



**International
Finance Corporation**
World Bank Group

Developing a Sustainable SME Banking Franchise in Pakistan

Best Practices and Policy Insights

Andrew McCartney
Senior SME Banking Specialist, IFC
Karachi, March, 2011

Key Messages

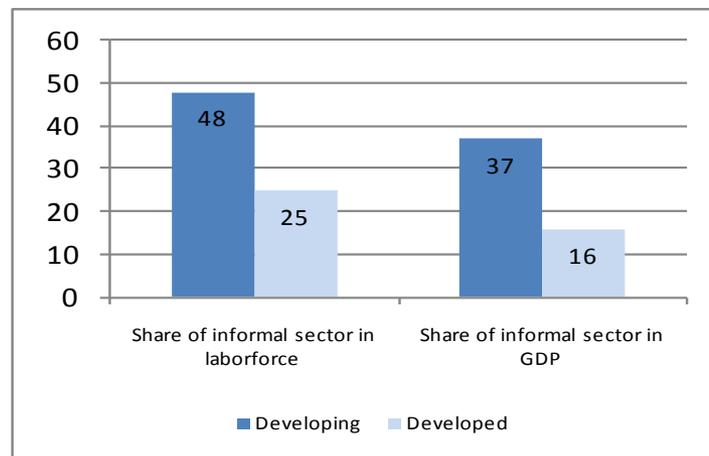
- SME growth represents a cornerstone of any successful economic development policy
 - SME's are a key engine of job creation and GDP growth
 - Access to financing represents a major driver for growth of SME's
 - Appropriate government interventions can stimulate sustainable SME lending
- SME constitutes a significant opportunity for Banks, providing the risk and returns are managed carefully.
 - SME Banking can be very attractive and profitable
 - However, the right capabilities need to be put in place
 - Today, the majority of Banks in Pakistan do not have these capabilities
 - Institution building work can support the development of these capabilities
- Going forward Institution building is now required to support the Banks along their respective business transformation journeys

SMEs globally account for a significant share of employment and GDP, especially when considering the informal sector

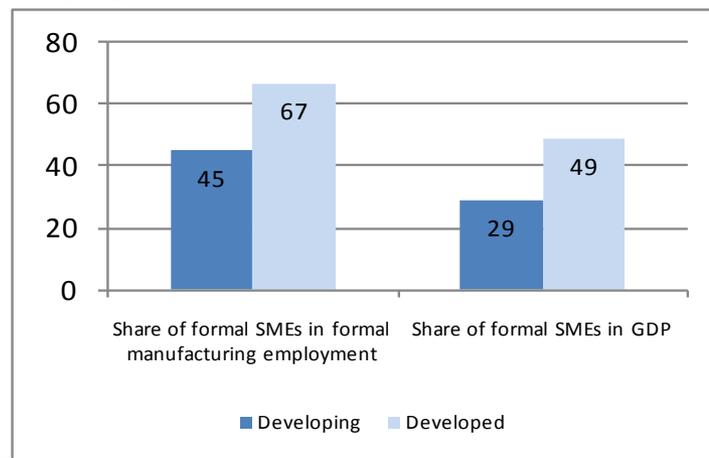
Key findings

- SMEs contribute a sizeable share to formal GDP - 29% on average in developing countries
- Informal sector consisting predominantly of SMEs accounts for up to 48% of total labor
- SMEs create more jobs than large firms. Employment in start-ups contributes greatly to overall job creation. US net employment growth would average negative without start-ups*
- Research indicates that SMEs could contribute more to economic development than they currently do. Majority of SMEs are small in nature
- WB Research Group (DECRG), concluded that SMEs are equally likely to be a characteristic of successful economies as they are to be a cause.

Share of Informal SMEs in Labor Force and GDP



Share of Formal SMEs in Formal Manufacturing Employment and GDP

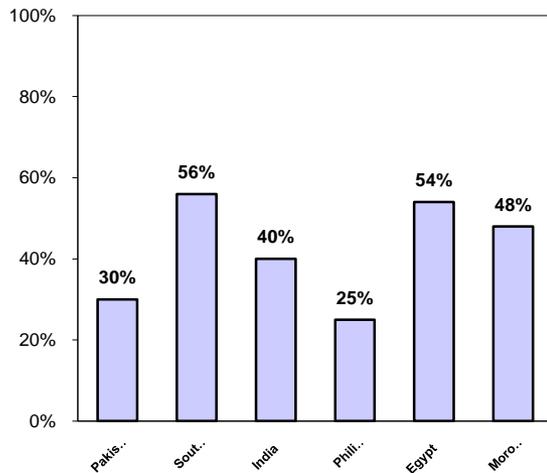


“80-90% of investment in developing countries is home grown...small business should be supported to stimulate economic growth, engender structural changes, reduce marginalization and create a more equitable income distribution” W.Luetkenhorst, UN Industrial Development Organization

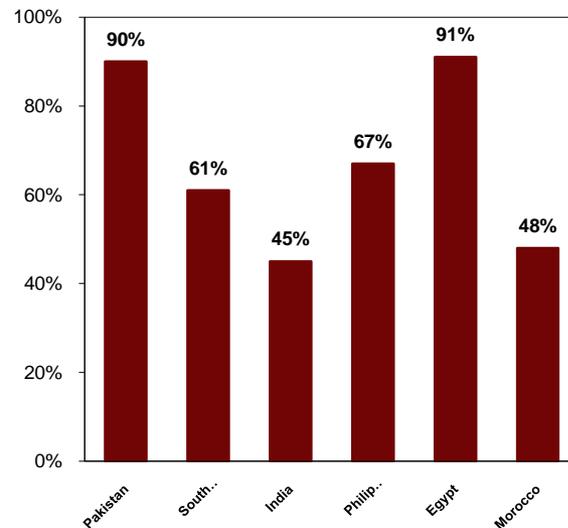
* Tybout 2002

Indeed, SME's are already a very important part of the Pakistan Economy

SMEs strongly contribute to the Pakistan economy ...



Contribution to GDP%



Contribution to employment* %

- Approximately 3.2 Million businesses in Pakistan of which an estimated 3 million are SME's
- SME census shows SMEs contributing more than 30% to the GDP and 25% to the country's total export earnings
- SMEs employ 70% of the labor force in manufacturing, services and trade

* Non-agricultural employment

Access to finance represents one of the major drivers for the growth of SMEs, especially in emerging markets

Top 10 types of regulation affecting number of SME's and growth potential

- Starting a business
- Dealing with construction permits
- Employing workers
- Registering property
- Getting credit
- Protecting investors
- Paying taxes
- Trading across borders
- Enforcing contracts
- Closing a business

Top 6 barriers to growth for SME's in developing countries

- Limited Access to finance
- Lack of electricity
- Heavy regulation
- High tax rates
- Practices of competitors in the informal sector
- Corruption

Source: Doing Business Report 2010, World Bank, Enterprise Surveys, IFC

Access to finance for SMEs in Pakistan remains constrained.....

- Fewer than 200,000 SME's (7% of SME's) currently borrow from banks in Pakistan
- SME lending has been on a downward trend over period from 2004 onwards accounting for 16% of total lending
- This extends to financial service outreach also, with less than 40% SME's found to have any form of banking relationship currently
- KfW survey estimates an SME funding gap of Rs277 billion (current SME lending 400 billion) for small businesses alone, representing some 1 million SME unserved SMEs as a minimum

... Finance gap is heavily concentrated in the S of SME.....

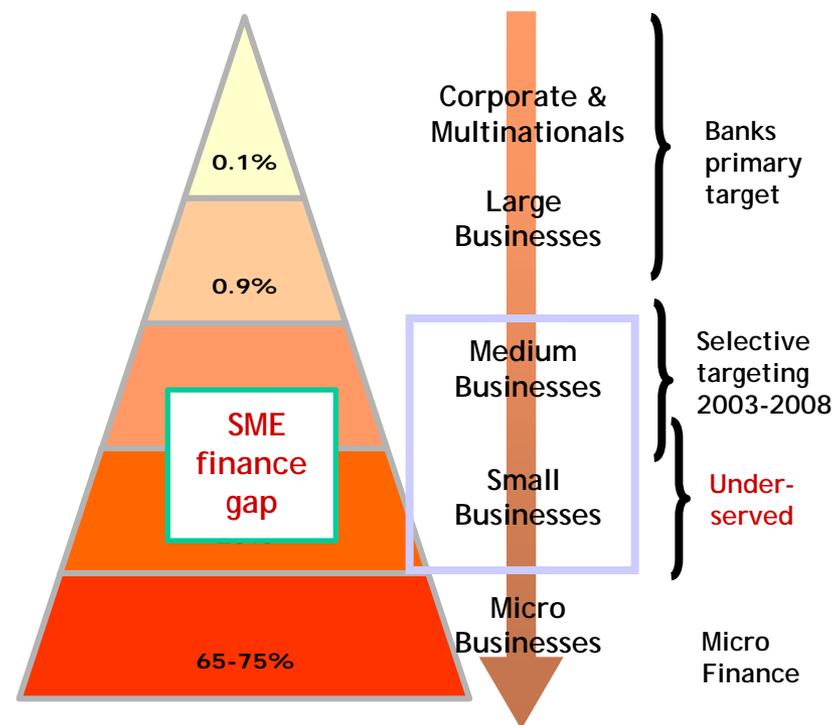
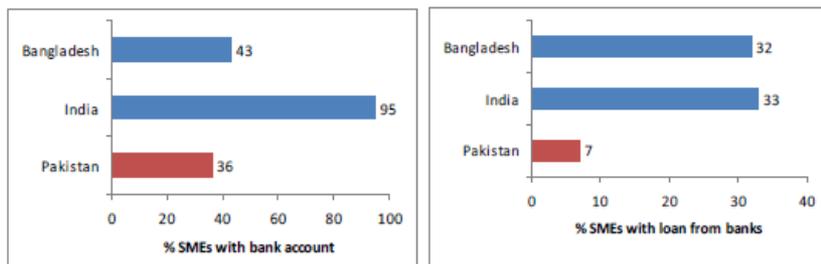


Figure 4.1: Access to Finance for SMEs in Pakistan, India and Bangladesh



Source: India ICA 2006 Manufacturing Enterprise Survey, Bangladesh 2006 Rural MSME Finance Services Survey, Pakistan KfW Demand Survey 2005

What has IFC learnt after 30 years?

- Deficiencies in the enabling environment and residual market failures (such as enforcement difficulties, imperfect information, protection of depositors, and market power) have motivated government interventions in the SME Finance
- PCG schemes are the most market-friendly types of interventions but often add only limited value and prove costly when they are not designed well. Common problems:
 - Loose criteria,
 - low fees,
 - Overly generous coverage ratios and payment rules
- Result: the provision of guarantees to enterprises that would have obtained credit anyway.
- Government can play a key role in building the capacity of financial institutions to serve the SME sector, frequently with the assistance of international organizations. Example: China SME lending project.
- In general, pricing should reflect the division between private and public benefits. In general, except where “pure” public goods are involved, subsidies are distorting and should be avoided

Key Messages

- SME growth represents a cornerstone of any successful economic development policy
 - SME's are a key engine of job creation and GDP growth
 - Access to financing represents a major driver for growth of SME's
 - Appropriate government interventions can stimulate sustainable SME lending
- SME constitutes a significant opportunity for Banks, providing the risk and returns are managed carefully.
 - SME Banking can be very attractive and profitable
 - However, the right capabilities need to be put in place
 - Today, the majority of Banks in Pakistan do not have these capabilities
 - Institution building work can support the development of these capabilities
- Going forward Institution building is now required to support the Banks along their respective business transformation journeys

SME Banking can be certainly be very profitable when done right...

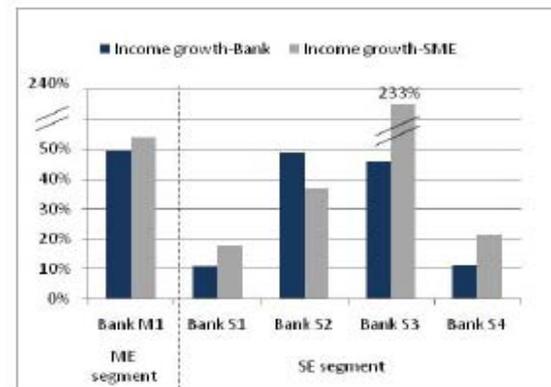
Key observations

- Often the most profitable part of the Bank on a risk return basis
- Ability to leverage existing corp/ retail infrastructure and automate for low costs critical
- Yields can be very attractive (S- 16-22%, M 9-15%)
- Margin compression inevitable but can be negated by establishing a “total wallet” P&L
- Key profit drivers are typically deposits and transaction banking, representing between 50-60% of total SME business profitability
- Need to take a 5-year view of product profitability

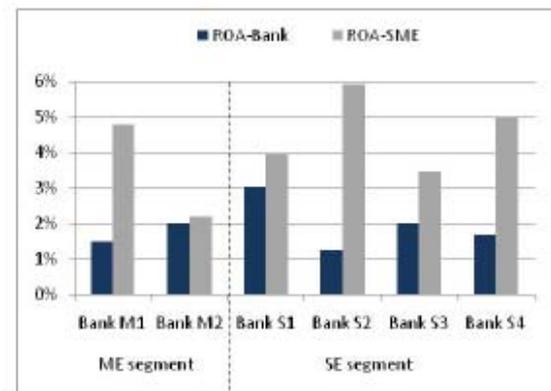
“We want to double in 3 years. Returns are the best in the Group. Risk-returns are now twice as high as all our consumer banking businesses”

Global Product Head, SME Banking Standard Chartered
Sept.2010

Faster Revenue Growth.....

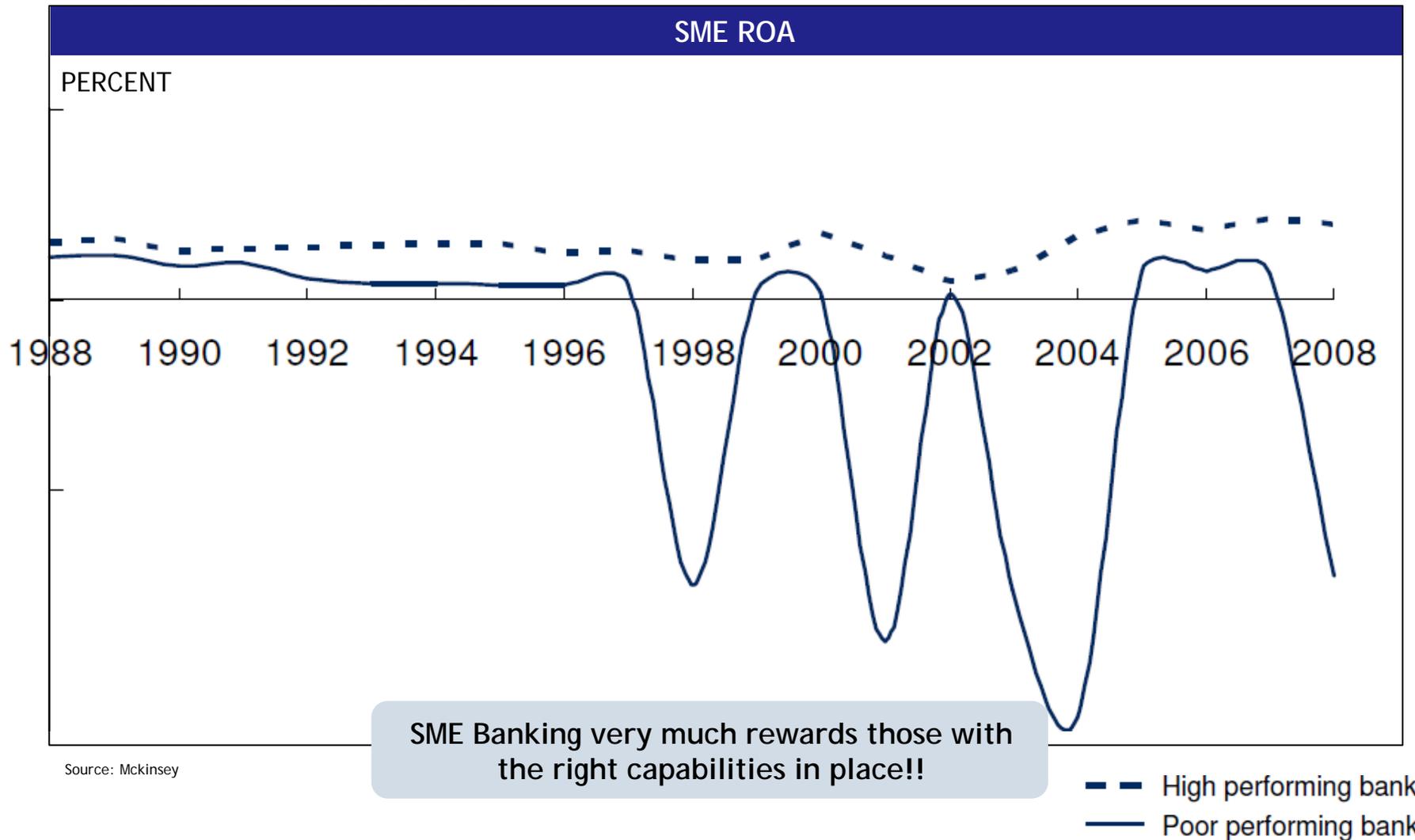


Higher RoA's.....



Source: IFC (2007) Benchmarking SME Banking Practices in OECD and Emerging Markets

But performance in SME Banking can vary considerably between the winners and the losers...



Banks in Pakistan are increasingly seeing opportunities in targeting the SME segment for growth...

Key themes



- Credit stagnation for last 18 months, with many adopting stop-start approaches
- Flight to quality has saturated the large corporate segment
- NPL Management has been the key driver of SME Banking profitability
- Post-mortem activities underway: what is wrong with our current approach?

But.....

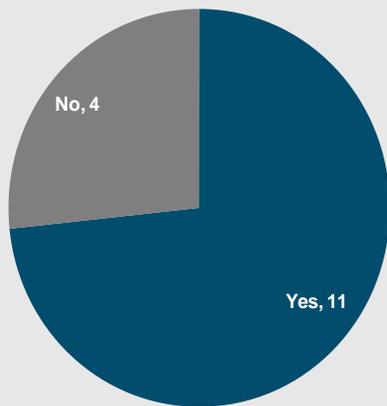
- Boards are now refreshing their strategies towards the segment and going for growth over next 3 years

“There is an increasing realization at our Board level that the new battleground for growth over the next 5 years will be the underserved SME”

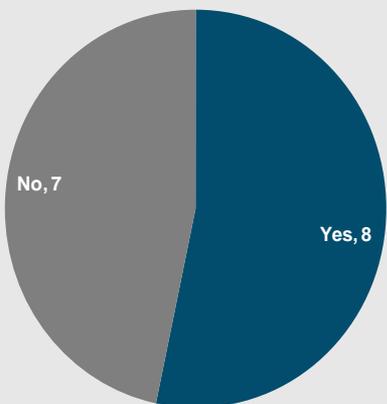
Senior Manager, Large Private Pakistan Bank Sept 2010

Indeed, a recent survey showed that 80% of Pakistan's top banks now wish to focus strategically on SME Financial Services

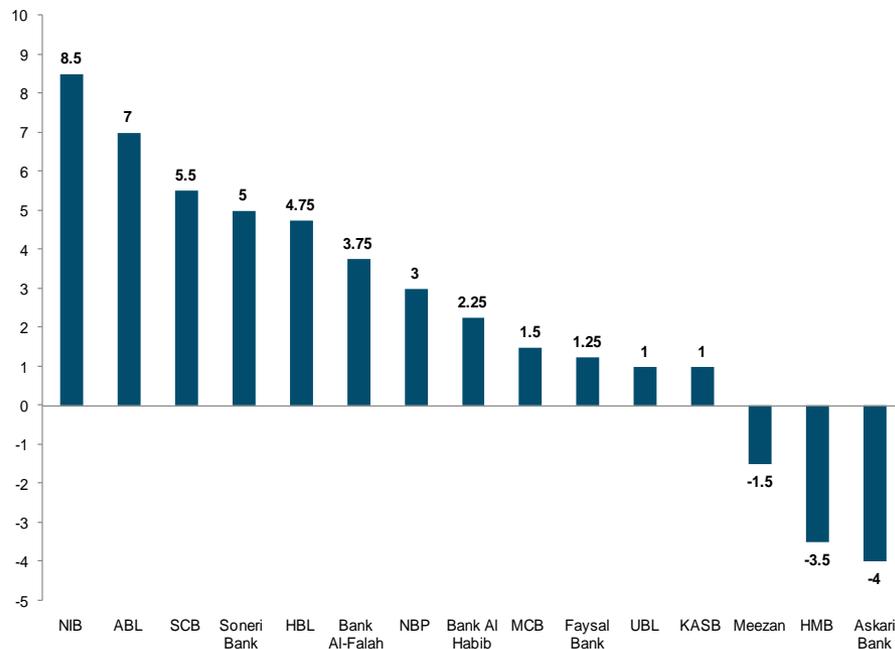
Focus of Top Management to offer SME Financial Services



Banks with separate SME Business Unit



Total Score based on the scoring module - Overall Strategic Focus



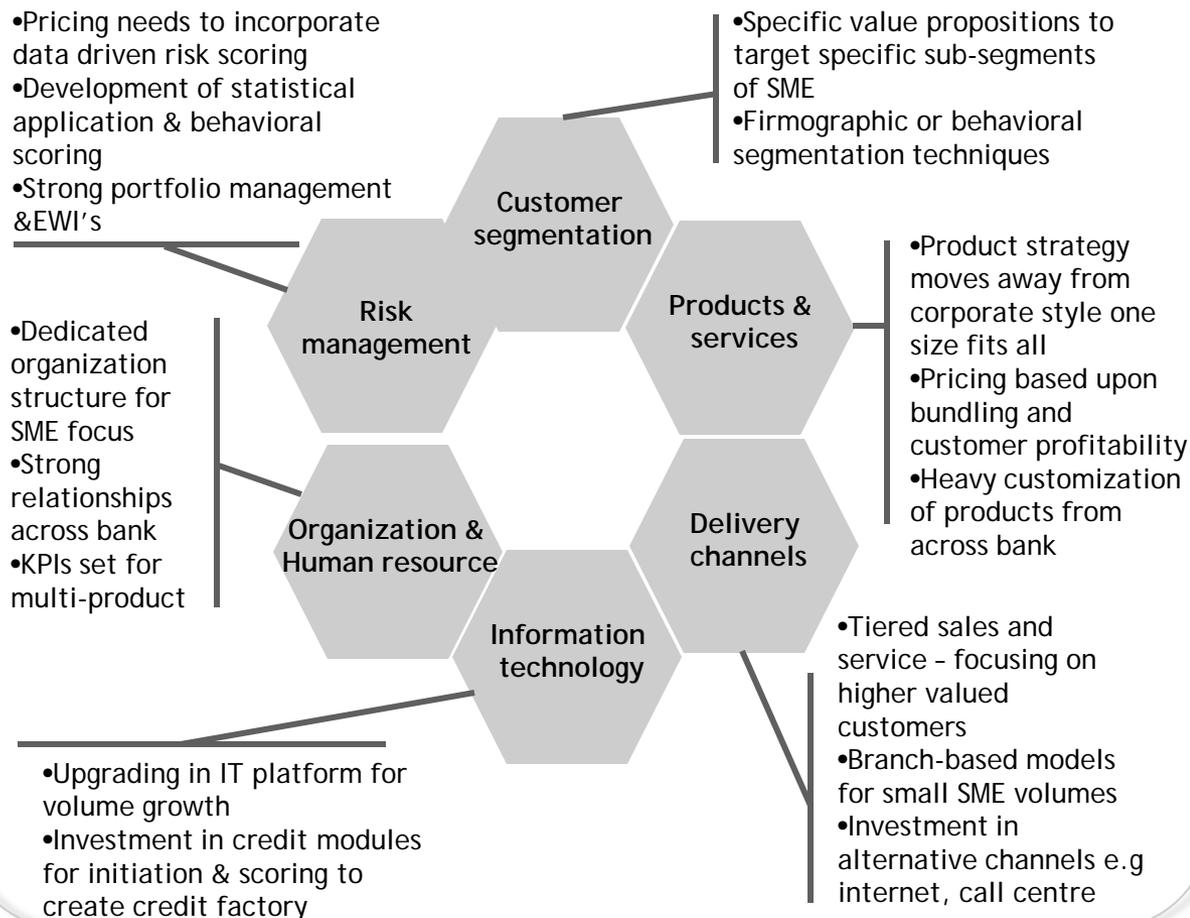
- Negative scores have been assigned to banks on account of the following attributes:
 - No strategic focus to offer SME Financial Services
 - Banks without a separate SME Business Unit
 - Banks with SME portfolio less than 5% of total bank portfolio
 - Banks with less than 5% market share of SME sector portfolio

In IFCs experience, Banks in Pakistan need to build strengths across a number of areas.....

Common models in Pakistan today

- SME treated as corporate for medium SME and/or retail clients for small SME
- Relationship-driven mid-tier banks with low growth and NPLs
- 100% secured lending driven with undifferentiated products of service levels
- Limited product program approaches
- Scientific approaches have been discredited over last 2 years
- Emphasis upon lending, not SME Banking

....Banks need to build capacity across 6 main areas to succeed in SME banking



IFC Internal Analysis, Pakistan 2010

The Pakistan Banking Sector still has a long way to go in terms of developing the capabilities to target the SME segment.....

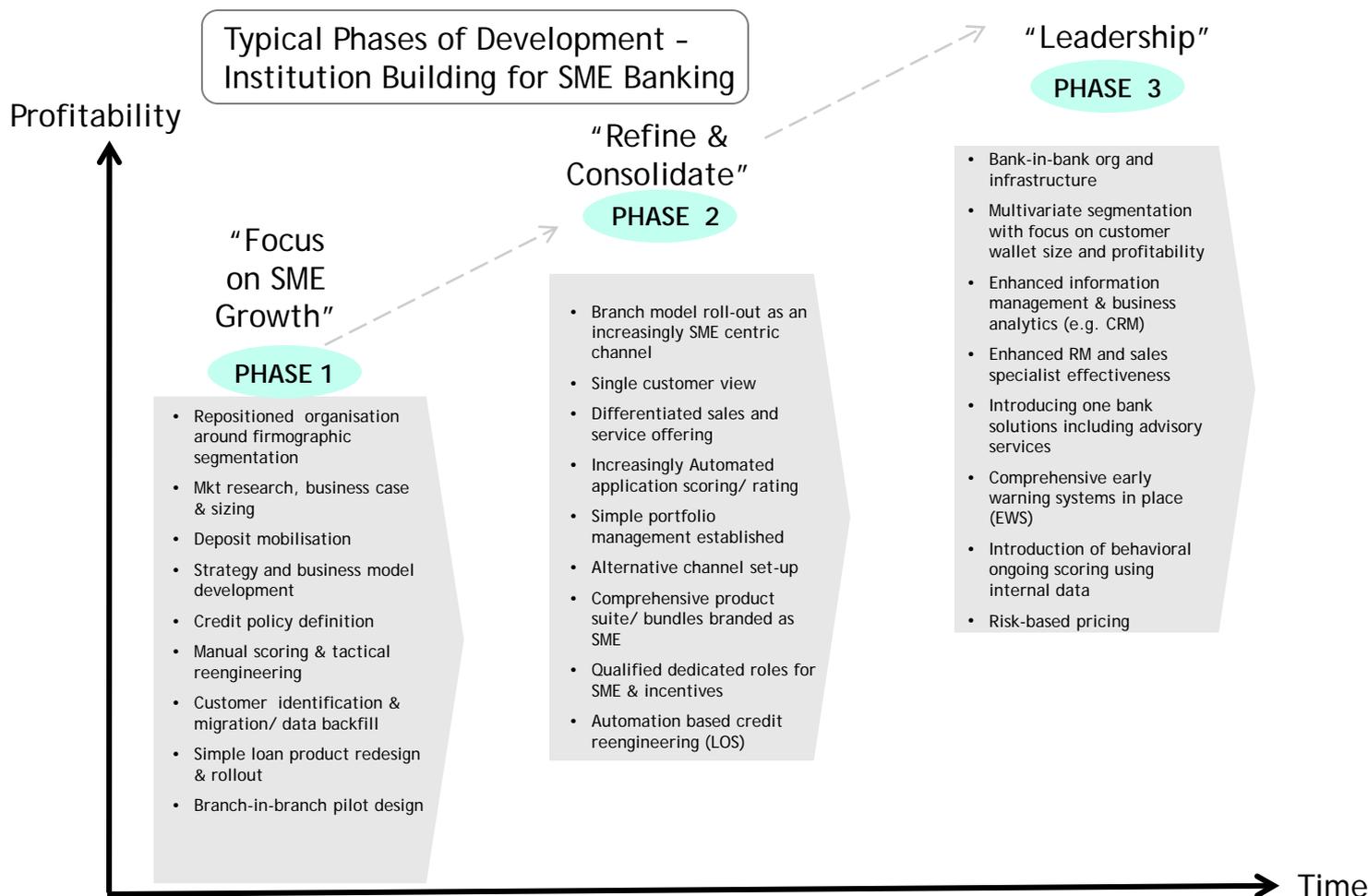
- Pakistani banks still predominantly treat SME's as large corporates or low-volume relationship models.
- Limited specialization in SME lending, and 50% of banks lacking SME tailored asset and liability products
- Procedures and policies for SME's remain complex, time consuming and costly
- Organisation and delivery structures are not conducive for high efficient SME banking operations
- Heavy reliance (90%+) on collateral rather than business based lending

Selective Metrics - Pakistan SME Banking segmentation study 2010	Value
No. banks with Separate SME Unit	50%
Average age of SME unit	<5 years old
Dedicated av. Number of employees per unit	1-15
No. Banks with SME branches	13%
No. banks with tailored products for SME	53%
Specialized credit process/ loan origination	13%

Key Messages

- SME growth represents a cornerstone of any successful economic development policy
 - SME's are a key engine of job creation and GDP growth
 - Access to financing represents a major driver for growth of SME's
 - Appropriate government interventions can stimulate sustainable SME lending
 - SME constitutes a significant opportunity for Banks, providing the risk and returns are managed carefully.
 - SME Banking can be very attractive and profitable
 - However, the right capabilities need to be put in place
 - Today, the majority of Banks in Pakistan do not have these capabilities
 - Institution building work can support the development of these capabilities
- Going forward Institution building is now required to support the Banks along their respective business transformation journeys

Going forward Institution building is now required to support the Banks along their respective business transformation journeys



IFC Internal Analysis 2010

IFC SME Banking Advisory has a set of products and solutions that can be customized for institution building

- Lead financial institutions to recognize and seize the untapped and profitable opportunities that the SME segment represents

- Raise awareness of best practices in SME Banking

- Build capacity of partner FIs committed to expanding financial services to SMEs and underserved market segments

Strategic Advisory

- Leading practice diagnostics
- Benchmarking
- Market assessments & sizing
- Business/strategic planning
- Strategic segmentation

Technical Business Support

- Sales/marketing planning
- Customer management
- Product optimization
- Credit reengineering
- Branch redesign
- Organization realignment

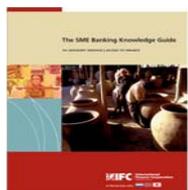
Institution Building

- Risk Management development
- Capital management & economic capital modeling
- ALM and market risk
- NPL and collections
- Corporate governance

Specialist Products

- Gender finance
- Energy efficiency
- Trade finance
- Business Edge
- SME Toolkit

IFC has a range of tools to support the industry



•**SME Banking Knowledge Guide:** Outlines leading practices and success factors for profitable SME banking operations. In six languages.



•**Banking Training Program:** Developed 3-day training course consisting of six modules covering the following areas: Strategy & Commitment, Understanding the Market, Product Design, sales & Delivery Channels, Credit Risk Management and Support Functions.



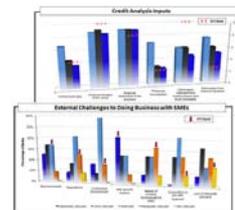
•**MSME Factsheets 2009:** Communicate achievements and showcase successes in our MSME Access to Finance advisory and investment services.



•**The MSME finance gap** is widely discussed, but to date, there have been few efforts to quantify either the number of MSMEs in the world or the nature of their met and unmet financing needs. This paper assess and describes the MSME finance gap.



•**SME Banking CHECK Diagnostic Tool:** A guide to assess SME banking operations and design relevant advisory services projects.



•**SME Banking Benchmarking:** An online SME Benchmarking Survey. Automatically benchmarks SME banking practices.



•**SME Banking Dashboard 2009:** Communicate program activities, achievements, new developments, portfolio composition and showcase success projects



•**Closing the SME finance gap:** A study on the SME finance abatement curve, methodology and how it can be used to calibrate the effectiveness of policy interventions in various countries aimed at closing the gap

Find these products and tools at <http://www.ifc.org/smebanking>

IFC has now been recognized as the knowledge leader for SME banking by the G20



IFC is currently supporting the G-20 **SME Finance Sub-Group**, leading an effort to:

- a. Conduct a **Stocktaking Exercise** on global SME Finance mechanisms to derive recommendations for the G-20 on scaling up SME financing
- b. Launch the **SME Finance Challenge**: *"A call to the private sector to put forward its best proposals for how public finance can maximize the deployment of private finance on a sustainable and scalable basis."* Winners to be announced in November 2010 summit in Korea "
- c. Propose to establish a **Global SME Finance Facility** to support the winners of the SME Finance Challenge and beyond (under discussion by G-20)
- d. Establish a **Global SME Finance Forum** to address the need for a knowledge management center for SME Finance (under discussion by G-20)
- e. Set up an **SME Finance Data** Working Group