Kazi Abdul Muktadir: Engaging the SMEs to stabilize economy

Keynote address by Mr Kazi Abdul Muktadir, Deputy Governor of the State Bank of Pakistan, at the 6th SME Banking Conference, Karachi, 5 September 2012.

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Ladies and gentlemen, it's my pleasure to address the delegates and speakers at this Conference, arranged by ***Shamrock Conferences International***, on **"*Engaging the SMEs to stabilize Economy*".**

Through this Conference, all the stakeholders in the SME sector have been brought together that will generate valuable debate on the issues confronting the sector and look at the various strategies being developed at the regulatory and policy level, to support this very important sector of our economy. It is particularly in this context that this Conference is really a timely initiative.

There exists strong evidence that SMEs expansion boosts employment more than large firm growth due to the fact that SMEs are normally more labour intensive. In Pakistan, the SME sector contributes 30 percent towards the country's GDP, employ more than 70 percent of the non-agricultural workforce, accounts for 35 percent of the value added in the manufacturing industry and generates 25 percent in the export earnings. The sector has huge potential in generating employment and alleviation of poverty in the country.

Today, most big industrial establishments depend on SMEs for their value addition. In most emerging markets, SMEs have played dominating role in the economy especially in reducing the poverty levels. Emphasis has been placed on pro-poor growth led by the private sector especially through SMEs. Sectors such as agriculture, services, manufacturing with heavy content of labor-intensive activities have received much support by the Governments because of their potential for reducing poverty. These countries have also successfully integrated their SMEs with the large corporate sector through sub-contracting which has proved to be an extremely useful and efficient way of integration across the size and scale.

The sustained and long-term growth of SME sector in Pakistan remains constrained by a number of factors on both demand and supply side. Most SMEs are sole proprietorships or family businesses that are managed rather informally, and therefore, face issues such as lack of formal business management skill, poor maintenance of accounts, lack of business planning, etc. They often do not have adequate collateral to meet banks' requirements, and have little awareness about available financing options. Further, reliable research data on important SME segments is also not available for use of banks.

At the same time, on the supply side, one of the primary issues seems to be dearth of appropriate skills to evaluate SMEs' credibility on non-traditional parameters. This is reflected in the lack of innovation in product design and in marketing of financial products for SMEs.

A sustainable solution requires that we take a more holistic view of this problem. A large number of players have to be involved in contributing to the success of SMEs. There are number of different stakeholders who have to work together in a coordinated and cohesive manner to ensure sustainable growth of SMEs especially removing the hurdles in the way of their easy access to finance. Important stakeholders are the Government, State Bank, Commercial Banks, SMEDA and various chambers and SME Associations.

First of all, the Government and State Bank of Pakistan need to provide a conducive and enabling environment for SMEs to operate. This requires that the macroeconomic policies are sound, the regulatory regime is supportive and the legal system is able to enforce contracts and property rights.

Secondly, organizations such as SMEDA have to play a critical role in the business developments support, advisory services and managerial training of SMEs. For example, most small enterprises do not maintain proper accounting of their operation and do not have a trained accountant on their staff. This impedes their ability to access credit from commercial banks. SMEDA can organize training courses in this and many other important areas.

SME Associations also need to come forward and launch awareness programs for their members on the opportunities that are already available, assist them in linking up with the appropriate support institutions, listen to the genuine difficulties and problems faced by their members and communicate these to the concerned quarters.

As far SBP's role is concerned, it has been taking various important measures for improving the business environment for the sector, and addressing financing needs of SMEs. Keeping in view the specific business dynamics of the sector, SBP issued specific Prudential Regulations (PRs) for SMEs in 2003 that greatly helped banks to focus on SME Financing and accordingly align their business strategies. These Prudential Regulations for SMEs do not make it mandatory for banks to require collateral but allow them to take cash flow generation as the basis for loan approval. We have always been open to any suggestion from the sector for further improvement and strengthening of these regulations.

Further, SBP has introduced various Refinance Schemes for SMEs. These schemes carry concessional rates for the end-users, in order to meet both short-term and long-term needs of different SME segments. Of special mention in these schemes are the Schemes for Modernization of SMEs, for developing alternate energy resources and establishing silos and storage houses. The maximum use of these schemes by SMEs can benefit the sector in a big way with resultant positive impact on the economy.

SBP has also launched a Credit Guarantee Scheme for Small and Rural Enterprises that shares credit losses of banks, to the extent of 40 percent on loans to the Small Enterprises, under a UKAID-supported financial inclusion program. This Scheme has been highly successful and the latest figures show that 64% of the guarantee limits allocated to banks have been utilized by them. Discussions are underway to further enhance the size of this facility so that a larger number of Small Enterprises are accommodated under the Scheme.

Additionally, SBP, in collaboration with IFC, is assisting banks in their capacity building efforts, focusing on the areas of Strategy Formulation, Product Development, Risk Management, HR Development and Marketing Area. Initially, Bank Al Falah has been selected for its capacity building, while many other mid-tier banks have been lined up for the subject consultancy project. This project will revitalize the SME lending by the participating financial institutions and will be a prototype for other financial institutions who could see financing to SMEs as profitable business ventures.

Keeping in view the absence of credible research data on SME clusters, SBP has been undertaking cluster development surveys, in partnership with IFC and LUMS, that will greatly help stakeholders, and especially banks, in coming up with cluster-specific products and tailored SME banking strategies. So far, 11 clusters have been covered whose survey profiles are available on the SBP Web, while surveys of 10 more SME clusters are underway, that will soon be completed for the use of relevant stakeholders.

Lastly, I would emphasize the role of banks that is crucial for the development of SMEs, given their critical positioning and greater capacity in terms of their outreach and availability of funds. The actual statistics for lending to SMEs are not satisfactory in recent years. Bank credit to SMEs has declined over the last 4 years from Rs 437 billion in 2007 to Rs 248 billion on June, 2012. With this decline, the SMEs' loan proportion to the total advances of banks has also decreased from 16 percent in 2007 to less than 8% percent in 2012.

Although, this decline can partly be attributed to adverse economic conditions during the period and growing NPLs, however, a more risk-averse posture of banks remains a major factor responsible for their low exposure to SMEs. In the recent years, banks have increasingly invested in safer havens – opting for government paper and increased financing for commodity operations, rather than supporting the fragile private sector which is the main driver of economic activity.

I would stress the financial industry to break-out of the tendency of lending to conventionally profitable and relatively safer sectors, and rather move towards promoting SMEs through prudent banking solutions. The banks should formulate strategies to overcome the challenges presented by the market as well as by the cyclicality in economic conditions. Banks need to shift from traditional banking approach towards SMEs to the provision of more customized and differentiated financial products and services to suit different SME segments. They also need to develop and implement appropriate credit evaluation techniques used globally such as credit scoring, cash flow based lending, and program based lending.

A strategic shift in focus for SMEs would greatly benefit the financial institutions themselves as SMEs will grow into larger corporations, resulting in increased business opportunities for them. Banks need to remember that their industry is only as strong as the underlying economy.

Let me conclude by restating the fact that SMEs will continue to play a very important and vital role in our economy where the twin problems of unemployment and poverty constitute major development challenge. Well targeted government intervention in this sector and effective coordination among the stakeholders remain indispensable for the true development of the sector and its sustainability.

Given the quality of participants in the conference, I am convinced that useful policy recommendations will emerge at the end of different sessions.

Thank you.