-sectors through Cluster Survey Studies; however, the JICA Survey Team's interviews with business associations and SMEs revealed that the financial needs of many of industry sub-sectors are not communicated to commercial banks. This has resulted in SCF application being limited to transactions related to major anchor companies such as Honda, Suzuki, Nestle, Engro, Reckitt Benckiser, and Unilever (see "3-2-5 Financial Products for SME Finance"). As described in "2-2 Overview of the Target SME Sectors", each industry sub-sector has different financial needs, which could be catered to by commercial banks. It is thus proposed that platforms by industry sub-sector be created through which dialogue between manufacturers and commercial banks be facilitated. Better understanding of the characteristics of sub-sectors and their financial needs will enable commercial banks to develop new financial products fitting the specific sub-sectors.

### (6) Capacity Development for Commercial Banks

The following capacity development needs could be addressed through JICA technical assistance so as to advance SME finance through commercial banks:

- Raising awareness on SME finance for banks' senior management;
- Develop and disseminate financial products (including Islamic financial products) and credit risk models for SME finance based on international best practices;
- Reinforce training programs specializing in SME finance at NIBAF, including training of trainers and non-financial advisory services;

- Simplification of reporting requirements for CGS in order to facilitate the utilization of CGS; and
- Development of college courses on entrepreneurship / SME development to expand the pool of human resources for SME finance.

# Annex 1 List of Banks Operating in Pakistan[1/2/]

| Banks | Visited by the Survey Team |
|---|---|
| **1. Public Sector Commercial Banks (5)** | |
| First Women Bank Limited | X |
| National Bank of Pakistan | X |
| Sindh Bank Limited | |
| The Bank of Khyber | |
| The Bank of Punjab | |
| **2. Local Private Banks (20)** | |
| Large Banks | |
| Habib Bank Limited | X |
| United Bank Limited | X |
| MCB Bank Limited | X |
| Allied Bank Limited | X |
| Bank Alfalah Limited | X |
| Medium Size Banks | |
| Bank Al-Habib Limited | |
| Meezan Bank Limited | X |
| Askari Bank Limited | |
| Habib Metropolitan Bank Limited | X |
| Standard Chartered Bank (Pakistan) Limited | |
| Faysal Bank Limited | X |
| Soneri Bank Limited | X |
| JS Bank Limited | X |
| Summit Bank Limited | |
| Bank Islami Pakistan Limited | |
| Dubai Islamic Bank (Pakistan) Limited | X |
| Small Banks | |
| Silkbank Limited | X |
| Albaraka Bank Limited | |
| Samba Bank Limited | X |
| MCB Islamic Bank Limited | |
| **3. Foreign Banks (5)** | |
| Industrial and Commercial Bank of China Limited | |
| Citibank N.A. | |
| Deutsche Bank AG | |
| Bank of China Limited | |
| The Bank of Tokyo Mitsubishi UFJ Limited | |
| **4. Specialized Banks (4)** | |
| Industrial development Bank Limited | |
| Punjab provincial Co-operative Bank Limited | |
| SME Bank Limited | |
| Zarai Taraqiati Bank Limited | |

Notes:

1/ Source: "Quarterly Performance Review of the Banking Sector, (July-September 2017)," Financial Stability Department, SBP.

2/ Large banks - total assets in excess of PKR900bn; Medium size banks - total assets >PKR150bn and <PKR900bn; Small banks - total assets less than PKR150bn, according to the definition by "Banking Survey 2016 - Commercial Banks Operating in Pakistan," KPMG.

# Annex 2 Pakistan's Economic and Social Developmental Goals and Policy Guidelines

"Pakistan Vision 2025" laid out seven pillars that guide their economic and social development towards the year 2025. The following lists the goals for each pillar;

**Pillar I: Putting People First - Developing Human and Social Capital**

**(1)** Increase Primary school enrolment and completion rate to 100% and literacy rate to 90%;

**(2)** Increase higher education coverage from 7% to 12% and increase the number of PhD's from 7,000 to 15,000;

**(3)** Improve Primary and Secondary Gender Parity Index to 1 and increase female workforce participation rate from 24% to 45%;

**(4)** Increase the proportion of the population with access to improved sanitation from 48% to 90%;

**(5)** Reduce the infant mortality rate from 74 to less than 40 (per 1,000 births) and reduce the maternal mortality rate from 276 to less than 140 (per 10,000 births);

**(6)** Reduce the incidence/prevalence of Hepatitis, Diarrhea, Diabetes and Heart Disease by 50%; and

**(7)** Pakistan will be the World Champions in at least 2 sports and win at least 25 medals in the Asian games.

**Pillar II: Achieving Sustained, Indigenous and Inclusive Growth**

**(1)** Become one of the 25 largest economies in the world, leading to Upper Middle-Income country status;

**(2)** Reduce poverty by half;

**(3)** Increase annual foreign direct investment from USD 600 million to over USD 15 billion; and

**(4)** Increase tax to GDP ratio from 9.8% to 18%.

**Pillar III: Democratic Governance, Institutional Reform & Modernization of the Public Sector**

**(1)** Place in the top 50th percentile for Political Stability (from bottom 1 percentile), Non-Violence / Terrorism (from bottom 1 percentile), and Control of Corruption (from bottom 13th percentile) as measured by the World Bank's Worldwide Governance Indicators.

**Pillar IV: Energy, Water & Food Security**

**(1)** Energy: double power generation so as to over 45,000 MW to provide uninterrupted and affordable electricity and increase electrification from 67% to over 90% of the population;

**(2)** Energy: (a) reduce average cost per electricity unit by over 25% by improving generation mix (15%) and reducing distribution losses (10%); (b) increase percentage of indigenous sources of power generation to over 50%; and (c) address demand management by increasing usage of energy efficient appliances/products to 80%;

**(3)** Water: increase storage capacity to 90 days, improve efficiency of usage in agriculture by 20%, and ensure access to clean drinking water for all Pakistanis; and

**(4)** Food: Reduce food insecure population from 60% to 30%.

**Pillar V: Private Sector and Entrepreneurship Led Growth**

**(1)** Rank in the top 50 countries on the World Bank’s Ease of Doing Business Rankings;

**(2)** Increase diaspora investment (via remittances) in the private sector from USD 14 billion to USD 40 billion; and

**(3)** Create at least 5 global brands in Pakistan (having more than 50% sales coming from consumers outside Pakistan), and make ‘Made in Pakistan’ a symbol of quality.

**Pillar VI: Developing a Competitive Knowledge Economy through Value Addition**

**(1)** Join the ranks of the top 75 countries as measured by the World Economic Forum’s Global Competitiveness Report;

**(2)** Triple labor and capital productivity;

**(3)** Improve Pakistan’s score on the World Bank Institute’s Knowledge Economy Index from 2.2 to 4.0 and increase internet penetration to over 50%; and

**(4)** Increase the number of tourist arrivals to 2 million.

**Pillar VII: Modernizing Transportation Infrastructure & Greater Regional Connectivity**

**(1)** Increase road density from 32 km/100 $km^2$ to 64 km/100 $km^2$ and share of rail in transport from 4% to 20%; and

**(2)** Increase annual exports from USD 25 billion to USD 150 billon.

## Annex 3 Utilization Status of the Credit Guarantee Scheme of SBP[119]

**(PKR in Million)**

| Sr. # | Participating Financial Institution (PFI) | Allocated Guarantee Limit | Guarantee Amount during Q3 CY17 | | | Outstanding Guarantee Amount as on 30-09-17 | | % of Allocated Limit as on 30-09-17 | |
|---|---|---|---|---|---|---|---|---|---|
| | | | General | Sector Specific | Total Sanctioned | Total Risk Coverage[a] | Sector Specific[b] | Total Utilization | Sector Specific Lending |
| A | B | C | D | E | F | R | S | T=(F+R)/C | U=(E+S)/C |
| 1 | HBL | 1,150.00 | 81.60 | 110.48 | 192.08 | 514.19 | 248.75 | 60% | 30% |
| 2 | MCB Bank | 800.00 | 12.65 | 24.70 | 37.35 | 630.94 | 147.77 | 84% | 22% |
| 3 | Bank of Khyber | 160.00 | 16.72 | - | 16.72 | 106.27 | 4.41 | 77% | 3% |
| 4 | Bank Alfalah | 400.00 | 80.18 | 10.10 | 90.28 | 193.79 | 61.29 | 71% | 18% |
| 5 | Faysal Bank | 68.00 | - | - | - | 45.19 | - | 66% | - |
| 6 | ABL | 120.00 | 56.84 | 1.90 | 58.74 | 48.62 | 9.78 | 89% | 10% |
| 7 | NBP | 100.00 | 16.24 | 26.95 | 43.19 | 54.96 | 28.65 | 98% | 56% |
| 8 | UBL | 130.00 | 22.71 | - | 22.71 | 84.30 | - | 82% | - |
| 9 | First Women Bank | 20.00 | - | - | - | 10.79 | 0.79 | 54% | 4% |
| 10 | Sindh Bank Ltd. | 37.00 | 2.1 | 3.00 | 5.10 | 8.45 | 1.79 | 37% | 13% |
| 11 | POICL | 10.00 | - | - | - | - | - | - | - |
| 12 | Askari Bank | 24.00 | - | - | - | 7.25 | - | 30% | - |
| 13 | SME Bank | 40.00 | - | - | - | - | - | - | - |
| 14 | Meezan Bank | 150.00 | - | - | - | 104.54 | - | 70% | - |
| 15 | Bank Al Baraka | 40.00 | - | - | - | 9.27 | 7.02 | 23% | 18% |
| 16 | Dubai Islamic Bank | 20.00 | - | - | - | - | - | - | - |
| 17 | BankIslami | 40.00 | - | - | - | - | - | - | - |
| 18 | FINCA MFB | 80.00 | 1.99 | 18.77 | 20.76 | 59.21 | 51.97 | 100% | 88% |
| 19 | Telenor MFB | 80.00 | - | 9.95 | 9.95 | 66.83 | 66.47 | 96% | 96% |
| 20 | Advans MFB | 60.00 | 15.68 | 9.56 | 25.24 | 28.42 | 26.30 | 89% | 60% |
| 21 | U-MFB | 40.00 | - | - | - | - | - | - | - |
| | Total | **3,569.00** | **306.71** | **215.41** | **522.12** | **1,973.02** | **654.99** | **69.3%** | **24.2%** |

**Note:** a) Total outstanding amount of loans sanctioned till June 30, 2017 has been reported by banks in CG-2 format and does not include loans sanctioned during Q3 of Calendar Year 2017; b) Sector specific outstanding amount of loans sanctioned till June 30, 2017 has been retrieved from CG-2 forms of concerned PFIs and matched against CG-1 statements of prior periods to determine sector specific loans

[119] "Financial Inclusion Program (FIP) Quarterly Progress Report, Jul-Sep 2017," DFID.

## Annex 4 Options for JICA Financial Assistance

| | **Type of Financial Assistance** | **Loan (A) (sovereign)** | **Private Sector Investment Finance (B) (non-sovereign)** |
|---|---|---|---|
| 1 | Loans to commercial banks for on-lending to SMEs | No demand due to sufficient liquidity for commercial banks. | |
| 2 | Loans to MSE banks for on-lending to large micro-enterprises and lower-end SEs | Liquidity demand by new MSE banks is unknown. Liquidity demand analysis needs to be conducted when new MSE banks are established. | |
| 3 | Equity investment in MSE banks | Not applicable. JICA's equity-backed sovereign loan requires equity investment by a Japanese corporation. | Feasible if new MSE banks request equity participation from JICA. However, creation of new MSE banks may take time. |
| 4 | Loans to Non-Bank MFIs for on-lending to micro-enterprises | Feasible. Non-Bank MFIs are short of liquidity. | |
| 5 | Foreign currency loan (stand-alone) for on-lending to export-oriented SMEs | May be feasible. Should JICA provide a loan by itself without a partner such as IFC, research on potential participating banks' capacity and client base for foreign currency loans needs to be conducted. | |
| 6 | JICA/IFC collaboration to create a fund for offering foreign currency loans or a Risk Sharing Facility to banks | Not applicable (IFC prefers to work with JICA's private sector investment finance) | Feasible should JICA agree to create a fund to provide foreign currency loans to commercial banks in multiple countries in collaboration with IFC. |
| | | Not applicable. JICA's project loan scheme cannot be applied to a risk sharing facility. | Feasible should JICA agree to create a fund to offer a Risk Sharing Facility in multiple countries in collaboration with IFC. |
| 7 | Equity investment in CGS for SME finance | Not applicable. JICA's equity-backed sovereign loan requires equity investment by a Japanese corporation. | Feasible when CGC is established. |
| 8 | Programmatic loan for SME development | Feasible. Capitalization of CGC can be part of the policy target. | Not applicable. |
| 9 | Loan to Leasing Companies | Not applicable | Feasible if Leasing Companies request a loan from JICA. |

## Annex 5 Overview of Pakistan's Microfinance Sector and Micro Enterprise Lending[120]

Pakistan's microfinance industry continues to grow and expand with it now being viewed as an important pillar to furthering the country's financial inclusion agenda. A favorable macroeconomic environment and economic stability played a catalytic role in the industry's growth over the previous years. The total asset base of the industry registered a remarkable 55% growth rate in 2016, standing at PKR 225 billion as compared to PKR 145 billion in 2015. MFBs accounted for 75% of the total asset base in 2016, while N-Bank MFIs (NBMFI) and Rural Support Programmes (RSPs) constituted 16% and 9% respectively. Telenor Microfinance Bank Ltd. (TMFB) has the largest asset base at PKR 36 billion followed by Khushhali Bank Ltd. (KBL) (PKR 34 billion) and National Rural Support Programme Microfinance Bank (NRSP-B) (PKR 26 billion) as shown in **Table 21**. The PKR 15 billion asset size of the largest NBMFI, National Rural Support Programme (NRSP), ranks 6th among all Microfinance Providers (MFPs). MFPs' sources of funds include the Pakistan Microfinance Investment Corporation (PMIC) that took over the Pakistan Poverty Alleviation Fund (PPAF)[121] portfolio in the microfinance sector, financed by federal and provincial governments and donors.

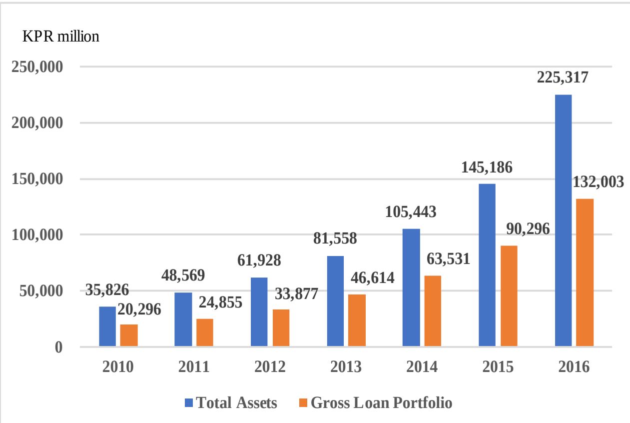


**Figure 30 Total assets and gross loan portfolio of microfinance**

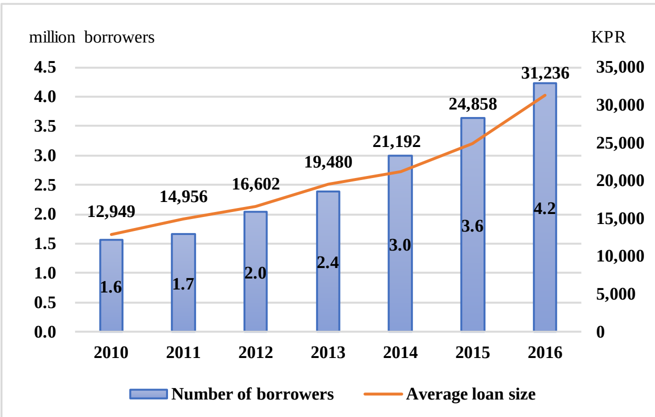


**Figure 31 Number of borrowers and average loan size**

Source: "Pakistan Microfinance Review 2016" and multiple issues of "Micro Watch", Pakistan Microfinance Network

[120] Most of the descriptions were extracted from "Pakistan Microfinance Review 2016", Pakistan Microfinance Network

[121] PPAF was established in 2000 to implement and monitor the Pakistani Government's interest-free loan scheme. By the end of 2016, PKR 5.5 billion had been disbursed through the revolving of its funds of PKR 3.1 billion (Pakistan Microfinance Review 2016). PMIC took over PPAF's portfolio in the microfinance sector.

**Pakistan Microfinance Investment Company Limited (PMIC)[122]**

PMIC is a for-profit company, set up jointly by PPAF, DFID through Karandaaz and the German Development Bank (KFW). PMIC provides wholesale financing to microfinance service providers across the country. PMIC attracts funding from development agencies, financiers, commercial banks and capital market to meet the liquidity demand of the sector which requires USD 3 billion to reach a target of 10 million active clients by 2020. 40% of PMIC's equity share is contributed by PPAF, 28% by DIFD and 32% by KFW. PMIC has currently PKR 6.67 million of equity and is expecting to raise it to the level of PKR 20 billion in the near future.

Outreach continues to grow at a double-digit rate with notable expansion in the deposit base of the microfinance industry with the total Gross Loan Portfolio (GLP) growing by 47 percent in 2016 to reach PKR 132 billion. The number of active borrowers increased in 2016 to 4.2 million from 3.6 million in 2015 with MFBs accounting for 42% of the total, and MFIs and RSPs constituting 37% and 21%, respectively. NRSP maintained its top position with a portfolio of 650,000 borrowers. During 2016, Akhuwat[123] registered a growth of 40%, surpassing KBL and became the second largest provider of microcredit in terms of active borrowers (568,000 borrowers). KBL reported 557,000 active borrowers in its portfolio. The current service delivery, however, only represents 20% of the market.[124]

This impressive growth in deposit base by MFBs led to a considerable decrease in GLP to Deposit ratio, from 93% in 2015 to 75% in 2016.[125] All 8 major MFBs, except for KBL, registered GLP to deposit ratios lower than 100% in 2016. This ratio indicates that MFBs are mainly relying on deposits to meet their funding needs, thereby reducing their costs of funds to 5.1% from 5.7% a year earlier. Moreover, a lower GLP to deposit ratio signals that MFBs have excess funds on hand and are adequately liquid, which is positive for the sector. Portfolio quality is sound with the Portfolio at Risk greater than 30 days having constantly remained below 2% since 2014, which is well under the 5% cutoff point. The borrowers in rural areas represent 54% of the portfolio, while those in urban areas 46%.

[122] Source: PMIC website (http://pmic.pk) and the Survey Team's interview with PMIC (19 January 2018).

[123] Akhuwat's main source of funds is interest-free loans from the Punjab Small Industry Corporation (PKR 10 billion as of end 2017).

[124] According to "Estimating potential market size for microcredit in Pakistan" (December 2015) by PMN, the potential market size for microfinance (potential borrowers of the loan size from PKR 20,000 to PKR 150,000) is estimated at 20.5 million.

[125] Source: Pakistan Microfinance Review 2016. These are indictive figures since the compositions of MFBs in 2016 and 2017 are different.

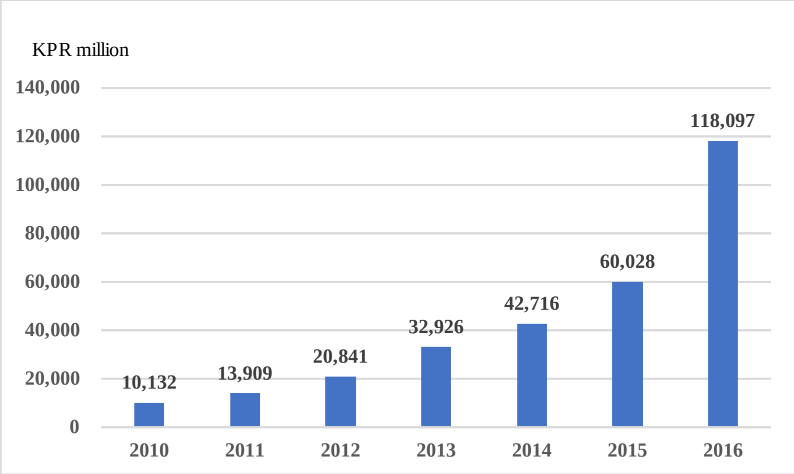


**Figure 32 Total deposits of MFBs**

Source: "Pakistan Microfinance Review 2016", Pakistan Microfinance Network

Micro-enterprise lending has the potential to fill the financing gap between microfinance clients and SMEs. The entities falling in this gap have similar dynamics as microfinance clients. All MFBs and NBMFI that responded to the Pakistan Microfinance Network were lending to this segment. The number of borrowers in this segment rose from 33,000 in 2016 to 56,000 in 2017; showing a growth of 80 percent. During the same period, the total loans outstanding for the segment stood at PKR 11.7 billion up from PKR 7.3 billion.[126] The borrowers from this segment are still a small fraction of overall borrowers of the microfinance industry, accounting for nearly 10 percent of total GLP. Lending to this micro-enterprise segment will likely increase the funding requirement of MFPs exponentially, and dedicated funding streams to this segment would likely increase lending and encourage NBMFIs to cater to this segment.

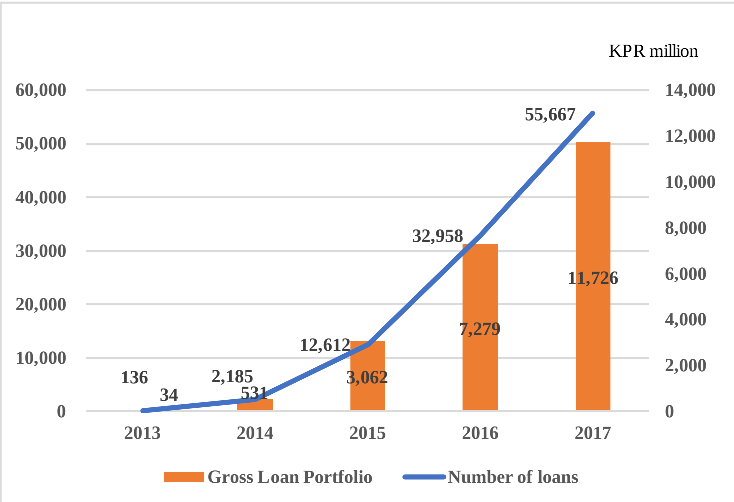


**Figure 33 Micro enterprise lending**

Remark: Data in 2017 is the average of first three quarters.

Source: "Pakistan Microfinance Review 2016" and multiple issues of "Micro Watch", Pakistan Microfinance Network

[126] Source: "Pakistan Microfinance Review 2016" and multiple issues of "Micro Watch", Pakistan Microfinance Network

**Microfinance Providers**

**<Microfinance Bank>**

A commercial bank licensed and prudentially regulated by the SBP to exclusively service the microfinance market. The first MFB was established in 2000 under a presidential decree. Since then, 11 MFBs have been licensed under the Microfinance Institutions Ordinance (2001). MFBs are legally empowered to accept and intermediate deposits from the public. As of 2016, there are 11 MFBs operating in the country.

**<Microfinance Institution>**

A non-bank microfinance institution (NBMFI) providing microfinance services. With the introduction of the non-bank microfinance regulatory framework by SECP in 2016, institutions carrying out microfinance services are required to register with SECP as NBMFIs. As of 2016, 11 MFIs have obtained NBMFI licenses, while 12 MFIs are in the process of obtaining the license.

**<Rural Support Programme>**

NBMFI providing microfinance services. An RSP is differentiated from the MFI peer group based on the purely rural focus of its credit operations. As of 2016, 3 organizations have obtained licenses under the new regulatory framework for NBMFIs, while 1 RSP is in the process of obtaining the license.

(Source: "Pakistan Microfinance Review 2016", Pakistan Microfinance Network)

**Pakistani Microfinance Network (PMN)[127]**

PMN traces its beginnings to 1997 when a group of microfinance practitioners laid its foundations as an informal platform for coordination, exchange of ideas and peer learning. It was transformed into a non-profit company in 2001. Its objectives are: (1) to promote an enabling environment that benefits the work of all stakeholders; (2) to build the capacity of stakeholders, especially that of retail microfinance institutions; and (3) to act as an information gateway by disseminating industry relevant information, improving transparency, promoting benchmarking, and serving as an information hub.

The network publishes an update of microfinance outreach (Micro Watch) quarterly and an annual assessment of Pakistan's microfinance industry (Pakistan Microfinance Review). In 2016, PMN was successful in securing the funding from DFID to implement its Business Plan for the period from August 2016 to September 2019.

[127] Source: PMN website (www.microfinanceconnect.info/)

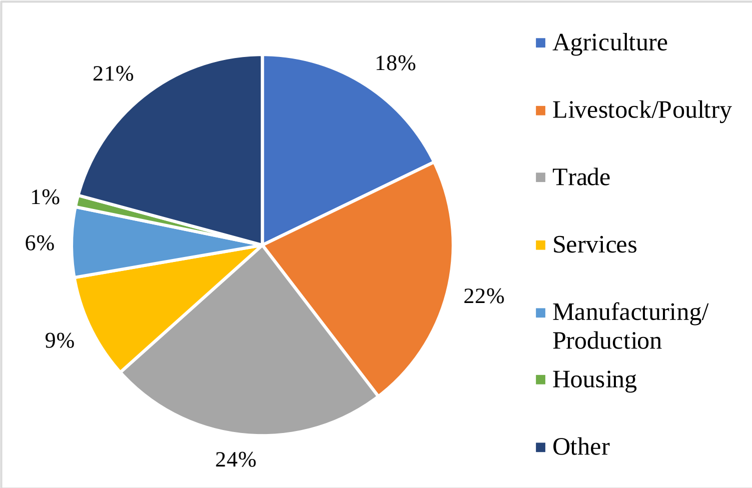


**Figure 34 Active Borrowers by Sector (2016)**

Source : “Pakistan Microfinance Review 2016”

## Table 21 Major Microfinance Providers in Pakistan

| | MFB | | | | | | | | NBMFI | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | TMFB | KBL | NRSP-B | FMFB | FINCA | AMFB | MMFB | U-Bank | NRSP | Akhuwat | KASHF | ASA-P |
| Total assets (PKR million) | 36,304 | 33,773 | 26,452 | 16,878 | 15,618 | 13,554 | 14,224 | 10,592 | 15,486 | 10,317 | 7,370 | 6,104 |
| Total equity (PKR million) | 4,586 | 4,937 | 3,234 | 3,831 | 2,433 | 707 | 1,230 | 1,122 | 4,468 | 1,403 | 1,575 | 1,482 |
| No. of branches | 74 | 139 | 97 | 120 | 105 | 89 | 51 | 77 | 160 | 500 | 187 | 230 |
| No. personnel | 3,473 | 2,708 | 2,340 | 1,541 | 1,324 | 1,516 | 740 | 939 | 3,221 | 3,491 | 2,096 | 1,592 |
| No. depositors (000) | 4,666 | 1,369 | 674 | 458 | 407 | 114 | 8,085 | 153 | - | - | - | - |
| Total deposits (PKR million) | 27,830 | 21,179 | 16,992 | 12,237 | 11,070 | 10,421 | 10,306 | 8,110 | - | - | - | - |
| Average saving (PKR) | 5,964 | 15,471 | 25,089 | 26,707 | 27,199 | 91,660 | 1,274 | 52,993 | - | - | - | - |
| No. of active borrowers (000) | 385 | 557 | 326 | 221 | 132 | 46 | 91 | 22 | 650 | 568 | 215 | 322 |
| GLP (PKR million) | 15,945 | 23,309 | 13,271 | 8,274 | 10,209 | 6,321 | 5,934 | 5,577 | 11,960 | 8,064 | 4,562 | 5,654 |
| Average loan balance (PKR) | 41,372 | 41,841 | 40,769 | 37,425 | 77,195 | 138,481 | 65,259 | 250,598 | 18,409 | 14,202 | 21,221 | 17,560 |
| Equity-Asset Ratio | 12.6% | 14.6% | 12.1% | 22.7% | 15.6% | 5.2% | 8.6% | 10.6% | 28.9% | 13.6% | 21.4% | 24.3% |
| GLP to Deposits Ratio | 57.3% | 110.0% | 78.4% | 67.6% | 92.3% | 60.6% | 57.6% | 68.8% | - | - | - | - |
| Portfolio at risk (>30 days)-to-GLP Ratio | 0.6% | 1.5% | 0.4% | 0.7% | 1.1% | 0.4% | 0.0% | 0.5% | 1.3% | 0.3% | 0.3% | 0.2% |

MFBs: MFB: Telenor Microfinance Bank Ltd; KBL: Khushhali Bank Ltd; NRSP-B: National Rural Support Programme Microfinance Bank; FMFB: The First Microfinance Bank Ltd; FINCA: FINCA Microfinance Bank Ltd; AMFB: APNA Microfinance Bank Ltd; MMFB: Mobilink Microfinance Bank Ltd; U-Bank: U Microfinance Bank Ltd;

MFIs: Akhuwat; KF: Kashf Foundation; ASA-P: ASA Pakistan limited

RSP: NRSP: National Rural Support Programme

# Annex 6 Financial Scheme of Foreign Currency Loans for Export Oriented Medium-sized Enterprises

Pakistan currently lacks liquidity in US Dollars as a result of accumulated current accounts deficits, as discussed in Chapter 1. MEs in export-oriented sectors are in need of modernizing and upgrading their production facilities to stay competitive in the international market.[128] The potential demand for foreign currency loans that help export-oriented MEs procure machinery and equipment from overseas is considered to be large. However, since traditional trade finance has a short tenor, the size of an amount to be repaid at once may be too large for MEs when procuring expensive equipment or machines from overseas. The proposed scheme offers loans in foreign currency to MEs with repayment periods of 3 to 5 years of which the tenor is similar to capital investment loans in local currency in Pakistan. The proposed scheme offers a new financial product that does not currently exist in Pakistan.[129] By meeting the aforementioned demand for capital investment, this financial scheme would bring out developmental effects of promoting export through capital investment for MEs and enhancing their financial access.

## (1) Regulations of Foreign Currency Financing

In order to control the level of foreign reserves, SBP restricts external outflow of foreign currency through tight regulations.[130] Pure foreign currency loans, where borrowers receive loans and repay them in foreign currency, are not generally permitted. Instead, commercial banks offer “nominal” foreign currency loans. For example, if an ME receives a nominal USD loan from a commercial bank to import equipment from abroad, the commercial bank sends USD funds to an overseas exporter. The ME borrower repays in PKR by applying the exchange rate at the time of repayment.[131] With this mechanism, borrowers bear the foreign exchange risk.

SBP can grant, on a case-by-case basis, permission specific to a certain scheme of foreign currency loans, i.e., loans with disbursement and repayment in foreign currency. Therefore, the proposed scheme can be implemented if SBP grants permission. The reaction from SBP was overall positive towards the proposed scheme; SBP assured that it would consider the proposal if there is demand from MEs and commercial banks. SBP also suggested that the fund flow of the microfinance component of the World Bank's recent project (FIIP) described in the following be replicated for the proposed scheme; World Bank => (Loan) => MoF => (Grant) => SBP => (Loans) => MFIs/MFBs.

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[128] According to the interviews with the commercial banks, no significant demand for foreign currency loans by SEs is anticipated; thus this scheme is intended for MEs.

[129] The trade finance offered in Pakistan is usually for less than 180 days. So this scheme offers a hybrid financial product of trade finance and a capital investment loan.

[130] “Foreign Exchange Manuals,” June 2018, Exchange Policy Department, State Bank of Pakistan.

[131] Commercial banks transfer the foreign exchange risk to borrowers by applying the exchange rate at the time of repayment to loan repayment.

### (2) Demand Forecast and Issues for Foreign Currency Financing for MEs[132]

All the banks that the Survey Team interviewed responded positively to the participation in the proposed scheme. Two banks presented expected annual loan amounts for this scheme. One bank projected it to be about USD 15 million to USD 20 million in the first year, which will grow to be about USD 50 million in five years if the scheme is successful. In addition, the other bank projected that an annual loan amount of about USD 25 million for commercial enterprises would be expected,[133] should the proposed scheme be offered to such enterprises. Industry sectors where potential demand for this scheme is expected include automobiles, textiles (including dyeing and composite textiles), leather, surgical instruments, sports goods, fishery (mainly refrigerating equipment), mining (marble), food and agricultural products (rice, confectionary, etc.). Regarding the size of the eligible ME borrowers and the amount of the loan, with a textile industry as an example, MEs with annual export sales of at least PKR 500 million would be appropriate for the scheme, taking into consideration the credit risk and other risk factors, according to our interviews with commercial banks. The loan amount per borrower was estimated at about USD 600,000 to USD 800,000.

Since providing loans with longer tenor would add more risk to the SME lending which is already a higher risk business, commercial banks are reluctant to finance capital investment loans for SMEs. Therefore, to encourage banks to execute the proposed scheme, the scheme needs to provide incentives such as provision of credit guarantees to manage risks of SMEs and longer tenor loans. In addition, the sales staff of the SME finance at commercial banks does not usually have experience dealing in nominal foreign currency loans. Technical training for treasury and sales staff, when introducing the scheme, may be essential.[134] Similarly, it may be necessary to conduct market research of demand and to extend marketing of the new scheme to raise awareness among targeted export-oriented MEs.[135]

While the importance of financial access and inclusion has been emphasized in recent years, strengthening regulations to prevent money laundering has gained much importance internationally. Since the latter may have a negative impact on trade finance in particular in developing countries,[136] it is important to assess its impact on the proposed scheme through a survey of banks and involved government agencies, and to consider offering an anti-money-laundering program similar to that of the World Bank. In addition, a few banks indicated that occasional misuse of the loaned funds by SME borrowers occurred in Pakistan. For example, funds borrowed for working capital were in fact invested

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[132] We conducted interviews with five banks, namely Habib Bank Limited (HBL), National Bank of Pakistan (NBP), UBL, JS Bank (JS) and Soneri Bank (Soneri).

[133] Commercial banks in Pakistan internally categorize enterprise borrowers to four groups. The commercial enterprises are larger than MEs but smaller than large corporations.

[134] Treasury department of commercial banks deal with foreign currency transactions.

[135] In 2009 the Italian government and UNIDO launched the program of suppliers' credits for SMEs, which provided euro-denominated loans for procuring Italian products and services (see Annex 7). One of the reasons why the program did not succeed was that awareness of the program was quite low among potential SME beneficiaries.

[136] "Trade Finance and SMEs," World Trade Organization, 2016.

in the stock market or real estate. Measures such as monitoring through random sampling need to be in place in order to ensure that USD funds offered through this scheme are used for defined purposes.

## Annex 7 Summary of Recent SME Support in Pakistan

Policies and Regulations

| Policy/Regulation | Org. | Year | Summary | Status/Problems |
|---|---|---|---|---|
| SME Policy 2007 | Ministry of Industries, Production & Special Initiatives | 2007 | (a) Objectives<br>The objective of SME Policy is to provide a short and a medium to long-term policy framework with an implementation mechanism for achieving higher economic growth through SME-led private sector development.<br>(b) Scope<br>The policy defines 4 major areas to work on: business environment, access to finance, human resource development, and support for technology up-gradation and marketing. Activities to improve financial access are the following.<br>• Incorporation of SME financing in the Annual Credit Plan of the SBP and monitoring to cater for underserved segment of the SME.<br>• Review of Prudential Regulations, periodically, in line with the SME credit demand and supply data.<br>• Establishment of Credit Guarantee and Credit Insurance agencies, operating in line with sound international practices, to provide incentives and risk cover for banks, so as to provide them with the relevant comfort in financing SMEs.<br>• Support to FIs in designing and launching industry-based program-lending schemes.<br>• Capacity building of the CIB to report positive and negative data & sharing of SME financing data by the SBP.<br>• Improvement in the regulatory procedures and fiscal incentives for Venture Capital companies.<br>• Introduction of Bankruptcy Laws with dedicated and effective judicial process.<br>• Expansion in the role of Banking Ombudsman to include redressal process for SME complaints.<br>• Awareness and promotion of options for formal financing and good accounting practices amongst SMEs.<br>• Promotion of Islamic mode of financing for SMEs.<br>(c) Implementation<br>SMEDA conducts monitoring and evaluation of the policy and report to the National Committee on Small and Medium Enterprises (NCSME). | • Nothing mentioned to how to secure the budget for the policy implementation nor implementation mechanism.<br>• The role and authority of NCSME are not defined.<br>• NCSME had only one meeting until November 2010 (situation after that should be researched).<br>• SME policy has been used just as a general guideline of SMEDA's activities.170 |

| | | | | |
|---|---|---|---|---|
| 5-Year SME Development Plan | SMEDA | 2014 | • This plan became a part of Vision 2025.<br>• Three pillars of the plan are: (a) Policy advocacy with the Strategic SME Development Framework (2013-18), (b) developing entrepreneurial ecosystem to support new enterprise creation & increase scale of business, and (c) sector development plans in the 13 priority sectors.<br>• In 2018 by the end of the period, the plan envisages increases in employment, GDP and exports by 10 million, USD 120 billion and USD 36 billion, respectively. | • The government is said to have allocated PKR 100 million to SMEDA for cluster development, but the detail of how it was spent requires further research. |
| SBP Vision 2020 | SBP | 2015 | • SBP's third strategic plan from 2016 specifies financial inclusion as one of six imperatives, as an implementer of NFIS. The plan promises to encourage alternative financial services for MSMEs, to promote Islamic banking, and to implement the National Financial Literacy Initiatives to improve awareness and utilization of financial services by consumers and various economic sectors. | |
| Prudential Regulations for SME Financing | SBP | 2003- | • Limited finance to SMEs from banks was ascribed to insufficient regulations. In order to remedy the problem, the Prudential Regulations for SME Finance was issued in 2003 and amended in 2013 and 2016.<br>• SBP established the Credit Information Bureau in 1992 to facilitate the creation of credit history by SMEs. The year 2003 saw the expansion of its scope by the introduction of an e-CIB system, which improved speed, reliability, and security of data.<br>• SBP is also supporting the establishing of the Nationwide Microfinance-exclusive Credit Information Bureau (MF-CIB) that will help microfinance providers (MFPs) in developing a robust risk management system and practices, which in turn reduces the risk of multiple borrowing and loan defaults.[137] | Prudential Regulations for SME Finance was updated in 2016. Also, SBP advised the banks to establish a unit that deals with SME finance. |
| National Financial Inclusion Strategy (NFIS) | SBP | 2015 | • Strategy for the years between 2015-2020. The goal is to expand financial access to at least 50% of adults, and to increase the share of SME loans in bank lending to 15% by 2020.<br>• 4 actions (drivers) of NFIS are to:<br>(a) Promote Digital Transaction Accounts (DTAs) and reach scale through bulk payments;<br>(b) Expand and diversify access points;<br>(c) Improve capacity of financial service providers; and<br>(d) Increase levels of SMEs' financial capability. | The recent NFIS initiatives taken by SBP are:<br>Issuance of Guidelines on Low Risk Accounts namely "Asaan Account" with simplified due diligence to expand the outreach of banking services to underserved segments of the society through conventional and innovative channels; |

[137] SBP (2016) "Pakistan Country Paper"

| | | | | |
|---|---|---|---|---|
| | | | • As for MSME finance, NFIS develops guarantee schemes and is to utilize other alternative models such as value chain finance, cross-selling, program lending, women-focused services, cash-based lending, and provision of nonfinancial supporting (technical assistance) services for business development. | • Establishment of Centers of Excellence in Islamic Finance Education to ensure adequate supply of trained human resource to the industry;<br>• Launch of Credit Guarantee Scheme for Small and Marginalized Farmers (CGSMF) with the funding support of GoP to share the losses with the banks against their collateral free financing to small and marginalized farmers;<br>• Development of Mark-up Free Financing Scheme for Solar Tube-Wells;<br>• Installation of biometric infrastructure to aid real-time account opening at discounted price structure (SBP, 2016);<br>• Asaan (Easy) Mobile Account (AMA) scheme approved in Jan 2017;<br>• Branchless Banking; and<br>• Introduction of SME financing targets for banks and DFIs for the first time in 2016. The targets assigned to banks/DFIs for FY 2016 were fully achieved and SME financing increased to more than PKR 400 billion as of December 2016.[138] |
| Strategic Trade Policy Framework (2015-2018) | Ministry of Commerce | 2015 | • By the end year 2018, STPF 2015-18 aims to enhance annual exports to USD 35 billion by achieving an efficient and demand-driven economy.<br>• The policy's four main pillars are: | The SME grant was disbursed on June 1, 2016 from Ministry of Commerce.[139] |

[138] SBP (2017) "Annual Performance Review 2016-2017"

[139] DAWN "Cash Schemes SROs Notified to Boost Exports" https://www.dawn.com/news/1268764 (Accessed December 18, 2017)

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|---|---|---|---|---|
| | | | (a) Product sophistication and diversification (research and development, value addition, and branding);<br>(b) improved market access (increasing the share in existing markets, exploring new markets, trade diplomacy and regionalism);<br>(c) Institutional development and strengthening (restructuring, capacity building, and new institutions); and<br>(d) Trade facilitation (reducing cost of doing business, standardization, and regulatory measures).<br>• To increase exports from SMEs by improving their products' design and promoting their innovation, the project approved the grant of PKR 5 million for SMEs. The grant was to be used for technical improvement, a tax reduction scheme for SMEs and export promotion, and cash support for import of agro-processing plants and machinery. About these different supports, Statutory Regulatory Orders were issued in 2016 that specified the subject sectors, conditions of enterprises and detailed procedures. | The status after the disbursement requires further research. |
| Punjab Growth Strategy (PGS) 2018 | GoP | 2015 | • Developed under the leadership of the Planning & Development Department (P&D) with the support of eminent Pakistani economists and the World Bank through the Jobs and Competitiveness technical assistance, the strategy aims at private sector-led and employment-intensive economic growth. Industry is named as one of the main drivers of this growth, for which the strategy outlines the way forward: improving industrial estates by providing critical infrastructure (energy, effluent treatment), creating clear property rights and improving one-window facilitation; and reducing the cost of doing business particularly in industrial clusters by improving the provincial regulatory framework.<br>• 7 objectives of the strategies are the following:<br>(a) Achieving 8% economic growth (real GRP growth rate) in Punjab by 2018;<br>(b) Increasing annual private sector investment in Punjab to USD 17.5 billion by 2018;<br>(c) Creating 1 million quality jobs every year in Punjab;<br>(d) Training 2 million skills graduates in Punjab by 2018;<br>(e) Increasing Punjab's exports by 15% every year till 2018;<br>(f) Achieving all Millennium Development Goals and targeted Sustainable Development Goals in Punjab by 2018; and<br>(g) Narrowing the security gap with regional neighbors such as India and Bangladesh by reducing crime and improving law and order in Punjab | |

Public Institutions

| Period | Institutions | Project Title | Summary | Status/Problem |
|---|---|---|---|---|
| 2010- | SBP | Schemes for SME finance[140] | **(a) CGS for Small and Rural Enterprises**<br>The scheme was launched in collaboration with DFID in 2010. Under the scheme, SBP shares risk with Participating Financial Institutions (PFIs) by guaranteeing up to 40% of PFIs' fresh portfolio of financing to SEs and farmers. Instead of evaluation of each and every loan, portfolio (principal amount only) of loans (extended after allocation of Credit Guarantee Limit) of a PFI which meet the given criteria is guaranteed under the scheme to the extent of its allocated Credit Guarantee Limit.[141]<br>**(b) Microfinance Credit Guarantee Facility (MCGF)**<br>To incentivize commercial banks and development finance institutions (DFIs) for provision of commercial capital to microfinance providers for on-lending to their clients, SBP established the MCGF at the end of 2008. Initially, it was started with a DFID grant of GBP 10 million, which was kept as reserve and used for issuing guarantee to microfinance providers (MFPs). Under the guarantee, SBP shared the borrower's default risk with banks for their lending to MFPs as (a) 40% partial guarantee on the principal outstanding or (b) 25% First Loss Default (FLD) on the principal disbursed.<br>**(c) Export Finance Scheme**<br>This is a short-term finance scheme for the export-related expenses. The current rate of finance for SMEs is 3% (1% refinance rate from SBP and 1% for the banks' spread).[142] The banks under the scheme are required to allocate at least 10% of the funds for SMEs.[143]<br>**(d) Refinancing Facility for Modernization of SMEs**<br>The facility aims at increasing SMEs' production capacity and productivity with a maximum 10-year loan for local purchase/import of new machinery for | **(a) Credit Guarantee Scheme (CGS) for Small and Rural Enterprises**<br>As of September 2016, the cumulative number of SMEs receiving a CGS-backed loan was 22,909.[146]<br>**(b) Microfinance Credit Guarantee Facility (MCGF)**<br>MCGF played an instrumental role in not just lending cumulatively PKR 20 billion (GBP 147 million) to the microfinance sector,[147] but developing relationships between MFPs and the commercial banks. As planned, SBP ceased to issue new guarantees under MCGF in April 2017.[148]<br>**(c) Export Finance Scheme**<br>The outstanding export finance as of June 30, 2017 was PKR 237.4 billion which is 16.7% higher than the preceding year.[149] The main recipient sectors are textile, machinery and leather processing. Since the collateral is still required, smaller enterprises without enough property still have difficulty in availing this finance.<br>**(d) Financing Facility for Modernization of SMEs**<br>At the end of 2016, the outstanding loan of the facility was PKR 65 million.<br>**(e) Financing Facility for Storage of Agricultural Produce** |

[140] SBP "SBP's Incentive Schemes" http://www.sbp.org.pk/Incen/index.asp (Accessed February 22, 2018)
[141] SBP "Credit Guarantee Scheme for Small and Rural Enterprises"
[142] SBP "Infrastructure, Housing & SME Finance Department Circular No. 4 of 2016," http://www.sbp.org.pk/smefd/circulars/2016/C4.htm (Accessed December 18, 2017)
[143] SBP "IH&SMEFD Circular No. 01 of 2014" http://www.sbp.org.pk/smefd/circulars/2014/C1.htm (Accessed February 20, 2018)
[146] DFID (2016) "Financial Inclusion Programme Annual Review"
[147] DFID (2016) "Financial Inclusion Programme Annual Review"
[148] SBP "AC&MFD Circular No. 01 0f 2017," http://www.sbp.org.pk/acd/2017/C1.htm, (Accessed February 18, 2018)
[149] SBP (2017) "Annual Performance Review 2016-17"

| | | | | |
|---|---|---|---|---|
| | | | Balancing, Modernization and Replacement (BMR) of SMEs and for purchase of new generators. Grace period is half a year, and end users' rate of service charge is 6% at the time of December 2017, composed of 2% of refinance rate from SBP and 4% of financing institutions' spread.[144]<br>**(e) Financing Facility for Storage of Agricultural Produce** Long-term finance provided to private enterprises including SMEs between June 2010 and December 2012 for local purchase/import of new plant & machinery /new generators used in Silos/Warehouses/Cold Storages. The facility is available for a maximum period of 7 years including a maximum grace period of half a year. At the time of December 2017, end user's rate of service charges is 6% at the time of December 2017, composed of 2% of refinance rate from SBP and 4% of financing institutions' spread.<br>**(f) Other SME financing schemes**<br>• Mark-up Subsidy and Guarantee Facility for the Rice Husking Mills in Sindh (MSGFRMS): By the Government of Sindh and Sindh Enterprise Development Fund (SEDF), the facility has been in effect since 2010 to increase efficiency of mills through technology upgrade. Under this scheme, end user's rate is reduced to 2%, and the financing institutions receives additional 2.75% from SEDF.[145] SEDF also provides credit risk sharing facility of up to 30% against the long-term loans extended to rice husking mills of Sindh.<br>• Prime Minister's Youth Business Loan (PMYBL): To promote entrepreneurship of unemployed youth, up to PKR 2 million can be financed under the scheme from 2013 with a mark-up subsidy and partial guarantee facility. As of June 2016, the loan was provided by 18 financial institutions.<br>• Scheme for Revitalization of SMEs in KPK, Gilgit-Baltistan and FATA: started in 2010. | In June 2016, the outstanding loan of the facility was PKR 1.76 billion.<br>**(f) Other SME financing schemes**<br>PMYBL: Between 2013 and 2016, finance was made to 17,700 applications out of total 74,461. The total amount of loan reached PKR 17,7 billion. |
| 2010- | SBP | SME Profiling | See IFC SME Profiling | |

[144] SBP, "Infrastructure, Housing & SME Finance Department Circular No.4 of 2017" http://www.sbp.org.pk/smefd/circulars/2017/C4.htm (Accessed December 18, 2017)
[145] SBP, "Infrastructure, Housing & SME Finance Department Circular No 6 of 2017" http://www.sbp.org.pk/smefd/circulars/2017/CL6.htm (Accessed December 18, 2017)

| | | | | |
|---|---|---|---|---|
| 2013- | Securities & Exchange Commission of Pakistan (SECP) | | • Working to improve SMEs' financial access by allowing SMEs to issue stock and bonds, besides finance from banks. It is believed that 5-10% of SME financing gap, which is between USD 75 billion and USD 150 billion, can be covered by capital markets.[150]<br>• SECP approved the Regulations for trading of SME's securities in 2013 for the Islamabad Stock Exchange, followed by the approval of the regulations for enlistment on the Karachi Stock Exchange. | Raising capital by issuing equity or debt securities involves high transaction costs, and complex regulatory and legal frameworks. It is yet to be seen how attractive risks and transactions costs can be for investors and SMEs. |
| 2008- | SBP | Financial Inclusion Program (FIP) | See DFID FIP | |
| | SME Bank Ltd. | | • The SME Bank was formed and incorporated as a public limited company under the Companies Ordinance 1984. Its major shareholder is GoP.[151]<br>• The objectives of the SME Bank are the following:<br>(a) To support, develop and promote SMEs by providing them with the necessary technical and financial assistance;<br>(b) To contribute to value addition by SMEs and support export-oriented SMEs; and<br>(c) To enable SMEs to play a vital role in stimulating GDP growth, create job opportunities and reduce poverty. | Privatization impending[152] |
| | SMEDA[153] | | • SMEDA has been a major governmental wing to support SMEs, especially through (a) provision of BDS directly to SMEs, (b) research on industrial sectors and clusters, and (c) enabling policy formulation and amendments. In the year 2016-17, SMEDA provided BDS to 6,742 SMEs.[154]<br>• Recently SMEDA approved a 2-billion program titled "National Business Development Program for SMEs" for providing direct facilitation for new business creation and expansion of businesses, which will be implemented for the next 5 years. The program is | |

150 SMEDA (2016) "SME Observer-2016", Vol.6

151 SME Bank Ltd. http://smebank.org/ (Accessed December 10, 2017)

152 SME Bank (2016) "Annual Report 2016"

153 SMEDA https://www.smeda.org/index.php (Accessed December 10, 2017)

154 SMEDA (2017) "Annual Report 2016-2017"

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| | | | expected to benefit 314,901 SMEs across Pakistan, consisting of 4 components:[155]<br>(a) Start-up & Business Development Support (business start-up support, credit worthiness assessment support, advice and information service, over the counter documents, marketing and market linkages);<br>(b) Management Development Support (organizational development support, SME training support, BDS provider strengthening and networking);<br>(c) Product Development Support (service acquisition (certification / testing), technical R&D support, business incubation at Academia); and<br>d. Research, Policy and Advocacy Support (Medium Enterprise market research / publications). | |
| 1984- | National Industrial Parks Development & Management Company (NIP)[156] | | • NIP supports rapid industrialization in the country by establishing new industrial parks and rehabilitating those that may be handed over by the Government/Provincial Government(s) to the private sector. | There are 6 ongoing projects:<br>• Korangi Creek Industrial Park<br>• Bin Qasim Industrial Park<br>• Rachna Industrial Park<br>• Gems & Jewelry Manufacturing Centers<br>• Khairpur Special Economic Zone<br>• Marble City Risalpur |



[155] SMEDA "PC I- National Business Development Program for SMEs"
[156] NIP http://www.nip.com.pk/ (Accessed December 10, 2017)

Donors

| Period | Donor | Counterpart | Project Title | Cost | Summary | Status / Problem |
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| 2017-(2022) | World Bank | | Financial Inclusion and Infrastructure Project | USD 137 million | • Work Bank loan to increase access and usage of digital payments and other financial services for households and businesses through: (a) improving market infrastructure and institutional capacity, (b) supporting the uptake and usage of Digital Payments and Financial Services and (c) improving access to financial services for MSMEs, with the following components:<br>(a) Direct Support to the National Financial Inclusion Strategy (NFIS) Implementation (USD 17.50 million)<br>(b) Supporting Expansion of Access Points for Financial Services (USD 9.40 million)<br>(c) Improving Access to Microfinance and to Financial Services for MSMEs (USD 110.10 million)[157] | • In the third component, although the disbursement of USD 33 million for the SME risk sharing facility to CGS is planned during the fiscal year 2018-19, it will be released only when the CGS becomes an independent entity. |
| 2016-2021 | World Bank | | Pakistan Punjab Jobs and Competitiveness Program for Results | USD 100 million | • The project supports the implementation of the Punjab growth strategy (PGS) to re-ignite manufacturing growth in the province.<br>• The project encourages important business environment regulatory reforms (e.g. business registration, permits and licensing, contract enforcement and property registration), and finance the deployment of important soft and hard industrial infrastructure in accordance with the economic spatial development plan (e.g. industrial zones and industrial cluster development centers).<br>• USD 100 million from WB, which will be disbursed to the provincial government based on the achievements of indicators (disbursement-linked indicators), accounts for 36% of the total program budget (the rest is contributed by the provincial government).[158] | • Investment Climate Reform Unit (ICRU) has been established under the Planning and Development Department of the Government of Punjab as an implementation unit of the project.<br>• Its mandates are: (a) province-wide reforms for regulations and legislations of doing business; (b) engage public and private sector players for PPP dialogue and advocacy; and (c) strategic investment initiatives for financial inclusion.<br>• As the first step of ease of doing business, ICRU is currently mapping all the regulations and legislations related to investment. |

[157] World Bank (2017) “Project Appraisal”
[158] World Bank (2016) “Project Appraisal Document”

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| 2014- | DFID / Karandaaz Pakistan | | | | • Karandaaz was established in 2014 by DFID as an NGO registered with SECP under the Enterprise and Assets Growth Programme (EAGR), which is aimed at improving MSMEs' access to finance.<br>• Three pillars of its activities are the following:[159]<br>**<u>(a) Karandaaz Capital</u>**<br>USD 50 million is committed by DFID to invest commercially directed capital through a wholesale credit business and direct corporate investment private equity platform. Karandaaz Capital is currently working with 3 financial institutions (Bank Alfalah, Meezan Bank and Orix Leasing), 7 corporate partners, and over 300 SMEs. Karandaaz also contributed to the establishment of and has a 37.8% stake of the Pakistan Microfinance Investment Company (PMIC) that provides credit in the form of loans to microfinance providers;[160]<br>**<u>(b) Karandaaz Digital</u>**<br>With USD 32 million in funding from the Bill and Melinda Gates Foundation, it promotes digitization of government payments, which will result in lowering the barrier to the customers' access to finance; and<br>**<u>(c) Innovation Challenge Fund</u>**<br>Fund for innovative ideas. For selection of the recipient, theme-based rounds are launched. As of January 2018, 2 rounds (about "International Remittance" and "Women-led Business") have taken place, and the winners of the former have received grants of PKR 148 million in total, while the latter is in the selection process. | **<u>(a) Karandaaz Capital</u>**<br>Till 30th June 2017, the aggregate disbursement stood at PKR 3.4 billion and the outstanding portfolio stood at PKR 2.2 billion.<br>**<u>(b) Karandaaz Digital</u>**<br>In process of finalizing supports to SBP for setting up a low cost payment system.<br>**<u>(c) Innovation Challenge Fund</u>**<br>The third round was open for applications until February 26, 2018, the theme of which is "Innovative Credit Scoring of SMEs." |

[159] Karandaaz Pakistan, https://karandaaz.com.pk (Accessed February 18, 2018)
[160] Karandaaz (2017) "Annual Report 2016-17"

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| 2014-(2018) | World Bank | | Developing Artisanal Livelihoods in Rural Pakistan[161] | USD 2.8 million | • The project will demonstrate to policy makers the effectiveness of a crafts-based cluster approach to alleviate poverty and improve living conditions of weavers and embroiderers (especially women and girls) and their families in targeted communities in Punjab and Sindh.<br>• The project was targeting the most vulnerable and poor artisans and providing them with high quality skill training. | • The project has conducted a significant number of skill development and institutional building activities in all project districts.<br>• The project has established a design unit for capacity building of semi-skilled artisans by developing contemporary marketable products.<br>• The project had initiated developing contemporary products for the semi-skilled artisans and provided focused training to them by the trained master artisans so that they can earn sustainable livelihoods through crafts. |
| | USAID | Khushhali Microfinance Bank etc. | Development Credit Authority | USD 5 million | • USAID partners with banks to increase outreach of SME finance by increasing utilization of the DCA partial guarantee extended to its partner banks.[162]<br>• In Pakistan, DCA started in 2014, and now JS Bank and Bank Alfalah are utilizing this facility.<br>• DCA guarantees up to 50% of the principle, which enables commercial banks to extend a total of USD 60 million of credit (of which USD 12 million should be allocated to the education sector). | • The impact of the program is yet to be evaluated in detail, but given the fact that the share of SME loans in JS Bank increased from zero to 12%, the program is successful in realizing SME loans. |
| | ADB | Khushhali Microfinance Bank | Expanding Access to Credit for Agriculture and Micro, Small, and Medium-Sized Enterprise Borrowers | USD 20 million | • A loan has been approved up to USD 20 million or Pakistan rupee equivalent to Khushhali Bank Limited (KBL) for this scheme under the Faster Approach to Small Non-sovereign Transactions (FAST) framework.[163] | |

[161] World Bank (2017) "Implementation Status & Results Report"
[162] Karandaaz (2017) "Nature and Characteristics of SME Financing and NPLs in Pakistan"
[163] ADB (2016) "FAST Report: Expanding Access to Credit for Agriculture and Micro, Small, and Medium-Sized Enterprise Borrowers (Pakistan)"

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| | USAID | Abraaj Group, Indus Basin Holding, JS Private Equity Management | Pakistan Private Investment Initiative (PPII) | USD 100 million | • To provide equity capital to SMEs in partnership with local private equity firms. | • The initiative started in 2016 with the period of 5 years, and 20% of the fund has been invested as of January 2018. |
| 2017-(2022) | USAID | | Small & Medium Enterprise Activity (SMEA) project implemented by Chemonics | USD 35 million | • With the total budget of USD 34.8 million, SMEA was launched in November 2016 to improve financial and operational performance of SMEs in 7 sub-sectors (information communications technology, light engineering, textile, hospitality, minerals, packaging, and leather, were selected as targets) through direct interventions to SMEs and activities that address factors constraining businesses.[164]<br>• The project activities can be broken down into 3 parts<br>(a) Regulatory reform where SMEs can engage more in policy-making,<br>(b) Provision of BDS to SMEs, and<br>(c) Grant for both of SMEs and innovative BDS providers that can facilitate SME activities. | • To conceive the right approach for these 3 activities, Chemonics is conducting a survey of the overall environment around SMEs and will also analyze each sector in detail. |
| 2013 -2015 | KP/ FATA /Balochistan, Multi Donor Trust Fund (MDTF) | | Competitive Industries Project for Khyber Pakhtunkhwa | USD 5.69 million | • The project is to improve the competitiveness of the marble and food processing sectors in Khyber Pakhtunkhwa (KP) by providing shared infrastructure and relevant skills along the marble sector value chain, and by addressing knowledge and coordination gaps along the food processing sector value chain.<br>• Major activities for the marble sector:<br>(a) Establishment of a machinery pool for marble quarries in Risalpur Marble City to increase productivity and reduce life threatening mining practices;<br>(b) Establishment of a Common Facility and Training Center (CFTC) to improve marble processing to meet export requirements and standards and to provide skills training to benefit the processing facilities; and, | • Against the initial budget of USD 9 million, the amount actually disbursed was USD 5.69 million. The project's achievement is rated as modest.<br>• In the marble sector, the utilization of the new excavation machines began to improve the production levels of marble miners participating in the project. The production and employment targets, however, were only partially achieved.<br>• In the food processing sector, the project addressed the knowledge gaps along the value chain. |

[164] Chemonics "Small and Medium Size Enterprise Activity (SMEA)," https://www.chemonics.com/projects/elevating-pakistans-enterprises (Accessed February 17, 2018)

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| | | | | | (c) Interventions to facilitate the integration of market linkages for KP marble products to both domestic and export markets to ensure that gains from the first and second stages of the value chain are actually translated into high-value-added sales.<br>• Major activities for the food processing sector:<br>(a) Value chain prioritization and analysis of Khyber Pakhtunkhwa's horticulture sector;<br>(b) Feasibility studies on selected projects along the food processing value chain; and,<br>(c) Cluster development program to improve coordination among stakeholders in the food processing industry.[165] | • However, the project did not address the coordination gaps along the food processing industry value chain as neither the value chain analysis or the industry cluster action plan was completed.[166] |
| 2013- | IFC | | Business Edge | | • IFC selects local training providers, builds their training delivery capacity, and accredits them to deliver business management skills training workshops called "Business Edge." | • Accredited training providers have trained 6,274 individuals, 1,412 (22%) of which are women, from 1,640 MSMEs, government organizations, and development organizations.[167] |
| 2010- | IFC | SBP | SME Profiling | | • Joint research of IFC and SBP on the major SME sectors. It is anticipated to utilize the collected data for design of financial products for SMEs and strategy/plan of SME finance. | • By 2010, research completed for 10 sectors. After that, reports of 11 sectors were added, the research of which were funded by DFID as a part of its Financial Inclusion Program.[168] |
| 2012-<br>(2020) | Multi Donor Trust Fund | | Economic Revitalization of Khyber Pakhtunkhwa and FATA (ERKF) | USD 39 million | • The project was funded by the multi-donor trust fund with a total budget of USD 39 million with the World Bank administrating the project on behalf of 10 donors.<br>• The project aims to create jobs by revitalizing the SMEs damaged during the military crisis in the northwest of | • The project created more than 8,000 jobs through the provision of matching grants to the SMEs in KP and FATA. USD 20 million has been disbursed to 1,700 SMEs until 2017.[169] |

165 World Bank (2016) "Implementation Completion and Results Report"
166 World Bank (2017) "Implementation Completion Report Review"
167 World Bank (2013) "The World Bank in Pakistan: Partners in Development"
168 SBP, "Infrastructure, Housing & SME Finance Department," http://www.sbp.org.pk/departments/ihfd-ifc.htm (Accessed December 9, 2017)
169 World Bank (2017) "Implementation Status & Results Report"

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| | | | | | Pakistan (conflict-affected area). The main implementer of this project is SMEDA. | • The 2nd phase started in March 2017 and will be completed in 2020. During this phase USD 19 million will be disbursed. |
| 2009-2014 | USAID | | JOBS Project | USD 80 million | • Targeted to job creation for youth who have skills by linking the private sector and programs of training institutions.<br>(a) Technical training (industrial sector)<br>➢ Based on the gap analysis of demand and supply of labor force in the high potential sectors, establish training programs and network by the collaboration of private companies and training institutions.<br>➢ Improve the system of labor management and HRD in companies<br>(b) Career service and entrepreneurship promotion<br>➢ Promote education relevant to labor market needs and entrepreneurship, and provide career services in high schools and universities<br>➢ Operate an entrepreneurship promotion center with Pakistani research institutions and foreign organizations<br>(c) Integrated work and learning program for youth with insufficient education<br>➢ The integrated work and learning program will be planned, and its implementing organization will be established after the pilot project to support employment and entrepreneurship of youth with insufficient education.<br>(d) Career information system<br>➢ Manage online portal site about jobs<br>➢ Establish job placement centers<br>➢ Promote women's entry to labor market with the Global Innovation Fund[170] | |

[170] JICA (2010) "SME Development Expert in Pakistan Implementation Completion Report"

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| 2009-2014 | USAID | | FIRMS Project implemented by Chemonics | USD 92.3 million | • Support SMEs in 12 sectors (dairy, educational services, fisheries, jewelry, horticulture and agro-processing, IT, leather, light engineering, marble, medical services, medicines and medicinal herbs, and textile) in 26 districts through private sector development, improvement of business environment and BDS.<br>(a) Private sector development<br>➢ Enhance competitiveness of companies by identifying and removing the constraints on investment, sales and employment<br>➢ Establish market linkages and provide training, technical supports, resources and grant to increase companies' technical capabilities and financial access, secure enough labor force, help enterprises acquire international standards.<br>(b) Enabling business environment<br>➢ Improve the business environment in and public supports to the target sectors (planning, budgeting, policy reform based on the international best practice, rationalization of regulations and administrative procedures, etc.)<br>(c) BDS<br>➢ For sufficient business support for SMEs, introduce franchise systems of private services to public and private customers, which will increase BDS quality and widen the network of BDS providers. | Despite the economic downturn, the project was able to surpass its targets of SME promotion in four of five major value chain indicators: sales, jobs, investment, and women's participation. Regarding the business enabling environment, more than 100 policy reforms have been made.[171] |
| 2009- | Government of Italy, UNIDO | SMEDA | SME Suppliers' Credit | EUR 7.75 million | • Funded by the Government of Italy, UNIDO and SMEDA established an Investment Promotion Unit (IPU) to finance SMEs through SME Bank Ltd.<br>• The fund was financed to SME Bank with 0% interest for 39 years, with which the bank offers supplier's credit in Euro (4%) or PKR (8%) for SMEs.<br>• Applications are sent to SME Bank after the screening by IPU that excludes problematic ones. 80% of finance is directly used for the payment to the procurement of | • At the time of 2010, no finance towards SMEs was realized mostly because SME Bank is not willing to approve loans in PKR for the uncertainty of the exchange rate.<br>• For SMEs, the loan in Euro is risky and hence not attractive. |

171 USAID (2014) "Final Report: Pakistan Firms Project"

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| | | | | | Italian goods and services (i.e. money is not transferred to Pakistan), and the rest can be used for the domestic payment.<br>• The repayment period is 4-7 years with a grace period of 3 years and collateral of fixed assets is required. Priority sectors include leather, marble, agro-industry and jewelry. | |
| 2008-(2020) | DFID | SBP | Financial Inclusion Program (FIP) [172] | GBP 50 million | • GBP 50.25 million was granted for SBP's FIP aiming at providing equitable and efficient financial services to the poor through CGS for Microfinance Providers (MFPs) and SMEs, as well as implementing institutional and regulatory reforms.<br>• Additionally, an Accountable Grant was signed with the Pakistan Microfinance Network (PMN) to strengthen its services to the microfinance industry in 2016.<br>• Expansion of the scope and outreach of financial services, including the promotion of value chain financing, warehouse receipt financing and digital payments, is also planned. | • The cumulative figure of PKR 20 billion (GBP 147 million) became available for lending since MCGF's inception in 2008, while the cumulative number of SMEs receiving a CGS-backed loan was 22,909. |
| 2007- | IFC | Habib Bank Ltd. (HBL) etc. | | | • IFC has invested a total of USD 1 billion in: (a) financial institutions (mostly equity participation and advice), (b) the manufacturing sector, and (3) infrastructures in Pakistan.<br>• Loan was extended only to Habib Bank Limited (HBL) in April 2015 (up to USD 150 million),[173] since the bank needed hard currency finance which is restricted in Pakistan. In exchange for a loan in hard currency provided by IFC, HBL increased SME loans.<br>• The advisory services for commercial banks have been offered since 2010 to HBL, Bank Alfalah, United Bank, Meezan bank, and Allied Bank.<br>• The service, which usually takes 18 to 24 months for each bank, is to assist the banks in formulating and | • HBL's Small Business Finance program contributed to the creation of 1,170 full-time jobs in SMEs. Mostly, the credit disbursed was used for working capital.[174] |

[172] DFID (2016) "Annual Review"
[173] IFC (2015) "IFC and HBL Supporting Job Creation in Pakistan"
[174] IFC (2015) "IFC and HBL Supporting Job Creation in Pakistan"

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| | | | | | implementing a comprehensive business model for SME finance. | |
| 2006-2009 | ADB | GoP (Ministry of Finance) | Improving Access to Financial Services (Phase I) Program[175] | USD 322 million | • The Program consists of a USD 300 million loan from the ADB's ordinary capital resources, a loan equivalent to USD 20 million from ADB's Special Funds resources, and a USD 2 million technical assistance (TA) grant.<br>• The Japan Fund for Poverty Reduction financed an additional grant of USD 2 million in support of the Program's objectives.<br>• The programmatic loan includes two tranches, each to be released after compliance with specified policy actions, some of which are (a) promotion of technology and applications to achieve a national scale of microfinance services at reduced cost; (b) expansion of the range and quality of financial products and services provided by microfinance institutions (MFIs); (c) development of public-private partnerships to expand outreach; (d) development of reliable business and credit information and systems; (e) provision of fast, reliable, and lower cost remittance services by commercial banks for overseas workers; and (f) financial literacy and capacity building. | • There has been substantial progress in implementing the Program. First, the Government adopted a national strategy for inclusive financial services and began its implementation. Second, the Government took several actions with respect to Khushhali Bank, which are designed to improve its performance and contribution to the private sector. Third, the Government implemented measures to promote competition among MFIs and protect loan borrowers by requiring uniform disclosure of the full cost of lending. Fourth, the Government took action to facilitate the introduction of new products and services by microfinance providers. (Progress at the time of June 2008) |
| 2006-2012? | USAID | GoP (Ministry of Finance) | Competitiveness Support Fund | USD 11.5 million | • The fund is established to increase competitiveness of the industry of Pakistan by supporting organizations that work for innovation and regulatory reforms.<br>• It is used for: (a) grant aid for materialization of innovative projects; (b) technical cooperation; and (c) finance through venture capital with the fund from USAID being spent mainly for (b) technical cooperation.[176] | • GoP allocated funds to implement recommendations from CSF's Action Plan for some sectors.<br>• However, it was mentioned in the article that the fund terminated its operation in March 2012.[177] |

[175] ADB (2008) "Progress Report on Tranche Release"
[176] USAID (2008) "Report on Evaluation of the Competitiveness Support Fund, Pakistan"
[177] Dost Pakistan "Competitiveness Support Fund" http://www.dostpakistan.pk/competitiveness-support-fund/ (Accessed December 18, 2017)

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| 2005-2010? | USAID | National Bank of Pakistan (NBP) | | | • Under the USAID program, ShoreBank International provided NBP with technical assistance for enhancing SME lending. | • ShoreBank International introduced a bonus system for NBP's loan officers based on the number of loans disbursed and the quality of the performance of the loan they managed.<br>• Loan officers were trained in the new lending methodology with onsite support provided to active branches.<br>• The number of loans to SMEs extended by NBP reached 510, amount of which is more than USD 12 million.[178] |
| 2004-2009 | ADB | | SME Sector Development Program | USD 170 million | • The finance for SME policy development and promotion of SMEs, consists of USD 152 million of policy loan and USD 18 million of project loan.<br>• The program is to have 3 outputs:<br>(a) Improve SME policy environment: Develop SME policy, establish effective labor protection and inspection policies, enhance SMEDA's effectiveness and outreach to SMEs by shifting its role from BDS implementation to development of SME policy;<br>(b) Improve market-based SME access to BDS: Enhance SME competitiveness through private sector services (establish Business Support Fund to cover 50% of BDS service charge): and<br>(c) Improve market-based access to and delivery of SME finance: Improve regulatory and credit information infrastructure and build private FI capacity, restructure and privatize SME Bank. | • SME Policy was adopted, but its implementation mechanism has not been developed, and SMEDA remains to be a direct implementer of BDS.<br>• Only the establishment of the regulatory framework was the condition of finance with little attention being paid to its effectiveness.<br>• ADB continued the loan despite insufficient effectiveness of the SME policy.[179] |

[178] World Bank (2009) "Bringing Finance to Pakistan's Poor: Access to Finance for Small Enterprises and the Underserved"

[179] ADB (2009) "Completion Report"

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| 2004-2007 | USAID | | Behind the Veil Program implemented by Mennonite Economic Development Associates (MEDA)[180] | USD 633,000 | • The project aims at building the value chain of embroidery in Thatta, Hyderabad, Karachi and Multan. USAID funded USD 506,000 and MEDA USD 127,000 | • Totally 213 intermediaries were trained, and 9,425 rural embroiderers were connected to the markets, among which 213 sales agents regularly engage 6,748 embroiderers. The income of embroiderers almost tripled on average. |
| 2004-2008 | USAID | | Pakistan Initiative for Strategic Development and Competitiveness (PISDAC) | USD 11.3 million | • Design and implement development strategy in sectors of dairy, gems and jewelry, marble and granite, horticulture, furniture, and surgical instruments to increase their competitiveness by adding productivity and value.<br>• Strategy Working Groups (SWOGs) established in each sector implemented the following activities:<br>(a) Establish model companies/facilities;<br>(b) Establish common facility centers;<br>(c) Establish training and research centers;<br>(d) Promote marketing, investment and export, and build the linkage between producers and importers; and<br>(e) Promote the acquisition of quality standard, mechanization and modernization of technology, and improve processing | • SWOGs initiatives generated additional incomes in the sectors.<br>• The final report indicated that the current and expected net present value (NPV) of additional incomes would be USD 209.4 million against the total PISDAC's budget USD 11.3 million.<br>• The report also estimated that PISDAC activities generated 7,902 jobs between 2004 and 2008.[181] |
| 2000-2008 | ADB | SBP | Microfinance Sector Development Project[182] | USD 85 million | • The loan targeted for (a) the expansion of the credit outreach through Khushhali Bank (KB) and (b) institutional strengthening of KB, SBP, 2 NGOs and Zarai Taraqiati Bank Limited.<br>• Out of USD 85 million, USD 74.2 million was financed for (a) credit outreach. | • KB overestimated the demand for microcredit. KB's loan disbursements between 20 August 2001 and 14 February 2006 were PKR 5.51 billion (USD 93.66 million), against an appraisal estimate of PKR 9.29 billion (USD 165.9 million), and its loans outstanding as of 31 December |

[180] MEDA (2008) "Behind the Veil: Access to Markets for Homebound Women Embroiderers in Pakistan Final Report"
[181] USAID (2008) "Economic Impact Assessment of the Pakistan Initiative for Strategic Development and Competitiveness (PISDAC) and Final Report"
[182] ADB (2008) "Completion Report"

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| | | | | | | 2007 totaled PKR 2.65 billion (USD 43.5 million).<br>• SBP did not use the funds for enhancing its capacity of supervising microfinance institutions because SBP received grant funding from the Swiss Agency of Development Cooperation for the same purpose.<br>• KB's performance on staff training was found to be satisfactory. |
| | ADB | | Business Support Fund | | • The fund was established as a part of ADB's SME Development Program. After the completion of the program in 2009, the fund was transformed into a non-profit organization under the Ministry of Finance (MOF) and ADB aiming at enhancing SME's competitiveness and profitability. | • Existence of the fund today is not confirmed. |
| | USAID | | Entrepreneurs project[183] | | • The project offers training that helps recipients develop better products, learn new skills, and organize clusters.<br>• The project's main objective is to increase the incomes of microentrepreneurs (predominantly women) by at least 50% on average, by promoting the production and marketing of selected agricultural and non-agricultural commodities. | • The mismatch of supply and needs of beneficiaries is pointed out in the audit report. |

[183] USAID (2013) "Pakistan Entrepreneurs Project"