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SMEs ACCESS TO CREDIT STRATEGY

Khyber Pakhtunkhwa

2023

SMEs Access to Credit Strategy
Khyber Pakhtunkhwa

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List of Acronyms

AIP	Accelerated Implementation Programme
BoIT	Board of Investment & Trade
BoS	Bureau of Statistics
CGS	Credit Guarantee Schemes
CSOs	Civil Society Organizations
DFIs	Development Finance Institutions
FATA	Federally Administered Tribal Areas
FERP	FATA Economic Revitalisation Programme
FATF	Financial Action Task Force
FBR	Federal Board of Revenue
FinTech	Financial Technology
GDP	Gross Domestic Product
KPEZDMC	Khyber Pakhtunkhwa Economic Zones Development & Management Company
MFIs	Micro Finance Institutions
MSMEs	Micro Small Medium Enterprises
NBFCs	Non-Bank Financial Companies
NBFIs	Non-Bank Financial Institutions
NCC	National Coordination Committee
NFIS	National Financial Inclusion Strategy
NIBAF	National Institute of Banking & Finance
NMDs	Newly Merged Districts
PSX	Pakistan Stock Exchange
SAAF	SME Assan Finance
SBP	State Bank of Pakistan
SECP	Securities & Exchange Commission of Pakistan
SMEDA	Small & Medium Enterprise Development Authority
SMEs	Small & Medium Enterprises
STR	Secured Transactions Registry
TL	Team Lead
Torso	Terms of Reference
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
VC	Virtual Capital

Foreword

The economic outlook and opportunities around us are changing rapidly, becoming competitive, disruptive, and innovative. This dynamism is increasing the opportunity cost for complacent policymakers who prefer the non-dynamic and traditional approach. Non-active economies will soon struggle to sustain their level of living standard, let alone grow progressively. The province of Khyber Pakhtunkhwa with a majority young population faces even serious challenges. This dividend of young population, if not realized will become a future liability as the dependency ratios of those who have remained financially inactive will eventually begin to increase. In short, the province can no longer afford to remain the same and that is why this strategy 'professes change'.

The Government of Khyber Pakhtunkhwa is looking to transform the way it supports its private sector and will have to define new avenues of action and engagement. The country and thus the province is experiencing the worst macroeconomic crises since Independence, natural disasters such as the floods of June 2022, and volatile law and order situation that has left the private sector of the province deprived of a level playing field and an enabling environment to do business. The province in the past has not been able to support the transformative change restricting business activity to a limited scale.

Growth of firms requires suitable access to credit. Here, the suitability is specific to the structure of the economy. Unfortunately, in the past, the government has resorted to an umbrella approach to support access to credit mainly relying on traditional credit schemes under the State Bank of Pakistan and through commercial banks. However, given the small scale, high informality, and limited documentation, the businesses in the province have been at a serious disadvantage with only 1.2 percent of national credit flowing in. The Government now recognizes that just limiting to the traditional approach will not produce the required amount of credit and more so on terms that make businesses profitable.

The government in its approach will have to be 'innovative', 'disruptive', 'adaptative', and 'opportunity proactive'. With this mindset we have developed the province's first ever Access to Credit Strategy that offers a new perspective and a new role of the government. The strategy offers multiple, yet specific to the province pathways that will help the businesses and enterprises to be able to access the required credit. Moreover, the strategy takes an inclusive approach and ensures that developed opportunities are equitably made available under the principle of "leave no one behind' and then let the private market operate smoothly to find its optimum equilibrium. Thus, the strategy by design is 'non-intrusive' and 'reformative'.

The strategy responds to the new environment that has emerged after the COVID-19 pandemic and the floods. Business's behaviours and ways of operating has changed, and COVID-19 has accelerated the process of change for business. This has led to new business model, especially the transition into the digital economy. However, the strategy sees this change as a positive disruption as it has opened new opportunities that must be nurtured.

I want to express my thanks and appreciation to all the stakeholders who were consulted for their inputs, most importantly I would like to acknowledge the support from the Planning Support Unit of UNDP funded by the USAID, officers of the Finance Department, Planning and Development Department, State Bank, Bank of Khyber, relevant Scheduled Banks, SMEDA, and other stakeholders. Finally, my special thanks and gratitude to Mr. Usman Khan for taking the lead in developing the overall strategy, incorporating the feedback of all stakeholders and the intention and objectives of the government to support our businesses in this comprehensive and futuristic strategy document. I pray to Almighty Allah to give us the strength to implement this strategy in true letter and spirit.

Muhammad Ayaz

Secretary Finance,

Finance Department, Government of Khyber Pakhtunkhwa

1

Executive Summary

The government of KP has set out to create a dynamic and inclusive economy for the province. Reaching this goal has been made more difficult due to the fragile national macroeconomic situation. Mounting fiscal and external deficits, a volatile exchange rate and rising cost of capital ***(as of August 2023 SBP base rate reached 22%)*** have made the achievement of this goal challenging. The Government of KP thus needs to strategically leverage its opportunities and address its short and medium-term challenges. The private sector in KP produces more than 90 percent of the goods and services in the province. It is, therefore, the main driver of economic growth, employment, and social outcomes in the province. The role of the private sector in current times becomes even more important as the government is squeezed into fiscal space. Thus, creating an enabling environment, in which the private sector can flourish, is the most cost-effective way of achieving development targets by the government. A critical constraint faced by the private sector and private establishments is the availability of suitable and timely finance. To this end, the Government of KP is keen to develop and implement local business-centric access to credit strategy to address the fundamental issues that the sector faces, to move towards sustained and inclusive economic growth over the next five years.

This strategy is not unique in identifying key constraints faced by the private sector in accessing credit, as strategies at the national level have somewhat documented it well. However, if one is critical of KP's performance, the regret is for opportunities missed and for not performing to their potential, rather than for a failed outcome. Thus, the strategy looks to address some of these key failures, especially the ones that result due to a lack of coordination or lack of information rather than a lack of resources. The strategy looks for a changed approach by designing interventions that are based on local problems and not selling standard solutions. However, the impact of this must not happen by itself. It must require a meaningful change in attitude and delivery. And the first requirement for such a change is to recognize that a change is necessary. This strategy is built on the principle of change—moving away from dead investments to more strategic context-specific tweaking to help credit markets function well.

The strategy is developed after a considerable amount of research and strong engagement with the relevant stakeholders in close collaboration with the Government of KP with technical assistance provided by the UNDP's FATA Economic Revitalisation Programme (FERP) funded by USAID. The first step of the Strategy formulation was the development of the framework which was presented to key stakeholders at workshops. Following the finalization of the framework a comprehensive workshop with banks and key financing agencies was held and a second more operational problem-driven solution exercise was conducted with the private sector, banks, microfinance institutions, Civil Society Organizations (CSOs), and the public sector in Peshawar. The workshop helped not only in prioritizing the key gaps and issues, but it also helped in determining key interventions that must help address local contextual challenges. This document brings together the findings from recent literature, feedback from stakeholders, and expert analysis to formulate a medium-term strategic approach for the Government of KP to help the provincial private sector get access to affordable and growth-friendly access to credit.

The Strategy has identified six main sources of finance for enterprises in KP. Firstly, the strategy explores traditional finance through commercial banks or the lack of it and links it to the core issue of the small informal size of KP establishments. The second source is leasing and hire purchase, which is again limited to a narrow range of product financing and KP's share is next to negligible. Thirdly, it explores trade credit which is one of the main sources and is based on the historic mercantile structure of the economy. Fourthly, it explores the new growth area of microfinance and FinTech but discusses the stagnancy and scale of such a source. Fifthly, schemes by the Government of KP and the federal government provide certain products, however, access is limited and there is little or no evidence of impact. Sixthly, it talks about the credit utilized by established utility companies which again at a national comparison is small for KP but has the data potential to provide knowledge on the credibility of borrowers.

The Strategy has used problems as pathways to find solutions to the access to credit challenges in KP. As information asymmetries between the borrowers and the lending agencies are the critical factor leading to inefficiencies in the credit markets, the most workable solution to address this issue is making the **provision of information** easier and more dependable. Establishing systems of credit reporting and credit information can help reduce information asymmetry and ease the decisions on credit. Another linked avenue to enhance credit flows is the support enabling **provisions for secured lending**. The evidence in the literature and through consultative sessions highlighted the excessive demands for collateral by lending institutions. Another area that can help lower risk for banks and lending agencies is **insolvency laws**. The greater the protection available to lenders and the more articulate rules are defined the greater must be the comfort to provide loans.

Credit Guarantee Schemes (CGSs) offer some level of security to lenders and thus are seen as one of the key strategies to enhance credit to the SME sector. CGSs, however, also carry the risk of moral hazard where the banks may not undertake adequate due diligence if they feel all the risk is protected—more context-specific innovation is required in CGSs. There are more innovative and blended financing opportunities that have been experimented with in various authorities that allow for increasing the scale of lending pot by using development finance as seed money—the strategy makes a case for this. Finally, the provincial government should use its resources to **coordinate the SME sector**, build capabilities and develop effective communications systems and strategies that ensure the timely provision of information to businesses about special initiatives, policy changes, and incentive schemes launched.

The Strategy recognizes the limitations that the Government of KP faces in terms of its mandate under the Constitution of Pakistan and therefore clearly distinguishes the role of advocacy and direct action. The main instrument used is the National SME Policy 2021 and the key strategy targets are derived from that. The Strategy sets ambitious targets for the government over the next five years. However, all these targets are consistent with the national targets set by the government. Implementing the strategy is expected to result in:

Target – 1 x2

Double the share of KP in advances from 1.2% to 2.4% in the next 5-years—advocacy with the State Bank under the National SME Policy 2021

Target – 2

Credit advances to KP SMEs to increase to 15% of the total national SME advances (currently the total SME advances are equal to PKR 500 billion) in next 5-years. Women share to equal 30%--Advocacy under target 1 above

Target – 3

Achieve a growth of 25% per annum in the MFI, MFB and NBFI portfolio for next 5-years with women share to equal 40%--provincial effort and advocacy

Target – 4

Design and pilot 5 innovative products of SME financing and scale successful products over the next 5 years—provincial effort

Target – 5

Train and build capabilities of at least 10,000 SMEs on developing credit profile and accessing credit—provincial effort

Target –6 SUSTAINABLE DEVELOPMENT GOALS

Supporting progress towards SDG Goals 1,5,7,8,9 & 10

The key recommendations under the strategy to help the government achieve the targets include:

1) The government of KP plays a strong advocate role with State Bank of Pakistan (SBP), Ministry of Finance (MOF), and other federal entities to correct the current imbalance in credit disbursements with KP at a serious disadvantage. The case to be pleaded should cover MFBs/MFIs and reforming some of the cumbersome processes.
2) The strategy provides specific actions to implement and complement the credit interventions under the National SME Policy.
3) The strategy outlines in detail the steps required for building sustainable capabilities of small firms, especially women-led businesses, and how they can access credit.
4) The role and scope of the Government of KP in providing adequate infrastructure and security to financial institutions and adequate secure land to set up physical branches in underserved areas, especially the Newly Merged Districts (NMDs).
5) The Government of KP should use a more aggressive and experimental approach to designing and implementing CGS Schemes that increase incentives and return for banks.
6) The Government of KP should work with Small & Medium Enterprise Development Authority (SMEDA) to speed up the process of SME data registry and enhance the availability of data for credit assessments.
7) The strategy asks for practical steps in helping MSMEs better utilize the electronic asset registry under the Secured Transaction Act to help build collaterals and access credit.
8) The strategy recommends reviewing the existing insolvency laws and processes to ensure that they are more conducive to supporting banks' forward credit to smaller firms.

9) Finally, the strategy recommends some futuristic actions where it calls for experimentation of blended finance products, enhancement of MFIs and FinTech, and support value-chain-based lending.

2

Introduction & Strategy Formulation Process

Small & medium enterprises (SMEs) account for 90% of firms in Pakistan or a total of over 5.2 million establishments, for KP the number is as high as 99% of the total provincial establishments. The assessments under SMEDA and the National SME policy suggest that if the informal micro, small and medium enterprises are added the number may well be larger than this.[1] The province of KP is house to a large number of SMEs with distribution skewed towards micro and small, predominantly informal enterprises–yet SMEs play a critical role in the provincial economy. In terms of sector contribution, manufacturing sector SMEs contribute 8.8 percent and construction sectors contribute almost 20 percent. Within the services sector, wholesale, retail, and hospitality have a 46 percent share, transport contributes 16 percent, other private services (education, social, and IT) contribute 14.3 percent and housing services contribute 5.4 percent. SMEs are the most significant contributors to employment, with close to 6.5 million individuals out of a total labour force of 10.3 million and a working age population of 26.1 million engaged with

[1] *National SME Policy 2021*

SMEs.[2] SMEs are also a substantial contributor to overall value added in the province, especially in key manufacturing sectors and modern urban services.

Despite this substantial contribution and potential, cottage, micro, and SMEs face greater financing obstacles than larger firms–these firms especially the small and informal have less access to external finance and higher transaction costs, higher risk premiums, and greater exclusion/higher rejection rate. Even in cases where these enterprises can access credit, it is usually underfinanced, and this increases the survival risk substantially. *"Cross-country studies show that the probability of being credit constrained decreases as firm size increases and that SMEs in the least-developed regions like Sub-Saharan Africa, East Asia, and the Pacific and South Asia are more likely to encounter significant financing obstacles. Not surprisingly, access to finance has been identified as one of the most critical constraints to firm growth. On the other hand, availability of external finance is positively associated with indicators of entrepreneurship such as the number of startups and firm dynamism and innovation."*[3]

Another extraordinary feature of the KP economy is its small informal household businesses and livelihoods. Most of these are operated and managed by the women of the house and are usually tied to some handcraft or hand skill that offer subsistence to a large segment of the KP population. These small ventures are an extremely important part of overall poverty graduation and income generation in the province. While data is limited on this form of enterprises/activities evidence suggests that most of these are deprived of finance and in some cases have benefitted from microfinance being provided through regular institutions or grant/subsidy-based institutions. However, the coverage remains low and has certain inefficiencies that limit growth.

The SMEs, micro, cottage, and especially women led businesses in KP have usually operated on self-financing, borrowed money from relations, utilize trade/supplier credit, or informal transactions with loan sharks. All these forms of injections are

[2] *Labor Force Survey, 2021, Government of Pakistan.*

[3] *World Bank (2018), Improving Access to Finance for SMEs*

limited and restrict growth opportunities and act as binding constraints to enterprise growth. The demand side suffers from key capacity constraints, culture and norms that limit the demand for formal credit. The access to public schemes is not '**selective by choice'** per se but is '**selective by capability and access to information'.** Thus, one observes a selection bias even in fundamentally well-designed public schemes and incentivized financing schemes.

Context to KP's 'Access to Credit' Strategy

The Government of KP is committed to generating '**inclusive economic growth'** despite severe challenges that the province has faced in the past and continues to face at present. KP province is the farthest from the seaport of Pakistan making it a costlier place to do business. The citizens of the province and its economy have seen a prolonged law and order and security crises leading to failing businesses, reduced/eliminated incomes, and migration of humans and resources. This unrest in the economy was still settling, when the COVID-19 lockdowns brought things to a halt and more recently the devastating floods that shook the entire country impacted KP substantially. During this period the official geography and administrative scale of the province increased as the independent unit of FATA became part of the province. These Newly Merged Districts (NMDs) while bringing additional resources to the province added adversely to the existing administrative and development challenges faced. Despite these enormous challenges the Government of KP is determined to support its citizens, its businesses, and its economy to graduate towards a '**higher living standard'**.

Under the Constitution of Pakistan all matters relating to '**currency, coinage and legal tender**' and '**banking or banking business other than corporations owned by the province and operating within the province only**' are part of the Federal Legislative List. Thus, policy and regulation governing the provision of credit is predominantly a federal subject and is managed by the State Bank of Pakistan. Moreover, the recent amendment to the State Bank Act allows further autonomy in monetary policy and other regulatory powers. Therefore, the space for a provincial government to take meaningful actions to support the provision of credit is quite limited. The Government of KP is cognizant of this situation and in developing this strategy has argued for the role of being a '**proactive advocate'** on regulation/policy and to develop '**province-specific programmes** that either augment the scale or enhance the access to schemes administered by State Bank or are pilot interventions that can then be proposed to the State Bank for scale-up. Additionally, the province sees a substantial role in '**building capabilities of citizens and private sector'** to be able to secure credit. Moreover, the Constitution allows space to establish provincially owned and controlled entities that operate within the province to provide banking-like services to the provincial populace.

The Government of KP while developing its credit strategy strongly highlights that the demand for credit in the province is different from bigger provinces like Punjab or cities like Karachi. The businesses in KP are predominantly small, operate in the informal sector, have strong cultural biases and religious beliefs, and have suffered years of neglect and war. Thus, it is not a case where the credit needs do not exist, but a case where needs have not been articulated well in the past. The purpose of the strategy, therefore, is to ensure that this '**difference in the structure'** of the economy and '**articulation of demand'** is addressed. A key step that this strategy takes to do this is to **clearly differentiate** between the borrower/user of **microfinance** and the client of **bank credit**. The aim is to present strategic actions to support both types of borrowers and to ensure that the government helps the transition of microcredit borrowers to bank credit via growth and enhanced need.

Finally, the Government of KP is **sensitive to the context created due to recent floods**. The province has seen massive destruction of its assets and the private sector has lost housing, livelihoods, markets, and businesses amounting to several billion dollars. The Government of KP has set the strategy to help support these individuals and businesses to raise finance to rebuild their losses with ease and at the lowest possible cost. The strategy by design has included a pivot to support rehabilitation and building resilience to floods and natural disasters.

Strategy Formulation Process

The Strategy has been developed by the Government of KP with technical assistance provided by the UNDP's FATA Economic Revitalisation Programme (FERP) funded by USAID. The first step of the Strategy formulation was the development of the framework which was presented to key stakeholders at workshops. Following the finalization of the framework a comprehensive workshop with banks and key financing agencies was held in Islamabad **(See Annex-I – list of participants)** and a second more operational problem-driven solution exercise was carried out with private sector, banks, microfinance institutions, CSOs and public sector in Peshawar **(See Annex-II – list of participants).** The workshop helped not only in prioritizing the key gaps and issues, but also helped in determining key interventions that must help address local contextual challenges. This document brings together the findings from recent literature, feedback from stakeholders, and expert analysis to formulate a medium-term strategic approach for the Government of KP to help the provincial private sector get access to affordable and growth-friendly access to credit. The strategy has reviewed the recommendations under the National SME Policy 2021 and the State Bank's SME Credit Policy 2017 to ensure the harmonization of approaches and interventions. Additionally, the strategy aligns with the support UNDP is providing through a-Consult for developing capabilities across the private sector and banking institutions to enhance access to finance **(See Annex-III for programme brief)**.

3

Current Sources of Finance/Credit for KP Firms

Traditional Credit

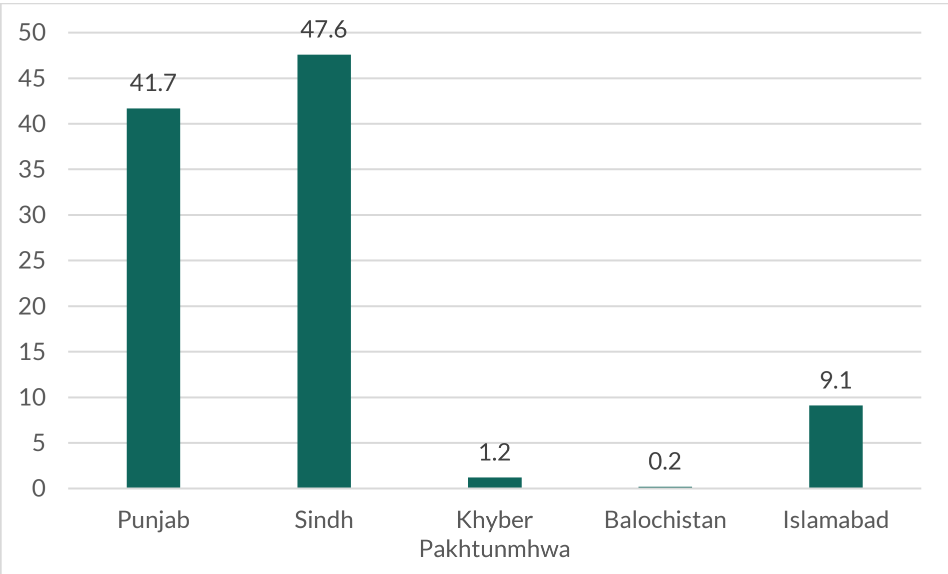
While there is no consolidated database to calculate the credit utilization by cottage, micro, and SMEs of the province, the recent studies including survey-based work done by UNDP in 2019 and 2021 show that the majority of the financing in the province is from 'own' resources. In most cases, these own resources include family borrowings, advances taken by 'loan sharks', or using the sale of family assets. There is only a small percentage of firms that report access to banking credit, while a greater number of smaller businesses report benefiting from microfinance institutions. While globally, **commercial banks have traditionally provided the bulk of the credit to SMEs**, in the case of Pakistan and specifically KP the structure is somewhat different.

While commercial banks perceive the SME segment (micro and cottage are excluded due to its non-formal nature) to offer high profitability as the higher risk premiums result in larger spreads, the overall uncertainty in the market limits their appetite to forward these loans. Thus, commercial banks in Pakistan are less exposed to SMEs than to large/corporate firms, provide a lower share of investment capital loans, and charge substantially higher fees and interest rates while keeping collateral requirements stringent for SMEs. The national aggregate numbers show that only 7% of the firms have an active bank loan or line of credit, while 64% of these loans require collateral with an average value of this collateral being 153% of the loan amount.

Moreover, only 8% of the firms use banks to finance investments and the proportion of investments financed using a bank loan is only 2%. The proportion of working capital financed by banks is just 2.5% as most firms use supplier/customer credit for working capital-which despite being substantially more expensive is seen as more 'available' and 'viable'. Out of the total 5.2 million SME establishments, almost 15% are operating in the KP province. The interviews and previous studies suggest that the situation depicted above at National Level is an optimistic view of affairs in KP. Thus, it is reasonable to assume that traditional sources of financing for SMEs via commercial banks are still minimal.

The evidence is further supported by aggregate numbers where **KP only receives 1.2% of the total credit disbursements by commercial banks, despite having a 10% share in GDP and a 15% share in SME establishments nationally**.

Figure 1: Region-wise Shares of Total Credit Disbursement (%), 2022



Source: State Bank of Pakistan.

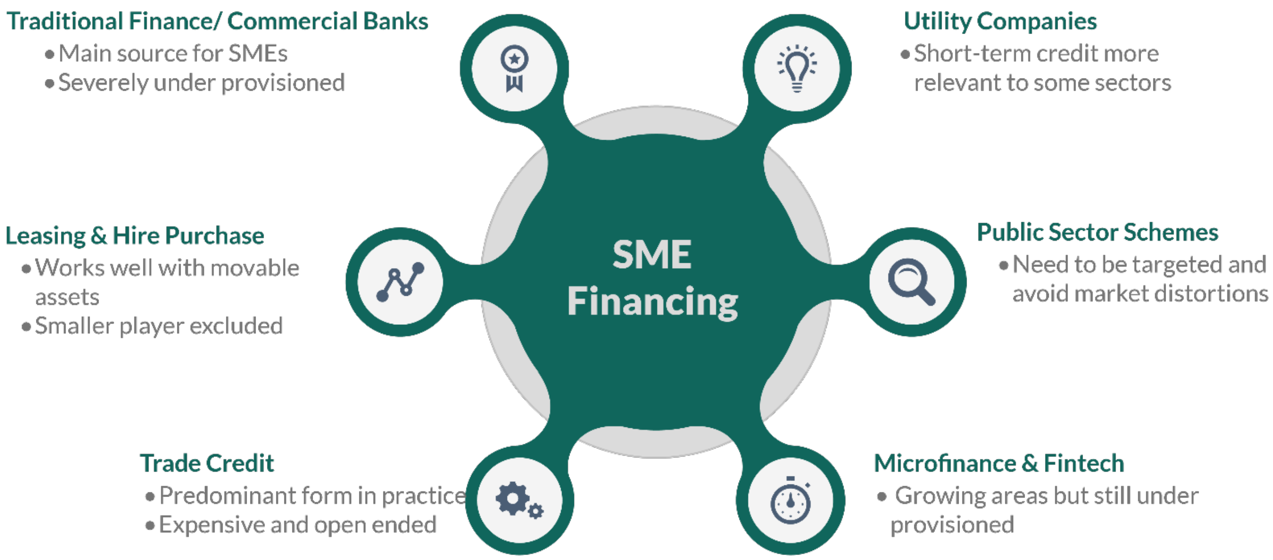
Leasing & Hire Purchase

A second source of financing for the private sector as an extension and beyond the commercial banks traditional lending is leasing and hire purchase. Leasing is considered an effective way for SMEs to expand their access to short and medium-term financing. However, leasing or 'hire purchase' must require an initial cash resource for the down payment and a matching cash flow for subsequent payments as per schedule. The latest statistical bulletin by State Bank shows that scheduled banks have a leasing finance portfolio of PKR 10 billion and DFIs, MFBs and NBFCs have over PKR 248 billion under other advances and financial leases. Assuming a similar pattern for overall lending, the absolute amount for KP must be extremely small and must include personal asset acquisitions as well. This form of lending works better in situations where SMEs do not have acceptable collateral as the assets procured under the lease act as security. More recently, Islamic Financing of assets have also picked up and is designed as an advance purchase of asset to make it compliant. These types of products have greater acceptability in the context of KP. However, a caveat needs to be raised that this segment also includes substantial exposure to vehicles being leased.

Trade Credit

A third source is trade credit where goods and services are supplied before payment. These transactions typically comprise unsecured and open-ended transactions usually working on personal repute and relations with the market agents. The Pakistani markets typically operate on trade credit varying between a month to 3-months depending on the sector and type of commodities. A more usual transaction is based on purchase cycles where with every new procurement the previous outstanding amount is cleared. Trade credit facilitates both suppliers as they can make larger sales and SMEs/businesses as can manage their cashflows better through this staggered mechanism without having to halt the production process. Suppliers work on this model as one they have greater information on the borrower along with levers to extract payments as required and they can charge a premium price on credit sales. The interviews done with businesses show that the effective implicit annual interest rate on trade credit can be as high as 30%. This is substantially more than the cost of formal credit in the market.

Figure 2: 6-Key Sources of Finances for SMEs & Micro/Cottage Firms



Microfinance and FinTech

A fourth key source of finance is **Microfinance and FinTech institutions**. These institutions have grown substantially over the last two decades and have played an important role to bridge the credit gap. These institutions, however, provide small/microloans to small businesses and individuals (women-led businesses) with a greater focus on rural and poor areas. Microcredit loans operate by building local networks, community-based collaterals, community guarantees, and similar other mechanisms. The Fintech companies on the other hand are using data on consumers more innovatively and intelligently to develop products suited to their needs and selecting customers that have lower risk of default. The current advances by DFIs, MFBs, and NBFCs is PKR 579.1 billion. This is a popular form of credit in KP, however, is more suited to very small or individual businesses. A recent estimation by Pakistan Microfinance Network suggests that there are **40.9 million** potential microfinance borrowers in Pakistan with loan sizes of PKR 20,000-150,000. Going by population split, this would mean that the potential demand for microfinance borrowers in KP is estimated to be around 6.1 million. The total active borrowers in Pakistan were around **8.2 million** (Pakistan Microfinance Network) and the number grew by 20% year-on-year. Assuming similar growth (a bit optimistic) the number as of now must be a maximum of 9.8 million, still substantially short of the potential. The borrowers in **KP under this segment must be around 1-1.5 million at most**.

Public Schemes

A fifth key source of financing for businesses is public schemes funded by the government. The Government of KP has initiated several schemes.

- Economic Revitalization of the KP Scheme supporting 4,477 SMEs financially across the province with an investment of PKR 6.2 billion.
- Insaf Rozgar Scheme (AIP), PKR 1.65 billion with over 4,200 applicated provided with loans.
- PKR 2 billion for Interest-free microfinance schemes (IFMS) with PKR 1 billion set up as a revolving fund.
- PKR 4.2 billion is being used to upgrade 2,500 SMEs, and support 1,000 startups, and 50 cottage industries supported.
- PKR 290 million for upgrading 200 SMEs in North Waziristan
- PKR 225 million for upgrading 150 SMEs and supporting 50 startups in South Waziristan
- PKR 200 million for supporting 175 startups and 150 youth internships in Zakha Khel Bazar.
- PKR 373 million for upgrading 150 SMEs, 50 startups and 300 youth training in Orakzai District.
- PKR 1.4 billion for training 5,500 youth in NMDs.

The schemes above depict the nature of financing and business support available to SMEs and individuals through resources directly provided by the government. However, there are two main issues with these types of interventions; (i) they may end up distorting the market especially the microfinance market as entities that operate on subsidy must alter market expectations of borrowers and (ii) the scale and fiscal space available to the government is limited and it cannot satisfy the need. Moreover, the government schemes have inherent inefficiencies and most of the time do not consider the opportunity cost of public investment decisions. Therefore, the use of these public schemes to support credit access must be sparingly used to correct market failures and must be efficiently designed, effectively executed and monitored, and evaluated for outcomes and impact. The analysis must include the opportunity cost of the government allocating funds toward these interventions. Moreover, the grant component should be kept at a minimum if not zero to avoid possible market distortions.

Utility Companies

A final source of credit available to SMEs is utility companies such as electricity, gas, water, and mobile communication. The payment for these utilities is post the use and thus the SMEs (especially those where utilities are key inputs, like steel furnaces) can enjoy a short period of credit. This type of credit is more important from its data perspective as it can help in building a credit profile of the customer and can address some of the asymmetric information issues in the credit market. Almost all consumers enjoy this short-term credit, however, the significance varies based on the nature of the business.

4

Factors Restricting Access to Credit

The reasons why credit does not reach its intended claimants in the micro, cottage, and SME sector has been analysed extensively in almost all geographical regions. The findings are not remarkably different as there is a clear inverse relationship between 'tightening of regulations' for prudence and 'credit ease' for cottage, micro, and SMEs sector. The financial regulations need to be tightened to protect from fraudulent and illegal activities, however, as these regulations tighten more small firms fail to qualify for mainstream credit. It is also the case that as small businesses carry more risk, banks do at times hide behind regulatory compliance to shy away from lending. Thus, the credit policy needs to strike a sensitive balance in terms of '**what is appropriate**' regulation. For example, Pakistan has been struggling to comply with FATF and this has resulted in making things tighter in the banking industry. This has resulted in reduced lending to the small sector. The main factors hindering the provision of **credit via the standard commercial banking sector** are provided below:

Skewed distribution of economic establishments

SMEs in Pakistan and more so in KP are sharply segmented with the distribution skewed in favour of small and micro firms. While the current SME definition differentiates between small and medium, the State Bank only gives ‘prescriptive’ advice to banks and is not ‘mandatory’ regarding size-based credit quota bifurcation. This usually results in medium-sized firms being better served than small ones. While there is merit in not making this into an air-tight regulation that impacts the working of the banking industry, there needs to be measures in place that push the banks harder to better comply with these prescriptions.

Information Asymmetries and Credit Market Failure

Information asymmetries and the risk of adverse selection are key reasons restricting commercial banks’ lending to SMEs, especially the smaller firms and firms operating in uncertain environments such as those in NMDs. The set of information that small/informal firms can provide to banks in the form of financial accounts, business information, expansion plans, feasibility studies, etc., is generally limited. This issue gets aggravated because of low levels of literacy among small entrepreneurs. Most small SME entrepreneurs in KP have graduated from small informal traders to owners of SMEs, who find the requirements of commercial credit complex. Moreover, small businesses deal with bank branches in their locality, while the decision to grant loans is taken by the head office. This further accentuates information asymmetry between the borrower and the lender.

Asymmetric information here implies that the borrower (the SME) knows far more about the state of her business than the lender (the bank). The bank, therefore, must spend a considerable number of resources and effort to obtain a realistic assessment of the business’s feasibility. Moreover, due to the semiformal nature of most small businesses, the bank might not be able to obtain the required information at all. In most cases, the information might not even exist with the businesses themselves, as articulated by stakeholders in the problem workshop. This becomes more problematic in the case of KP, especially businesses operating in NMDs.

The above issue results in two problems. First, banks are unable to differentiate adequately between high-quality and low-quality entrepreneurs/businesses. In such a situation, interest rates do not work as a screening mechanism. High-interest rates may lead to an excessively risky portfolio because of the problem of ‘adverse selection', with most persistent applicants for loans being the ones with the least capacity to repay (Stiglitz, and Weiss, 1981). [4] Second, once the banks have provided the funds, they are not able to monitor or assess if the enterprise is utilizing the funds appropriately for business development or using it inappropriately for personal consumption – a 'moral hazard' problem.

To address the issues resulting from information asymmetry, banks usually require that financing be collateralized, with collateral often exceeding 100 percent of the value of the loan. This, however, is problematic as most SMEs do not have many assets that can be collateralized, especially in the case of KP where many SMEs belong to the trading sector and usually possess low value or no assets at all. The most common form of collateral is land, but that too is problematic, especially in NMDs where land titling has severe gaps. This adds more to the costs. Consequently, the easiest option is to not lend to small firms, especially when there are no mandatory compliance requirements.

Risk Profile

Commercial banks often reveal that the higher risk profile of small businesses is a significant factor limiting the provision of credit. Most banks regard SMEs, especially small firms, as riskier than large firms. SMEs face a more uncertain market environment, experience greater variance in returns, and have a higher rate of failure. Most small firms are poorly equipped in terms of both human and capital resources to withstand external economic shocks. Furthermore, the inadequacy of accounting and costing systems often results in small firms operating in losses or at profitability levels much lower than optimal. Finally, SMEs in Pakistan operate in an ambiguous and uncertain environment regarding governance, which reduces the security of transactions. For example, in Swat, due to the security situation, the land transactions are so risky that banks either refuse to accept them as collateral or accept at substantially lower than market price. This high level of risk implies that

[4] *Stiglitz, J. E., & Weiss, A. (1981). Credit rationing in markets with imperfect information. The American economic review, 71(3), 393-410.*

banks operate at a much larger spread thus increasing the cost of credit and making it non-feasible.

Transaction Costs

The cost of appraising a loan application or undertaking an assessment of a new client is independent of the size and location of the financing under consideration. Therefore, the cost per rupee disbursed is significantly lower on larger loans and for companies that are in more agglomerated areas as compared to small ones and those located in far-off locations such as NMDs. This severely reduces, if not eliminates, the bank's potential profits on such small loans and thus explains their reluctance to consider such loans.

SME Development Products

The traditional products available with banks are mostly commercial/ personal loan types, with no customized products designed to facilitate SME development. The scheduling of payments, effective costs and terms of the loan are such that it becomes too costly for small businesses to use. Evidence supports that several small businesses which were able to access credit, later became bankrupt as they were not able to meet the repayment schedules agreed with the banks. The credit products should be based on the business model of small firms and should allow some flexibility and time for firms to grow. This problem is also linked to banks having little or no information on the business models of small firms and different sectors. This lack of capacity of banks results in generic product offerings, creating an environment where riskier loans are disbursed. This is compounded by the fact that SMEs tend not to use banks for their transactions, which further limits banks' understanding of their business.

Procedural Issues

Opening a bank account is a tiring and complicated process that makes credit disbursement decisions to small businesses a second-order problem. A first-order problem is to get small businesses to start banking relations through the opening of a standard bank account (a key problem in NMDs). The processes and procedures to open a bank account are so stringent that most small businesses keep operating without an account or avoid transactions through the banking channel. In addition, SMEs fear the use of their transactions data by FBR, and consequent predatory behaviour. This lack of relationship results in little or incomplete information banks have about small businesses leading to the eventual credit rationing of small firms. This must require simplification but also handholding support to help SMEs navigate this challenge.

Limited Leasing

A **second source of credit** for SMEs is **leasing**. The leasing products are offered by specialized leasing companies which have a dominant market share, followed by MFIs and commercial banks. While the leasing business has grown, secondary markets for leased business equipment are scarce except for movable assets, such as cars and other vehicles. Therefore, the product coverage is not comprehensive and may come with varying levels of deposit requirements. It is for these reasons why most SMEs fail to access credit under this window. The costs under leasing may be slightly higher and as the ownership of assets is with the financing institution the SMEs are always at the risk of losing a productive asset if they fail to maintain payments for business risks outside their control. Leasing of assets also requires mandatory insurance of assets which further increases the costs as overall business asset ownership may not be acceptable to lending institutions.

Stagnancy of Microfinance

Microfinance is an important source of finance for small borrowers and the numbers suggest that the potential number of small borrowers is far greater than current provisioning. However, several issues limit the credit provisioning and credit growth for the SMEs. Firstly, the State Bank guidelines allow a maximum limit of PKR 3 million to a MFB for a single borrower, while the limit as regulated by SECP for MFIs varies but as per SECP guidelines the maximum loan to enterprise is PKR 500,000. These are limited numbers and, in most cases, much less than the usual requirement of small businesses. The interest rate charge of MFBs and MFIs is also substantially higher than commercial banks—in the current environment, it is close to 30% per annum. In addition to the above constraining factors two additional issues have been highlighted:

- The MFIs in KP and Pakistan are operating on different models where a few are more closely linked to public sector grant programmes and interest-free or subsidized interest schemes. This implies that MFIs working with grant or aid money operate at a much lower cost of capital, offer attractive products, and can work at lower costs due to consolidated pooled assets. The competitor MFIs working on their own, or market capital are not able to compete or offer attractive products. The consumers do not treat the two differently and by default prefer the subsidized products thereby reducing demand despite having spare capacity in the market. Thus, this grant-based lending is distorting the market which is reducing the overall growth and demand in the market.
- There is a growing body of evidence that rapidly growing MFIs amplify the 'graduation problem'. Successful small firms eventually must graduate to the traditional financial system, as MFI loans are too small to fully meet the financing demands even of small SMEs. However, several obstacles hamper this graduation. In most cases (for loans less than Rs 30,000 even if no reporting is required to State Bank) credit worthiness/profile of MFIs is not recorded in credit bureaus so MFI borrowers cannot build up a credit history. Moreover, traditional financial institutions may not be willing to downscale their lending portfolio from the level of an established SME to one that is graduating from micro and is still operating under more location-customized ways of operating. Hence, a strong microfinance sector may help to provide credit for poorer households and microenterprises but as an unintended consequence impede access to external finance (of sufficient size) for (smaller) SMEs.[5]

[5] *https://onlinelibrary.wiley.com/doi/full/10.1002/jid.3614*

Spiral of Trade Credit

Trade Credit is a predominant form of financing that supports the flow of funds and fuels economic activity in KP and the rest of Pakistan. However, it is not without shortcomings. Trade credit varies from sector to sector and is usually cyclical, which means, while businesses are using a credit cycle, they also have firms with outstanding credit. In other words, in an operating cycle, a firm simultaneously runs creditors and debtors so effectively it is the firm's own money that is stuck. The advantage of trade credit is some flexibility and continuity of activities. However, COVID-19 lockdown had significant negative impacts on trade cycles. The lockdowns and closure of markets meant that the credit cycles were extended beyond standard durations leaving a lot of small businesses in severe liquidity crunch. Some establishments also report higher costs of transacting through trade credit.

Impact of Public Schemes

Public programmes are an essential and probably the only intervention tool available to provinces under the Constitution to directly interfere in the credit provider to SMEs. The Government of KP is running several programmes to facilitate the SME sector with its financing needs. However, to date, no formal assessment of these schemes has been taken to learn about their impacts and bring about improvement. As good practice government interventions, especially investments should be used to address critical market failures of pure public good. Credit by no definition is a pure public good as is rival in nature and excludable. Thus, the government's intervention must have to be purely on the grounds of addressing market failures. To do that public projects need to evaluate the design comprehensively by taking into account of the appropriate opportunity cost, market distortion, and spill-over costs of carrying out such transactions. Moreover, given the scale of the private sector, any amount of money provided to facilitate credit financing is only marginal.

5

Intervention Space to Enhance Credit Access & Utilization

Information asymmetries between the borrowers and the lending agencies are the critical factor leading to inefficiencies in the credit markets. In the presence of this adverse selection problem resulting from lack of information, the credit provision is sub-optimal firms that are even willing to pay a higher rate of interest are denied access. The most workable solution to address this issue is making the provision of information easier and more reliable. Establishing systems of credit reporting and credit information helps reduce information asymmetry and ease the decisions on credit. **The credit reporting system** provides informative data points that help lenders assess the characteristics of the borrowers and categorize their level of risk and make informed decisions about credit. For example, information such as past behaviour, repayment history, and current debt exposure help lending institutions develop a more comprehensive and specific risk assessment framework that must lead to more optimal decisions. The Government of KP under the current Constitutional provisions can take several strategic actions to address this.

Another linked avenue to enhance credit flows to the SMEs is support enabling **provisions for secured lending.** The evidence in the literature and through consultative sessions highlighted the excessive demands for collateral by lending institutions. This collateral historically has been in the shape of clearly titled land as that offers maximum security to lending agencies. However, land and especially clearly titled land is not available to the majority of SMEs in KP, especially those located in NMDs. However, the State Bank under its SME Credit Strategy developed rules for establishing the asset registry. SECP under the Financial Institutions Act, 2016 launched the Secured Transaction Registry (STR) in April 2022 for registration of security interests on movable assets of entities covering unincorporated entities, sole proprietorships, and partnerships to enhance their access to finance. Most firms in the KP SME sector own movable assets, such as machinery, vehicles equipment, and other assets (all described in rules) that can be entered into the STR and can then be easily collateralized for seeking loans. The additionality that has come under the secured transactions act is the registering of trade receivables as well, thus making invoice factoring a key source of revenue.

Another area that can help lower risk for banks and lending agencies is **insolvency laws**. The greater the protection available to lenders and the more articulate the rules are defined the greater will be the comfort to provide loans. The limited companies are registered and regulated for bankruptcy and insolvency by the SECP, however, firms registered with provincial directorates operate under provincial laws and rules. Strengthening these insolvency frameworks such that they offer higher protection to lenders will enhance credit provision. For example, having out-of-court legal procedures to restructure debt in case of insolvency will increase confidence to lend.

Credit Guarantee Schemes (CGSs) offer some level of security to lenders and thus is seen as one of the key strategies to enhance credit to the SME sector. CGSs, however, also carry the risk of moral hazard where the banks may not undertake adequate due diligence if they feel all the risk is protected. On the other hand, CGS that offers partial protection does not eliminate the risk for banks. Thus, the CGS needs to develop an equilibrating balance to ensure that banks find it lucrative to offer products under CGS yet do not behave sub-optimally under moral hazard.

There are more **innovative and blended financing opportunities** that have been experimented within various jurisdictions that allow for increasing the scale of lending pot by using development finance as seed money. For example, public investment by the government can be used to develop a blended finance product that can then attract funding lines from low-return investors as well as high-return investors—the product will then be designed to use zero return of low-return resource streams to ensure higher return for main resource contributor. These products can enhance the scale of public investments and minimize market distortions.

Finally, the provincial government can use its resources to **coordinate the SME sector**, **build capabilities and develop effective communications systems** and strategies that ensure timely provision of information to businesses about special initiatives, policy changes, and incentive schemes that are launched. The provincial government can also support in providing enabling infrastructure to MFIs to open branches in underserved areas.

6

The Strategy Recommendations

Defining the SME Sector

There is no universal definition of micro, small, and medium-sized enterprises. Each economy has evolved its definition to its own context and economic circumstances. There has been extensive work done under the National SME Policy 2021 and a consensus definition has been developed. The definition is now in use by State Bank of Pakistan and SMEDA for all practical purposes. Therefore, to avoid any conflict with national schemes and initiatives, the Government of KP should also use the same definition. The definition is reproduced below:

Enterprise Category	Criteria- Annual Sales Turnover
Small Enterprise (SE)	Up to PKR 150 million
Medium Enterprise (ME)	Above PKR 150 million to PKR 800 million
Start-up	A small enterprise or medium enterprise up to 5 years old will be considered as Start-up SE or Start-up ME

However, to ensure inclusion and better coverage of women-led enterprises it is suggested that for provincial imitative two additional categories may be added as below:

- Cottage & Rural: Up to Rs. 10 million
- Micro: Above Rs. 10 million and up to Rs. 50 million

Multipliers of SME Credit Enhancement

The key multiplier for SMEs' access to credit is its direct impact on employment. The SME employment multiplier relative to credit is almost 0.6. This implies for every 1% increase in credit to small firms' **employment will increase by 0.6%.** A 0.6% increase in employment based on GDP and employment elasticity implies almost a **1.2% growth in value added**. Moreover, a 1.2% increase in value-added will **reduce poverty by almost 1%.**[6] These multipliers suggest a strong case for enhancing credit availability to SMEs in KP for generating inclusive employment and growth.

Unemployment is a critical issue for the Government of KP as it has the highest rate of unemployment rate at 8.8%. Moreover, 72.5 percent of the total employed individuals are employed in informal sectors which are all SMEs. The figure below provides the overall distribution of employment across main economic sectors. Manufacturing, construction, wholesale and retail, transport and storage, and private services are considered the dominant employers. The provision of credit in these specific sectors will have a substantial impact on employment.

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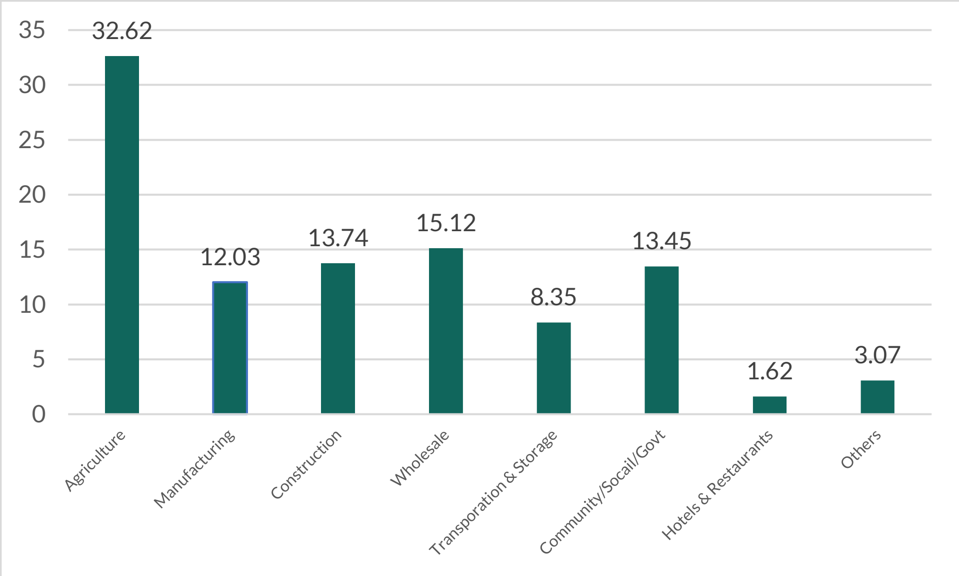
[6] *Adapted from Sub-Nation Growth Model developed under the Punjab Growth Strategy*

Figure 3: Employment Distribution across Economic Sectors



Source: Planning & Development Department, Government of KP

Strategy Targets

The strategy proposes both hard qualitative targets and some more qualitative targets to help the SMEs in KP graduate for scale and employment.

Target 1: Double the share of KP in advances from 1.2% to 2.4% in the next 5 years. This target is in line with the Federal Government's ambition of increasing SME Credit to PKR 1.8 trillion. This number means that the overall exposure to MSMEs must increase more than 3 times. The Government of KP should advocate that the increase in credit should be more balanced and fairer.

Target 2: Credit advances to KP SMEs to increase to 15% of the total national SME advances (currently the total SME advances are equal to PKR 500 billion) in next 5 years. Women share to equal 30%. This target is in line with the federal government view on SME credit and the main role of the Government of KP is to be a strong advocate for implementing key recommendations of the SME Policy 2021.

Target 3: Achieve a growth of 25% per annum in the MFI, MFB and, NBFI portfolio for the next 5-years with women's share to equal 40%. This target must involve advocacy and direct interventions that the Government of KP takes to initiate such as capacity building, joint programmes, and provision of land and secure place for financial institutions must help attain the target.

Target 4: Design and pilot 5 innovative products of SME financing and scale successful products over the next 5 years. This is a realistic target and the Government of KP can modify its existing support schemes considering this strategy and impact assessment to help develop and implement these products.

Target 5: Train and build capabilities of at least 10,000 SMEs on developing credit profiles and accessing credit. This target is just an extension of existing schemes and must require better structuring and stronger partnerships to achieve.

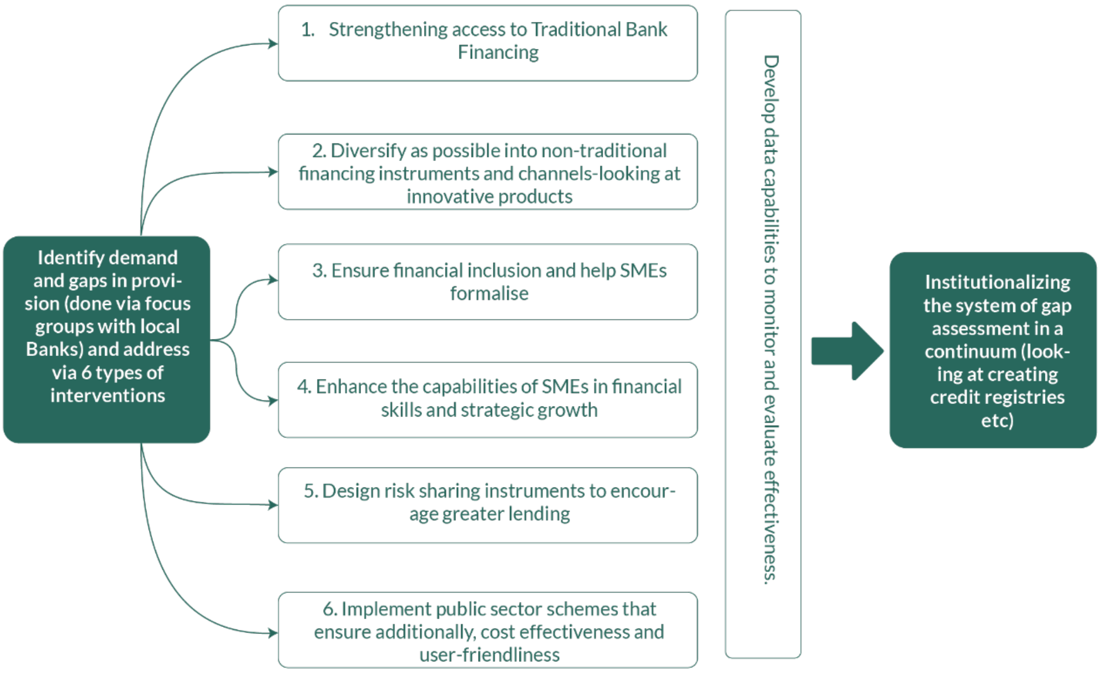
Target 6: The strategy will align the Government of KP investments under SDG Goals 1, 5, 7, 8, 9 & 10 to ensure MSME growth results in substantial progress under these goals.

The set of targets is set in line with the federal government's ambitions, yet they allow for the role that the Government of KP can play to enhance the provision of credit in the province. The critical measures that have been suggested in the strategy below clearly differentiate the role of the federal government where the province acts as an advocate, while at the same time highlighting key measures where the province can act on its own. The strategy is clear in this regard and sets a government-specific role to move forward.

Strategy Recommendations

The Government of KP is cognizant of the fact that despite devolution it is still not a master of its fate when it comes to supporting cottage, micro, and SME businesses in terms of accessing credit. The overall credit policy and regulatory environment is set by the State Bank of Pakistan and the implementation of certain policies as in the case of MFIs and secured lending resides with SECP—both of which are federal agencies. As part of the consultative process, the government has developed a holistic strategic framework that allows substantive and impactful actions to improve access to firms, businesses, and individuals across the province.

Figure 4: Strategic Framework



The role of the Government of KP in terms of overall credit regulations and policies must be that of a '**proactive advocate'** while province-specific interventions must be that of a '**catalyst**' and '**facilitator**'.

The Strategic Actions developed by the Government of KP to address the issue of credit and finance availability are presented below:

1. Advocacy Role

The government of KP to become a strong advocate to support the provision of suitable credit to small businesses residing in the province by:

- The Government of KP is to act as a proactive advocate to present the case of severe underserving of credit in the province and must repeatedly request to SBP and MoF to address this issue. The advocacy should register that despite contributing 10% to the national GDP, housing 15% of the National SMEs, and 15% of the country's population the share of KP in credit is just 1.2%. This share should at least double with the SBP to stringently monitor this. The issue may be progressively raised at the NCC on SME Policy and in all IPCC meetings by the Chief Secretary.

- The Government of KP to develop a '**provincial case**' on easing out regulatory requirements and reducing the processing burden for small firms in KP, especially women-led businesses and businesses operating in the NMDs. The government should use the precedent of policies such as 'sales-tax exemption' in NMDs to make a case **for lowering the initial process of inducting businesses into banking and financial institutions**. Moreover, the government should advocate that additional tax and depreciation exemption **may be notified** to make it attractive for both commercial banks and MFI/MFBs to open more branches in the NMDs and underserved districts of KP.
- The Government of KP requests the State Bank **to share KP specific SME credit and advance via MFBs/MFIs and NBFIs every quarter** to help the province monitor gaps in provision and look at developing complementary products and programmes. The data may not be made public but only kept internally for use by the KP government to monitor progress on the strategy targets.

The above recommendation can support the implementation of pillars 1, 2 and 3 of the strategic frameworks.

2. Actions to implement and complement the Credit interventions under the National SME Policy

The Government of KP advocates for early implementation of strategic recommendations made in the National SME Policy and must take specific actions included in the provincial mandate to speed up the process of implementation and augmentation of impact. More specifically the government takes the following steps under each of the specific policy recommendations **(Section 3.1 of the National SME Policy 2021)**: The above strategic interventions cover all 5 fundamental pillars of the framework and help the province design action in line with the National Policy.

3. Building sustainable capabilities of small firms especially women-led businesses.

The government must develop and launch an extensive capacity building programme that aims to train at least 10,000 SMEs over 5 years. The training must cover a wide variety of topics all aimed at supporting businesses and small firms to become better equipped at accessing credit through all available means. The Constitution allows the province to '**establish any entity relating to banking services as long as it is owned and managed by the province and only operates within the province**.' Using this provision, the Government of KP should establish a '**Provincial Chapter of NIBAF**' by taking support from SBP and NIBAF. The provincial chapter of NIBAF can operate within KP and work on similar yet localized principles and problems. The provincial chapter of NIBAF can be established under Finance Department or Planning and Development Department or Industries Department to act as the provincial agency for managing all capacity-building and information-sharing requirements for enhancing access to credit in KP. The entity can look to provide support in the following institutions:

- Capacity building and joint product development with banks, MFBs, MFIs, and other financial institutions. The entity can become the centre of excellence and provincial knowledge hub on credit processes, procedures, requirements, and delivery. The training aimed at financial institutions can be priced to raise sustainable funding and generate resources to train SMEs for free or at subsidized costs.
- Undertake training of SMEs on account opening, account management, managing movable asset registry, loan processes, loan applications, types of loans and financial institutions, and guidance on how to expand the credit portfolio and build creditworthiness.
- Design and implement communication and awareness activities and establish central and field level (at chambers, offices of trade bodies, industrial estates) information points. These must be used to disseminate, contact, and follow up with businesses and individuals to register their interest in key government schemes and incentivized lending products and help them connect with

appropriate and relevant financial institutions. For example, women can be made aware and supported to access the SPB special incentive schemes for women's businesses.

- Help develop data development guidelines and train SMEs to maintain credit-friendly data.

4. Provision of adequate infrastructure access and security to the staff of financial institutions

A key reason why the banking branches and MFIs/MFBs are not expanding in the KP province is difficult to access in far-off areas and NMDs. The government must ensure that access infrastructure (roads etc.) to distanced geographic locations is provided, ready-to-move space for MFIs/MFBs, allocated space in industrial estates, and incentives such as reduced stamp duties where financial institutions purchase their own space. Additionally, the government must provide for the security of the staff of financial institutions so that they can post quality people in NMDs and remote areas.

5. Innovative Credit Guarantee Schemes (CSG)

CGSs, if implemented effectively can increase the scale of credit provision by lowering the risk for financial institutions. The Government of KP is currently implementing the federal government's SAAF Scheme which offers credit guarantees up to 60%. The government must look to establish province specific CGS Scheme that must offer either higher protection or must allow the financial institutions to share in capital gains of assets purchased under the loans. This must not only reduce the risk for banks but must also allow them to make a higher return thus making it more attractive to use this window. The government must also ensure extensive communication efforts around these efforts and the existing CGSs of the State Bank to ensure more people are aware and apply for these.

6. Enhancing Data Availability for Credit Assessment

The Government of KP must set up a system of SME registration using an online portal and further develop it into a credit reporting system that can be accessed by financial institutions. This should later be merged with the national system to be developed by SMEDA. The government should notify a team at the Industries Department which must liaise with SMEDA to set this registration system based on identical structure and common identified for easy integration. The intervention should merge with the simplification of registration efforts under the EODB reforms.

7. Support SMEs in gaining access to secured lending.

The movable asset registry has been operationalized, however, the subscription to the registry is still on the lower side. A key finding from the consultations was that most SMEs and individual borrowers had no information on this facility. The government of KP must therefore undertake extensive awareness and training of SMEs to enrol assets at the registry working with the financial institutions. The movable asset list comprises not just machinery and vehicles but assets like factored invoices etc. that can be used as electronic collateral for secured lending.

8. Improving the insolvency laws & processes

The laws for provincially registered firms on insolvency reside under the ambit of provincial governments. The government must reform the insolvency laws to ensure swift completion of processes and greater protection for debtors. These changes must also consider looking at alternative firm structures such as provincial-level Limited Liability Partnerships (LLPs) and similar other more conducive business structures that offer greater security to financial institutions.

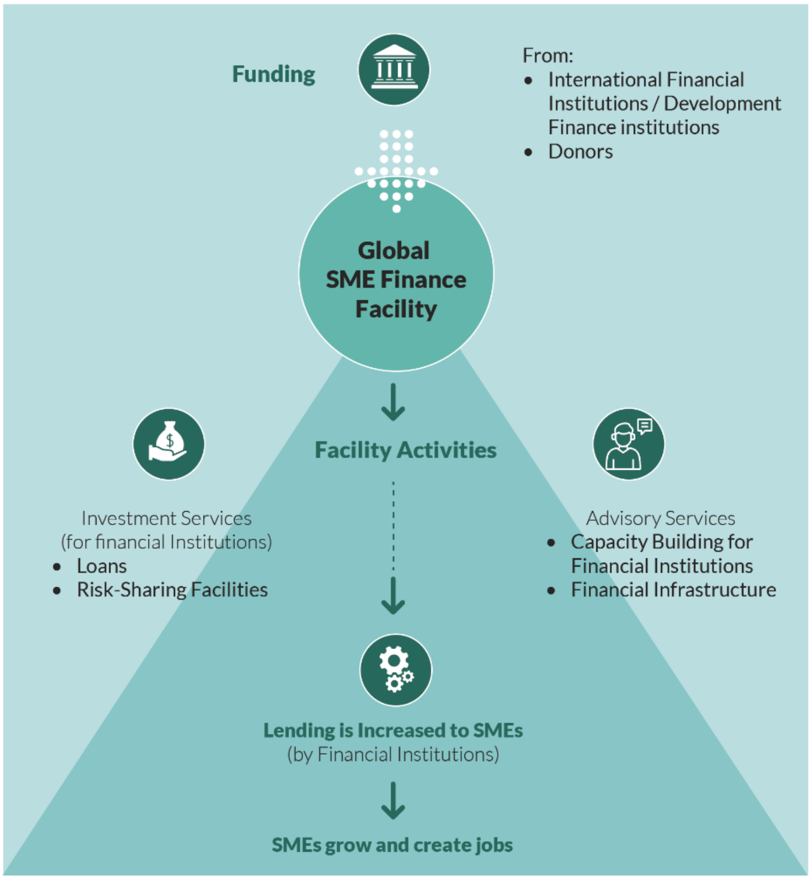
9. Augment the scale of existing trade credit.

The current trade credit system is complex and paperwork intensive. There are technological solutions available that can help digitize and automate the trade supply chain and make checks much quicker, more efficient, and less costly. These systems can be implemented across the value chain of some segments of the value chains. The government must partner with financial institutions and SMEs to pilot such an intervention and based on success scale up as required.

10. Design and implement 'Blended Finance' Products to raise capital for SMEs.

The government must create an SME Financing Fund for PKR 5 billion. There is an opportunity to align this fund with the Global SME Finance Facility. This facility helps increase access to finance for SMEs in fragile countries and underserved markets by providing financial intermediaries with a dedicated SME lending window and guaranteeing loans made to SMEs using blended finance (see figure below). The Global SME Finance Facility has undertaken several advisory projects with banking institutions in Pakistan to help them develop specialized banking products and advisory services for SMEs. The government must develop a partnership with the facility and instil the capabilities in Industries Department and KP Small Industries Board to develop this blended finance activity.

Figure 5: Global SME Finance Facility



The government must work with the International Finance Corporation (IFC) and World Bank to set up credit lines for SME financing using seed money invested from the SME Fund. The structure of these funds could be like the World Bank-supported Pakistan Mortgage Refinance Product.

11. Strengthening SMEs to equip them better to gain access to credit.

The government through the Industries Department must implement cluster development initiatives to strengthen key clusters across the KP. The cluster development initiatives must help in creating coordination networks, joint sourcing of inputs, joint delivery of orders, increasing access to technology, and work on product development. As the firms begin to operate as networks, they have a strong chance of accessing credit as a group.

12. Setting up women incubators and support centres for micro businesses

The government must establish well-functioning women's resource and incubation centres for small-scale individual businesses and women trying to start up new ventures. These centres must act as capacity-building units to not only incubate these businesses but connect them with available financing and grants and help with the application process. The government has to date approved three incubation centres for women, however, none of them are operational as of now. The government may work with UNDP to pilot start these at rapid speed and pilot credit initiatives to attract women businesses at these places. The model should look at future sustainability by including value-added services.

13. Develop value chain lending in the province.

The government must undertake value chain studies to understand the structure of the balance sheets and income statements of the sector. Based on these the government must work with financing institutions to develop credit products along the value chain by linking up the larger player with smaller ones. This work must be done jointly by the private sector and the Industries Department and Bank of Khyber

(BoK) to identify key value chains and support the development of lending instruments for MSME vendors guaranteed by larger players in the value chain.

14. Promote MFIs and FinTech

The government must support the penetration of MFIs and FinTech and must work with provincial revenue authorities to add additional tax incentives and with other provincial bodies to improve regulation to ease the establishment of these entities.

Possible Products to Initiate Strategy Implementation

A number of products have been identified to kick-start the implementation of the strategy. The details of these are as follows:

1. Electronic Registry for Creating Collaterals

- Number of Institutions that can offer the Product: 49 Financial Institutions (41 banks, 6DFIs, 2 MFBs) – Capacity to support over 0.5 million micro-small businesses of KP.
- Pilot with BoK in 3 districts
- Target 300 MSMEs to register, train and help them in creating electronic collaterals.

2. Innovative Credit Guarantee Scheme

- Applicable to all 41 scheduled banks, the number of beneficiaries will depend on the amount allocated as a guarantee.

3. Women Incubation Centres

- A cohort of 25-30 women can be supported every quarter per centre (2 are being planned). The partners can be BoK and Akhuwat and Kashaf Foundation.

4. SME Registry and Credit Rating System

- All 49 financial institutions can subscribe to this to access information on the potential borrowers and decisions on loans may be facilitated. This will benefit all MSMEs that will register.

5. Blended Finance

- The closest example is the MSME loan portfolio created with Bank of Punjab (BoP). A government seed investment of PKR 9 billion is likely to create a total lending portfolio of PKR 30 billion. The product will remain effective if opened to only 4-5 scheduled banks in KP. The exact size will depend on the development purpose seed contribution.

Annex – I

Access to Finance Panel Discussion Islamabad

24/08/2022

List of Participants:

Government:

- Special Assistant to CM KP on Industries
- Planning and Development Department KP
- Industries Department KP
- Agriculture Department KP

Chambers/Associations:

- Provincial Chief SMEDA KP
- Women Chambers of Commerce KP
- Federation of Pakistan Chamber of Commerce and Industry
- Mohmand Chamber of Commerce
- Hashoo Foundation
- KPEZDMC
- KP Board of Investment and Trade
- Mardan Chamber of Commerce and Industry
- Rural Empowerment and Institutional Development

Banks:

- State Bank of Pakistan
- Bank of Khyber
- Mobilink Microfinance Bank

SMEs

- Makeup and Me
- Fascino Couture
- Global Nomads
- Nayabs Rogue
- Fast Packages
- Mera Maan
- Silver Oaks
- Unidesk

UNDP Consultants/Officials

Annex-II

Strategy Thinking Workshop: Formulation of KP Access to Credit Strategy 08/09/2022.

List of Participants:

Government

- Planning and Development Department KP
- Industries Department KP

Commercial Banks

- United Bank Ltd.
- MCB Bank Ltd.
- Allied Bank Ltd.
- Bank of Khyber
- Bank Al-Habib Ltd.

Microfinance Institutions

- Telenor Microfinance Bank
- Khushhali Microfinance Bank
- Pakistan Microfinance Investment Company
- Akhuwat

<u>SME's</u>

- Get Groom
- SPP/Sami & Sami

<u>Chambers/Associations</u>

- Small Industries Development Board
- Women chamber of commerce and industry KP
- SMEDA-KP

<u>UNDP Consultants/Officials</u>

Annex-III

I-Consult Firm

UNDP has hired a firm 'I-Consult' for following key activities to enhance access to Finance in KP and specifically in NMD's.

1. Plan to increase access to finance and banking services for SMEs in NMDs.
    - Identify 5 Commercial Banks/microfinance banks operational in NMDs and brief on Products and services offered to customers.
    - Brief on financial needs of customers based in NMDs.
    - Potential opportunities for the banking sector to operate in NMDs.
    - Challenges faced by the banking sector in NMDs.
    - Role of government and Central bank in facilitating banks to operate in NMDs.
    - Plan of action and implementation methodology under this assignment
2. Expand the financial literacy programme (of the Govt of Pakistan) into NMDs & provide access to banking services to beneficiaries:
    - Partner with the 5 selected banks and conduct financial literacy programme for 3000 people in NMDs.
    - Conduct 9 Mobilization and awareness sessions 3 sessions per district for women) on the use of banking services (15-20 participants per session)

- Open bank accounts for about 1000 (30% women) customers in different commercial banks and microfinance banks operating in NMDs. Out of 1000 beneficiaries, ensure that 500 (30% women) must get loans from banks including loans from different Government schemes such as the Insaf Rozgar Scheme.

3. Support 5 banks operating in NMDs to establish a dedicated desk for serving women's businesses. This must include the following:
    - Training on cash handling, customer service, and basic banking functions to at least 30 resources and support banks in the recruitment of trained women resources.
    - Support in establishing a women's kiosk/table at 3 commercial banks.

4. Conduct 2 webinars/workshops on banking and finance in NMDs

    - Arrange a panel of speakers and decide on topics for these webinars/seminars.
    - Invite participants from the public and private sectors.
    - Develop reports of these webinars/workshops