POLICY BRIEF **3 of 3**

IMPROVING ACCESS TO FINANCE FOR SMALL AND MEDIUM-SIZED FOOD ENTERPRISES FOR A BETTER-NOURISHED PAKISTAN

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KEY MESSAGES

- Pakistan's many small- and medium-sized enterprises (SMEs), including the large number involved in (nutritious) food supply, are held back by lack of access to adequate finance. Actions could be taken by government, private banks, and other finance providers to help resolve this critical capacity constraint.
- Based on recent research with SMEs in Pakistan, this brief proposes policy recommendations to a) address the different financing needs of micro, small, and medium enterprises; b) to improve SME access to formal sector financing (e.g. through mandatory targets for lending to small enterprises, including women-led enterprises); c) to build capacity of banking staff dealing with SMEs in order to respond to their needs; and d) to boost financing available to SMEs outside the formal sector (for instance through alternatives like venture capital, private equity funds, crowdfunding, and non-banking finance institutions).
- Finally, given existing gender inequalities, there is a strong need for policy responses to support more women SMEs in accessing finance (e.g. through dedicated quotas for women or through raising lending limits).

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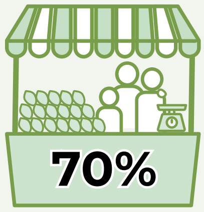
INTRODUCTION

Small- or medium-sized enterprises (SMEs) are a dominant feature of Pakistan's business landscape.

Most Pakistani businesses – **90%**, or more than **5.2** million – are classified as SMEs.

They employ some **80%** of the non-agricultural labor force, contribute **40%** to the country's GDP, and **30%** to total exports.



About **70%** are estimated to be operating in the informal sector and most are modest in terms of sales turnover (annual turnover figures for **98%** of these SMEs fall below PKR 150 million; SMEDA, 2022).

About this brief

In the context of the latest national SME policy "2021 SME Policy Pakistan", this brief, focusing on **facilitating SMEs access to finance**, and its two related briefs,[6] have been prepared to develop policy recommendations using the most up-to-date research (conducted over the last 5 years) on ongoing issues faced by Pakistani SMEs, particularly food-related SMEs.

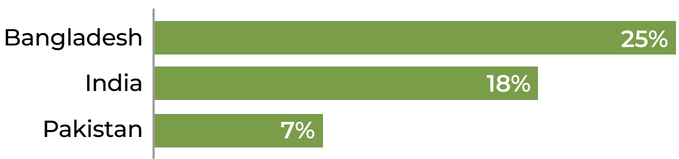
SMEs in the food sector

The food sector is considered Pakistan's largest industry, accounting for 27% of national value-added production, and 16% of total employment by the manufacturing sector. Much of this food manufacturing and processing is small- or even micro-sized, and many of these businesses are in rural areas, depending heavily on agricultural raw materials and poorly skilled non-farm labor (SMEDA, 2021).

Unfortunately, not enough of the food that is produced by SMEs is nutritious, safe and sustainable. SMEs face many barriers, including operating in environments that do not always reward good practices. In many cases, SMEs require more support and appropriate incentives if they are to underpin the major changes in our food systems that are needed to ensure food security and public health (GAIN, 2021).

Evidence suggests that SMEs, including those in the food sector, are constrained by the macro policy and regulatory environment, including complex and expensive tax regimes, procurement policies favoring large enterprises, lack of a dedicated MSME (Micro, Small and Medium Enterprise) policy, and other constraining factors (See Policy Brief-1 titled, "Macro policy and regulation change can better nourish Pakistan. Creating an enabling environment for small- and medium-sized food businesses"), by cross-cutting market constraints from both supply and demand sides (See Policy 2, titled, "Addressing market constraints facing small and medium-sized food enterprises for a better nourished Pakistan"), as well as low access to financing (CDPR, 2023). Regional comparisons on private sector financing highlight much room for improvement (**Figure 1**)

Figure 1: SME receipt of private sector financing in 3 South Asian countries



Source: CCP, 2023

5 Focusing on the external macro policy and regulatory environment affecting SMEs, and on supply and demand constraints facing SMEs in turn.

KEY CHALLENGE AREAS

A major constraint preventing SMEs from growing and expanding their businesses is the lack of access to finances on suitable and affordable terms. Disbursement of credit to small firms is restricted for several reasons, including capacity issues of the firms themselves, their informal recording of business transactions, their lack of collateral, and in some cases poor credit history. Moreover, managing limited financial and human resources can be a challenge, especially when it comes to investing in research and development, marketing, purchasing equipment, and expanding operations (CDPR, 2018).

Accessing formal sector financing

Formal financial resources and services are critical for SMEs to grow and expand their businesses, while insurance is important to cover their risks. However, it can be difficult for SMEs to access these resources and services. Difficult evaluation requirements and predatory practices linked with loan documentation are among the common barriers they face.

A key missing component is the availability of risk capital. The current system forces firms to become corporate entities in order to raise equity, imposing a disproportionately heavy burden of administration and reporting on start-ups or small businesses. Additionally, current rules require SMEs to register as non-financial institutions, which has precluded the registration of any SME as an on-shore venture capital fund. Moreover, banks often feel advancing loans to small firms is too risky, with a disproportionally high perception of food SMEs being risky investments. Credit market failures also occur owing to information asymmetry. Finally, commercial banks often fail to understand that businesses that depend on the natural environment (e.g. agriculture-related) require credit for only short periods of time (CDPR, 2018).

Differing financial needs of Small and Medium Enterprises

According to the 2021 SME Policy outlined by SMEDA in 2022, small enterprises (SEs) are characterized by an annual turnover of up to PKR 150 million, while medium enterprises (MEs) fall within the range of PKR 150 million to PKR 800 million. Notably, the 2021 SME Policy doesn't differentiate between the annual turnovers of SEs and microenterprises. Additionally, the definition of MEs is considered overly broad. There exists a significant disparity in the financial needs and operational requirements across these segments, warranting distinct definitions based on turnover and employee count for each. Analysis of banking data reveals that MEs secure over 80% of bank financing, leaving SEs struggling to obtain the necessary funds for expansion and development (CCP, 2023).

Although the State Bank of Pakistan (SBP) is launching a credit guarantee scheme aimed at benefiting micro, small, and rural enterprises (Box A) with assistance from the UK government, enhancements are required. It is crucial for both global and local financial services providers to guarantee that SMEs can readily access the necessary capital under feasible terms. This accessibility is vital for enabling SMEs to navigate present challenges effectively and start sustainable investments that fortify their resilience (CCP, 2023).

Box A: The current SBP credit guarantee scheme is not fit for purpose

The current aim is to provide collateral-free credit. A selection of participating Financial Institutions (PFIs[8]) is made by SBP, and each FI shall be allocated a credit guarantee limit on an annual basis. The borrower's eligibility is restricted to micro- and small enterprises, as well as farmers with small landholding. It will operate with a preference for new customers, but existing eligible borrowers can avail themselves of the additional lending facility. Up to 60% of risk coverage is envisaged for clean lending[9], with the percentage reducing dependent on the underlying value of the collateral provided. The tenor of the financing is limited to 5 years. The reimbursement of the guaranteed claim shall not obviate the Fis' right to recover the defaulted amount. Microenterprises are only allowed financing between PKR 150,000 and PKR 500,000, while for farmers the amount is up to PKR 2 million only. No threshold is provided for small enterprises, while medium enterprises are not even eligible under the scheme. The capped amounts are too low. Pakistan needs a robust credit guarantee system for MSMEs to support their efficiency, growth, and innovation. Without such a credit guarantee system, the targets (if any) given to FIs will increase their risk exposure, and the scheme will be of little help.

Source: CCP, 2023

Gender inclusion

Although women constitute almost 50% of the working age population in Pakistan, their participation in Pakistan's labour force is only 24.6%. Only 1% of the Pakistani female population are entrepreneurs, compared to 21% of the male population. Only 12% of firms have female owners, compared to a global average of 34%. SBP data shows that women-led SMEs received only 3.2% of the total SME financing in 2022 (SMEDA, 2022).

The proposed National Coordination Committee (NCC) on SME Development (under the National SME Policy, 2021) includes various governmental bodies, however, it lacks women's representation both at the federal and provincial levels. The previous 2007 SME policy proposed that an NCC including women development departments, while also setting a target to increase the share of women entrepreneurs to a minimum threshold of total SMEs. The 2021 policy lacks any target for 2025 (CCP).

POLICY RECOMMENDATIONS

The policy interventions suggested here are intended to correct market failures arising particularly from externalities and information asymmetries present in markets – especially those to do with financing. They aim to lower the disproportionately high costs faced by small firms, and to create a supportive environment to encourage the set-up and success of fast-growing and innovative enterprises. These recommendations are inclusive of geographical coverage and gender. They also include special concessions for women-led businesses to facilitate improved gender outcomes (CCP, 2023).

8 Examples of participating Financial Institutions (FIs) include banks, credit unions, microfinance institutions, venture capital firms, and other financial entities actively involved in specific financial programs or initiatives. These institutions collaborate with government agencies, international organizations, or private entities to provide financial services or support to particular target groups or sectors.

9 Clean lending typically refers to the practice of providing loans to borrowers based solely on their creditworthiness and the viability of the proposed project or business venture, without requiring collateral or guarantees. In clean lending, the lender evaluates the borrower's financial history, credit score, income stability, and repayment capacity to determine the likelihood of timely repayment.

Addressing the different financial needs of Small and Medium Enterprises

Access to Finance for MEs (Medium Enterprises) will enable more businesses to avail formal sector financing. The SBP may take the following measures to ensure that small and micro enterprises are not neglected in mainstream SME lending (CCP, 2023):

a) Separate indicative targets for SE (Small Enterprises) and ME be given to banks/ Development Finance Institutions (DFIs) to ensure maximum credit disbursement in the sector.

b) Sector-specific targets be set for SE and ME based on the growth potential of the sector (food would be a prime candidate here, with its market expected to grow annually by 7.5%; Statista Market Insights, 2024).

The SBP should consider developing a framework to engage with the chambers of small traders and small industries with the purpose of increasing financial access for small enterprises. The chambers of small traders and small industries have knowledge of the business type, entrepreneurial capabilities, and skills of SEs and, therefore, they can serve as reference and/or attestation bodies where the small businesses lack acceptable collateral. Such a framework would a) increase financial access for small businesses and b) encourage more businesses to be registered with the small chambers, joining the formal sector (CCP, 2023).

Accessing formal sector financing

Pakistan's public sector commercial banks need to be encouraged to finance the SME sector. Top-tier banks (based on their total assets, deposit size, and number of branches) could be given mandatory credit targets for SE lending (CCP, 2023).

Moreover, to improve SMEs access to available financing opportunities, it is recommended that SBP requirements of insurance and evaluation reports may be eliminated by introducing finance schemes for SMEs backed by government guarantees. In other cases, the potential costs associated with these requirements should be clearly addressed in loan policies and procedures to ensure applicants are aware of the costs and thus not at risk of exploitation due to a lack of knowledge. Furthermore, standardized pricing of insurance and evaluation reports could be introduced for SMEs (e.g., bracket pricing according to asset location, type, measurement, or quantity) (CCP, 2023).

Dedicated SME banking network and trained staff

Dedicated SME desks across the banking network could be set up to educate, guide, and facilitate SME access to financial services. Capacity building of banking staff dealing with SMEs could bring critical improvements to SME sector lending. Bank staff should be made fully aware of SBP's financing products, for instance, be able to explain the financing needs of SMEs, and have the necessary skills to assess their financials (CCP, 2023).

The State Bank 2017 Policy on SME Credit should be fully implemented. The role of SMEDA should be strengthened to initiate an SME registration and information gathering exercise leading to credit scoring and the setting up of a credit bureau. SMEDA should advocate and lobby commercial banks to advance credit to SMEs. Immediate steps include a) offering back-to-back Letters of Credit (LCs) for exporters and b) operationalizing the electronic registry of movable assets for all sectors. The State Bank currently has a credit refinance scheme at 0 percent for women – this scheme needs to be made fully operaitonal (CDPR, 2018).

Accessing financing outside the formal sector

Diversifying available financing channels (beyond commercial banks and DFIs) can contribute critically to improving SME access to finance. Non-Banking Finance Institutions (NBFIs) and leasing companies can play an important role in providing credit to the SME sector. Many international venture capital funds already operating in the region (e.g. Bangladesh and India) are unwilling to operate in Pakistan due to the stringent regulatory requirements and limited exit opportunities. Improvements to the regulatory environment can encourage such alternate financial instruments, (venture capital and private equity funds, crowdfunding, and NBFIs) to enhance financing to SMEs and startups (CCP, 2023).

Unlocking private equity investments can substantially augment investor commitments and bolster SMEs' capacity to secure private equity capital. Combining private equity with tailored technical assistance across various sectors, such as food businesses, can equip SMEs and startups with strategies for sustainable growth. Pakistani commercial banks can be leaders in this initiative by prioritizing sectors for equity investments, steering their loan portfolios towards operational loans. This reallocation of resources would catalyze economic activity, foster business expansion, and drive overall economic development. Moreover, the provision of technical support for business operations and expansion would further fuel economic progress (CCP, 2023).

To develop an entrepreneurial ecosystem, the Limited Liability Act should be adopted by provinces (as partnerships fall within the provincial domain). This would allow a general partner in a non-incorporated firm to take on an equity partner, offering them limited liability, while retaining unlimited liability for the general partner. A legal framework could also be created for crowdfunding, with appropriate rules at the Securities & Exchange Commission of Pakistan (SECP) for venture capital funds to register. Tax incentives could also be used to channel individual and corporate savings into equity finance to increase access to equity finance for SMEs (CDPR, 2018).

Finally, an appropriate regulatory environment is required for local financial technology or 'fintechs' to be established. Fintechs are composed of specialized software and algorithms used on computers and smartphones to help companies, business owners, and consumers better manage their financial operations, processes, and lives. It is recommended that SMEDA facilitates training provision to SMEs in the use of digital platforms through the Business Development Services Fund (BDSF; CDPR, 2018).

Gender inclusion

A review of regional and international practices suggests that specific measures can be taken to encourage women entrepreneurs. For example, banks can be required to maintain 10 - 15% of SME financing for women entrepreneurs (CCP, 2023).

While the Small and Medium Enterprises Authority (SMEDA) is part of the National Coordination Committee on SME development (NCC) put in place to review the policy and the regulatory framework governing SMEs to reduce barriers faced by women entrepreneurs, women still need greater representation. The National Commission on the Status of Women, provincial women departments, and women-led SMEs should be represented in the NCC, so that they may propose and recommend further measures in policy and legislation inclusive of women and/or sensitive to women's needs. (CCP, 2023).

Lessons can be learned from Bangladesh on increasing access to finance for women entrepreneurs, where favorable government policies – such as requiring Financial Institutions to lend 15% of the total credit to women entrepreneurs and ensuring women entrepreneurs are serviced by dedicated desks in banks/NBFIs – have helped to grow the participation of women in the labor force (CCP, 2023).

CONCLUSION

In conclusion, access to adequate finance is important to fostering a more enabling environment for Pakistan's SMEs. Pakistan's SMEs, including the large number involved in (nutritious) food supply, are held back by lack of access to adequate finances. This constraint hinders their growth potential and inhibits their ability to contribute effectively to the nation's economy. However, government, private banks, and other finance providers can help resolve this critical capacity constraint.

This brief proposes policy recommendations to address the different financing needs of micro, small, and medium enterprises, improve SME access to formal sector financing, build capacity of banking staff dealing with SMEs in order to respond to their needs, and boost financing available to SMEs outside the formal sector. Finally, given the existing gender inequalities, there is a strong need for policy responses to support more women SMEs in accessing finance.

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