ARANDAAZ

NBFCs in Pakistan

Regulatory Landscape and Bottlenecks

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Edited by
Ali Shahrukh Pracha

Designed by
Yasir Farhan

Reviewed by
Mehr Shah, Director Knowledge Management & Communication, Karandaaz Pakistan, and
Ali Akbar, Senior Manager Knowledge Management, Karandaaz Pakistan

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NBFCs IN PAKISTAN: REGULATORY LANDSCAPE AND BOTTLENECKS

Acronyms and Abbreviations

‘C’	Corporate enterprise
‘M’	Medium enterprise
‘m’	Micro enterprise
‘S’	Small enterprise
ABL	Allied Bank Limited
AePS	Aadhaar Enabled Payment System
AFC	Asset finance company
AI	Artificial intelligence
ALCO	Asset-liability committee
ALM	Asset-liability management
API	Application programming interface
BB	Branchless banking
BDC	Business Development Bank of Canada
BDRAL	Bangladesh Rating Agency Limited
CAD	Canadian dollar
CAGR	Compound annual growth rate
CAR	Capital adequacy ratio
CASA	Current account savings account
CDC	Central depository company
CGC	Credit Guarantee Corporation (Malaysia)
CGS	Credit guarantee scheme
CIB	Credit Information Bureau (Pakistan)
CIBIL	Credit Information Bureau of India Limited
CIC	Core investment company
CLA	Corporate Law Authority
CNIC	Computerised national identity card (Pakistan)
COD	Certificate of deposit
COI	Certificate of investment
CRD	Credit risk database
CRO	Chief risk officer
CTTL	Callmate Telips Telecom Limited
CY	Calendar year
DCA	Development Credit Authority
DFI	Development finance institution
DFS	Digital finance service
DNBR	Department of Non-Banking Regulation (Reserve Bank of India)
EMI	Electronic money institution

EU	European Union
EMIP	Euro-Mediterranean Investment and Partnership
FCDO	Foreign, Commonwealth & Development Office
FI	Financial institution
FIIP	Financial Inclusion and Infrastructure Project
FMCG	Fast-moving consumer good
FSB	Financial Stability Board
FSDC	Financial Stability and Development Council
FSF	Financial Stability Forum
FSR	Financial stability report
FSU	Financial stability unit
FY	Fiscal year
G2P	Government to person
GBP	Great Britain pound
GDP	Gross domestic product
GFC	Global financial crisis
GoP	Government of Pakistan
HBFC	House Building Finance Company
HQLA	High-quality liquid asset
IBFT	Inter-bank fund transfer
ICF	Innovation Challenge Fund
IFS	Investment finance service
IH&SMEFD	Infrastructure, Housing, and SME Finance Department
IL&FS	Infrastructure Leasing and Financial Services Limited (India)
IMF	International Monetary Fund
INR	Indian rupee
ISP	Industry support programme
KYC	Know your customer
LCR	Liquidity coverage ratio
LMS	Lending management system
LoC	Line of credit
LOLR	Lender of last resort
LTV	Loan to value
MCR	Minimum capital requirement
MFB	Microfinance bank
MFI	Microfinance institution
MFSM	Monetary and Financial Statistics Manual

MPG	Micro payment gateway
MSMEs	Micro, small, and medium enterprises
MUNFI	Monitoring Universe of Non-bank Financial Intermediation
NABARD	National Bank for Agriculture and Rural Development
NACH	National Automated Clearing House
NBFC	Non-bank finance company
NBFI	Non-bank finance institution
NBFC-ICC	NBFC investment and credit company
NBMFC	Non-bank microfinance company
NCCPL	National Clearing Company of Pakistan Limited
NCD	Non-convertible debenture
NFIS	National Financial Inclusion Strategy
NIFT	National Institutional Facilitation Technology
NPCI	National Payments Corporation of India
NPL	Non-performing loan
OAEM	Other assets especially mentioned
OECD	Organisation for Economic Co-operation and Development
OEM	Original equipment manufacturer
OIBPL	ORIX Investment Bank Pakistan Limited
OLP	ORIX Leasing Pakistan Limited
OTC	Over the counter
OTP	One-time pin
P2M	Person to merchant
P2P	Person to person
PFSL	Parwaaz Financial Services Limited
PKR	Pakistani rupee
PMRC	Pakistan Mortgage Refinance Company
POS	Point of sale
PR	Prudential regulation
PRISM	Pakistan Real-time Interbank Settlement Mechanism
PSE	Public-sector enterprise
PSO	Payment system operator
PSP	Payment system provider
PSX	Pakistan Stock Exchange
QR	Quick response
RBI	Reserve Bank of India
RoA	Return on assets

RoE	Return on equity
RPS	Retail payment system
RTGS	Real-time gross settlement
RTP	Request to pay
SAAF	SME Asaan Finance Scheme
SBP	State Bank of Pakistan
SECP	Securities and Exchange Commission of Pakistan
SIDBI	Small Industries Development Bank of India
SLR	Statutory liquidity requirement
SLS	Special liquidity scheme
SMEs	Small and medium enterprises
SMEDA	Small and Medium Enterprise Development Authority
SMERA	SME Rating Agency of India Limited
SPV	Special purpose vehicle
STR	Secured Transactions Registry
TAT	Turnaround time
TEB	Türk Ekonomi Bankası (Turkish Economy Bank)
TFCL	Taleem Finance Company Limited
UK	United Kingdom
UPI	Unified Payments Interface (India)
USD	United States dollar

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Executive Summary

Non-bank finance companies (NBFCs) in Pakistan are small and inconsequential in the lending space. Globally, NBFCs and other financial intermediaries have played a crucial role in creating credit and are considered to be a vital cog in the shadow banking system. In the domestic context, however, despite significant developments in the regulatory framework, growth in credit by NBFCs, particularly in the small and medium enterprise (SME) segment, has struggled to take off. With the government's stated policy direction toward the financial inclusion of underserved segments such as SMEs, NBFCs could be taking on a larger participating role, given their specialised licenses, relaxed credit and risk policies, and the opportunity to experiment and innovate in light of less stringent regulatory oversight.

The Securities and Exchange Commission of Pakistan's (SECP) role should be to balance regulatory oversight to ensure the segment is able to protect itself from liquidity and financial crises, while enabling product and process innovation. From that perspective alone, post several rounds of regulatory amendments and revisions, the current regulatory regime works for the NBFC segment, with perhaps some interventions. Also worth mentioning are recent efforts by the SECP to build its own capacity to regulate and supervise NBFCs, its receptiveness to giving new NBFC licenses to interested players that can move the segment in a new direction, becoming more active on the innovation front with its recently established regulatory sandbox and introducing tiered regulatory frameworks for the likes of startups, venture capital firms and digital platforms. These developments are very welcome given recent trends in SME financing in several countries where SMEs are increasingly turning to alternative financing instruments such as, online alternative finance, leasing and hire-purchase and factoring.

What should be NBFCs' key target markets? SME lending is a great opportunity for NBFCs to prove their mettle. Over the past few years, despite the government's strong drive to promote SME lending that resulted in a host of interventions, banks have not made adequate headway. These interventions include credit guarantee schemes (CGS) for participating banks; a separate set of simpler prudential regulations (PRs) for 'S' and 'M' borrowers; relaxations in PRs in calculating capital adequacy ratios (CARs) and general reserve requirements; demand-side refinancing schemes and mark-up subsidies; developments in foreclosure laws; the passing of secured transaction laws to register movable assets; and providing SME lending targets to banks. SME borrowers of the banking sector stand at ~180,000—of which the majority are reportedly in the 'M' category, and overall, SME lending has remained inconsequentially small in total private-sector lending. According to the SME Scoreboard 2020 report, financing instruments other than straight debt have experienced strong growth in recent years. While fintech have been a transformative force in some jurisdictions, leasing and factoring are also showing strong growth. Thus, in Pakistan too, NBFCs can fill the gap in SME financing with curated segment-specific models and increased digitization. In fact, the government and financial sector regulators could consider extending greater support to NBFCs to meet its lofty goal of reaching 700,000 SME borrowers by 2023.

NBFCs should also be mobilising and diversifying liquidity avenues to circumvent the high cost of funds associated with banks. This can be done by diversifying funding sources and the borrower mix while also providing advisory services where supplemented income can be earned. To diversify sources of funds NBFCs in other countries have raised capital from public funds, partnered with banks to create viable co-lending models, and in some cases have also tapped off-shore credit markets with bond issues. NBFCs have also diversified product portfolios by creating new models for a range of different borrowers with different risk profiles.

A new opportunity has presented itself with the emergence of fintechs and digital finance providers. Fintechs around the world—with the help of financial institutions (FIs) or without—are filling the gap that traditional lenders have left uncatered.

In Pakistan, they are still in early development and where regulators are still in the process of determing how to regulate them or support them to spur growth—this may be the perfect time for key partnerships to surface and develop. NBFCs can collaborate with a variety of fintechs, data providers, and aggregators to make technology a centre point for their business models and find workarounds for legacy technology infrastructure. By doing so, they can reduce their operational costs, and craft superior product and service offering to become more competitive.

Through strategic partnerships, leveraging new types of technologies and data, and by diversifying delivery channels, NBFCs can refine and modernise their business models to be ready for the changing lending landscape. These partnerships can be with banks where they could be propositioned to outsource lending to segments they are underserving:

- With original equipment manufacturers (OEMs)[1], suppliers, retailers, and e-commerce platforms which will allow for an expansion in customer base;

- With payment operators and aggregators which will open NBFCs to a host of alternative delivery channels;

- With data providers, data registries, credit scorers or rating agencies, digital loan underwriters, and the growing number of fintechs that are capturing new customer data on which unique and targeted credit solutions can be built.

[1] *Referred to as both: a manufacturer of original equipment such as parts and components for a brand, and as an assembler of the final product for the original brand.*

Section 1

Introduction to the Study

Globally, NBFCs and other financial intermediaries play a crucial role in the creation of credit and are considered a vital cog in the shadow banking system. Yet, despite significant developments in the domestic regulatory framework over the last two decades, growth in credit by NBFCs, particularly to businesses in the SME segment, has struggled to take off.

The experience over the last two decades across both Organisation for Economic Co-operation and Development (OECD) economies and emerging market economies suggests that credit by NBFCs to traditionally unbanked borrowers, particularly to enterprises in the 'S' and 'M' segments, is instrumental in supporting economic activity. At the same time, risks to the shadow banking system have also attracted increased regulatory oversight in recent years.

Domestically, the announcement of the National Financial Inclusion Strategy (NFIS) in 2015 allowed access to finance to take centre stage in the policymaking agenda. The policy's objectives to mainstream financial inclusion and reach out to underserved market segments such as micro, SME, agriculture, and new home buyers emphasise the importance of technological innovations and fintech solutions in bridging these gaps, especially via payment systems, branchless banking (BB), digital banking, etc. While the framework strongly highlights the role of microfinance institutions (MFIs) to reach access to finance targets, both the original strategy and the Government's 100-Days Agenda on the NFIS overlook the role of other lending-focused NBFCs.

While it is true that lending NBFCs currently account for significantly less than 10% of total private sector credit, that alone should not, and cannot, provide sufficient justification for overlooking their potential role in reaching unbanked and under-banked sectors and segments of the economy. This is especially pertinent given recent amendments and enhancements made to the regulatory framework governing NBFCs and the evolving digital finance landscape which has the potential to transform the lending space. Examples of regulatory enhancements include the introduction of the non-bank microfinance company (NBMFC) license which has resulted in consolidation of the non-bank microfinance sector under a standardized governance framework. Such developments offer significant promise, especially with respect to the extension of credit to segments traditionally considered to be 'un-bankable' such as in agricultural and manufacturing SMEs, and low-income households and micro businesses.

The un-bankable challenge is common to many emerging markets[2]. Stringent PRs govern banks' lending behaviour, setting strict criteria for obligor risk profiles such as minimum equity base, independent financial audit, and most importantly, prohibitive collateral requirements. Where discretion is exercised in lending decisions mainly due to information asymmetry, sponsor profiles and 'comfort' take precedence. 'Name-based lending' thus, serves as a unique filter that disqualifies most prospective borrowers, save large corporate houses. Even a superficial gap analysis reveals potential for a fresh category of borrowers that neither commercial banks (focused on corporate) nor MFIs (focused on low-income groups), currently serve.

NBFCs operate under a less stringent regulatory framework compared to banks. In fact, the pursuit of a less restrictive regulatory environment for NBFCs was the main purpose behind shifting them out of the regulatory purview of the SBP and under that of the SECP. By instituting a less restrictive regulatory environment for

[2] *Borrowers with a high-risk profile who do not have clean, adequate immovable collateral, financial books in order, verifiable credit history with banking channels, and/or a prior relationship with FIs.*

NBFCs, it was argued, these entities will be better positioned to grow and to provide financing to segments excluded by commercial banks. Unfortunately, the envisioned outcome (growth and providing financing to excluded segments) has so far not been achieved.

To determine the reason for this outcome, this study was commissioned by Karandaaz Pakistan. For this purpose, the study conducted an in-depth analysis of:

1. The domestic NBFC segment involved in lending services (who are the players, what services do they offer, what has been their performance over time);

2. The evolution of legislation by juxtaposing the regulation of lending NBFCs with commercial banks and the regulatory frameworks of peer economies;

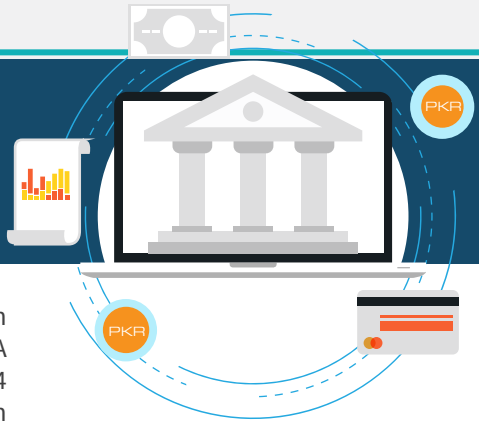
3. The evolving operating environment for NBFCs, including the offtake of digital finance and an increasingly digitized financial sector architecture, and the growing emphasis of the Government of Pakistan (GoP) on driving access to finance and documenting the informal economy; and

4. The key challenges (regulatory and non-regulatory) that lay bare NBFCs' difficulty in growing the sector's contribution to overall credit, and also purposefully catering to the SME lending space.

Recommendations made rely heavily on extensive stakeholder consultations, literature reviews of peer countries and regions, and success and failure stories from the domestic and global context.

Section 2

Types of NBFCs in Pakistan



NBFCs in Pakistan—or non-bank financial institutions (NBFIs) in other jurisdictions—are companies incorporated under Section 282A to 282N, Part VIII-A of the now-repealed Companies Ordinance, 1984 (now, Companies Act, 2017). As the name suggests NBFCs offer an array of financial services but do not operate with a full banking license.

Operationally, this means that NBFCs do not fall under the purview of the SBP and operate under a relatively relaxed regulatory framework. However, in effect, the core distinction between commercial banks and NBFCs is that the latter are prohibited from taking deposits from the public, in particular, call and demand deposits. Thus, they do not contribute to the creation of money supply as commercial banks that are part of fractional reserve banking do. The Banking Companies Ordinance, 1962 defines banking as "*the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise.*" While NBFC regulations in Pakistan allow NBFCs to take deposits, these are never call or demand deposits, and somewhat resemble fixed tenor debt obligation instruments such as term finance certificates (TFCs) rather than traditional bank deposits[3].

As a result, historically, NBFCs have been subject to less stringent restrictions and requirements compared to those imposed on scheduled banks. Similarly, there is a list of criteria that a non-deposit-taking NBFC must fulfil to upgrade to a deposit-taking entity—see Annex A for a comparison of the regulatory environments for banks, deposit-taking and non-deposit-taking NBFCs. Theoretically, the more relaxed regulatory oversight for NBFCs is designed to encourage creativity and innovation in the financial services offered by such NBFCs, allowing them to extend their reach to prospective borrowers not served by traditional commercial banks. For reasons discussed at length in this report, this objective has not come to fruition in the domestic context despite considerable success globally.

Type of NBFCs

Under the Companies Act, 2017, NBFCs fall under the definition of 'Financial Institutions', clause 31(b), and include a wide array of entities: "*modaraba or modaraba management company, leasing company, investment bank, venture capital company, financing company, asset management company, and credit or investment institution, corporation or company.*"

This bewildering array of NBFCs can be broadly segmented into two types:

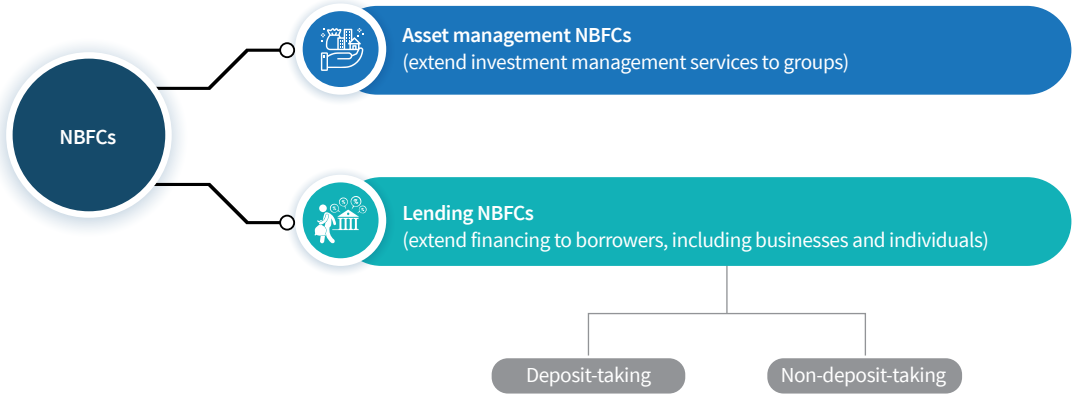
1. Those that function as investment management institutions for a broad group of retail and/or institutional investors;

2. Those that engage in the extension of finance to borrowers by drawing on capital invested, both debt and equity. This second category is further broken down into deposit-taking and non-deposit-taking NBFCs.

From a regulatory perspective, the distinction between asset management-type and lending-type NBFCs was introduced through amendments to the NBFC Regulations, 2008 through SRO 1160/(I) in 2015.

[3] *SECP regulations.*

Exhibit 1: Type of NBFCs in Pakistan



Asset or fund management NBFCs: The first category is licensed as fund management NBFCs or types thereof. It includes entities that engage in asset management services, real estate investment trust (REIT) management services, pension fund scheme business, private equity, venture capital fund management services, or any combination thereof.

Lending NBFCs: The second category includes NBFCs that are licensed to undertake leasing, housing finance services, discounting services and micro finance. Lending NBFCs are engaged primarily in the provision of finance to borrowers[4]. A lending NBFC may invest only in its licensed form of business. Leasing companies, housing finance companies, and discount houses must invest at least 70% of their total assets in leasing, housing finance, and discounting services, respectively, on a quarterly average basis. Lending NBFCs also include NBMFCs. The investment finance service (IFS) license allows all these services to be provided by a single entity.

Significantly, the regulatory framework prohibits a crossover of functions between fund management and lending NBFCs. According to the Non-Banking Finance Companies (Establishment and Regulation) Rules, *"a fund management NBFC shall not be eligible for seeking licence for any form of business allowed to lending NBFCs, and a lending NBFC shall not be eligible for seeking licence for any form of business allowed to fund management NBFC."*

This separation of roles exists because fund management NBFCs attract investors with a higher risk appetite for equity and/or other hybrid pools of securities/investments. By contrast, the exposure of lending NBFCs is considerably lower due to the debt-based nature of the core product.

This study is concerned with lending NBFCs and henceforth will focus only on this catagory.

[4] Defined as:

1. *Any accommodation or facility on the basis of participation in profit and loss, musharika, or modaraba basis, mark-up or mark-down in price, hire-purchase, lease, rent-sharing, bills of exchange, promissory notes or other instruments with or without buyback arrangements by a seller, participation, term certificate, musharika or modaraba certificate, or term finance certificate.*
2. *Guarantees, indemnities, letters of credit, or any other financial engagements or issues undertaken on behalf of a person with a corresponding obligation of that person.*
3. *A loan, advance, or discounting services to any person.*
4. *Micro-financing, including any form of finance such as leases, advances, consumer loans, or housing finance.*
5. *A financial facility or accommodation provided on the basis of the Islamic mode of financing.*

Any other form of financial facility provided to a person.

Types of lending NBFCs

Leasing companies

The 2003 rules define leasing as *"the business of providing finance on operating lease or finance lease or Ijarah basis"*[5]. If undertaking the business of leasing only, a leasing company must invest at least 70% of its assets in the business of leasing with the rest in other assets such as loans and advances, investments in property, cash in bank, operating assets, etc. For SMEs especially, leasing is an alternative mechanism to facilitate access to finance as it enables the use of capital equipment, in particular for new and young enterprises without a track record and with limited capacity to provide collateral. Leasing provides the possibility for SMEs to expand their access to short- and medium-term financing.

Discount houses

These are firms that buy and discount receivables, invoices, bills of exchange, banker' acceptances, commercial paper, etc. Discount houses also tender for treasury bills and deal in short-dated government bonds. Under the NBFC regulations, discount houses may not extend finance for more than 180 days in tenor, are recourse-based, must maintain appropriate margins, and ensure that the financial instruments discounted are legally enforceable and properly discharged in the name of the NBFC.

Typically, discount houses have a low-risk appetite and a highly specialised and restrictive product portfolio. For example, they cannot offer pre-shipment inventory finance or long-term financing in any form. Thus, while a useful product offering in the overall mix of financial services, on its own, the existing model does not make for an attractive proposition for an NBFC focused on lending.SMEs, on the other hand, can benefit greatly from using discounting services to manage their cash flow, especially when money is needed urgently for example, to keep up with rising order numbers while working capital is low.

Discount houses across the world have historically been a crucial cog in short-term money markets as they provided liquidity to the financial system, especially in Britain and India. However, they disappeared into oblivion as bank treasuries began to function on a modern footing, especially after advancements in the derivatives market over the last two decades.

Housing finance companies

As the name suggests, housing finance companies advance finance for house building. Crucially, finance is extended for the purchase of land only in conjunction with construction thereupon. Thus, a maximum of 50% of the loan amount may be disbursed for the purchase of land, while the remainder must be disbursed as construction progresses. House finance service companies are specialised FIs with an explicitly defined business activity.

Investment finance companies

An Investment Finance Company (IFC) can be established under the IFS license. As the name suggests IFS license holders can undertake investment finance services and also discounting, leasing, housing finance services and micro financing. An NBFC with this license is not required to obtain a seperate license for each form of business. It was expected that consolidation of different financial services under one umbrella will lead to the emergence of stronger, well-capitalized entities, while also providing impetus to lending.

[5] *"It includes financial services provided on operating lease or finance lease basis (in accordance with applicable International Accounting Standards) or any other admissible mode determined by the Commission from time to time" [Non-Banking Finance Companies (Establishment and Regulation) Rules, 2003].*

Non-bank microfinance companies

This category of NBFCs was introduced in 2015 with the aim to place an existing specialized category of microfinance lenders under the purview of the SECP governed by a uniform regulatory framework. Until the NBMFC category was introduced, microfinance institutions (MFIs) functioned under a range of laws including the Trusts Act, Societies Act, Section 42 of the Companies' Ordinance, among others. NBMFC is a non-deposit taking company primarily engaged in the business of providing lending services to poor individuals and micro enterprises.

Modarabas

Modarabas are allowed to offer any financial product or conduct any business provided it is *Shariah* compliant and approved by the Religious Board[6]. Thus, modarabas can invest in stock markets, trading of *halal* commodities, and project financing activities. Modarabas can raise funds by issuing Certificates of Modaraba and Musharaka and can also issue *sukuk* and *musharaka* based TFCs[7].

Exhibit 2: Type of lending NBFCs

Type of NBFC	Description	Services offered	Raising investment/deposits externally
Leasing company	Lending for purchase of tangible assets on a rental or purchase model	Operating and Financial Leasing	Issuance of Certificate of Deposit provided the company is listed on the stock exchange *(among fulfilment of other criteria)*
Discount house	An entity providing liquidity in capital markets	Discounting corporate receivables, short term money market instruments and financing against guarantees	Issuance of Certificate of Deposit provided the company is listed on the stock exchange *(among fulfilment of other criteria)*
Housing finance companies	Specialized home financing entity	Loans for purchase, construction or renovation of home, small builder loan	Issuance of Certificate of Deposit provided the company is listed on the stock exchange *(among fulfilment of other* criteria)
Investment bank	Non-bank entity providing corporate finance services	Brokerage and Advisory, Project Financing, Underwriting, Portfolio Management, Capital Market Financing, etc.	Issuance of Certificate of Deposit provided the company is listed on the stock exchange *(among fulfilment of other criteria)*
Non-Bank microfinance companies (NBMFCs)	Loans to small entrepreneurs and micro enterprises	Loans of up to PKR 500,000 for an individual, and up to PKR 1,500,000 for housing and microenterprise lending	**Cannot** mobilize deposits from clients
Modaraba	Islamic Finance Model with a clear distinction between management and investors	Trading in *halal* commodities, Investment in Stock Markets, Project Finance, *Sharia* Compliant Financial Products	Issuance of Certificate of Modaraba provided the company is listed on the stock exchange for trading purposes

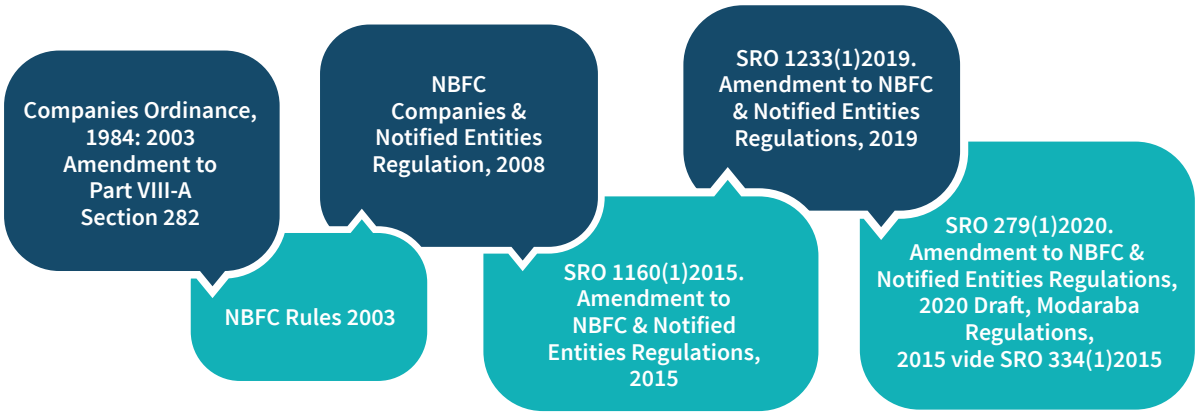
NOTE: 1) An NBFC license for Investment Finance Services is valid for undertaking Discounting, Leasing and House Financing Services; 2) Lending Companies can only issue Certificates of Deposit (COD) with the permission of SECP and subject to the fulfilment of certain criteria

Source: Karandaaz Pakistan. Regulatory framework for NBFCs in Pakistan-The SME lending perspective. 2020

[6] *The Government of Pakistan constitutes the Religious Board for modarabas under section 9 of the Modaraba Companies and Modarabas (Floatation and Control) Ordinance, 1980. The board is comprised of a chairman and two Shariah scholars. The religious board approves the prospectus of all modarabas prior to commencement of operations. All the products and business activities of a modaraba are also approved by the religious board.*
[7] *Jama Punji https://jamapunji.pk/knowledge-center/modaraba*

Section 3

Contextualising NBFCs Under a Governance Framework



Transitioning NBFCs to the Companies Act, 2017

In November 2002, the Companies Ordinance, 1984 (now repealed) was amended to provide legal cover to transfer the regulatory control and oversight of NBFIs from the SBP to the SECP, with the former retaining control of only one category of NBFIs—development finance institutions (DFIs). Since then, NBFIs came to be known as NBFCs. Earlier, NBFIs were regulated by the central bank under the Banking Companies Ordinance, 1962, which was itself amended in 1997 to allow the transfer of NBFIs to the SECP.

Currently, the Companies Act, 2017 is the supra-legislative document that governs all incorporated companies in Pakistan. Although the Act repeals the preceding Companies Ordinance, 1984, the section governing NBFCs (Part VIIIA Section 282A through Section 282N) has not been repealed and remains "applicable *mutatis mutandis*" under Section 509 of the Companies Act, 2017.

It is worth mentioning that in 2020 the SECP released a draft of the 'Non-Banking Finance Companies and Collective Investment Vehicles Act'[8]. The stated purpose of the bill is to better monitor and supervise NBFCs and collective investment vehicles, to catalyze growth and development in the sector, and protect investors from fraud and malpractice. The draft was released by SECP for consultation purposes and the process is still underway. Once the process is concluded, the SECP's Policy Board will approve it and send it to the Ministry of Finance for parliamentary approval[9].

[8] *SECP. Draft Non-Banking Finance Companies and Collective Investment Vehicles Act, 2020.*
: https://www.secp.gov.pk/document/draft-non-banking-finance-companies-and-collective-investment-vehicles-act-2020/
[9] *"While ensuring full autonomy of the Commission, the 1997 Act provides for establishment of a Securities and Exchange Policy Board (Policy Board). The main objective of the Policy Board is to provide guidance to the Commission in all matters relating to its functions and to formulate policies in consultation with the Commission." SECP website: https://www.secp.gov.pk/about-us/policy-board/*

Non-Banking Finance Companies and Collective Investment Vehicles Act, 2020 *(under consideration)*

Though licensing requirements have been mandated since 2003 (to ensure that entities carry out only businesses and activities for which they are licensed), the new bill introduces penalties for performing an unauthorised non-bank financial service activity without the stated license. The penalties, which can go as far as seven years in jail and fines up to PKR 100 million, give more credence to the regulation and ensure accountability, not to mention bring more formality to sector operations. Moreover, license-seeking entities must be registered per the Companies Act, 2017, but extending that requirement further, the Act would ensure that proposed directors, major shareholders, CEOs, chairpersons, and boards of directors fulfil the fit and proper criteria and meet the Act's terms and conditions and requirements. The fit and proper criteria will be determined by the Commission, which may include educational background, financial status, experience, and the ability to serve honestly and fairly. NBFCs will also not be able to appoint a director or CEO without prior SECP approval.

So why did the central bank pass on the control of NBFCs to the SECP? According to sector experts the primary reasons were twofold. The first set of reasons were administrative. It was argued that even when NBFCs were under the SBP's regulation, the institution did not have complete power, especially when it came to liquidating FIs—the enforcement power was missing. There were also far too many small NBFCs and employing resources against a stringent supervisory framework was considered to be a sub-optimal use of SBP's resources. The second set of reasons pertained to the growth and development of the sector. Experts reasoned that by moving NBFCs under a less stringent set of regulations, NBFCs will be better positioned not only to grow but also to access borrower segments with a variety of risk profiles.

As briefly mentioned above, the SBP retained control of only one category of NBFIs—DFIs. Compared to other categories of NBFCs not only were the DFIs fewer in number, most were at a government to government (G2G) level with the purpose of improving trade flows and bilateral infrastructure development. For more details on why SBP retained control of DFIs see Box 1.

Non-Banking Finance Companies (Establishment and Regulation) Rules, 2003

The major objective of the introduction of the concept of 'NBFCs' was to enable the existing (largely) single-product institutions serving specific market niches, to offer a whole variety and range of financial products subject to compliance with tiered regulatory requirements. In line with this objective SECP notified a framework for the regulation and monitoring of NBFCs, the Non-Banking Finance Companies (Establishment and Regulation) Rules, 2003 (NBFC Rules). The NBFC Rules contained general provisions applicable to NBFCs (licensing criteria and processes, sponsor specifications, fees, etc.) as well as specific provisions dealing separately with each financial service (except discounting) that an NBFC may undertake. The differences in the legal and regulatory framework for each category of NBFCs aimed at creating distinct operating environments, but this also raised some challenges. As per SBP's 2006 Financial Sector Review report, the low capital requirements for lending NBFCs and modaraba management companies constituted a major challenge for the sector in mobilizing low cost funding. Furthermore, in the absence of capital adequacy requirements for NBFCs and modarabas based on risk weighted assets, risk management of these institutions was considered to be inadequate.

The SBP's review concluded that: *"risk management of NBFCs and modarabas merit attention. Major differences in regulatory approach towards banks and NBFIs can lead to regulatory arbitrage, which can pose challenges to financial sector stability. A risk-based approach to oversight and effective enforcement of laws is particularly important in the case of deposit-taking institutions, to avoid the social implications of excessive risk-taking and poor performance. In the absence of a financial safety net framework and insolvency regime in Pakistan – to provide for an orderly exit of institutions that have become inoperative, unprofitable or illiquid – protecting depositors' interest is a paramount issue[10]."*

[10] *State Bank of Pakistan. 2006. Financial sector review. https://www.sbp.org.pk/fsr/2006/English/Performance%20and%20Risk%20Review%20of%20the%20NBFIs.pdf*

Box I: Why did SBP retain control of DFIs?

To date, ten DFIs continue to operate under SBP regulatory oversight: Pak-Libya Holding Company Limited, PAÏR Investment Company Limited, Pak Brunei Investment Company, Pakistan Kuwait Investment Company Limited, Pak China Investment Company Limited, Saudi Pak Industrial and Agricultural Investment Company Limited, Pakistan Industrial Credit and Investment Corporation Limited, Pak Oman Investment Company Limited, House Building Finance Company (HBFC), and Pakistan Mortgage Refinance Company (PMRC).

Of these, seven DFIs have been established bilaterally with partner countries on a government-to-government level. One DFI is wholly owned by the Government of Pakistan (GoP) and one DFI was established as a private-public partnership. The GoP maintains operational oversight through its representation on the board of directors appointed by the Ministry of Finance.

To understand why SBP retained control of DFIs some historical perspective is necessary. DFIs played a key role in the early stages of economic development through industrialisation in many emerging economies. In Pakistan, this transformation took place during the mid-1950s to 1970s. State-owned and funded, many DFIs were established with the support of the World Bank extending stand-by credit lines with government guarantees. The DFIs would then on-lend funds to enterprises, many of which were state-owned, to set up industrial units for consumer and agri-based goods. The established DFIs played a dominant role in jumpstarting the industrial sector, especially with the government's focus on developing export-oriented and import-substituting industries.

After 1971, however, DFIs lost many assets due to the war. The government, meanwhile, embarked on a nationalisation regime converting industries, businesses and FIs to state-owned enterprises. The DFIs began to finance many of these loss-making public-sector enterprises (PSEs). With no recovery in sight the non-performing loans (NPLs) racked up. The World Bank was also financing and had contributed to the growth of DFIs in many Asian countries to support growth and industrialisation. Successive governments' insistence on subsidising loans to inject equity into sick PSEs and writing-off loans through special budgets led to the DFIs slipping into insolvency, which persuaded the World Bank to rescind financial support from them[a].

During the 1980s, the GoP formed Banker's Equity Limited, a new DFI to provide long-term financing to the private sector. Private sector businesses of the time set up new units on the back of tax holidays and subsidised lending from this DFI and other national banks with little skin in the game and weak business models. Many of these ventures failed and sought loan write-offs which they were eventually provided.

The reform phase to privatisation was as abrupt and expensive as nationalisation. PSEs that had been borrowing from DFIs (which were borrowing from international financiers) were sold at throwaway prices, many of which never survived post-transaction. As a result, most DFIs were shut down after absorbing the loan losses of these PSEs, with the exception of HBFC that survived due to government financial support.

Current DFIs are mainly dependent on short-term borrowing from the interbank market to finance their assets (47% of total funding) as well as T-bills/Pakistan investment bonds. Much like NBFCs, their current source of funds is costly and short-term, causing them to remain small and insignificant in the financial services space.

[a] *Faruqi, S. 2015. The role of DFIs in industrial growth and transformation: Why the East Asian countries succeeded and Pakistan did not. The Lahore Journal of Economics, 20: SE (September 2015): pp. 13–30. DOI: http://dx.doi.org/10.35536/lje.2015.v20.isp.a2.*

2008 onwards: How the SECP's PRs came into being

In 2008, the SECP notified Prudential Regulations (PRs) for the operations of NBFCs under its ambit, including separate ones for leasing companies, housing finance companies, and modarabas. To ensure a gradual and smooth transfer of regulatory control, the PRs notified by the SECP were modelled along the same lines as PRs applicable under the SBP's ambit.

At the time of transition policy makers and financial sector experts believed that by regulatory transfer, NBFCs (especially with regard to lending) could operate with greater flexibility. Since SBP PRs were stringent and banks' hands were tied in terms of clean exposures, by moving the NBFC segment to the SECP, there was a case for making regulations less demanding to facilitate credit decisions. However, at the time, the SECP had limited capacity to supervise and monitor these entities. As a result, the NBFC regulations' transition from the SBP to SECP was not well phased out.

The SECP was also not geared to support NBFCs the way the SBP was to support banks. During 2003–2007, asset growth in NBFCs (PKR 259–567 billion; growing 17–23% each year) was driven mostly by mutual funds with the share of leasing companies, investment finance companies, modarabas, and housing finance companies shrinking. In fact, all other segments registered negative growth through those years. In terms of asset composition, the asset share of mutual funds in total assets of NBFCs grew from 22% to 55% during the period. In some quarters NBFCs' declining performance was associated more readily with the exit of several companies over these years rather than the dismal financial performance of existing entities.

NBFCs' near complete reliance on bank borrowings further increased the borrowing-to-liability ratio to 62.3% in 2007, compared to 55.1% in the previous year. The rising interest rates caused the spread to shrink from 3% in FY06 to 2.7% in FY07, which caused profitability to plummet. As stated by the SBP's performance review of that year: *"return on average assets (RoA) and return on average equity (RoE) of NBFIs was 1.3% and 4.9% [in FY07] respectively, having declined markedly from their peak levels of 4.3% and 17.7% respectively, in FY03. This is in sharp contrast to the performance of the banking sector, with an RoA of 1.5% and RoE of 15.5% for the year CY07."*

It was clear that the NBFCs needed market outreach, product innovation, resource mobilisation, increased capitalisation, and restructuring of underdeveloped segments, which the PRs of 2008 hoped to bring. The resulting regulations, however, were more stringent, erring on the side of caution, and not quite allowing NBFCs the room to innovate.

The regulations increased the minimum capital requirement (MCR) for each type of business being conducted by NBFCs, which the SECP believed would benefit the segment in the long run. Essentially, the low capital base of the NBFCs had been identified as a challenge to mobilising low-cost funding. It was also believed to have resulted in a fragmentation of the sector with a large number of small and weak companies operating with very little market share. The hope was that increased MCRs would lead to the consolidation of small units into stronger contenders in the financial system while the weaker entities would exit[11]. The industry however, had already been through one round of consolidation by the time the higher MCRs were introduced. During 2003–2008, numerous NBFCs were merged, with the total number of NBFCs slashed by half.

The NBFCs also faced a major existential challenge in the form of having a limited source of funds, which were also expensive. The high cost of funds associated with reliance on bank credit lines and the potential of them drying up in turbulent times made NBFCs extremely vulnerable to a liquidity crisis. The amendments to the regulations addressed this issue but inadequately, allowing NBFCs to raise deposits from certificates of deposit (COD) with tenors of 30 days and more, thereby reducing the earlier restriction of keeping a minimum of three-month tenor deposits.

[11] *State Bank of Pakistan. 2008. Financial stability review 2007–08 (chapter 10). https://www.sbp.org.pk/FSR/2008/PDF/Chapter%2010%20%20Performance%20review%20of%20NBFIs.pdf.*

Box II: Why does Pakistan have no discount houses?

The NBFC Prudential Regulations, 2003 restricted the tenor of factoring products offered by discount houses to a maximum of six months, a crucial limitation which has been retained ever since. Moreover, because factoring companies could not enter other operations such as leasing or modarabas (as these require a separate license), the loan books of discount houses were to be concentrated in short-term (working capital) loans in their entirety.

Furthermore, even within working capital or short-term financing, receivable factoring is a single unique type of product that only caters to post-shipment capital needs. This means that discount houses/factoring companies had zero opportunity for product diversification. These limitations made for a highly ill-advised business model for any firm, irrespective of how lucrative the rate of returns charged on receivable factoring may have been.

In the case of foreign trade finance, receivable discounting would have meant the loan book becoming sub-standard on the first day beyond the due date because, realistically, overdues in the realisation of export payments are a norm, especially for manufacturing firms. The problem is further exacerbated where local discounting is concerned.

While this may not necessarily mean that discount houses would run losses, catering to a singular target market so prone to overdues would mean the routine classification and reporting of sub-standard/overdue loans, negatively affecting borrowers' credit reports, lender-borrower relationships, and the quality of lenders' loan books. Given these stringent conditions it is little surprise that only one firm briefly ventured into the factoring/discount house business in Pakistan.

The high share of bill discounting and export finance schemes in the short-term lending portfolio of commercial banks to private sector businesses stands in sharp contrast to the failure of NBFCs in performing receivable factoring. As of June 2020, over 20% of short-term loans by commercial banks to all domestic private sector borrowers consist of export and bill discounting schemes.

Based on the above, it is tempting to conclude that where NBFCs failed, commercial banks succeeded. However, commercial banks have incremental opportunity to earn commissions/spread on the conversion of foreign exchange at the time of settlement/realisation of export trade bill. Moreover, no doubt, a significant factor in the success of banks is also access to the SBP's export refinance (ERF) schemes. This assessment can be made based on the fact that in-land bills are just 10% of commercial banking trade finance business. As mentioned above, in the context of in-land bill factoring, it offers no other incremental earning potential, other than the spread over the cost of funds on lending.

To enable the offtake of in-land bill factoring Karandaaz has been working with a commercial bank to install a supply chain discounting platform. The platform will enable a three-way partnership between the vendor, corporate and bank, enabling the bank to shift its risk away from the vendor and on to the corporate. A key benefit will be the freeing up of working capital for smaller vendors.

As the current regulatory regime for NBFCs currently stands, there seems to be little benefit in obtaining a dedicated license for discounting services, especially since under the IFS license, NBFCs can perform discounting services as well as housing finance and leasing services, thereby decreasing the concentration risk from just maintaining short-term lending assets, as in the case of discount houses. Offered under the IFS license and coupled with technology solutions, discounting services may become a viable segment for NBFCs to target.

For modarabas, a conceptual framework was developed for *sukuk* issuance[12]. A *sukuk* is a *sharia*-compliant bond-like instrument, however it is structured as a direct asset ownership interest.

Another major change introduced was in the operational framework of NBFCs. Prior to the 2008 regulations, an NBFC could add a new license on top of an old one by simply meeting the MCR of the same. This progressively tiered capital requirement approach allowed NBFCs to hold multiple licenses, opening the segment up to function overlaps and conflicts of interest[13]. The 2008 regulations did away with this progressive approach such that companies in the business of asset management and investment advisory could not offer leasing, discounting, housing finance, or IFS services at the same time simply by complying with the MCRs, and vice versa.

The regulations also introduced changes to the criteria for non-performing loan (NPL) classification, making it more stringent by eliminating the other assets especially mentioned (OAEM) category with direct classification into sub-standard loans after an overdue period of 90 days. New requirements that came into effect in 2011 distinguished between short-, medium-, and long-term financing facilities, along with increased provisioning requirements.

Overall, these amendments, additions and revisions to the regulations proved counterproductive as they created a heavily restrictive environment. Most NBFCs also did not diversify into new products and portfolios, seeing as they did not perform exceptionally well in their core business which led to a general lack of resources, fewer opportunities to innovate, and less appetite for further investment.

Notable revisions to the framework for lending NBFCs in 2015 and 2020

In 2015, the SECP notified landmark amendments to the Non-Banking Finance Companies (NBFCs) and Notified Entities Regulations, 2008. The 2015 amendments revamped the regulatory framework for lending NBFCs, making them more conducive and practical. Coupled with further revisions in 2020 the amendments also directed focus on enhancing the role of lending NBFCs in SME lending and venturing into segments which banks are either reluctant to service or do not have the regulatory space to do so.

The concept of small- and mid-sized, non-deposit-taking NBFCs was introduced with a significantly reduced equity requirement of PKR 50 million. A new class of NBFCs, 'non-bank microfinance companies' (NBMFC), along with a comprehensive framework for providing finance to poor persons and micro-enterprises, was introduced. Under this new category existing non-bank MFIs, registered under a variety of legal dispensations, came under the ambit of the SECP's NBFC regime. The concept of capital adequacy ratio (CAR) was introduced for deposit-raising NBFCs, and their deposit-raising ability was capped based on equity, credit rating, and CAR requirements. Existing NBFCs were allowed one year to comply with the new minimum equity, CAR, and rating requirements.

Moreover, the equity requirement for non-deposit-taking NBFCs involved in housing finance, leasing, and discounting services was reduced from PKR 700 million to PKR 50 million. For IFS license holders, the requirement was slashed from PKR 1 billion to PKR 100 million with the intent to encourage existing and new NBFCs to introduce specialised lending products without being constrained by the high equity requirements introduced in 2008. In essence, the regulatory environment became relatively more scaled with less strict restrictions for non-deposit-taking NBFCs compared to those for deposit-taking NBFCs.

Some of the key amendments with implications for SME lending are explained in more detail in the following pages.

[12] *Ibid.*
[13] *Ibid.*

Exhibit 3: Regulations for deposit-taking NBFCs (2015)

Capital adequacy ratio (CAR)	8% for the first two years; 10% for subsequent years
Creation of reserve fund	> or = 20% of the after-tax profits credited till the time that the reserve fund equals the amount of the NBFC's paid-up capital, and thereafter, a sum not less than 5% of after-tax profits credited to the reserve fund
Restrictions on deposit-raising	• Only raise deposits by issuing certificates of deposit (CoDs) with a maturity of not less than three months • Maintain a minimum credit rating • Caps on deposits linked to credit rating and equity as follows:

Credit rating	Total deposits from all sources, including from individuals, sole proprietors, provident/gratuity funds, trusts, charitable institutions, and section 42 companies	Deposits from individuals, sole proprietors, provident/gratuity funds, trusts, charitable institutions, and section 42
AA- and above	5 times of equity	4 times of equity
A- to A+	3 times of equity	2 times of equity
BBB to BBB+	2 times of equity	Nil

• 15% of the outstanding funds raised through deposits should be invested in government securities or instruments

NBFC listing	Listed on the stock exchange

Maximum exposure limits

In the 2015 amendment to the NBFC regulations of 2008, maximum exposure limits (per party and for groups) were reduced to mitigate the systematic risks facing NBFCs such that the maximum exposure limit to a single party as a percentage of the equity maintained by the NBFC was reduced from 30% to 20%. This was provided that the maximum outstanding fund-based exposure did not exceed 15% of the equity of an NBFC (previously 20%). The maximum exposure limit to a group could not exceed 25% of the equity of an NBFC (previously 50%) provided the maximum outstanding fund-based exposure did not exceed 20% (previously 35%). Exposure limits for NBFCs engaged exclusively in the business of issuance of guarantees and for non-deposit-taking NBFCs providing financing to other NBFCs were also specified.

Defining 'small' and 'medium' enterprises

More recently, via SRO 279(I)/2020 the SECP adopted definitions for 'small' and 'medium' enterprises. While SMEs were previously classified by the regulator using the Companies Act, 2017, the recently adopted definition is more in line with the SBP's classification of SMEs. The definition included in the NBFC Regulations follows a two-factor criteria i.e., number of employees and annual sales turnover, with the lower thresholds being similar to those of the SBP's.

Exhibit 4: SECP's revised criteria for categorizing SMEs

Feature	Small enterprises (SE)	Medium enterprises (ME)
Number of employees	A business entity (not a public limited company) that has up to 50 employees *(including contractual employees)*	A business entity that has between 51-250 employees (Manufacturing & Service), or 51-100 employing (Trading) *(including contractual employees)*
Annual sales turnover	Up to PKR 150 Million	Above PKR 150 million and up to PKR 800 million *(all types of Medium Enterprises i.e., trading, services and manufacturing)*

In aligning definitions and lending criteria with the SBP, data across regulators can be synthesised and a more complete picture can emerge in relation to SME borrowing by commercial banks and NBFCs. While other government agencies—Federal Board of Revenue (FBR), Board of Investment (BOI), Small and Medium Enterprise Development Authority (SMEDA)—still need to align their definition of the 'm', 'S' and 'M' segments, alignment between SECP and SBP sets a very good precedent.

Easing documentary requirements

In its recent amendments, SECP has relaxed the requirement of obtaining audited financials for 'S' enterprises, making it mandatory only for loan amounts exceeding PKR 15 million (previously above PKR 5 million). If the borrower is classified as a public company or a private company, which is a subsidiary of a public company, or a private company with paid up capital of PKR 3 million or more, the NBFC is required to obtain a copy of its financial statements duly audited by a practicing chartered accountant, while in case of any other company, copy of financial statements audited by a practicing chartered accountant or a practicing cost and management accountant can suffice.

The lower end of the 'S' segment is generally considered to be less structured with limited formal reporting protocols in place, in addition to a general unwillingness/inability to incur hefty compliance and audit costs. This modification will not only align the provisions for SME lending with SBP's Prudential Regulations, but will also address the limitations and fears of borrowers, making the regime more market and client friendly.

Unsecured financing limits

The SECP has retained existing limits on unsecured financing at PKR 200,000 for deposit-taking NBFCs. In the case of non-deposit-taking NBFCs however, the limit has been set at 10% of equity (for a single borrower or a group). Aggregated unsecured financing shall not exceed the NBFC's equity.

Box III: Deposit-taking NBFCs

The regulatory framework for deposit-taking NBFCs may come to define, at least partially, whether lending-type NBFCs will succeed in diversifying their sources of funding, and reducing their vulnerability to economic downturns and exogenous shocks.

Differences of opinion exist among stakeholders on the following crucial elements[a]:

1. Whether deposit-taking NBFCs—especially those that take short-term deposits encashable within three months—contribute to monetary aggregates. According to International Monetary Fund (IMF) Monetary and Financial Statistics Manual (MFSM) guidelines, beginning June 2008, all deposits (in the form of CoDs) held with NBFCs are classified under 'transferrable deposits, and/or other deposits". By definition, deposit-taking NBFCs contribute to near-money aggregates, M1 and M2. However, because CoDs are not bearer/negotiable instruments, they cannot function as bills of exchange.

2. Another question that comes up often is, if deposit-taking NBFCs function like banks by creating money, should they not be regulated under the central bank's ambit? On the one hand, the SBP does not appear keen to take over NBFC supervision as it believes the size of the sector vis a vis the banking sector, and the sheer number of NBFCs will result in suboptimal utilization of SBP's resources. On the other hand, the SECP has been deepening its understanding of the sector as well as its capacity to regulate lending NBFCs, as demonstrated with continuous amendments to the regulatory framework.

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3. It is also argued that unless central bank supervision translates into integration into the SBP's payment system and a lender-of-last-resort (LOLR) role to NBFCs, NBFCs will have little to gain from returning to the SBP's jurisdiction, apart from exposing themselves to more stringent compliance regulation. This ask is contended by an opposing set of views that question whether direct access to the payment system is really a precondition for the success of lending NBFCs. A scan of developing country regulatory regimes for lending NBFCs shows that in many cases lending NBFCs do not have direct access to payment systems (Jordan, Egypt, Bahrain).

To safeguard depositor interest, the latest amendments to the Non-Banking Finance Companies (NBFCs) and Notified Entities Regulations, 2008 have placed many restrictions on deposit-taking NBFCs, including:

1. Three-year operations history, of which operations must be profitable for two consecutive years.
2. Compliance with minimum equity requirements and CAR ratios—CoDs must be settled/encashed upon maturity (no rollover allowed) in case of non-compliance for more than six months.
3. Minimum equity requirement: PKR 1 billion (for new deposit-taking NBFCs).
4. CAR requirement: 10% in line with Basel-III.
5. Mandatory listing on the stock exchange.
6. Minimum credit rating of A-.
7. Maximum deposits should be equal to five times of equity, of which a maximum of four times of equity may be raised from individuals, sole proprietors, provident/gratuity funds, charitable institutions, and Section 42 companies (NBFC deposits are also not insured by the Deposit Protection Corporation, unlike those of banks, which make them riskier, and due to the three-month tenor that needs to be maintained, deposit mobilisation is also more costly. This adds another layer of disadvantage that deposit-taking NBFCs inherently face).
8. Furthermore, 15% of funds raised through CoD issuance must be placed and must remain in government securities. This is similar to the statutory liquidity requirements (SLRs) for schedule banks. Similarly, a deposit-taking NBFC is required to credit 20% of profit after tax into a reserve fund every year.

By making deposit-raising challenging, it appears that the regulator seeks to discourage unabated growth in the asset base of NBFCs. However, the regulator should balance the segment's need to mobilise funds with the measures needed to protect deposits. The suitable balance will evolve out of a detailed assessment of the various sources of funds that can or should be tapped by lending NBFCs, juxtaposed with the costs associated with tapping these sources.

As things stand, it appears that deposit-taking NBFCs will continue to be regulated by the SECP.

[a] *Informed by consultations with industry experts.*

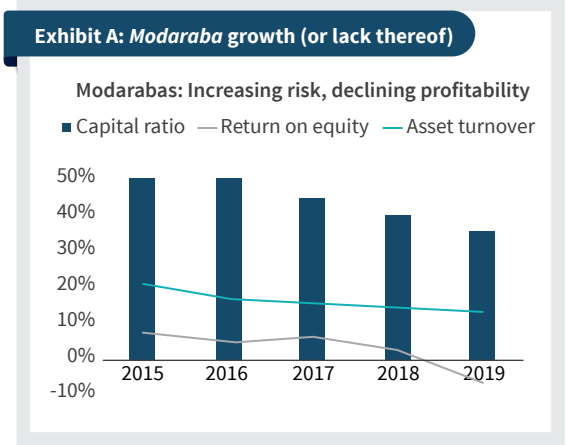
Ultimately, when it comes to regulatory regimes, the regulatory environment will change as NBFCs grow in size. If the segment becomes systemically important, the regulatory regime will likely become more stringent. In India, where NBFCs account for over 20% of total credit the Reserve Bank of India (RBI) has been working on moving the regulatory environment of NBFCs to a four-layered, scale-based structure where the top layer will be subject to the strictest regulations and the lowest layer (non-deposit-taking NBFCs) to the least. If that sort of growth materialises among NBFCs in Pakistan, the SBP's experience with regulating, supporting and monitoring the banking sector could prove invaluable.

Box IV: A short case study of the modaraba model

History

The Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980 lay the foundation stone for the Islamisation of Pakistan's financial system. As a first step in ensuring that modarabas remained *ribah*-free, modaraba companies were to be registered under the then Companies Act, 1913 and regulated by the Ministry of Finance through the Registrar of Modaraba Companies and Modarabas. The martial law administration established the Corporate Law Authority (CLA) in March 1981, which was conferred the status of a statutory body in 1984 with the promulgation of the Companies Ordinance, 1984. By 1989, all work related to modarabas was transferred from the Finance Division to the CLA, which was restructured into the autonomous regulatory body, the SECP, in 1997 and regulates modarabas to this day.

Exhibit A: *Modaraba* growth (or lack thereof)



Modaraba translates literally into partnership, which involves two parties—one partner extends finance to the other with the objective of carrying out a business activity. The provider of finance is called the *rabb-ul-mal,* while the receiving partner is called the *modarib* (working partner). The working partner contributes management skills to the modaraba. A modaraba company is an entity engaged in the business of floating and managing modarabas for either a fixed or indefinite period.

As per the Ordinance, modarabas are classified into two categories:

1. Multipurpose modaraba: Modaraba having more than one specific purpose or objective.
2. Specific-purpose modaraba: Modaraba having one specific purpose or objective.

The modaraba experience

Thus, unlike other NBFCs, modarabas were never solely regulated under the central bank. Until 2000, the PRs for modarabas were notified by the SBP which regulated modarabas to the extent of compliance with these PRs. Because modarabas were incorporated and have grown primarily under a non-bank regulator since their inception, they present an interesting case study.

The first modaraba, a specific-purpose modaraba, was floated in 1980. In 1985 three multi-purpose modarabas were established, with the number of entities growing to 52 by 1996. Conceptualized as a source of medium-term financing, modarabas have not really moved outside of the big cities (Karachi, Lahore and Islamabad) to explore new markets and introduce new innovative products.

With a limited product range, many modarabas have been using available funds to invest in capital markets, often making their performance cyclical with the performance of the stock market. Modarabas, therefore, do not boast a strong track record of performing their core function of improving access to credit for borrowers.

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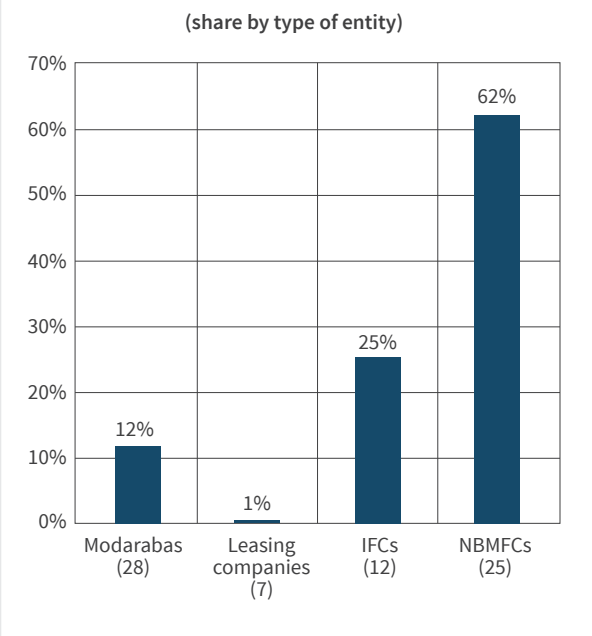
A weak focus on the core function of improving access to credit for borrowers, and a preference for profit distribution had a two-pronged effect:

1. Modarabas were established by business groups to park the income of group companies and sister concerns to minimise tax liability on group income.

2. Maximum distribution of profits meant that modarabas were unable to grow in size due to minimal re-investment and retention of profit. The total equity of the modaraba industry grew at a compound annual growth rate (CAGR) of 3.96% during FY15–FY19. The corresponding figure for the leasing industry was nearly 11%.

Of a total of 72 lending-type NBFCs operating in the country, the highest number is that of modarabas. Yet, as of June 2020, their share in total assets stood at just 12% (more than half the share in total assets of lending-type NBFCs is that of NBMFCs). Further bifurcation for a share in loans and advances, shows similar levels for modarabas at 12% of the total (October 2020). Nevertheless, from the angle of profitability, modarabas are in no way a financial failure. While growth in lending-type NBFCs (other than microfinance) has declined, with many leasing companies having wound up operations in the past 12 years, the number of modarabas in operation are 28. In fact, the Pakistan Stock Exchange (PSX) has seen the floatation of at least two new modarabas in the past two years with an equity base of PKR 1.05 billion. Interestingly, at least two-thirds of the modarabas listed on the PSX have direct common control with other listed entities.

Exhibit B: NBFC loans and advances



The consensus from stakeholder consultations (senior financial industry experts) is that while modarabas have remained financially successful, the success stems from a tax anomaly per which income earned by modarabas is fully tax-exempt, provided 90% of profits are redistributed among certificate holders.

Lessons

The modaraba experience in Pakistan offers few lessons to help understand the expansion of credit to SMEs in the country. Firstly, as mentioned above, most of the modarabas in Pakistan have been formed to have investments of group companies parked for tax advantages and as a result the investment and lending activities are restricted to group members. This typically translates into modarabas having a small number of larger clients. Thus, the interests of modarabas are not seen to be in broad-based SME lending.

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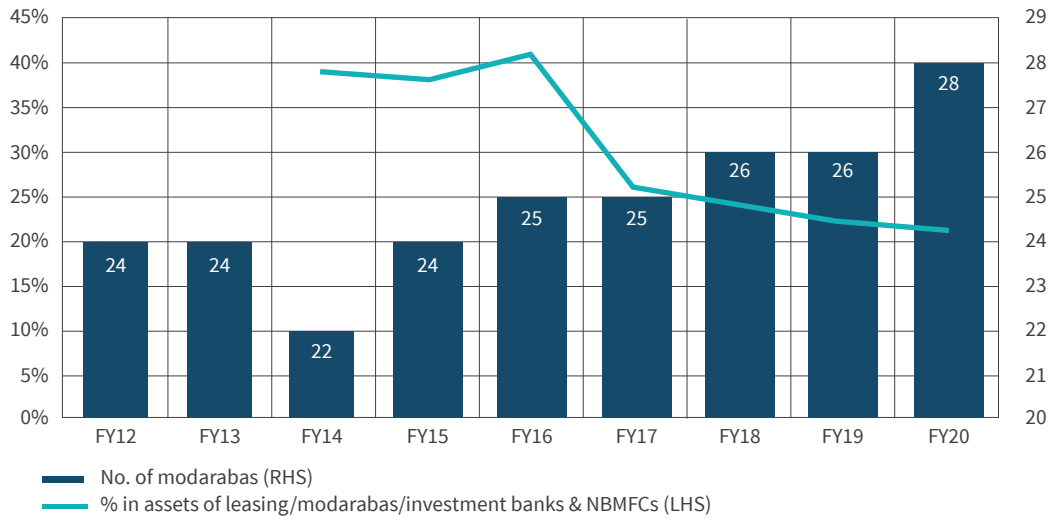
Exhibit C: Modarabas through the years



Secondly, most modarabas in the lending business are formed by small conventional banks as an alternative to having an Islamic finance window where the license requirement is high. Under a modaraba subsidiary, these banks can offer Islamic lending products, including to SMEs. But since banks in general have demonstrated limited interest in SME lending, their modaraba subsidiaries also exhibit similar tendencies.

During the 40 years since modarabas were first introduced, no substantial changes have taken place in their governance structure other than bringing them into the ambit of the SECP. In July 2020, the federal government introduced a Modaraba Companies Amendment bill in the National Assembly which is expected to further relax the regulation surrounding modarabas, including permission for the floatation of non-listed modarabas.

While FY20 ended in across-the-board losses for the industry due to poor economic conditions, entry into the IMF programme, and the onset of COVID-19, the number of modarabas has been on the rise - from 22 in 2014 to 28 in 2020. Despite the continued formation of new modarabas, it is hard to see these entities taking a driving role in pushing the expansion of credit to SMEs.

Section 4

State of SME Lending in Pakistan

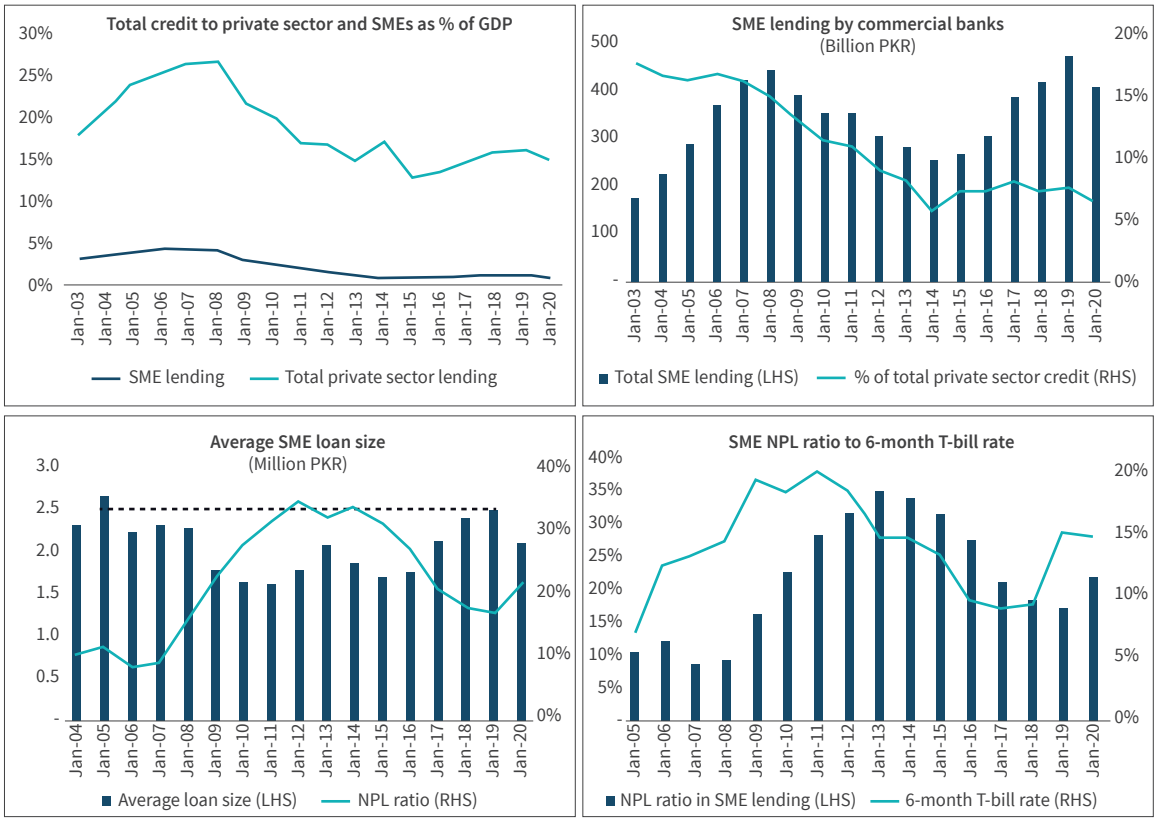
Declining private sector banking credit

Since the 2008 financial crisis, Pakistan's private credit offtake has been on a permanent retreat, rising slightly during FY14–FY19. The causes are well-documented as government borrowing from the financial system has crowded-out appetite for private sector credit. At its peak in 2007–2008, private-sector borrowing stood at 27% of the gross domestic product (GDP), which has since declined to nearly half. FY20 closed on a dismal note—such levels were last seen in the early 1990s.

SME bank lending

However, at least private-sector borrowing is growing in nominal terms. Over the last 12 years, private sector credit has grown at an annual CAGR of 6.6% against nominal growth in GDP of 12% per annum. Meanwhile, nominal growth in SME lending has been negative in CAGR terms.

Exhibit 5: SME lending and NPLs



Source: State Bank of Pakistan. SME finance quarterly updates.

In FY08, SME borrowing stood at PKR 437 billion, which, fast forward to FY21, has shown virtually no change—as of March 2021 outstanding SME financing stood at PKR 443.77 billion, down from PKR 481.78 billion in December 2020[14]. SME credit from commercial banks has, in fact, declined at a negative CAGR of 0.72%.

Lending to SMEs is not only falling in relative terms, which has been documented *ad nauseam*. The decline in value was particularly precipitous up to FY14 when SME credit bottomed out at PKR 250 billion, levels last touched a decade ago.

It bears no surprises then, that in relative terms, SME lending had declined to less than one percent of GDP by FY20, from over four percent consistently maintained during FY05–FY08. Similarly, as a percentage of total private sector credit, it fell from 17% pre-2008 to under 6% in FY14, with modest recovery ever since.

As per SBP's Quarterly SME financing data tables, domestic private banks remain the largest provider of credit to SMEs accounting for PKR 299.6 billion (67.5%) out of PKR 443.7 billion as of March 2021, followed by public sector commercial banks at PKR 94.08 billion. Of the total lending to SMEs, DFI accounted for only PKR 2.88 billion as of March 2021[15].

Average loan size and NPL ratio

The average loan size to SME borrowers over the last decade has consistently hovered around just PKR 2 million, much less than even the clean lending exposure limit of PKR 5 million allowed to banks against an SME borrower. The average loan size saw a slight uptick in FY17-19 but dropped again in FY20 as the impact of the COVID-19 pandemic and its associated lockdowns kicked in.

Meanwhile, NPLs in SME loans improved to ~15% in December 2018 from over one-third at the peak of the NIB Bank crisis. Not surprisingly, FY20 saw an increase in NPLs from 15.62% in December 2020 to 18.64% in March 2021[16]. With the COVID vaccination drive gaining momentum during the second half of CY2021, it will be useful to keep a close eye on NPLs as restructured loans come due.

SME borrowers

It would follow that average loan size has fallen because banks have begun to restrict per-party exposure on SME borrowers to ensure that the debt burden for SME borrowers remains in a healthy range. In fact, the opposite has happened. As per SBP's quarterly updates the total number of borrowers has declined—from a peak of 215,000 in FY14, the total number of SME borrowers were recorded at 178,000 as of March 2021. The outreach is inconsequential when viewed against both, the universe of an estimated 4.5 million[17] SMEs in the country, and the national financial inclusion target to reach 700,000 borrowers by 2023.

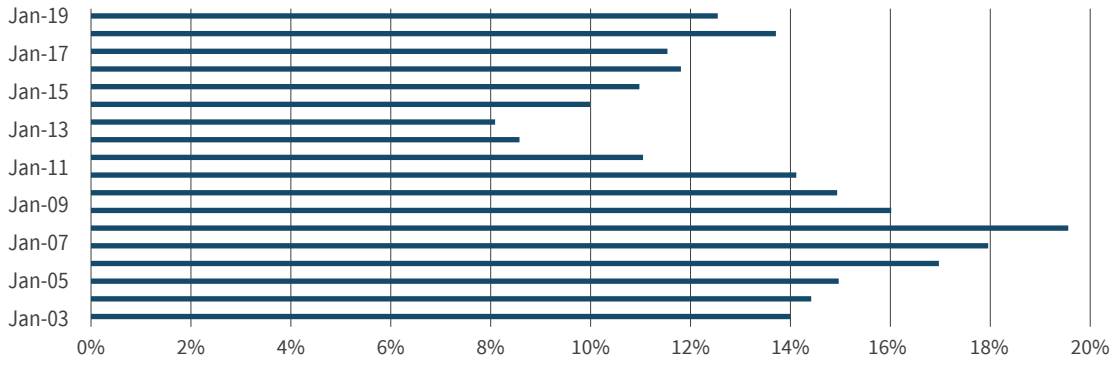
Consultations with bankers indicate that most banks do not have a dedicated SME finance group or division. Banks' disinclination to lend to SMEs, aside from their obvious preference for dominant borrowers (the government, large corporates) originates from a multitude of reasons that increase bank credit risk, including the following:

- SMEs' lack of organised and formal structures—most are outside the tax net and not registered with SECP;
- The absence of credit history—SMEs have historically borrowed from the informal sector;

[14] *State Bank of Pakistan. SME financing data tables, March 31, 2021. https://www.sbp.org.pk/sme/PDF/DFG/2021/Mar.pdf*
[15] *Ibid*
[16] *Ibid*
[17] *Karandaaz Pakistan. 2019. Feasibility study for SME financing platform.*

- The inability to assess credit worthiness due to information asymmetries;
- SMEs' inability to arrange adequate and titled immovable collateral. Where small enterprises have real estate that could fully or partially secure a loan, the collateralisation process remains cumbersome[18];
- When banks have to take recourse from courts for foreclosure on defaults, this process may take years;
- The legacy of past defaults suffered by several banks.

Exhibit 6: Share of SME borrowers (as % of total private sector borrowers)



Source: State Bank of Pakistan. SME finance quarterly updates.

Box V: Challenges for banks in SME segmentation and reporting

In terms of segmentation, borrowing clusters in most private sector commercial banks are bifurcated along the lines of corporate, commercial, retail, and consumer banking groups. While the latest SBP PRs define SMEs based on annual turnover or number of employees, commercial banks do not follow the classification very stringently. This is due to two factors:

1. Based on banks' internal credit policy documents, the definition of a medium-sized enterprise often overlaps with the size of a typical 'retail' and 'commercial' banking borrower. For example, until 2019, most banks classified borrowers with an annual turnover of PKR 500 million–PKR 2 billion as commercial, while the size of 'medium' enterprises defined by the SBP has an annual turnover of up to PKR 800 million.

   Note: Within the SBP PRs for SMEs, it is also stated: *"when an entity's one parameter is as per ME and its second parameter is above the upper limit prescribed for ME, then the subject entity shall be categorised as commercial/corporate entity".* The clear segregation problem would, therefore, persist even if banks were following SBP-prescribed SME definitions.

2. Banks often cluster borrowers according to sponsor group and do not necessarily treat entities separately.

   The second factor is more crucial because SBP regulations for group exposure demand that borrowers belonging to the same sponsor group be monitored for aggregate exposure. For operational reasons, banks prefer to park such clients together, which often results in medium-sized enterprises being parked as corporate, even if their standalone turnover may demand otherwise.

Continued on following page

[18] *JICA. 2018. Data collection survey on SME finance in the Islamic Republic of Pakistan.*

Banks' data collection and reporting systems have been developed based on these ground realities. Thus, while the resulting mis-reporting is not deliberate, it is an outcome of the legacy systems established at banks.

It is also worth noting that at most commercial banks, classification as a small, medium, retail, commercial, or corporate enterprise takes place at the time of bank account opening, which is independent of the customer's loan application (which may or may not be approved at a later stage). The initial classification by account type/enterprise size is also not updated thereafter, and thus, the borrowing data fetched from core banking software is unlikely to reflect the current size of the enterprise.

Moreover, the definitions of retail, commercial, and corporate banking borrowers are revised periodically (usually due to currency depreciation) at which time the bank may reclassify borrowers internally within banking groups, without their account type ('S', 'M' or 'C') changing in the core banking system. Because commercial banks are permitted to formulate their own credit policies, they have so far not aligned definitions of retail to small, and commercial to medium.

Banking groups are defined across broad-based criteria of risk-rating and industries/sectors, based on which standards for minimum and maximum pricing, preferable collateral, type of product offered, and profitability targets are defined. These criteria are deeply intertwined with sponsor risk, and as such, the size of the enterprise is less relevant.

Thus, it may not be incorrect to assert that the seemingly indifferent behaviour of commercial banks towards SMEs will continue unless lending to SMEs is tracked and recorded more systematically, based on a uniform classification of 'S' and 'M' segments.

Note: To gauge the extent of the anomaly caused by erroneous classifications, it may help to seek the data of bank deposits tagged to these 'S' and 'M' accounts, and then compare it against:

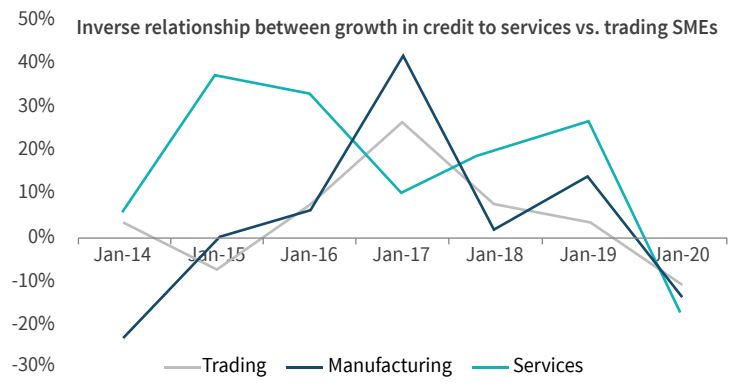
1. Bank deposits by retail and commercial accounts, respectively
2. Bank lending to 'S' and 'M', respectively
3. Compare bank lending to 'S' and 'M' with bank credit to retail and commercial.

Sectoral trends in bank lending

Yet, quarterly SBP statistics reveal that commercial banks have not altogether abandoned SME lending. While overall lending to the segment may have stagnated, the share of lending to services SMEs has been on a rise, accounting for 24% of total SME bank credit in March 2021 compared to 19% in March 2015.

In fact, until the most recent round of monetary tightening began 18 months ago, credit to services SMEs grew over 3.3 times in five years. Part of the reason may be a reduction in sales tax on services SMEs.

Exhibit 7: Growth in credit to SMEs (by sector)

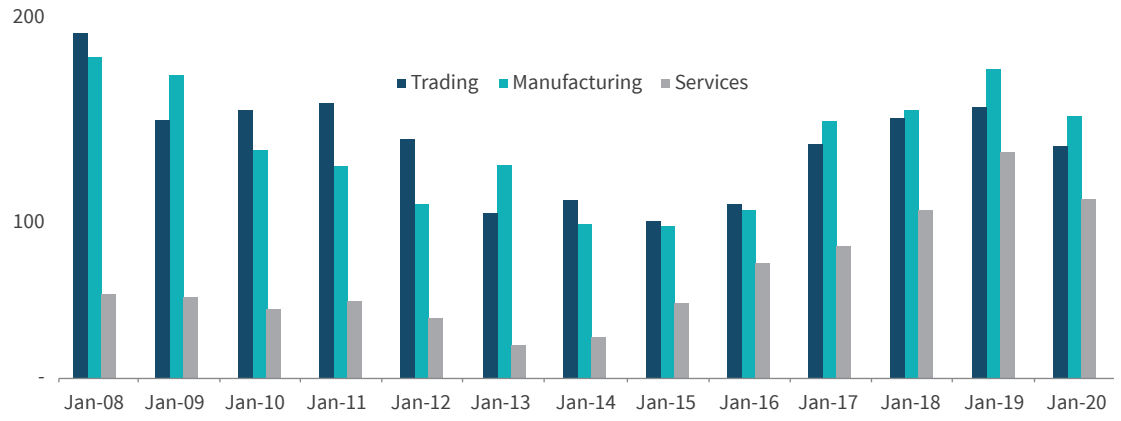


Source: State Bank of Pakistan. SME finance quarterly updates.

Although the SBP has in recent years begun to share private sector lending data by industry type (ISIC-4), the data does not classify these industries as trading, manufacturing or services type. Although it remains unconfirmed, there are high chances that the trading, manufacturing, and services classification is done at the time of account opening and is based on self-declaration by the customer.

Even so, it is clear that the increasing proportion of SME credit to the services sector is accounted for by the transportation and storage industry where credit to passenger and freight transport by road/land forms a sizeable chunk of SME lending at PKR 21 billion as at 30 June 2020[19].

Exhibit 8: SME credit by sector (Billion PKR)

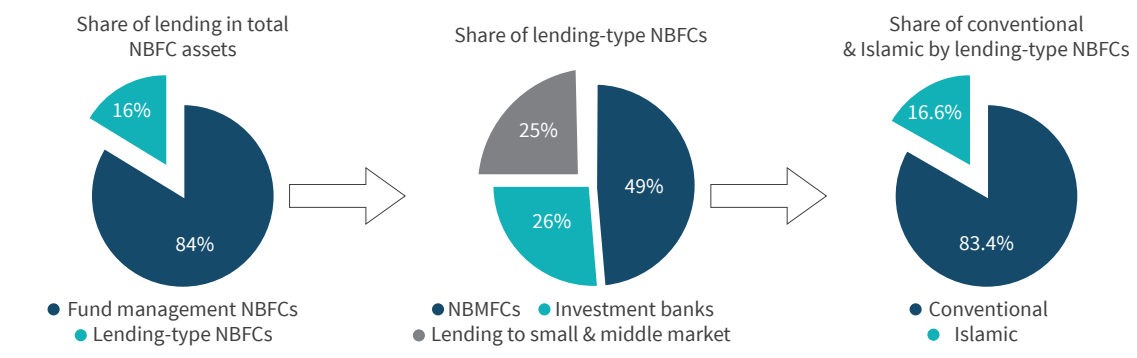


Source: State Bank of Pakistan. SME finance quarterly updates.

NBFC lending to SMEs

Lending-type NBFCs appear to be a major segment—there are twice as many lending NBFCs as there are scheduled commercial banks—but once the layers begin to peel off, lending by NBFCs in general, and to the SME universe specifically, becomes quite insignificant. Of the PKR 1.7 trillion asset base sported by the NFBC sector as a whole, lending-type NBFCs account for 16%. Of this, in December 2020 NBMFCs accounted for PKR 129 billion, modarabas for PKR 51 billion, IFCs for PKR 66 billion and leasing companies for PKR 6 billion[20].

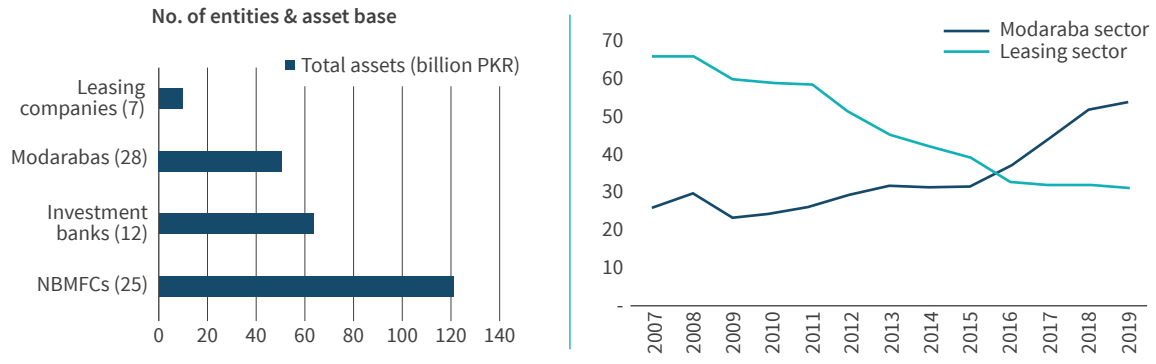
Exhibit 9: Distribution of NBFC sector assets



Source: Securities and Exchange Commission of Pakistan. Annual Report 2020

[19] *State Bank of Pakistan. 2021. Ecodata by type of finance.*
[20] *State Bank of Pakistan. 2020. Financial stability review 2020. (Chapter 5) https://www.sbp.org.pk/FSR/2020/Chp-5.2.pdf*

Exhibit 10: Lending-type NBFCs (Oct. 2020)

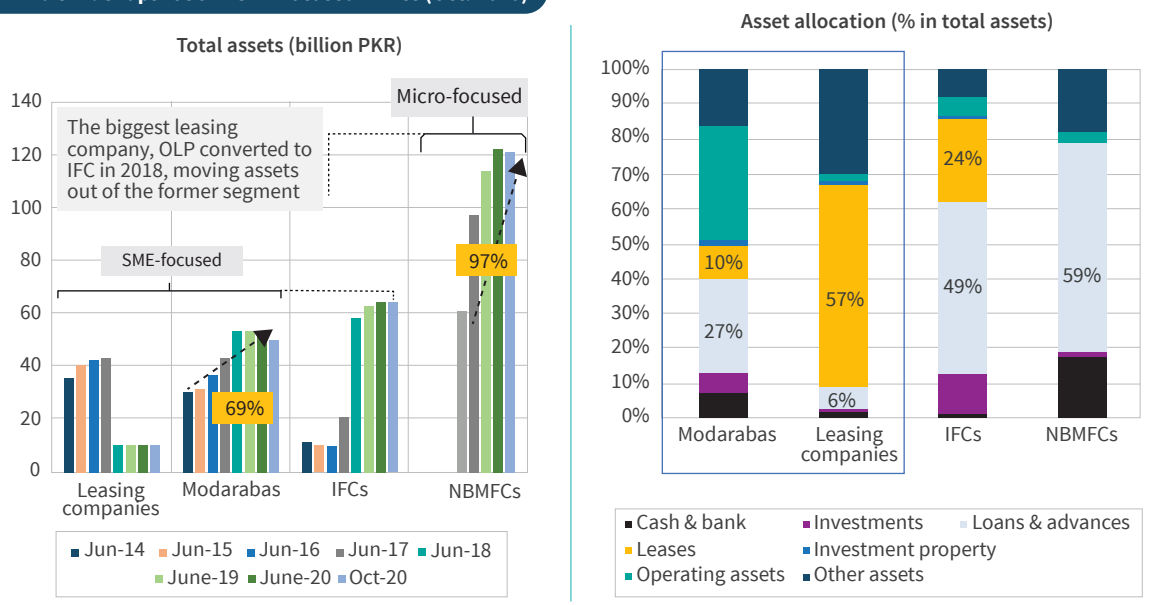


Source: Securities and Exchange Commission of Pakistan. Annual Report 2020

NBMFCs form the largest portion of the lending-type NBFC universe, when viewed in terms of asset base, and number of borrowers. However, these target an entirely different market where net annual business income is less than PKR 0.6 million. Modarabas, of which there are 28 in the market have already been discussed earlier, with seemingly limited contribution to SME lending. That leaves the IFCs and leasing companies. The former segment, which has a significant overlap with the leasing and NBMFC segments, has 12 organizations of which five are investment banks. The market share for this segment (77.11% in terms of assets) is heavily concentrated with two IFCs of which one is purely focused on advances to the microfinance providers (both bank and non-bank). The leasing category on the other hand, is made up by a meagre number of six entities, with a total asset base of PKR 6 billion.

Since ORIX Leasing Pakistan Limited (OLP) was reclassified as an IFC, the performance of the remaining leasing companies is indicative of a sector in need of a complete overhaul. Six of seven leasing companies (prior to the merger of Sindh Leasing Company Limited with Sindh Bank Limited) scored losses during FY19. Similarly, six have defaulted on the PSX for various disclosure-related non-compliance issues. Five of these companies trade for penny stocks, which is just one more indicator of this dismal performance.

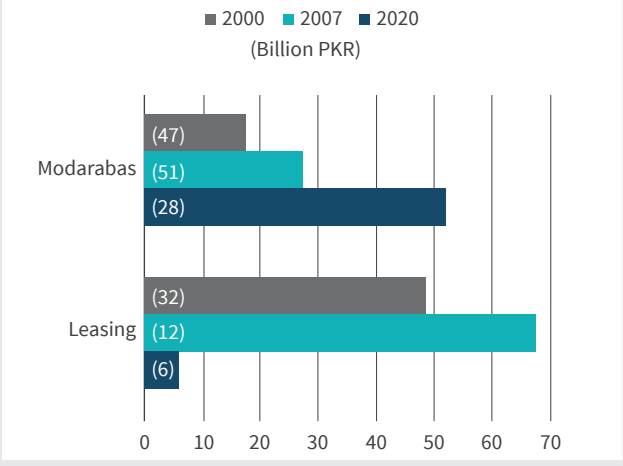
Exhibit 11: Snapshot of MSME-focused NBFCs (Oct. 2020)



Source: State Bank of Pakistan. Financial stability review reports

Based on this background, it would not be incorrect to estimate that less than five percent of overall SME credit is catered to by NBFCs.

Exhibit 12: Trend in no. and asset base of lending-type NBFCs



Source: SBP and SECP

Is leasing fading out?

As per traditional lending NBFC practices, the asset-backed or hire-purchase model of leasing companies, where equipment or movable assets are leased against assignment over underlying assets, are the least fraught with risk of willful default, while also allowing the lender immediate exit through recourse to possession and forced sale of the asset.

However, the leasing segment of NBFCs, whose assets once peaked at over PKR 60 billion pre-2008 crisis, is fast becoming extinct. From 32 leasing companies in 2000, by January 2021 six entities remained with a total asset base of PKR 6 billion[21]. Vehicle financing so far is the only area that has been exploited—even by banks where there is hefty competition.

Several reasons are cited for this, including the negative experience of a few lending NBFCs in the repossession of assets (mainly equipment). Repossession itself is difficult, and the forced sale value often fails to recover the lender's exposure. This is because the market for used equipment is limited—capacity expansion in Pakistan is mostly focused on the use of imported used equipment or Chinese products. The problem does not hold true for vehicle financing. Here, repossession is easier, and there is a vibrant secondary market. However, restricted tax relief for vehicle depreciation has limited the growth of this segment for leasing companies. The financial leasing of cars only applies to business lessees. Individuals are offered hire-purchase financing, and this area has come under competitive pressure because most banks offer car financing products.

Other reasons often cited by experts relate to the weak governance and management of these NBFCs, i.e., the lack of capable management, inadequate personnel training, poor risk management (in cases, substandard loans were issued which caused high delinquencies in times of crisis, in others there were incidences where over-invoicing of assets was done to draw higher financing than what was needed), lax operating policies, over-aggressive marketing, slow response to market trends including digitization, non-willingness to inject further capital in case of equity impairment, and resistance to consolidation.

In addition, there are external factors such as difficulty in contract enforcement and the ineffectiveness of the legal system. The absence of bankruptcy laws has also historically encouraged willful defaults.

Taking a more long-term view, some experts contend that in the aftermath of the 2008 crisis when NPLs in banking sector SME loans, rose sharply, the regulator helped walk small-, and mid-sized banks out of the difficult period by providing, among other measures, liquidity support. The leasing industry suffered a similar fate after the financial crisis yet could not benefit from similar regulatory support. Instead, the main thrust of the SECP's policy-level efforts at the time was to reform the capital markets. As a result, leasing companies and their unique issues did not feature adequately in policy discussions, and the industry was left on autopilot.

[21] *State Bank of Pakistan. 2020. Financial stability review 2020. (Chapter 5) https://www.sbp.org.pk/FSR/2020/Chp-5.2.pdf*

This however, is not the complete story as some companies started failing before 2008 for operational reasons. Examples include Asian Leasing, NDLC, First Leasing, and Askari Leasing. With the exception of OLP, which successfully navigated the regulatory environment and the macro economic downturns, it can be concluded that leasing companies have struggled to scale up and develop compelling business models.

Going forward, the NBFC lending model in Pakistan is likely to come under additional pressure from a number of external forces, the biggest of which is likely to be technology advances enabling stiffer competition as financial service providers offer personalisation, real time mobility, in addition to reducing the cost-to-serve and an increased ability to launch new products and reach new customer segments. If leveraged, there remains room for non-banks to do business in the sector provided they develop requisite competencies, and strengthen their governance and management practices.

Box VI: OLP - Can leasing be the torchbearer of SME financing?

Introduction to the company

ORIX Leasing Pakistan Limited (OLP) was incorporated in 1986 as a joint venture between ORIX Corporation, Japan, and local investors including Bankers Equity Limited and DFIs such as Pak Kuwait Investment Company (Pvt.) Limited and Saudi Pak Industrial and Agricultural Investment Company (Pvt.) Limited. ORIX Corporation was established as a leasing company in Japan in 1964. In Japan the group has expanded considerably to include lending, investment, life insurance, banking, asset management, automobile, real estate, and environment and energy-related business. It is now a global financial services giant with undertakings across four continents. ORIX Corporation began establishing an international set-up in the early 1970s, and today, its overseas presence is represented in over 30 countries, including Pakistan.

In March 1988, OLP raised capital through an initial public offering (IPO) which was oversubscribed by 17 times. The International Finance Corporation (IFC) had extended an umbrella loan to a number of leasing companies, including OLP, which was convertible to equity. In 1996, OLP's stellar financial performance and impressive management track record motivated the IFC to convert it to equity, acquiring 5.6% of the company's equity.

Current shareholding pattern

Currently, nearly 50% of OLP's shares are held under the category of associated companies, undertakings, and related parties, where ORIX Corporation, Japan, is the sole shareholder with 49.6%. Crucially, ORIX is no longer a subsidiary of its Japanese sponsor as it does not hold a majority voting share in the company. However, the footprint of the foreign sponsor has played an instrumental role in OLP's success in the local context.

Other significant shareholders in the company include Arif Habib Corporation at 7.42%, State Life Insurance Corporation at 5.25%, and Aberdeen Asian Smaller Companies Investment Trust PLC at 5.16%. In line with international best practices, the spouses and minor children of directors and the CEO hold less than one percent of the shares in the company. The remaining 32.57% are distributed among other categories including banks, DFIs, modarabas, mutual funds and the general public[22].

Continued on following page

[22] *ORIX Leasing Pakistan Ltd. 2020. Annual Report. http://www.orixpakistan.com/financialdf*

A detour to ORIX Investment Bank Ltd.

The now-defunct ORIX Investment Bank Pakistan Limited (OIBPL) was an NBFC providing corporate finance, brokerage, and other services to large enterprises and was listed on the then Karachi Stock Exchange. OIBPL was a subsidiary of OLP.

Following the telco boom of the 2000s after the liberalisation of the industry, OIBPL acquired shares of Callmate Telips Telecom Limited (CTTL), a long-distance private operator, on behalf of a client. This proved to be a fatal mistake as the company went under just two years after its IPO, costing the investment bank over PKR 500 million. This severely eroded the equity base of the investment bank, even putting the operations of the parent leasing company at risk.

The failure of CTTL coincided with the meltdown in the domestic equities market, meaning that recapitalising the investment bank would have been equivalent to putting good money after bad. Left with few choices, OLP was forced to amalgamate the operations of its subsidiary, acquiring both its toxic assets and hefty liabilities in the process.

Stakeholder consultations revealed that in order to maintain its equity requirements and capital adequacy standards, OLP was forced to raise equity through a rights issue. However, its Japanese sponsors insisted that unless OLP obtained a high credit rating, it would not invest in the rights issue.

It is at this stage that OLP's carefully cultivated public image as a Japanese sponsor-supported company allowed it to raise capital through a secondary offering, even though it was not readily subscribed by its foreign majority owner. According to stakeholders, time and again, OLP's foreign ownership has allowed it to gain the confidence of investors in capital markets (both in debt and equity), including commercial banks, who apply the 'Japanese-sponsor discount' when pricing OLP issue.

Transitioning to the IFS license

In 2018, OLP changed its license from 'leasing only' to that of an 'investment finance company' (IFC). With an IFS license OLP could diversify its product portfolio to include non-leasing financial services such as housing finance, discounting, and microfinance (although the latter has been provided by OLP for nearly two decades).

The leasing license had proved to be a limitation for OLP as the company had to hold 70% of assets in leasing alone. The immediate need for a change of license was its car financing business which was always a major and growing segment. The financing of high-value cars and all cars to individuals (as opposed to businesses) is typically executed as hire-purchase. This is because tax depreciation on cars leased to businesses is restricted by value, and prices have escalated enormously while no tax depreciation is available for leasing to individuals. The change of license has effectively moved OLP to a financing model as opposed to leasing.

Since acquiring the IFS license, OLP has not expanded into new product lines, but it is an understanding from the company's management that growing into new business segments is a major goal for the upcoming future, especially diversification into working capital and housing finance. But this may not be in the offing unless economic conditions improve substantially.

Continued on following page

That said, OLP's previous ventures into working capital financing and discounting were not entirely successful because of defaults, and eventually, those products were discontinued. A change in strategy to approach these new segments may work to its benefit. After all, OLP has had no problem raising resources in the last ten years. Its business volumes are determined by its appetite depending on how it perceives market risks at any given time.

Product portfolio and financial performance

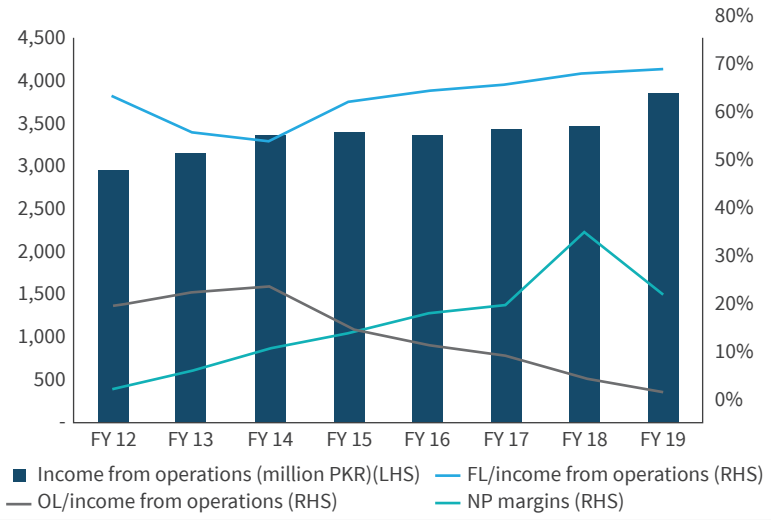
Currently, OLP's product portfolio comprises corporate leases, auto leases, commercial vehicle leases, operating leases, micro-credit, e-business, and Islamic finance.

Lease revenue remains the largest source of earnings on OLP's balance sheet. In FY20 lease revenue saw a marginal increase, despite a significant decline in advances from PKR 13.88 billion in FY19 to PKR 9.08 billion in FY20 as disbursements were sharply curtailed in the wake of COVID-19. NPLs increased from 5.4% to 9.6% but ROE was reported at 8.6% and EPS at PKR 4.2.

On the liability side, its portfolio of short-term CoDs has been reduced from PKR 2 billion in 2016 to under PKR 1.05 billion. Similarly, more than half of long-term CoDs have also been retired, lowering the book value from PKR 7.6 billion in FY16 to PKR 3.4 billion in FY20.

The CoD portfolio was built up when banks were very reluctant lenders. This source is relatively expensive because of the rates that have to be offered and the regulatory liquidity margin that has to be maintained. As per its annual report, long-term CoDs were issued at a rate of return ranging from 7 – 13.15% for terms ranging from three to ten years, declining slightly in 2019 to 6.50 – 12.82% per annum and issued for terms ranging from two to ten years. Offering liability services also has several operational and cost implications in terms of maintaining a branch network, and meeting regulatory and compliance requirements.

Exhibit 13: OLP's financial performance



Source: OLP Annual Reports and Company Accounts

OLP has, therefore, chosen to continue relying on financing from banks and financial institutions, with PKR 8.28 billion utilized in long-term finance under markup arrangements with FIs. These finances are repayable within a period of 36 to 60 months. The total bank borrowing-to-deposits ratio has therefore been rising, indicating that despite its deposit-taking status, OLP is happier to raise capital through short-term and long-term lines with commercial banks and other FIs.

Continued on following page

Today, OLP is adequately capitalised with sufficient funds available to meet its liquidity needs. It boasts a debt-to-equity ratio of less than 1.8× (better than most non-financial firms listed in the equities market). It has a high CAR of 33.57% against the regulatory requirement of 10%. However, it is worth bearing in mind that availability of term funds depends largely on economic conditions and banking sector liquidity.

> *"In the 1990s, foreign currency loans were available through multilateral agencies. OLP used them extensively and had lines from IFC, World Bank (through Bankers Equity for microfinance lending), ADB and FMO. These sources were attractive because SBP offered exchange risk cover but since discontinuation of the scheme these sources have completely dried up. Subsequently, Citibank arranged a currency swap for an overseas loan taken by OLP but the facility was short lived following a sharp devaluation causing providers of the foreign exchange significant losses."*
>
> ***(interview with leasing expert)***

Reasons for OLP's success

Several reasons are put forth for OLP's success.

Strong brand and sponsor—OLP's perception was a result of a carefully cultivated brand in the public imagination, which, combined with its linkage to a strong sponsor enabled it to raise funding on multiple occassions.

Governance—OLP's hallmark in the local market during its 34 years of operations has been its governance, marked by the footprint of a conservative approach to risk management inherited from its Japanese sponsor. OLP staff assert that the NBFC can lay claim to its management's independence from adverse sponsor influence and board of directors since inception. Even today, 45% of its nine-member board is staffed by independent directors. OLP has constituted four board committees—Audit, HR, Risk and Credit. All the committees, except for the credit committee, are chaired by independent directors.

Robust and evolving risk management and operating guidelines—During the first 20 years of operations (and especially in the 1990s), OLP took pride in pioneering risk management systems and achieving automation through the deployment of technology.

The Board's Risk Committee closely oversees and monitors risk. There are several additional committees and policies in place including a credit committee, an asset and liability management committee (ALCO), a Business Continuity Plan (to guide employees in the event of any disaster or operational breakdown) and an IT Committee. A COVID Committee was formed to make SOPs and ensure that all government guidelines are followed across the country in OLP's offices.

OLP's operating guidelines, which are considered very conservative in the industry, are based on IFC's practices. OLP was aware that IFC has enormous experience in pioneering leasing and introducing legal frameworks for the industry globally; according to some experts, it has promoted more than 70 companies worldwide.

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> *OLP's operating guidelines stipulated maximum exposure to a single industry sector of no more than 25% of portfolio. This was seen as very restrictive when textiles accounted for half our GDP and the guideline was very unpopular with marketing staff. At the time one leasing company had 65% exposure and another 45% (neither of which survived).*
>
> ***(interview with leasing expert)***

Human resource—Stakeholder consultations revealed that while the leasing industry as a whole found it difficult to compete for human resource with the banking industry in terms of compensation and benefits, OLP focused heavily on internal training and staff retention.

Outreach and diversified geographic footprint—Outreach is important and local presence is highly desirable to capture new business, especially in the 'S' segment, where smaller business owners find it difficult to take out time to travel distances and bear the cost of travel. Also, regular, personal contact with customers is invaluable for developing long term relationships and monitoring the health of the existing portfolio. The long term relationship is especially important bearing in mind that significant value and volumes are derived from repeat business. The scale and resource base of leasing operations limit the extent of the outreach. OLP established the largest network with 38 offices across the country.

> *Certainly, regulatory impediments to growth should be identified and removed as soon as possible. However, a great deal of the responsibility for development of individual organisations rests with their sponsors and management.*
>
> ***(interview with leasing expert)***

End note

Leasing remains OLP's primary business, pre and post acquiring the IFS license. Being committed to its primary leasing market OLP acquired Standard Chartered Leasing to expand in size. The most important factor in diversification is the degree of market risk. Often, new projects are launched on a pilot basis and subsequently developed (in original or modified form) or aborted based on the experience.

In a bid to increase SME lending, OLP entered into a supply chain financing programme with Karandaaz in 2017, later restructured as a financing line. Under this facility OLP has grown its 'S' enterprise portfolio by an estimated 300 small businesses and deployed PKR 725 million.

Second-order crowding-out?

Consider that successful leasing companies like OLP had pioneered commercial vehicle and fleet financing/leasing models a decade ago with impressive results. In fact, the success of commercial vehicle financing with low default incidence was what piqued banks' interest in the model. Since FY14, when the SBP began to push commercial banks to re-energise SME lending, banks sought to target SME markets with lower levels of risk and vehicle and fleet financing was identified as the perfect go-to option. Meanwhile, the struggles of the NBFC sector since 2008 have also given banks space to permanently wear all hats.

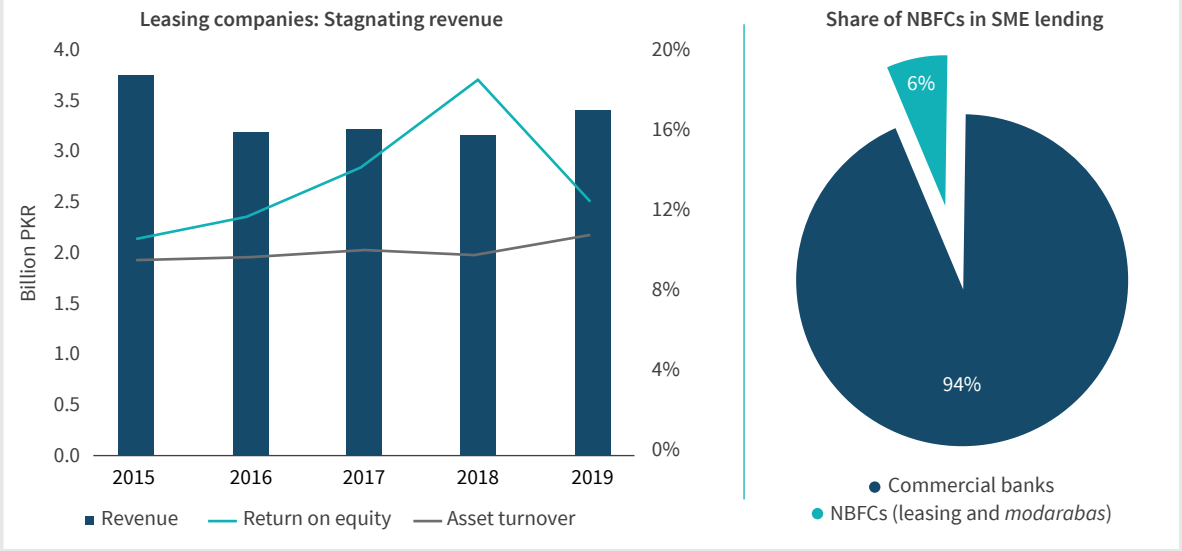
With access to low-cost current account savings account (CASA) deposits, commercial banks will always win a fight with NBFCs on overall market share. Thus, it may be pertinent to ask: while the GoP may be crowding-out private sector borrowing, are commercial banks' universal banking operations also crowding-out leasing companies?

To answer this question fairly, it is important to look at the situation not only from the context of sectoral depth but also innovation by the leasing industry. As mentioned earlier, the number of leasing companies declined from 32 in 2000 to six in 2021. Of the remaining entities, no leasing company has reached the same outreach and size as OLP. In fact, when OLP was reclassified as an IFC, the leasing sector's asset base declined from PKR 45 billion in December 2017 to PKR 6 billion in December 2020[23].

Another factor that is difficult to ignore is the introduction of new products and services by leasing companies. Over the years OLP has explored the medical diagnostics sector and heavy equipment/machinery space, but new products have been slow to appear, at least at the same scale as what was achieved in the vehicle financing space.

Thus, the opening of doors to the leasing business for commercial banks may have allowed them to capture a space that was pioneered by the leasing industry, the leasing industry can benefit from exploring and developing new sectors in the 'S' segment given their less restrictive lending requirements.

Exhibit 14: Leasing revenues and share of NBFCs in SME lending



Source: State Bank of Pakistan. Financial Statement Analysis of Financial Sector 2015-2019

[23] *ORIX Leasing Pakistan Ltd. 2020. Annual Report. http://www.orixpakistan.com/financialdf*

Peer-country analysis: What is the NBFC model missing?

The de-risking of commercial banks from SME lending in the aftermath of the global financial crisis (GFC) of 2007–2008 has not been limited to Pakistan. SMEs across the globe, especially in the United Kingdom (UK), European Union (EU), and North America, have faced diminished credit from the banking sector as stringent capital adequacy guidelines forced banks to re-orient their higher risk-weighted lending portfolio to less risky avenues. As a result, while banking sector assets have increased considerably over the past decade, SME lending has not.

Across many economies, NBFIs have taken an increasingly dominant role in SME lending. However, when the going gets tough, unlike banks, NBFIs struggle to access liquidity support from the central bank. This was witnessed in the US and more recently in India.

Lessons from the US post the global financial crisis of 2008

Non-bank institutions hold more than double the financial assets of traditional banks in the US financial system. In Europe, too, NBFIs have become an increasingly important source of financing for the real economy over the past decade. Although NBFIs bring easier access to credit for SMEs, they also pose a challenge to the stability of the financial system. Research indicates that non-banks' lack of access to central bank refinancing operations has created obstacles in the transmission mechanism of monetary policy and for the role of LOLR. In fact, the existence of a large financial sector without direct access to the central bank is often considered a leading explanation for the severity of the 2008–2009 crisis and the consequent expansion of monetary policy tools.

In the US, the Federal Reserve (the 'Fed') created various new lending facilities through which subsets of US non-banks could borrow against collateral when needed. As these new facilities still proved insufficient to satisfactorily stem the crisis, the Fed eventually resorted to the purchase of over USD 3 trillion of private securities to keep asset prices from dropping further and prevent contagion to the real economy.

These securities were sold to the Fed primarily by non-banks, suggesting that the funding pressures were indeed mainly located in the non-bank sector. Meanwhile, traditional banks kept their share of asset holdings close to pre-crisis levels.

Legislation following the GFC, especially the Dodd-Frank Act, attempted to reduce the need for LOLR loans in the event of future liquidity crises. The Financial Stability Oversight Council was established in 2010 and designated several key non-bank institutions as 'systemically important financial institutions'[24], and these firms are also subject to supervision and regulation by the Fed. Similarly, the concept of systemically important financial market utilities was also introduced, which were subjected to enhanced oversight by three supervisory agencies, the Federal Reserve Board, the Securities and Exchange Commission, and the Commodity Futures Trading Commission.

India's 2018 NBFC crisis

NBFCs in India play an important role in providing credit by complementing commercial banks and catering to niche sectors. The Department of Non-Banking Regulation (DNBR) within the RBI is entrusted with the responsibility of regulating the NBFC sector.

[24] Systemically important NBFCs have an asset size of PKR 5 billion or more. NBFCs-ND (where ND refers to non-deposit-taking NBFCs) are categorised into two broad categories:
1. NBFCs-ND—those with assets of less than PKR 5 billion
2. NBFCs-ND-SI—those with assets of PKR 5 billion and above
For systemically important core investment companies (NBFC-CIC-SI), the asset size is PKR 1 billion.

In September 2018, one of India's largest NBFCs, Infrastructure Leasing and Financial Services (IL&FS) defaulted on several obligations—bank loans (including interest), term and short-term deposits and also commercial paper redemption obligations. The conglomerate funds infrastructure projects across India and among its shareholders are Life Insurance Corporation (LIC), State Bank of India (SBI), Japan's Orix Corporation and House Development Finance Corporation (HDFC). Soon after several other NBFCs (DHFL, Reliance Capital Finance, Reliance Home Finance) also faced a liquidity crisis. The NBFC crisis of 2018 shows that the risks inherent to the NBFC model cannot be eliminated, however, they can be mitigated with timely and appropriate interventions by the regulator.

A framework for liquidity and stress management - Although the RBI's regulations do not allow NBFCs to seek liquidity support from the LOLR, the central bank took emergency provisions to inject liquidity into the system as the crises deepened. For example, commercial banks must invest funds availed under targeted long-term repossession operations in investment-grade bonds, commercial paper, and non-convertible debentures (NCDs) of NBFCs. The RBI imposed a further restriction that small- and mid-sized NBFCs and MFIs should receive at least 50% of these funds. Banks can avail substantial funding through targeted long-term repossession operations.

A revised framework was put in place in 2019 pursuant to a judgment of the Supreme Court of India, which found the then-existing framework for the resolution of stressed assets ultra vires. During the year, the focus was on improving transparency in the financial statements of banks, enhancing credit discipline among large borrowers, the alignment of the SLR with liquidity coverage ratio (LCR) requirements, along with new guidelines on the implementation of liquidity standards and capital regulation under Basel-III norms, and strengthening data protection and cyber security norms.

Recategorizing NBFCs - The RBI also decided to harmonise three different categories of NBFCs based on the principle of regulation by activity rather than by entity. Accordingly, three categories of NBFCs—asset finance companies (AFCs), loan companies, and investment companies—will be combined into a single category: NBFC investment and credit company (NBFC-ICC).

Appointment of chief risk officer for NBFCs - To augment the risk management practices of the NBFC sector, NBFCs with an asset size of more than INR 50 billion (USD 680 million) have been advised to appoint a chief risk officer (CRO) with clearly specified roles and responsibilities, who would be required to function independently to ensure the highest standards of risk management.

Liquidity framework for NBFCs - The guidelines on the liquidity risk management framework for NBFCs, including those for non-deposit-taking, systemically important core investment companies (CIC-ND-SIs) with asset sizes of INR 1 billion (USD 13.5 million), and above all, deposit-taking NBFCs irrespective of asset size, were reviewed to strengthen the Asset-Liability Management (ALM) framework for NBFCs. A liquidity risk management framework for NBFCs was enforced by the RBI in 2020.

Liquidity risk management framework for NBFCs - NBFCs have developed significant interlinkages with the rest of the financial sector in terms of access to public funds and participation in credit intermediation, with implications for systemic risks. This warranted a review of the liquidity risk management for NBFCs. Existing ALM guidelines are applicable to non-deposit-taking NBFCs with an asset size of INR 1 billion (USD 13.5 million) and above, and deposit-taking NBFCs having a deposit base of INR 200 million (USD 3 million) and above. Additional items include:

1. Instructions on the three pillars of the ALM framework, ALM information systems, ALM organisation (including the formation of asset-liability committees (ALCOs), their constitution, etc.), and ALM processes.
2. Monitoring of structural and short-term dynamic liquidity and interest rate sensitivity.
3. Maturity gap analysis across time buckets with a focus on 30-day buckets in which the negative gap is not meant to exceed 15% of cash outflow.

4. Core investment companies with asset size of INR 5 billion (USD 68 million) and above to disclose the maturity pattern of assets and liabilities.

Augmentation of the General Framework for Management of Liquidity Risk - Several measures have been introduced for management of liquidity risk:

1. ALM guidelines: ALM guidelines have been recast along the lines of those applicable to banks, incorporating:
   a. Off-balance sheet and contingent liabilities;
   b. Stress testing;
   c. Contingency funding plans;
   d. Intra-group fund transfers;
   e. Collateral position management;
   f. Diversification of funding.

2. Maturity buckets revised: Maturity buckets have been made granular by trifurcating the 1–30/31-day bucket into 1–7 days, 8–14 days, and 15–30 days, with cumulative gap limits set at 10%, 10%, and 20% of the respective outflows. Cash flow stress will be captured at an early stage, and mitigation is expected to be timely.

3. Liquidity risk monitoring tools: NBFCs will be required to monitor a) concentration of funding (by counterparty, instrument, currency); b) available unencumbered assets (that can be used as collateral for raising funds); and c) market-related monitoring information (equity prices, coupons on debts raised, regulatory penalties and the like).

4. Stock approach to liquidity risk management: NBFC boards are required to identify critical ratios and monitor them against internally prescribed ceilings. An illustrative list could include short-term liabilities to total assets, short-term liabilities to long-term assets, commercial papers to total assets, NCDs of original maturity less than one year to total assets, short-term liabilities to total liabilities, and long-term assets to total assets.

Introduction of the liquidity coverage ratio for large NBFCs - The proposed LCR framework will apply to all deposit-taking NBFCs and NBFC-ND-SIs with an asset size of INR 50 billion and above. It will be implemented in a phased manner.

NBFCs will be required to maintain an LCR of at least 60% from 1 April 2020, progressively increasing in equal steps until they reach the required level of 100% by 1 April 2024. They must then maintain it at 100%.

1. NBFCs must hold high-quality liquid assets (HQLAs) to cover net cash outflow over the next 30-day period in a situation of stress.
2. HQLA computations will be based on prescribed haircuts applied on eligible assets.
3. For the computation of net cash outflow in the 30-day period, the stress scenario is built by overestimating outflows by 15% and underestimating inflows by 25%.

RBI creates a Financial Stability Unit - The purpose of the Financial Stability Unit (FSU) is to monitor the stability and soundness of the financial system by examining risks to financial stability, undertaking macro-prudential surveillance through systemic stress tests, financial network analysis, and by disseminating information and analysis through the Financial Stability Report (FSR). It also functions as a secretariat to the sub-committee of the Financial Stability and Development Council (FSDC), a coordination council of regulators for maintaining financial stability and monitoring macro-prudential regulation in the country.

Global directions

The Financial Stability Board (FSB) is an international body that monitors and makes recommendations about the global financial system. It was established after the G20 London summit in April 2009 as a successor to the Financial Stability Forum (FSF). The board includes all G20 economies, FSB members, and the European Commission. Hosted and funded by the Bank for International Settlements, the board is based in Basel, Switzerland.

The FSB's monitoring methodology involves two steps. The first step casts the net wide to capture an aggregate measure of the financial assets of entities that engage in NBFI business, the "Monitoring Universe of Non-bank Financial Intermediation" (MUNFI). MUNFI includes insurance corporations, pension funds, and financial auxiliaries. The second step narrows the focus to non-bank financial entities that are involved in credit intermediation and that have increased potential for posing risks to financial stability (through liquidity/maturity transformation and/or leverage), resulting in the FSB's "narrow measure" of NBFI.

To implement this activity-based approach to monitoring NBFIs, authorities assess non-bank financial entities' business models, activities, and associated bank-like risks that may be posed to financial stability and classify the relevant entity types into one or more categories. Authorities exclude entities that are either:

(i) not typically part of a credit intermediation chain; or

(ii) part of a credit intermediation chain, but not involved in significant maturity/liquidity transformation and/or leverage.

This approach incorporates authorities' supervisory judgement (or qualitative information), given that data is sometimes not available. The inclusion of non-bank financial entities or activities in the narrow measure is based on a conservative assessment of potential risks to financial stability (including on a pre-mitigant basis), and does not constitute a judgement that policy measures applied to address the financial stability risks from NBFIs and their activities are inadequate or ineffective.

Section 5

Promoting SME lending

Several interventions on multiple levels have been made to promote SME lending in the country. However, it is often asserted that NBFCs are overlooked and/or excluded from these initiatives, despite the fact that NBFCs can play a central role in augmenting access to finance for SMEs.

This section presents some of the key initiatives undertaken with the intention to shed more light on the inclusion of NBFCs while also identifying gaps, if any.

Policy and regulatory interventions

In 2015 the GoP approved the National Financial Inclusion Strategy (NFIS), which set ambitious financial inclusion targets at multiple levels, including for SMEs. The incumbent Government revised the strategy in 2019, releasing it as its 100 Day Agenda and terming it the 'enhanced' NFIS. The document including several revised targets, including the targets for SME financing, which were revised upwards[25].

To meet the revised targets by the end of 2023, SME lending will need to grow by ~30% annually, even with private sector credit holding constant at current levels.

Exhibit 15: NFIS targets for financial inclusion of SMEs (2015, 2019)

Category	Original NFIS targets (up to 2020)	Enhanced NFIS targets (up to 2023)[26]
Improve access to finance for SMEs	15% of total private sector credit 500,000 SME Borrowers	- 17% of total private sector credit - Extend financing to 700,000 SMEs
		1). Launch fully functional e-registry 2). National SME Policy to be in place 3). Reorganize and empower SMEDA 4). Provincial governments to play role 5). Census of business enterprises 6). Banks to be incentivized through fiscal measures

The revised NFIS also tasked relevant departments and agencies with undertaking an economic census (an exercise last conducted in 2005), launching a functional e-registry for movable collateral, introducing tax incentives to encourage banks to lend to SMEs, and drafting an SME Policy, among other measures. Progress has been made on several of these targets including the SME Policy which was presented to the Prime Minister in October 2020, the launch of a digitalized Secured Transactions Registry (STR) and the introduction of tax benefits on bank earnings from SME lending (more on this later).

In 2017 the SBP had also unveiled a Policy for the Promotion of SME Finance. The SBP's approach hinged on **improving the regulatory framework** by revising PRs, introduction of SME lending targets and strengthening the secured transactions regime; **market development** via the introduction of refinance and risk coverage

[25] *Government of Pakistan. National Financial Inclusion Strategy – Government's 100-days agenda. http://www.finance.gov.pk/NFIS.pdf*
[26] *National Financial Inclusion Strategy: Government's 100 Day Agenda. http://www.finance.gov.pk/NFIS.pdf*

Box VII: National SME Policy 2021

The National SME Policy launched in January 2022 is built on two overarching pillars:

Reforming the policy and regulatory environment for SMEs—focus on creating enabling and business friendly policies, regulatory simplification and instituting a regime that allows easy entry and exit of firms and start-ups to flourish.

Addressing SME market constraints, both demand and supply side—The supply side focuses on fiscal and monetary incentives, SME facilitation, entrepreneurship and innovation, credit and skills and infrastructural provisions necessary for SME growth. On the demand side the policy focuses on issues of market access and the role of public procurement in creating demand for SME products and services.
The Policy also recommends adoption of a uniform SME definition by all stakeholders and issuance of SME size certificates, based on voluntary registration on the SME Registration Portal. In addition to enabling identification of SMEs for targeted support and training, the portal could provide an invaluable information source that can be mined to develop insights on the location, sector, size of these entities, while separating out the 'S' and 'M' segments for better tailored business development support.

schemes, promoting Islamic modes of SME financing and conducting cluster surveys; and **improving awareness and building capacity** of banks and SMEs[27].

Over the last few years the SBP has introduced multiple amendments to prudential regulations for SME lending, specified SME lending targets and is actively encouraging banks to establish dedicated SME departments. The revised PRs for SME lending set higher limits for clean lending (enhanced from PKR 2 million to PKR 5 million). Furthermore, general reserve requirements were reduced, capital adequacy ratios were relaxed and simplified loan applications were developed. Regulatory amendments by the SECP have also been comprehensive; these have been discussed at length in section 3.

Risk-sharing schemes

Credit guarantee schemes

Liquidity is not the primary constraint for SME financing by the banking sector. As such, donors have been using financial schemes to enhance banks' risk-taking capacity. One of the most limiting factors in lending to SMEs is their inability to provide collateral. To overcome this limitation several donors set up credit guarantee schemes for SMEs in Pakistan, including the Credit Guarantee Scheme (CGS) managed by SBP and funded by Foreign, Commonwealth & Development Office (FCDO), IFC's risk sharing facility, and the Developmental Credit Authority (DCA) of USAID. NBFCs have not availed of these schemes.

CGS was structured to provide guarantees on a loan basis, while the other two risk sharing facilities were umbrella structures, covering a part of the SME portfolio, reimbursing the bank for a fixed percentage of incurred losses that exceed a predefined threshold.

In the 100 Day Agenda, a key milestone is the establishment of an independent credit guarantee company. This process is currently underway, with plans to establish the company as a public-private partnership. This facility will be accessible to NBFCs once the entity is up and running. Lessons from international experience on credit guarantee schemes are discussed in section 6.

[27] *State Bank of Pakistan. 2017. Policy for Promotion of SME Finance. https://askaribank.com/wp-content/uploads/2018/07/PolicyPromotionSME-Finance.pdf*

Box VIII: Credit Guarantee Scheme (2010 – 2020)

CGS for small and rural enterprises was created within SBP in March 2010. The objective of the scheme was to improve the financial access of small enterprises and rural borrowers by enhancing their creditworthiness through partial credit guarantees. In addition to increasing the number of SME and rural borrowers, a major objective of the scheme was to promote lending that was not structured around the value of an immovable collateral. In 2013 the average collateral value was estimated at 113.7% of the loan amount.

Under CGS guarantees were provided for individual loans made to target borrowers by banks, DFIs and microfinance banks. CGS guarantees covered up to 40% of loans in case of default. SBP also allocated a limited amount of total guarantees to each participating FI and encouraged them to apply CGS guarantees to SME loans in selected industry sectors with the aim to promote programme lending. CGS also provided FIs with financial assistance (grants) equivalent to 2% of the allocated guarantee limit to build their operational and staff capacity. During FY17, risk coverage was raised from 40 – 60% for women borrowers, start-up businesses and small, rural and micro enterprises operating in under-served areas of the country. To push lending to under-collateralized SMEs, the risk coverage was linked with loan collateralization such that there was 60% cover on clean lending, 40% if the collateral was valued at 100% of the loan amount, and only 20% if the collateral exceeded the loan amount.

An impact assessment of the FIP project states that: *"In terms of indicators, targets set for increasing the number of SMEs and rural borrowers with CGS-backed loans, these have more or less been met every year. [However] by FY13, it was clear that the program was finding difficulties in achieving its second milestone of increasing clean or under-collateralized lending. The program was reexamined, expended and new performance indicators were introduced… By the end of the program 16% of the SMEs supported under the scheme were under-collateralized."*

Source: Pakistan Microfinance Network. 2021. Impact assessment of FCDO's Financial Inclusion Programme.

Refinance schemes

SBP has set up multiple refinance schemes, some of which are SME specific, while others are accessible to SMEs. SBP offers these refinance schemes and facilities through banks and DFIs. While consolidated and regularly updated data on the overall uptake of such schemes is not easily available, scrutinizing borrowing under these schemes by some of the major commercial banks provides insight on utilization.

Of the total borrowing by selected banks amounting to PKR 502.9 billion under these refinance schemes, bank borrowing under the SME-specific refinance schemes amounts to PKR 601 million i.e., 0.12%. While this number might be an under-estimation as several of the other refinance schemes can also be accessed for lending to SMEs, ascertaining the exact proportion for SME and non-SME portfolio was not possible.

SBP is also supporting the provincial governments in their refinance and risk sharing schemes to enhance SME finance. These include a Mark-up Subsidy and Guarantee Facility for Rice Husking Mills in Sindh by the Government of Sindh and Sindh Enterprise Development Fund (SEDF)[28] and a Scheme for Revitalization of SMEs in Khyber Pakhtunkhwa (KPK) and merged districts, and Gilgit-Baltistan. Both schemes were started in 2010.

[28] *State Bank of Pakistan. 2017. IH&SMEFD Circular Letter No. 06 of 2017. https://www.sbp.org.pk/smefd/circulars/2017/CL6.htm*

Exhibit 16: Borrowing by banks under SBPs refinance schemes (Dec. 2020)

Millions PKR

Scheme	Exclusively for SMEs?	Can SMEs avail?	NBP	HBL	BAFL	UBL	MCB	ABL	JS
Under Export Refinance Scheme	No	Yes	31,138	60,068	45,179	30,724	34,999	28,781	21,496
Financing scheme for Renewable Energy	No	Yes	481	1,716	4,552	147	75	2,898	433
Refinance facility for Modernization of SMEs	Yes	Yes	178	153	–	4	–	–	96
Financing facility for Storage of Agriculture Produce (FFSAP)	No	Yes	256	292	491	–	191	–	193
Under Long-Term Financing Facility	No	Yes	16,380	25,923	24,532	22,244	22,150	24,598	1,985
Refinance Scheme for Payment of Wages and Salaries	No	Yes	1,168	30,928	29,171	5,587	10,074	121	11,543
Temporary Economic Refinance Facility	No	Yes	538	4,917	–	–	1,695	388	52
Refinance Facility for Combating Covid-19	No	No	61	1,300	–	–	–	–	230
Refinance and Credit Guarantee Scheme for Women Entrepreneurs	No	Yes	–	163	–	–	–	–	33
Refinance facility for working capital of SMEs	Yes	Yes	–	136	–	–	–	–	34
Other refinance schemes			–	–	1,582	768	–	8	–
SME Asaan Finance Scheme (SAAF)	Yes	Yes	*Introduced in August 2021*						

Source: Financial statements FY20 (various banks)

SME asaan finance scheme (SAAF)

In August 2021 SBP announced the SME Asaan Finance Scheme (SAAF) to facilitate bank lending to SMEs, especially those SMEs that are unable to meet collateral requirements of banks. SAAF is a refinance and credit guarantee facility under which SBP will provide subsidized funds for lending to SMEs (banks will access funds at 1% p.a. and extend financing to SMEs at end user rate of up to 9% p.a.), while the GoP will provide partial credit guarantees to participating banks (60% risk cover for loans up to PKR 4 million; 50% for mid-size loans PKR 4-7 million; 40% for relatively larger loans of PKR 7-10 million). Collateral free loans will be available to SMEs for long term fixed capital investment and working capital requirements. The scheme is expected to run for three years, starting in September 2021[29].

The scheme has several interesting features: i). The loan cap of PKR 10 million rightly indicates a focus on the 'S' segment; ii). Banks will not be using their own liquidity or deposits for lending; they will simply be borrowing from the SBP refinancing window, and lending to SMEs. iii). A maximum spread of 8% can be charged by the bank which should provide sufficient incentive for banks to lend to SMEs, as it potentially covers operational costs and any residual credit risk not covered by the GoP guarantee. Worth mentioning are a few additional facets that can be explored: i). The spread should ideally decrease as credit cover provided by GoP increases; and ii). SBP should consider opening this scheme to lending NBFCs, as already being done under the Kamyab Pakistan Program (KPP) in which banks can provide wholesale funding to NBMFCs for on lending.

[29] *State Bank of Pakistan. 2021. SME Asaan Finance Scheme (SAAF). https://www.sbp.org.pk/smefd/circulars/2021/C9-Annex-Ai.pdf*

Augmenting the lending ecosystem

Credit bureaus

Credit bureaus are central to well-functioning credit markets. The information provided by credit bureaus helps establish the repayment history of borrowers making it easier for them to access loans by allowing creditors to assess the repayment track record and capacities of their customers. While SBP established the first credit bureau in 1992 and converted it into an e-CIB in 2006, the Credit Bureau Act of 2015 provides clear guidelines for the incorporation and functioning of these entities. The Act prescribes that credit bureaus will be established as public limited companies against a minimum capital requirement of PKR 250 million (or as prescribed by GoP from time to time) and will be licensed by the SBP. The Act has expanded the universe of data providers to include such unconventional sources as utilities, telecommunication firms, insurance companies, retailers and even landlords. A range of FIs including commercial banks, DFIs, MFBs, and NBFCs are mandated to utilize at least one credit bureau for their lending decisions. The Act also makes it mandatory for FIs to become a member of, and share data with at least one licensed credit bureau.

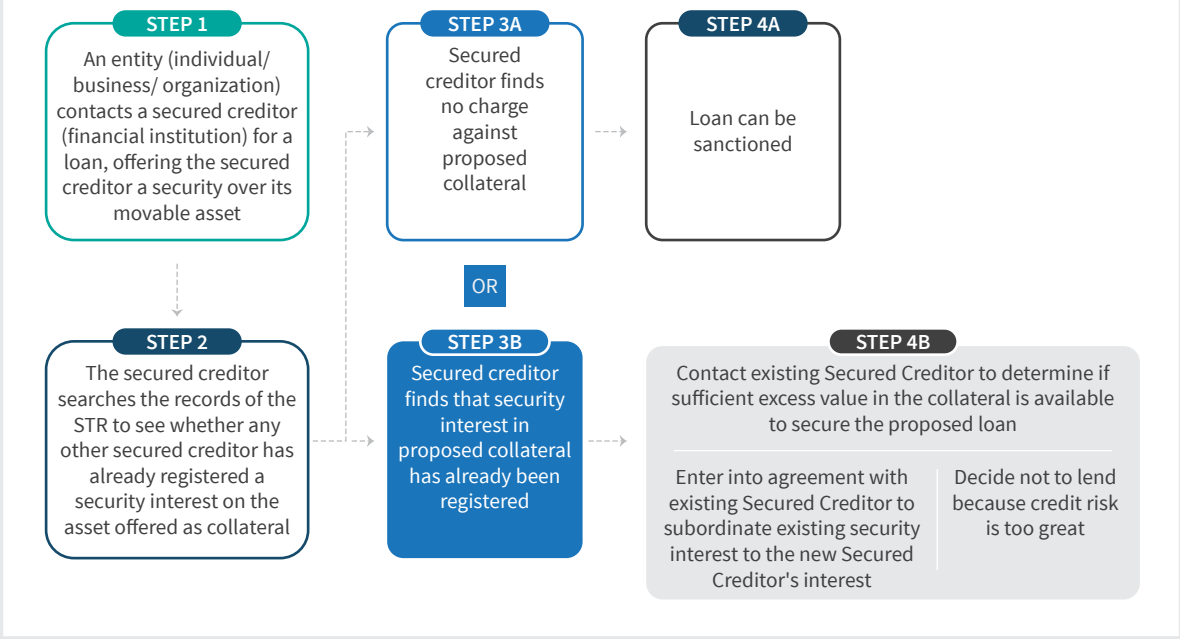
Currently three credit bureaus are functioning in the country—the e-CIB of the SBP, DataCheck and Tasdeeq. The latter two are private credit bureaus. Among their members are major local and foreign banks, leasing companies, and other financial institutions (more on this in section 6).

Secured Transactions Registry

The Secured Transactions Registry (STR) is an online register established under the Financial Institutions (Secured Transactions) Act, 2016 (STA). It enables individuals and MSMEs to access credit using a wide range of movable assets as collateral. For financial institutions STR offers greater transparency and visibility around recorded charges, resulting in lower cost of doing business and reduced non-performing loans (NPLs).

The first creditor to register a security interest will have priority in the collateral should the entity (borrower) default.

Exhibit 17: Process for registering charge in STR



The SECP maintains the registry. Almost all business with the registry is conducted online through its website (https://str.secp.gov.pk/). A total of 141,768 charges have been listed in the registry as of June 2021. Of these 17,242 charges have been created for the first time in the digitized registry, with the remaining constituting earlier charges moved into the registry since its digitization. Of the new charges created, only 116 have been created by NBFCs.

Exhibit 18: Charges created in the STR (as of June 30, 2021)

Type of FI	No. of Charges
Commercial Banks	17,116
Microfinance Banks	0
Development Finance Institutions	10
Non-bank Finance Companies	116
Total	17,242

Source: Securities and Exchange Commission of Pakistan

Industry cluster initiative - Munsalik

Led by the industry association, the Pakistan Microfinance Network (PMN), Munsalik is a centralized loan management system (LMS) with transactional banking functionality. Munsalik will enable NBMFCs to digitize their internal processes from client engagement and onboarding to loan disbursement and repayment. In addition, several value-added services will become available by way of integration with a variety of service providers in the wider digital ecosystem including Raast, NADRA, the credit bureaus and AML/CFT platforms. Munsalik will provide end-to-end back-office automation facility including a mobile application for loan officers.

The platform will provide a single point of contact for NBMFCs with the digital financial ecosystem and will also revolutionize customers' journey through a many-to-many model for real-time loan disbursement and repayment transactions. Five NBMFCs have already been onboarded by Munsalik, with plans to onboard an additional six when the system goes live[30]. Munsalik is registered as a for-profit private limited company with the SECP under section 16 of the Companies Act, 2017.

Digitizing the payments landscape

Payment systems are designed to facilitate and/or control the transfer of money between financial institutions participating in different transactions and arrangements. The SBP regulates and supervises the country's payment system network while also monitoring and setting future directions for the system.

In 2007 SBP introduced the Payment Systems and Electronic Funds Transfer Act (PS&EFT Act 2007). Starting with the launch of a real-time gross settlement (RTGS) system in July 2008 which enabled digital clearance and settlement of wholesale, large-value payments between SBP regulated financial institutions, the central bank has led the drive to digitize the payment landscape of the country.

The main purpose of introducing the RTGS systems was to handle large value interbank funds transfers on a gross basis and in real time, introducing efficiency into and de-risking the settlement process of large payment flows. RTGS—Pakistan Real-time Interbank Settlement Mechanism (PRISM)—is owned and operated by the SBP.

[30] *Pakistan Microfinance Network (PMN). Presentation: Overview of Munsalik Platform.*

Retail funds transfer instruments include paper-based instruments (cheques, pay orders, demand drafts, etc.), ATMs, POS networks (debit and credit cards) and electronic instruments (IVR, payment cards, and mobile/internet banking, etc.)[31]. Retail payment systems are considered to be socially important due to their widespread use in an economy.

The digitization of payment systems infrastructure across instruments has been supported by a regulatory environment that is becoming more conducive for consumers and businesses, and that recognises the costs, risks, and inefficiencies associated with cash transactions. With a broader vision for financial inclusion under NFIS and a recently introduced National Payment Systems Strategy (2019), the government together with the support of international organizations and donors is keen on digitization; and considers DFS to be a major accelerator for finclusion.

With the introduction of rules for Payment System Operator/Payment System Provider (PSOs/PSPs)[32] and electronic money institutions (EMIs), cashless digital payment instruments are encouraged which will expand payment systems beyond banks to non-bank entities and fintech disruptors. However, these together with BB and over-the-counter (OTC) services typically capture low-values as there are stringent limits on transactions and have significant barriers to entry through minimum equity requirements. The latter of which can restrict small fintechs to enter the marketplace without fulfilling high equity and other regulatory requirements.

There are also signs of progress in promoting other cutting edge digital services, such as crowd-funding, peer-to-peer lending, robo-advisory services and other fintech solutions. The SECP's regulatory sandbox is testing several initiatives.

NBFCs do not have direct access to the payment infrastructure; they have to operationally rely on agency agreements with banks to make payments on their behalf. In their role as monetary and financial stability authorities, many central banks limit direct NBFC participation in payment systems. Varying views are put forth on NBFCs' access to payment systems. On one side, it is posited that having direct access to payment systems can level the playing field for NBFCs. As such, open and equitable access to payment infrastructure, it is argued, would allow NBFCs to provide end-to-end service to clients, without having to rely on agency relationships with banks for disbursement and collection of loans and repayments. The other side argues that as NBFCs do not offer checking and demand deposit facilities to their customers, there is really no need for direct access to the payments system beyond real time clearance facilities for disbursal of loans and collection of repayments. Moreover, direct access to payment systems comes laden with supervisory and compliance burdens, the costs of which will outstrip the cost of maintaining an agency agreement with a bank.

Even in India where access to the centralized payment system is being allowed by RBI for some NBFCs, closer investigation reveals these NBFCs fall into the category of payment system providers, prepaid card issuers, card networks and white label ATM operators. The category of non-banks allowed will be allotted a separate Indian Financial System Code (IFSC), and they will be allowed to open a current account with the RBI in its core banking system.

And last but not least, it is worth mentioning that widespread uptake of digital finance infrastructure, beyond payments, will only truly digitise the economy once it is backed by other digital infrastructure modalities such as digital identity for seamless and low-cost customer onboarding (see box below for details on IndiaStack).

[31] State Bank of Pakistan. Retail Value Payment Systems. https://www.sbp.org.pk/PS/RVPS.htm [Accessed on August 17, 2021]
[32] PSOs and PSPs are businesses that provide payment system services as intermediaries to route, process, clear, switch, and/or verify payment transactions. This opens avenues for greater financial inclusion across segments of the population and strengthens the interoperability of payment systems. As part of SBP rules, PSOs and PSPs are not custodians of customers' money and do not perform any banking functions. They can make agreements with banks, NBFCs, other PSOs/PSPs, merchants, and e-commerce service providers (see State Bank of Pakistan. 2014. SBP issues rules for payment system operators (PSOs) and payment service providers (PSPs). https://dnb.sbp.org.pk/press/2014/PSOs-23-Oct-2014.pdf). Examples of PSOs and PSPs may include, but are not limited to, switch operators, electronic payment gateway service providers, e-commerce gateway service providers, POS gateway service providers, remittance gateway service providers, and automated/electronic clearinghouses.
[33] Know your customer.

Box IX: IndiaStack, an evolving digital infrastructure for financial inclusion

IndiaStack is India's public digital infrastructure which is allowing the economy's move into a cashless economy. It is a set of APIs that enable instant communication between servers and devices. The stack has four layers:

Presence-less layer: This provides a unique digital biometric identity with open API access, which means individuals can verify their identity to anyone without having to provide documentation. This includes the Aadhaar card owned by the Unique Identification Authority of India.

Paperless layer: This layer stores and retrieves information digitally. It includes Aadhaar e-KYC[33], e-Sign, and Digital Locker owned by the Department of Electronics and Information Technology.

Cashless layer: This layer enables digital payments and other financial transactions and allows payment interoperability. It includes UPI and Aadhaar Enabled Payment Systems (AePS) owned by the National Payments Corporation of India (NPCI).

Consent layer: This layer enables data to move freely and securely. It is a modern privacy data-sharing framework with an open personal data store owned by the RBI.

Key tools that enhance the functionalities of the stack include the following:

- Unique identification number or Aadhaar card that provides a biometric reading of an individual. *In Pakistan, this already rests with NADRA.*
- e-KYC provides the instant verification of customers to the industry. *Adopting e-KYC mechanisms in Pakistan is crucial.*
- AePS that enables transactions at retail outlets, the disbursement of government entitlements, and bank-to-bank transfers using the Aadhaar number. *Raast in Pakistan will do this in its first use-case.*
- UPI enables interbank transactions, merchant payments, funds routing, and payment collection requests by powering multiple bank accounts into a single mobile application. *This is also a use-case under Raast.*
- e-Sign lets an Aadhaar cardholder electronically sign documents. It is authenticated through biometric readings and one-time pins (OTPs).
- DigiLocker works as the government's repository for documents. Users can sign up for services by linking their Aadhaar cards, and then upload, eSign, and share documents. *This and e-sign can be adopted in Pakistan.*
- Digital Signature allows individuals to electronically sign contracts with any entity. *Laws are in place in Pakistan that provide legitimacy to digitally signed documents.*
- e-National Automated Clearing House (e-Nach) permits a paperless repayment set up. It is the electronic process of helping FIs and other government bodies provide automated payment services. Once users sign eNACH, they give permission to the concerned authority to debit specific amounts from their banks on fixed days.

Whereas eSign, eKYC, eMandate, and biometric integration across web and mobile platforms provide customer verification and documentation, in turn enhancing loan-on-boarding, the UPI and AePS provide instant payment support. IndiaStack and other growing APIs are building a rich database of private and public users which can ultimately be leveraged to extend lending services to underserved MSMEs.

Section 6

The Big Connect: Digital-NBFCs-SMEs

How DFS can help connect the dots for NBFCs

Given the growth in DFS, its regulatory developments, and their potential in the financial services space, the future of NBFCs in Pakistan can be as much about competition as it can be about collaboration, though current NBFC models have delved deeper into or leveraged neither opportunity. There is virtually no competition with banks in lending. SME lending by NBFCs makes up a very small share of the total segment's financing (focused lending is mainly in micro, even though the potential in the 'S' segment is huge), which is overall small to begin with. Typically, NBFCs are supposed to provide financing in areas underserved by the banking system, which adheres to strict and onerous credit policies dependent predominantly on collateral and, as a result, steers clear of many risky assets. But aside from leasing, Pakistani NBFCs have not explored the many unique segments of opportunities. Meanwhile, there is also little collaboration with banks where NBFCs have an agent-client relationship. They depend almost entirely on these principal relationships in raising funds. With the right regulatory push, however, NBFCs could be developing partnerships on a more equal footing with banks and, in the process, even negotiating better lending terms (more on that later).

At the other end of the chain are fintechs. Once fintechs begin to take off, their low-cost, tech-heavy business models could usurp some of the space that has been created by NBFCs. However, by synergising efforts and key competencies (fintechs bring the tech knowhow whilst circumventing documentation and compliance pain points for customers, and NBFCs bring the customer base and segment knowledge), digital transformation can be transformative for NBFCs too. This is especially opportune given the growth in DFS and the regulatory developments to spur it on. With a host of APIs, it can bring efficiency into NBFCs business models through speedier transactions by digitising processes (the entire loan cycle[34] can be digitised, especially the pre-disbursal portion) which, in turn, will cut down transaction costs. It can expand its customer base by reaching out to remote borrowers and improving the borrower mix by capturing latent demand as mobile and internet penetration grows. In the same vein, three-way partnerships can also be developed where banks, NBFCs, and fintech disruptors minimise risks and provide a solid backbone on which innovative solutions can rest.

Digitising supply chain financing

Supply chain financing is an emerging area for the financial sector to explore, especially in lending to SMEs where lending-type NBFCs can play a transformative role. It is referred to as techniques and practices used by FIs to manage the capital invested into the supply chain and reduce the risk for all parties involved (manufacturers, distributors, retailers, consumers). Each financial intervention (financing, risk mitigation, or payment) in the supply chain is driven by an event in the physical supply chain. For instance, physical events within the supply chain—such as purchase orders, pre-shipment inspections, despatches/shipments, invoices raised by the seller, goods accepted by the buyer, or goods entered in the buyer's warehouse—create opportunities for credit intervention[35]. The emerging trend in supply chain financing is the leveraging of technology for more targeted and faster solutions for underserved business entities.

[34] *Verifying borrowers, conducting credit assessments, making instant loan disbursals, and accepting auto payments from customers.*
[35] *ICC Academy. Undated. Supply chain finance: An introductory guide. https://icc.academy/supply-chain-finance-an-introductory-guide/ (accessed 9 June 2021).*

According to research by the Business Recorder, there are over 1.5 million retailers, 15,000 distributors (and sub-distributors), and 2,500 manufacturers and service providers in Pakistan's retail value chain, which are served by closed-loop cash management solutions or undocumented cash transactions. The turnaround time (TAT) lag is 3–4 days in the distribution-to-manufacturing leg and 6–7 days in the retailer-to-distribution leg. Digital onboarding can reduce the TAT lag, generate additional liquidity, and cut down operational costs, including costs associated with delivery, distribution, and documentation.

The annual payment flow from manufacturer to retailing is estimated at USD 225–250 billion. Complete digital onboarding—savings on operational costs and bank charges—within this segment is estimated to generate additional liquidity of USD 800 million–1 billion[36].

The fintech path - CredAble and Nucleus Software

Banks, NBFCs, and other FIs globally are using digital interventions—credit checks, loan underwriting, improving loan approval speed, receiving and disbursing payments faster and more securely, and outsourcing the entire loan origination process to fintech providers and aggressively expanding customer base.

In India, a fintech company with an NBFC license called CredAble is offering supply chain financing solutions to SME vendors by partnering with banks, NBFCs, and other financial players. It combines the anchoring model by transferring the risk to the large corporate to which SME vendors are supplying. This takes away the question of the SME's creditworthiness which is at the heart of the lending problem.

The programme is digitised, so each step from documentation to verification to approvals uses a cloud-based technology that is faster, more secure, and scalable. FIs can partner with CredAble as a strategic partner to provide supply chain solutions to their existing customers.

Nucleus Software is another fintech company that provides lending and transaction banking solutions to the global financial services industry through its digital lending solution called FinnOne. The service helps FIs digitise their end-to-end loan lifecycle beginning with the onboarding of new borrowers, and assists FIs in making better credit decisions through credit scoring. Several NBFCs in India are using this automated loan service for effective credit risk management as they expand into new business segments.

Similar to CredAble is a local digital collection solution for a B2B value chain offered by Haball. Haball integrates itself with a corporate client's (manufacturer) existing system on ERP and collects real-time information of verifiable orders, invoices, and shipments. The corporate requests onboarding with the bank on Haball's platform and nominates credible buyers (distributors or retailers) for the bank to extend supply chain financing.

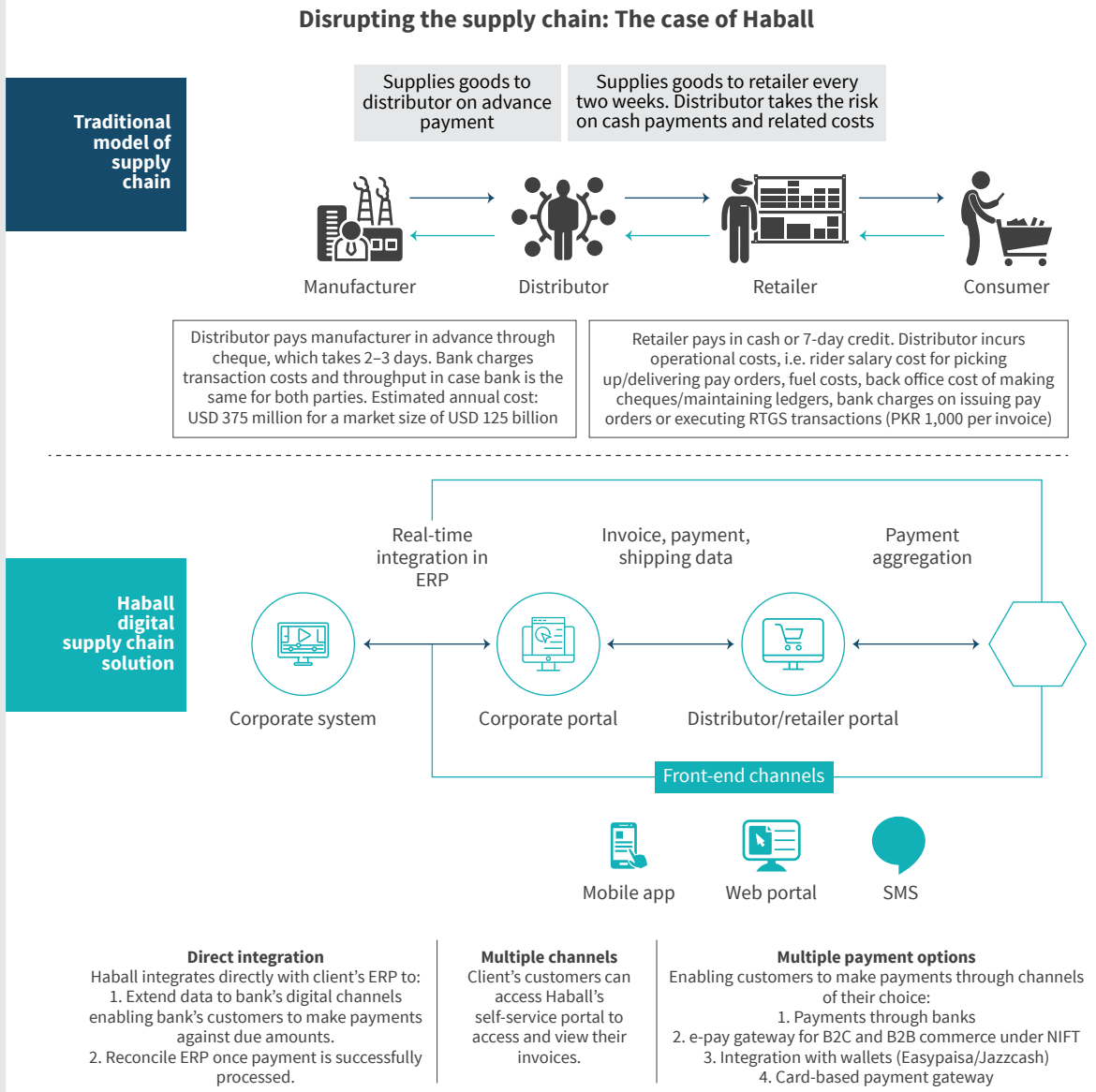
The corporate or manufacturer provides business and transaction history related to buyers to the bank and allots limits to their buyers to enable the financing. This is where the distributor or retailer comes in using its own Haball portal to make an order request from corporate, which is then sent to the bank through Haball (see Exhibit 19).

The bank approves financing and Haball facilitates accounts receivable and payable functions. The platform has automated the entire procure-to-pay and order-to-cash payment processing lifecycle. Calling it Blink, the payment system by Haball is an interoperable, open-loop payment gateway that allows corporates to send and receive payments in real-time, enabling the instant realisation of funds, automatic reconciliation, and payment knockoff[37].

In April 2020, Haball and NIFT, licensed as a PSO/PSP and offering nation-wide cheque clearing services entered into an a greement for enabling B2B payments through NIFT's Digital Financial Services platform under the brand name NIFT ePay. Prior to this in 2018 Haball has also entered into an agreement with 1-Link (also a PSO/PSP license holder) and Meezan Bank to scale digitization of B2B payments.

[36] *Business Recorder. 2020. Digitizing supply chain transactions. Business Recorder. 16 September. https://www.brecorder.com/news/40018812/digitizing-supply-chain-transactions (accessed 9 June 2021).*
[37] *Haball. 2018. Haball. https://www.haball.pk/ (accessed 9 June 2021).*

Exhibit 19: Digital transformation of the supply chain network



Exploring retail and wholesale lending for NBFCs

The case of Northern Arc

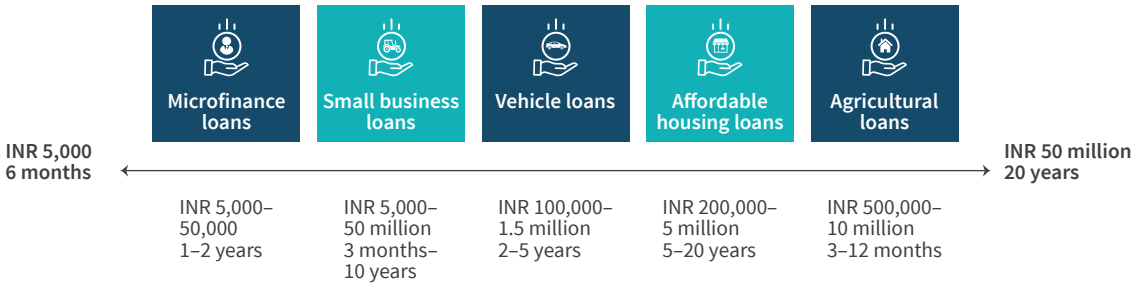
Northern Arc is a major success story in the area of wholesale lending in India. It facilitates lending in underserved and financially excluded segments of the Indian economy by partnering with key institutions (including microfinance companies and NBFCs), targeting these areas, and connecting them to debt investors. By raising debt from capital markets, partner institutions can meet a variety of client needs with products, including working capital, enterprise funding, short-term needs, and housing finance requirements. The model ensures that Northern Arc retains continuous skin in the game by being one of the largest investors—taking up about 20% of the risk.

This enhances credit and ensures that the model identifies partners on the basis of a robust underwriting framework. Northern Arc's selection of partner institutions has enabled the company to cover asset classes ranging from microfinance to affordable housing finance, small business loans, vehicle finance, agriculture finance, and corporate finance catering to the non-financial services of small enterprises. In India, most of these asset classes are being catered to by a growing number of NBFCs. In its capacity as an investor, Northern Arc monitors the performance of each transaction on an ongoing basis. The underlying pool performance data is mirrored and tracked on a loan-by-loan basis which leads to key insights. To date, it has gathered such granular data with over 11 million data points on the basis of which proprietary risk models can be developed to provide early warning signals.

On the borrower side of the equation, Northern Arc enables affordable liquidity, which allows the cost of funds to be lower through structured finance products, and also enables price discovery. This is particularly attractive for NBFCs that cannot raise demand deposits and largely depend on bank borrowing to meet liquidity requirements which is costly and largely unavailable.

Exhibit 20: Northern Arc credit exposures

Covering the entire gamut of retail credit through a focus on high-quality partners covering multiple asset classes



Can Parwaaz take off?

Parwaaz Financial Services Limited (PFSL or Parwaaz) is a newly incorporated NBFC wholly owned by Karandaaz. It has been established with the aim to design, introduce and scale a variety of different lending products targeting the MSME segment powered by technological solutions and strategic partnerships. The working model is to create a lending management system (LMS) and leverage partnerships with banks that will provide access to the payment system and other banking products.

A secondary option for Parwaaz is to enter wholesale lending for other NBFCs—in line with the example provided above of Northern Arc. While the current portfolio of NBFCs is limited, the SECP is keen on giving new NBFC licences in specialised fields—such as education financing, housing financing, etc. New entrants will lead to the emergence of new models that are driven by technology, but will need financing to take their ideas off the ground. Bank financing is expensive and requires collateral—the smaller the NBFCs, the harder it is to negotiate a reasonable LTV at affordable rates. Parwaaz can extend a wholesale line of credit (LoC) to new NBFCs at market rates. It can also bring informal lenders on its platform and formalise them by being the middleman for on-lending. In mobilising new investors and lenders, Parwaaz will be harnessing not only an emerging market of new investors, but also a new class of lenders that are serving financially excluded segments.

Taleem Finance Company Limited (TFCL)

TFCL was established in February 2020 as an education finance company. It is registered with the SECP under an IFS license. As of August 2021 the company has an oustanding portfolio of PKR 153 million, 193 active clients of which 83 are schools, 14 are alied business and 96 loans have been disbursed to the parents of students running business.

Credit guarantees and risk-sharing mechanisms

SME access to finance is constrained due to information asymmetry and the absence of adequate collateral—as clear financial records and cashflows are not available, and the ability to produce them is also missing. This increases the uncertainty of a project's rate of return while increasing the lender's administrative costs to onboard a new SME borrower, especially given the smaller loan size. The credit default risk associated is also high, which keeps commercial banking channels away as they have alternative, less risky assets to pursue with lower transaction costs[38].

Another major outcome of information asymmetry is adverse selection leading to credit rationing, i.e. firms typically lend on the basis of firm size and collateral, and may not even offer higher interest rates to SMEs even if they are willing to pay against their riskiness. By covering a portion of the default risk, CGSs have emerged worldwide as policy tools for overcoming information asymmetries and increasing lending in underserved segments[39].

The guarantees should help offset the FI's (traditional) collateral requirements, while an external agency provides a partial guarantee of the loan exposures. This third party is often a government agency with support from international development agencies or international FIs.

Hybrid portfolio partial CGS in Bangladesh

The CGS for SME (uncollateralised) loans in Bangladesh is modelled as a hybrid portfolio CGS and ensures that all parties have skin in the game. This scheme is available to NBFCs. First, banks and other FIs (who have three years of experience lending to SMEs) have to apply for participation in the CGS programme for a five-year period. They also have to pay an initial annual guarantee fee which is one percent of the total value of an individual loan. This fee is lowered if the FIs can maintain an NPL rate of 5% or less. In the case of default, the NBFC or bank will bear 20% of the risk (to the loan amount), with the government providing 80% coverage[40]. FIs can use their own credit policies for loan assessment, but there are minimum and maximum thresholds, and the loan tenor is limited to five years.

Lessons from international markets

The SME market or 'mesofinance' is defined by the European Investment Bank as the *"provision of a package of financial services to clients that are too big to be served by most MFIs, but too small or opaque to be fully bankable."* Mesofinance should be of interest to banks (provided they downscale), to microfinance (provided they upscale), and other regulated FIs (provided they adapt their delivery techniques).

The Facility for Euro-Mediterranean Investment and Partnership (FEMIP) notes that the lack of access to finance for the missing 'middle" has economic costs for the growth of the Mediterranean region. Over the last decade, efforts have been made to fill this gap through direct lending programmes where state-owned banks play a larger role.

According to FEMIP, government-owned banks across the Mediterranean are more willing to lend to SMEs even if they perceive them as higher risks. Even in countries like Egypt, Jordan, Morocco, and Tunisia where state-owned banks no longer own a large share in the total assets of the banking sector, their share in SME lending is over 50%.

[38] *Organisation for Economic Co-operation and Development. 2018. Enhancing SME access to diversified financing instruments. Discussion paper, SME Ministerial Conference. Mexico City: Organisation for Economic Co-operation and Development. https://www.oecd.org/cfe/smes/ministerial/documents/2018-SME-Ministerial-Conference-Plenary-Session-2.pdf.*

[39] *Organisation for Economic Co-operation and Development. Undated. Facilitating access to finance: Discussion paper on credit guarantee schemes. http://www.oecd.org/global-relations/45324327.pdf.*

[40] *Raihan, T. 2020. New credit guarantee scheme approved by Bangladesh bank. The Daily Star. 23 August. https://www.thedailystar.net/opinion/news/new-credit-guarantee-scheme-approved-bangladesh-bank-1949181 (accessed 9 June 2021).*

This is because government banks are less selective in their strategies to target the SME sector, have a lower ratio of collateralised loans to the SME sector, and a higher share of investment loans in total SME lending.

The case of Kafalat: The largest guarantee scheme in the Middle East

The Lebanese Kafalat scheme is the largest SME CGS in the Middle East and North Africa region and provides a relevant example of a scheme that has generated reasonable outcomes. It has good outreach, has generated positive returns on equity for the past several years, and has retained and reinvested all profits in newly issued guarantees. Kafalat loans are provided at subsidised interest rates, financed by the Lebanese treasury, and administered by the Central Bank of Lebanon. In 2006, Kafalat signed a partnership with the EU and the Ministry of Economy and Trade of Lebanon (MoET) to increase the amount and size of the loan guarantees beyond the level offered until 2005. Banks that lend to SMEs based on the Kafalat loan guarantees developed under this partnership were required to not impose any collateral requirements on top of the guarantee from Kafalat. However, according to the Investment Climate Assessment (ICA) for Lebanon by the World Bank in 2018, while Kafalat reached a significantly high percentage of surveyed firms (38%), the majority of ICA firms with a Kafalat guarantee were still required to have substantial collateral. The main benefit of a Kafalat guarantee for respondent firms was the longer maturity of lending and lower interest rates, thus reducing their cost of financing. The distribution of loans per sector is as follows: industry 61.5%, tourism 23.4%, agriculture 8.2%, new technologies 5.9%, and handicrafts 1%.

The case of Türk Ekonomi Bankası in Turkey

The story is not too different in economies with a more developed financial system. Turkey, for example, has made major strides in lending to SMEs in recent years. And the success story of a Turkish commercial bank stands out.

Türk Ekonomi Bankası (TEB - Turkish Economy Bank) was established in 1927 and is one of the oldest FIs in the country. A privately-owned bank, TEB's SME story began, when in 2005, it entered a strategic partnership with BNP Paribas, the largest bank in the Euro area. Under the strategic partnership, TEB has invested in several subsidiary or affiliate companies such as TEB ARVAL Vehicle Fleet Leasing, TEB Factoring, TEB Financing (consumer financing), and BNP Paribas Financial Leasing. This has made it possible for the holding company—a run-of-the-mill commercial bank—to offer an array of universal financial services without turning into a one-stop universal bank. On the one hand, the financial muscle of the sponsors, TEB and BNP Paribas, has allowed the financial services subsidiaries (which also includes portfolio management and investment securities companies) to establish themselves in the local market with a strong footing. On the other hand, it has allowed the subsidiaries to draw on the strategic vision, quality human resource, risk management practices, established brand, and correspondent relationships of the parent.

Since 2005, TEB has established itself as a one-of-a-kind SME one-stop-shop. It has developed a well-trained staff of SME consultants who provide advisory services to SMEs on production operations, marketing activities, human resource management, and organisational structure. TEB also established an SME academy, where entrepreneurs belonging to the SME sector seek training in managing businesses. This was followed by SME TV and digital platforms in recent years.

The holding company model for NBFC lending established by TEB offers a model to succeed in an otherwise challenging environment while leveraging the ability to cross-sell. Clients that are un-bankable under the commercial banking platform are more readily served through the windows of the financial services arms, while cleverly allowing the parent bank to maintain transaction banking relationships and offer trade services through its counters. Even with a Chinese firewall between the two organisations, the extent and length of relationship of the commercial bank with an SME firm naturally allows the lending services arm to draw comfort while making credit decisions.

The case of British Business Bank

Lending to the UK's SMEs dropped precipitously in the wake of the financial crisis. The high street banks began to deny credit to SMEs. In response, the government set up the British Business Bank (BBB) with GBP 3 billion from the British taxpayer, with the explicit objective of ensuring a better and more effective supply of credit to small businesses, especially in areas where the marketplace does not work properly. In five years since its inception, it has served 40,000 customers, extending a net fresh credit of GBP 2.3 billion.

BBB came about as the government made pledges in the wake of the financial crisis to: 1) increase funding for start-ups by increasing the number of fresh loans to 100,000, where BBB has become responsible for funding and managing the start-up loan delivery partner; 2) provide finance to companies that have a significant growth target to scale-up their operations; and 3) improve diversity in the marketplace.

The key learning from BBB experience is that it works with the marketplace instead of competing with established banks or lenders by becoming a direct lender. In areas such as start-ups and small businesses where the economic case for credit is not compelling enough for banks to take commercially viable lending decisions, BBB partners with market players to leverage their reach and network and take private-sector lending alongside it. So far, it has over 80 market players as partners.

By not becoming a direct lender, BBB is able to deliver its funding while avoiding the high infrastructure and distribution costs associated with becoming a direct lender, while also ensuring that it does not crowd out private sector appetite for SME lending. This also ensures that the government's footprint through its funding or guarantee does not crowd out innovation in the marketplace, especially the challenger banks, which have seen growth in the wake of the financial crisis. In fact, the bank has provided funding to several peer-to-peer lending solutions to increase their capacity. It was set up with a significantly low required rate of return over a five-year period: just 2%. This allowed it to take greater risk and incentivise private sector lenders to make credit origination decisions by either share in its book or offering risk participation arrangements.

Business Development Bank of Canada

The story is not dissimilar where the Business Development Bank of Canada (BDC) which was established in 1995. BDC is a national development bank wholly owned by the Government of Canada. It was incorporated under an act of Parliament that mandates it to promote entrepreneurship with a special focus on the needs of SMEs, and to fill market gaps and maximise financing alternatives for businesses. Government-led initiatives like this allow partner commercial banks to bypass the traditional collateral requirements for SMEs by instead obtaining a credit guarantee from the government.

In the wake of the COVID-19 pandemic, both the ability and willingness of national development banks to provide financial support to the SME sector stood tall when alternatives financial lenders bailed out due to the economic shock caused by the lockdowns. In March 2020, the Government of Canada re-established the Business Credit Availability Program, allowing national development banks to provide over CAD 10 billion to small businesses. For instance, BDC ensured that loan requests of up to CAD 100,000 were processed within 48 hours with zero collateral.

imSME - Malaysia's loan referral platform

To the east, there are more examples. In 2018, the Credit Guarantee Corporation Malaysia Berhad (CGC), a full-service credit guarantee company supported by the Central Bank of Malaysia (which owns 78%) and other partners, launched the country's first SME loan referral platform called imSME. The platform is essentially a loan marketplace that opens borrowers to a range of collateral-free financing products and services offered by participating banks and agencies.

On the platform, SMEs can explore various lending options and choose which fit their needs best depending on different stages of business development. The platform has 26 participating partners that include banks, NBFCs, DFIs, capacity-building agencies, and alternative financiers such as P2P service providers. The platform has search, referral, and match capabilities and is internally exploring psychometric assessment and data analytics. It has a financial advisory team that assist SMEs in finding the right match, and with agency partnership, also provides capacity building services to firms[41].

In its primary role, the CGC provides loan guarantees to SMEs—since its establishment, nearly 500,000 guarantees have been provided with SME financing valued at over MYR 63.7 billion. Its subsidiary, Credit Bureau Malaysia, provides credit information services and helps build the credit history of SMEs to improve their bankability. Both of these services, together with strategic partnerships, enhance the imSME platform to unleash a wide array of solutions for the segment.

Ant Financial - Using big data instead of collateral for 3-1-0 lending

China's Ant Financial has a 3-1-0 digital lending rule. This means borrowers can complete their online loan application in three minutes and obtain approval in one second using zero human touches. Its subsidiary, MyBank, provides unsecured small online loans to businesses that are selling products on Alibaba's marketplaces, Taobao.com, and Tmall.com. The e-commerce platform allows Ant Financial to build credit scoring systems that are used to determine the creditworthiness of borrowers almost instantly. Here, big data—customer behaviour in the form of monthly sales, payments and repayment patterns, and spending habits—is replacing the need for traditional collateral that lending institutions typically rely on to make credit decisions. Effective risk assessment methods allow the company to have a default rate of just 1%[42]. The average loan size was around USD 27,000 in 2015. In theory, the artificial intelligence (AI) running at the backend determines the loan size, tenor, and other loan terms.

Research conducted by Peking University used Mybank data to reach two important conclusions. First, the supply of unsecured lending by big tech is less sensitive compared with traditional lending's sensitivity to local business conditions or house prices as bank lenders react to changes in the value of immovable collateral while big tech reacts to variations in firms' revenues. By substituting data for collateral, the transmission of financial sector shocks and monetary policy can be substantially reduced to the economy. Second, tech companies leverage information generated on online platforms for risk assessment which allows smaller firms to meet borrowing needs, where banking channels typically stay away due to information asymmetries and the high cost of evaluation. Since tech companies are observing firms' performance in real-time, they are aware of changes in firms' financial conditions and can enforce loan repayment—if needed—through direct access to borrowers' revenues. In essence, it is assessing and screening and monitoring and enforcing throughout the lending process[43].

Credit rating and scorecards

Next to strict collateral requirements, information asymmetry is the biggest deterrence for FIs when extending loans to MSMEs. Public and private credit rating agencies remove those information asymmetries, counter adverse selection and moral hazard problems, reduce the information monopoly of lenders, and bridge the gap between lenders and borrowers by creating a knowledge databank. They can help evaluate the financial health and creditworthiness of the borrower. FIs create risk profiles for different borrowers based on which they determine underwriting metrics.

[41] *imSME. Undated. Products. https://imsme.com.my/portal/products/ (accessed 9 June 2021).*
[42] *Chataing, M-S and Kushnir, K. 2018. How Is Ant Financial closing the SME finance gap in China? SME Finance Forum. https://www.smefinanceforum.org/post/how-is-ant-financial-closing-the-sme-finance-gap-in-china (accessed 9 June 2021).*
[43] *Money and Banking. 2020. Big tech, fintech, and the future of credit. https://www.moneyandbanking.com/commentary/2020/12/21/big-tech-fintech-and-the-future-of-credit (accessed 9 June 2021).*

In Japan, a credit risk database (CRD) was established that rates SMEs using both financial and non-financial data and classifies SMEs along healthy, medium-risk, and high-risk segments[44]. Banks can use these tools to strengthen, decentralise, and improve timeliness in their credit assessment processes[45].

Other examples come from Bangladesh and India. Bangladesh houses a dedicated specialised credit rating agency for SMEs called the Bangladesh Rating Agency Limited (BDRAL)[46]. In India, the Credit Information Bureau of India Limited (CIBIL) was established as a public-private partnership to give lenders credit information about SMEs. Meanwhile, the Small Industries Development Bank of India (SIDBI), together with ten banks and a data analytics firm, Dun and Bradstreet, set up the SME Rating Agency of India Limited (SMERA) as an exclusive rating agency for MSMEs. In Pakistan, the Credit Information Bureau (CIB) currently maintains records for over four million borrowers, including SMEs. However, the coverage of the credit bureau is less than 7% as a share of the adult population. The corresponding figure is 63% for India and 100% for countries like Japan and Korea. Research suggests that the existence of a public credit registry can often restrict or have a crowding-out effect for private credit bureaus. This, in turn, would limit the scope of information and services that can be made available to lenders. Private credit bureaus can spur competition, which, together with the use of technology and digital interventions, can create a mountain of data, especially for riskier MSMEs where information is sparse.

Exhibit 21: Obtaining credit in Pakistan and peer economies

(The World Bank's 'Doing Business 2020')

Location	Strength of legal rights index (0–12)	Depth of credit information index (0–8)	Credit registry coverage (% of adults)	Credit bureau coverage (% of adults)
East Asia & Pacific	7.1	4.5	16.6	23.8
Europe & Central Asia	7.8	6.7	24	41.7
OECD high income	6.1	6.8	24.4	66.7
South Asia	5.5	5.1	5.1	21
Bangladesh	5	4	5.2	0
India	9	7	0	63.1
Indonesia	6	8	30.9	40.4
Japan	5	6	0	100
Kenya	11	8	0	36.4
Korea, Rep.	5	8	68.2	100
Pakistan	2	7	11.7	6.7
South Africa	5	7	0	66.5
Sri Lanka	2	6	0	48.7
Turkey	7	8	80.2	0

Private credit bureaus operating in the country have been registered under the SECP as private companies, but after the Private Credit Bureaus Act of 2015, private credit companies will have to obtain licenses from the SBP and be regulated accordingly. To date, only two companies have obtained a private bureau license, of which one, DataCheck, has been active for several years. The company processes over three million enquiries every year and maintains nine million files on individuals. The advantage to promoting private credit bureaus is the value-added services they can provide, including scorecards, ratings, employee screening, non-financial information (such as mobile phone bills, credit reputation, debt servicing business information), credit decision support services, etc[47].

[44] Yoshino, N. and Taghizadeh-Hesary, F. 2016. Major challenges facing small and medium-sized enterprises in Asia and solutions for mitigating them. ADBI Working Paper 564. Tokyo: Asian Development Bank Institute. http://www.adb.org/publications/majorchallenges-facing-small-and-medium-sized-enterprises-asia-and-solutions/.

[45] Ibid.

[46] "SME Credit Rating is a comprehensive and independent third-party evaluation of the SME. It takes into account the financial position and several qualitative parameters of the SME that have a bearing on the creditworthiness of the entity. It conveys the probability of the subjects' ability to pay back a loan or obligation to the lender or the investor" (see Bangladesh Rating Agency Limited. 2021. What is SME credit rating? http://www.bdral.com/about-us/what-is-sme-credit-rating/index.html (accessed 9 June 2021).

[47] Business Recorder. 2017. 'Pakistan to have its first credit bureau soon,' Director Banking Conduct, SBP. Business Recorder. 6 October. https://fp.brecorder.com/2017/10/20171006223982/ (accessed 9 June 2021).

Under the Credit Bureaus Act, 2015, credit bureaus can collect and disseminate credit data from all FIs including NBFIs, insurance companies, and utility providers, and undertake credit scoring and consolidate credit data for analysis and research needs.

The most important concern when accessing the credit information of borrowers is the integrity and privacy of data. The SBP's regulations for private bureaus have system security and access control guidelines for credit scorers. Controls are also being finalised for outsourcing arrangements with third parties. However, borrowers should have the right to access their information to verify the data and dispute data inaccuracies which can then be corrected by the credit bureau before the loan goes into processing. Currently the Consumer Grievances Handling Mechanism caters only to complaints after loans are processed and defaults are registered, when they should ideally be open at the time of the submission of the loan application.

The draft Personal Data Protection Bill, 2020 released by the Ministry of IT & Telecom contains several clauses relevant to the financial sector. These must be finalised in close consultation with the financial sector regulators.

Box X: The challenge of breaking away from conventional credit risk-scoring models

In its third round of the Innovation Challenge Fund (ICF), KRN penned an agreement with two commercial banks—Allied Bank Limited (ABL) and Alfalah Bank—to support them in developing an innovative credit risk-scoring model for SMEs that deviates from conventional collateral-based lending. SMEs have a hard time arranging adequate collateral. In many cases, immovable properties do not qualify because titles are not clear or land registries are not updated (both Punjab and Sindh are developing digital records of property deeds). Manual records are difficult to track and do not provide true picture of business financial health and cashflows. In other cases, SMEs simply do not have any immovable property that they can mortgage. For that and other reasons, existing credit policies identify the SME group as risky, where commercial banks, in particular, keep exposure limited. The vision is to create an evolving and interactive risk scoring model that replaces the stringent collateral requirements of banks, using instead, dynamic data being generated through multiple sources and using a wide array of parameters, including financial and non-financial variables. The model will encompass various innovative features i.e. inclusion of psychometric trends, spending behavior, customer norms using telecom or other data, evaluating obligor's acumen for this business, etc.

The challenge, however, has been how to capture these new measures of data. In small-ticket loans (mostly in the 'm' or 'S' loan category), alternative data such as telecom information, electricity usage, and market-based data visible from the supply chain (originating from distributors, retailers, sellers) can all be used to develop a risk assessment model. Here, even automated decisions can be made (Finja is currently doing that).

For larger ticket loans (mostly in 'S'), however, the due diligence required is greater, and relationship managers come in to provide subjective evaluations, which will be supplemented by financial and alternative data. This segment documentation is weak, and it is hard to assess the cashflows from traditional evaluation processes. Moreover, relationship managers usually have targets on the aggregated loan amount, not on the number of loans. They prefer a few 'M' accounts, which are easier to manage.

Continued on following page

The due diligence cost can be reduced by deploying technological tools to evaluate financial and alternate data. Meanwhile, machine learning tools can be used to refine the model by running multiple cases over a period of time. The problem begins in accessing this financial data and being able to rely on it. For a bank like ABL that has existing lending experiences with specific SME sectors, where a loan is extended to a consortium of SMEs, it would be easy to pilot a sector-specific tool where data is aplenty and shareable. Bank Alfalah on the other hand is developing a sector-agnostic credit risk scoring model. This model is challenging because it will require vast amounts of data to develop the risk scoring model and for refining it to make it usable.

Hence, the ABL model can serve as a pilot on which several learnings can be developed. It would be better to start conservative and go through the technology learning experience. Such a model could easily be replicated for NBFCs that are sector-focused with an existing pool of customers and domain expertise. In the medium term, the approach can be tweaked for sector agnostic banks and NBFCs.

For broad-spectrum models such as the one being developed by Bank Alfalah, partnerships with data aggregators and payment solution providers as well as emerging fintechs can go a long way in making and refining dynamic credit evaluation models. However, the fintech space has only just started to open, and as such, use-cases will develop over time—right now, they are lending in small pockets (mostly at retail end) and for small-ticket loans.

Peer-to-peer lending

Though regulations for peer-to-peer lending in Pakistan have not made any headway (the SECP has only recently sent a P2P provider in its first cohort of regulatory sandbox to work), the opportunities for lending in the MSME space using P2P are tremendous.

In India, P2P platforms are organised as NBFC fintech companies (with net owned funds of INR 20 million) that help businesses meet their credit needs by providing unsecured loans. The models work as an auction where lenders (which can be individual savers and FIs) make a bid for a borrower's loan requirements which is subsequently accepted or rejected by the borrower. The platform coordinates between borrower and lender and may offer other services—credit assessment, KYC verification, digital documentation, loan recovery, loan repayment, etc.

The RBI governs NBFC-P2P providers (existing NBFCs can register for a P2P license) under its regulatory framework introduced in 2017. An NBFC-P2P is defined as a non-bank institution that acts as an intermediary to provide loan facilitation services (including online) to participants (not including lending to institutions like banks or NBFCs). NBFC-P2P platforms have to obtain a license, but restrictions apply[48]. To facilitate these NBFCs, the RBI increased aggregate limits for borrowers and lenders across P2P platforms to INR 5 million (approx. USD 67,000) from the previous INR 1 million (approx. USD 13,000). In a one-on-one transaction, the amount by a single lender to a single borrower cannot exceed INR 50,000. The new aggregate caps have expanded the lending space considerably[49].

[48] They cannot lend on their own and only act as an intermediary in an online marketplace. They cannot provide credit guarantees. They cannot raise deposits and are not permitted to participate in the international flow of funds. All storing and processing of data must be on hardware located in India. They have to undertake due diligence on the participants and have to maintain documentation of loan agreements.
[49] Chandra, K., Narendran, N., Sanyal, J., and Hashwani, K. 2021. Fintech in India: Overview. https://uk.practicallaw.thomsonreuters.com/w-015-3281?transitionType=Default&contextData=(sc.Default)&firstPage=true (accessed 9 June 2021).

P2P providers lend to small and medium loans in the UK and China

Funding Circle is the UK's largest P2P lending marketplace that allows investors, governments, and FIs to lend to small businesses. Through strong underwriting information powered by APIs using both traditional (business and personal cash flow, collateral, and asset base) and alternative data (real-time cash flows and borrowers' online activity), lenders can choose low to high-risk borrowers and get returns accordingly. To date, it has mobilised loans of nearly GBP 7 billion with 81,000 investors on its docket[50].

In China, Jimubox is the largest loan provider to the SME segment, particularly to medium-sized enterprises in a bid to reach the missing middle. The loan bid from the borrower must be approved by a channel partner that is a third-party credit guarantee company that may even register for the bid on behalf of the SME. Jimubox has field teams that supplement historical borrower data retrieved from traditional sources that feed into the internal credit risk assessment system. Jimubox has also developed a secondary liquidity market for its loans to circumvent the issue of liquidity mismatch. Liquidity risk is a major problem where SME borrowers want longer repayment terms while investors only want to provide short-tenor loans (up to a few months). To tackle the mismatch, Jimubox has an active secondary market for its loans and each month, investors trade as much as 25–27% of its loans by value in the secondary market[51].

Co-origination partnership models with banks

The co-origination of loans allows banks and their NBFC partners to co-lend to a group of customers where the origination portion of the loan is performed by the NBFC while the bank provides financing to fund the majority of the loan. This works best when there are specific segments that are being targeted, such as SMEs or women. While the target group is well-understood by the NBFC (and the recommendation to originate the loan comes after the risk assessment by the NBFC), the bank provides it with the liquidity required to actually make the loan happen. Here, either the bank runs its own credit analysis before extending the loan or the arrangement to run a credit check on the borrower is made prior to the arrangement. The NBFC benefits from precious liquidity while the bank takes advantage of the NBFC's loan origination and servicing capabilities. By sharing risks, this model can allow for many underserved segments to be covered, which would expand the overall customer base for banks and NBFCs.

A technology layer can enter here through a third-party arrangement with a fintech that would provide back-end connectivity support to the bank and the NBFC and integrate protocols and communications between the two parties seamlessly. The model would benefit from the tech-layer here, especially where the systems of banks and NBFCs must communicate and interact to determine the creditworthiness of the borrower at the time of loan origination and evaluate loan pricing.

Apart from its clear advantages, one major problem that can pose a threat is that the borrower, in essence, is entering into a lending agreement with both the bank and the NBFC. Dual-lender credit can seem daunting even though operationally, the customer does not have to deal with each lender separately for repayments. The other issue that has hindered these models in India is the difficulty in matching—banks and NBFCs have different underwriting parameters while both also have different IT systems. Operationally, the IT integration between banks and NBFCs must be seamless for co-origination to occur.

[50] *Oxford Economics. 2021. Supporting SMEs through the crisis and recovery: Funding circle's 2020 impact. Oxford: Oxford Economics. https://www.fundingcircle.com/uk/impact (accessed 9 June 2021).*

[51] *Deer, L., Mi, J., and Yuxin, Y. 2015. The rise of peer-to-peer lending in China: An overview and survey case study. London: The Association of Chartered Certified Accountants. https://www.accaglobal.com/content/dam/ACCA_Global/Technical/manage/ea-china-p2p-lending.pdf.*

Box XI: Finja (Pvt.) Limited: A super NBFC

Finja was founded in 2016 as a financial services and lending platform for merchants (*karyana* shops) and MSMEs, providing them with unique payment, collection, and credit solutions. It partners with banks, FIs, and merchants and holds both an EMI license and the IFC license through two separate entities. This allows it to operate as an integrated financial solutions provider using digital platforms and not rely solely on agency arrangements with banks to provide liquidity to customers. The EMI license provides Finja with an access point into the national payment system otherwise not accessible to NBFCs.

Since the EMI license allows Finja to take deposits, it provides the company with a consumer-facing brand. The EMI license can facilitate Finja in building use-cases that are leveraged to make more tailored lending products. Finja's leap into EMI while being an NBFC also opens the doors for other NBFCs to replicate this model and learn from it. Finja identifies itself as bank-agnostic, whereby it is compatible with all bank accounts and wallets in the country. This means Finja users can have a primary bank account anywhere and be able to make transactions via the Finja portal seamlessly. Through the Finja portal, corporations can open a virtual account with Finja, which requires only the basic credentials and subsequently allows companies that register to link their operating accounts with the portal and transfer funds through IBFT or RTGS.

Finja is successfully leveraging its EMI status and has upgraded and retooled a new-age payments platform called 'Finja Business'. Under the new design, institutions and corporates can sign up instantly without any paperwork or an in-person meeting and manage essential business operations such as payments, disbursements, and e-invoicing/collections for employees, vendors, suppliers, and partners. Additionally, businesses can also conduct tax calculations, manage employee leaves and attendance, and enjoy real-time reporting and analytics. To date, almost 2,000 businesses have made disbursements close to PKR 15 billion (USD 87 million) using the portal. However, one caveat here is that the EMI license is in the pilot stage, and the transactions taking place are small in value at very short tenors. Once the EMI license matures, transactions can be scaled up.

Products and services

Finja Business

Payroll management: This allows the real-time transfer of funds to employees without opening their salary bank accounts using their current bank account or wallet, or to any valid identity card.

Vendor management and payment: This allows the tracking of vendors and vendor payments to any account or wallet.

E-invoicing and receivables: This helps to create, upload, and send invoices, and receive payments quickly.

People management: HR management solutions, including employee data management, onboarding employees, tracking time off, analytics, and reporting.

Business payments: Allowing corporations to transfer funds without a corporate bank account, including bill payments, tax payments, and vendor and salary payments.

Finja supply chain financing and business loans

Supply chain loans: Retailers can buy goods and inventories from Finja's network of distributors on credit with a 30-day repayment cycle.

Productive (90-day) working capital loans for MSMEs.

Advance against salaries and equal monthly instalments: Up to 40% of salary can be taken out as a loan to be repaid in 30 days. Online purchases can be made at equal monthly instalments from 3 to 12 months.

Term-advances: Credit tenures for 2–18 months underwritten by employers.

Continued on following page

Lessons from Finja

Finja collects valuable data from transactions on its platform that helps it to create better lending and payment products. When employers pay wages through the portal, even though salaries are not going into Finja wallets, there is valuable consumer data coming into use through the flow of funds which allows Finja to lend to corporate employees by feeding data into its credit engine. Finja has built partnerships with multiple banks and FIs such as Meezan, Faysal, Easypaisa, and ANT Financial, and is creating lending and payment products to serve an otherwise excluded or underserved market.

Using technology for credit assessment, Finja has convinced banks to use its expertise for their loan management processes. In evaluating the loans, Finja is motivated to go beyond basic KYC. For instance, when lending productive working capital loans to small businesses, Finja sends a team to visit the borrower shop and conducts an on-ground evaluation of inventory, collecting credit data from the shop's suppliers. This data is fed into the AI engine to design the loan. Because Finja does the credit assessment and origination for new loans and has AI-based lending solutions, commercial banks are sharing their credit books with the company to outsource the loan management process and lending in many unserved or underserved target groups through a risk-sharing mechanism (80:20) in exchange for a profit.

Finja is tapping into underserved markets through data techniques and strategic partnerships. The biggest scope of continuous growth for Finja is in value-chain financing. Finja is focused on digitising the *karyana* store or the local corner store network, which is a major component of the economy, but remains underserved. With the outbreak of COVID-19, consumer preferences moved swiftly from large grocery outlets to their neighbourhood *karyana* stores from where they could safely purchase daily essentials. Hence, this segment was in dire need of credit to optimise its sales cycle and achieve business growth. Finja, through its partnership with multiple fast-moving consumer goods (FMCG) organisations and their distributors (e.g., Nestle, Unilever, Sigma, Phillip Morris, Reckitt Benckiser, and Punjab Beverages), has already crafted relationships with over 5,000 merchants in multiple cities and extended short-term digital loans of over PKR 236 million (USD 1.5 million) to this segment at the back of using its NBFC status.

With its *karyana* model, Finja is performing two important tasks: providing credit to a *karyana* shop that does not have access to liquidity from formal banking channels while also ensuring that the distributor or FMCG gets paid without being out-of-pocket for the length of the credit period. This creates a whole new ecosystem where the entire value chain wins. Meanwhile, Finja is collecting a lot of data—through its own business portal or through credit bureaus—which allows it to identify new potential borrowers for banks and partnering institutions. By constantly building this mountain of data, Finja can grow and further tailor its lending products closely tuned to borrower needs.

Finja is strengthening its microloan portfolio, but with a full-fledged EMI license, higher transaction limits will allow it to venture into upscaling segments.

Section 7

The Role of Institutions

Strengthening SMEDA's role in SME development

The Small and Medium Enterprise Development Authority (SMEDA) is the only major government body that was founded to develop the SME segment in Pakistan, to set development agendas and targets, and to advise the government on SME-related policies. Over the years, the agency has facilitated business development services to SMEs, conducted sector and cluster studies to understand and in turn cater to the development needs of different SME groups, and conducted seminars, workshops, and training.

While numerous measures, interventions and projects have been undetaken, SMEs in the country and the ecosystem they operate in continue to be beset by challenges. In 2007, SMEDA introduced a national SME policy that was never fully implemented. In 2004, SMEDA initiated an industry support programme (ISP) to mobilise technology and knowledge transfer to local SMEs through engagement with international partner organisations. While SMEDA provided capacity building and technical assistance, growth in major SME segments could not take off.

SMEDA has a deep understanding of why SMEs in Pakistan are lagging in productivity and competitiveness and what challenges they face. However, it lacks consistent access to financial resources or funding budgets. The GoP's 100 Day Agenda on the NFIs recognised the need to strengthen SMEDA's institutional capacity so that the organization can effectively participate in building the SME landscape. It would require adequate resources and power to influence policy implementation and would need an endowment fund to lead new policy initiatives.

SME data: missing in action

The last economic census was conducted in 2005. Detailed data on SMEs does not exist, and most numbers are extrapolations and guesstimates from a 15-year-old census. As such, while SMEDA regularly gathers information and data on the SME sector, it is not formalised and accessible. The true extent of SMEs and their specifics (from the perspective of business, financial, and operational capacities and capabilities) remain unknown. The availability of systematic and comparable data on the demand side is crucial. A national SME policy without a robust database on SMEs is akin to missing a limb without which a policy could not walk.

SME definition standardisation and segmentation exercise

There is no uniform definition of SMEs—different definitions are used by the SBP, SECP, FBR and SMEDA. Any policy or reform framework, as a result, is inconsistent across institutions and makes it difficult to ascertain target segmentation or assess demand across segments and performance thereon. SMEDA and regulatory bodies in the country should synthesise a single definition for SMEs on which financing/lending criteria and regulatory and SME development policies can be designed. Most recently, the SECP has reconciled its definition based on annual sales turnover and the number of employees in line with the SBP. SMEDA has already proposed a revised definition (see below exhibit). These are positive steps and must be taken further.

Exhibit 22: Definitions proposed in SME Policy 2020

Category	Definition
New	Registered, independent enterprises, under 5 years old, with a sales turnover of up to PKR 50 million
Micro	All enterprises with a turnover below PKR 6.5 million, not elsewhere categorized
Small	Registered, independent enterprises, with a sales turnover above PKR 6.5 million and under PKR 100 million
Medium	Registered, independent enterprises, with a sales turnover between PKR 100 million and PKR 650 million

Source: Small and Medium Enterprises Activity. Development of revised SME Policy of Pakistan. 2020

The government and regulators must do more

The government has made great strides in developing a strategy for financial inclusion and accomplished several milestones. However, the focus has been on banks for far too long, even though history suggests that the banking industry has limited its lending to SMEs, favoring less risky avenues.

Box XII: Progress on NFIS targets

In 2015, the government developed the NFIS for a board vision to achieve national financial inclusion. The broad contours of the framework include facilitation for mobile wallets and easy accounts to expand the existing base; increasing access points such as bank branches, banks, ATMs, POS machines, and retail stores with mobile money options; introducing new financial service providers; creating a national payment gateway; upgrading PRISM; enabling businesses to send and receive remittances and payments; promoting e-commerce; building bank and DFI capacity for lending to MSMEs; and raising the financial awareness of poor people and women. Under the government's 100-day agenda, the strategy envisaged extending finance to 700,000 SMEs and raising private sector credit with a 17% share to SMEs[52]. The strategy included the following:

Established a Credit Guarantee Company.	Under discussion
Establishment of unified and integrated e-registry	After the passing of the Financial Institutions (Secured Transactions) Act, 2016, an e-registry for charges on moveable assets was developed. Until April 2021, 50 FIs were registered, with over 70,000 unique entities being recorded and over 20 different immovable collateral types used
Strengthening of SME Bank Limited and First Women Bank through privatisation	Expected to be privatised during FY21-22
Speedy disposal of SME loan cases by banking courts	No progress. However, there has been headway in the implementation of non-judicial foreclosure laws
Providing refinance long-term and short-term facilities to the tourism and IT sectors	Under SBP promotion of SME policy
Designing a national SME policy	Developed and launched
Reorganising and empowering SMEDA	In process
Setting up small industrial zones	No progress
Conducting a census of business enterprises	No progress
Lowering the income tax for small companies from 25% to 20% in the next five years	As per the income tax ordinance, there is a 1% reduction each year (starting from 2019). Therefore, as per the schedule within the ordinance, this rate would be 20% in 2023 and onwards
Reducing the tax on the income of banks earned on SME portfolios from 35% to 20%	This was done in 2019 through the announcement of a mini-budget. Income from such loans would be taxed at 20% until 2023

[52] *Government of Pakistan. 2018. Government's 100-days agenda: National financial inclusion strategy. http://www.finance.gov.pk/NFIS.pdf.*

In fact, banks' reluctance has left a space open for new entrants that can provide more targeted products and services to ignored borrowers. With the help of technology partners, NBFCs can target innovative lending solutions for different SME segments with fewer regulatory bindings than banks. But that requires some handholding from the regulator and parity with banks on any concessional or refinancing schemes (including guarantees) that have so far only been available to the banking sector. The perennial issue of the high cost of funds facing NBFCs (as they rely on bank lending) can be easily dealt with if NBFCs were allowed to raise from public funds, including capital markets.

This would diversify their borrower mix. Co-lending agreements can also play a part here. Moreover, the tax benefits that are available for SME lending to banks should be extended to NBFCs. In the start, since NBFCs do not have the luxury of earning fee-based income, the government could provide tax holidays so they are not at a disadvantage with banks on costs. Better negotiated partnerships with banks can be brokered by the government to meet SME lending targets.

India's SIDBI in building an SME information database

SIDBI in India was established as a financial inclusion entity with the goal of providing financing, promotion, and development for MSMEs. The bank does direct lending to fill existing credit gaps in the MSME sector and creates innovative lending products—indirect lending to reach the wider financing needs of the sector through banks, NBFCs, MFIs, and new-age fintechs; facilitating government schemes for the segment; promoting emerging start-ups and providing handholding to budding entrepreneurs.

Its earlier product, Credit Plus, provided credit, non-financial advisory, and mentoring facilities to MSMEs. Its most unique product is the CriSidEx which is a collaborative exercise carried out together with a global analytical company, CRISIL. This MSE sentiment index tracks SME activity, collects data on them, and rates them. It essentially creates an information infrastructure for small and micro-enterprises where data is patchy and most difficult to gather. While the index provides information to lenders to make timely credit decisions, it also provides information to policymakers to assess the impact of their policies on SMEs more broadly.

How ready are Pakistanis for digital onboarding?

Where it is crucial for NBFCs (and other financial service providers in general) to use digitisation as a tool to enter niche markets and provide diversified, tailored products, to a great extent, the readiness of the population is equally important. According to the Financial Inclusion Insight Survey, 2017[53], 13% of Pakistani adults were active users of financial accounts (including banks, NBFIs, and mobile money) from 8% the prior year with a pronounced growth in mobile money accounts from 0.5% to 3%. Users of advanced services such as savings, insurance, investments, and credit grew to 10% from 7%. The use of mobile money to pay bills was a strong driver of growth here. The latest edition to this tracker for 2020 saw the numbers climb—active users of financial accounts are up to 21%, where mobile money account users climbed to 9% in pre-COVID 2020. While banks lead (15%), full-service NBFI account users stood at 2%. Mobile money users of advanced services, such as saving, borrowing, insurance, and investment increased from 2% to 4% of adults from 2017 to 2020[54].

Proximity: 9 of 10 adults were proximate to at least one service[55] within five km of their homes. POS (mobile money agents or kiosks) do not seem to be barriers to financial inclusion. Some 52% of respondents were within a five-km distance of a mobile money agent, 51% to a retail store with a mobile money kiosk, 62% to a bank branch, and 55% to an ATM. ATMs were less accessible than bank branches, indicating that banks are not maintaining a 1:1 ratio between branches and ATMs.

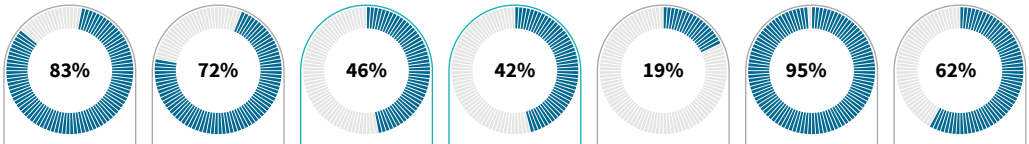
[53] *Khan, I. and Schueth, S. 2018. Pakistan - Wave 5 report: Fifth annual FII tracker survey. Washington D.C.: InterMedia. https://finclusion.org/uploads/file/pakistan-wave-5-report_final.pdf.*
[54] *Khan, I. and Schueth, S. 2021. Pakistan - Wave 6 report: Sixth annual FII tracker survey. Washington D.C.: InterMedia. http://finclusion.org/uploads/file/fii-pakistan-wave-6-2020(1).pdf.*
[55] *Mobile money agent, retail store or kiosk, bank branch, ATM, banking agent, committee/ROSCA, MFI, saving/lending group.*

Mobile phone penetration: Mobile phone ownership seems to have boosted digital finance. Around 52% of individuals owned a phone, which implied SIM services, while one in four adults owned a smartphone. Solutions that require only aliases—mobile phone numbers or e-mail addresses—can be boosted by just an increase in mobile phone ownership. Mobile internet, social media, and app users stood at 24%, matching the smartphone user statistic. Only 11% of individuals used mobile phones for financial transactions.

Readiness: Though there were marked improvements in the readiness of Pakistani adults in adopting DFS between 2015 and 2017 (see Exhibit 24), due to new rules[56], indicators related to phone usage like ownership of a SIM card and ability to send and receive text messages showed large declines. However, the ability to send or receive a text message, which is a proxy for being able to use a mobile money account, grew significantly prior to 2020, which demonstrates growing readiness in DFS. One major achievement is in financial literacy, which has increased significantly to 19% from 14% in 2017. Financial literacy refers to knowledge of the fundamental concepts of interest rates, interest compounding, inflation, and risk diversification. Such knowledge is vital for the DFS space to expand into more specialised products and services for individuals as well as business entities—particularly micro and small.

Exhibit 23: Readiness to adopt DFS: Financial inclusion insights tracker

2020: Key indicators of readiness to adopt digital financial services
(Shown: Percentage of Pakistani adults, N = 3,567)



	Necessary ID*	Mobile phone access (own/borrow)	Own a SIM card	Ability to send and receive text messages	Financial literacy	Basic numeracy	Mobile money awareness
2017	86%	78%	59%	52%	14%	99%	79%
2016	95%	77%	52%	44%	16%	95%	76%
2015	95%	76%	56%	40%	NA	95%	72%

Source: Kantar Pakistan FII Tracker surveys: Wave 3 (N = 6,000, 15+), September–October 2015; Wave 4 (N = 6,000, 15+), September–October 2016; Wave 5 (N = 6,000, 15+), September–October 2017; Wave 6 (N = 3,567, 15+), February–March 2020.

[56] *Banning and blocking millions of phones using counterfeit technology.*

Section 8

Recommendations

Despite issuing revised PRs for SME lending and a promotion policy to bolster SME lending by the traditional lenders (that includes concessionary refinance schemes for SMEs and lending targets for banks, and a credit guarantee scheme [CGS]), bank lending to SMEs has continued to struggle. As long as commercial banks have safer lending avenues with better-perceived risk-and-reward profiles, they will prefer alternatives such as investment in government guaranteed debt, over lending to SMEs.

That leaves two choices. First, to liberalise financial innovation to the point that next-generation solutions such as peer-to-peer lending services, private equity, and venture capital fill the gap by enjoying an unencumbered path to growth. A free market for SME credit along such lines may flourish in the long term, but its evolution may also go through boom-and-bust cycles, leaving many entrepreneurial ventures as casualties in its wake. Pakistan's regulatory mindset needs to be geared to seed innovation, and there is a regulatory need to guide and control the direction of growth. Second, for the government to step in as a marketplace lender, helping incentivise access to credit for SMEs through such instruments as CGSs, risk participation arrangements, and concessionary funding as seen in the case of Mediterranean countries, and even developed economies such as the UK, Canada, and EU. Where commercial banks recede, NBFCs and MFIs should be liberalised and supported to fill the gaps in parity with commercial banks in terms of inclusion in various schemes.

In that context, the three major deterrents to NBFCs that have shackled their growth in catering to SME markets are: i) the higher cost of funds; ii) the exclusion of NBFCs from government and central bank-backed concessionary funding, credit guarantees, and risk-sharing arrangements; and iii) NBFCs' inability thus far to leverage an increasingly digitized financial ecosystem. Solutions catering to minimising these deficiencies could unleash potential volumes for NBFCs, especially in the underserved, but growing SME economy.

Mobilising and diversifying NBFC liquidity to circumvent the cost-of-funds issue

1. **Diversifying funding sources:** Even though reliance on the banking system may persist (as is the case in most economies), regulations for NBFCs may be relaxed to explore other secure funding sources, including the issuance of debentures, commercial papers, and other capital market instruments, whilst relaxing regulations for deposit-raising NBFCs. In India, access to public funds (of which public deposits are a subset) is available to both deposit and non-deposit-taking NBFCs. However, liquidity risk management guidelines should go hand-in-hand.

2. **SBP schemes:** Existing and upcoming refinancing and risk-sharing schemes should be made available directly or indirectly to NBFCs. To boost SME lending, NBFCs should be considered important vehicles for providing credit solutions. In India, the MUDRA Bank was set up to provide liquidity to NBFC-MFIs. According to estimates, the cost of funds for NBFCs would come down 1–4%, depending on the funding received by the FI. SBP should consider access for NBFCs to the recently announced SAAF scheme whether directly or via wholesale arrangements with banks. It is also worth exploring whether such refinance schemes may be placed outside the scope of the central bank. Several examples of refinance schemes managed by central banks (India, Sri Lanka, Bangladesh, Nigeria) and outside the central bank (Germany, UK, USA) provide models that can be closely evaluated to determine whether refinance schemes can be managed under an alternative arrangement to extend the remit of these schemes to FIs not managed by the central bank.

3. **Co-lending models for banks and NBFCs:** The government could allow co-lending models for banks and NBFCs to enter arrangements for credit disbursement to SMEs with the sharing of risks and rewards—while they conform to regulatory guidelines.

This would improve the flow of funds to the designated sector at an affordable cost since banks have a low cost of funds and NBFCs have access to niche markets. In India, priority sectors were identified for which the co-origination of loans could take place. In such cases, co-lending banks can take their share of the individual loans on a back-to-back basis in their books. On the other hand, NBFCs are required to retain a minimum 20%-share of the individual loans on their books.

4. **Extending the scope of the line of credit (LoC) facility:** The SBP established LoC for MFBs and MFIs (including NBMFCs) for on-lending to micro-enterprises. The grant of USD 75 million (available through the Public Sector Development Programme) under the World Bank-funded Financial Inclusion and Infrastructure Project (FIIP) was established for 25 years to inject long-term liquidity into the microfinance sector. The LoC operates through participating FIs which will enter an arrangement with the SBP under this facility and provide loans to micro-enterprises[57]. Regulations for MCR/CAR are in place while pricing for LoC, and onward lending to end-users will be market-based. This facility should be extended to the SME segment and allow all NBFCs to participate.

5. **Sovereign guarantees and special liquidity schemes (SLS):** The government can improve NBFC liquidity through portfolio guarantees by banks—for the purchase of bonds and commercial papers of NBFCs. In India, a partial CGS has worked well to not only provide liquidity, but also address the issue of asset-liability mismatches. Any public sector bank in India can purchase the securities of an NBFC with a minimum rating of 'AA'. The guarantee is a one-time, six-month facility to public sector banks to cover the first loss in case of default of up to 10%. The recipient NBFCs are mandated to keep their capital to risk-weighted assets ratio above the regulatory minimum while optioning to buy back the assets. Furthermore, the National Bank for Agriculture and Rural Development (NABARD) announced a partial guarantee on pooled loans extended to non-deposit-taking NBFCs and MFIs. Under the pooled loan issuance structure, any bank or NBFC known as a principal lender can extend loans to NBFCs/MFIs per agreed terms. These loans are pooled through a common partial guarantee offered by guarantors. Similarly, an SLS where liquidity is provided to NBFCs through an special purpose vehicle (SPV), registered NBFCs/MFIs can raise short-term funds by selling debt in the primary and secondary markets. In the aftermath of the 2008 crisis, the Bank of England introduced an SLS to temporarily deal with liquidity problems faced by UK banks. Banks could exchange high-quality illiquid assets for liquid UK treasury bills, which would, in turn, be exchanged in private markets for cash.

6. **Tax advantages:** Under the NFIS, one of the government's targets was to reduce the tax on the income of the banks earned on SME portfolios (35–20%). This should be implemented and extended to NBFCs (from 29% to 15%). Furthermore, there can be tax advantages on the profits of depositors to make NBFCs competitive.

7. **Diversifying assets to create new revenue streams:** Instead of focusing on costs, NBFCs should create feasibilities for a variety of different products and services offered to a diversified class of assets, even within the SME domain. The loans can be tailored and designed to maximise returns. This is where technology and analytics can play a prominent role. Meanwhile, new customer profiles can be created for underserved potential borrowers—especially through partnerships with e-commerce and B2B market players for wider customer acquisition. Lending packages can include value-added services, including advisory, capacity development, and handholding activities that can supplement income.

8. **Wholesale lending:** This is similar to the case of Northern Arc where an NBFC works as a wholesale lender to other NBFCs and raises debt through the capital markets. The wholesale lender has skin in the game by being a major investor to mobilise funds for partnering NBFCs and MFIs so that they can on-lend to their target segments. The PMIC is a wholesale lender to the microfinance industry. Its role in extending similar facilities to all lending NBFCs should be explored. The wholesale lending model can also be examined for extension to informal lenders. This will not only help in bringing informal lending into the documented sector, but also reduce the rates charged to end-consumers.

[57] *State Bank of Pakistan. 2018. Rules for the line of credit fund under financial inclusion and infrastructure project. Islamabad: State Bank of Pakistan. https://www.sbp.org.pk/acd/2018/C1.pdf.*

While there are multiple entry points for government interventions in helping NBFCs' liquidity positions, there is a limit to the benefit of reducing the exposure of NBFCs to the high cost of funds. These will invariably remain high as banks will remain a primary funding source for them. The alternative is to focus on bringing operational efficiency through automation, digital onboarding across the value-chain (from data gathering to data analytics to digital payment solutions), and exploring a wide range of alternative delivery channels beyond agent agreements with banks which will all enhance NBFC business models.

Strategic partnerships to leverage data, diversify delivery channels and access payment systems

NBFCs should strengthen their existing business models through strategic partnerships with a wide range of FIs, asset management companies, insurance companies, payment service providers, fintechs, etc.

1. **Corporate banking channels:** Partnerships with banks where they outsource loan origination, credit assessment, and credit processing to a digital NBFC—similar to what Finja is trying to do—hold promise. NBFCs can manage the SME portfolio for banks where the value proposition that NBFCs bring to the bank is in the form of digital onboarding and presence in clusters. The British Business Bank in the UK has over 80 market players it partners with to leverage their reach and network and serve segments otherwise left financially excluded. In the same vein, TEB (Turkey) offers some guidelines for workable holding company models. By investing in its subsidiaries and affiliates operating in the NBFC space, the bank has ventured into a wide array of financial services without having to become a universal bank. The SME-focused subsidiaries draw on the strengths of the parent (such as risk management practices) and serve the erstwhile underserved segments, while the commercial banking arm benefits from cross-selling.

2. **Partnerships with OEMs:** Through partnerships with OEMs (large corporates/anchors), retailers, e-marketplaces, e-commerce/P2P platforms, NBFCs will open themselves up to greater opportunities for B2B customer acquisition and expand their customer reach considerably where tailored solutions such as supply chain financing can be provided. This is in line with the case of Haball.

3. **Include NBFCs in ambit of proposed credit guarantee company:** To that end, the proposed credit guarantee company should extend guarantee schemes to NBFCs in parity with banks for on-lending to new and existing SME borrowers. Aside from operational growth, by reducing portfolio risk through the guarantee mechanism, NBFCs can improve credit ratings which would enhance their ability and capacity to raise deposits and access market liquidity.

4. **Digital payment operators and aggregators:** Through partnerships with aggregators (e.g., Haball) and PSOs or EMI license holders, NBFCs can integrate with payment systems indirectly and create new delivery channels (Finja is currently doing this).

5. **Leveraging data:** NBFCs can leverage data by partnering with data providers, aggregators that access both public or private data, surrogate data registries, data extractors for credit scoring and verification, credit scoring and rating agencies, digitising loan underwriting and operational processing enablers (in India, these enable eSign, eKYc, eStamping, eNACH, etc.), data analytic firms that analyse existing data, including from surrogate sources and so on. NBFCs can tailor products and provide targeted credit solutions (and faster) by capturing customer data from different sources and backing it with analytics. End-to-end digitisation can improve credit delivery, augment underwriting, mobilise transactions, reduce operational costs, reduce operational risks, improve risk mechanisms (through real-time data collection and monitoring), massively expand customer acquisition, especially in untapped markets, improve loan approval rates, and substantially reduce delivery times.

Fintech and digital service providers in Pakistan are growing, but perhaps not at the desired speed. Regulators are still figuring out how to monitor and regulate whilst also promoting the evolving digital landscape. While all sorts of fintech solutions will (and can be) driven by the private sector, they come with their own set of constraints and require a strong regulatory framework for fruitful governance and impactful growth.

Annex A: Regulatory requirements for banks versus deposit-taking and non-deposit-taking NBFCs

	Banks/microfinance banks (MFBs)	Deposit-taking NBFCs	Non-deposit-taking NBFCs
Regulator	**SBP**	**SECP**	**SECP**
Capital adequacy ratio (CAR)	Banks: 12.5% MFBs: 15%	8% for first two years 10% thereafter	Nil
Cash reserve ratio (CRR)	Banks: 5%; 10% special cash reserve DFIs: 1%	Nil	Nil
Reserve fund	20% of after-tax profits until the reserve fund equals the amount of paid-up capital; after which 10% of the after-tax profits will be credited	20% of after-tax profits until the reserve fund equals the amount of paid-up capital; after which 5% of the after-tax profits will be credited	Nil
Minimum capital requirement (MCR)	Local bank: PKR 10 billion Foreign bank: PKR 3 billion–10 billion, depending on number of branches[a] DFIs: PKR 6 billion MFBs: PKR 300 million–1 billion, depending on operational level[b]	PKR 1 billion for new NBFCs PKR 750 million for existing NBFCs seeking IFS licenses PKR 500 million for existing leasing NBFCs	PKR 50 million[c] (housing finance companies, discounting and leasing companies) PKR 100 million[d] (investment financial services)[e]
Caps on deposits		AA- and above: 5 times of equity A- to A+: 3 times of equity BBB to BBB+-: 2 times of equity[f]	Nil
Statutory liquidity requirements (SLRs)	Conventional banks: 19%[g] Islamic banks: 14% DFIs: 14%	15%[h]	Nil

NOTES:

[a] Branches of foreign banks are required to maintain an assigned capital (net of losses) of PKR 3 billion if operating with five branches or less; PKR 6 billion if operating with 6–50 branches; and PKR 10 billion if operating with more than 50 branches.

[b] For MFBs, the MCR has been set at PKR 1 billion, PKR 500 million, PKR 400 million, and PKR 300 million for operating at the national, provincial, regional and district level, respectively.

[c] This used to be PKR 700 million before the regulations of 2015.

[d] This used to be PKR 1 billion.

[e] State Bank of Pakistan. 2015. Financial stability review 2015 (chapter 5). Islamabad: State Bank of Pakistan https://www.sbp.org.pk/FSR/2015/pdf/Chapter-05.pdf.

[f] Non-Banking Finance Companies (NBFCs) and Notified Entities Regulations, 2008 (amended in 2015).

[g] 19% and 14% of total demand liabilities and time deposits with a tenor of less than one year.

[h] Outstanding funds raised through deposits will be invested in government securities/instruments/investments allowed by the SECP.

Source: SBP and SECP

Annex B: Stakeholder Consultations

Regulators		
SECP	Khalida Habib	Executive Director, Strategy Development
SBP	Syed Inayat Hussain	Executive Director, Financial Stability and Banking Services Group
	Mian Farooq Haq	Director, Infrastructure, Housing, and SME Finance Department (IH&SMEFD)
Authorised EMIs		
Finja (Pvt.) Limited	Qasif Shahid	Co-founder and CEO (E-money wallet for consumers and merchants)
Karandaaz		
Karandaaz Board	Shamim Ahmed Khan	Board Director
Karandaaz	Naresh Kumar	NBFC Project Director
Karandaaz	Muhammad Fahad Khan Niazi	Policy Lead, Digital Financial Services
Credit bureaus and credit-scoring agencies		
Tasdeeq	Mumtaz Hussain	CEO
SME ecosystem		
SMEDA	Hassnien Javed Janjua	
	Nadia J. Seth	General Manager, Policy and Planning Division
	Sheryar Tahir	Head External Relations
	Farha Yasin	Deputy General Manager, Business and Sector Development Services
SME prospective obligors - focus group		
Automotive parts manufacturers	PAAPAM members, Karachi cluster	Capt. Akram, Chairman PAAPAM
		Usman Malik, exporter of radiators and tractor parts
		Razzak Gauhar, SVC, exporter of tractor and car parts
	PAAPAM members, Lahore cluster	Irfan Qureshi, dye casting parts, tractors
		Mohsin Qaiser, electronic parts, motorcycle parts
Sports goods exporters	Sialkot	Asad Malik, Gloves Exporters Association
		Ijaz Khokar, Readymade Garments Exporters Association
		Fizan Akbar, Sialkot Chamber of Commerce
Agricultural value chain	Agriculture Republic	Aamer Hayat Bhandara, progressive farmer, Punjab
		Fouad Bajwa, Public policy entrepreneur
		Mahmood Nawaz Shah, progressive farmer, Sindh
NBFCs		
ORIX Leasing Pakistan Limited	Ramon Alfrey	Deputy CEO
Tageer Finance	Kashif Yaqoob	Deputy CEO
NBFI and Modaraba Association	Muhammad Shoaib Ibrahim	CEO

Sector experts		
FINCA Microfinance Bank Limited	Farid Khan	CEO
Digital Pakistan	Tania Aidrus	Ex-Chief Digital Officer, GoP
Financial markets expert	Khalid Mirza	Ex-Chairman, SECP Policy Board
Haball	Omar Bin Ahsan	CEO

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About Karandaaz

Karandaaz Pakistan is a Section 42 company established in August 2014 and focuses on fostering economic growth and creating jobs through the financial inclusion of unbanked individuals and unserved enterprises, with a special focus on women and youth. The company has four verticals:

Karandaaz Capital

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

Karandaaz Digital

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

Karandaaz Innovation

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

Karandaaz Knowledge

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

Karandaaz Pakistan has received funding from the United Kingdom's Foreign, Commonwealth & Development Office (FCDO) and the Bill & Melinda Gates Foundation (BMGF).

For more information, contact us at: **info@karandaaz.com.pk**

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