

# Challenges and Potential of SME Sector Financing in Pakistan and a Way Forward; through CPEC

## Introduction:

Small and Medium Enterprises (SME) are the firms that have limited businesses activity. Commonly, SMEs are the startup companies or already operating companies with limited financing. By a standard textbook definition; SME is characterized by the firm having a number of employees and various amounts of financial assets. According to OECD, Small and medium-sized enterprises (SMEs) are non-subsidiary, independent firms which employ less than a given number of employees. This number varies across countries. The most frequent upper limit designating an SME is 250 employees, as in the European Union. However, some countries set the limit at 200 employees, while the United States considers SMEs to include firms with fewer than 500 employees.

In Pakistan, SME authority is the Small and Medium Enterprise Development Authority (SMEDA). According to the state bank of Pakistan, 'A small Enterprise (SE) is a business entity which does not employ (including contract employees) more than 50 persons and annual sales turnover is up to Rs.150 million. Small Enterprises can be extended finances up to Rs.25 Million.

With small size of SME there are a number of problems in getting the proper financing for the firms due to new entry, credit worthiness, risks of venture failure and the ability to service their loans properly. Now, that China Pakistan Economic Corridor (CPEC) is near its completion of early harvest stage, a number of bottlenecks that had previously retarded the industrial growth in Pakistan are also being removed one by one e.g. energy projects, law and order situation and new network of communication. In this scenario, it is expected that SME will be the main beneficiaries of the opportunities produced under the CPEC. Also a number of other countries such as China, European Union countries and USA have shown interest in investing in Pakistan.<sup>1</sup> With expected growth, the need for financing is also intensely felt.

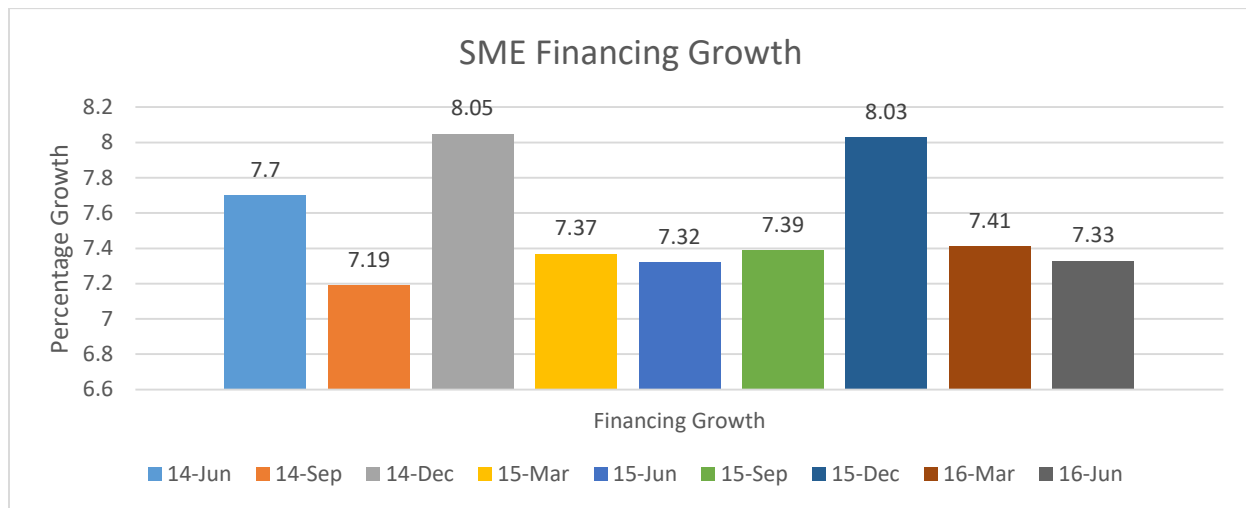
## Situation of financing in Pakistan

Year (December)	Total private sector loans	SME loan outstanding	Growth	Percent in total	No. of SME's financed by banks and DFIs
2012	3144	267	-	8.5	132,167
2013	3332	273	2.25	8.1	136,940
2014	3579	288	5.49	8	134,521
2015	3864	305	5.90	7.9	157,887
2016	4359	401	31.48	9.1	177,595

*Figure 1 Banking and DFI loan financing of SMEs Source: SBP Annual SME Review, 2016*

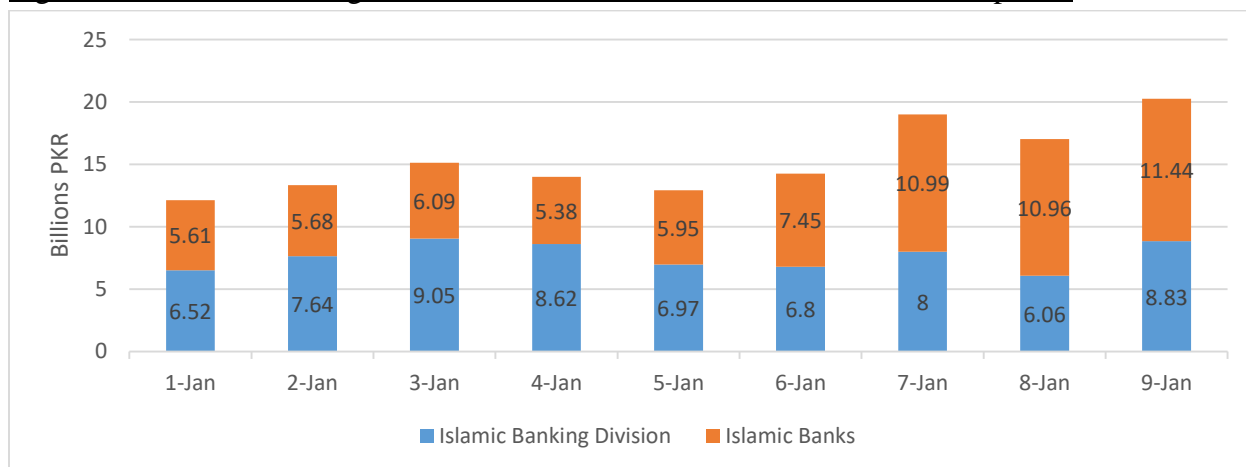
<sup>1</sup> <https://www.imf.org/external/np/seminars/eng/2015/jica2015/pdf/1-B11.pdf>

**Figure 1: Showing the quarterly growth rate of SME financing**



*Figure 2Source: SBP Quarterly SME Review*

**Figure 2: Islamic Financing and Conventional Banks with Islamic Finance Options**



*Figure 3SBP SME Financing Annual Report*

### **Policy Recommendations:**

1. Commercial banks are unable to provide loans to the SMEs because most of the SMEs do not keep the fair and clear financial statements. They usually have different statements for different people, e.g. general public, tax authorities, partners and themselves. So the need is to improve this issue.
2. The other contributing factors to the issues in SME financing are the low HR capacity. With low capacity, book keeping of the SMEs is problematic which leaves the financial statements unclear and hence cost the credit worthiness of the firm.

3. SMEs can raise funds not only from banks but also from the equity market. But here, very few numbers of SMEs are willing to float new equity in the fear of equity dilution. This hurts the SME growth. So this area needed to be focused by the financial institutions.
4. Pakistan should realize the importance of SME development; especially for employment. There is need to have a concrete SME policy. For CPEC completion, Pakistan must focus B2B sector and not just G2G.
5. Pakistan should have a strategy to provide suppliers for foreign financed projects so that more benefit could be accrued from such projects.
6. The empowerment of SMEDA and TDAP is compulsory for the growth of SMEs and related issues.
7. One of the most important hurdles in the way of financing to the SMEs is an A-symmetric of information which prevents the institutional investors as well as individual investors from investing in the small and medium enterprises. There are no proper rules and regulation for SMEs to disclose their information which makes investors reluctant to finance the SMEs. In order to boost financing for the SME sector we need proper discloser of information of SMEs so that risk can be minimized.
8. There is dire need to adopt the advance financial mods of financing so that entrepreneurs may have vast range of choice to get finance. In a country like Pakistan Islamic mods of financing is of great importance, because conventional banking is not accepted by a large diaspora in Pakistan.

**Note:** *This document is based on Annual International Conference's session, which was mutually organized by Centre of Excellence-CPEC and Sustainable Development Policy Institute (SDPI) on 5th December, 2016.*