

## **WHY LEND TO SMALL AND MEDIUM ENTERPRISES?**

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Why should commercial banks lend to Small and Medium Enterprises (SMEs)? They haven't done this before. What has happened that they should do it now? Aren't there higher risks of default and non-payment in case of these types of borrowers? These are legitimate questions and I would like, this morning, to focus on five different aspects of this issue:

- a) The overall context and direction of commercial bank lending.
- b) Win-win situation for the banks, entrepreneurs and national economy.
- c) Credit appraisal technology for SMEs.
- d) Regulatory and infrastructure support.
- e) Learning from international best practices.

**a) The Overall Context and Direction of Commercial Bank Lending:**

Until recently there was market segmentation in delivery of credit by financial institutions. Commercial Banks focused on lending to government and public sector, trade financing and corporate sector while Development Finance Institutions (DFIs) and Specialized Banks (SBs) provided credit for agriculture SME, housing, etc. The leasing companies found their niche in auto financing and equipment leasing. Despite this segmentation, Commercial banks remained

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dominant players in the market and accounted for more than 90 percent of the assets in the financial system.

The model of DFIs and SBs served the economy well in the 1960s and 1970s but experience across a vast variety of countries and in Pakistan itself has demonstrated that this single product delivery institution was no longer relevant or viable to meet the demands of the 1990s and the current decade. This model has been abandoned in Pakistan and replaced by a new business model of universal banking where the multiple distribution channels of commercial banks are used to deliver multiple products. Growing competition in financial service industry has led to emphasis on total banking solutions to meet the customer needs. Pakistan has also adopted the universal banking as the backbone for its financial sector. SME lending fits into this model very well.

b) **Win-win Situation for the Banks, Entrepreneurs and National Economy:**

By lending to SMEs, the banks will have diversified portfolio across sectors and will be able to manage their risks more prudently. Furthermore, banking spreads are under pressure because of tough competition and surplus liquidity in the system. Thus, building the new customer base of SMEs will earn relatively higher margins for the banks and soak some of the excess liquidity. Depositors will also benefit, as the new equilibrium between supply and demand of loanable funds will take place at a higher price.

Prudence and Profitability are the two pillars upon which the commercial bank lending to SMEs should be built. If some of you are too risk averse and not willing to commit resources the profitability of the banks will suffer in a competitive environment, as other banks will be able to snatch the business from you. On the other hand, if you are not prudent and take excessive risks you will cause enormous losses to your bank. Thus, a good banker is one who combines prudence with consideration of profitability in his decision making process.

Most SMEs in Pakistan are still stuck in the technology and product mix of 1960s and 1970s. Lack of access to capital has not allowed them to modernize their production techniques, hire skilled human resources, upgrade the quality of management and invest in new equipment. Bank lending to SMEs will facilitate the SMEs to accomplish all this and also their product mix to meet the demands of domestic and export markets. The credit you provide to them will enable them to acquire new technology and improve the quality of their products to meet the needs of 2010. They will reposition themselves through the new financing facilities to earn more profits and expand their businesses. Some of them will make the transition to large enterprise sector.

As SMEs account for 30-40 percent of employment in the country and are labour intensive the consequential rise in productivity and efficiency would make a significant contribution in accelerating employment generation, GDP growth and poverty reduction. SMEs also contribute to exports and assimilation of new

technology in the production process would make their products competitive in the international markets.

It is true that the SMEs are risky businesses and more vulnerable to failures under adversity than the large businesses because they do not have the wherewithal to withstand adverse shocks. Their ability to pay may be impaired from time to time. But, at the same time, these entrepreneurs have a better record of willingness to pay. Pricing of loans to SMEs will reflect this aspect of riskiness of assets balanced by the history of payment of individual customers.

It may thus be seen that lending to SMEs is a win-win situation as banks will earn good profits in this line of business, depositors will earn higher returns, the SMEs will be able to upgrade the quality and range of their products and the national economy will benefit from higher GDP growth and employment generation.

c) **Credit Appraisal Technology for SMEs:**

For SMEs, portfolio approach, program lending and credit scoring methodology will be the main tools for credit appraisal rather than evaluation of the individual enterprises. To accomplish this, the loan officers will have to develop different competencies than what they have used during the appraisal of corporate sector proposals i.e. balance sheets, audited financial statements, value of collateral.

As cash flow projections will form the crux of loan appraisal it is incumbent upon the loan officers to calculate the expected debt servicing capacity by carrying out

sensitivity analysis on the underlying assumptions. For example, what happens if the sale revenues decline by 10 percent relative to the base assumption? What if the input costs rise by 10 percent? Only when a robust set of projections emerges from this analysis the decision should be made. The banker should know the product line, input costs and market demand which keep on changing from time to time as the market is dynamic and would dramatically affect the cash flows vis-à-vis the paying capacity of the entrepreneur. Every single decision will be based on product specification and sales potential and you won't look at documents, as the SMEs don't have any.

This approach requires the loan officers to acquire technical expertise in quantitative techniques. The old ways of relying on documents, collaterals and securities have to be abandoned in case of SME loans. The mindset has to be changed. Instead of sitting in offices, carefully monitoring and post loan disbursement, follow up of the borrowers and industry by visits in the field would have to be vigorously pursued. Restructuring of repayments may have to be carried out if unanticipated exogenous shocks hit the economy, industry or the borrower. A rigid approach and insistence on original schedule of payments, despite the genuine difficulties faced by the borrower, will result in assets turning sour and build-up of a non-performing portfolio. We would soon see the repetition of Rs. 250 billion NPLs, which were experienced in case of corporate sector by following an inflexible and bureaucratic approach.

The banks and their staff will have to use information technology as an aid in the monitoring and follow-up of SME loans. The bank staff will have to do hand holding of the borrowers and help in building their capacity. This new kind of relationship between bank and customers will alone assure success of SME lending.

d) **Regulatory and Infrastructure Support:**

The State Bank of Pakistan (SBP) has already responded to the needs of the SMEs by modifying and putting in place a new set of Prudential Regulations in consultation with all the stakeholders. We would be willing to further improve and strengthen these regulations if any practical difficulties arise in their implementation.

The SBP is expanding the scope and coverage of its existing on-line Credit Information Bureau by including small loan amounts also. This database will be a powerful tool for all the banks and financial institutions in mitigating risks by avoiding lending to habitual defaulters and non-performers. The Credit Bureaus will be established in the private sector in future and incorporate a lot more information on credit history and behaviour of borrowers.

More recently, a SME Network has been established under which SMEDA, SME Bank, PSIC and all stakeholders will coordinate their diverse services to assist the SMEs. The banks should be able to plug in this network and facilitate the provision of required services and assistance needed by their borrowers.

e) **Learning from International Best Practices:**

The present training workshop organized by IFC is an ample demonstration of our desire to make best use of knowledge available in this field. IFC has a credible track record in this field and is committed to fostering and promoting SME sector in Pakistan. We should learn from their expertise and experience and the international best practices and adapt them to our peculiar circumstances. I am, therefore, glad to note that the case studies developed for this workshop all pertain to Pakistani enterprises. We don't have to reinvent the wheel but carefully examine what has worked elsewhere and what hasn't worked.

The commercial banks have lived up to my expectation by accelerating lending to agriculture sector and proved that they can branch out in new areas of business if they set their minds on it. I wish to congratulate the Presidents of Commercial Banks that they have overtaken ZTBL in agriculture lending. This sector accounts for 25 percent of GDP and 60 percent of population is directly linked with this sector besides many indirect links. We cannot conceive of sustainable and equitable growth without helping agriculture and SME sectors. I am quite confident that they will show the same zeal and commitment towards SME lending and extend their outreach throughout Pakistan.

**Conclusion:**

Let me conclude by advising you that, as the Trainers of Trainees for SMEs, you should act as the change agent for introducing a new culture, technology and competency in SME lending in your respective institutions. You should take a holistic approach and tell your Presidents what is needed to upgrade systems, skills, controls and technology to bring about this change. Your initiative and performance will pave the way for rapid penetration of commercial banks in SME sector in a prudent and profitable manner.