KARANDAAZ

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# Pakistan Innovative Finance Forum

November 25-26, 2019

Islamabad

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# Innovative Financial Solutions for SME Finance: Synthesis of Takeaways

Karandaaz Pakistan, in partnership with the Asian Development Bank Institute (ADBI), Japan; and the Pakistan Resident Mission of Asian Development Bank (ADB) organized a two-day conference—Pakistan Innovative Finance Forum ("Forum")—on 25 and 26 November 2019 in Islamabad. The second day of the Forum focused on innovative models and approaches for increasing access to finance for small and medium enterprises SMEs. Speakers and panel participants deliberated on various aspects for developing a market for SME financing.

The key topics included: i) data mining for credit decisions, ii) crowdfunding to release reliance on bank capital, iii) invoice discounting and social impact funding, and iv) effective techniques for meaningful impact assessments. In addition, SMEs participating in the Forum also shared first hand experiences and challenges in accessing finance from formal and informal sources. The complete programme for November 26, 2019 is given in Annex A. The discussions and lessons about SME finance are synthesized below.

## SME LANDSCAPE IN PAKISTAN

Pakistan's small and medium enterprises (SMEs) represent a huge untapped potential market for financial services providers. Despite unmet demand, SME lending as a proportion of total private sector lending has declined from 15% in 2008 to 7.5% in 2019—much lower than say 39% observed in Turkey, 25% in Bangladesh and 18% in India and Sri Lanka. Of the 3.2 million enterprises as reported by the 2005 Economic Census, barely 200,000 have access to formal finance. International Finance Corporation (IFC) evidence indicates that 9 out of 10 new jobs worldwide are created by small businesses. Pakistan is no different where micro, small and medium enterprises (MSMEs) are estimated to employ approximately 80% of the non-agricultural labour force.

According to the IFC's SME Finance Forum report, 41% of formal MSMEs in developing countries have unmet financial needs, which translates into a financing gap of USD 5.2 trillion. When the requirements of informal SMEs are factored in, this amount increases to USD 8 trillion. Demand for SME financing in Pakistan, as estimated by a recent study commissioned by Karandaaz, ranges between PKR 3 - 4 trillion of which formal finance meets only 15 to 20% while the rest is either financed through informal channels or remains unmet.

There are both supply and demand side challenges which are contributing to this market failure. Traditionally, public sector deficit financing in Pakistan has resulted in the crowding out of private sector, in particular SMEs. Commercial banks have also found it convenient to deploy capital in virtually risk-free government assets or large corporates. The relationship-based banking model which is prevalent in the country, also puts pressure on Relationship Managers to focus on low risk clients, primarily large corporates, with larger ticket size needs as it helps to keep the bank's cost to income ratio low. In addition, Pakistan relies primarily on commercial banks and does not have a well-developed non-bank financial institution (NBFI) environment to service SMEs.

From the demand side, inadequate financial literacy and lack of documentation among SMEs pose a significant challenge to accessing formal finance. Out of total 3.1 million industrial consumers in Pakistan only 43,000 are under the tax system. Due to a lack of trust in the public sector and higher potential scrutiny, businesses prefer to keep themselves out of the formal system. It will not be incorrect to say that the taxation system of Pakistan has been overly restrictive for the manufacturing segment, while the trading segment has thrived. Another problem is the regulatory burden of the tax system, which is overbearing for SMEs. This has created a non-conducive environment for small businesses which constitute the bulk of SMEs. Similarly, accounting systems and practices have been devised keeping in mind the large corporates; this is discouraging to SMEs because of the high cost of compliance. These factors translate into a double disadvantage for the manufacturing sector, with multiple claims from economists on a shrinking manufacturing sector, relative to services and trading. It was also pointed out that SMEs are usually family-run businesses and when they achieve scale there is a significant disparity in their actual wealth and the ones disclosed in the wealth statement. This gap is then filled through the occasional amnesty schemes, incentivizing tax evasion.

## DEVELOPMENT OF SME ECOSYSTEM

Globally there are 40 SME focused stock exchanges with an average market capitalization from as low as USD 4 million to over USD 1.5 trillion catering from one to two thousand listed companies and offering SMEs, green field projects, and not-for-profits additional avenues to raise private capital. The SME Board which was set up by the Pakistan Stock Exchange (PSX) a few years ago, has been defunct with no listings recorded. However, recently, the Securities and Exchange Commission of Pakistan (SECP) introduced a regulatory framework for the Growth Enterprise Market (GEM). This is a very promising step towards development of domestic capital markets, while diversifying the sources of funding available to SMEs with the added incentive to formalize. Under the new regulations, listing requirements have been relaxed. Most promisingly, the requirement of market maker has been abolished and the concept of eligible investors has also been removed. To ease the compliance burden, companies looking to list themselves on the GEM board shall no longer be required to follow the same code of corporate governance as entities looking to list on the PSX, and the companies will now have a choice of getting listed without having intermediaries onboard. This development provides a new platform to SMEs to raise finance and unlock value through enhanced tradability. In addition, Agriculture is one of the key sectors in the local economy. Acknowledging this, SECP has developed regulations for collateral management companies (CMCs) and introduced the provision for acceptability of electronic warehouse receipts. Two companies have so far applied for the CMC license.

Equity Crowdfunding is another area that SECP is exploring to enable start-ups to meet their financial needs. Stakeholder consultations have been completed on the draft regulations for equity crowdfunding in Pakistan, and changes in the Securities Act and Companies' Act are being considered in tandem. On another front, the SECP's initiative to relax regulations on Private Equity Funds and Real Estate Investment Trusts shall provide further stimulus to developmental projects. Policy measures are required at the State Bank of Pakistan (SBP) and Federal Board of Revenue (FBR) to make the flow of foreign exchange less cumbersome for foreign investments and address taxation ambiguities, respectively. In addition, the Board of Investment (BOI) is working with the Law Enforcement Agencies (LEAs) to develop a portal which shall streamline the approval processes and address the difficulties that Venture Capital/Private Equity Funds currently face to bring in money.


The Electronic Money Institutions (EMI) regulations and Micro Payment Gateway (MPG) are significant initiatives to promote digital payments, online as well as offline, and shall push the cash-based economy towards documentation. It was argued that Digital Financial Services (DFS) need to evolve and deliver services beyond cash in and cash out and to capture payment transactions in the system. The availability of digital payments data can lead to the use of new credit models such as the one deployed by Kopokopo Kenya that can be considered a reference case study. Kopokopo is a service operator that has embedded an overdraft line for merchants. Such models should be replicated in Pakistan, not only to facilitate merchants but also to reduce application processing time. Recently, Bank Alfalah has developed a product which uses Point of Sale (POS) data on similar lines, with embedded merchant financing. The programme however, is still in the early stages.

Another missing piece that was highlighted is the absence of a borrower database. There is a sizeable commercial opportunity for credit bureaus to provide information about borrowers through innovative services. Previously, banks were reliant on the e-CIB to assess the credit worthiness of their borrowers. This service only encompasses negative information about borrower, thereby providing data on a segment within the existing borrower base. SBP has now given licenses to two new credit bureaus, established and run as private entities. These credit bureaus are developing databases for both microfinance and SME borrowers and report both positive and negative information about the borrower. They envision developing innovative credit scoring modules and integrating comprehensive SME borrower data.

Cost of doing business on both the supply side and the demand side is heavy. The supply side has to run substantial due diligence procedures while the demand side ends up raising finance from more expensive sources. Fintechs, along with credit rating agencies, can venture into this space to address information asymmetries through Credit Risk Databases (CRD). CRD is a recent initiative in the Philippines that aims to facilitate SME financing. CRD makes it possible to mitigate the problem of information asymmetry between SMEs and financial institutions (FIs) by establishing a robust statistical model.

One of the main issues for SMEs in accessing funding emanates from the inability of SMEs to prepare adequate information for loan appraisals, making it difficult for FIs to capture their credit risk. CRD is a database which contains financial statement information and default information of borrowers, mainly collected from banks and credit guarantee associations. The CRD database is used by FIs to measure and analyse the credit risk of borrowers while financial regulators use it to monitor credit risk at the macro level.

The idea of Big Data and cluster analysis was also highlighted as a potential enabler for FIs to understand the target SME market. Credit Guarantees are an effective instrument for encouraging FIs to build SME portfolios because a guarantee de-risks the portfolio by covering losses up to a pre-specified proportion of the portfolio. However, the challenge is to ascertain an optimal percentage of the portfolio to be guaranteed to ensure that such instruments encourage banks to increase SME financing while keeping skin in the game. ADBI has developed a model for calculating an optimal credit guarantee ratio, which broadly depends on three variables: i) Macroeconomic Variable, ii) Government Policies, and iii) Banking Profile.

Specialised NBFIs is another aspect that needs to be evaluated carefully in Pakistan. In India, there are a number of specialised NBFIs offering housing finance, vehicles finance (specialised for tractors and motorbikes), etc. However, in Pakistan the NBFI sector has shrunk over the years. When the sector was regulated by the SBP, it benefited from the SBP's presence as a bank of last resort, boosting commercial banks' confidence in lending to the sector. However, subsequently when the sector no longer had access to this facility by the SBP, it struggled to raise and maintain long term finance. The 2008 scenario further deteriorated the situation. Currently, Orix Leasing Pakistan (OLP) is the only significant leasing company in Pakistan, with ~80% of the market share. Borrowers in the microfinance industry stand at 7 million. While an estimated 10% of them graduate annually, they remain untapped by commercial banks. FIs, specifically NBFIs, should step in to tap this growing market. One of the recommendations that came forward is to have deposit taking NBFIs under the ambit of the SBP, instead of the SECP, thereby increasing access to an alternative avenue to raise capital.

Pak Brunei Investment Company, a Development Finance Institution (DFI), shared their innovate model for SME financing. They took a cost centre approach and developed a specialised programme to cater to the 'Small' end of the SME spectrum. In addition to plain vanilla financing, Pak Brunei extended advisory services to clients in terms of accounting best practices and other related documentations. When the SBP issued SME financing targets, in order to comply, the company started to focus more on an 'upper Medium' segment. It was therefore opined that for target setting to be successful, specialised entities with sector focus are required. Equipment rental model is another area that can be explored. Again Pak Brunei, after conducting thorough due diligence, started a Rental Modaraba company to lease heavy machinery in the Sher Shah area of Karachi. It was argued that to be successful a strong engagement with the clients is necessary. Major competition comes from informal finance providers because they are well connected in the markets they cater to and the clients are familiar with them.

Digital banks which are popularly referred to as 'Challenger Banks' are disrupting traditional banking models in developed markets. The establishment of digital banks in Pakistan can be another ground breaking initiative. Karandaaz is working with the SBP to develop a regulatory framework for digital banks. The proposed structure is being viewed as a natural evolutionary step for EMIs. EMIs can issue e-Money, but cannot generate sufficient income only on transactions, while digital banks can take deposits and utilize them to build a loan portfolio and earn income. Digital channels also offer other opportunities such as a digital invoice discounting platform that can develop the vendor financing market. Specific credit products can be developed based on Big Data and Data Analytics of specific types of information e.g. in India, cellular data is used to predict behaviour of potential borrowers.

## EXPERIENCE OF SMES IN ACCESSING FORMAL FINANCE

To understand the perspective of SMEs, a panel of SME owners was invited to share their experiences about their dealing with financial service providers (formal and informal). The SME owners quoted higher mark-ups, cumbersome documentation, complex processes and long processing times at commercial banks as major difficulties. It was also shared that the approved loan amount is usually lower than the requirement which makes it difficult to pursue the initial plan with which an SME approached the bank, necessitating revisions and alterations. Another issue highlighted by SMEs which affects their cash flow cycle and hence timely payment of loans was the delay in payment faced from undocumented clients. Such clients do not settle their invoices for up to a year while established brands run a settlement cycle of 45-60 days. This forces SMEs to give a discount of 5-10% for cash-based settlements, however, they cannot factor that discount into their invoices.

Within the textile industry, informal business committees extensively operate to provide finance. The committee members pool their money just as small Rotating Savings and Credit Associations (ROSCAs), however, per participant contribution runs into a few million rupees. The process is very well formulated and is very common in the textile industry due to high working capital requirements. If an owner requires money prior to his turn, community members lend their share at a discount. The finance head from a high-end fashion chain, shared that initially they decided to pursue formal financing only, given that he himself came from a corporate banking background, but even with available collateral they faced significant challenges in raising formal financing in the early years of operations. With more than 20 years of business history and growing to a large corporate entity, formal institutions are now willing to lend and the group has recently signed a deal for a green field project in textile space.

The panel also included founder of a fruit processing plant in Gilgit Baltistan that procures local fruits thus leading to minimization of wastage for small farmers as they can sell to his facility rather than transporting it to nearest urban centre. He shared that despite being the 6th largest producer of apricot globally, 70% of the produce is wasted due to lack of storage capacities. To capitalise this gap, the company established its processing plant in Gilgit Baltistan. It works with a farmer base of 656 farmers. The first round of funding accessed by the business amounted to PKR 15 million for the processing plant in Skardu; the proceeds were primarily raised from friends and family. For the second round, the company has approached commercial banks but, due to lack of collateral the company is facing hinderances in getting the requisite funds sanctioned. If successful in raising financing form banks or other sources, he plans to use the funds for technical training of farmers and expansion of processing facilities across other cities.

Owner of a food retail chain from Karachi, narrated a similar account. Initial funding was raised through friends and family, while subsequent growth has been financed through retained earnings. At a later stage when the business was an established name in the local market, commercial banks were approached and the company was successful in raising finance.

However, since the raised proceeds had a higher cost, the business decided to pay back the loan sooner, for which they had to pay a penalty. With the current economic slowdown, supplier credit is also being extended on tighter terms such as lower payment cycle, and the efforts to enhance documentation of enterprises has hindered growth in the short term. On the franchising option, the owner mentioned that she isn't ready to dilute control over the brand she has been operating for the last 19 years. SMEs are usually closely held family run businesses, and this reluctance of owners to share control hampers business's ability to scale.

The situation is even more difficult for technology companies. Their books usually have intellectual properties as main asset, which is not acceptable as collateral by financial institutions. In addition, the absence of pure cash flow-based lending in Pakistan exacerbates the situation. A recently established tech-based logistics platform shared that being a start-up in an industry that has drawn significant local and international attention has made it relatively easier for it to source finance from venture capital funds instead. It was shared that many more international VCs invest in Bangladesh and India; but Pakistan is usually not their mandate because of limited exit opportunities and stringent requirements of the regulator. Furthermore, the international VC/PE funds are reluctant to take exposures as the Pakistan's economy is not very well integrated with peer countries.

## THE SUPPLY SIDE PERSPECTIVE

From the supply side, the panellists argued that value chain financing and cluster financing are two aspects that can lead to building quality SME portfolio. Agri value chains, more specifically potato and maize chains are very well developed and can be used as a reference point for a potential pilot. Bank Alfalah, for example, offers both on and off-balance sheet solutions under its supply chain financing module, and 40% of bank's SME portfolio is under supply chain finance model.

It was argued that the current SME portfolio of commercial banks, is skewed towards Medium segment clients, having an average loan size of PKR 8 million, while average loan size for microfinance is ~PKR 50,000, showing that requirement for lower ticket sizes are not being met by commercial banks. NBFIs, with a specialised focus for this segment, can venture in to fill this gap. Targeted approach however is necessary to effectively cater to different tiers within the SME clients and a relationship-based model is required for effective risk management. Resultantly, commercial banks don't see this as a profitable space; therefore, they focus on building corporate portfolio with relatively less operational costs.

One of the recommendations was to have separate risk management teams for SME, commercial and corporate clients, at the commercial banks. In Bank Alfalah, separate teams have been formalised within the Bank's risk department to address the usual overlap between corporate risk and SME risk teams. In addition, the bank has piloted clean lending for ticket sizes up to PKR 4-5 million. The programme is now 3.5 years old, with a billion rupees as outstanding portfolio. Documentation issues at the client's level continue to exist, however, innovative solutions are required that can be used as proxies for hard core financial information. Many SMEs are also bank's depositors, and financial institutions have a rich database of their transaction history. It was recommended that this data can be leveraged to assess the repayment capacity of the obligor and can promote cash flow-based lending.

## MEASURING IMPACT OF SME INTERVENTIONS

Effective impact assessment is an important area of interest for multilaterals, development institutions or impact funds. Standardized procedures to measure social impact are not present, due to which comparison and measurement of impact made by social impact funds becomes a challenge. Non-profit organizations usually have their own impact assessment modules and mechanisms which makes it difficult to have an aggregated analysis on the performance. Assessment of SMEs cannot be treated uniformly. Medium size firms usually have longer maturity and higher demand for formal lending as compared to the small firms, necessitating a bifurcated approach to impact assessments for "Small" and "Medium" entities.

CDC Group, a wholly owned subsidiary of UK's Department for International Development, conducted a survey of 113 borrowers of one of its investee companies in India, which showed that i) On aggregate, 5,600 – 7,200 jobs are estimated to have been created by MSMEs receiving a loan from formal institutions, from 2013-15, ii) 80% of all SMEs grew their sales, income and assets after availing the loan, at average annualised rates of 9, 10 and 7%, respectively, iii) 55% were first-time borrowers of formal finance, having previously relied on personal finances, family and friends, and informal money lenders iv) Firms with female management (22% of the sample) exhibited stronger financial performance on average, and were more likely to hire women.

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UN Secretary-General's Special Advocate for Inclusive Finance for Development (UNSGSA)

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Federal Minister for Economic Affairs, Government of Pakistan

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## ANNEX A: DAY 2: APPLYING INNOVATIVE FINANCE SOLUTIONS TO SME SECTOR (NOVEMBER 26, 2019)

### FINAL AGENDA

| Registration \| 08:30 AM | | |
|---|---|---|
| **Time** | **Agenda Item** | **Guest/Panel** |
| 09:15 AM | **Welcome Address** | **Dr. Shamshad Akhtar**<br>*Chairperson Karandaaz Pakistan and Former Governor State Bank of Pakistan* |
| 09:30 AM | **Opening Address** | **Mr. Hammad Azhar**<br>*Federal Minister for Economic Affairs, Government of Pakistan* |
| 09:50 AM | **Key Note Address**<br>*Documenting the SME sector for enhanced lending and ease of doing business* | **Syed Shabbar Zaidi**<br>*Deputy Governor, State Bank of Pakistan* |
| 10:10 AM | **Key Note Address**<br>*SBP's Road Map for Enhanced SME Lending* | **Mr. Jameel Ahmad**<br>*Deputy Governor, State Bank of Pakistan* |
| 10:30 AM | **Remarks by DFID, British High Commission** | **Mr. Richard Crowder**<br>*British High Commissioner (Acting)* |
| 10:50 AM | **Micro Payment Gateway Signing Ceremony and Remarks on Financial Inclusion** | |
| **Tea Break \| 11:15 AM** | | |
| 11:30 AM | **Presentation 1**<br>***Credit Guarantee Schemes for SMEs; and Hometown Crowd Funding for Start Ups***<br>*What mechanisms such as credit guarantees, collateral supports, directed credit, information repositories and /or demand side initiatives (financial literacy, etc.) have been most beneficial in closing the SME financing gap?* | **Dean Naoyuki Yoshino**<br>*Head Asian Development Bank Institute (ADBI)* |
| 12:00 PM | **Presentation 2**<br>***Credit Risk Database for Assessing SME Credit Worthiness-Experience in Japan*** | **Mr. Satoshi Kuwahara**<br>*President, Credit Risk Database (CRD) Association, Japan* |
| 12:20 PM | **Panel Discussion A**<br>***SME Ecosystem in Pakistan—the Missing Pieces***<br>*What type of institutional and ecosystem strengthening is needed in Pakistan to provide an impetus to SME financing, reduce information asymmetries and enhance participation by banks, NBFCs and DFIs?* | *Moderator:*<br>**Mr. Waqas ul Hassan**<br>*Senior Financial Sector Development Expert, Department for International Development, Pakistan*<br>*Panel Members:*<br>• **Mr. Shauzab Ali**<br>*Commissioner SECP*<br>• **Ms. Ayesha Aziz**<br>*MD Pak Brunei*<br>• **Mr. Yahya Khan**<br>*Head of Digital Banking, Bank Alfalah*<br>• **Mr. Tariq Maqbool**<br>*CEO PACRA Analytics* |
| 01:00 PM | **Audience Q&A** | |
| **Lunch Break \| 01:15 PM** | | |

| Time | Agenda Item | Guest/Panel |
|---|---|---|
| 02:00 PM | **Presentation 3**<br>***Measuring Impact in SME Lending*** | **Mr. Alex MacGillivray**<br>*Director Evaluations, CDC Group* |
| 02:20 PM | **Audience Q&A** | |
| 02:30 PM | **Panel Discussion B**<br>***SME Experience of Accessing Financing (formal and informal)*** | *Moderator:*<br>**Mr. Ali Khizer**<br>*Senior Economist and Columnist*<br>*Panel Members:*<br>• **Mr. Wasif Butt**<br>*Owner and Finance Manager Maria B*<br>• **Ms. Naila Naqvi**<br>*Founder and Manager Pie in the Sky*<br>• **Ms. Samina Masood**<br>*CEO M Tex*<br>• **Mr. Ahmed Khan**<br>*Founder and CEO Cheetay*<br>• **Mr. Asif Mehdi**<br>*Chief Operations Officer, Shazday, GB* |
| 03:15 PM | **Audience Q&A** | |
| 03:30 PM | **Panel Discussion C**<br>***Innovative financing for SMEs--Invoice Discounting, Non-Bank Funding and Social Impact Funds*** | *Moderator:*<br>**Mr. Ali Sarfraz**<br>*CEO Karandaaz Pakistan*<br>*Panel Members:*<br>• **Mr. Javed Iqbal**<br>*Head of SME and Commercial Banking, Bank Alfalah Limited*<br>• **Ms. Maleeha Bangash**<br>*Head Ease of Doing Business, Government of KP*<br>• **Mr. Ahsen Khawaja**<br>*SME Financing Expert*<br>• **Mr. Naresh Kumar**<br>*Senior Vice President, Head SME Banking* |
| 04:15 PM | **Audience Q&A** | |
| 04:30 PM | **Thank You Note** | **Mr. Ali Sarfraz**<br>*CEO, Karandaaz* |
| **End of Program \| 04:40 PM** | | |

## About Karandaaz

**KARANDAAZ PAKISTAN,** a not-for-profit company established in August 2014, promotes access to finance for small and medium businesses through a commercially directed investment platform and financial inclusion for individuals by employing technology enabled digital solutions. The company has financial and institutional support from leading international development institutions, principally the United Kingdom's Department for International Development (DFID) and the Bill & Melinda Gates Foundation.

### Karandaaz Digital

Focuses on expanding the poor's access to digital financial services in Pakistan by working across the ecosystem with all stakeholders.

### Karandaaz Capital

Provides wholesale structured credit and equity-linked direct capital investments to micro, small and mid-size enterprises (MSMEs) that demonstrate compelling prospects for sustainable business growth and employment generation in Pakistan.

### Karandaaz Innovation

Manages the Innovation Challenge Fund and Women Entrepreneurship Challenge, providing risk capital and grants to partners with the aim to generate innovative solutions in areas of financial inclusion and entrepreneurship.

### Knowledge Management and Communications

Supports the company's core financial inclusion goal by developing and disseminating evidence based insights and solutions.

Karandaaz Pakistan receives funding from the United Kingdom's Department for International Development (DFID) and the Bill & Melinda Gates Foundation (BMGF).

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